News and Views

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Tax Dollars At Work

The New York State DEC has a program where they distribute day-old pheasants to landowners and conservation groups across the state. My neighbor decided to participate and was given 40 of the little buggers. It turns out he has no place to raise them, so they are now living in my barn, awaiting the arrival of their 18-week birthdays when they will be released onto our properties.

The DEC offers this program because pheasant populations are quite low owing to increased populations of those further up the food chain, such as hawks, foxes, and coyotes. In the past, I've seen how effective this program is at increasing pheasant populations.

A typical cycle goes like this:

1. DEC provides birds to my neighbor,
2. My neighbor releases said birds into the wild,
3. An all-you-can-eat predator buffet ensues and birds are devoured within two days,
4. Hawk, coyote, and fox populations increase to do further damage to any remaining native pheasants,
5. DEC repeats until tax payer subsidies dry up.

I like to think of this as yet another government stimulus plan. However, instead of stimulating the economy, it is the predators' appetites that are being stimulated. Is it any wonder New York is in such bad shape?

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CAPITAL MARKETS REVIEW

The first quarter of 2011 brought all manner of nastiness around the globe. Protests and regime changes in the Middle East roiled the international oil markets, further raising the specter of inflation. Economic weakness in Europe continued, with Portugal being the latest nation likely to need a bailout. Even worse was Japan's triple whammy of earthquake, tsunami, and nuclear meltdown. Interestingly, while commodity, currency, and international stock markets were all impacted by these events, stocks in the U.S. held up surprisingly well and have even extended their rally. Large-cap stocks earned 5.9% in the first quarter (see graph on page 2), a very strong showing.

Positive Trends in the U.S.

What accounts for this level of gain in the face of global catastrophe? I think there are a number of factors. Most importantly, job creation is starting to return in earnest. The unemployment rate ticked down to 8.8% in March, with healthy job gains in the private sector. That is still a reasonably high unemployment rate, but it is down considerably from the peak of over 10.0% during the recent recession. If this momentum in job creation continues, it will go a long way toward putting the economy on solid footing. Also, valuations for U.S. stocks remain compelling. During the worst of the stock market crash in 2008 and 2009, the price-to-earnings ratio for the S&P 500 fell to 13.5. Currently, after a rally of almost 100% over the past two years, the P/E ratio stands at 14.0. While prices have gone up considerably, corporate earnings have also grown very quickly, so the valuation level hasn't changed much. Stocks still look like a bargain compared with their valuation levels of the past 20 years. Finally, psychology likely has a lot to do with the stock market rally continuing. There has been a ton of cash on the sidelines since the market crash in 2008. Many investors have been hesitant to get back into stocks. Now, things are finally looking more stable for the economy and the stock market, so flows into stock mutual funds have been positive recently for the first time in almost three years. Ironically, investors are more comfortable investing after a market recovery, when the easy money has already been made, but that is human nature.

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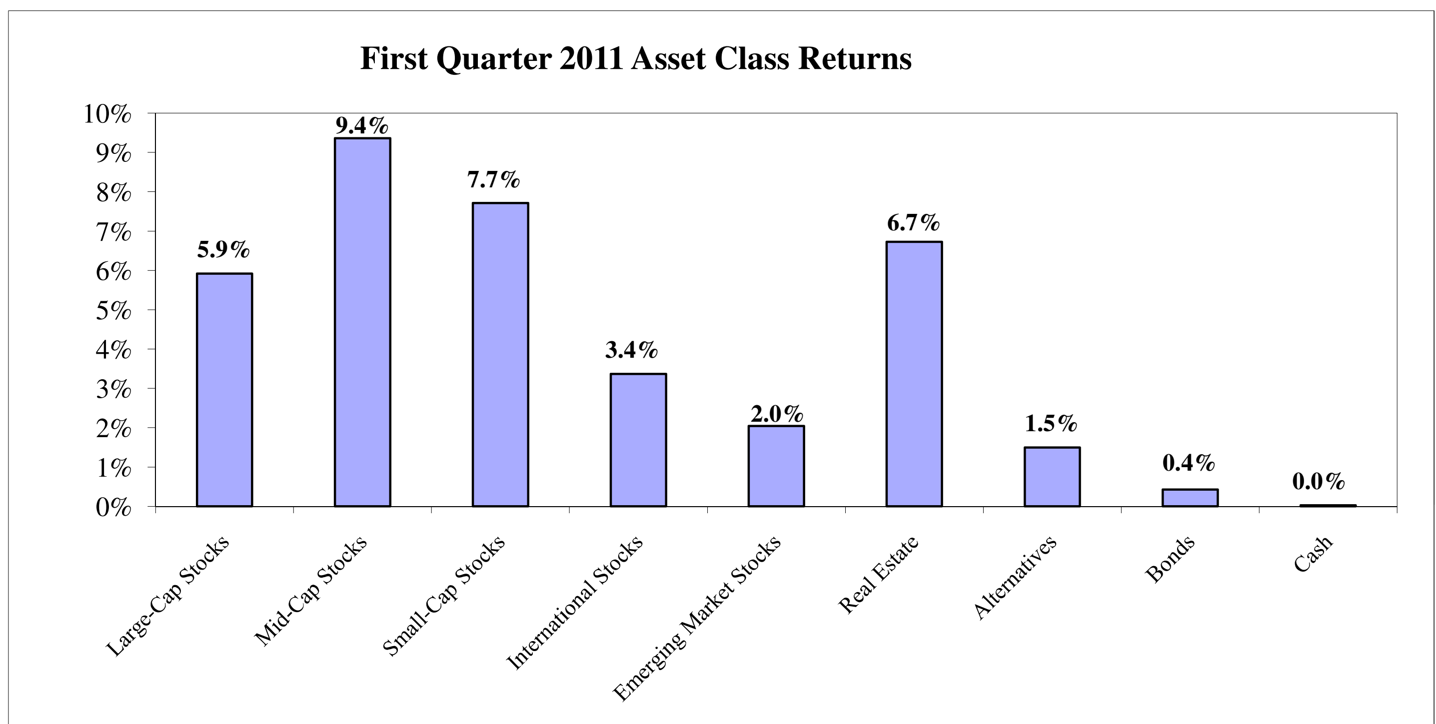
Small-Cap Rally to Continue

Mid-cap and small-cap stocks also posted strong gains in the first quarter, rising 9.4% and 7.7%, respectively. Smaller stocks have outperformed their large-cap brethren for over ten years now. These cycles are common in the stock market, and the average small-cap rally has lasted ten and a half years, using data from 1960. We're just beyond ten and a half years in the current small-cap rally, and many are arguing that large-caps are due to resume the leadership role. I have certainly worried that would be the case, as smaller stocks have played a starring role in the portfolios I manage for clients. However, there are those who are arguing for a continuation of the small-cap rally. Most notable is Louise Yamada. Louise runs a boutique research shop in New York and is a regular on CNBC and in periodicals such as Barron's. She previously headed the technical analysis team at Salomon Smith Barney, where she was ranked top among her Wall Street peers for many years. Louise's work shows that, for many reasons, smaller stocks could have much further to run before the rally runs out of steam, possibly extending for several more years. Louise notes that smaller companies tend to perform better during times of expanding economic activity and when inflation rises, so they could be well positioned for future gains.

Emerging Market Buying Opportunity

International stocks were up in the first quarter, but not nearly as much as domestic stocks. Developed world stocks rose 3.4% and emerging market stocks gained 2.0%. Given that Japan is a fairly large weight in the developed world index, it is not surprising that returns were lower than other parts of the world. More surprisingly is what has happened to the emerging markets of late. Returns have been positive, but generally below the returns of the more staid S&P 500. "Relative" performance for emerging market stocks has declined sharply the past six months and over the past three years you would have done just as well in large-cap U.S. stocks than you would have in emerging market stocks. Given the disparity in economic growth potential between the U.S. and most of the emerging market nations, this hiccup in performance could be a chance to buy high growth, international stocks at reasonable prices. Additionally, most of the developed world nations, including the U.S., are depreciating their currencies. This should help boost the currencies of emerging market nations, which results in higher



returns for U.S. investors when you translate your gains back to dollars.

Real Estate: A Conundrum

Real estate continued to outpace the stock market, earning 6.7% in the first quarter. Real estate's hot streak the past couple years remains a conundrum. As I've written before, industry fundamentals do not appear favorable, yet real estate investment trusts (REITs) post strong stock market gains every quarter. We've discussed high vacancy rates and lower rental rates for commercial office properties previously. The latest news is that malls and strip malls have also fallen on hard times. Vacancy rates for these properties are as high as they've been in over ten years as shoppers do more buying on line and retailers retrench. Trouble with some larger retailers like Borders and Blockbuster, both of which recently declared bankruptcy, have also weighed on shopping centers. It is hard to find much of a silver lining for real estate business conditions, and yet the investment returns have been stellar.

Alternative Investments

The diversified portfolio of alternative investments we track earned a return of 1.5% for the first quarter. Unsurprisingly, commodities were the drivers of this return, gaining over 10.0% in the quarter as oil, gold, and food prices continued to rise. The remaining asset classes all gained or lost small amounts. Interestingly, one currency fund we track was up 2.6%, while the other currency fund lost 1.3%. This shows how divergent different strategies can be, even within a single asset class. Finding securities that move in different patterns, those with low correlation with one another, is exactly what we are looking for in the alternative portfolio. Broad diversification from these securities helps reduce overall portfolio risk.

Bonds Slowing Down

Bonds eked out a small gain of 0.4% in the first quarter. Positive economic news during the quarter drove Treasury yields up, which hurt bond returns (bond yields and prices move inverse to one another). However, Treasury bond yields remain at very low levels. Corporate bonds fared somewhat better, earning a bit over 1.2% in the first quarter. Interest rates for corporate bonds also rose modestly in the first quarter, but because corporate bonds yield more than Treasury bonds, the decline in principal value was offset more than in the Treasury sector. Inflation-protected bonds (TIPS) rose 2.1% in the quarter. As inflation expectations rise, investors will likely be increasingly drawn to the relative protection offered by TIPS.

Overall it was another solid quarter for investors. As we rapidly approach the tax filing deadline, you can also take solace in the fact that none of the exchange-traded funds (ETFs) we use paid capital gains distributions in 2010. There were some small distributions from some of the mutual funds we hold (which is why we favor ETFs when possible), but they were relatively modest. The combination of solid returns and low taxes is the best of both worlds. Investing with index funds and ETFs helps insure we capture the returns offered by the capital markets in a very efficient way with respect to both taxes and fees.

Data Supports Index Funds

Better late than never, I suppose. Standard & Poor's (S&P) compiles research on the performance of actively managed mutual funds twice per year. However, it often doesn't get released until well after the fact. It was late in the first quarter that 2010 year-end data was updated. Nevertheless, it is a great piece of research and provides an interesting view of active versus index investing and some of the old adages of investing.

The table on page 4 shows the percentage of actively managed mutual funds that fail to outperform their appropriate benchmark index. Over shorter periods, actively managed funds can sometimes outperform the market, but over longer periods the odds are significantly against the active management set. While the table shows that in every period some active managers do

perform well, trying to identify them in advance is the tricky part. Other studies have shown that there is no persistence in strong performance. So, those managers that performed well in the past are unlikely to perform well in the future. Yet another study showed that most of the active managers that do perform well, do so because of luck rather than skill.

Clearly, active management is a difficult game to play, which is why index funds and exchange-traded funds make a better alternative. It is better to participate in the market and ensure returns commensurate with the risk you are taking on than to reach for higher returns with low odds of success.

The S&P study also helps expose some common misconceptions about investing. For example, the common wisdom suggests that indexing makes sense in the more "efficient" parts of the market such as domestic, large-cap stocks, but that active management makes more sense in less followed parts of the market like smaller-cap and emerging market stocks. The data of course shows just the opposite, that mid-cap, small-cap, international, and emerging market stocks are all better represented by index funds than by active managers. Another investment myth is that indexing is fine in a rising market, but active management makes more sense when the market declines. Earlier S&P data, published in 2009, showed just the opposite. Active managers generally fail to outperform the market in bull and bear markets.

There really is no magic to indexing, it is just a convenient wrapper for the components of a successful investment program. If you can get the right risk profile, keep costs low, manage taxes, diversify, and build your portfolio the right way, performance should take care of itself. Unfortunately, active management tends to ignore most of these components. That is why boring old index funds tend to win the day.

Mutual Funds That Trail Benchmark Index

Fund Category	1-Year	3-Year	5-Year
Large-Cap	65.72%	57.65%	61.83%
Mid-Cap	73.75%	83.90%	78.19%
Small-Cap	53.42%	70.11%	63.02%
International	39.83%	69.94%	81.71%
Emerging Markets	64.00%	77.55%	89.55%
Bonds	68.29%	58.70%	68.09%
Muni Bonds	64.71%	91.67%	94.29%

Source: Standard & Poors, data through December 31, 2010

WHAT IS ARMBRUSTER CAPITAL MANAGEMENT?

Armbruster Capital Management is an investment advisor to individuals, families, and smaller institutions. Because we don't sell any investment products, we remain unbiased in our selection of funds. We use index funds to drive down costs, manage the tax bite, and gain broad exposure to the various segments of the global capital markets. Ongoing communication is the cornerstone of our service offering. You can reach us on our cell phones anytime.

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