The ACM Journal

Arbor Day

In order to ensure that our children have happy childhood memories of the holidays (unrelated to presents), my wife and I invest countless hours creating positive family experiences. One of the more ridiculous is what we do with our Christmas tree.

Each year, we wait until the snowiest day on forecast. We then head out to a local tree farm to find just the right tree to cut down with an old fashioned saw. Some years we've used an axe, but that has proven unduly burdensome.

Of course, locating the perfect tree is not so easy. It often requires multiple stops at tree farms dotted around two or more counties, and can last most of the day. Trees at most tree farms may suit the average family's needs, but we have exacting standards. We also have a very high ceiling.

Accordingly, the perfect tree must measure at least sixteen feet high. It also must have full boughs, be properly shaped, and possess that all-important *je ne sais quo*.

One year, when the children were young, we found a particularly rural tree farm run by an elderly gentleman. It was slim pickings that year as it was late in the season, but we found a perfectly

continued on page 6

IN THIS ISSUE

Arbor Day 1
Are Stocks Overvalued? 1
Portfolio Review 3
Compliance Corner 5
Firm News..... 6

Are Stocks Overvalued and Ready to Correct?

We have fielded a lot of questions lately about the level of the stock market. Typically, investors get nervous when the stock market declines in value. However, with visions of 2008 still in our heads, many investors are increasingly nervous as stocks continue to rise and reach new highs. Accordingly, we thought we would take a closer look at valuation levels.

Robert Shiller, a finance professor at Yale University, and a recent Nobel Prize recipient, believes that stocks are wildly overvalued. As evidence, he cites the "Cyclically Adjusted Price/Earnings Ratio", which he developed. This ratio is an indicator that shows the value (the price or "P" in "P/E") of stocks today versus their historical earnings (the "E" in "P/E") smoothed over the past ten years. This metric shows that stocks are trading at a Cyclically Adjusted P/E Ratio of around 25 times their historical earnings. The average since 1871 (that is not a typo, the data actually goes back to when Ulysses S. Grant was president) was 16.5. The current reading is obviously quite high by historical standards. This is all the more alarming because Robert Shiller correctly called both the internet and housing crises.

Even scarier, respected research firm The Leuthold Group notes that current valuation levels are identical to those of the bull market highs of 2000 and 2007, just before things got really ugly.

However, in order to have a free market, both sides of a debate must be represented. If everyone thought the market was going to go in the tank, it would already be there. There is just as much heft on the other side of the argument.

continued on page 2

continued from page 1

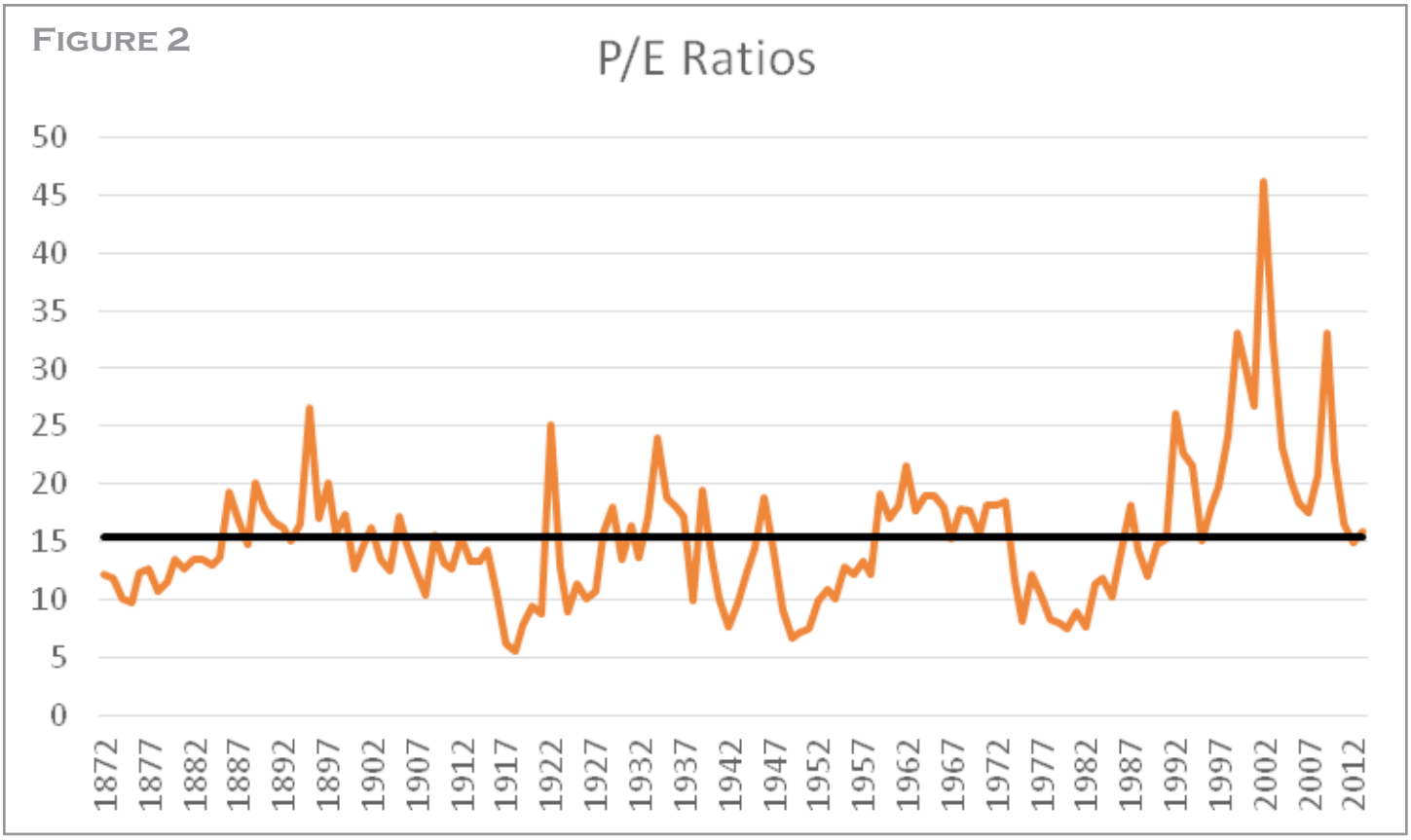
Charles Schwab strategist, Liz Ann Sonders believes there is more upside for stocks, perhaps a lot more. She points to the chart in Figure 1, and notes that stock prices, smoothed over ten years, tend to trend in one direction for many years. The market can overshoot on both the upside and downside, and these trends can persist for quite some time. Given that we are only five years into the current upcycle, there could be a lot more room for stocks to run.

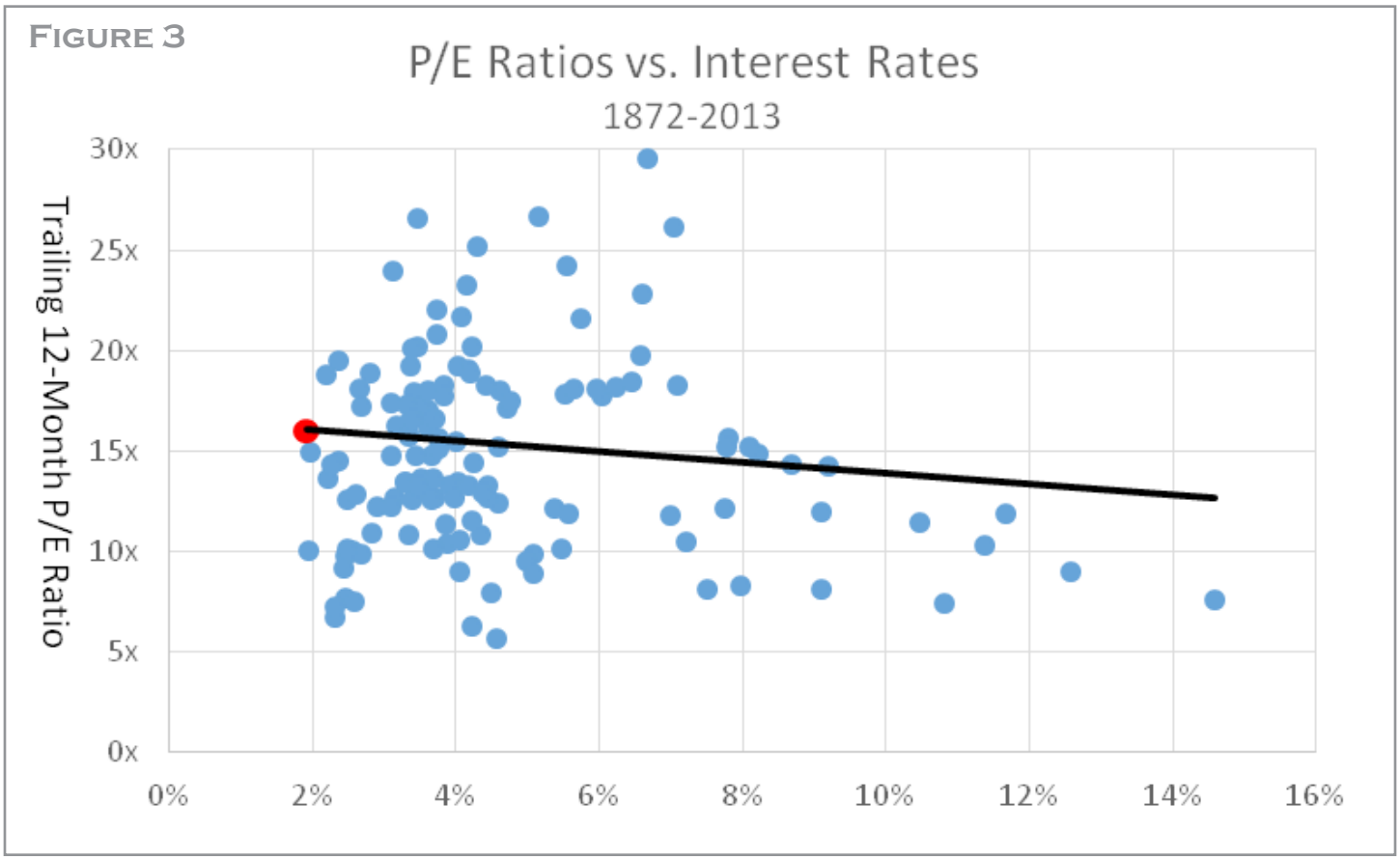
Jeremy Siegel, a finance professor at the prestigious University of Pennsylvania, also believes stocks have more upside. He uses valuation, as measured by the Price/Earnings ratio, as his justification. Interestingly, his conclusions run contrary to Robert Shiller's analysis that we discussed above, despite using similar data. Siegel points out that the P/E ratio generally has been higher during periods of low interest rates, such as we have today. He notes that while the long-term average P/E ratio may have been lower, it has been 18-19 times earnings during periods of low interest rates. Accordingly, he believes the market is currently 10% to 15% undervalued at today's P/E ratio of around 16.

Investment strategist James Paulsen largely agrees with Siegel, noting that the long-term P/E ratio has had a fairly low average, but since 1990, the level has risen significantly. Thus, comparisons of current valuation levels with the long-term average may lead to an overly cautious forecast. While warning that the "this time it's different" mindset can be dangerous, Paulsen also notes that we have almost 25 years of data in this new environment, on which he bases his analysis.

Clearly, there are strong arguments on both sides of the overvalued/undervalued stock market debate. We took a look at the data ourselves to see what we could learn. Figure 2 shows the price/earnings ratio going back to 1872, using the then current price divided by trailing 12-month earnings. The black line is the average over the entire period. While valuations are ticking up currently, they are not significantly above their average, making stocks perhaps modestly overpriced by this metric.

This does not take the low interest rate environment into account, so we looked at the relationship between P/E ratio levels and longer-term interest rates as well (see Figure 3). This graph plots historical P/E ratios (on the Y axis) versus the interest rates in effect at the time (on the X axis). There is an inverse relationship for sure, but not terribly strong. The red dot is the current data point. The current trailing P/E is around 16 and interest rates were around 2.0% (note: they have risen to around 3.0% since this last observation). You can see





that we're sort of in the middle of the range for periods of low interest rates. There have certainly been periods with higher valuations, and some lower.

Where does this leave us? Unfortunately, with no real clear answer. Stocks don't appear significantly overvalued, but neither are they cheap. My take is that we're around fair value currently. Not a time to panic and head for the exits, but maybe a time to cautiously move in with new money for investment. Over the next six months, the market may be higher or lower than today, but looking back from ten years from now, I'd wager this will look like a pretty good time to buy.

We also looked at the historical return data to see what has happened to stock market returns following years of big run ups, like in 2013. We looked at data going back to 1926 and ran the "serial correlation" of historical 12-month returns with prospective 12-month returns. This should show if there is any relationship between historic and future performance. What we found is that the correlation is -5.0%, very close to zero. This implies there is effectively no relationship between past and future returns, or that returns in any period are independent. This is not surprising, as this phenomenon has been proven in many past studies and publicized most famously in Burton Malkiel's A Random Walk Down Wall Street. So, statistically speaking, 2014 could be just as good a year as 2013. I wouldn't hold your breath on that one, but decent returns are still possible, and I believe quite likely from here, particularly for long-term investors willing to ride out shorter-term volatility.

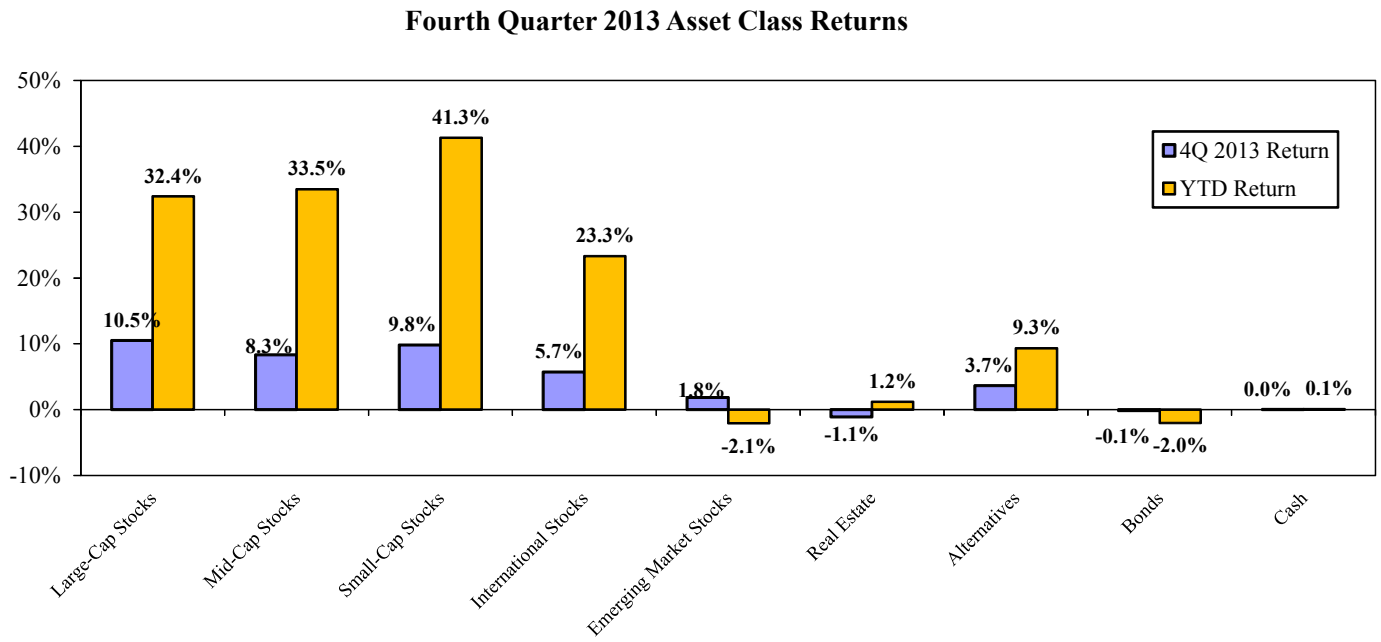
Portfolio Review

As we welcome in the New Year, and bid a fond adieu to 2013, we thought it appropriate to reflect on the successes and faux pas in our portfolios over the past twelve months. Since investment advisors are wont to focus on the positive, let's start with the successes.

Stocks, fairly broadly defined, were an unqualified success in 2013. Sure, uncertainty dotted the political and economic landscape, with the fiscal cliff, sequester, a government shutdown, concerns over Federal Reserve "tapering", a poisonous gas attack in Syria, among others. Nonetheless, stocks shrugged off the bad news and made new highs throughout the year. The chart below shows how

continued on page 4

Portfolio Review *continued from page 3*



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

the various components of the capital markets performed during the fourth quarter and full year.

While the S&P 500 rose over 32% for the full year, the large-cap funds we favor performed even better. The large-cap momentum fund we use rose over 35%, and our large-cap value funds gained in excess of 40%. Our "factor-based" investment approach should continue to outperform the core stock market over time, though it doesn't always work over shorter time periods. Clearly, though, in 2013 the large-cap funds we invest in did what they were supposed to do, and handily outpaced the S&P 500.

Small-cap stocks also performed quite well. This is surprising, given the fact that small-cap stock valuations are significantly higher than large-cap valuations, and have been for some time. Most market watchers have been calling for a small-cap correction for several years now. One possible explanation for the continued rally is that we're actually at the beginning of a new bull market cycle, a time when small-cap stocks tend to outperform. While this may sound crazy, there is some evidence that the market still has a long way to run (see the article on stock market valuation for further discussion on this). Because we tend to focus on small-cap "value" funds, rather than small-cap core, our selected funds generally performed a bit better than the index in this market segment too.

International stocks were a mixed bag last year. They were a success in the developed markets, but a disappointment in the emerging markets. While not up as much as U.S. stocks for the full year, developed market international stocks, particularly those in Europe and Japan, made a significant comeback in 2013 after several years of lackluster returns. Foreign economies, while not great, are starting to recover from their recent meltdowns. Our factor-based investment approach did not work as well in international markets in 2013. Both our value and momentum funds lagged the core MSCI EAFE index by a small margin.

Emerging market stocks were among the big losers in the equity markets in 2013. As the Fed threatened to "taper" its purchases of bonds in the U.S., investors fled the emerging markets, fearing that a slowdown in global liquidity would hurt smaller economies abroad. So far it has been a self-fulfilling prophecy. Emerging economies and stock markets have suffered as money flows to larger, supposedly steadier economies in the developed world. As a result, valuation levels are, dare I say, cheap. The P/E ratio for the MSCI Emerging Markets index is only 12 times trailing earnings. This is significantly below valuations in the U.S. or other developed economies, and we are seeing economic growth that is roughly twice as strong. I still believe

the emerging market stocks will prove a runaway success over the next ten years.

Real estate investment trusts (REITs) were also among the dogs of 2013, though they eked out a positive return. REITs outperformed stocks significantly coming out of the 2008 recession, but have been a big disappointment this year. With bonds paying such low interest rates the past few years, investors sought out anything with a decent yield. This caused REIT shares to run up, perhaps further than they should have. Now, with the threat of rising interest rates on the horizon, anything with a yield is suffering. We started to reduce our holdings in REITs earlier in 2013, but do still have exposure. Over the long term, REITs are a great vehicle for stock-like growth, but with fairly low correlation with stock returns. In other words, they add a lot of diversification to your portfolio, and should be a core holding for the long run.

As with REITs, investors seek out bonds for the income they produce. However, since bonds have been producing a lot less income these days, investors are moving on. Also, when interest rates rise, which is a strong possibility from today's low rates, bond prices tend to fall. So, rather than face the prospect of losses and paltry income, many investors have sold their bonds in search of better investments. Indeed, with 10-year Treasury bond rates rising from below 2.0% to just over 3.0% in 2013, bonds did in fact suffer a loss. Still, bonds are an integral part of most portfolios because of the risk control they offer.

We have responded to the unpleasant bond market environment by shortening the duration of our bond portfolios. This helps reduce risk when interest rates rise. We also shifted sector exposure a bit during 2013. We sold out of Treasury bonds almost entirely early in the year, because the risk/reward tradeoff seemed unpalatable. We shifted into GNMA ("Ginnie Mae") mortgage bonds as a substitute. However, with the Fed talking about slowing their purchases of mortgage bonds, we sold these late in the year. Mostly we've been holding the proceeds in cash, which has proven wise so far, given that bond prices have fallen during this period. We'll look to move this cash back into bonds early in 2014, but probably not mortgage bonds.

Alternative investments continued to disappoint. These funds tend to perform well during periods of stock market volatility, which has been very low this past year. Historically, the funds have been uncorrelated with the stock market, which is one of their most attractive qualities. However, given the huge run up in stocks in 2013, low correlation was not a good thing. We remain committed to alternative investments, as they offer a way to earn solid returns over the long run, but also help significantly reduce risk in your overall portfolio. We expect the risk control they offer will become increasingly important in the year ahead.

Generally, we had an excellent year in 2013. Not everything went our way, but performance was very strong across our portfolios because of the stock market rally. We will continue to focus on finding the best investments to represent the global capital markets in a risk-controlled, low-cost, tax-efficient manner. Feel free to call if you would like to discuss the specifics of your portfolio in greater detail.

Compliance Corner

The nature of our business requires us to obtain sensitive personal and financial information from our clients. As a registered investment adviser with the United States Securities and Exchange Commission (SEC), we must adopt policies and procedures to protect this nonpublic, personal information. Our policy mandates that ACM employees are prohibited from disclosing nonpublic, personal information to any person or entity outside of our firm, except as authorized by our clients or an appropriate regulatory institution. We also take all reasonable measures to ensure secure transfer and/or disposal of documents containing sensitive information about our clients.

Registered investment advisors are also required to file Form ADV with the SEC or state securities regulators on an annual basis. A copy of our updated Form ADV is available at any time upon request. A copy of this brochure is also available on our website. Please let us know if you would like us to send you a copy.

Arbor Day *continued from page 1*

good tree by the road that everyone else seemed to have missed. Perhaps it was because it was off the beaten path, or perhaps it was that it was 25 feet tall.

I laboriously cut down the tree, and then realized that it was too heavy to move very far. It was also about that time that the children were getting impatient and bored. It took another hour, but under pressure to move the project along, I held up the trunk of the tree as far as I could while Nipa reversed the truck into where I was standing. It wasn't terribly safe, but this allowed the truck to slide underneath the tree's trunk.

Even after all that, the tree never really did fit into the truck very well. We drove home with tree spilling out all over the sides and back, and the trunk was so heavy that it dented the roof of my truck.

At home, with the help of our tractor, the chainsaw, some neighbors, ropes, and pulleys, we finally had the tree up and ready to decorate. Decorating the tree took many hours, and thousands of lights, but when it was all done, it was spectacular. In the end, I was scraped all over, had pine needles in my hair and clothes, was sticky from head to toe from all the sap, and the house was a bit worse for wear, as was my marriage. But, the kids have fond memories of that tree.

This year, overwhelmed with all the holiday chores, we copped out a bit. A friend called and said he was going to the public market to buy a tree, and asked if we wanted one. We were quick to accept. Several hours later, a reasonably-sized tree showed up at our door. We had it up and decorated in no time. With time and therapy, I'm sure the kids will forgive us for sullying their holiday memories.

Firm News

ACM had another year of strong growth in 2013. We added a significant number of new clients, thanks to referrals from all of you. And, of course, the rising stock market is good for our business. One of the more exciting opportunities we pursued last year is working as a sub advisor to other investment managers. We have one contract signed and are working on a couple others. This means the other investment managers will focus on servicing their clients, but we will handle all the investments. We're flattered that our competitors view us worthy of working for their clients, and we are thrilled to be working collaboratively with others in the investment world.

We experienced some employee turnover during the year, which was mildly disruptive, but also opened up new opportunities for us. Our administrative assistant moved on to a job in her old career, which was a great move for her. We miss her in the office every day, but still keep in touch. John Lyon, our portfolio analyst, also left us. John took a job down in sunny Florida at a large investment research shop. Mark has covered John's responsibilities, but we will probably look to hire someone new later this year.

A new addition to our team occurred late in the year. Chris Cebula, CPA joined us as Chief Financial Officer. Chris will focus on internal operations, technology, finance, and also a bit of business development and client service…you have to wear a lot of hats around here. As a CPA, Chris's tax knowledge will come in handy for our clients. He has already been a resource for us in this area on many occasions.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, New York, ACM is employee owned, independent, and free of conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

Armbruster CAPITAL MANAGEMENT, INC.

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