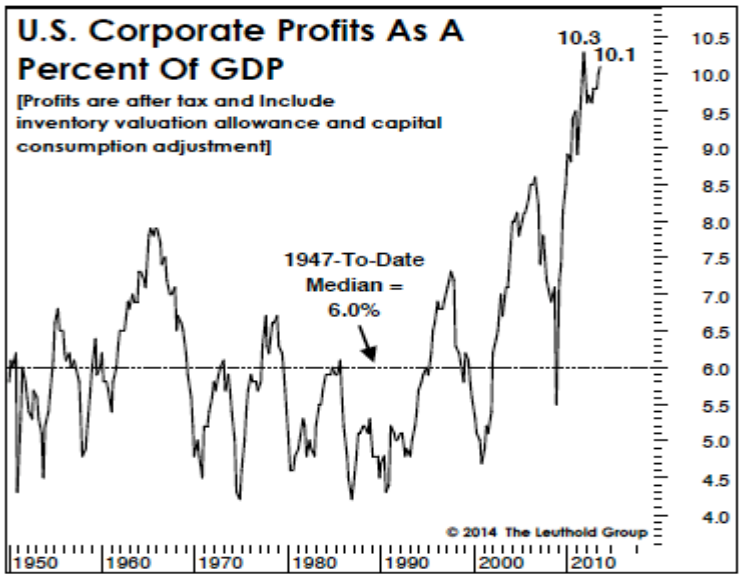
First Quarter 2014 Commentary: Investing Purgatory

With the first quarter in the books, the Dow posted a slight loss and the S&P 500 posted a slight gain. Given what happened last year, we think breakeven performance allows us all time to digest a few things.

Although last year's increase in the stock market was welcome, the performance was skewed in favor of a small number of companies. ***The top ten contributors to the performance of the S&P 500 trade at a lofty Price to Earnings Ratio of 58!*** We have not seen these types of nosebleed valuations since the tech bubble of the late 90's.

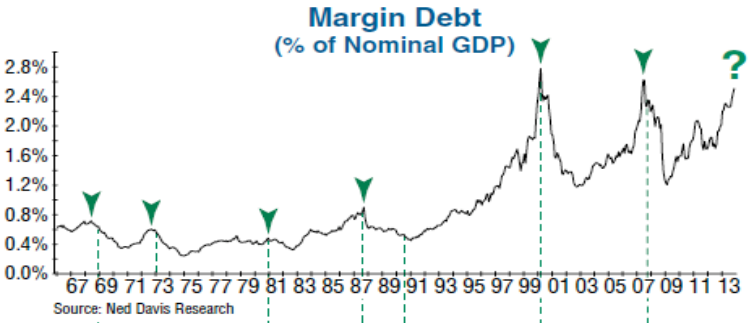
This type of behavior reminds us to focus on "what can go wrong" as opposed to "chasing after the hot deal."

The corporate environment continues to benefit from the lowest interest rates in 50+ years. Although this has ***helped boost profit margins to levels well above the averages***, we are skeptical as to how long this can last. Wage pressures, and healthcare expenses, are rising which will eventually lower profit margins.

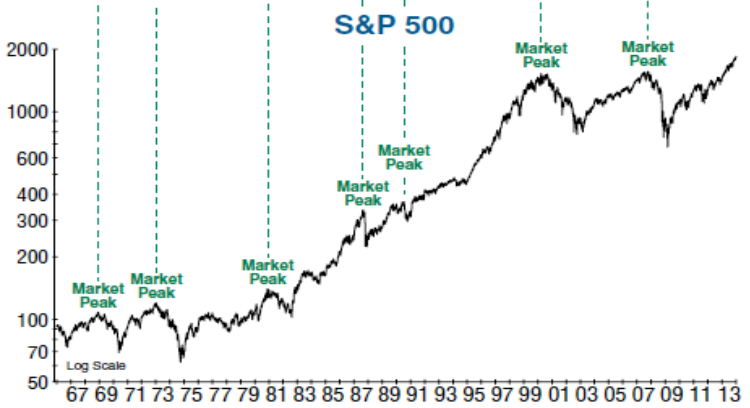


Although the 10 Year US Treasury bond yield finished the year at about 3%, ***rates have actually declined to about 2.75% at the end of the quarter***. This comes despite the Federal Reserve slowly easing back on their "Quantitative Easing" program (aka: interest rate manipulation).

Adding fuel to the fire, ***the average investor is borrowing funds at record levels*** against the value of the securities in their portfolios. Sometimes they pull the money from an account to buy a new car and sometimes they use it to buy more securities. Either way, it is borrowed money that eventually has to be paid back.



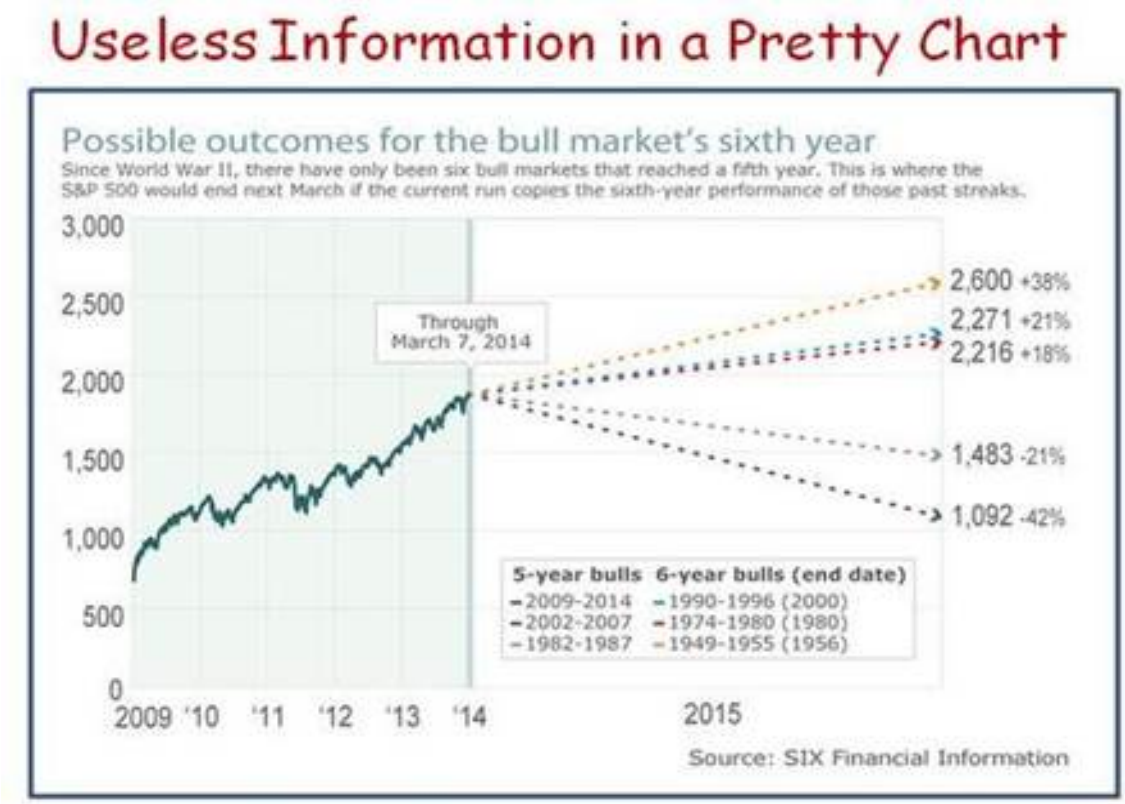
With interest rates so low, and a strong stock market, ***the allure of leverage can be rather seductive. However, leverage can also be a cruel mistress who yanks the rug out from under speculators when they least expect it.***



(OVER►)

During the quarter ***we celebrated the fifth anniversary from the market bottom on March 9, 2009***. As such, many wonder where the financial markets will go from here. We found the accompanying chart to be humorous and interesting. Since World War II there have been six bull markets that have reached a fifth year. ***In the sixth year the performance ranged from +38% to -42%.***

We're not sure this tells us anything particularly useful—but it is an effective reminder that ***the stock market is very volatile one year to the next.***



According to Standard & Poor's, with the current bull hitting its 5-year anniversary it is the second longest bull market since the early 1930's. Although we all have enjoyed the financial rebound, valuations still matter. As such, consider the following:

- The trailing P/E multiple of 18.6X on the S&P 500 Index is ***higher than 24 of the past 35 bull market peaks*** since 1900.
- The Shiller CAPE (cyclically-adjusted P/E) multiple of nearly 26X is ***higher than all 29 of the prior bull market highs*** since 1900.
- The S&P 500's Price/Book ratio of 2.7X is ***higher than all 5 of the past 28 bull market peaks*** in the past 90 years.
- The Price/Sales ratio of 1.6X is now ***higher than all but two of the 18 bull market tops since 1995***.
- The Wilshire 5000/Gross Domestic Product and the Value Line 3-5 Year Market Appreciation Potential are at multi-decade extremes.

We make these points not to scare anyone. However, it is important to understand that ***valuations are stretched***. If we had to make a guess, we think the broad markets will deliver, at best, single digit returns over the next ten years.

Valuation Of "Median" S&P 500 Stock Almost Identical To Levels Seen At 2007 Peak (And Above The 2000 Peak)

(OVER►)

For us, this puts even more emphasis on protection against downside risk as opposed to chasing after returns.

Furthermore, this reinforces the need to invest in appropriately priced companies—as opposed to chasing after broad categories. ***Despite the extended valuations of the stock markets, we still think it offers the best opportunities for long term investors***.

Interestingly, as the market has become fascinated with companies like Tesla, Twitter, Facebook and Amazon, it has actually left many other companies behind. ***Fortunately, those left behind have more sane financials which in turn presents us with decent opportunities.***

Of the approximately 1,000 companies that we track on a daily basis, we can still find a variety of well established opportunities with reasonable valuations.

In general, the decent opportunities lie within companies that are considered "high quality"—ones that are consistently profitable.

As always, we welcome any questions, observations or suggestions that you may have.

Finally, Sather Financial will celebrate its 15th anniversary on Thursday April 24th.

Since we have no reason to exist without our clients and friends, we invite you to join us for a cold drink, a snack and enjoyable conversation.

The festivities will start at 5 p.m. at Fossati's (108 S. Main St., Victoria). We hope to see you there.

Sincerely,

Dave

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

Warren

Warren Udd
CERTIFIED FINANCIAL PLANNER™