January 12, 2015

The Longer-Term Investor: 2015 and Beyond

"Wars are not won by evacuations."
- *Winston Churchill*

As we enter the New Year, many investors are facing a fog of investment war caused by their fear of the recent record levels of the equity markets, the latest spike in volatility, and an increasing uncertainty of how to face the future. Investing is a marathon and often feels like a war when confronted with conflicting factors such as:

1. Equity, art, and real estate markets at or near all-time highs
2. Interest rates stubbornly staying at virtually all-time lows, resulting in investors earning paltry bond and cash returns
3. Inflation remaining quite low
4. Oil prices having dropped by about 40% in the last three months
5. A new Congress controlled by Republicans hoping to break years of political paralysis
6. Geopolitical hot spots in Russia/Ukraine and the Middle East
7. Employment steadily improving in the U.S., but mostly at lower level jobs
8. A slowing economy in China while Japan is in recession, Europe is on the brink of recession, and the Eurozone is still facing structural issues
9. A squeezed middle class in the U.S. with real wage growth continuing to be minimal
10. A slower growing deficit but still raising the national debt to approximately 18 trillion dollars
11. The continuing war against a growing crisis of terror led by the barbaric ISIS

I am sure I have left out a number of both comforting and troubling factors also contributing to this fog surrounding the thoughtful, longer-term investor, but the above factors do present a formidable list. So, it is not surprising that our clients are looking for even more direction after the volatility of 2014, despite reasonably good results from most of our bond, defensive, and traditional equity investments. The easy thing for investors to do is "evacuate" from higher-risk assets such as equities after having realized years of appreciation. In our opinion, this would be a mistake. The key is how to invest in equities.

First, let us just briefly mention that being a longer-term investor is, in our view, the only way to succeed in an investing world constantly challenged by a changing and seemingly growing "wall of worry" that evokes fear. Investing for the longer term requires ignoring the emotions of fear and greed that typically negatively influence investors. Fear and greed are normal emotions, but they can destroy wealth creation and even worse, can lead to a permanent loss of capital. Numerous studies have shown that many investors make the wrong investment decisions when driven by fear or greed.

Reducing investment risk or trying to mitigate volatility is a worthwhile exercise which we believe can be accomplished through prudent asset allocation. A customized asset allocation reflecting one's investing temperament as well as one’s stage in life can put one on the path to reasonable investment returns without being overly influenced by either fear or greed. Of course, the asset allocation has to be unemotionally reviewed periodically to reflect changes in market valuations and other life factors.

Over the past several quarters we have urged clients to become somewhat more defensive while remaining prudently exposed to certain markets that have continued to appreciate. As we face this new year and years to come, global growth might become more difficult making quality and selectivity in picking investments even more critical. Additionally, unavoidable volatility from events that one cannot even forecast requires investors to be patient, and unemotional, while having faith in their advisor's judgment as to asset allocation and selection of quality investments.

Now, being a longer-term investor requires a brief discussion on what "longer-term" means. As our clients span the age spectrum from infants to about ninety, longer is obviously relative. However, the good news is that people are living longer and one should have an investment plan that seeks to provide returns at least above the rate of inflation after taxes over the long term (we hope to be able to do better than that). This requires thought on what asset allocation provides good risk-adjusted returns while still permitting one to sleep at night.

Specifically, while equity markets are at highs, earnings are at record levels for the S&P 500 (constituting many large, domestic companies) as well as many smaller companies. We believe that many (but not all) companies' earnings will set new records in 2015. That is why we focus your equity investments in high quality companies with continued earnings growth; high-quality companies with growing and above-average dividends; or those that represent what we, or the managers we entrust your funds to, consider great opportunities from a valuation standpoint. In previous letters we have talked about being concentrated in the best ideas. We are cautiously optimistic and believe that there will typically be solid investment opportunities in reasonably valued companies. The challenge is focusing on those and not others. That is why we still believe strongly in active management, not passive index funds. We are confident that the team at FLI, and the managers we work with, are up to that task! Looking ahead, we believe that we can continue to deliver reasonable appreciation over the longer term in our equity strategies. The combination of reasonably valued, quality companies, coupled with earnings and revenue growth, should result in investment success this year and in the future. As a point of information and pride, our under-allocation to companies domiciled outside the U.S. proved to be prescient as those markets as a whole continued to underperform U.S. equities. We still do not see much changing and remain underweight to both developed and developing international equity markets. We also seem to sleep better with the vast majority of our equity and fixed income investments being domiciled in the U.S. However, we continue to believe that having some international allocation is prudent while we wait for fundamentals to dictate a greater allocation. Furthermore, we do achieve some additional international exposure through great U.S. domiciled multi-national companies like Coca-Cola, PepsiCo, Microsoft, Apple, Pfizer, and many others.

In the fixed-income area, we, along with most, have been wrong. We expected that longer-term interest rates would increase in 2014. They declined. This shocked most. However, we still believe this could happen sometime in 2015 and those that have purchased long-term bonds to achieve higher yields might be in for some unpleasantness. Meanwhile, our defensive equity strategies, where we are over-allocated in lieu of a higher allocation to bonds and traditional equities, did well and we expect that to continue. So, we remain convinced that long-term interest rates will creep up during this coming year and therefore are concerned that high-quality bonds will not deliver a return above inflation (even for those that take some interest rate risk by extending maturities). However, we still believe that all clients should have a bond allocation although we remain under-allocated for most at this time.

In the real estate and private equity sectors, we continue to realize returns of capital and profits from most of the investments made in prior years. While we explore new investment opportunities in these areas, we are mindful of a lot of capital chasing these opportunities. We will be quite selective as valuations are rich. A continually improving domestic economy would help future appreciation. It is worth mentioning that all asset classes are being helped by foreign investment in U.S. assets. Foreigners are gravitating to dollar investments in bonds, stocks, real estate, and collectibles providing some wind in our sails. This reflects confidence in our economy and democracy. Lastly, we have avoided direct investment in commodities (fortunately) and continue to do so. They have been a miserably performing asset class in 2014 and we do not believe this will change any time soon (notwithstanding this, one of our outside managers is investing in what he believes to be a deep-value gold/copper mining company).

I would be remiss in not mentioning an opportunity that could be helpful to investment and economic happiness. It resides in Washington, D.C. After years of paralysis, a new Republican-led Congress could seek bipartisan legislation to help advance challenges in taxation, infrastructure investment, immigration, energy independence, and reducing hyper-regulation. Any improvement in some or all of these areas would create more confidence, investments, jobs, and economic growth. This would be good for investors as well as society. Of course, my optimism is a contrarian opinion to most. We will know more within the next year or so.

Summing up, our clients did reasonably well in 2014 following a great year in 2013. In our view, it is not time to abandon equities. It is time to be both more defensive and more selective within risk assets. Following the sage advice of Churchill (of course from a different context), we will not win the war of long-term investing by selling those asset classes that give investors meaningful returns above inflation over longer periods of time (and after taxes for our high net worth clients).

Our specific recommendations remain similar to our suggestions at the start of 2014:

1. Underweight fixed income, but maintain an allocation. Short-term rates should creep up, probably by mid-year, and continue to slowly increase, taking long-term rates with them. This assumption is based on a global economy growing by at least 3% and our Fed raising short-term rates some time in 2015, with current guidance indicating mid-year.

2. Remain overweight to our defensive basket with particular emphasis on our two defensive equity strategies. We expect solid dividend increases to help our Dividend Growth strategy and earnings, revenue growth, and reasonable valuations of our select large-cap growth companies to contribute to the success of our other defensive equity strategy.

3. Maintain a modest underweight to our traditional equity strategies with a greater concentration within this basket to large-cap domestic companies and continue to de-emphasize foreign-domiciled companies.

4. Private equity and real estate will remain opportunistic selections for us on a case by case basis. We continue to pursue opportunities within this basket, but must be convinced the reward is worth the greater risk and illiquidity.

Compounding reasonable returns over the long term by avoiding big down years through a prudent individualized asset allocation is the right battle plan for “longer-term investors.” This diversification, not evacuation from equities, should lead to long-term success while enabling our clients to sleep soundly at night.

Please give thought to our perspective and feel free to counsel with any of us on our investment committee.

Have a healthy, happy, and prosperous 2015!

Best regards,

Robert D. Rosenthal
Chairman, Chief Executive Officer
and Chief Investment Officer

P.S. A historical footnote is required. Third years of presidential terms and periods where the power in Washington is divided have a very strong record of positive equity returns. History is a guide, not a guaranty.

*The forecast provided above is based on the reasonable beliefs of First Long Island Investors, LLC and is not a guarantee of future performance. Actual results may differ materially. Past performance statistics may not be indicative of future results.

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