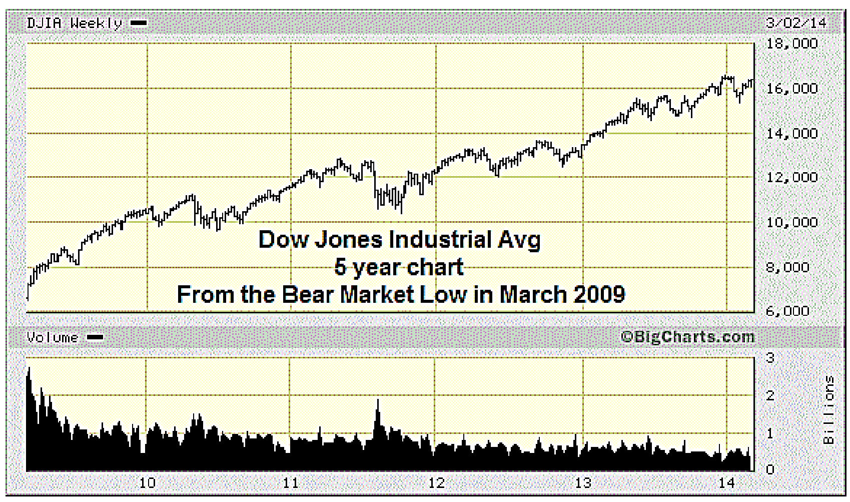
American Heritage Financial

MARCH UPDATE

March 5, 2014

Will You Know It When You See It?

Buy Low, Sell High: Those four words might be considered the greatest investment advice ever. It is very simple; buy a stock when the price is "low" and sell it when the price is "high." What could be easier and more rewarding? The only problem is, *Is it a good strategy if it is impossible to follow?* It is like the famous *"You know it when you see it"* definition of porn. You only know if prices are "low" or "high" ***after*** you see it. In other words, buying low and selling high is easy only **in hindsight**—*executing the strategy in real time is another matter.*



It is timely to give this old investment strategy some thought since markets continue to hit record highs while many investors have long felt it is already too high. How high is the market? After the 30% surge in 2013, the S&P began 2014 with a couple of rocky months and now sits with a tiny 0.6% gain for the year. Over the past twelve months, the S&P is ahead by 22.5%. Going back to the bear market low of March 9, 2009, (five years ago this month!) the S&P is up an **astonishing 175%**. Of course, if you go back to the previous market high in October 2007, the S&P is **only 19% higher** over that six year five month period. *So, "high," if measured relative to "low," depends on one's starting point!*

A better method of defining "high" for the market is to apply valuation metrics. We all understand high (or low) prices in everyday purchases. If a loaf of bread is priced higher than a comparable loaf we define that as a "high" price, but if it is "better" bread, we may feel the price is justified. In the market, we define "better" as "value," and there are endless metrics to measure value in the market.

For example, stock prices can be compared to total economic output (GDP), to book value, to cash flows, to dividend yield, etc., but the standard metric for market valuation is *price* compared to *earnings, or the **P/E ratio**.* Again (like porn) we only know earnings for sure **after** we have seen them. Based on recently reported 2013 earnings, the market is trading at 16.9 times earnings. But since the market is a forward looking animal, **future earnings** are much more important than past earnings and we have to rely on "estimates" of future earnings. Based on 2014 estimates, the market is trading at about 15.0 times future earnings. So does this range of current and future P/E ratios tell us if the market is high or low? Over the past 30 years, the market trades at an average of 16.1 times earnings, so we are smack dab in the middle of the "historical" valuation range based on P/E's.

Of course other issues also influence stock prices such as interest rates, government policies (i.e. taxes, regulation, stimulus programs, etc.), demographics, technology, currency fluctuation, wars, and—we hate to bring it up—*weather*, among others. If your eyes are now sufficiently glazed over, you might prefer to return to the simpler, "buy high and sell low" strategy!

The purpose of this trip to nowhere is to provide an opportunity to reiterate the only truly effective investment strategy we know of, that is to ***buy good quality stocks at what appear to be reasonable valuations and hold the stocks long term***. We take pride in our process for selecting great stocks and—just as important—using those stocks to build high quality, diversified, long-term investment portfolios that have shown their ability to weather both good and bad markets.

Our investment process is built on five principals: **Quality, Growth, Value, Diversification** and **Long-Term**. Notice, **Quality** comes first. Our search for high quality companies starts with quality management building a productive, ethical enterprise. **Growth** is a required factor for any sustaining activity and it is extremely important for stocks. The greatest companies in the world will not be a good investment if the purchase price does not represent reasonable **Value**. **Diversification** is recognition that mistakes happen in investing and diversification helps reduce volatility and smooth returns over time. Our firm achieves a unique diversification mix through a proprietary asset allocation model which is based on **expectations** for each investment in a portfolio. We emphasize the **Long-Term** aspect of our process because we buy stocks for the long-term and the entire investment process is a long-term—one might say ***lifetime***—process.

Our emphasis on our process of buying good stocks and holding them long term is because it is the answer to the unrealistic investment strategy of "Buy High – Sell Low." As much as we like that simple concept, our experience has proven the value of our more complete investment process. It seems particularly appropriate to focus on these ideas now—when it is so difficult to determine if the market is "high" or "low."

On the other hand, in spite of our belief in our process, we don't live in a vacuum and we understand that over-riding influences may demand occasional adjustments to our strategies. There currently are a few concerns which have our attention. We are watching short-term interest rates because they must remain low to support the bull market. Low rates appear a given based on the Federal Reserves repeated assertions—but it bears watching. A second concern is that earnings estimates come to fruition. Corporations are operating at record high margins so any slowing in the economy (and the recent weather is just one reason the economy could disappoint) would have a negative impact on earnings. A third concern is the volatile world in which we live and the impact global events could have on our own economy. Many of the recent global headlines are significant geopolitical events but the economic impact is unlikely to be significant—yet, there is risk that anyone of those events could escalate into something that could upset our market.

On the other side of these concerns, there continue to be strong reasons to expect the upward momentum of this bull market to continue. One unique aspect of the current environment is that the economy could suddenly become much stronger than anticipated. Corporations are sitting on record levels of cash and they will be under great pressure to deploy that cash should economic growth tilt up. In addition to excess cash and liquidity, positive drivers such as low energy prices, the manufacturing renaissance, demographics and the European recovery are already spurring growth. Last, the stock market is looking more and more like those "snow rollers" seen recently. With investors still flush with cash and ever-increasing stock prices, there is risk of a "melt-up" in stock prices in an all-out buying panic.

Needless-to-say, come melt-up, melt-down or flat-line, we believe in maintaining a balanced, long term investment strategy designed to meet your long term goals. Don't hesitate to call if you have questions about your particular situation.

Best regards,

Your Advisory Team

EGI Financial, Inc.
American Heritage Securities, Inc.

Questions or comments? Email us at: ahs@egifinancial.com or call 330-535-0881.
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