Marketline Monthly, November 2013

***Domestic Stocks***

The Dow surged another 3.5% last month, the NASDAQ matching with 3.6%. The S&P lagged slightly at 2.7%. This will be one of the best stock market years on record.

This month’s “common question” is: now that the market is trading at new highs, what do we do about protecting portfolios in the inevitable crash? On the one hand we like this question because it means that there’s still a lot of pessimism out there – including some of our own! Pessimism means there’s still buying power in the market and stocks can still go up. On the other hand, the question of protection is odd, because stock investors know that stocks fluctuate unpredictably and always have. Yet these same investors still want “protection”, any type of which will dilute returns. If an investor isn’t willing to put up with the volatility of stocks to get the return of stocks, the best protection is not to invest in stocks at all. Another alternative is to time the market by selling when you think trouble is coming. We don’t do this because we don’t know how and it turns out no one else does either. Or we could buy derivatives called “puts”, which constitute a bet that the market will drop. They are like an insurance policy. If the market drops, puts rise in price; if sold then, they can help offset the decline in the rest of the portfolio. Accounts must be certified individually to purchase puts, which involves setting up a margin account. A put is not an investment. It pays no income. It has an expiration date, and if the market doesn’t drop by then, the put expires worthless and if you are still worried about the market you will have to buy another one. Also, it won’t protect the whole portfolio, only part of it, and buying and selling them costs money. The put strategy decreases returns in exchange for less risk.

*Our approach* begins with distinguishing between “the market” and “our stocks”. Since we don’t know how to predict the market, but we do know a lot about our stocks, this approach makes sense to us. The most efficient way of dealing with expensive stocks is to sell them and repurchase cheap stocks. This is what we do every day – well, not every single day, but it’s what we strive to do on an ongoing basis. If we can’t find cheap stocks, then we will buy bonds or sometimes keep cash for a while. The level of the market has no effect on this strategy. The strategy remains the same at Dow 9000 as at Dow 16,000. What changes is how many stocks seem expensive and how many stocks seem cheap. At Dow 16,000, fewer stocks are cheap and more are expensive, so we may end up with more cash than “normal”. We recently sold an oil service company. But we also bought a genetics testing company and added to a couple retail stocks.

Finally nearly every portfolio owns stocks **and** bonds. Often, bonds rise while stocks fall. That protection can help in a big market swoon but it is not completely reliable. Nothing can keep a stock portfolio from losing money if the stock market goes down a lot. So, always, your stock position should match your investing intent, and your attitude about volatility should synch with how you use your funds.

***Fixed Income***

Bonds sank last month to about the level of August/September, with the thirty year yielding 3.81%. The ten year closed at 2.74%. Notably, mention of taper recently resulted in a small bond market rally, opposite of what we should expect.

Is this it? Is the sum total of this big bad bear market in bonds coming to a minus 2% on the Barclays bond index for the year and a yield of not even 4% on the long bond? If this bear market is for real, it better get going. Maybe 2014 will be the bond bear’s year, with a better economy in store.

Munis remain our favorite bond market sector but selectivity is critical. Disclosure is better than it used to be but still far short of what it should be. For those who follow this column closely, we have resorted to writing to the Chief Financial Officer at Columbia Hospital, as our phone calls were not returned, to follow up on our questions about conflicts of interest disclosed in the hospital’s financial statements. We still have not heard back.

***International***

Returns overseas were wildly disparate last month. Canada, where most of our foreign investments are headquartered and traded, was up only 0.3%. Canada’s economy is in a slow slog much like the rest of the developed world. Our exposure here could be a detriment for a while. Our response to this has been to find another Canadian stock – markets where returns have been low are a good place to look for value. Elsewhere, Mexico was up 3.6% but Brazil pulled a switcheroo and sank -3.3% after a strong October. This kind of volatility is de rigueur for Brazil. In Europe, the FT-SE index of one hundred large companies dropped -1.2%. The Nikkei was up another 9.8%, making two extremely strong months in a row. The Hang Seng index, somewhat of a proxy for the Chinese economy, was up 2.9%.

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