The Investment Letter

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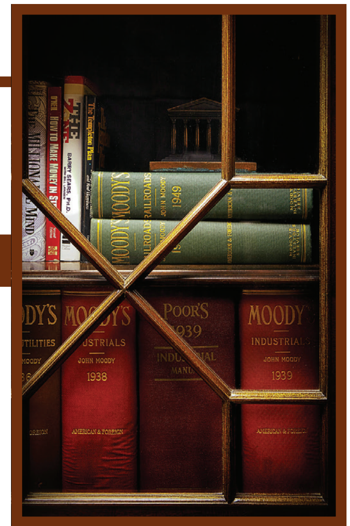

Identifying Opportunities in Equity Markets

One of the most frequently asked questions in investing has always been; "Where are the opportunities today?" While there is not one right or wrong answer to that question, we feel that any answer, without first considering an investor's risk tolerance, is imprudent.

That is exactly why before we recommend securities of any kind, we have to understand the willingness and ability of that individual to accept risk in their portfolio. It may turn out that they are uncomfortable with any principal risk, in which case opportunities don't matter, they are trumped by protection from loss.

Only once we've determined an acceptable risk tolerance for the client do we look at opportunities. One place we often start is by evaluating market sectors for attractive valuations. A number of free online services will use proprietary models to show which sectors are relatively overvalued, undervalued or fairly valued. If you're interested in seeing for yourself, you can check out Morningstar's sector valuations, which can be found at www.morningstar.com/market-valuation.

According to the Morningstar data, Utilities are fairly valued by historical standards. This means we may be comfortable investing in this sector for clients who desire current income and some principal protection but shouldn't expect a huge amount of upside reward or downside risk based on current prices.

Being relatively undervalued (or overvalued for that matter) doesn't necessarily make a particular sector attractive. Sometimes the entire sector is priced in such a way to reflect the risk inherent in that portion of the economy. For example, let's look at two of the most undervalued sectors, as of this writing, according to Morningstar, Financials and Energy.

Financials are currently the most undervalued sector in the US equity market. This, however, does not necessarily make them a can't-miss buying opportunity. Financials have a lot of headwinds that they are facing. Interest rates are currently low and the threat of negative rates (similar to other parts of the world) is a very real concern. Slower growth, which means less demand for lending, is also a concern that weighs heavily on those stocks.

Energy names have also been hit hard and for good reason. Demand for oil and natural gas is steady to slowing, while supply is up sharply, causing an imbalance that only self corrects through lower prices at the pump. This is great news for drivers but for owners of Energy names much less so. Uncertainty about future production levels and expectations of demand are heavily dependent on international relations. These are often with Middle Eastern countries and nations like Russia, with which our political relationship is somewhat tenuous. Despite the attractive price of the Energy sector and high dividends that many of these firms pay, the risk may be too much for conservative investors despite the opportunity being there.

Conversely, Consumer Staples is a much more defensive sector, which is slightly overvalued relative to the market, according to Morningstar. Again, this is a case where the numbers don't

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tell the whole story. With global risks, as we've detailed above, investors tend to flock to the relative safety of big, well-known, defensive names and particularly those in a defensive sector. These companies tend to be better insulated from the sometimes dramatic fluctuations that markets experience on a day-to-day basis and therefore, despite being slightly overvalued, may still be an appropriate investment for those seeking a greater relative degree of principal protection with current income.

There is usually no shortage of opinionated answers from pundits - although they quite often can't agree on the details. Part of the reason for so many differing viewpoints is that there is no right (or wrong) way to evaluate an investment. By some measures a security could appear to be an incredible value, by others it could look significantly overpriced.

Looking at just a few measurements is rarely enough to make a truly informed decision about a security. This is why, when evaluating a potential investment, we look at it from many angles and try to understand the company, the industry and the overall economy, not just the numbers. Perhaps, more importantly though, is to weigh the value and risk of the investment in the context of what is appropriate for each individual client rather than painting all clients with a broad brush.

Also, it is important to understand the inputs going into the over/undervalued calculation – a different set of calculations will likely yield different results. We are in no way suggesting we agree with Morningstar's methodology, only that it is one way of evaluating sector valuations.

As with everything in investing, the best data and analysis is worthless without a good handle on risk and your willingness to accept fluctuations in holdings. Even if you are ultimately correct, markets often act unpredictably, and sometimes for longer than we care to admit. With that said, it seems fitting to end on a famous quote regarding the dangers inherent in investing and the unpredictable nature of investing.

> **"Markets can remain irrational longer than you can remain solvent."**
> *– Economist, John Maynard Keynes*

Investment Counsel News

Inside the Office

Let us know what you think about our newly re-designed statements. The new format is easier to read while also providing more detail about your account.

Outside the Office

Dorothy is back from vacation! She and her husband, Kirk, enjoyed cruising for a week in the Caribbean.