Weekly Market Commentary



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Highlights

The top 10 lessons of 2013 for investors need to be put into two categories: those that investors can take to heart as sound wisdom for the year to come, and those they should try to forget as they prepare for 2014.

Historically, stocks have posted the most consistent gains when GDP has been around 3%.

2013's Top 10 Lessons for Investors

Each year that passes contains some wisdom for investors, but along with that wisdom can be some folly. 2013 was a year that bestowed an abundance of each on investors.

The top 10 lessons of 2013 for investors need to be put into two categories: those that investors can take to heart as sound wisdom for the year to come, and those they should try to forget as they prepare for 2014.

Lessons investors can take to heart for 2014:

- Bonds can lose money. After a 13-year streak of annual gains, the bond market measured by the Barclay's Capital Aggregate Bond Index fell about 2% on a total return basis in 2013, as interest rates rose from their all-time low in 2012.
- 2. Sentiment can matter more than fundamentals. Investors were willing to pay more for stocks, leading to a rise in the price-to-earnings ratio as they grew more confident in the durability of future growth. This brighter outlook drove most of the S&P 500 Index's gain in 2013, not the midsingle-digit pace of earnings growth or lackluster 2% gross domestic product (GDP). This is not uncommon. Historically, stocks have posted the most consistent gains when GDP has been around 3%. When GDP for a quarter was within plus or minus a half of a percentage point of 3%, the S&P 500 has posted an average gain of 6.5% during that quarter—the highest of any 1% range in quarterly GDP and nearly triple the 2.4% gain when GDP was more than twice as strong.
- 3. Time heals all wounds. In fall 2013, the one-, three-, and five-year trailing returns for the stock market rose into the double digits, and money finally started flowing into U.S. stock funds after the five years of net outflows that followed the financial crisis.
- 4. Defensive stocks can lead the market higher. During the first four months of the year, the defensive sectors—those that are less economically sensitive and tend to fare better when growth is weakening such as utilities, telecommunications, consumer staples, and health care—led the overall market to double-digit gains. For the year as a whole, the defensive health care sector outperformed with a powerful gain of 39%, as measured by the S&P 500 Health Care Index. This was an unusually strong performance for a sector that tends only to be among the top-performing sectors in years when overall S&P 500 returns are low (2011) or negative (2008). While overall cyclical stocks generally fared the best, for parts of the year defensive stocks led the way up.



5. Annual returns are rarely average. The 27% gain in the S&P 500 Index (30% including dividends) in 2013 was well above the long-term average of 5% (10% including dividends). Historically, annual returns have only been in the 5–10% range in eight of the past 86 years.

Lessons that **may have to be unlearned** to pursue investment success in 2014:

History shows that 2013 was an outlier and that risk management tools like diversification have tended to benefit investors.

- 6. Diversification is worthless. A passive, buy-and-hold portfolio of U.S. stocks did very well in 2013, whereas diversification, tactical positioning, or hedging generally acted as a drag on returns. History shows that 2013 was an outlier and that risk management tools like diversification have tended to benefit investors.
- 7. Risks are never realized. The key risks of 2013 were not realized: a recession from higher taxes and spending cuts, a default from government brinkmanship over the debt ceiling, a European financial crisis from Italian election debacle and Cyprus bank bailouts, a collapse in the housing market due to rising interest rates, etc. But that did not mean the risks were not threatening; any of them could have resulted in a very different outcome for the year. Risks may not always be as well behaved.
- 8. Stocks go up in a straight line. In 2013, the S&P 500 Index jumped 27%, but it saw only one notable pullback along the way. The pullback was less than 6% from peak to trough and lasted just one month. That compares to an average year that holds four market pullbacks of greater than 5% with at least one major pullback that has a peak-to-trough decline of 15.8% in the S&P 500 over the past 20 years. More volatility may be in store in the years ahead.
- 9. Dividends do not matter. The S&P 500 Dividend Aristocrats Index, composed of companies that have increased dividends every year for the last 25 consecutive years, performed in line with the overall S&P 500 in 2013. Instead, it was those companies that used their cash to do the most buybacks that outperformed. The S&P 500 Buyback Index, which focuses on the 100 companies in the S&P 500 that are doing the most buybacks, posted a total return of 45% outperforming the S&P 500 by 16%. However, in an income-hungry market, dividends are likely to be attractive to many investors in the years ahead.
- 10. Policy is all that matters. In 2013, all eyes were on Washington as investors and the media obsessed over the fiscal cliff, sequester, tapering, shutdown, and debt ceiling. In 2014, the economy and markets will likely be more independent of policymakers as growth accelerates and high stakes fiscal battles are avoided.

These lessons are helpful for pursuing investing success in the year ahead. The accumulated wisdom from lessons learned over many years suggests that with long-term interest rates remaining historically low, corporate earnings likely to grow in the high-single digits, job growth improving, and inflation remaining below 3%, conditions are ripe for stocks to again reward investors in 2014. ■

IMPORTANT DISCLOSURES

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no quarantee that strategies promoted will be successful.

Stock and mutual fund investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

INDEX DESCRIPTIONS

The Barclays Capital U.S. Aggregate Index is comprised of the U.S. investment-grade, fixed-rate bond market.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The S&P Healthcare Index is comprised of companies in this sector primarily include healthcare equipment and supplies, health care providers and services, biotechnology, and pharmaceuticals industries.

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