WOLF GROUP CAPITAL ADVISORS
GLOBAL WEALTH MANAGEMENT

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"While enthusiasm may be necessary for great accomplishments elsewhere, on Wall Street it almost invariably leads to disaster." – Benjamin Graham

Of all the parameters that influence our investment decision-making process, sentiment may be the most difficult to measure and understand. Interest rates, earnings, cash flow, economic growth, and so forth, all present themselves in tidy numerical fashion, suitable for all sorts of analysis. Assessing the mood of investors and of the populace at large represents a bigger challenge. We know that bear markets end when the dominant mood reaches "despair" (think back to March of 2009, in case you have forgotten what "despair" feels like…) and bull markets end on widespread euphoria, but successfully measuring the gradations of mood between these two extremes challenges even the most experienced investor. Benjamin Graham, often called "the Father of Investing," understood the importance of sentiment in assessing market cycles and the attractiveness of any given investment. He likely understood *all aspects* of investing better than anyone else, ever! We will take a closer look at his contributions to the industry after the break…

Fourth Quarter Review

For the quarter, the equity bull market continued its strong bull run. We can measure the current bull market's strength in many ways, but one data point deserves mention – the market has traded for over 830 days without a correction of 10% or more. The strength in the fourth quarter comes despite a backup in interest rates, slowing profit growth, mixed economic data and nearly universal commentary that the market appears "risky" or "too high." We saw good breadth in stock returns as well in the quarter – all of the major indices performed well. This kind of breadth usually suggests more good news for the markets rather than marking a peak. Only investors in commodities, bonds and/or emerging markets failed to realize the above-average returns seen in the major indices. For the year, investors were well rewarded for their past persistence, patience and remaining fully invested. Gold, which had been the darling of past years, fell 9% for the quarter, and has fallen over 30% from its September 2012 highs.

Here is what the fourth quarter looked like by the numbers:

Index	4th Qtr 2013	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	10.2%	29.7%	29.7%
S&P 500	10.5%	32.4%	32.4%
NASDAQ	10.7%	38.3%	38.3%
Russell 2000	8.7%	38.8%	38.8%
MSCI EAFE	5.8%	23.3%	23.3%
MSCI EAFE Small Cap	5.9%	29.7%	29.7%
MSCI Emerging Markets	1.9%	-2.3%	-2.3%
Barclays Aggregate Bond	-0.1%	-2.0%	-2.0%
Barclays Municipal Bond	0.3%	-2.6%	-2.6%
Dow Jones Commodities	-1.1%	-9.5%	-9.5%

Meet Mr. Graham

Although not exactly a household name (like Warren Buffett), Benjamin Graham holds the unique honor of creating the modern investment profession. Stock markets and investing existed long before Graham was born, but no one before him did what he did – turned the somewhat disrepute exercise of stock investing into a well-respected profession.

He was born in London in 1894, but his family moved to America when he was an infant. His father, an importer, lost all his money in a failed business venture in England, and the move to the States was an attempt to start anew. By 1907, Benjamin had lost both his father and all of the family savings. Always a bright student, Benjamin entered Columbia University at the age of 16 and finished his course work in three and a half years. Upon graduation, he had his choice of a faculty position in three departments: math, philosophy or English. Instead of accepting a teaching position, he talked his way into a back-office job at Newburger, Henderson & Loeb, a New York City-based investment firm.

Wall Street in those early days was chaotic – loose ethics, limited regulation, fuzzy rules and sketchy public information. The U.S. Federal Reserve was brand new. The Securities Exchange Commission's creation was still years away. Annual reports were only available at the New York Public Library. The practitioners of the day considered their work more art than science. What little information available was considered only superficially. The investors of the day were more inclined to invest by *feeling* and what they called "clinical judgment," rather than by any kind of deep analysis.

Graham thought there must be a better way. His approach was wildly successful. By 1919, he had created his own firm and was earning over $500,000 a year. The crash of 1929 nearly wiped him out, but he was able to bounce back within a few years. In 1934, he and David Dodd (an instructor at Columbia, where Graham also taught while running his investment firm) wrote the definitive text on investing, *Security Analysis*, which is still in print and still widely read by professional investors. In 1949, he penned *The Intelligent Investor*, a work targeting amateur individual investors, imparting much of the content of *Security Analysis* in a less academic style, which also is still in print.

Later in life, he became a mentor to Warren Buffett, who many consider the greatest investor in the modern era. Buffett often credits his success to the fundamental investment principles created, taught and practiced by Benjamin Graham. His celebrity glow may not burn brightly today, but his investment philosophy, his writings and his approach to investor sentiment still have relevance and impact in today's capital markets. Oh, and by the way, his investment record stands among the best in the modern era.

Graham, Benjamin. The Intelligent Investor Revised Edition. New York: Harper,1973.Print.

Key Elements of the Benjamin Graham Approach to Investing

To experienced investors, Graham's key elements may appear obvious or even simplistic. Yet, at the time he published these ideas, they were cutting-edge and revolutionary in nature. In addition, he was not some academic musing in his ivory tower. He was a practitioner, honing and refining his ideas and methods in the laboratory of real markets and real money. Here is a sampling of his fundamental investment principles.

1) ***A stock is not a ticker symbol.*** Too often investors view a stock as mystical token represented solely by its price. Graham truly believed and taught that owning a stock actually means owning a share of a company – a company with factories, employees, products, assets, liabilities, sales, customers and suppliers. Understanding the underlying reality of the share price can focus an investor's attention on things that can move that share price.
2) ***The market is a pendulum swinging from euphoria to despair.*** Another way to say this is that investor sentiment swings from fear to greed. At market bottoms, fear rules and despair abounds. At market tops, euphoria reigns with the fear of missing further gains encouraging all kinds of risky behaviors (margin buying, options trading, etc.) by unsophisticated investors. The most successful investors are able to override basic human nature, and buy amid despair and sell when everything is unicorns and rainbows.
3) ***The future value of every investment is a function of its current price.*** Most people understand the normal pricing mechanism of goods and services they buy. They can usually tell when something is "on sale." They tend to buy more of something when it is on sale. When stocks go "on sale," many people feel disinclined to buy them. Graham taught clearly that buying stocks with attractive (low) valuations increased one's chances of making money. Stocks with high valuations (which generally means they are well known and popular), tend to provide less attractive returns. The math here is simple; the psychology is not. We all may understand "buy low-sell high," but actually doing it is hard.
4) ***Investors cannot eliminate the risk of being wrong.*** In many endeavors, achieving near perfection is attainable. The complexity of the investment decision-making process leads to everyone making mistakes. Even the best analysis, using the best tools and all available information cannot compensate

for the uncertainty inherent in the forces that drive stock prices – economics, corporate actions, interest rates, and the most volatile of all – human emotions. The good news is that stock investing is not totally random, and investors can skew the odds of being right in their favor by doing rigorous analysis and sticking to a proven investment style or philosophy.

5) ***<u>The secret to successful investing is within yourself.</u>*** Although Graham possessed an above-average intellect, he did not think intelligence alone could make one a good investor. "Trait of character" seemed more important to him. He also considered independent thinking, discipline, eagerness to learn and self-control more important than raw smarts. Those who simply follow the ebbs and flows of the market are unlikely to become successful investors. He said, "The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. The investor has the full freedom to choose whether to follow Mr. Market or to think for himself. Professional money managers, especially mutual fund managers, have no choice but to mimic the market."

Those interested in learning more about his fundamental guiding principles should search out his writings, which are still valid and meaningful decades after he penned them.

Investing Versus Speculation

At the time Graham began investing, one could argue that everyone who bought and sold securities were speculators. They tended to buy and sell based on feeling, non-public information and/or other non-analytical factors. As Graham developed his unique investment style, he was able to draw a clear distinction between speculation and investing. "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." Perhaps some will disagree with this definition. The line between speculation and investing probably shifts over time as well. In the late 1990s, many dot.com speculators likely considered themselves mainstream investors. During the 2008-2009 financial crisis, many likely viewed every asset, excluding cash and U.S. treasury bonds, as highly speculative. Even today, many people who think they are investors may actually be speculators.

He further fine-tunes the difference between investing and speculating with this: "The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices."

In our view, when a person wants to buy a capital market asset based solely on: 1) something read or heard in the media, 2) a tip from a friend or relative or 3) a feeling based on a superficial direct encounter (like shopping at a store – with regrets to Peter Lynch, this is not investing), it is speculation. To be clear – there is nothing inherently wrong with speculation; confusing it with investing can lead to trouble.

This is How We Invest

Graham considered the following elements to be "decisive" in determining the intrinsic value of a stock:

1) The company's "general long-term prospects"
2) The quality of its management
3) Its financial strength and capital structure
4) Its dividend record
5) Its current dividend rate

In our quest for inexpensive stocks (that is, stocks trading at a large discount to their intrinsic or fair value), we consider all of these elements. We also look at historical valuations (employing all applicable ratios such as price-to-earnings, price-to-book, price-to-free-cash flow, etc.) to assess where a stock's current valuation lies relative to past cycles. Because nothing in the capital market remains constant, we must attempt to compare the company's current situation with the past, and make some assumptions about the company's future.

Once we have assembled all the important data, assessed all of the non-quantitative elements of the company (quality of management, etc.), and composed a short essay highlighting the main investment thesis, defining the possible risks and showing a price target, we meet in our Investment Policy Committee to discuss the merits of any new stock we consider. After debating the pluses and minuses of the stock, we vote on whether to add it to our Buy List. Each member of the committee has veto power, and we add no name to the list without unanimous consent. This was set up this way so that every single name on our Buy List would have the full faith and confidence of the entire committee. In addition, the most senior person on the committee cannot override the opinion of others. So far, we feel this approach has worked well for us.

We use a similar approach in selecting mutual funds, although the parameters we consider are obviously different. Here too, all must agree to add or remove any fund from our list of favored ones.

We continue to be amazed that the principles and ideas Graham discovered so many years ago continue to work today. We and our clients owe a huge debt of gratitude to this man and his work.

The Outlook

It has been a long time since we have seen a 10% correction in the stock market. In a normal bull market, 10% corrections are natural and normal. We experienced larger-than-normal corrections in 2010 and 2011, and none in 2012 or 2013. This is not unprecedented, just a bit on the unusual side. Thus, a correction of up to 10% would not be surprising, in our view. We have no particular insight as to why or when this may happen; we just want to highlight this possibility.

We continue to think that we are in an equity bull market. The chance of a bear market (a decline of 20% or more) in stocks, in our view, is remote. The stock market tends to reach its cyclical peak six months before the beginning of a recession. These peaks are most often accompanied by a spike in interest rates, high capacity utilization, low unemployment, strong capital spending and some kind of "froth" in a key industry (such as housing). We can find no evidence of these conditions now and strain to see any of these things on the horizon. Corporate earnings continue to grow, cash is still piling up on corporate balance sheets and companies still seem to be conservative in capital spending and hiring. Housing has improved and this will likely help consumer spending. Most economic forecasts expect global GDP to be stronger in 2014 than it was in 2013. The U.S. Federal Reserve is likely to back off from its super-accommodative monetary policy position at some point, but this should not have a significantly adverse effect on the U.S. economy or the stock market. In fact, the so-called "tapering" should happen only as the U.S. economy becomes stronger and self-sustaining.

Cash (beyond some reasonable "rainy day" reserve) continues to be the worst asset for investors to hold, in our view. We continue to think that the longer-term trend for interest rates may be higher, but a simple "sell bonds and buy stocks" cannot apply to all investors. Patches of economic weakness, uncertainty due to military (or political) conflict and market shocks are all good reasons for investors whose long-term asset allocation is not 100% stocks to hold bonds.

Sincerely,

Wolf Group Capital Advisors