A Q1 Letter to Clients: Bernanke, Buffett and Siegel on the Prospects Ahead
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by Dan Richards

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Each quarter since 2008, I have posted a template for a letter to serve as a starting point for advisors looking to send clients a summary of what’s happened in the past 90 days and the outlook for the period ahead.

Advisors have told me that they’ve got a great response to these quarterly letters. The templates rank among my most popular articles. This letter goes into more depth on global growth forecasts than past templates; if this is more detail than you think your clients will be interested in, you can easily delete this section.

Just a reminder that if you’re going to use this letter, take the time to customize it and put it into your own words, so that it truly does represent your point of view.

An overview of Q1 2012 markets: Bernanke, Buffett and Siegel on the prospects ahead

The first quarter of 2012 represented the strongest start for the U.S. stock market since 1998, with Japan turning in its best first quarter gains in 24 years. This was largely driven by a reduction of fears about an extremely negative outcome in Europe, as well as stronger economic data in the U.S.

Of course, there are some formidable issues still to be addressed. This letter provides perspective on some of these issues and outlines some thoughts on what we can expect for the balance of 2012 and beyond. As part of that, I have tapped into recent comments from Ben Bernanke and Warren Buffett, as well as Christine Lagarde, managing director of the International Monetary Fund and the Wharton School’s Jeremy Siegel, today’s leading market historian.

Before getting into their views, here’s a summary of market performance in the first quarter, all in local currency so as to exclude currency fluctuations. Even with strong first quarter returns, most markets with the exception of the United States are underwater over the past 12 months.
The single factor that more than any other will drive stock markets over the mid-term is the path of global economic growth – Europe in particular remains a question mark. In early January, the International Monetary Fund reduced its forecast for global growth and predicted that continental Europe would see a mild recession in 2012. Here are excerpts from the IMF’s January forecast for economic growth:

<table>
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<th>Economic Growth</th>
<th>Actual</th>
<th>Projections</th>
<th>Changes from Sept 2011 forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>World output</td>
<td>5.2%</td>
<td>3.8%</td>
<td>3.3% 3.9%</td>
</tr>
<tr>
<td>Advanced economies</td>
<td>3.2%</td>
<td>1.6%</td>
<td>1.2% 1.9%</td>
</tr>
<tr>
<td>Emerging economies</td>
<td>7.3%</td>
<td>6.2%</td>
<td>5.4% 5.9%</td>
</tr>
<tr>
<td>Canada</td>
<td>3.2%</td>
<td>2.3%</td>
<td>1.7% 2.0%</td>
</tr>
<tr>
<td>United States</td>
<td>3.0%</td>
<td>1.8%</td>
<td>1.8% 2.2%</td>
</tr>
<tr>
<td>Euro area</td>
<td>1.9%</td>
<td>1.6%</td>
<td>-0.5% 0.8%</td>
</tr>
<tr>
<td>China</td>
<td>10.4%</td>
<td>9.2%</td>
<td>8.2% 8.8%</td>
</tr>
</tbody>
</table>
Bernanke & Lagarde: Signs of improvement … but efforts must continue

Since this forecast was released in January, actions by global governments have changed the European outlook for the better. Indeed, it was greater optimism about a resolution to Europe’s issues that fueled the first quarter’s strong market performance.

There is still much work to do, however. March 20 featured a press conference by Christine Lagarde, Managing Director of the International Monetary Fund and formerly Finance Minister in her France. She painted a more positive but still cautious picture. Here’s how her remarks began:

“In terms of global economic outlook, we are certainly not – and I do say not – in as bad a situation as we were only three months ago and there have clearly been some significant improvements …

…coupled with an uptick coming out of the United States of America … It gives an overall picture (for Europe) that is slightly more positive than it was three months ago, not to say that all the difficulties have been cleared. If I have one message, it’s that the reforms and the efforts underway in advanced economies have to continue and that the same vigorous rigor has to be applied by Governments in the programs and the efforts that they have undertaken.”

The very next day, Ben Bernanke spoke to the House Committee on Oversight and Government Reform about the Federal Reserve Board’s views on Europe. He pointed to improvement in Europe and focused on three positive steps on the continent to increase stability. He also discussed favorable results of stress tests of banks in the event of a severe pullback in the U.S. economy.

But his closing comments echoed Christine Lagarde’s note of caution about the need for further action to address Europe’s structural issues:

“The recent reduction in financial stress in Europe is welcome given our important trade linkages. The situation however remains difficult and it’s critical that European policy leaders follow through on their commitment to achieve a lasting stabilization. I believe our European counterparts understand the challenges they face and they’re committed to take the necessary steps to address those issues.”

Should you be interested in watching them, here are links to the comments from Ben Bernanke and Christine Lagarde.

And here’s a link to the IMF’s most recent global growth forecast:

From my own point of view, it’s worth noting that given European issues and a slowdown in China, there is broad consensus that the next five years will see “2, 6 and 4” growth – an average of 2% in developed countries and 6% in emerging economies, leading to 4% global growth overall. It’s this divergence in growth between developed and emerging countries that is driving increased focus by multi nationals on faster growing emerging economies.

Warren Buffett: “America’s best days lie ahead”
In the face of challenges for developed economies, there is a persistent view of America as an “empire in decline” – this was reinforced by last year’s downgrade of US debt and by the stalemate in Congress over dealing with America’s deficit and debt challenges.

As I look at formulating recommendations for my clients, I don’t subscribe to the view of a declining America. Without dismissing its issues, the biggest competitive advantage for United States is its vitality and capacity for change and innovation. It continues to dominate in high tech and remains a magnet for the best and brightest talent from around the world.

I’m not alone in this view. Here’s an excerpt from Warren Buffett’s annual letter to investors released in February,

“In 2011, we will set a new record for capital spending—$8 billion—and spend all of the $2 billion increase in the United States. Money will always flow toward opportunity, and there is an abundance of that in America. Commentators today often talk of “great uncertainty.” But think back, for example, to December 6, 1941, October 18, 1987 and September 10, 2001. No matter how serene today may be, tomorrow is always uncertain.

… The prophets of doom have overlooked the all-important factor that is certain: Human potential is far from exhausted, and the American system for unleashing that potential—a system that has worked wonders for over two centuries despite frequent interruptions for recessions and even a Civil War—remains alive and effective. We are not natively smarter than we were when our country was founded nor do we work harder. But look around you and see a world beyond the dreams of any colonial citizen. Now, as in 1776, 1861, 1932 and 1941, America’s best days lie ahead.”

You can read Warren Buffett’s full letter to investors here.

A long term perspective on valuations

While economic growth enables long term increases in corporate profits as a whole, in the short and mid-term we have to pay a fair value for the companies we buy. Anyone who invested at the peak of the U.S. market valuations in 2000 learned a hard lesson about the perils of losing focus on what we pay for a dollar of earnings.

There are few more hotly debated issues on Wall Street than whether today’s market is overvalued, undervalued or priced just right. In looking at all the available data, my own conclusion is that the market is roughly fairly valued.

That’s not to say it doesn’t face some speed bumps in the period ahead. But I was interested to see a March 29 interview with Jeremy Siegel of the Wharton School. Author of Stocks for the Long Run, which examined almost 200 years of market data, in this interview Siegel looks at historical precedent and sees significant upside potential at today’s stock valuations. Here’s a link to his interview:

What this means for your portfolio
While all portfolios are customized to clients’ specific needs, there are three guiding principles to the advice that I offer.

1. The first relates to the allocation between stocks and bonds and comes from Benjamin Graham, the Columbia professor who was Warren Buffett’s teacher and who is considered the father of value investing. In a recently discovered 1963 talk, Graham had this to say on asset allocation:

“In my nearly fifty years of experience on Wall Street, I’ve found that I know less and less about what the stock market is going to do but I know more and more about what investors ought to do … my suggestion is that the minimum amount (of the investor’s) portfolio held in common stocks should be 25% and the maximum should be 75%. Consequently the maximum amount held in bonds would be 75% and the minimum 25% … any variations should be clearly based on value considerations.”

2. The second principle relates to, barring a significant change in circumstances, sticking within the investment framework that we’re decided upon.

Some of you may recall that my advice in early 2009, as we faced what appeared to be an end of the world scenario and some stocks hit lows they hadn’t seen in 20 years. At that time, I urged clients to maintain a core level of equity exposure. Recently, I have had questions from clients about increasing equity weight in portfolios, given low interest rate and strong stock performance in the first quarter.

While I am always happy to discuss this on a case by case basis, given the level of uncertainty that still exists, I generally advise against increasing equity allocation from the level that we had going into 2012.

3. The final principle relates to the role of cash flow from investments. In an uncertain environment for economic growth and equity returns, we continue to place priority on the cash yield from investments. In my view, the returns on some REITs, corporate bonds and dividend stocks in selective sectors continue to make these attractive relative to the available alternatives.

Should you have any questions on anything I’ve covered in this note or on any other issue, please feel free to give me or one of the members of my team a call. And as always, thank you for the opportunity to serve as your financial advisor.

Dan Richards is a top-rated presenter at advisor conferences and an award winning instructor in the MBA program at the University of Toronto, as well as author of Getting Clients Keeping Clients: The Essential Guide for Tomorrow’s Financial Advisor. To learn more about his conference keynotes and workshops, email.