

November 2014

## From Garfield, PA to Berlin



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November 2014

*Views as of November 2014 and subject to change. Investment advice offered through Fragasso Financial Advisors, a registered investment advisor.*

# INVESTMENT OUTLOOK

## NOVEMBER 2014

### Key Takeaways

- 1) After an unusually long absence, volatility made a comeback as markets weigh central banks' direction.
- 2) The economy is moderately improving in the United States, stagnating in Europe and slowing its growth in emerging markets.
- 3) The re-emergence of U.S. manufacturing may provide new investment opportunities.
- 4) The outperformance of U.S. equities may have priced in at least part of the real economic differentials.
- 5) Emerging Markets and European equities provide relatively more attractive valuation
- 6) Potential European Central Bank stimulus geared to help economy may help European equities but hurt the Euro currency.
- 7) With rates at even lower levels than last year, it is prudent to pursue a diversity of strategies aimed to cushion the effects of a potential rise in rates while still providing income.

# INVESTMENT OUTLOOK & TACTICAL ALLOCATION UPDATE

## Garfield, PA

On weekends, I often venture for some great coffee on Penn Avenue, a few short blocks from my house. It is a spot where the Pittsburgh neighborhoods of Friendship, Bloomfield and Garfield intersect. Along with coffee you can find lots of art, music and some of the best dining Pittsburgh has to offer.



You can also find heavy infrastructure works along with some urban grit and abandoned buildings. "Garfield, USA is a neighborhood in transition," writes<sup>1</sup> Njaimah Nije, a multimedia producer based in Pittsburgh.

Carol Moore, a long-time Garfield resident in Njaimah's story noted, "I know it's never going to get back to the '50s and '60s because we have to move on, we can't stand still. But I hope it becomes a neighborhood like it was then ...."

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<sup>1</sup> <http://urbanful.org/2014/09/08/garfield-usa-neighborhood-transition/>



The story of Garfield is a microcosm of the much larger story of U.S. manufacturing rebirth; one of our strongest investment themes. Like Garfield, U.S. manufacturing is benefiting from the same underlying economic forces in play today: a tailwind from technological innovation and ripple effects of the shale gas production and economic growth.

## Will U.S. manufacturing return to its glory days?

The U.S. will not transform itself back into a post- World War II manufacturing powerhouse overnight. The world does not need a post-war rebuild and the baby boom generation, which has driven much of the economy, is starting to retire. However, U.S.-based manufacturing is increasing market share and there are investment opportunities to be found for those willing to do the research.

For many decades, American companies outsourced their manufacturing work overseas. Today many are returning to U.S. shores. The financial crisis of 2008 has curbed wage growth and made the American worker increasingly competitive. Energy cost has decreased significantly with the advent of shale gas and

oil. By producing domestically, companies are also minimizing transportation costs to end markets.

At Fragasso Financial Advisors we continuously research new opportunities on our clients' behalf. We currently focus on smaller to medium manufacturing companies that are closely tied to the U.S. economy. We also seek other beneficiaries of the resurgence of the domestic manufacturing trend such as small banks that are providing financing to manufacturing businesses. We have recently increased portfolio allocations to the U.S. manufacturing theme. The actual allocation varies along with the unique circumstances of every client portfolio.

## Recent Market Volatility

You know we live in a globalized world when Pittsburghers are enjoying the most popular street fare in Berlin: the Currywurst.



Unfortunately, in a globalized world, we also get to endure the stock market effects of the latest political squabbles between the European Central Bank (ECB) and German officials in Berlin over monetary stimulus.

After a relatively steady, almost uninterrupted climb over the last couple of years, equities started behaving as equities do. The S&P 500 dropped over 7.4 percent<sup>2</sup> from the all-time high reached on the day of the Ali Baba IPO, as

public disagreements over the best course of action for the ECB triggered the decline.

Traditionally, given the historical experience of the Weimar Republic, Germans have a greater than average fear of inflation. They tend to view central bank policies of "easy money" with great skepticism. However, the realities of today are very different than in the early 1920s. In light of weak German economic data and deflationary fears in many parts of Europe, markets have already assumed stimulus was forthcoming and reacted negatively when it was called into question. Stories related to ISIS in the Middle East and the Ebola scare did not help matters.

The most important thing to remember about market volatility is that, regardless of its causes, it is a normal phenomenon that always has been and always will be part of investing. I have addressed the issue of volatility and how to successfully navigate through it in my recent [Understanding and Managing Market Volatility white paper](#).

Investors should take emotion out of the decision making process. This can be accomplished by putting short-term volatility in perspective, focusing on long-term financial goals and maintaining a disciplined rebalancing process of an appropriately diversified portfolio.

We believe that despite the usual political wrangling, the key actors that caused the recent stock market declines (i.e., central banks) will end up implementing the type of policies that are appropriate for the current environment of moderate economic growth in the U.S., slowing growth in China and almost no growth in Europe.

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<sup>2</sup> As measured by the S&P 500 Index from 09/19/2014 to 10/15/2014

## Portfolio Strategies & Themes

### Fixed Income

In July of 2007, Chuck Prince, the then CEO of Citigroup was quoted as saying, "As long as the music is playing, you've got to get up and dance. We're still dancing." Prince was referring of course to riding the wave of leveraged mortgage securitization, which in the end nearly brought down the financial system.

Prince's dance ended badly and turned out to be very expensive for Citigroup shareholders. From the end of July 2007 until the market hit bottom on March 9, 2009, the Citigroup stock lost 98 percent of its value.<sup>3</sup>

As responsible stewards of your capital, our first priority is to help protect your assets over the long run so it is there when you need it. The fixed-income portion of your portfolios is meant to help protect capital rather than squeeze the last drop of potential return out of the most over extended areas of the market (long-term U.S. Treasuries) by attempting to dance until the last second.

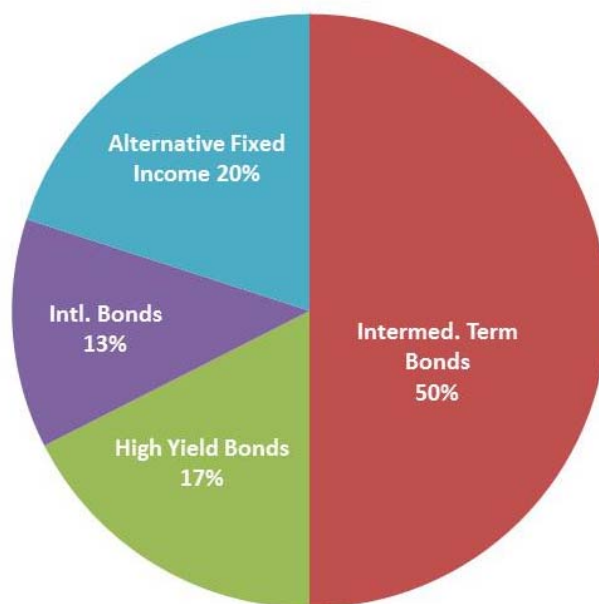
[At the beginning of the year, we believed the probability of interest rates rising significantly in 2014 was remote.](#) However, to stay prudent, we still positioned bond portfolios to help protect principal in case rates did rise. We accomplished this by investing in shorter maturity fixed income, broadly diversified across various sectors through specialized managers.

As it turned out, interest rates actually dropped further and accelerated their decline during the last two months. Longer-term fixed income appreciate in price more than shorter-term ones when interest rates drop. Conversely, if rates were to rise in the future, longer-term fixed income will lose more value than shorter-term ones.

<sup>3</sup> Citigroup shares closed at \$465.7 per share on July 31, 2007 (adjusted for reverse splits and dividends). On March 9, 2009 Citigroup shares closed at \$10.5. Source: Morningstar Direct

Since rates today are even lower now than at the end of 2013, the risk of principal losses if rates increase has risen. Moving into the new year, we will continue to tilt fixed-income portfolios towards fixed income that can better help protect principal if interest rates rise.

### Taxable Fixed Income Allocation as of 11/30/2014



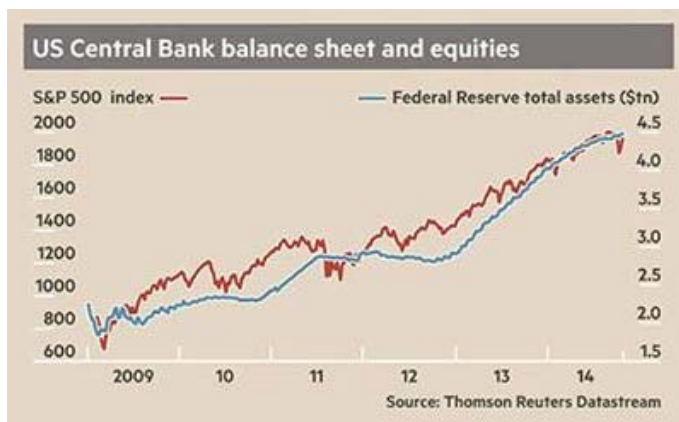
As the Federal Reserve has pushed interest rates to near zero, generating income has become increasingly challenging for investors. We have been researching a multitude of non-traditional ways to generate income on behalf of our clients while attempting to keep risk in check.

To help protect fixed-income portfolios in a potential rising rate environment, we continue to employ flexible strategies that seek an absolute positive return. Such strategies have the ability to invert the portfolio's sensitivity to interest rates and may actually benefit from rising rates. We have also made some manager-specific adjustments, in response to management changes in several bond funds. Among the adjustments we have selectively introduced a managed portfolio of diversified real estate-based income generating strategies.

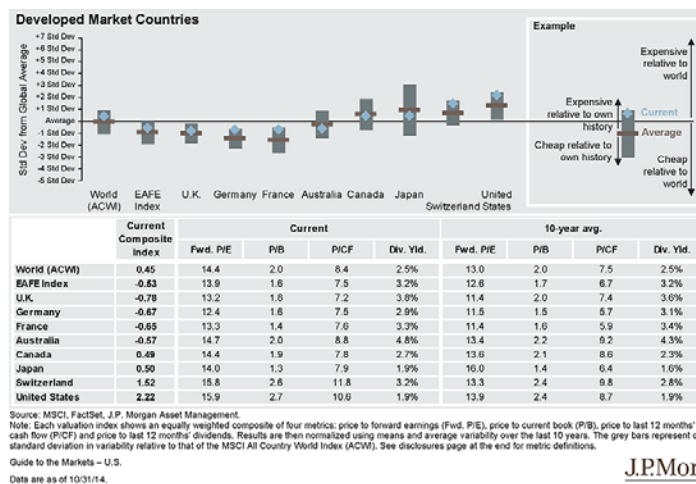
To further diversify from any one risk and generate additional income we look for investment opportunities around the world. In most developed economies, the interest paid by government fixed income is even lower than the 2.3 percent yield of the 10 year U.S. Treasury bond. In Canada, 10-year government fixed income yield 2.0 percent, in France 1.3 percent, in Germany 0.9 percent and in Japan 0.5 percent<sup>4</sup>. We have currently allocated the international portion of fixed-income portfolios to emerging markets fixed income. In this area, we invest through experienced managers who have the ability to buy fixed income that are denominated in either local currency or U.S. dollars as market conditions evolve.

## Portfolio Strategies & Themes Equities

We are favoring the manufacturing theme in the U.S. because it may benefit from a tailwind of favorable fundamentals: more competitive labor cost, cheaper energy and proximity to end markets. Additionally, the smaller capitalization companies that belong in this group have experienced pullbacks and appear relatively less expensive than large U.S. equities. Large U.S. equities have performed relatively well over the last few years. Prices were pushed up by an improving economy and in no small measure by the actions of the Federal Reserve.



At current levels, large U.S. equities look relatively more expensive than other developed nation equities by many measures. Large U.S. equities are more expensive for a reason: they have higher earnings growth than their counterparts and the U.S. economy is doing better than most developed economies in the world. However, investors need to keep in mind that the stock market moves well ahead of the real economy and is driven by the rate of change in expectations. For example, even if an economy is doing poorly but expectations change from "dismal" to "pretty bad," equities have a tendency to rally.



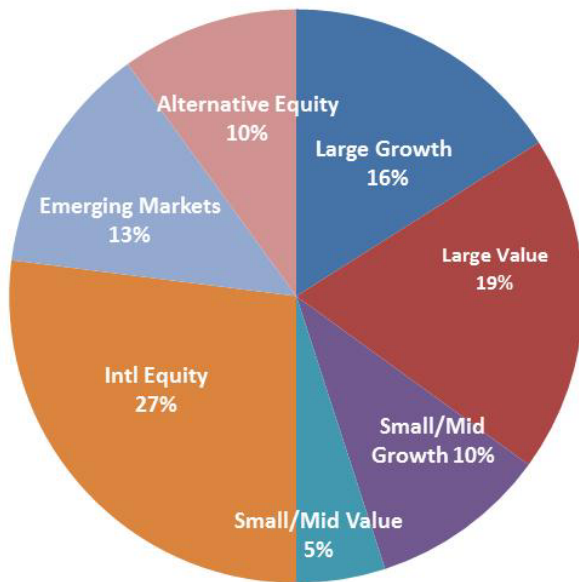
J.P.Morgan  
Asset Management

The Federal Reserve is on course to end its bond buying program, while the ECB is just starting its own. The effect of an ECB stimulus may prove positive for equities, but negative for the euro currency. We will therefore seek to invest in European equities likely to benefit from the central bank stimulus but hedge the currency risk back to the U.S. dollar.

After having underperformed U.S. markets, emerging markets equities also appear attractively priced. Eastern European equities have been affected by the geopolitical crisis in Ukraine. As the U.S. is likely to shift its priorities to the Middle East, tensions with Russia may ease providing an opportunity for those markets to potentially rebound. We are maintaining our target allocation to emerging markets and rebalance portfolios towards areas that may have shrunk relative to other asset classes.

<sup>4</sup> Source: Bloomberg 10/27/2014

## Diversified Equity Allocation as of 11/30/2014



## Our Philosophy

We believe a broadly diversified portfolio that is not overly exposed to any one risk stands the best chance to provide desired risk/reward profiles in the current environment. Actual adjustments to individual client portfolios will vary and are always a function of your unique circumstances.

Our clients' portfolios are customized to fit specific objectives, so not every theme mentioned here is equally reflected in all cases. Implementation methods and vehicles may also vary from case-to-case.

We believe proper risk control remains the key to avoiding costly mistakes. As market conditions change, we actively manage risk on a full-time basis through time-tested, textbook principles:

- Keep asset allocation in line with objectives.
- Avoid overexposure to any one risk.
- Hedge riskier positions to protect against worst-case scenarios.
- Maintain an appropriate cash cushion for peace of mind.

In today's low-interest rate environment, many investors are confronted with the conundrum of reconciling their need for income with their desire to preserve capital.

If you find our methodology helpful and believe others may also benefit, please don't keep us a secret. We have the experience and know-how to help other people or organizations important to you.

We appreciate your business.

*NOTE: The actual investment vehicles used to gain exposure to various investment sectors mentioned above vary along with the unique circumstances of every client portfolio.*

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Chief Investment Officer  
Fragasso Financial Advisors*

**Past performance is no guarantee of future returns.**

**A word about risk:** Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in the **bond market** is subject to certain risks including market, interest rate, issuer credit and inflation risk; investments may be worth more or less than the original cost when redeemed. Investing in **foreign denominated and/or domiciled securities** may involve heightened risk due to currency fluctuation, economic and political risk, which may be enhanced in emerging markets. **Mortgage and asset-backed securities** may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer credit worthiness; while generally supported by some form of government or private guarantee, there is no assurance that private guarantors will meet their obligations. **High-yield, lower-rated securities** involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risks than portfolios that do not. **Alternative strategies such as arbitrage, hedged equity, market neutral or long/short** may result in higher internal transaction cost and tax consequences of short-term gain. Funds may engage in option transactions and short sales. Option transactions involve special risks that may make it difficult or impossible to unwind a position when the Fund desires. With short sales, you risk paying more for a security than you received for its sale. In addition to the normal risks associated with investing, merger arbitrage strategies may realize losses if the proposed reorganizations in which the strategy invests are renegotiated or terminated. Other arbitrage strategies may include but are not limited to convertible risk, synthetic convertible risk, convertible hedging risk, covered call writing risk. In **hedged equity** strategies, selling index call options can reduce the risk of owning equities, but it limits the opportunity to profit from the increase in the market value of equities in exchange for the upfront cash at the time of selling the call option. Additionally hedged equity strategies may lose part or all of the cash paid for purchasing index put options. Unusual market conditions or the lack of a ready market for any particular option at a specific time may reduce the effectiveness of a hedged strategy. **Diversification** does not ensure against loss. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors. Each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

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