KWAG November 2014 Update

Good Afternoon! The overall theme of the quarterly newsletter sent out several weeks ago was one of reversion to the mean, and we covered four separate topics in that context. First, we discussed the normal (expected) increase in stock market volatility, which we said provided a nice rebalancing opportunity. Second, we discussed the long-term benefits of investing in small caps and noted the present opportunity to rebalance into them, since they had become relatively less-expensive than large cap stocks. Third, we discussed the inevitable increase in interest rates and what this means for bond investors. And finally, we discussed the benefits of using proactive managers to take advantage of short-term deviations from the longer-term trends in both the stock market and bond market.

The good news is we didn't have to wait long to see any of these deviations begin to revert back toward the mean.

The Numbers

During the first half of October, both the S&P 500 (large company index) and the Russell 2000 (small company index) experienced a nice healthy 5% dip. This dip extended the large cap decline to 7.4% and the small cap dip to 13.2% from their respective all-time highs. However, since mid-October, the S&P 500 has rebounded a full 8% (reaching another all-time high), while small caps have risen nearly 12%. That's one heck of a bounce-back over just the last few weeks. For the month of October, the S&P 500 was up 2.3%, while the Russell 2000 was up 6.5%.

Our Managers

Last month, we wrote "*the small cap opportunity presents one of the best "relative" buys we have seen in small caps since 1999*". In addition, and prior to last month, we have written about how "*increases in volatility typically lead to changes in stock market leadership*". This is precisely why we diversify our stock portfolios across **the entire stock universe and use active managers**. During volatile periods, active managers can take advantage of underpriced (and often overlooked) companies and purchase them at very attractive of prices. A specific example of this type of opportunity occurred last month in the Champlain Small Company fund (CIPSX) which was up 8.4% for the month of October. Over the last few quarters, the management team at Champlain has consistently written about the relative inexpensive prices of many small cap companies. As they pointed out in one of their recent updates, "…*long-term investors will be significantly rewarded for their patience.*" We agree, and the month of October proved to be a very nice reward.

Interest Rates

After bottoming out at a yield (or interest rate) of 2.14% in mid-October, the 10-year Treasury note increased by 22 basis points to 2.36% over the last few weeks, representing an increase in yield of over 10%. This quick yet significant increase in intermediate-term interest rates has driven "interest rate sensitive" bond prices lower, as one would expect. We believe this is the type of thing we will see more of in the future, and why we stress that investors need exposure to a well-diversified portfolio of bond funds of all types, each actively managed by experienced bond managers. When you own a bond portfolio that contains bonds that are not significantly impacted by rising interest rates, you significantly reduce your overall risk exposure and can even increase your potential return. During October, every one of our core bond funds had positive returns in spite of the rising interest rate environment. We think that speaks volumes about the type of bond managers we've employed in our client portfolios.

The Election

With the mid-term elections yesterday, a few people have asked about the new budget priorities going forward and how it will affect the stock market in general. It's important to remember that government consumption is one of the LEAST variable components of our GDP. Year-to-year, the overall government spends a pretty consistent amount and most spending is non-discretionary. This consistency forms a solid base from which the rest of the economy can plan for future spending. For example, since 2000, the change in government spending (as a percentage of GDP) has not changed more than 1.5% in either direction.

The truth is, we believe the change in leadership in the Senate will have very little impact from an economic standpoint, at least in the short-run. Longer run it remains to be seen, but remember that power is still split between the legislative and executive branches, so we think it's unlikely we'll see significant changes from the pre-election status quo.

In Closing

As usual, if you have any questions about this update, our quarterly newsletters, your statements or our managers, please feel free to call or e-mail us at any time. The recent referrals are very much appreciated, and as always we remain 100% committed to your long-term financial well-being.

- ***Joe & The Gang at KWAG***

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