



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

October 2014

Autumn Jitters

After spending many years in Wall Street ... I want to tell you this: *It was never my thinking that made the big money for me. It always was my sitting. Got that? My sitting tight.* It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I've known many men who were right at exactly the right time.... And their experience invariably matched mine – that is, they made no real money out of it. *Those who can be both right and sit tight are uncommon. I found it one of the hardest things to learn.*

Edwin Lefèvre, *Reminiscences of a Stock Operator*, 1923

The Dow Jones advanced from 66 to 11,497 in the 20th Century, a staggering 17,320% increase that materialized despite four costly wars, a Great Depression and many recessions.... Since the basic game is so favorable, Charlie [Munger] and I believe it's a terrible mistake to try to dance in and out of it based upon the turn of tarot cards, the predictions of "experts," or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.

Warren E. Buffet, *Berkshire Hathaway 2012 Annual Report*

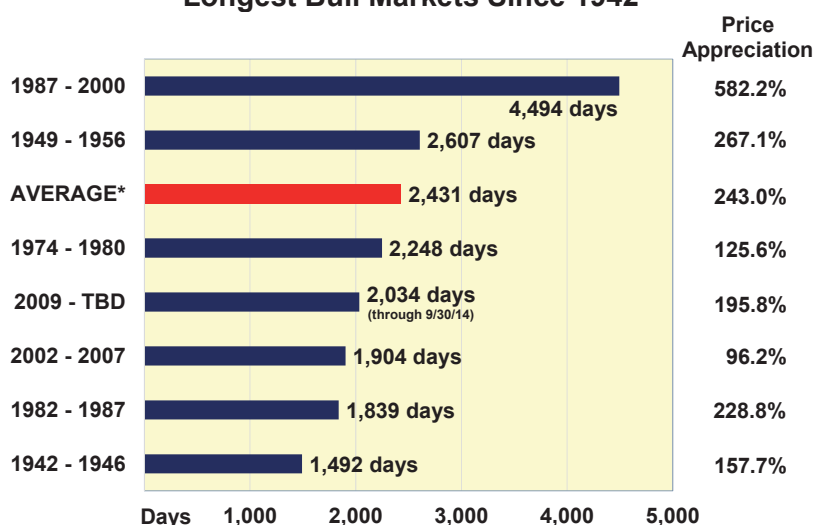
With the current bull market in its sixth year since the bottom in March, 2009, some of our clients have queried us about the advisability of getting out of the market. And, as September and October have historically been volatile months for the stock market, the number of client calls has increased with the advent of autumn. There are not many investors still alive who experienced the October, 1929 Crash, but many of us remember vividly the Crash on October 19, 1987 when the Dow Jones dropped 22.6% – the largest one-day percentage drop in U.S. history. Despite these memorable October events, September has historically been the worst month for the stock market. According to Jeremy Siegel's invaluable book, *Stocks for the Long Run*, September has been the only month in which the S&P 500 Index has had a cumulative negative total return from 1926 through 2012. Interestingly, investors over the recent past have begun to anticipate this "September effect" so that August has been the worst month since 1995. But this year's autumn volatility, combined with the duration of this bull market, has many investors asking whether they should sell stocks.

Is the Bull Market Getting Long in the Tooth?

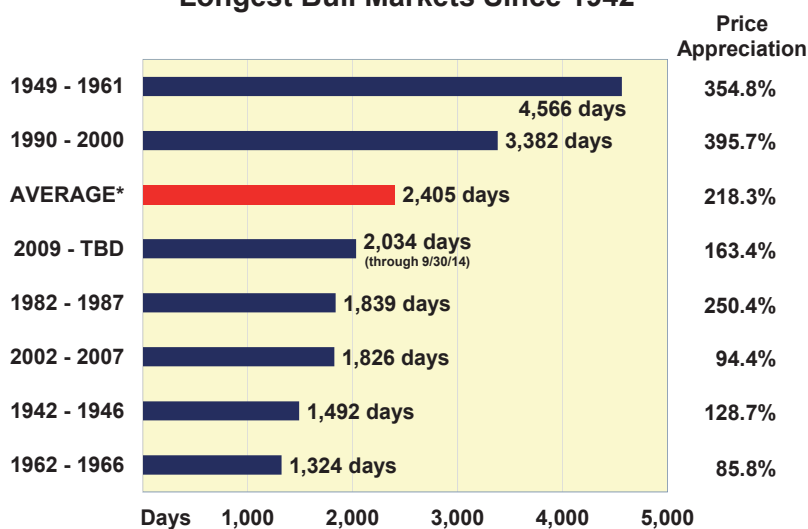
With the total return of the S&P 500 Index up over 220% since the March, 2009 bottom, many investors feel that the stock market may be overvalued. However, the S&P 500 has only appreciated 34% since 2000 – an annualized total return of 4.0% during this 14¾-year period. This is less than half of the average annualized return of the stock market over the 87-year period since 1926. This lengthy period of underperformance was due to the stock market's recovery from its extreme overvaluation at the end of the dot.com bubble at the turn of the century, as well as the Panic of 2007-2009 when the S&P 500 tumbled 58%. However, in financial markets in democratic capitalist countries, there tends to be a reversion to the mean, and the average annual total return for the S&P 500 from 1926 through 2013 has been 10.1%.

In order to gauge whether the current bull market may be reaching the end of its run, it is useful to examine the history of previous bull markets in the U.S. In constructing the charts below, we have used the generally accepted definition of a bull market which is an advance of 20% or more. And when a bull market is in evidence and the relevant index declines 20% or more (defined as a bear market), then we consider that particular bull market to be over. Based on these assumptions, the charts below chronicle major bull markets for both the S&P 500 Index and the Dow Jones Industrial Average. In both charts, the data is compiled using only price appreciation rather than total return.

S&P 500 Index Longest Bull Markets Since 1942



Dow Jones Industrial Average Longest Bull Markets Since 1942



*Average is calculated using above bull markets (excluding current bull market)

Source: Bloomberg

As the above charts show, the longest bull markets in both indexes lasted 12+ years – 1987-2000 for the S&P 500 and 1949-1961 for the Dow Jones. In both instances, a case could be made that the bull markets lasted even longer. With the S&P 500, the bull market, which President Reagan’s policies launched in 1982 and which continued under Presidents Bush and Clinton until early 2000, actually lasted 17 years, but the Crash of 1987 divided the bull market in two. Despite the Crash of 1987, the

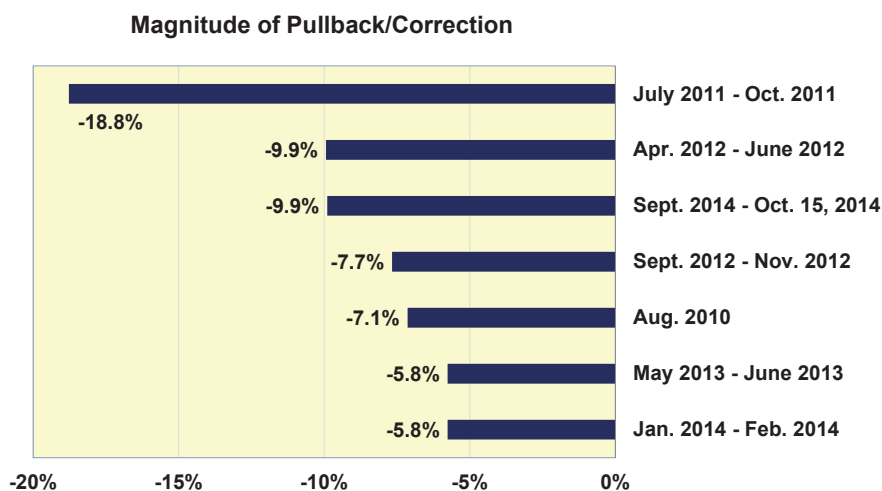
S&P 500 actually turned in a small positive total return that year. With the Dow Jones, the bull market which began in 1949 experienced a brief bear market in 1961, and then continued its extraordinary run until 1966, when the turmoil surrounding the Vietnam War and the chaos during the civil rights movement brought it to an end.

The current bull market, which commenced on March 6, 2009, has been underway for over 5½ years. It is the fourth longest running bull market since the 1930s, but not even half as long in duration as the bull markets in the 1950s/1960s or the 1980s/1990s. Also, the current bull market was punctuated by a significant correction in the second half of 2011, when the S&P 500 dropped over 19%. An important observation is that the two longest running bull markets followed lengthy periods of economic and/or political disruption (the 1930s/1940s and 1960s/1970s). It is quite possible that the current bull market, which has followed the crushing sell-off of 2000-2002 (when the NASDAQ dropped 78%) and the Panic of 2007-2009, will repeat this pattern of a long bull market run, making up for more than a decade of investor distress.

The Wall of Worry

In any bull market run, negative economic and political trends and events occur from time to time which worry investors and cause market downturns or corrections (defined as a 10% drop in the market indexes). The chart below presents the date and the magnitude of the pullbacks and corrections which have occurred since the bull market commenced in March, 2009:

**S&P 500 Index Pullbacks and Corrections
March, 2009 – October, 2014**



Source: Bloomberg

The so-called “Wall of Worry” is the wall of investor worries and anxieties that the market has to overcome in order to continue its advance. Some may wonder, if there is so much to worry about, how can there be a bull market at all? The best way to think about this is that a bull market is a process – not an event. If many investors are worried, some will have sold stocks and have substantial cash reserves. These cash reserves (used by doubters to buy stocks) are what propel the market higher. It is when there are few sellers (and therefore no cash reserves) that the market tends to drop. In other words, when all the worriers and skeptics are converted and have already bought stocks, the bull market is over. Over the past year, there has been no shortage of things to worry about. Following is a list to refresh your memory:

Top Investor Worries 2013-2014

Economic

1. Lack of growth in Europe & Japan
2. Global deflation
3. Economic slowdown in China
4. Anemic U.S. GDP growth rate
5. U.S. fiscal deficit & federal debt
6. Underemployment in U.S.
7. Income inequality
8. Tax inversion
9. Oil & other commodity prices

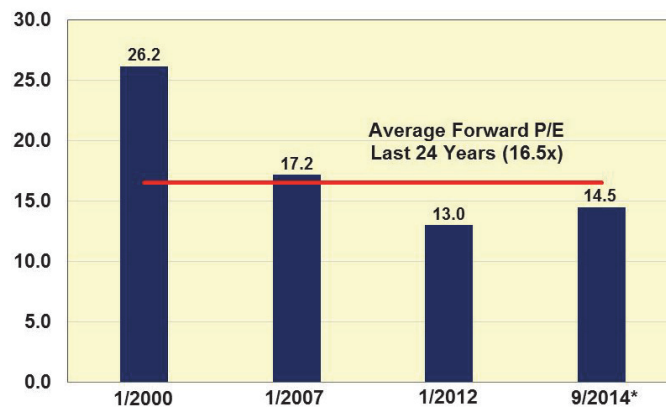
Geo-Political

1. Russia/Ukraine conflict
2. Putin & Eastern Europe face-off
3. ISIS & collapse of Iraq and Syria
4. Hong Kong/China conflict
5. Israel/Gaza war
6. Iran's nuclear ambitions
7. China's clashes with neighbors
8. West African Ebola virus
9. Devolution in Europe

Stocks for the Long Haul

The fundamental determinants of stock market prices are earnings, interest rates, and liquidity. At BFS, we believe that the upward trajectory of U.S. corporate earnings will continue into 2015 with S&P 500 operating earnings of \$130 or more. We also take Fed Chair Janet Yellen at face value – that the Fed will seek to keep interest rates low well into 2015. And there is abundant liquidity in the market. These positive trends have kept a floor under the market's valuation this year – despite periodic modest pullbacks. Using forward annual operating earnings, the chart below shows the stock market's valuation currently compared with markets at certain points over the past 15 years:

**S&P 500 Index Price/Earnings Ratios
2000-2014**



* Calculated on 2015 operating earnings.

Source: Bloomberg/Standard & Poor's

In conclusion, we do not believe that investors should let this seasonal autumn volatility scare them out of stocks. With the market's major advance over the past several years, investors may want to examine their asset allocation to right size the equity portion of their portfolio, but Warren Buffet's advice makes great sense. As long as investors have a long-term approach to the stock market, there is more risk being out of the market than there is being in the market – especially if investors own quality names with great brands, balance sheets, and cash flow, which are the kinds of companies which we at BFS favor.

Bradley, Foster & Sargent, Inc. *Investment Management*

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