Stock markers cooled off some in the 3rd quarter, with the S&P 500 being up only 1%. As of September 30, stocks have done reasonably well with the S&P having gained 8.3% YTD, while the MSCI All Countries Index recorded a 2.0% gain. The Dow Jones Industrials have not done as well and was up only a few percent YTD. Since the end of the quarter, markets have been very volatile and generally negative with investors fretting between two diverse worries. One worry is that the U.S. economy will strengthen and the Federal Reserve will allow interest rates to rise higher than expected in 2015 which would inhibit economic growth and corporate profit. The other concern is that the U.S. economy will falter due to economic weakening in Europe, Japan, Brazil and perhaps China, call it "global fears." The recovery is weakening in Europe due to the slowing economy in Russia along with France and Italy. Unless structural changes are made in France and Italy they will remain mired in a stagnating economy much like Japan over the last 20 years. The jury is out on economic reform in these countries, but the outcome is uncertain. With weakening overseas economies, the U.S. dollar has strengthened which could negatively affect the earnings of U.S. multinational companies.

So far we have evaded the much talked about correction (a decline of 10%), partially because it is so much talked about. However, with a maturing economic recovery and fair market valuations, markets are susceptible to investor emotions as we have witnessed in October. I cannot predict the outlook for the economy but my best guess is that the U.S. economy continues to grow modestly.

Over the summer we sent articles out to you that suggested the folly of trying to time stock markets. Below, I would like to quote from a recent Wall Street Journal article that refers to a study done at Cambridge College.

“In 2008, Mr. Smithers and London University economics professor Stephen Wright conducted research into long-term investment strategies on behalf of Cambridge’s Clare College, which was founded in 1326. His conclusion: Investors with long-term horizons should maintain a minimum of around 60% in stocks, even during equity bubbles.

The reason is three-fold. First, he says, average returns from stocks have historically been so much better than alternatives that even overvalued stocks are likely to prove a reasonable bet. That may be especially true in the current environment, where both bonds and cash offer very low yields. Using data on U.S. stocks since 1801, Mr. Smithers says stocks have produced compound average annual returns of 6.8% above inflation—compared with around 3.5% for bonds and 2.8% for cash.

Second, Mr. Smithers says, history has shown that overvalued stock markets often become even more overvalued before correcting back down. Investors who get out first miss out on further gains along the way. And they may have to wait many years before markets return to long-term trends.

For example, those who got out of stocks in 2000 had to wait until 2009 until share prices hit their lows.

Third, he says, investors who try to move completely into cash when markets are up usually intend to buy back when stocks have fallen to more appealing levels, but they often don’t. Such an approach involves too much emotional stress, he says.

> To be sure, all of this applies only to long-term investors who are able to withstand the stock markets volatility, Mr. Smithers adds. All financial experts agree that those who have shorter-term horizons, or who cannot handle too much risk, should hold a much smaller portion of their money in stocks."

The added twist compared to other articles we have sent out is the recommendation to have at least 60% of investable assets in stocks even when it appears that markets are overvalued. Currently, I believe that stocks are fairly valued to modestly undervalued if our baseline forecasts holds. More importantly, even with good stock market returns over the last 5 ½ years, we are still climbing a "wall of worry" as the "great recession" is still pertinent in investors memories. However if the U.S. economy were to weaken, it would be difficult for stocks to continue to gain ground. I have attached another article on market timing, make note particularly of the last paragraph.

In summary, I believe that being positioned in stocks as we currently are is prudent as markets do not seem extended regarding valuations. However, I would like to meet with you in the next few months to start a discussion on what would we do if markets did get overextended in the next year or two, which would be a good problem to have. I have also attached an article by Howard Marks who I admire. It is heavy reading but does present well the case that the future is unknowable. Also, remember that stocks provide high historical returns, but the price of realizing those gains is the discomfort created by stock volatility. But as Howard Marks states, volatility is not the true risk in holding stocks.