FBB capital partners

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Dear clients and friends,

"The gambling known as business looks with austere disfavor upon the business known as gambling"
-Ambrose Bierce, *Epigrams of a Cynic*

If you take a betting chip and place it on "red" at a roulette table, the odds of winning are just about even at 1.06-to-1, assuming standard European rules.* If you do win and bet again, the odds of the ball landing on red a second time are statistically the same as before for the next spin of the wheel, though the odds of winning two *consecutive* spins more than double to 3.23-to-1. But assume you do indeed win twice in a row, lucky you! You then bet once more on what is fast becoming your favorite color and hit the trifecta, though the odds of three consecutive wins on red are 7.69-to-1, or only an 11.5% chance.

But let's not let ever-diminishing probabilities get in the way of a hot hand. Momentum is clearly your side, and soon your closest friends and their co-workers are betting along with you, and every spin lands on red. 10 spins, 15 spins, yet close to 50,000-to-1 odds! Other gamblers who had spread their bets across the table now feel compelled to double up on red. Red is suddenly the hot topic on the evening news, red makes the cover of Bloomberg magazine, and you just put a down payment on a vintage red Ferrari Barchetta.

Obviously, the risk of betting on red all the time, and of increasing your bets in defiance of the odds, is that the ball will eventually stop on black. Or zero. Or double zero! And though our roulette analogy is admittedly over the top, we are beginning to see behavior among some stock market participants that parallels the speculative "bet on red" mentality, as they set aside long-standing asset allocation principles and instead make concentrated gambles.

"Horse sense is the thing a horse has which keeps it from betting on people."
-W.C. Fields

The US equity markets did have an exceptional year in 2013, so it's little wonder stock investors are exuberant. Markets in the rest of the world did not fare quite as well, with the EAFE (Europe Australasia and Far East) index up a third less than the S&P 500, the Pacific ex-Japan index up mid-single digits and emerging markets finishing negative for the year. The US stock market's performance belied continued slow domestic earnings growth, as stock prices climbed faster than underlying business earnings. By our estimates, stocks are presently at the upper end of what we calculate to be "normal" historical valuation ranges, but are far from extreme levels.

The bond market, which had been a relatively safe bet for most of the past three decades, actually did turn red in 2013, with the aggregate bond index down around 2%. Three factors contributed to the modest weakness in bonds: continued strength in the US labor market, signs of stabilization among the European economies, and the Federal Reserve's decision to begin to ever-so-gently rein in its runaway Quantitative Easing program. But while 2013 may be considered a "bad year" for bonds, it is important to keep in mind that a bad year for bonds is never as bad as a bad year for stocks.

Some have argued that 2013 was the year when asset allocation stopped working. An emphasis on stocks – US stocks in particular – was all you needed for high returns. We would take the opposite side of that argument: ***Asset allocation worked in 2013 the same as it has always worked.*** There have been years when stocks have performed best, there have been years when bonds performed best, there have been years when commodities or REITs performed best. The wheel spins, and sometimes the ball stops on red, sometimes black, sometimes the zeroes. Once in a while a "hot hand" develops and one asset class outperforms for an extended period of time. However, the changes in market leadership are often abrupt and not easily foreseen, with worst-to-first scenarios being surprisingly common (and vice versa.) Asset allocation is the process by which we balance our clients' risk tolerance against the potential reward for taking risks. Its ultimate purpose is *risk management*: smoothing the ride, spreading the bets, and investing for the long haul, not betting on the next spin of the wheel.

Looking forward, we anticipate a modest acceleration from the "slow and low" economic expansion we started talking about in 2010. The likely cause will be an uptick in business capital spending, as continued gains in domestic employment finally translate to capacity expansion. Also helping the economy will be an increase in government spending as parts of the mandated "sequester" budget cuts are reduced or overturned. This has negative long-term implications for the US budget deficit and related debt overload, but for now investors appear willing to turn a blind eye to such problems. Housing, which has been an economic tailwind for the past couple of years, will be less of a factor as higher mortgage interest rates quell demand from the marginal home buyer.

We expect stocks to outpace bonds this year, but do not expect last year's equity market gains to be repeated. Within equities we believe the European bourses may hold better value than US markets and are looking for opportunities overseas. Bonds have likely priced in a further reduction in the Fed's Quantitative Easing program, and given a lack of inflation pressures, we do not anticipate a substantial rise in interest rates in the very near term. After last year's gains we are not reducing our equity exposures in our asset allocation models, but given a more tempered outlook we are not recommending increasing them either.

With best wishes for the New Year,

Mitch Schlesinger
FBB Capital Partners

* We prefer the lower 2.7% house edge on a European table compared to 5.26% under US rules. And who wouldn't? Special thanks to FBB's Maggi Keating for her topical suggestion for this quarter's letter.