LYKE Financial Inc.

Investing Insight

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Surprise! No Selloff in 2013

The unusually strong performance of US stocks in 2013 was a welcome surprise for investors who are following a simple buy-and-hold strategy and a source of exasperation for many professionals caught flatfooted by the steady rise in share prices.

It was the best year for the S&P 500 Index since 1997, with a total return in excess of 32%. The size and value dimensions were even more rewarding: 2013 was the best calendar year since inception for the DFA U.S. Large Cap Value Portfolio, with the DFA U.S. Micro Cap Portfolio had its second-best performance in 32 years of operation.[1]

To some experts, it wasn't supposed to look like this. A Barron's cover story appearing in November, 2012 warned investors to "get ready for the recession of 2013." The title of a Time article on the outlook for financial markets that same month shouted, "Why Stocks Are Dead," in oversize type. A prominent economic forecaster who predicted the downturn in 2008 suggested that four elements—stagnating US economic growth, the European debt crisis, a slump in emerging markets, and military conflict in the Middle East—could combine and lead to a "superstorm."

Another prognosticator—and longtime Forbes columnist—ticked off a long list of worries, including a new wave of housing foreclosures, persistent government deficits, weak consumer spending, high unemployment, and unsustainable corporate profit margins. His prediction for 2013: "The S&P 500 Index drops to 800, a 42% decline." Others fretted about a deepening slump in China that could drag the rest of the world down with it.

Detroit's bankruptcy filing in July—the largest American city to do so—and the acrimonious debate over public finances in many cities and states suggested to some that a tectonic shift in municipal finance was underway with worrisome consequences. One prominent Wall Street researcher observed that "the aftershock of the largest municipal bankruptcy in US history will be staggering, and Detroit will set important precedents."

Individual and professional investors alike braced themselves throughout the year for a sharp selloff that never materialized. At times, the perverse reaction to rising prices was not delight but apprehension of an even steeper decline to come. On March 5, 2013, for example, the Dow Jones Industrial Average finally eclipsed its previous record of 14164.53, set in October 2007. But the *Financial Times* reported that the prevailing mood among veteran New York Stock Exchange floor traders was "more anxious than joyful."

Month after month, a Greek chorus of financial journalists recycled the same arguments we have heard regularly for the past several years: Economic growth is well below average, stocks are expensive relative to earnings, corporate profit margins are historically high and can only come down, earnings growth is too weak, asset prices have been artificially inflated by an expansive monetary policy, and so on. A sample of headlines that might have unsettled investors appears below:

January 12
"Rebirth of Equities Ain't Necessarily So," *Financial Times*

February 8
"Scant Pickup in Economic Growth Seen for 2013," *Wall Street Journal*

March 7
"Stock Market Defy Economic Woes," *Financial Times*

April 2
"Lesser Expectations: Earnings Hopes Dim for First quarter," *USA Today*

May 18
"Stock Market Optimism on This Scale Hard to Explain," *Financial Times*

(Continued on page 3…………)

[1] Past performance is no guarantee of future results.

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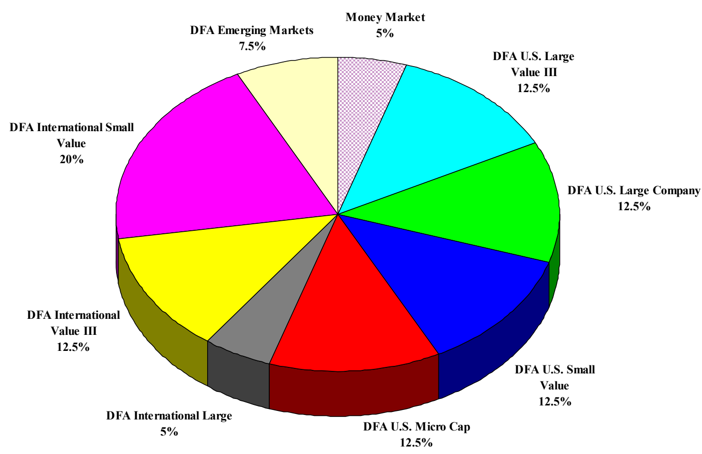
"That would look really good in my office."

Portfolio Returns: January 1, 2013—December 31, 2013*

AGGRESSIVE GROWTH

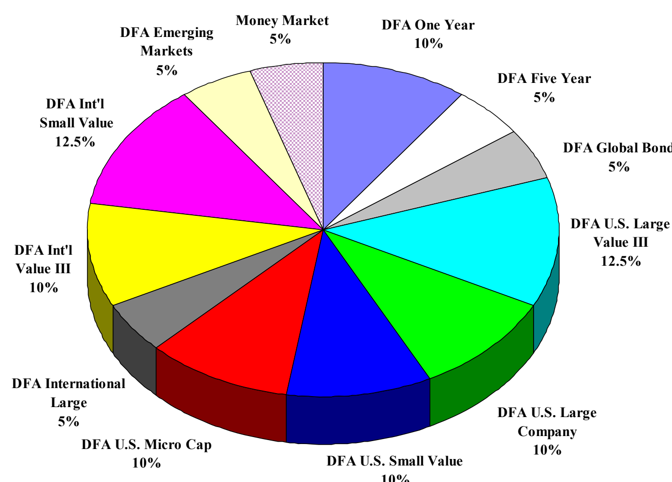
95% Equities/5% Fixed



Rate of Return 28.56%

LONG TERM GROWTH

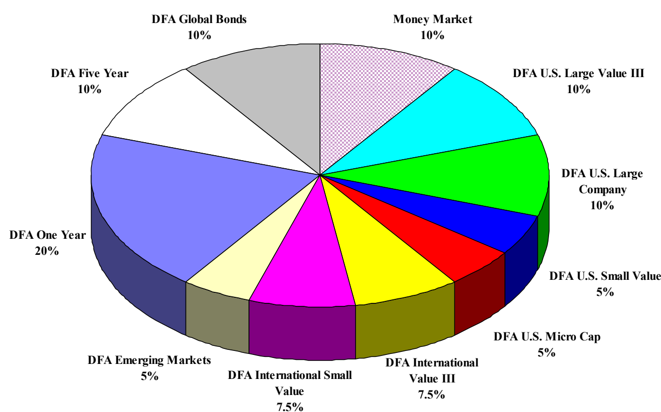
75% Equities/25% Fixed



Rate of Return 22.12%

BALANCED GROWTH

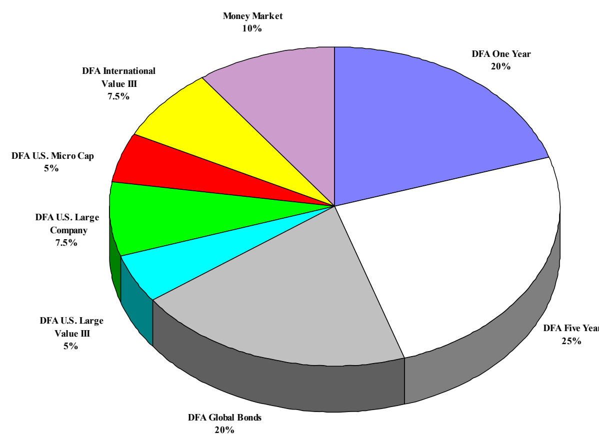
50% Equities/50% Fixed



Rate of Return 13.13%

INCOME & GROWTH

25% Equities/75% Fixed



Rate of Return 5.98%

*Individual returns may vary slightly based upon assets, size and fees charged, performance shown is net of fees. Performance shown reflects the reinvestment of dividends and other earnings. The returns shown represent past performance and are not indicators of future results.

July 7
"As Investors Rush in, Stocks Are Sending Warning Signals," *Wall Street Journal*

August 24
"Lofty Profit Margins Hint at Pain to Come for U.S. Shares," *Wall Street Journal*

September 18
"Profits Boost Needed for Wall Street's Equities Run," Michael Mackenzie, *Financial Times*

October 7
"Get Ready For a Drop in Stock Prices," Shefali Anand, *Wall Street Journal*

November 16
"Is This a Bubble?" Joe Light, *Wall Street Journal*

With so many economic hobgoblins to frighten them, many investors found it easy to dismiss more positive developments as unsustainable or irrelevant. Auto sales, for example, have been surprisingly strong in recent years, but investors could find plausible reasons for caution in 2013. A New York Times financial reporter observed, "After steady increases for decades, Americans are driving less. …Walking cities are growing faster than suburbs. And wherever people happen to move, they are buying smaller, more fuel-efficient cars. ...All this means that autos—one of the biggest industries in the United States—will not soon regain the explosive growth of the early 2000s."

Some Americans are indeed buying more fuel-efficient cars; electric-only Tesla luxury sedans are popping up in driveways in tiny neighborhoods across the country. But many other Americans are eagerly signing contracts for powerful full-size pickup trucks; light-duty truck sales were up roughly 20% through November, and the Ford F-150 continues to be the best-selling vehicle in America by a substantial margin. Last year turned out to be a rewarding one for shareholders of most auto manufacturers and suppliers as well.

SELECTED AUTOMOTIVE STOCKS: 1-YEAR TOTAL RETURN AS OF DECEMBER 31, 2013

Stock	Return
Tesla Motors (TSLA)	344.14%
Visteon (VC)	74.32%
Johnson Controls (JCI)	69.84%
Magna Intl (MGA)	66.61%
General Motors (GM)	41.76%
Paccar (PCAR)	34.64%
Cummins (CMI)	32.18%
Ford Motor (F)	22.24%

Source: Morningstar (www.morningstar.com), accessed January 2, 2014

What can investors learn from this year's market behavior? Most of us accept the idea that predicting the future is difficult. And predicting how other investors will respond to unpredictable events is harder still. But, for some of us, the temptation to engage in such efforts is irresistible. If only we could do so, we could be so much wealthier, have the satisfaction of outwitting other clever market participants, and make ourselves more attractive to members of the opposite sex. But results from this past year tell us we should be skeptical of our ability—or anyone else's—to do this well enough to outperform a simple buy-and-hold strategy. When investors are studying the long-run record of US stock market returns several years from now, we suspect many of them will find it difficult to recall exactly what it was that they were so worried about and discouraged them from pursuing the capital market rewards that were there for the taking.

Source: Down To The Wire by Weston Wellington, Vice President, Dimensional Fund Advisors

Is It Ever Going To End?

Much of the United States has endured periods of deep freeze these past couple months. Even states that usually have fairly mild winters have been subjected to Mother Nature's wrath of ice, snow and blizzard-like conditions. From the looks of the national weather map, as you read this, you're more than likely in one of them. *(Continued on back…….)*

Meeting Expectations

All DFA portfolios are designed to deliver "market rates of return." DFA is not trying to "beat" the market by employing crystal ball type strategies, only working to achieve market returns, historically outpacing 90% of the active managers who attempt to beat the market.

To evaluate your portfolio, it is helpful to look at the various DFA funds and **compare them** to the specific markets in which they are invested:

	01/01/13 - 12/31/13 Return*
DFA U.S. Large Co.	**32.33%**
S&P 500 Index	32.39%
DFA U.S. Large Value	**40.60%**
S&P 500 Value	31.99%
DFA U.S. Micro Cap	**45.06%**
Russell 2000	38.82%
DFA U.S. Small Value	**42.38%**
Russell 2000 Value	34.52%
DFA Emerging Markets	**-3.12%**
MSCI Emerging Market Idx	-4.98%
DFA Int'l Large Company	**20.69%**
MSCI EAFE Large Co Idx	19.43%
DFA Int'l Large Value	**23.38%**
MSCI EAFE Value	22.95%
DFA Int'l Small Value	**32.39%**
MSCI EAFE Sm Cap Index	26.40%
DFA One Yr. Gov't Bond	**0.34%**
BarCap 1-3 Yr. Gov't	0.37%
DFA Short-Term Gov't Bond	**-0.45%**
BarCap 1-5 Yr. Gov't	-0.12%
DFA 5 Yr. Global Bond	**-0.41%**
Citi World Bond Index	-4.00%

**Morningstar 12/31/13*

I remember as a youth the monstrous winter storm of 1977 and 1978. Sub-zero temperatures, hurricane scale winds and buckets upon buckets of snow. The massive wintery deluges led to highway closures, school and business closings, power outages and all sorts of related complications.

Of course, as kids, the near catastrophic impact of these storms was mostly lost on us; we loved it. School was replaced with sledding at Mueller Park, snowball fights and doubling down on hot chocolate.

The infamous Cleveland Superbomb storm of 1978 saw a blizzard with winds topping at 100 mph. A few weeks later, Boston experienced much the same with hurricane gale force winds at 110 mph.

Weather this extreme was a statistical anomaly (an outlier)—it was outside the norm of what you would typically expect….but it happened.

As an investor, winters such as the one we're experiencing are a reminder that market returns are much like weather patterns. We'll have periods of what's considered normal and expected weather conditions. And then events surface that seem well outside the norm.

The danger is acting on these anomalies as if they are somehow an indication of a new or unending phenomenon. For example, many investor in the late 90's thought technology stocks would continue to rise at a meteoric rate with little chance of falling back to earth. Even "professional investment managers" chased this sector in the hopes capturing significantly outsized returns over a more prudently diversified, broad market-based portfolio.

With the advantage of hindsight, we all know how the story ends: tech stocks plummeted in value. Much like the weather—market sectors, countries and certain asset classes will have performance periods where their returns are volatile and extreme. But, historically, time seems to guide the returns back towards their historic averages.

We should be mindful of the tendency to get caught up in what behavior psychologist called Recency Bias. Recency Bias is simply the expectation that what is happening currently will continue to happen in the future. As Warren Buffet said in 1999 to investors— "Investors project out into the future what they have most recently been seeing. That is their unshakable habit; looking in the rear-view mirror instead of through the windshield."

Source: The Advisor Lab

Economic Outlook 2014

As we begin 2014, the U.S. economy appears very much like an ocean liner, finding it very difficult to change either speed or direction. As the table illustrates, overall GDP growth rates, employment growth and consumption have all been stuck in a very narrow range for the last three years.

With little change in the 2% GDP growth rate, employment growth may not change that much, either. Slow growth, a wide output gap (a fancy capacity utilization measure) and a bumper farm crop should all keep inflation in check in 2014, though medical costs may rise faster than in 2013, bringing up the overall rate of inflation. With the Fed now officially tapering bond purchases, 10-year Treasury bond rates should move up to reflect the inflation rate plus a spread. Auto sales should continue to do well in 2014 with continued employment growth, new models, and an aging fleet. Unfortunately, auto sales are now approaching previous highs and the law of large numbers is beginning to set in, with year-over-year growth rates likely to slow.

Probably the biggest news in the fourth quarter was that the Fed would begin tapering its large $85 billion bond purchase program. This program was a truly extraordinary measure; never before has the Fed reacted so boldly and so beyond its sphere of short-term interest rates. Give extraordinarily tight fiscal measures and a slow-growth economy, the program was both helpful and necessary. With the economy at least a little better and an easing of the fiscal tensions, however, it was probably time for it to end. Markets had already anticipated the tapering last spring, and interest rates had previously made their move up. Further rate increases are possible, but the worst may be

Economic Outlook for 2014

	2011	2012	2013E	2014E
GDP	2.0%	2.0%	2.3%	2%-2.5%
Inflation	3.0%	1.8%	1.3%	1.5%-1.8%
Employment Growth (mo. avg.)	202,000	189,000	190,000	190,000
Unemployment Rate	8.5%	7.8%	7.1%	6.2%-6.5%
10-Year Treasury	1.9%	1.8%	2.9%	3.4%-4.0%
Auto Sales (millions)	12.8	14.5	15.7	16-16.5
Housing Starts (thousands)	624	830	925	1,050-1,100
Existing Home Sales (millions)	4.3	4.7	5.1	5.1

Source: St. Louis Federal Reserve. Numbers for 2013 and 2014 are estimates. These estimates are based on Morningstar calculations and economic analysis. They (and the opinions expressed in this article) are not intended to be used or interpreted as investment or financial advice. Please consult with a financial professional for advice specific to your situation.

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