# Registered Investment Advisor Firm

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## *Answer Forum*

Occasionally I receive feedback from the newsletters where typically the e-mailer (or caller) will have a question related to their particular circumstance or they just want an opinion on some form of investment they either own or are considering buying.

First, if you're one those that has taken the time to contact me with feedback or a question – thank you. As I receive various questions, I know many other readers may have the same or similar concerns and issues, so I thought it might be of benefit if I try and answer some of the questions in a very general sense.

Because my readership includes non-clients, I have a duty and obligation to not present market data or individual investment advice that may be misinterpreted or inappropriate for someone who's risk tolerances and investment objectives I'm unfamiliar with. That's why you don't see me discussing specific securities or in general graphing market performance or dividends and yields.

I know that a lot of individual investors tend to chase yield and past performance when trying to squeeze a little more out of their securities.

I have been asked what I thought about buying a 5 year bank CD in order to increase yield to meet income needs. As I write this, the yield on a 5 year Treasury is 1.65%, and a search of competing bank CD rates reflects (depending on the size of the CD) a rate of yield ranging from .60% to 2.30%.[1] is currently being offered.

In the not too distant past, this answer would have been simple as CD rates tended to trail other fixed income securities. Now, rates have started to creep up, so you have to ask yourself how you would feel if 3 years from now, after you've locked up your money for 5

[1] http://www.bankrate.com/funnel/cd-investments/cd-investment-results.aspx?prods=19

years with 2 years remaining, a 1 year CD might be yielding 3%? Part of that equation must include any penalties for early termination of the CD. Typically that penalty is 6 to 12 months of interest, but each issuing institution has their own set of rules related to the CD.

Some of you might have or are considering doing exactly this without contemplating what happens in a rising interest rate environment, or any penalties for early termination.

I also know that some "investors" manage their portfolios like "traders," and if you don't know the distinction between being a "trader" or a long-term "investor," you need to take the time to educate yourself before making your next trade.

When looking at the markets, it's always a challenge to try and find topical issues to write about on a monthly basis while still keeping the focus geared to a longer term time perspective.

Because markets can be volatile, writing these newsletters are particularly challenging for the months of December, March, June, and September. Why – because "earnings season" is a quarterly event and begin in January, April, July and October.

If companies disappoint, the markets tend to reflect that disappointment and because the newsletter must be written and finalized before earnings are reported, short-term market responses can appear incongruent with intermediate to long-term advice.

That explanation just addresses corporate earnings and does not consider geopolitical developments that are always waiting the wings.

I hope this helps answer and explain why I don't address specific securities, specific market performance or make market timing projections, except perhaps on a macro-level where there's a probability of a causal effect, like in the section below.

I'll try to make the Answer Forum a more frequent part of the newsletters if you think it would be helpful.

Of course, that requires your participation with feedback and your questions. Please don't be shy, it helps me and you might just be helping someone else.

## *The Fed Remains On Track*

The Federal Reserve (Fed) has indicated their intention to complete their Quantitative Easing (QE) program this October. Until then, QE continues but at a reducing rate.

As I mentioned in the Answer Forum, one of the wildcards that affects the markets are geopolitical risks. The US markets have shown tremendous resiliency in the face of world developments. In part, I believe this is due to the Fed reminding the markets that they do not detect any meaningful increase in inflation while continuing QE into October.

I've written here before that the Fed's QE actions are unprecedented, so trying to calculate with any reasonable sense of accuracy what the end of QE will mean to world markets is a challenge.

To perhaps get a better sense of the possibilities, we have to look to the past, and to interest rate hikes by the Fed.

The Fed has indicated that they intend to keep interest rates low for an "extended period of time" following the completion of QE.

However interest rate tightening does not occur in a vacuum, instead it's a result of the Fed seeing acceleration in economic growth. So it may be reasonable to view the end of QE as being very similar to a rate tightening by the Fed.

The Fed's inaction could cause interest rates to move higher. Again, as I've written in the past, rising rates will have a negative impact on fixed income (bonds) securities.

This is due the inverse relationship between fixed income prices and their rates of return. If you own a bond that is currently paying a rate of 3% a year and rates rise where new issues coming to market pay 5%, your bond will decrease in price and value on the open market should you decide you need or want to sell it.

Because of this negative influence on fixed income, it could result in a positive influence on equity markets (stocks) as the end of QE signals the acceleration of economic growth, and the Fed bond buying is simply not as necessary to stimulate the economy.

**Wait a minute, what's that I see in the punch bowl?**

Despite the encouraging signals from the Fed and the market's resiliency in the face of bad news from overseas, price to earnings (P/E) multiples are slightly higher than average. These multiples can be expected to be slightly higher in a low interest rate environment, but with the end of QE, interest rates should rise.

Because P/E multiples are just slightly higher than normal, they might not come under pressure right away, but they are also not likely to increase at the pace they have over the past few years either.

Future gains in the market are going to be harder to materialize as market valuations are becoming slightly stretched.

Let me be very clear I'm not making a prediction about a market correction (those are be expected, they're normal and healthy over the long-term), but valuations are getting a little stretched.

While it has always been the case that valuations in a bull market do not end at historical levels, the data indicates that future gains will be harder to materialize as we revert to the mean and normalized markets without QE, and with rising interest rates.

*Davis Investment Group*

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

Davis Investment Group custodies all client assets at Charles Schwab & Co. Davis Investment Group's home office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

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