Third Quarter 2013 Commentary

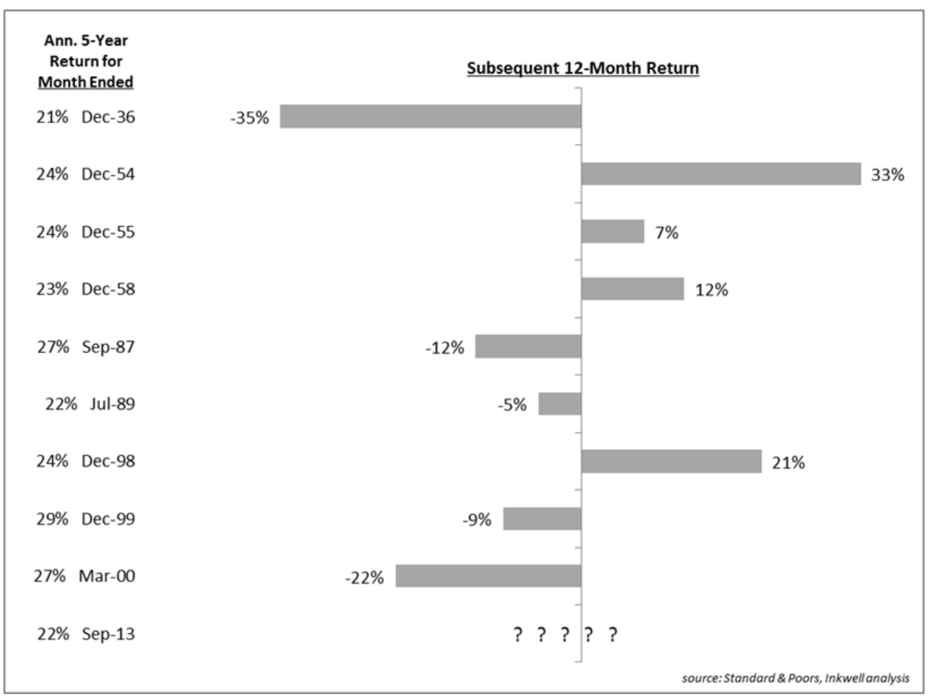
The stock market had another strong performance in the third quarter, making it three-for-three so far this year. After rising 10.6% in Q1 and 2.9% in Q2, the S&P 500 rose a further 5.2% in Q3, for a total year-to-date gain of 19.8%. The Dow Jones Industrial Average has also been rising, but not as quickly as the S&P: the Dow was up just 2.1% in the third quarter, for a total year-to-date gain of 17.6%.

Going back to the recent market bottom in March 2009, when the S&P 500 hit a low of 667, it has since risen 152% through September 30. This represents an annualized rate of 22% over the almost-five year period, significantly higher than the market's long-term annualized rate of return of about 11%.

Which got us to thinking… does that mean we're due for a correction? After such a large run, is the market ripe for a fall?

So we examined our S&P database, which goes back to 1927, looking for 5-year periods during which the index returned more than 20%. We found 10 such time periods, 9 historical ones plus the one we are currently experiencing.

Taking a closer look at those 9 previous periods of strong 5-year returns, there is no discernible pattern for how the market will perform in the ensuing 12-month period. As the chart below shows, 5 of the 9 periods did show market corrections over the next year, ranging from a slight decline of 5% to a collapse of 35%. However, the other 4 periods showed fairly healthy increases, from a modest 7% to a whopping 33%.



So does the current environment resemble one of the previous time periods more than the others? To our way of thinking, no. The first period, in 1936, was as the economy was climbing its way, through fits and starts, out of the depths of the Great Depression. The next three periods, all in the mid-1950s, were as the U.S. economy was on a tear following the end of World War II, with the influx of servicemen and women returning to civilian life. The late 1980s periods were following the defeat, at long last, of terrible inflation. And the late1990s were the peak of the Internet-related stock market bubble.

Today we are continuing to scrape and claw our way out of a deep economic hole, with interest rates still at rock-bottom levels (though they are starting to rise) and the Federal Reserve continuing to do everything it can to juice the flow of money through our economic veins. The only constant we can see comparing today's situation with the past is that our Congress is not behaving in the most trustworthy manner. We view the current renewal of the brinksmanship surrounding the government shutdown and debt ceiling as just one more in a long line of missteps by our elected leaders. Thankfully, our economy and our stock market are more dependent on our nation's thousands of companies than it is upon 535 individuals in Washington, D.C.

So, ignoring the perennial Congressional ineptitude, today's environment is unique, and it will probably see a unique result in terms of stock market performance over the next twelve months. Do we know what that performance will be? Absolutely not. We don't even have a guess as to which ballpark it will be in.

But we do know that some companies appear cheap relative to their intrinsic business value, and we will continue to buy those. And other companies appear expensive, so we will either avoid those or sell them. This strategy has borne good results for us so far, and it has been time- and battle-tested by others who have come in the decades before us.

As we continue to steer the S.S. Inkwell on its course through these uncharted waters, we are sincerely grateful to have like-minded clients on board with us.

In other news…

We also want to report that, not to be outdone by the rising market, Aaron's household increased by 67% during the quarter. On September 3, Aaron, Kari, and Isaac welcomed Colin Ripley and Nora Suzanne into the world. While Aaron has not slept in a month and his diet consists mainly of caffeine, he couldn't be happier.

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