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THE SEIA REPORT

Successful wealth management is the result of an ongoing collaboration between investor and advisor, built upon trust and maintained according to the highest standards of integrity and expertise.

2014 Q1 EQUITY MARKET OUTLOOK: "DO THE MATH"

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INTRO: ***Food for the (Left) Brain***

Analysts can value assets in many ways. For real estate, metrics such as Cost-per-Square Foot and Capitalization Rates are common. For equities, valuation ratios include Price-to-Cash Flow (P/CF), Price-to-Sales (P/S), Price-to-Book (P/B) and the lengthy Enterprise Value-to-Earnings before Interest, Taxes, Depreciation and Amortization (EV/EBITDA). However, the most common valuation metric may be the Price-to-Earnings ratio (P/E). To calculate a P/E, simply take the price of the stock (P) and divide by its annual earnings (E). For example, a stock trading at $120 that is projected to earn $10/share in the upcoming year is said to be trading at a 12 (Forward) P/E, or alternatively is said to have a forward P/E multiple of 12x. If investors collectively feel that a 15x P/E is warranted, the stock would then move north towards $150, even if the underlying earnings projections remain the same.

You might be wondering why I am leading off our quarterly newsletter with such an interesting and exciting topic such as math? While we have been bullish on equities for quite some time and still believe they will outperform bonds, investors need to be cognizant of the fact that we are up nearly 1200 points off of the 2009 lows. After a year in which global equities (ACWI) returned north of 20%, it might be wise for investors to take a breath and reassess the equity landscape—or to simply "do the math."

WHERE ARE WE: ***Elevated (but not extreme) Valuations Compared to History***

Similar to the P/E of an individual stock, investors can also value a group of stocks (or an index) in a similar fashion by adding up all of the prices as well as all of the earnings of the underlying companies and applying the same ratio. Why are we mentioning this now? Stocks finished the year at 1848 and subsequently crept higher, approaching 1860 in late February. At these levels, the S&P 500 was valued around 16 times projected 2014 earnings, which, while not at extreme levels, is elevated. Consider for a moment that the current P/E is well above the 5-year average (13.2), the 10-year average (14.1), and the 35-year average (12.6).

Bullish investors would argue that "averages" also include bear markets and that one should only compare to other bull markets. Fair enough. Research from Goldman Sachs reveals the stock market had an average peak valuation of 15 in the prior nine bull markets dating back to 1982. If you exclude the Tech Bubble (a time of extreme valuation), the average peak valuation is 14. And more recently, the three bull markets since 2006 have peaked out in the middle at around 14.7. It is also worth noting that since 1976, except for the era immediately surrounding the Tech Bubble (1997-2000 and a brief four-month period in 2003-04), the U.S. stock market has *never* traded at a P/E greater than 17.

HOW DID WE GET HERE: ***The TINA Trade***

continued on page 2

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2014 Q1 EQUITY MARKET OUTLOOK: "DO THE MATH"

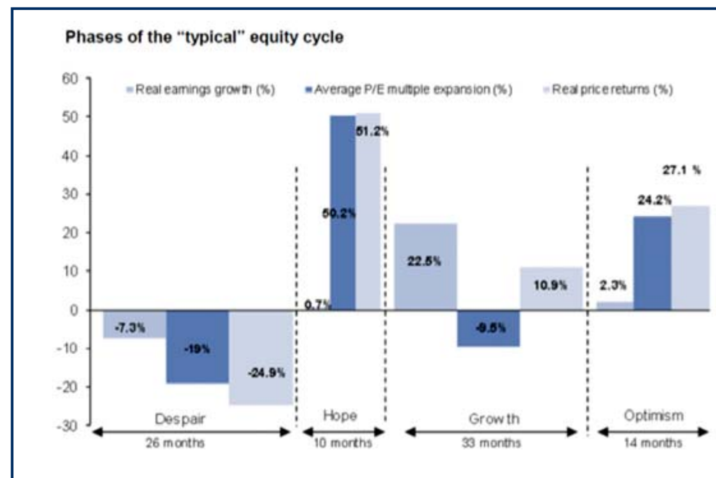
continued from page 1

Why are P/E multiples elevated? To simplify, stock prices (the "P") have risen faster than the underlying earnings (the "E"). So that begs the question: why did prices rise so quickly? While the environment on Main Street certainly does not feel like that of 1999, stocks themselves have had multiple tailwinds. Easy monetary policy combined with low input costs (stagnant wages) have resulted in very high profit margins. But perhaps more importantly, U.S. stocks benefited from a dearth of alternate investment choices, known as the TINA trade—buy U.S. equities as "There Is No Alternative". European equities were mired in a debt-crisis and recession until very recently. In the second largest economy, Chinese stocks are still off 4000 points (-65%) from their 2007 highs. Gold is off 650+ points (-35%) from its 2011 highs. And puny Bond yields are still unattractive relative to history. Thus, investors (including us) plowed money into U.S. equities, pushing prices ever higher.

WHERE ARE WE GOING: *2011-2012 Despair > 2013 Hope > 2014-2016 Growth?*

Bull markets don't abruptly end solely due to high valuation multiples; rather, bull markets typically end due to a policy mistake or recession. The good news is that we don't see either on the horizon. Equities can still head north, but the movement might be more muted and its reasons will be different from last year's gains. In 2013, over half of the market gain was attributable to a 2½ point rise in the P/E multiple from 13.4x to 15.9x (The S&P 500 total return of 32.4% can be broken down into 2.8% from Dividends + 11.2% from Earnings Growth + 18.4% from P/E expansion). While we don't see too much room in further P/E expansion, returns can be gained from dividends and earnings growth. Fortunately, investors in 2014 may finally witness the first synchronous global expansion since the onset of the crisis. This will then allow equity markets to transition to their next phase—Growth.

Consider the chart below, which outlines a "typical" equity cycle. The market may be transitioning from the period in which "Hope" and rising P/E's drove the market higher. In a "Growth" phase, stock prices move higher due to real earnings growth. A synchronous global expansion would go a long way in helping companies improve the bottom line. Europe's era of austerity is over. Japan's successful attempt to depreciate their currency is translating into a more competitive industrial export landscape. U.S. GDP is gaining steam, which should lead to better job growth and wage gains. And, manufacturing indices are improving throughout the world. Real global growth may be here. *(Investors don't need to look too far back to see evidence of earnings growth and its affect on valuations. From 2003 to 2007, the S&P 500 was up over 700 points, moving from 800 to over 1500. Yet near the beginning of that bull market, the P/E was over 16. From an elevated P/E, stocks were still able to rise as earnings growth outpaced the rise in stock prices. Thus, the P/E multiple actually contracted over the ensuing four year bull market).*



Finally, consider that U.S. equities are not an investor's only option in 2014. As we mentioned, Developed Markets overseas, such as Europe and Japan, are just beginning to snap out of their doldrums. Many equate their environment to the U.S. in recent years, when "Despair" morphed into "Hope". Developed Market indices are still almost 30% below their 2007 highs and valuations are much lower near 13.3. And for perspective, let's say indices need three more years to reach their pre-crisis peak (which then would total 10 years since 2007, equating to a "lost decade"), investors could still reap returns north of 11% per year.

Whether its earnings growth stateside or P/E expansion overseas, equity investors could still profit in the year ahead— albeit at a level most likely lower than the gains of 2013.

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Why Does Family Wealth Fade Away?

Many are the stories of family wealth lost. In the late 19th century, industrial tycoon Cornelius Vanderbilt amassed the equivalent of $100 billion in inflation-adjusted dollars – but when 120 of his descendants met at a family gathering in 1973, there were no millionaires among them.[1]

Barbara Woolworth Hutton – daughter of the founder of E.F. Hutton & Company, heiress to the Woolworth's five-and-dime empire – inherited $900 million in inflation-adjusted dollars but passed away nearly penniless (her reputed net worth at death was $3,500).[1,2]

Why, as the *Wall Street Journal* notes, does an average of 70% of family wealth erode in the hands of the next generation, and an average of 90% erode in the hands of the generation thereafter? And why, as the Family Business Institute notes, does only 3% of family businesses survive past the third generation?[1,3]

Lost family wealth can be linked to economic, medical, and psychological factors, as well as industry changes or simple fate. Yet inherited wealth may slip away due to far less dramatic reasons.

What's more valuable, money or knowledge? Having money is one thing; knowing how to make and keep it is another. Business owners naturally value control, but at times they make the mistake of valuing it too much. Being in control can become more of a priority than sharing practical knowledge, ideas, or a financial stake with the next generation. Perhaps a business owner simply doesn't have enough time in a 60-hour workweek to convey his/her know-how or determine outcomes that make sense for two generations. A good succession planner, however, can help a family business manage these concerns.

As a long-term direction is set for a family business, another direction also should be set for family money. Much has been written about baby boomers being on the receiving end of the greatest generational wealth transfer in history – a total of roughly $7.6 trillion, according to the *Wall Street Journal*. But so far, young boomers are only saving about $0.50 of every $1 they inherit. If adult children grow up with a lot of money, they may also easily slip into a habit of spending beyond their means, or acting on entrepreneurial whims without the knowledge or boots-on-the-ground business acumen of mom and dad. According to online legal service Rocket Lawyer, 41% of baby boomers (Americans now aged 50-68) do not have a will. Wills are a necessity, and trusts are useful as well, especially when wealth stands a chance of going to minors.[1,4]

Vision matters. When family members agree about the value and purpose of family wealth – what wealth means to them, what it should accomplish, how it should be maintained and grown for the future – a shared vision can be expressed in a coherent legacy plan, which can serve as a compass for wealth preservation.

After all, estate planning encompasses much more than strategies for wealth transfer, tax deferral, and legal tax avoidance. It is also about conveying knowledge and values. In the long run, nothing may help family wealth more.

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Emerging Markets: Is Now the Time?

By Vince DiLeva, MS, CFP®, AIF
Senior Partner

The U.S. economy has been improving over the last four years, and now the European economies are showing signs of stabilization and improvement, too. Meanwhile, many other parts of the world continue to struggle. The U.S. dollar is strong; global commodity demand is weak, and inflation is at a minimum. These factors, as well as others, have pushed emerging market equities and fixed-income prices lower over the last 12 months.

Most investors do not have significant exposure in emerging market equities, let alone emerging market bonds. This might be where an opportunity presents itself to investors. Most investors have flocked to U.S. equities in the last year and pushed U.S. markets to full valuation. With U.S. markets at all-time highs, it might be time to rebalance and invest a portion of the portfolio elsewhere.

The expectations are that interest rates will remain low and may go lower in the emerging markets. If global growth remains tentative, and we do not have inflation, it is unlikely that rates will move higher in the emerging markets. This might mean an opportunity to lock in yields in emerging market bonds at 5.5 percent to 6.5 percent while the 10-Year Treasury is around 2.7 percent today. If we have continued anemic growth in the emerging markets, and rates go lower, you could see price appreciation in those bonds that complements the yield. Over the next few years, as interest rates move higher in the U.S. and put pressure on U.S. bond prices, emerging markets will be an excellent way to diversify the fixed income portion of your portfolio.

The global economic recovery is showing some pockets of strength. The continued recovery in the United States and European economies should start to support growth in China and other emerging economies. In 2013 China's GDP data only showed a mild slowdown in comparison to that of 2012. It's expected that China's growth will continue to slow over the next few years as its economy continues to mature. But as global growth improves and commodity usage increases, those factors should improve the economies of such countries as China and Brazil.

For some investors, emerging equity and fixed income market declines can be viewed as opportunities to add these investments in a portfolio. They are a very volatile part of the market, but can sometimes be viewed as an opportunity, as those markets look like a value.

We will need improved global growth from the U.S. and Europe to pull the emerging markets with us. They will eventually rise with the tide, and I believe this opportunity is getting closer.

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Advisor in the Spotlight

In this quarter's SEIA Report, we would like to highlight David L. Johnson, CFP and his team in Tysons Corner, VA.

David has over 18 years of financial planning experience and focuses on providing objective and creative solutions to families and organizations, in addition to assisting clients with their investment and financial planning needs.

David has been a guest speaker at several industry conferences, government agencies, and public service organizations, including the U.S. Department of Agriculture and the American Red Cross. He has spoken about Asset Management, Retirement Distribution Methods, Estate Protection Strategies, and other relevant investment-related topics. David also spends a significant amount of time volunteering in the community and teaching financial literacy courses to elementary and middle school students through Junior Achievement.

A native of Northern Virginia, David graduated from George Mason University and holds a B.S. degree in Finance with a concentration in Investment Management and Corporate Finance. He completed the George Washington University Financial Planning certificate program and earned his Certified Finanacial Planner™ certification in 2001. David also is an active member of the National Capital Area Financial Planning Association. In his free time, David loves the outdoors and enjoys international travel, high-altitude mountain climbing, and running. David resides in Tysons Corner, Virginia with his wife, Sharon, and his son, Grayson.

David's Associate Advisor, Kyle C. Smith, CFP®, began his career in financial advising in 2006 and has been working directly with David and his clients since 2008. As an Associate Advisor, Kyle's mission is to provide a diverse range of solutions while focusing on an individual client's specific concerns and circumstances.

Kyle earned his undergraduate degree from Towson University with a B.S. in Finance and earned his Certified Finanacial Planner™ certification from the College of Financial Planning in 2013. Kyle holds the FINRA Series 6, 7, 63, and 65 professional securities licenses as well as Life, Health, and Variable insurance licenses (VA Insurance License #536072).

In his free time, Kyle enjoys playing and following sports as well as working on cars. He currently resides in Arlington, VA with his wife, Kim.

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SIGNATURE FUND *for* GIVING

By Marshall Smith
Operations & Project Manager

It was a very successful 2013 for SFFG. We raised almost $25k for our three local nonprofit partners: A Place Called Home, Toberman Neighborhood Center, and Children's Hospital of Orange County. These donations will be used towards educational, counseling, and mentorship programs, as well as a new heart monitor for CHOC.

Additionally, we raised almost $35k for nonprofits across the country. Our Partners, Advisors, and staff work with these organizations on a more individual basis. Our Signature Fund has raised over $150k in total donations since its launch in October 2011.

The holiday generosity of our Advisors—who donated $100 on behalf of each of our Private Client Group members to charities across the country—was a major factor of our success. For 2014, one of our main goals is to get all of our staff and clients involved, not only by donating money but also their time.

Thank you all for your continued support. We could not achieve such growth and make such an impact without you.

If you have any questions regarding our Signature Fund for Giving or about how you can get involved, please contact Marshall Smith at 310-712-2323 or msmith@seia.com.

Upcoming Events

A Place Called Home Presents
Stars and Strikes 2014
Celebrity Bowling and Poker Tournament

When: Wednesday, March 19, 2014 7pm-11pm
Where: Pinz Bowling & Entertainment Center
12655 Ventura Blvd., Studio City, CA 91604

For more information and tickets:
www.starsandstrikesforapch.org

Toberman Neighborhood Center Annual Gala
The Sky is The Limit
An evening honoring Hall of Famer Kareem Abdul-Jabbar

When: Saturday, April 5, 2014 6pm
Where: Manhattan Beach Marriott
1400 Parkview Ave., Manhattan Beach, CA 90266

For more information and tickets:
please visit www.toberman.org,
email gala@toberman.org,
or call 310-832-1145 x119

CHOC
Festival of Life

When: Sunday, May 4, 2014 11am-3pm
Where: Oak Canyon Park
5305 Santiago Canyon Road
Silverado, CA 92676

For more info about this event visit:
www.choc.org