A Quarterly Newsletter Bringing you Financial Insights from the Leaders

September 2013
Volume 6, Issue 3

# 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.*

# ALL COUNTRY WORLD INDEX (ACWI): A BETTER MOUSETRAP

**Deron T. McCoy, CFA, CFP®, CAIA, AIF®**
***Director of Investment Strategy***

A lot can change in six years. For example, in 2007, Apple launched its game-changing mousetrap (the iPhone); but that year also marked the beginning of the financial crisis. In October 2007, U.S. equity markets started to retreat from their recent all-time highs and markets fell into turmoil. It seemed, diversification was a lost cause as global capital markets moved in lockstep with one another—moving synchronously up or down and reacting violently to each ensuing crisis (Bear Stearns, Lehman, AIG, Fannie Mae, TARP, Greece & the European Debt Crisis, the U.S. Debt-Ceiling showdown and subsequent downgrade, etc.). From 1990 to 2006, equity markets had a total of 87 "all-or-nothing" trading days (i.e., >80% of the stocks within the S&P 500 move in the same direction), averaging five per year. From 2007 to 2012, there were 249 "all-or-nothing" days, averaging 41 per year! But time heals all wounds and as we get further from the crisis, global capital markets are becoming increasingly uncorrelated. Diversification is again becoming a meaningful and useful tool for investors, who need to upgrade their tools to enhance future investment selection.

When selecting investments, investors must have a basket of choices—otherwise known as indices. Unfortunately, many investors still quote the Dow Jones Industrial Average (DJIA). Much to my dismay, my father still quotes the index as my Granddad did before him. I understand that DJIA is the most celebrated and historic of all indices, dating all the way back to 1885. Though the DJIA may be good for history books, it is useless as an investment tool. Among its many problems, it represents only 30 stocks and is hardly a true representation of a country that has over 5000 public companies of meaningful size. Also, the DJIA is a price-weighted index—meaning a company's share price is the determining factor of its weighting within the index (normally, a stock's weighting is determined by either its size or its earnings). For example, 3M (MMM) makes up 5.60% of the DJIA. It has a market capitalization (market cap) of $80 billion with a current share price of $116. In contrast, Bank of America (BAC) is twice as large with a market cap of $156 billion—but makes up only 0.70% of the index because its share price is only $15. Thus 3M has 8x the weighting of Bank of America due to share price alone.

Investors clearly need a better mouse-trap. The S&P 500 is an improvement over the DJIA as it not only represents more stocks (500 vs. 30) but also weights stocks by size (larger companies with larger market caps have an automatic larger position in the index). Moreover, sophisticated investors can estimate earnings/share of all 500 companies (some analysts project $124 in aggregate earnings/share by 2015) and assign a valuation multiple (some analysts project

*continued on page 2*

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# ACWI: A BETTER MOUSETRAP

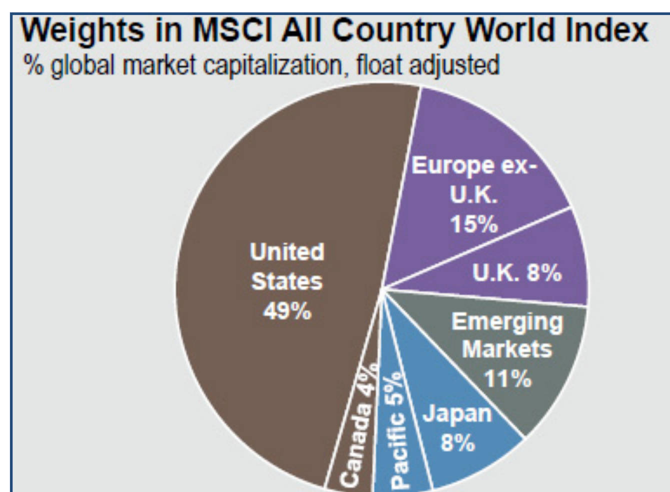
*continued from page 1*

Price/Earnings multiples will expands to 17) to come up with a projected index price level target ($124 x 17 = 2100 in 2015).

However, this index artificially constrains investment choices, as it contains only U.S. Large Cap companies and does not consider that 66% of global equities reside outside of the index. Other indices (Russell 3000, Wilshire 5000, S&P 1500, etc.) expand their scope to capture the entire U.S., yet still far short excluding overseas markets such as Europe/UK (which makes up 23% of the globe), EM (11%), and Japan (9%). With increased globalization, the rise of Emerging Markets (EM), increased news flow, and easier/cheaper access to global investments, a new benchmark (mousetrap) is needed to measure and quantify Planet Earth's equity opportunities. Enter ACWI.

The popular "MSCI All Country World Index" (ACWI) captures 85% of the globe by measuring the market performance of 2500 large and mid-sized companies in 24 Developed countries and 21 Emerging Markets. We can capture 99% through the lesser known "MSCI ACWI Investable Market Index" (ACWI IMI), which adds global small caps to the mix.

Why do we mention this now? We certainly are aware that the investment world is inundated with acronyms and that "ACWI IMI" doesn't necessarily roll of the tongue. Fortunately, this is not something you have to commit to memory. But you may hear these terms in the future as we believe that over the next leg of the business cycle, some of the largest investment gains may come from overseas and small cap markets (please see USA vs. Europe: Ryder's Cup-Investment Version). Although domestic large cap stock indices have outperformed most international indices over the past 5 ½ years, a lot could change in the next six years. To help enhance future investment selection, investors should add a couple more international acronyms to their investing repertoire.

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# USA vs. EUROPE: “Ryder’s Cup—Investment Version”

**Deron T. McCoy, CFA, CFP®, CAIA, AIF®**
*Director of Investment Strategy*

### Momentum vs. Valuation

In the two years since we recommended to buy U.S.A. (June 2011 newsletter, “Soft Patch be Damned—Time to get Patriotic”), the U.S. has been one of the leading equity markets and has outpaced both Developed and Emerging Markets (see chart below). From June 1, 2011 to July 31, 2013, the S&P 500 returned 31.41% while Developed returned 6.26% and Emerging lost over 13.98%. Momentum clearly resides in the U.S., but with the large run-up the more compelling valuations now may lie overseas.

At quarter’s end, the S&P 500 traded at a 14.2 forward Price/Earnings multiple, whereas Germany/France/U.K. all trade under 12. Emerging Markets are even more attractively priced at a sub-10 forward multiple (other valuation multiples like Price/Book, Price/Cash-flow, etc. paint a similar picture). But cheap stocks can stay cheap—a catalyst is needed to move prices higher. We believe that Europe may finally be at an inflection point; over a 3-5 year investment horizon, Europe’s valuations possibly could trump U.S. momentum.

### Potential Catalysts

We have been watching Europe for some time as the region has demonstrated attractive valuations combined with an investment landscape of improving earnings growth potential. If the political rhetoric improves and the leadership strengthens the European banking system, margins could normalize and earnings could grow. Slow moving politics, harsh austerity, and a lack of private-sector confidence, however, keep the continent from reaching its true potential. But the landscape is changing.

- *Leadership*: It has been one year since the head of the European Central Bank Mario Draghi told capital markets that the ECB would do “whatever it takes” to save the euro and effectively the European Monetary Union. While the underlying problems have not been solved, Draghi seemingly has bought enough time for politicians to act.
- *Politicians & Stimulus*: It has been four months since we learned that German Chancellor Angela Merkel’s austerity-first policy might be altered to rescue Europe from its debt crisis. As soon as the economic malaise hit Germany, Merkel had political cover to change her tone. The German government is backing away from its austerity mandates and is now planning to spend billions to stimulate ailing economies in Southern Europe. According to Der Spiegel, “The government's change of heart isn't just a sign of self-lessness and compassion. More than ever, the chancellor is worried that Berlin's tightfisted, heartless, austerity-obsessed image could solidify throughout Europe and do irreparable political damage.”
- *Economic Improvement*: Germany’s about-face has brought an effective end to austerity measures, translating into a 15-month high in Euro-area Economic Confidence. Within Germany, Consumer Confidence is at a seven-month high. European GDP (and the Goldman Sachs proprietary “Current Activity Indicator”) seemingly troughed late last year and is on the upswing. The Recession may end in the months/quarters to come. Improving economic conditions combined with easy monetary policy should contribute to accelerating earnings growth.
- *Attractive Valuations*: As Europe trades at a 15-20% discount to the U.S., investors may reap rewards as investment dollars rotate back across the pond searching for value.
- *Math*: The European Recession and resulting unemployment have been brutal on an entire generation. But if it takes another four years to get back to even, then European equities could add another 12% annualized return, going forward, for a total return north of 55%.

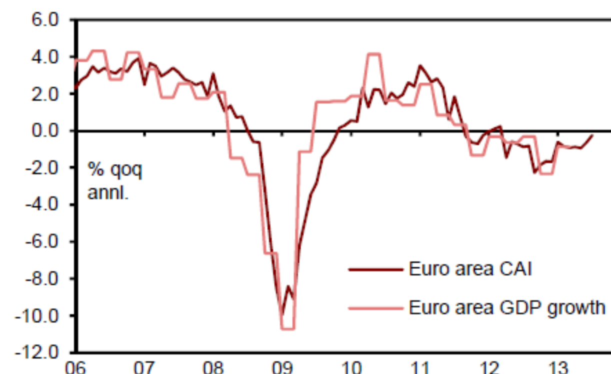
### Conclusion

Europe is intriguing and we see the same types of “green shoots” we saw in the U.S. in 2010 (stimulus, improving data points, attractive valuations, math, etc.). And like the U.S. in the years after the crisis, European stock prices could rise in a number of ways.

- Foreign investors could reengage (rebalance) in the continent by locking in U.S. gains and rotating into a cheaper asset class—causing stocks to rise.
- European investors, seeing the light at the end of the Recession tunnel grow brighter, could feel better and raise consumer confidence, which typically increases valuation multiples—causing stocks to rise.
- As growth finally replaces a long recession, earnings could power higher—causing stocks to rise.

While the risks in Europe are still elevated, the continent seems to be at an inflection point and the upcoming months and quarters may be a good time to overweight the region (How much? Consider that Europe makes up over 20% of the ACWI). However, stocks will not rise in a straight line and there may be fits and starts as smaller countries continue to make headlines (i.e. Cyprus). Indeed, Europe’s road back to normal will be bumpy, but at least it has a good roadmap—the good ol’ U.S. of A.

**Our Euro area *Current Activity Indicator* points to a contraction of 0.2%qoq annualised...**
Euro area GDP and Current Activity Indicator




*Source: Goldman Sachs Global ECS Research.*

# Investment Landscape: Rotation

## Annual Returns for Key Indices
## (1994 – June 30, 2013)

Ranked in order of performance (Best to Worst). Data Supplied by Morningstar Principia

| 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 (As of 6/30/13) |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| EAFE<br>7.78 | LCG<br>38.13% | LCG<br>25.43% | LCG<br>34.73% | LCG<br>38.16% | SCG<br>43.09% | SCV<br>22.83% | SCV<br>14.02% | Bond<br>10.26% | SCG<br>48.54% | SCV<br>22.25% | EAFE<br>13.54% | EAFE<br>26.34% | EAFE<br>11.17% | Bond<br>5.24 | SCG<br>34.47 | SCG<br>29.09 | Bond<br>7.84 | SCV<br>18.05 | SCG<br>17.44 |
| LCG<br>3.14% | LCB<br>37.58% | LCB<br>22.96% | LCB<br>33.36% | LCB<br>28.58% | LCG<br>37.38% | Bond<br>11.63% | Bond<br>8.43% | SCV<br>(11.43%) | SCB<br>47.25% | EAFE<br>20.25% | LCV<br>8.71% | SCV<br>23.48% | LCG<br>9.13% | SCV<br>(28.92%) | EAFE<br>31.78 | SCB<br>26.85 | LCG<br>4.65 | LCV<br>17.68 | SCB<br>15.86 |
| LCB<br>1.32% | LCV<br>36.99% | SCV<br>21.37% | LCV<br>31.87% | EAFE<br>20.00% | EAFE<br>26.96% | LCV<br>(0.51%) | SCB<br>2.49% | EAFE<br>(15.94%) | SCV<br>46.03% | SCB<br>18.33% | LCB<br>4.91% | LCV<br>20.80% | SCG<br>7.05% | SCB<br>(33.79%) | LCG<br>31.57 | SCV<br>24.50 | LCB<br>2.11 | EAFE<br>17.32 | SCV<br>14.39 |
| LCV<br>(0.64%) | SCG<br>31.04% | LCV<br>20.54% | SCV<br>31.78% | LCV<br>18.91% | SCB<br>21.26% | SCB<br>(3.02%) | SCG<br>(9.23%) | SCB<br>(20.48%) | EAFE<br>38.59% | LCV<br>15.03% | SCV<br>4.71% | SCB<br>18.37% | Bond<br>6.96% | LCG<br>(34.92%) | SCB<br>27.17 | LCV<br>15.10 | LCV<br>(0.48) | SCB<br>16.35 | LCV<br>15.73 |
| SCV<br>(1.55%) | SCB<br>28.44% | SCB<br>16.53% | SCB<br>22.36% | Bond<br>8.70% | LCB<br>21.04% | LCB<br>(9.11%) | LCV<br>(8.18%) | LCV<br>(16.59%) | LCV<br>30.36% | SCG<br>14.31% | SCB<br>4.55% | LCB<br>15.79% | LCB<br>5.49% | LCB<br>(37.00%) | LCB<br>26.46 | LCB<br>15.06 | SCG<br>(2.91) | LCB<br>16.00 | LCB<br>13.82 |
| SCB<br>(1.81%) | SCV<br>25.75% | SCG<br>11.32% | SCG<br>12.93% | SCG<br>1.23% | LCV<br>4.88% | EAFE<br>(14.17%) | LCB<br>(11.89%) | LCB<br>(22.10%) | LCB<br>28.68% | LCB<br>10.86% | SCG<br>4.15% | SCG<br>13.35% | LCV<br>1.99% | SCG<br>(38.54%) | LCV<br>21.18 | LCG<br>15.05 | SCB<br>(4.18) | LCG<br>14.61 | LCG<br>12.04 |
| SCG<br>(2.44%) | Bond<br>18.46% | EAFE<br>6.05% | Bond<br>9.64% | SCB<br>(2.55%) | Bond<br>(0.82%) | LCG<br>(19.14%) | LCG<br>(16.12%) | LCG<br>(28.10%) | LCG<br>27.08% | LCG<br>6.97% | Bond<br>2.43% | LCG<br>11.01% | SCB<br>(1.57%) | LCV<br>(39.22%) | SCV<br>20.58 | EAFE<br>7.75 | SCV<br>(5.50) | SCG<br>14.59 | EAFE<br>4.10 |
| Bond<br>(2.92%) | EAFE<br>11.21% | Bond<br>3.64% | EAFE<br>1.78% | SCV<br>(6.45%) | SCV<br>(1.49%) | SCG<br>(22.43%) | EAFE<br>(21.44%) | SCG<br>(30.26%) | Bond<br>4.10% | Bond<br>4.34% | LCG<br>1.14% | Bond<br>4.33% | SCV<br>(9.78%) | EAFE<br>(43.38%) | Bond<br>5.93 | Bond<br>6.54 | EAFE<br>(14.82) | Bond<br>4.21 | Bond<br>(2.44) |

- Large Cap Blend (LCB) = S&P 500
- Large Cap Growth (LCG) = S&P 500
- Large Cap Value (LCV) = S&P 500
- Small Cap Blend (SCB) = Russell 2000
- Small Cap Value (SCV) = Russell 2000 Value
- Small Cap Growth (SCG) = Russell 2000 Growth
- Europe Australia and the Far East (EAFE) = International index
- Bond = Aggregate Bond index

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# SEIA Trading

SEIA is happy to announce the formalization of our new Trading Department which will be lead by our current Head Trader Vince Reyes. Trading will now operate independently from the DIMES/Research department. Due to SEIA's recent surge, establishing an independent trading operation would undoubtedly serve our clients better. The primary focus is to get our clients the best execution possible which is a critical element in achieving their investment objectives.

Although most trades are done electronically, complex orders are handled personally by our experienced traders. Our traders have an in depth knowledge of market structures that help facilitate timely and efficient executions critical to fulfilling our client's objectives. SEIA's Trading Department is well versed in all asset classes including equities, mutual funds, bonds, and options. Our equity trading team has earned a premier reputation within the industry and with our clients.

Vince Reyes, Head Trader at SEIA s tarted his career with Dean Witter in 1991 after graduating from The University of California Riverside. He worked with Wedbush and Crowell Weedon from 1993-2007 as a NASDAQ Market Maker and Proprietary Trader. Vince works with traders Erik Soderberg in Orange County and Edward Troy in the Century City office. Recently, our trading department established a new trading partner, Morgan Stanley, and integrated the Bloomberg Terminal into our organization. Trading continues to provide the very best services by applying a combination of our years of experience, personal touch, and the most up to date technology.

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SEIA-08262013-00910

# Quantitative easing: How do I adjust my portfolio to benefit from the Fed's upcoming exit?

*By Gary K. Liska, MS, CFP®, AIF®*

For several years, the Fed has been stimulating the economy with an aggressive, unconventional monetary policy. Quantitative easing (QE), while controversial, has been effective in stabilizing the economy and job market in the aftermath of 2008's Great Recession. Case in point: The auto and housing sectors have stabilized, the Fed program has been profitable for bond and stock investors alike.

However, questions remain. The U.S. GDP has stalled at an anemic sub-2 percent growth rate and unemployment still hovers above 7 percent; the economy has recovered only 6.4 of the 8.8 million jobs lost (source: JP Morgan Guide to Markets, 6/30/13).

Historically, when the economy is standing on its own feet (without Fed support), three-month T-bills (now 0.15 percent) reflect inflation, which is currently around 1.75 percent, and 10-year Treasury bonds (now 2.50 percent) reflect real GDP + inflation, which today is 3.5 percent but is forecast to grow to over 5 percent in 2014.

If economic growth continues or picks up the pace, investors should expect a long journey northward in interest rates. In May and June the Fed announced it would consider "tapering" its asset purchases to reduce some of its easy money policies. While the eventual exit may be 12 months away, investors are already crowding the exits. The bond and stock markets reacted with trepidation: Stocks, bonds, gold and other commodities fell 5 percent to 15 percent in a matter of weeks.

But consider this: Should not investors rejoice that the Fed believes the economy is strong enough to be weaned off the stimulus measures implemented because of the Great Recession? We think so. The resulting uncertainty has increased risk premiums and new dislocations—but also new opportunities. Uncertain investors argue over the timing of the exit, but we see any further weakness as a buying opportunity in certain types of assets.

As other countries lag behind in their economic recovery, our advice is to reposition for the next leg in the U.S. recovery, by overweighting U.S. mid- and small-cap stocks while maintaining a focus to large caps with outsized exposure to domestic demand. For fixed income, we do not anticipate runaway inflation but do expect higher interest rates to dominate the investment horizon. Thus, bond investors should rethink their game plan and adjust to this new inflection point. Floating-rate bonds, bank loans, managed futures, equities with strong dividend growth, MLPs and REITS should be considered. Assets hoarded during the crisis should be shunned, and assets that were shunned should be reconsidered.

Tapering may begin by September, with an eventual exit next year. But short-term rates will be anchored near zero, as the Fed funds rate probably will not be raised until 2015. The Fed's "shot across the bow" gives investors time to adjust. So, with the rules of the game now changed, investors should reposition for the next leg of the bull market.

# SIGNATURE FUND *for* GIVING

*By Marshall Smith, Associate Advisor*

We are pleased to announce that through the generosity of our staff, advisors and partners here at SEIA, we were able to raise $5,000 in support of The One Fund.

Created by Massachusetts Governor Deval Patrick and Boston Mayor Thomas Menino, the purpose of The One Fund is to raise money to help those families most affected by the tragic events that unfolded during the Boston Marathon on April 15, 2013. For more information regarding The One Fund please visit their website at: https://secure.onefundboston.org

Also, it is with great pleasure to announce a new partnership with the Children's Hospital of Orange County. We look forward to many years of support and collaboration with our friends at CHOC. Please take some time to visit their website at www.choc.org to see firsthand the wonderful work they do and how you can help.

Our Signature Fund for Giving was created in 2011 to support local youth in Southern California. Since inception we have raised over $100k for both local and national non-profits. While we continue to work with our partners, A Place Called Home, Toberman Neighborhood Center, and the Children's Hospital of Orange County, we continue to strive to connect and grow with other nonprofits across the country.

*Thank you all for your ongoing support and contributions. For questions on how you can get more involved with our Signature Fund for Giving please feel free to contact me at 310-712-2323 or at msmith@seia.com*