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Economic and Market Commentary

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His hair was black as coal, eyes bright and alert, young Duleep Singh was small for his age, yet he carried himself with a dignity and composure that strangers recognized immediately. And why wouldn't he? After all, his father was the late Ranjit Singh, founder of the Sikh Empire, who had ruled most of the Indian subcontinent before his death.

Now young Duleep, a Maharajah himself, not yet 15, had just been released from prison and traveled 6,000 miles to Britain to begin a life in exile. But first he was charged by Lord Dalhousie, the newly appointed Governor General of India, with an important mission. That mission was to present to Queen Victoria, the Empress of India, one of the greatest spoils of war ever, the famed Koh-i-Noor diamond known as "The Mountain of Light."

The Curse of the Koh-i-Noor Diamond

The jewel's history is clouded in mystique and washed in blood. Some say its history dates back as early as 3200 BC to ancient Mesopotamia, while others trace its origins to the Kollur mines of India during the rule of the Kakatiya dynasty. Whatever its early origins may have been, by 1306, the stone was said to be cursed. Hindu text from the time recounts the lives of rulers who had owned the diamond as having suffered violence, murders, mutilations, torture and treachery.

"He who owns this diamond will own the world, but will also know all its misfortunes. Only God, or a woman, can wear it with impunity."

By the early 14th century, the famed oval white diamond had been cut to 186 carats and was the size and shape of a small hen's egg. At the time, it was the prized possession of the Rajah of Malwa. Alas, that ownership ended when the Rajah was forced to relinquish ownership to the ruler of the Kakatiya Empire in 1323. The Kakatiya Empire had stood for 250 years, yet months after taking possession of the diamond, it fell.

For the next 200 years, the diamond was the property of the Delhi Sultanate, which consisted of many Muslim dynasties that ruled in India. The Sultan's armies were comprised of Mongols, Turks, Persians and Afghan warriors and were most accomplished fighters. Yet their time too would pass. The Sultan of Delhi met defeat at the Battle of Panipal, when Prince Babur and his Mughal army defeated them in 1526. When taking possession of the Koh-i-Noor, Prince Babur claimed the stone was "worth the value of one day's food for all the people in the world."

The Mughal's rule was marked by violence and bloodshed. Sons of emperors rebelling and overtaking their fathers, brothers killing brothers, entire families wiped out. Eventually the Koh-i-Noor became the possession of Mughal Emperor Shah Jahan, who was famous for building the Taj Mahal. He had the stone placed into his ornate peacock throne.

Westerners were unaware of the stone's existence until 1665, when French traveler and pioneer jeweler, Jean Baptiste Tavernier traveled to India to open up the diamond trade there. His journals recorded seeing the diamond for the first time and declaring it the biggest in the world and gave it to a sobriquet, "The Great Mogul."

Next came the Persians who defeated the Mughals and stole the diamond in 1739. Persian King Nadir Shar was credited with giving the diamond the name it's known by today. Nadir Shar's Empire soon fell when he was assassinated, and the curse continued. The diamond passed to successive Persian rulers who were each dethroned and ritually blinded until Ranjit Singh took the Empire and the stone in 1800 and founded the Sikh Empire. The Sikh Empire eventually fell to the colonial aspirations of the British in 1849.

Once the British took possession of the stone, Prince Albert ordered it recut in 1852 to its current size of 105 carats which increased its brilliance dramatically. In 1936, the stone was set into the crown of the wife of King George VI, mother to Britain's current ruling monarch, Queen Elizabeth.

Today, many lay claim to the Koh-i-Noor, including the Taliban, who trace its origin in India through Afghanistan in ancient days. Indian Sikhs lay claim as having been the last owners before the British. As for the British, they argue that, since the stone has passed through so many hands throughout the centuries, they have as much right to it as anyone.

The Ultimate Symbol of Wealth

Diamonds are the only gemstones made from a single element: Carbon. Millions upon millions of years ago, deep below the earth's crust, extreme heat and pressure turned pure carbon into colorless diamond crystals. Through volcanic activity, these crystals were eventually brought closer to the earth's surface. Traveling through volcanic pipes known as kimberlite pipes, some of these dense masses of carbon atoms eventually made their way to the surface and were mined in areas that had that had experienced volcanic activity in the past.

For more than 5,000 years, diamonds have been mined in India along the rivers Krishna, Penner and Godavari. The ancient Greeks considered them "tears of the gods." Romans thought them to be "splinters from falling stars." The Hindus attributed so much power to diamonds that they placed them as eyes in the statues of deities.

Diamonds have been thought to bring luck, success, even heightened sexual prowess and have the ability to attract others. (Think "Diamonds are a Girl's Best Friend" from *Gentlemen Prefer Blondes*.) Plato wrote of diamonds as living beings, embodying celestial spirits. Medieval royalty valued them for their rarity, beauty and durability, even believing they could counter the effects of astrological events.

The very word diamond comes from the Greek word for “indestructible.” That’s why today most diamonds mined are used toward industrial purposes— cutting, polishing, grinding hard surfaces.

They are used to manipulate concrete, metal and ceramic and in surgical instruments, computer chips and eyeglasses.

Less than 20% of diamonds prove to be gem quality used for jewelry. Those used in jewelry are graded in a very scientific and exacting manner.

The Four Cs

Color

A one-carat diamond requires billions of carbon atoms to bond, and all of those atoms must be carbon to create a colorless diamond. The slightest deviation creates a colored diamond. A bit of boron makes a blue diamond, nitrogen makes a yellow diamond.

Diamond color is graded on an alphabetical scale using the letters D through Z. The colors D, E and F are considered to be completely colorless, with D being the best.

Cut

There are over 250 registered diamond cuts. The Heart, the Princess, the Oval, the Marquise, the Cushion and Pear, the Round Brilliant, just to name a few. When evaluating a diamond and grading its cut, one is not referring to the shape of the diamond but rather how it’s 57 facets (standard form) come together. Is the table (the top of the diamond) cut too wide or too narrow? Is the girdle of the diamond (its widest point) in proper relation to the crown (above the girdle) and the pavilion (the part of the diamond below the girdle) to ensure that all the facets are symmetrical, permitting more light to penetrate the stone and maximize its beauty.

Carat

Don’t confuse carat with karat, the unit measurement of gold. The carat refers to the weight of the stone. One carat is equivalent to a weight of 200 milligrams. In general, the larger the carat, the more expensive the diamond. Do keep in mind; however, a larger, low-quality diamond may be less expensive than a smaller high-quality one. The largest faceted diamond in the world is the Golden Jubilee, weighing 545.67 carats. It is a “fancy brownish-yellow color and fire rose cushion cut.” Roughly the size of a softball.

Clarity

The clarity of the diamond refers to a measure of the number and size of the tiny imperfections that occur in almost all diamonds. They are referred to as inclusions and blemishes. Examples of different types of inclusions are “clouds, knots, bearding, graining, cleavage and feathers.” Types of blemishes are “grain boundaries, nicks, scratches and pits.”

Many of these imperfections are microscopic and do not affect a diamond's beauty in any discernible way. Gemologists grade clarity under 10 times magnification. It is measured on a scale of I3 to FL. These are short for Imperfect Three and Flawless. Imperfect stones are ones with eye visible inclusions. Flawless stones, on the other hand, have no internal or external imperfections even when viewed under 10 times magnification.

Why is it diamond's clarity so important? Because inclusions and blemishes can inhibit a diamond's ability to transmit and scatter light, the very characteristics that gives diamonds their brilliance and sparkle.

Which now leads me to the intended purpose of this monograph, "shedding some light." Allow me to share some market perspective.

Perspective

The word perspective has its origins in medieval Latin's *perspetirum* from the stem of "perspicere," to look at closely. Its modern usage when applied to ideas has come to mean "the faculty of seeing all the relevant data in a meaningful relationship."

When reflecting on the equity markets for the year just past, 2014, one could mistakenly conclude that the broad-based markets were healthy and robust. Everything was going up, and everybody was making money. That is, everybody but you. After all, weren't the most common indices like the Standard & Poor's 500 and the Russell 1000 both up double digits? Even the Dow Jones Industrial Average was up more than 7%. Wouldn't it be safe to assume that these indices are there to give a clear indication as to the health of the stock market? If only it were true but, unfortunately, it's not.

To make sense of the equity indices, one needs to know how they are constructed and how they work. Armed with that knowledge, one can then better assess risk and the general health of the market. Let's look at the major indices one at a time, keeping in mind that there are more than 19,000 publicly-traded stocks in the United States and another 100,000 publicly-traded companies around the world.

Standard & Poor's 500

The S&P 500 was originally introduced back in 1923. It follows 500 large American companies and bases its formula on a market capitalization basis. What does that mean in English? It means that all companies are not treated equally but based on their size. Let me give you an example.

Apple Computer is the largest company in the world, with a market capitalization of approximately \$700 billion. (Market capitalization is calculated by taking the closing stock price of the company and multiplying it by the number of outstanding shares of the company.) They are innovators who produce hardware, software and control content, truly a world class company.

Goodyear Tire Company is also part of the S&P 500. This legendary manufacturer, named for Charles Goodyear, inventor of the first and most versatile of the modern “plastics,” vulcanized rubber, first opened in 1898. They employ 72,000 workers worldwide, sold over 40 million tires last year and have a fully-funded pension plan for their employees. Their market capitalization is approximately \$7 billion.

Since Apple is approximately a hundred times larger than Goodyear, Apple’s stock counts a hundred times as much as Goodyear’s for the purpose of calculating changes in the index. Contrary to many people’s thinking, the S&P 500 is NOT based on the average rate of return of all 500 companies.

The Dow Jones Industrial Average

The Dow Jones Industrial Average was first calculated in 1896 and is currently owned by S&P Dow indices which is majority owned by McGraw-Hill Financial (you’ll begin to see a pattern forming). It was created by Charles Dow, the editor of the Wall Street Journal at the time. It consists of 30 stocks and is a “price weighted index.” Let me give you an example of how it works.

Visa Corporation is a Dow Jones component. The company has a market capitalization of approximately \$140 billion, and its stock trades for approximately \$250 per share.

General Electric, founded back in 1892 by Thomas Edison, is also a Dow component. Its employees include more than 300,000 people around the world and it has a market capitalization of approximately \$260 billion. Its stock currently sells for approximately \$25 per share.

Since Visa’s stock sells for 10 times as much per share compared to General Electric’s, its returns count 10 times as much for the purpose of calculating changes in the Dow index, even though they are barely half the size of General Electric.

Parenthetically, GE is the only remaining company in the Dow Jones Industrial Average from the original components of 1896.

Russell Indices

The Russell indices are US-based indices first introduced in 1984. The Russell 1000 tracks the 1000 largest US companies. The Russell 3000 tracks the 3000 largest US companies, and the Russell 2000 tracks the bottom 2000 companies of the Russell 3000. Like the S&P 500, they are cap-weighted indices.

NYSE Composite

The NYSE Composite tracks 2000 companies, roughly 1600 of them American companies and 400 of them foreign companies. It was originated in 1965 and is based on a “float weighted market capitalization model.” In English, its market cap weighting excludes the shares of stock that are either government owned or closely held. In other words, it is a market capitalization

index based on those shares that could be available for purchase in the marketplace on any given day.

Wilshire 5000

The Wilshire 5000 was originally launched in 1974. It is a cap-weighted index of US stocks. It is currently tracking approximately 4000 stocks, and since 2004 has been managed by the Dow Jones company (remember the pattern forming?).

Let Me Bring It Home

It would not be unreasonable to ask, so what's wrong with cap-weighted indices? Don't they reflect capital concentration in the marketplace? The answer is yes, they do, and therein lies the danger.

Market cap weighting methodology is particularly vulnerable to volatile markets. What happens historically is as a sector comes into favor, the indices increase their representation to that industry. Think back to the year 2000, when technology made up 35% of the S&P 500. The tech bubble burst, and the market declined more than 40% peak to trough. If you had bought a NASDAQ index fund in 2000, you'd still be down 20% 15 years later.

Want a more recent example? By early 2008, banking and finance made up over 30% of the S&P 500. When the bottom of the market fell out, the major indices were down roughly 50% before bottoming out in 2009.

Remember the old adage, "the bigger they are, the harder they fall?" Few individual investors can withstand a 50% decline in their portfolio. (Don't forget, it will take a double or 100% return on your investments before you're back to even.)

So, if you're still with me and your eyes haven't glazed over yet, let me give you "perspective" on the broad-based market. Again, I'm going to reference indices. But this time, they're going to be equal weighted indices, indices where each component, whether large or small, counts the same. Apple and Goodyear count the same, Visa and General Electric count the same. All of the "cap" weighted indices have their "equal weighted" counterpart. Unfortunately for many investors, these equal weight indices are not often followed, which leads many an individual to momentum buying (chasing the hot dot) and ultimately much pain and loss.

Remember the Russell 3000 Index? It tracks the largest 3000 companies of the 19,000 publicly-traded companies in the US. For 2014, the Russell 3000 Index showed a 10.77% cap weighted rate of return, whereas the very same companies, when calculated on an equal weighted basis, returned 4.29%. This return rate is a far more accurate indicator of the real broad-based market returns US equities experienced in 2014.

Going Forward

Relative to long-term historical valuations, US equities are no longer cheaply priced since the market lows of 2009, S&P 500 P/E ratios are up some 50%. Stock market growth in 2015 will be much more a function of corporate profitability than valuation expansion.

Although I am generally optimistic for the US equity markets over the next 12 to 18 months, I'm also cautious. I anticipate continued and heightened volatility which will require firm-handed investment bias.

This coming year, we will continue to dampen volatility through the use of yield-based instruments while trying to avoid the overly bought fixed income market. We will maintain ample liquidity to be able to capitalize on favorable market entry points.

My goal for our clients continues as it has for the last 20 years—to protect wealth while earning a 7% to 8% annualized return over a three-to-five-year cycle with the least risk possible. If I'm to err, it should be by being overly cautious, not overly aggressive. I know I work for investors, not traders.

With Best Regards,

Ray Lent
RLL/dot
Enclosures