

Factors for Prosperity in 2013

lucky **13**
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Welcome to today's presentation- "Lucky 13- Factors for Prosperity in 2013" presented by Lyn Adams, CFP. Today's presentation is a continuation of our recent communications highlighting the significant improvements we are observing throughout different areas of our domestic and global economies. We'd like to spend a few minutes today to review how the investment markets fared in 2012 as well as provide our opinion on what may be ahead for 2013.

Important Notes

This presentation is for educational purposes only. Nothing we will talk about should be considered a recommendation to buy or sell any security. Many risk controlled investments are complex products and any specific product should be reviewed by you and/or your financial advisor before purchasing.

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Before we get started, a few disclosures include..

2012 Returns by Style

2012			
	Value	Blend	Growth
Large	17.5%	16.0%	15.3%
Mid	18.5%	17.3%	15.8%
Small	18.1%	16.3%	14.6%

For 2012, positive returns have occurred across all market caps.

Source: JPMorgan



Despite a lot of noise and distractions, (Fiscal Cliff, Eurozone debt crises, U.S. debt ceiling debate, concerns about Federal Reserve tactics, concerns about slowdown in China's growth, etc.) the stock market delivered strong returns in 2012.

2012 Return Comparisons

Equity	
• Emerging Markets	18.22%
• MSCI EAFE	17.32%
• Russell 2000	16.35%
• S&P 500	16.00%
• NASDAQ	15.91%

All stock categories had good results in 2012.

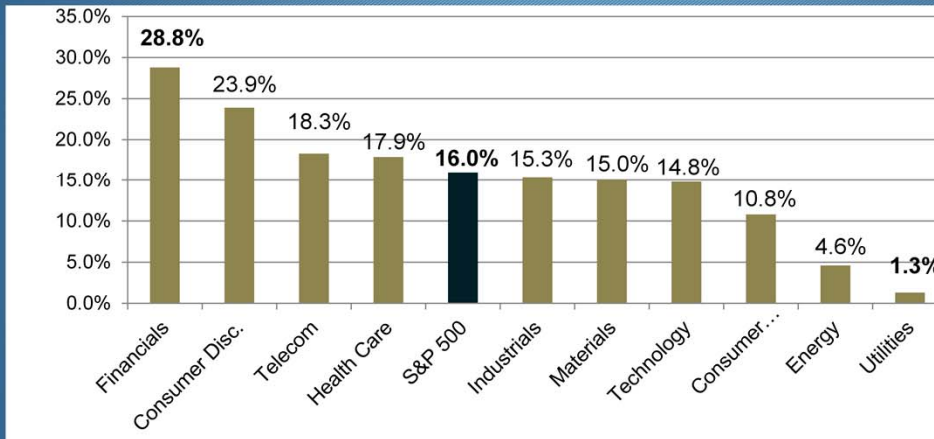
The narrow difference in returns demonstrates that all stocks have become very correlated, which makes it difficult to diversify market risks out of a stock only portfolio.

Source: Morningstar



Notice how similar the results are across various stock categories for 2012.

Sector Breakdown YTD 2012



Source: JPMorgan



Here is a look at the sector breakdown through the end of 2012. Financials led the way as they continued their bounce off lows in the 2008 financial crises. Utilities were the weakest as the average price for Utilities stocks remains well above historical norms. It is interesting that the sector that seems to be most unpopular with public investors produced the highest returns, while the sector that seems to be amongst the most popular with public investors produced the lowest returns.

Sector P/E comparison

Sector	Forward P/E	15-yr avg
Utilities	14.3x	13.6x
Technology	12.2x	23.8x

Source: JPMorgan

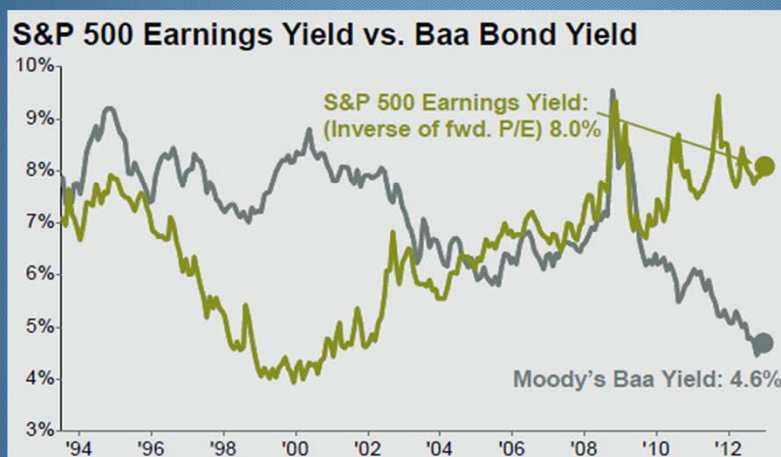


Lets look a little closer at this relationship between Utilities stocks and Technology stocks. The elevated interest in Utilities can be seen by the investment community pricing these stocks higher today than their historic average price/earnings ratio (14.3x earnings versus historical 13.6x). On the flip side, investors are only willing to pay 12.2x tech stock earnings today compared to historical 23.8x earnings.

We can come up with many reasons why investors have this preference (investors want the high dividend from utilities for income, the perception that utilities are “safer” than tech, people like the predictable nature of utilities cash flows over tech), but stop and ask yourself which one is a better value? Utilities cannot increase their profits without regulation. Utilities lose profits rapidly as interest rates rise because they are laden with debt. Technology advancements continue to drive extraordinary profits worldwide. Most large tech companies have tons of cash and very low debt.

Its interesting that many public investors are looking in the wrong direction for growth opportunities.

Earnings of stocks vs bonds



Source: JPMorgan



Here is another example of the exact same behavior. The earnings of corporations today represents about 8% of their total value. Hence the term “earnings yield”. The “earnings” on most corporate bonds (their dividend payout as a percentage of the purchase price of the bonds) is only about 4.6% if these bonds are held to their average maturities.

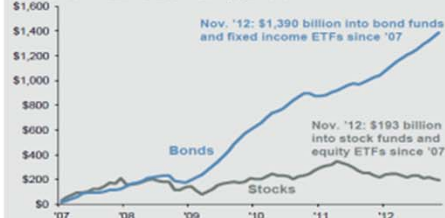
The clear public interest in bonds as demonstrated by continued flows into bonds is almost absurd given the low yields that is available today on bonds compared to the outflows public investors continue to remove from stocks at this time. Over long periods of time the divergence between S&P earnings yield and Moody's Baa Yield is much tighter than at present.

Fund flows in recent years

Billions, USD	AUM	YTD 2012	2011	2010	2009	2008	2007	2006
Domestic Equity	4,290	(130)	(132)	(81)	(28)	(148)	(65)	(0)
World Equity	1,562	7	4	58	28	(80)	139	149
Taxable Bond	2,832	244	136	230	311	22	97	45
Tax-exempt Bond	590	53	(12)	11	69	8	11	15
Hybrid	980	46	30	24	10	(26)	42	18
Money Market	2,617	(77)	(124)	(525)	(539)	637	654	245

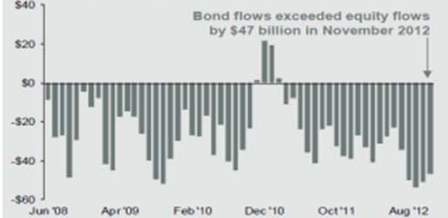
Cumulative Flows Into Stock & Bond Funds

Includes both mutual funds and ETFs, \$ billions



Difference Between Flows Into Stock and Bond Funds

Billions, USD, U.S. and international funds, monthly



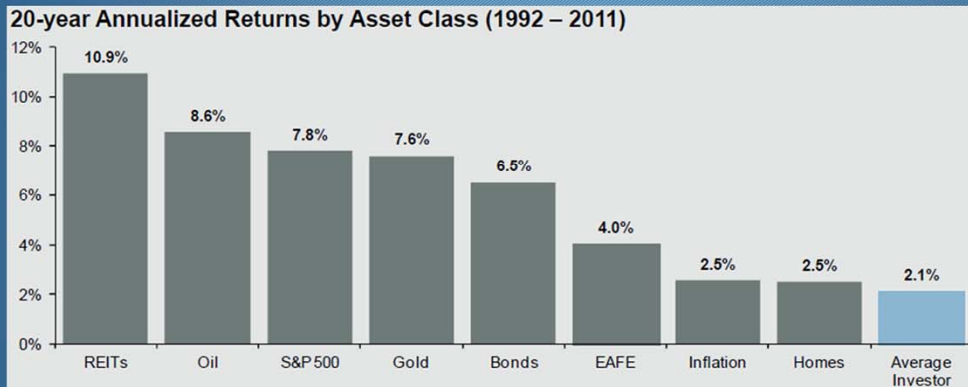
Source: JPMorgan



Flows out of stocks in the past 7 years have been over \$584 billion (and they really have not slowed down in the past 2 years while economic improvement is clear.) Flows into bonds for the same period have been well over \$1T (with a significant acceleration in the past year.)

There is an old saying, “investors can remain irrational longer than you can stay solvent”. This is a case where you don’t necessarily want to bet the ranch that the world will suddenly wake up and realize what they are doing does not make sense, but at the same time we should be looking for ways to take advantage of this dislocation. In our growth portfolios, we continue to add to low priced stocks on pricing dips while others are busy chasing the last dime of yield off the street bonds can offer before the giant steam roller of rising interest rates comes thru and creates some havoc in the bond world.

Success rate for average investors



Source: JPMorgan



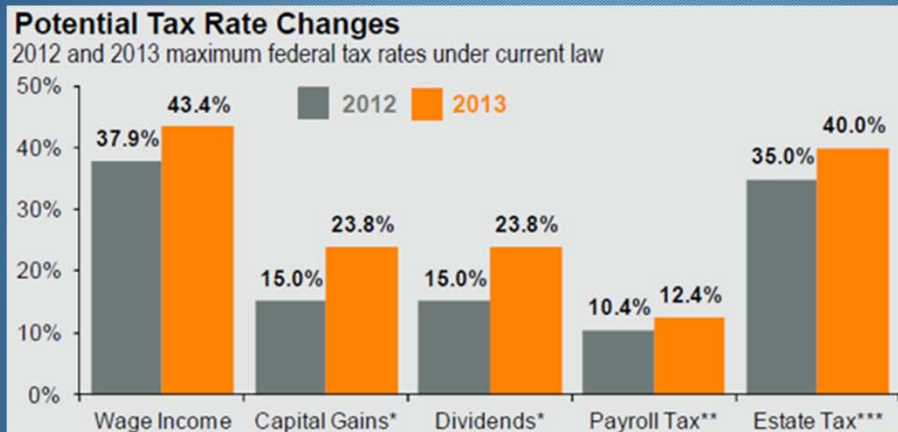
These behaviors we are highlighting are a significant part of the reason that average investors' actual returns end up so much below averages from the major investment classes. The public always seems to want to buy things when they are expensive and then sell them when prices fall.

Five Factors Favoring Stocks in 2013



Lets shift our conversation to talk a little about the future. Specifically our view on what will drive the market in 2013.

Factor #1 – Certainty on Taxes



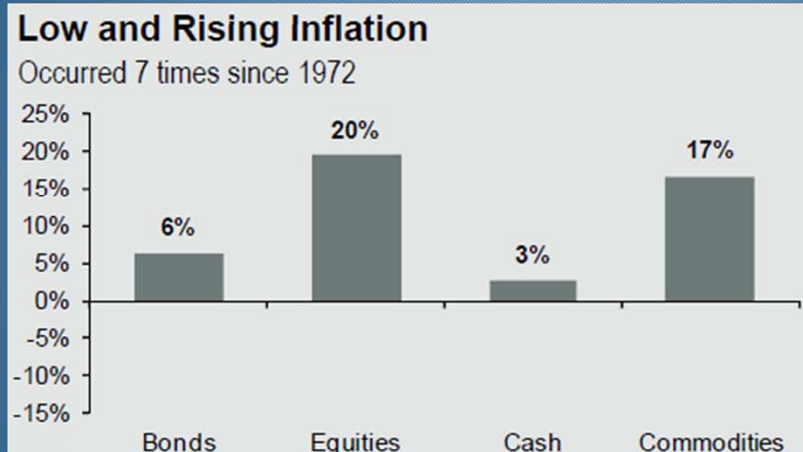
Source: JPMorgan



After many months of Washington antics, we finally got legislation on tax reform. The certainty of tax rates and rate thresholds helps solve many problems created for investors when there is uncertainty on these issues. Although the TRA2012 does not completely solve the government's long term sustainability issues, it is a significant move forward in passing something that begins to attack the long term fiscal problems in the U.S.

The fact that Congress was able to get tax law passed in such a politically polarized environment also gives us hope that the remaining budget items can be resolved. The more certainty we get on policy reform, the more we expect capital investments to flow from our cash rich corporations. Once they understand the rules, they can make decisions to deploy their monies intelligently for growth.

Factor #2 – Inflation



Source: JPMorgan



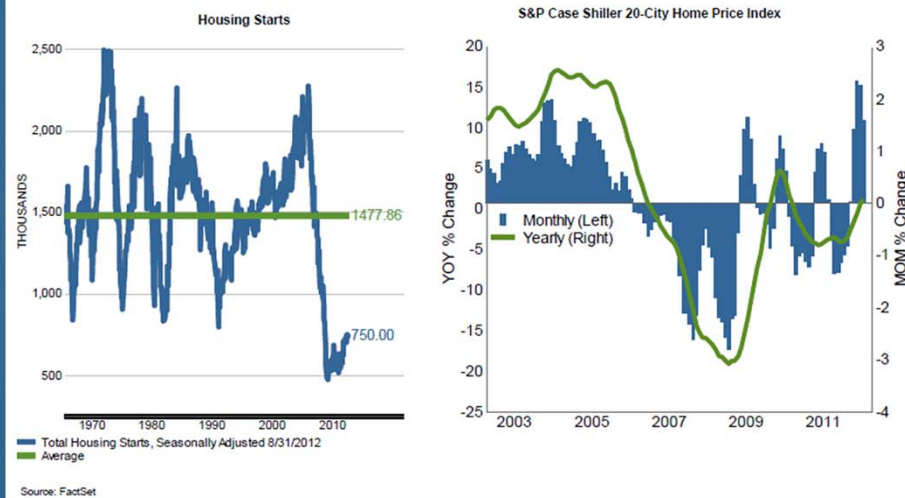
Inflation is often talked about in a negative light as no one likes to pay more for goods and services. However, the other side of inflation is the benefit of inflated asset prices for people who own the assets. Our Federal Reserve has enacted such dramatic inflationary measures over the past few years. We have not seen core inflation rise much because our nation's workforce is not being completely utilized due to lingering unemployment. It is nearly impossible to see headline inflation rise significantly without having wage inflation.

So, at this point we can see the effects near 0% interest rates and the trillions of dollars infused into the financial system through the Fed expanding its asset base (buying up all kinds of loans and mortgages) show up in the price appreciation of assets like stocks, bonds, commodities, real estate, and more. We just have not reached a point where labor is tight enough to create wage inflation. We see that still being 18-36 months off.

Here is a point that I'd like to make. I hear a lot of folks who are understandably upset about the Federal Reserve's policies and fear that we will experience significant inflation in the years ahead. What I do not understand is that it seems that many of these folks then proceed to sell their stocks and put their money in cash as if that is some sort of safe haven to defend against inflation. That is another example of irrational thinking. The chart here shows us the average returns by asset class during the last 7 periods of low and rising inflation in the U.S. since 1972. Stocks have generally been the best performing investment during a rising inflation period, not cash.

Factor #3 – Housing

When housing starts revert to normal activity, it could convert to approximately 3 million new jobs in construction and related industries.

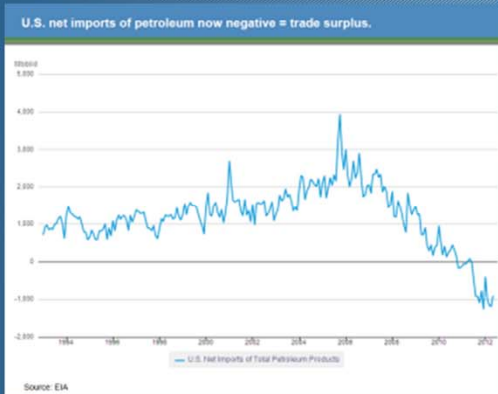


Factset shows the trend up in new home construction in the U.S. and Case Shiller shows us that prices for homes are trending up. Consider how much our economy has improved in the past 2-3 years with near zero support from the housing industry. We do not see Real Estate development and growth to return to long term averages in 2013, but we do think 1M new starts is a realistic number of new homes that will begin in 2013 given trending data and population growth. This could easily result in 500,000 new jobs in 2013 and an acceleration of our economy because of the velocity of money.

Consider the construction worker that is currently not employed or under employed that during 2013 will get back closer to full employment. He is probably driving around in a 7-12 year old work truck that he has been waiting to replace until he could get more work. Once he gets back to having more consistent work, what are the odds that he decides its time for a new F-150? And when he gets the new truck, how many jobs does that create at the Ford plant to make that truck. And when these factor workers now are getting plenty of work, what will they do with the extra money?

Real estate can have an extraordinary impact on job creation as well as impact real GDP growth. In 2013, we think this will begin to become more evident to investors.

Factor #4: Energy Independence



We do not hear much about the #1 job creating industry in the U.S. at this time in the headlines, but..

Source: EIA

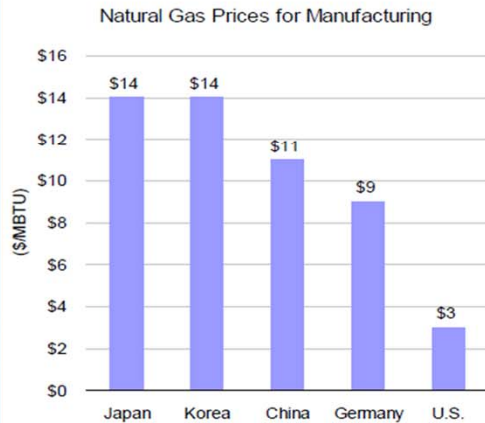


We've talked about this in our last couple of live events. I don't like to keep coming back to the same stuff, but this is a GAME CHANGER for the U.S.

Not only does abundant cheap energy available underneath our own soil eliminate shipping costs, military costs to protect shipping routes, provides jobs in extraction, refinery, pipeline, etc. It also significantly impacts manufacturing costs in the U.S.

Factor #5 Manufacturing Jobs

Low relative gas prices make the U.S. a very competitive location again for industries that use a high amount of energy such as chemicals, steel, paper or mining.



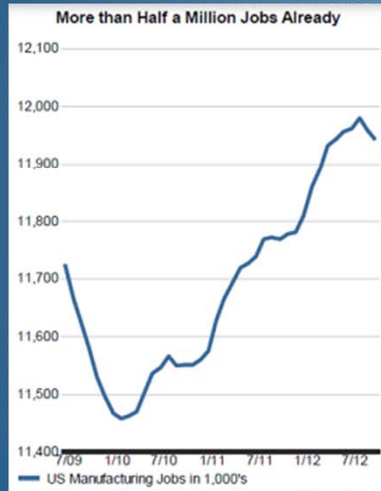
Source: ISI; data as of 07/24/2012.

- Exxon plans to build a chemical plant in TX to take advantage of cheap natural gas prices.
- Huntsman will expand production in the U.S. due to low natural gas prices.
- Petrochemical makers e.g. Dow and Shell, are adding capacity because of low-cost energy.
- Canada's Methanex will relocate a plant from Chile to Louisiana due to low natural gas prices.
- The tire manufacturers Continental and Michelin are moving production from Europe to the US.



Look at what cheap natural gas prices do to our cost of manufacturing compared to other manufacturing hubs around the globe. This is a long lasting competitive advantage that is beginning to influence major job creation in the U.S.

Factor #5 examples



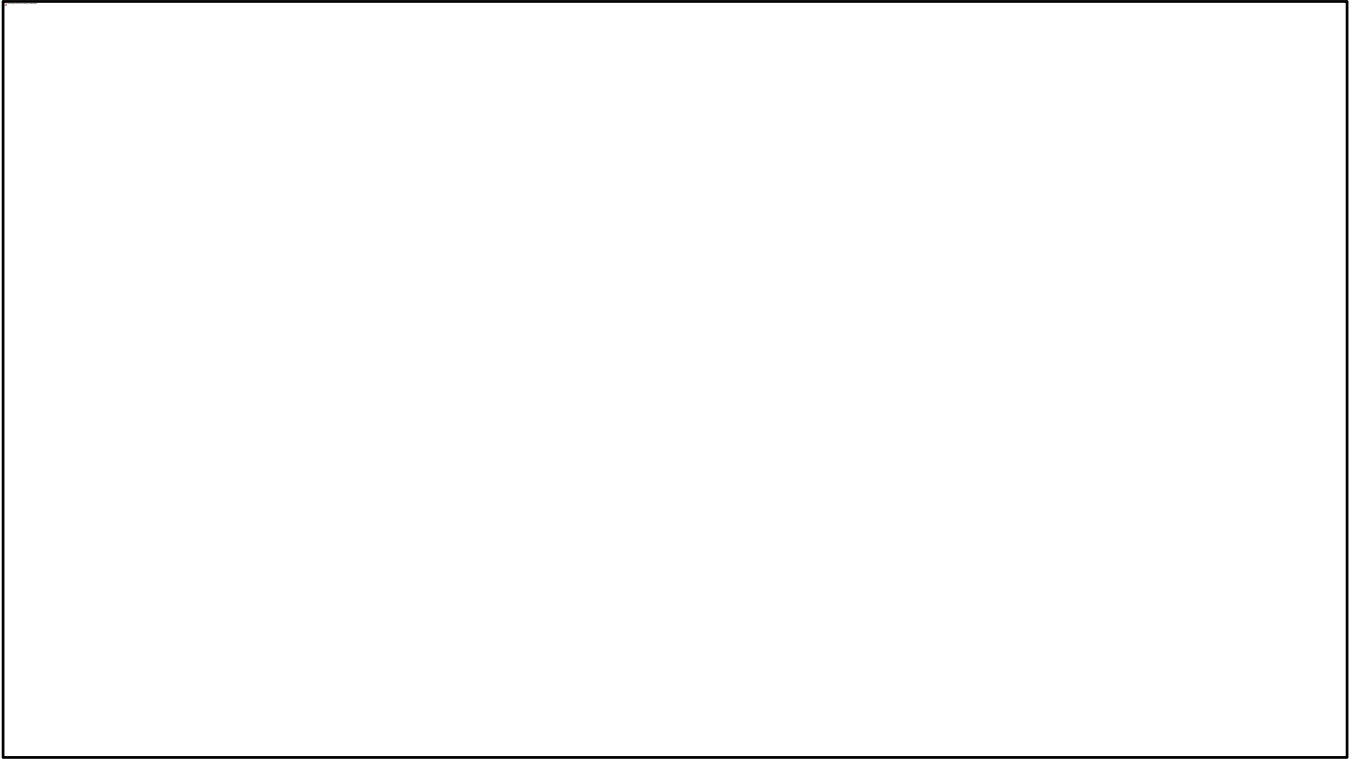
Countless Examples Across Sectors

Company	Clip
Airbus	Airbus will build a factory in AL. Assembling planes with nonunion workers and using dollars, Airbus will reduce costs.
Caterpillar	Caterpillar will build a factory in GA, and expand a manufacturing facility in SC to create 80 jobs.
Coleman	Moving its production of wheeled plastic coolers from China to Wichita, KS.
Continental	Spending \$524 million and adding 1,200 jobs as it builds a new tire plant in the US.
Electrolux	Electrolux plans to close its Quebec plant, and move to a new plant in Memphis to lower costs.
Element Electronics	Element Electronics is moving production of flat panel TVs to Detroit from China.
GE	GE is creating three new manufacturing and R&D facilities and will hire up to 650 in the US, and announced it will bring back 800 jobs from Mexico to KY.
Google	Google's new wireless home media player is being manufactured in the US.
Honda	Honda's choice to build its "supercar" in OH highlights confidence in the US.
Jacobs	Jacobs awarded \$1b contract for pipe manufacturing in TX.
Marinetek	Marinetek, a Finnish company, opened its North American headquarters in Florida and will create mfg jobs.
Maserati	Maserati will manufacture a car in Michigan.
Master Lock	Master Lock is moving production to Milwaukee from China.
Michelin	Michelin will invest \$950m and expand its Earthmover tire plant in SC which will create 800 new jobs.
Nissan	Nissan will increase production in Americas from 70% of vehicles sold in the region to 85%.
Norfolk Southern	Norfolk Southern expects to add 275 jobs with the \$160m expansion of a Ohio rail yard.
Otis Elevator	Otis Elevator is moving production to SC from Mexico.
Rolls-Royce	Rolls-Royce will build a manufacturing facility in Indianapolis to produce aircraft engines.
Siemens	Siemens closed its plant in Ontario, moving production to an existing plant in NC in part because of lower labor costs.
Stanley Furniture	Stanley Furniture shifted its crib manufacturing back to the US from China.
Starbucks	Starbucks taps US factory, not China, for its coffee mugs.
Toyota	Toyota to move production of Highlander to Indiana for export.
Volkswagen	Volkswagen hiring 800 US workers at its TN plant to meet demand for its Passat model, which will be \$8,000 less than the current \$28,000 model made in Germany.
Whirlpool	Whirlpool brought back production of KitchenAid mixers to the US from China.

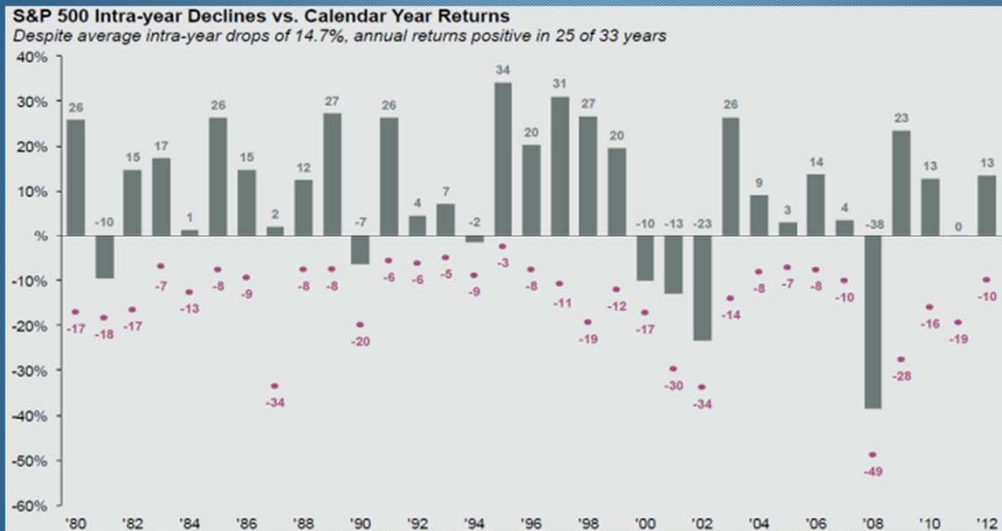
Source: ISI (left); FactSet (right).



This is really heating up. Look at the examples we see already in the re-emerging manufacturing industries in the U.S.



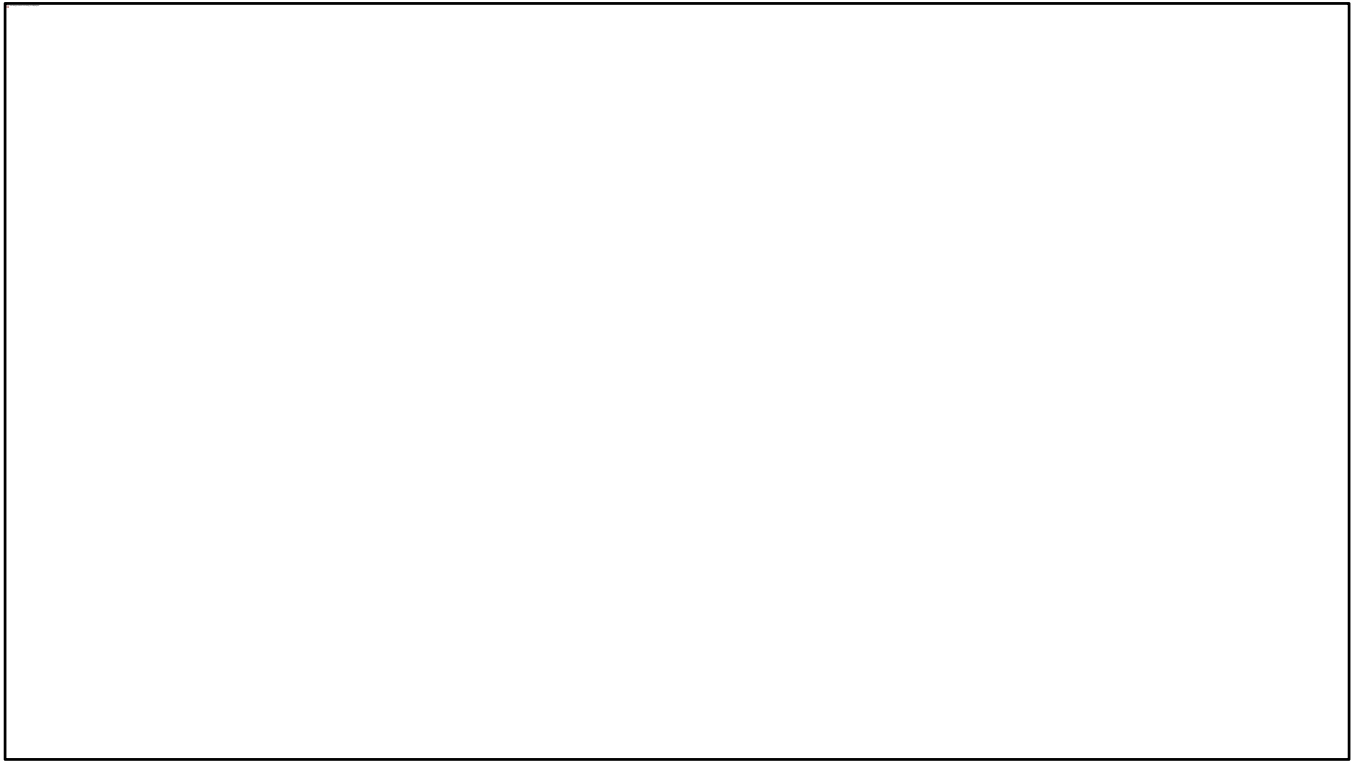
Still Expect Volatility



Source: JPMorgan



Even though things are improving, it would be wise to remember that volatility is part of the journey. It is the hassle we have to endure to make money with stocks in the long run. Be ready to look for additional monies to invest



Remember this is what a “bull market” feels like. Stocks quietly advance with ever improving earnings while the masses are out complaining about the latest political news. The media seeks daily what they can report that will be the next apocalypse because everyone is being told that the sky is falling. Good grief, according to even the Mayans, the world was literally supposed to end last month. Let the worriers worry. We need to stay focused on investment merits of the things we are buying, proper diversification techniques, taking profits as necessary, and patiently building portfolios.

