WEALTH MANAGEMENT, INC.

Weinstat Wealth Management, Inc.
516-621-3507 | MWeinstat@WeinstatWealthManagement.com

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Greetings,

Volatility is back in a big way. I have to watch CNBC each day because it is the business that I have chosen and I need to be informed, which benefits us both. Even though I am not an active trader, I always have to keep my eyes and ears open for buying opportunities for you and the rest of my clients. If I were not in the business, I would simply look at the statements from the custodian of the assets once a month, which would be my recommendation for you. I expect the market volatility to continue for awhile.

What I find more interesting than this day to day volatility is how misleading the market indices are in relation to investor returns. If you look at the return of the S&P 500, you might think that the average investor is doing well. That is not the case. I believe this is the worst year for mutual funds managers relative to the market since 2007. I read this morning that only 20% of active managers have returns that are better than the broad market. As badly as the mutual fund managers are doing, the hedge fund managers are doing worse. Just over two weeks ago, I read in the Wall Street Journal that the average hedge fund had a return (after expenses, a 2% management fee + 20% of profits) of 1 ½%.

In the September 22, 2014 edition of "Barron's", I read some more details of just how misleading the market returns are this year and why. While the broad market index is marginally off its record high, the average S&P 500 stock is down 7.2% from its high. The S&P 500 is a market capitalization-weighted index so this year it has been heavily influenced by the largest stocks, which are significantly outperforming smaller stocks this year. One third of the stocks in the Russell 2000 small cap index are down 10% or more this year. The average stock in the S&P 400 mid cap index has already corrected as it is down 11% from its high. The energy sector in particular has been a mess as the average energy stock from all the S&P indices is down 20% from its high.

You might be thinking, what does this all mean to us? I am not strictly a bottom line person so this information is relevant to me. Unless you are a passive investor (meaning that you have your stock market assets in index funds), this information is important to you also. It is a sign of a healthy market to have greater participation than there is now. Am I concerned about the lack of breadth in this market?

I am not happy about it. I would be concerned if my clients weren't doing well relative to the market that is for sure. The technicals of this market are not good. The technicians use charts to determine the direction of the market in the short term. The charts ostensibly give indications of the short term direction of the market. As a long term "investor", my focus is more on the fundamentals of the market and more importantly, the fundamentals of the individual holdings that I and my clients own. The fundamentals of the stock market and the economy are decent. The fundamentals of the corporations that essentially make up the "market" are pretty good. By far and away the most relevant factor for me is corporate profits and they were very good last quarter. As the domestic economy improves, I expect earnings to improve over the next two quarters. The problem is economies outside the United States. People like to complain about how lousy the US economy is and most of those complaints are valid. I look at the domestic economy as the tallest midget in the room. Compared to the world, in general, the US economy is significantly better. I find it a positive sign that we made it through earnings pre announcement season with very few earnings pre announcements. Last week two economic bell weathers, Nike and Federal Express both posted outstanding business results. The only head wind for earnings could be the strong dollar. A stronger dollar makes our exports more expensive and many multi national companies will have their revenues adversely affected because of currency translations. They will be adversely affected because when their products are sold abroad, the local currency is translated into more expensive dollars, thus lowering the company's revenues. My biggest concern is valuations. The stock market is far from cheap. Someone could make a case that given the low interest rate and low inflation (at least according to the government's numbers) environment, that stocks are reasonably priced. As long as corporate profits don't disappoint going forward, I can buy that case. Since much of the market gains over the past two years have been a result of PE multiple expansion, future market gains (for at least the next year) will be determined mostly by increases in corporate profits. I do know as a stock picker, my biggest challenge now is finding high quality companies at reasonable prices, although I have been finding some bargains recently.

I watched Richard Bernstein on CNBC on the morning of September 29. Mr. Bernstein many years ago was the lead "strategist" for Merril Lynch. That was before Merril Lynch was taken over/bailed out (you can call it a shot gun wedding) by Bank of America. While at Merril Lynch, Mr. Bernstein was quite cautious during a bull market. Now Mr. Bernstein runs his own company so he is very optimistic/bullish on the stock market. On the morning of September 29, Mr. Bernstein made some astute statements pertaining to this market. He stated that when the DOW drops by over 100 points in one day (that is only 2/3 of 1%), many investors are ready to run for the hills as if it is the second coming of the collapse of Lehman. He then pointed out (correctly) that Lehman (and the stock market) collapsed just over six years ago. The conditions that caused the collapse at that point in time simply do not exist now. Yet, market psychology is still so fragile that many retail investors are fearful that they will lose much of their money after just a few bad days in the market. I have said it once and I will say it again, 3-5% pull backs are normal. 10% corrections are normal. The fact that the market has not had a 10% correction in three years is NOT normal. A 10% correction is part of the stock market cycle. I don't know when it will happen but I know that it will, most likely sometime next year. Occasionally, I listen to some talking heads on CNBC chat about complacency in the stock market when the indices reach all time highs. I have very little idea what these people are thinking since this continues to be the most hated bull market ever. Markets at all time highs don't equate to the public being complacent. If anything, when I chat with investors, I hear as much fear and skepticism as I have heard over the past several years, despite great returns. That is one of the reasons why I remain optimistic with the stock market. I don't believe that the stock market returns over the next 5 years will approach the returns of the past 5 years. That would be unrealistic and I will elaborate on that in the next investment letter.