A Multi-Dimensional Market

An important skill shared by many successful investors is the ability to think critically. We describe the stock market as a complex, adaptive system that requires approaching most issues from a three dimensional perspective as opposed to a linear one.

It is wise to challenge any claim made by market prognosticators and fully investigate the opposite position. Most often you find kernels of truth in both. Point in case is the current debate regarding profit margins.

At first blush it seems obvious that **profit margins** are extended and are at risk of reverting to the mean (see chart). In fact, in past newsletters we have pointed to this risk as something to be worried about. But there are strong arguments supporting a secular change in profit margins. Research by David Bianco, chief equity strategist at Deutsche Bank, and others **have shown that much of the increase is due to two factors. First, the increased weight of the technology sector in the S&P 500, a sector that usually carries the highest profit margins, and second, the increased proportions of overseas profits, which benefit from lower corporate taxes.**

All we have to do is look in our portfolio for confirmation of this theory. One of technology's biggest success stories, Google, operates with net margins around 22% and an overall tax rate in the high-teens which is much lower than the prevailing U.S. corporate tax rate. Companies like Google structure their global businesses to minimize taxes, a legitimate and legal practice that nonetheless has recently been criticized by several politicians.

An additional contribution to high profit margins has been low interest rates. Many companies have taken advantage of record low rates by increasing long term debt and will be much less sensitive to any future rate increases. However, this condition mostly applies to blue chip companies. Many U.S. businesses are highly levered and will suffer when interest rates rise.

We will continue to follow this debate. Most likely, profit margins will soften at some point but will not fall dramatically. It is worth pointing out, however, that corporate profits have stagnated. According to Zacks, profits in dollar terms were actually lower in the third quarter than the second quarter. The only reason per share profits rose was the widespread use of share buyback programs. Expectations for profit growth in 2014 are currently rather high. Analysts are forecasting that companies in the S&P 500 will grow earnings per share by 10.9% in 2014, leaving plenty of room for disappointment.

As we have mentioned in recent newsletters, steeper valuations have caused us some concern and we have sold or trimmed some positions we felt were overvalued. As more and more investors and strategists move to the bullish camp it will get more difficult to find undervalued and perhaps even fair valued opportunities. If earnings growth continues to remain sluggish the upbeat expectations for future earnings performance may fade and the momentum of the market with it.

Wishing you a Happy Thanksgiving.

Jim Tillar, CFA *Steve Wenstrup*

WE'RE MOVING

AS OF DECEMBER 1ST, 2013 WE WILL BE MOVING TO A NEW LOCATION NEARBY

OUR NEW ADDRESS IS:

1065 E. CENTERVILLE STATION RD.
DAYTON, OH 45459

• OUR OFFICE IS LOCATED NEAR THE INTERSECTIONS OF CLYO RD. AND FRANKLIN ST. ACROSS THE STREET FROM ST. LEONARD'S (FRANKLIN BECOMES CENTERVILLE STATION RD. EAST OF CLYO RD.)

• ALL OTHER INFORMATION REMAINS THE SAME.

• WE HOPE YOU WILL TAKE THE TIME TO VISIT