DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q1 2013
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Bienville Model

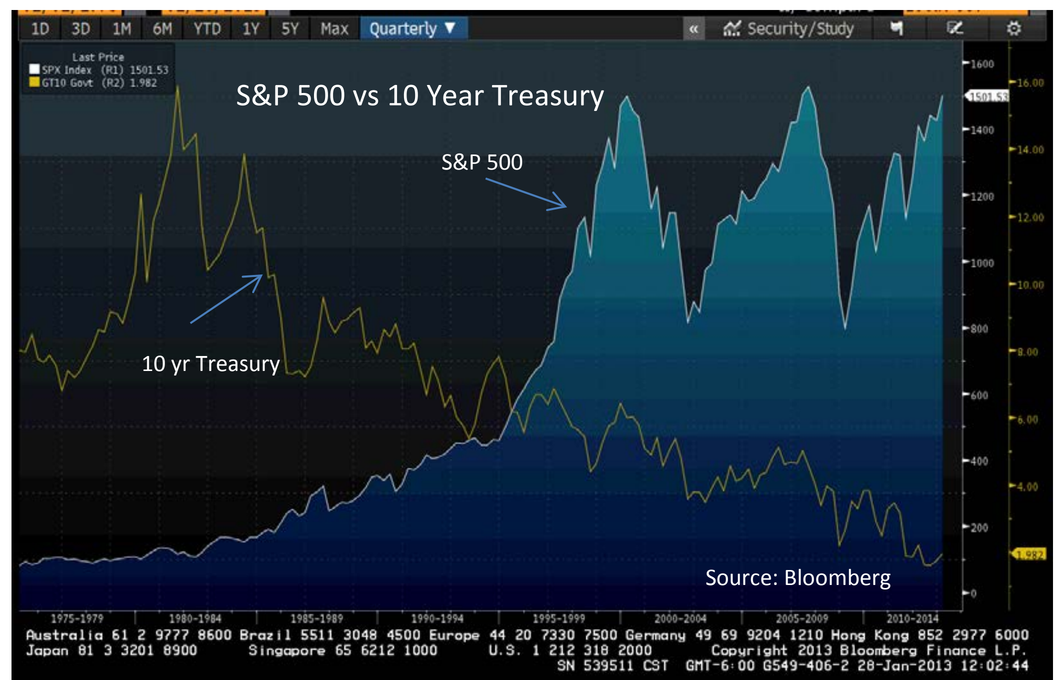
January 2013

Over FED

"In a crisis, be aware of danger—but recognize the opportunity." – John F. Kennedy

As investors take *stock* and turn the page on another year, they once again have the opportunity to start anew. Remembering the key lessons of the recent past is imperative to understanding how assets need to be positioned for future success. 2012 was a year when complacency replaced volatility, the Federal Reserve went from being the buyer of last resort to the buyer of first resort, and efficiently priced asset classes became hyper-efficient. Previously existing pockets of inefficiency disappeared and the associated *Windows of Opportunity* began to close. In an ironic twist, the old 'risk-off' trades such as Treasuries became the new 'risk-on' trades as their yields hit and hovered at 250-year lows, all but assuring declines in principal values when rates begin to rise. Equities were viewed as the new 'risk-off' trade as cash flow starved investors sought refuge in the dividend yields of blue-chip stocks (see chart below), driving major market indices within shouting distance of all-time highs.

While this may sound similar to an episode of "The Twilight Zone", such is the bizarre world in which investors find themselves as the new year begins. So far, 2013 is gearing up to be a year where cash flow is king. The rules of traditional, prudent asset allocation have been turned upside down as investors have increasingly abandoned their preferred habitats in a quest to find more yield. As a result, simply buying the market because it is the least bad alternative and hoping for the best is a path fraught with danger. To use an analogy, generating portfolio excess return is akin to picking up loose change in front of an oncoming steamroller. However, there will be opportunities, so it will be incumbent upon investors to understand the past, realize where markets and the economy are today, and proceed with caution in the future.

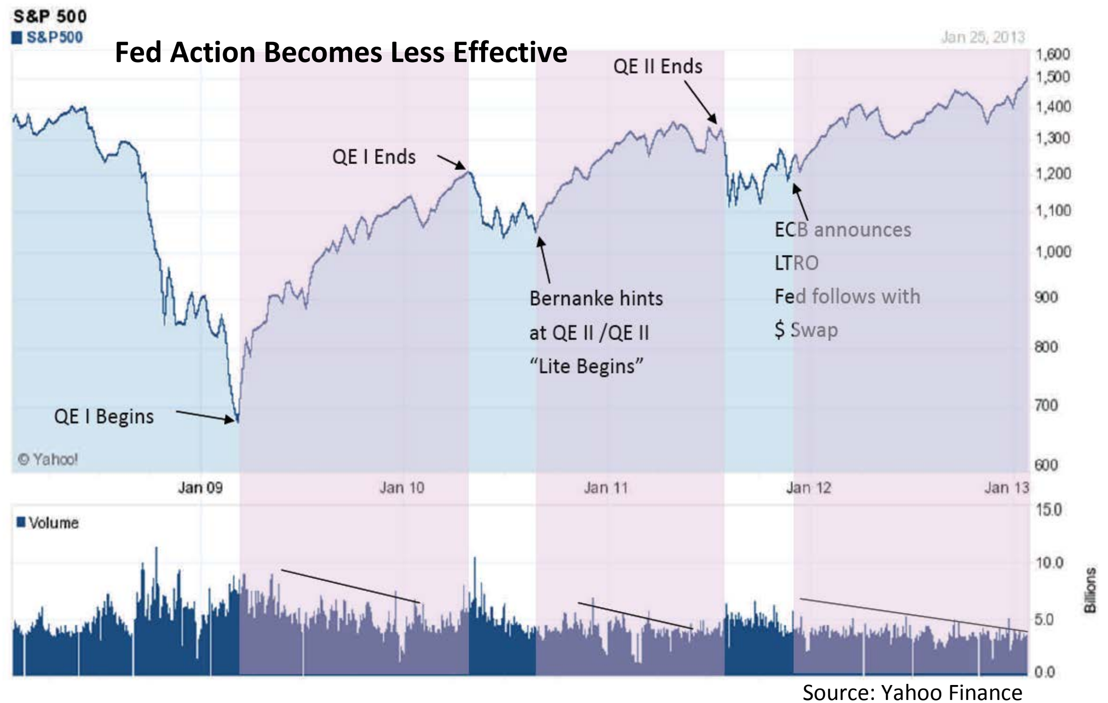


Dis-connecting the Dots

On the surface, the current investment landscape may seem quite complicated; however, it really breaks down to a simple case of cause-and-effect. The key to understanding the disconnect between today's markets and the economy is to work backwards and find its cause. In doing that, one cannot help but draw a straight line to the Federal Reserve and its supposedly accommodative policies.

In the 1970's, legendary investor Marty Zweig coined the phrase "Don't fight the Fed", with the connotation being like telling a child not to squirm while their pediatrician is trying to give them a shot. In other words, it was sort of a 'help me help you' type of argument. With the Fed having historically been viewed as a market proponent, this mantra held fairly true to form. More recently, however, Zweig's quote has come to take on an entirely different connotation altogether. In a paradigm shift of epic proportions, the Fed has become less a market proponent and more a market opponent by falsely buoying the equity market and submerging the bond market in negative real interest rates.

With interest rates ostensibly at zero, the Fed became something like an aging boxer that lost a step and didn't pack the monetary policy punch that it used to when short-term rates were at 5%. To regain its step, it sought out different ways to fight the economic slowdown, with the alternatives being a variety of QEs, a twist, and even an occasional shout. Remarkably, these plan B's resulted in an expansion of the Fed balance sheet from over $800 billion to almost $3 trillion! [1] In 2012 alone, the Fed purchased roughly 90% of all new Treasury issuance, [2] cementing its new status as buyer of first resort.



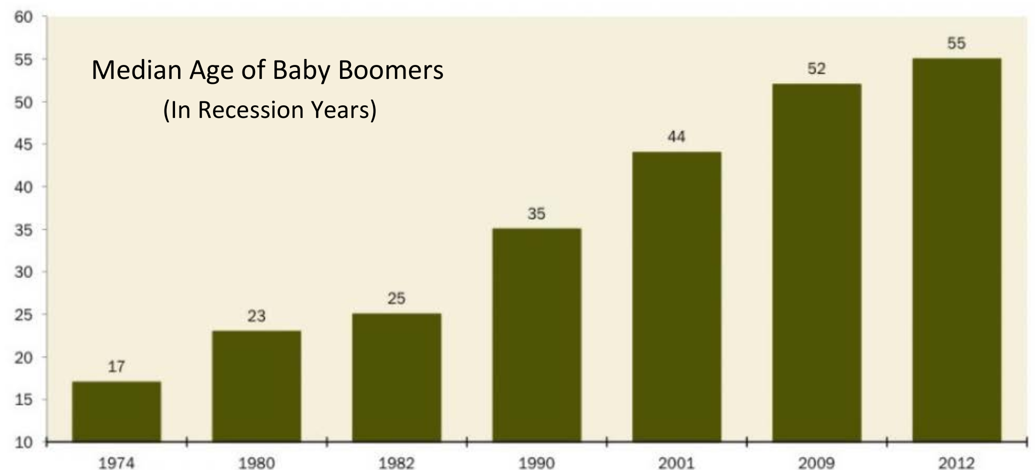
Source: Yahoo Finance

> **Paying the Fed?**
> "After five years, the principal investment [of a 5 year US Treasury] will only purchase about 90% (principal only-not including coupon payments) of what it will purchase today, assuming inflation remains at just 2% over the entire period."
> *--Brian Rhling, CFA*
> *Wells Fargo Advisors*

Fed Up

Fed action has been a game changer and is the primary *cause* to the current state of markets *effect*. Acting as an 800-lb gorilla in the markets, the Fed has driven down yields to the point where many bonds are barely, if at all, keeping up with inflation. As a result, would-be investors have been effectively crowded out of Treasuries and other investment-grade fixed income securities and into more traditionally risky asset classes such as equities, high-yield corporate bonds, and non-agency mortgage-backed securities. The Fed has essentially forced investors at least one standard deviation beyond their comfort zones in order to achieve an adequate return on their investments. The result has been a surging stock market and a dramatic narrowing of credit spreads; last year alone saw Non-Agency spreads come in nearly 600 basis points from low double-digit yields to roughly 4-5%.

This shift has occurred at an inopportune time, as America's population is aging and becoming more and more dependent on their portfolios for income. The median age for Baby Boomers will reach 56 in 2013[3] (see chart below) which is the age when many investors begin to leave the capital appreciation club and join the capital preservation crowd. At this juncture, income and total return-oriented investors are faced with a tough choice – invest in bonds (many of which have negative real rates of return) or take the risk of a potential loss of greater magnitude by investing in higher yielding dividend paying stocks. Even in situations where one's risk profile might suggest differently, this is a trade-off that many investors have been willing to take. After all, if a loss is only potential, conversely, there is a potential for gain. Nonetheless, the net effect has been an overall increase in risk exposure right at the time when risk exposure would ordinarily be dialed back.



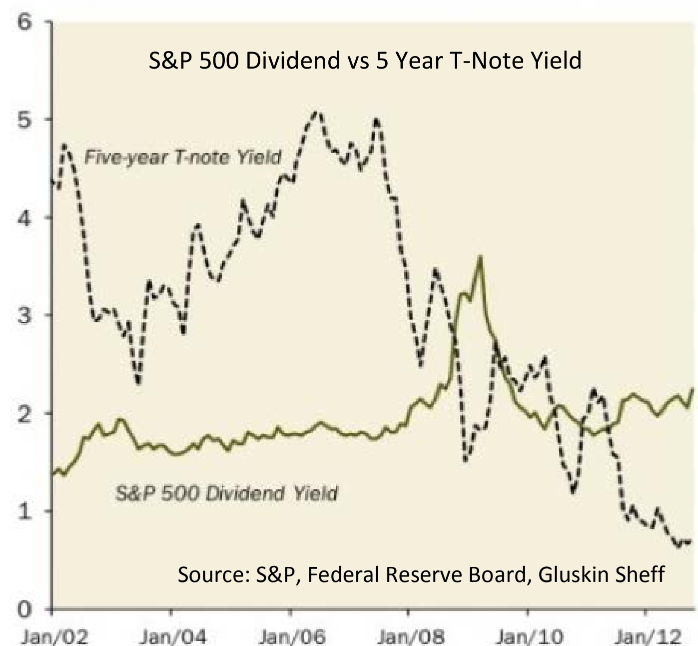
Source: Haver Analytics, Gluskin Sheff

Unfortunately, there are no textbooks on how to invest when the Fed is the buyer of first resort. There is still a notion out there that markets will remain resilient and unemployment will improve as long as the Fed continues its maneuvering. The reality, however, may prove to be a little different. Each successive quantitative easing has packed a little less punch, suggesting that the Fed may have to change course at some point in the near future. And while Chairman Bernanke is a student of history, he need only look at the printing of the mark during the post-World War I Weimar Republic to understand that debasing a currency will only have a temporary positive impact on creating full employment in an economy. Nonetheless, as long as there is evidence the Fed will continue to prime the monetary pump, it is likely some investors will continue to see investing in dividend paying stocks as an amenable alternative to investing in bonds. So for now, current monetary policy will continue to be a slow moving steamroller. It is bound to pick up speed at some point, and the days of low volatility and a safety net for investors will end.

Yield Sign - Proceed with Caution

At the beginning of 2012, with global fiscal, monetary, and economic headwinds looming, Doucet Asset Management advocated positioning for the worst while waiting for the best. Portfolio cash balances were high, fixed income securities were short, and equities were chosen on a very selective basis. This strategy served us well last year. While the worst-case scenario never materialized, none of the major macro risks that existed in 2012 have gone away completely. If you listened to our politicians on the evening news, you would be convinced that the problems in Europe were solved, the fiscal cliff was avoided, and the debt ceiling debate was averted. The numbers, however, tell a different story. Europe is still a mess where regional GDP continues to fall, unemployment rates continue to rise, and sovereign debt continues to grow larger. And while a 13th hour deal was struck on the fiscal cliff, the increase in payroll tax from 4.5% to 6.5% will result in a 1% hit to an already anemic sub 2% GDP, and there is still the matter of $7 trillion worth of sequestrations set to hit unless Congress can come up with a solution. As for the debt ceiling debate being averted, the short-term extension only guarantees that it will once again be a hot topic in the matter of a few short months.

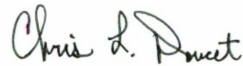
Even with all these wolves still in the woods, the stock market bulls remain unfazed. They point to the fact that the S&P 500 is trading at less than a 15 P/E multiple and is significantly out-yielding the 5-year Treasury (see chart). Even more, the consensus of analyst estimates is that the S&P 500 is trading at about 13.5x price to estimated 2013 earnings. For this reason and others, hedge funds are the most levered they have been since 2004[4]. But, it is a fallacy to view these sorts of numbers in a vacuum. Much of the improvement in earnings came with a return to normality from a severe disruption in the business cycle. Corporate earnings were further aided by stimulus measures, both fiscal and monetary. This begs the question, with an array of new taxes slated for 2013, round 2 of fiscal cliff negotiations, unresolved problems in Europe, and a loss of effectiveness of Quantitative Easing, what will be the encore that drives corporate earnings higher and causes even anemic GDP growth to continue?



Despite these cautionary overtones for 2013, all is not bad and the market is not without its opportunities. Over the course of 2012, we were relieved to see positive momentum in housing, corporate earnings, and employment, regardless of the catalysts that fueled these improvements. Do expect, however, market opportunities to be harder to find and more labor intensive than simply buying the market. More than most years, many of the opportunities we expect to see will likely be extremely short-term in nature, falling more under the umbrella of being a trade than a longer-term investment. On the investment front, though, we are beginning to see attractive risk-adjusted opportunities in four different areas: new asset classes, short duration opportunities in the bond market (particularly with municipals), non-dividend paying stocks that we anticipate to begin paying a dividend in the near future, and modestly valued dividend paying stocks with increased earnings potential. Additionally, the year ahead will likely present great opportunities to sell asset classes that have gone from being inefficient to hyper-efficient (such as high-yield bonds and non-agency mortgages) and redeploy proceeds into some of these less-efficient investment and trade ideas.

A major theme in 2013 will be investors continuing to seek out alternative, risk-adjusted ways of finding cash flow from their investments. The difficulty will be finding instruments in this category that provide an adequate margin of safety in the event that the market loses faith in the Fed and its ability to control interest rates or that the economic improvements begin to unravel. Managing money will be equal parts investment management and risk management. While picking up loose change in front of an oncoming steamroller may not have the appeal of grasping for bills closer to the roller, we believe that it's a strategy that carries with it a better risk-return trade-off in the end. Traditional asset allocation may be down, but do not count it out just yet. For every investor that grabs a bill, there is likely to be another (or more) whose hand is run over in the process. As the change-grabbing investors roll their quarters and exchange them for bills, don't be surprised to the injured bill-grabbers look on with envy.

Sincerely,



Chris L. Doucet
Chief Executive Officer

Firm News

Doucet Asset Management has moved, please take note of our new suite number, 304.

Footnotes

[1] Joshua Zumbrun and Carina Saraiva, Bloomberg, December 11, 2012

[2] Liz Capo McCormick, "Treasury Scarcity To Grow as Fed Buys 90% of New Bonds," Bloomberg, December 3, 2012

[3] David Rosenberg, " 34 Charts You Must See Before Making a Move in 2013," Business Insider, December 21, 2012

[4] Tyler Durden, "Hedge Funds Most Levered and Long Since 2004," www.zerohedge.com, January 14, 2013

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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