Dear Clients and Friends,

The S&P 500 index recorded another 3.2% gain in the second quarter, bringing the year-to-date S&P 500 gain to 13.8%. While the U.S. stock market has been strong, other assets haven't fared so well. Emerging market stocks, U.S. Treasury bonds, and gold fell -4.9%, -7.8%, and -27% respectively year-to-date. Volatility in all of these assets spiked after Federal Reserve Chairman Ben Bernanke suggested the central bank could start "tapering" its $85 billion a month in bond purchases before the end of the year. Many believe interest rates will rise precipitously when the Federal Reserve's actions abate. Potentially rising interest rates is viewed as a key challenge for stocks and bonds going forward. In this quarterly letter, I will address the implications of rising interest rates and how we intend to position portfolios for success.

In prior letters, we have discussed the value disparity between stocks and bonds and how bonds offered very little return along with downside risk should interests rates rise. This year, some of these predictions have come to fruition. In the past month, the possibility of the Federal Reserve tapering caused a spike in interest rates as the 10-year Treasury yields rose from 1.8% to 2.8%. The result was the worst first half of a year for bonds since 1994 and the biggest stock/bond return disparity since 1987. We think this trend could continue.

Will rising interest rates kill the bull market in stocks? We don't think so. While interest rates may revert upward toward their historical levels, we believe the stock market is already anticipating such an increase. As I will outline on the following page, stocks already trade at proper valuations commensurate with our estimates for interest rates. Since 1962, when the 10-year Treasury yield has moved at least two percentage points higher, the S&P 500 has posted average annual gains of 10.8%. In short, we still think there is good opportunity to build wealth in the stock market.

The most important question now is how do we best position a portfolio in view of rising rates? In the last section, I'll discuss some particular factors and industries that perform the best in rising interest environments. While this is useful, the real key is to buy companies with improving fundamentals that could go up no matter what interest rates do. We are constantly looking to buy "special situations," which is a security whose price stands to appreciate sharply as a result of circumstances unique to that company. This could be the result of introducing an exciting new product, hiring improved management, redeploying assets, or being bought out.

In summary, we see opportunity in the equity market and in the particular securities we own. While such a strong start to the year may seem unique, the S&P 500 has actually seen double-digit first half returns 25 previous times since 1929. Historically, the S&P 500 rose 72% of the time by a median amount of 8.4% for the remaining 6 months of the year. We are optimistic for continued success.

If you have any questions, please contact me at tom@eidelmanvirant.com

Sincerely,

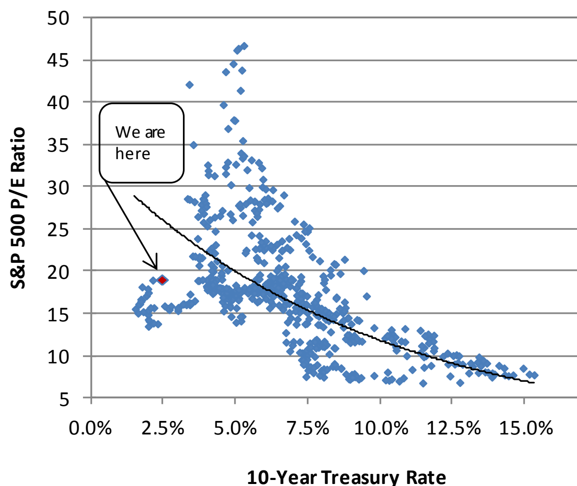
Tom Eidelman, CFA

WILL RISING INTEREST RATES KILL THE BULL MARKET?

In our opinion, a primary reason why the stock market has continued to surge upward can best be summarized as "stocks are the only game in town." Due to record low interest rates, individuals and institutions have needed to up their risk tolerance and allocation into stocks in order to achieve their retirement and spending goals. Such demand continues to drive stock prices upward.

Stocks and bonds compete with each other for investor's savings. When interest rates are high, investors demand high dividend yields and lower stock valuations to compensate them for taking more risk. Chart A below shows this strong inverse correlation between stock valuations and interest rates (S&P 500 P/E ratio vs. 10-year Treasury bond yield).

Chart A: Inverse Relationship between Stock Valuations and Interest Rates (June 1962-June 2013)



Source: Shiller Yale, monthly data.

Interest Rates Likely Going Higher

Given the inverse relationship between interest rates and stock valuations, it is no wonder that people are concerned about rising interest rates. We are also in the camp of believing interest rates are likely to start rising. For the past 50 years, short-term interest rates have averaged the inflation rate plus 1% while long-term rates have averaged the inflation rate plus 2.5%. This rate entitles bond holders to maintain purchasing power and achieve a rate of return to compensate them for credit risk, interest rate risk, and opportunity cost.

Due to the coming reversal of aggressive Federal Reserve policy and renewed worldwide economic growth, we expect interest rates to return to historical levels. In the case of the 10-year Treasury bond, this would equate to a yield of 5-6% compared to the current rate of just 2.5%

Stock Prices Anticipating Higher Rates?

Does a potential doubling of interest rates imply the stock market is due for a big sell off? We don't think so. Since 6/2004, the 10-year Treasury declined from 4.7% to the current rate of 2.5%. However, stock valuations stayed virtually the same at 19x estimated earnings. The reason? Stock market investors have been skeptical that rates will stay low indefinitely, so they are unwilling to bid stocks up. If stocks had followed their historical bond relationship, stocks should have risen to 28x earnings (roughly 40% higher than today's prices). In other words, since stocks never went up to their implied valuations, they may not decline when interest rates go back up. Stocks already trade at proper valuations commensurate with our estimated fair value of interest rates. More specifically, if the 10-year Treasury bond rate increases back up to 5%, the historical stock/bond relationship implies stocks should trade at roughly 19x earnings, which is already the current valuation for the S&P 500 Index. In our view, the S&P 500 has already priced in interest rates reverting to their historical levels.

Stocks Should Continue to Perform going Forward

If interest rates slowly revert to historical levels, we anticipate continued appreciation in the stock market. Future returns will be dependent on earnings growth (historically 6%) plus dividend yields (currently 2%). With the 10-year Treasury bond priced to yield 2.5% annually vs. our estimate for equity returns, we favor stocks as the best way to grow wealth for the foreseeable future. In fact, Since 1926, the stock market has returned a median of 7% annually in the 19 cases after the Federal Reserve implemented its first rate increase.

The most important question now is how do we best position a portfolio in view of rising rates? In the next section, I'll discuss some particular factors and industries that perform the best in rising interest environments.

HOW TO CAPITALIZE ON HIGHER INTEREST RATES

As I presented on the previous page, we think a stronger economy and reversal of aggressive Federal Reserve policy will cause interest rates to start going up. While we outlined why the stock market is priced to deliver adequate returns, the real question is how do we earn superior investment returns given a rising interest environment? What sectors could perform best and what particular company-specific factors should we be looking for when picking investments? We believe we can construct a portfolio to succeed in a rising rate environment.

Stock Picking Factors

We looked back in time to find the stock-specific factors that worked the best when interest rates were rising. These were the factors that worked best:

1. Small size
2. Conservatively financed (large cash position)
3. Economically sensitive
4. High estimated growth
5. Low valuation ratios (price/book value)

What is exciting for us is that these are many of the same factors we always look for! Analyzing such companies is our primary area of expertise. In addition to passing our quantitative criteria for a rising rate scenario, our holdings such as Micron Technology (MU 7/10/13 Price: $12.55) have specific circumstances that excite us for the immediate future.

Micron's memory industry has seen limited capacity growth over the past few years, while demand from smart phones, tablets, and other devices continues to expand. MU recently acquired a Japanese competitor out of bankruptcy at a very attractive price and now have assets that analysts estimate to be worth $20/share to replicate. We think the acquisition and supply/demand imbalance could ignite shares up to replacement value.

Special Situations

We are constantly looking to buy such "special situations," which is a security whose price stands to appreciate sharply as a result of circumstances unique to that company. This could be the result of a introducing a new exciting product, hiring new improved management, redeploying assets, or being bought out. While the firm specific factors are critically important, we still want to make sure the macro environment is favorable. So what industries have performed the best in a rising rate environment?

Financial Stocks are One of Our Favorites

Financial stocks have historically been one of the best performing sectors in a rising rate environment, outperforming the market by nearly 20% in the two years following a rate hike. As rates rise, banks can make higher margins by making business and consumer loans at higher rates, thus increasing their net interest margin.

As we've written extensively in "The Case for Bank Stocks" and "Stan the Man: Investing in Community Bank Stocks," we believe bank's strong franchises, improving fundamentals, and low valuations offer potential for good future returns. Despite rising substantially, banks still trade at substantial discounts to the rest of the market and offer good potential total returns.

Areas to Avoid—Utilities & Telecom

We believe companies that provide income, but lack growth are the most vulnerable to rising interest rates. Because these assets compete with bonds, such companies become less valuable as rates rise. In general, this group includes utilities, telecommunication companies, and Master Limited Partnerships (MLPs). During the recent interest rate spike from May 2nd to June 4th, utility and telecom stocks fell -8.6% and -5.6%, while more cyclical areas like financials and industrials each rose roughly 5%. Utilities have historically underperformed the market by roughly 10% in the year before the fed raises rates and continues until six months after. We think a total return approach of looking at a combination of dividend yield and capital appreciation will best position investors in the future.

Conclusion

Higher interest rates may concern some investors, but a careful analysis of company fundamentals combined with an eye toward the best performing sectors and factors should help us construct a portfolio that can thrive.

Disclosures

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