SAGE PAGE

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In managing the equity portion of our clients' portfolios, we look at the SAGE stock positions from 2 perspectives.

We watch overall market conditions and we closely monitor the corporate performance of our stock holdings. Since the inception of SAGE Investment Advisors of Raymond James Ltd. four years ago, we have been satisfied with overall price levels and stock market conditions, and we have been very happy with the corporate performance of the great companies we hold. Our SAGE Model holdings have increased the dividends they pay us by 15.90% per year, their book values by 9.26% per year and have generated above average return on equity. As a result, **the SAGE Equity Model has enjoyed 14.29% compound annual growth for the 4 years ending June 30th, 2014.**

The companies we hold continue to perform well, but we are now becoming concerned with what we see in the overall market.

"Every 5 to 7 years investors forget there is a recession every 5 to 7 years"
- David Sherlock

Forgetting our history dooms us to repeating it. It is interesting to note that it has been over 5 years since the last stock market bottom in 2009. Since then we have experienced a very strong stock market recovery which has been propelled by:

- Double digit earnings growth
- Large share buybacks
- Aggressive monetary stimulus.

These drivers of the recovery, however, are now moderating. Earnings growth is slowing, we are seeing less share buybacks and the tapering of quantitative easing is well underway. We also note, with interest, that the Federal Reserve has recently started to speak out on the continued strength of equity markets, stating, "Valuation metrics in some sectors do appear substantially stretched…"

At SAGE, we monitor several indicators that help us understand these broad market forces. We thought it would be appropriate to share 4 of the key measures we use to assess the above developments.

EQUITY RISK PREMIUM

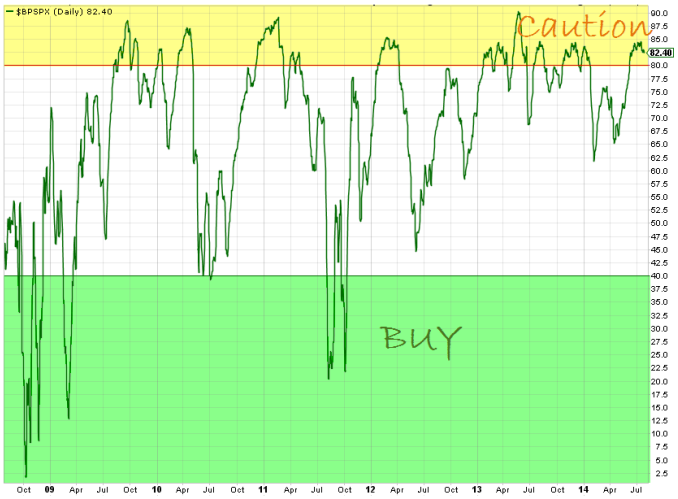
Equity risk premium is the difference between a stock's earnings yield (earnings per share divided by the stock price) and the interest yield provided by bonds. Comparing the S&P 500's earnings yield of 5.14% to the US 10 Year Treasury Bond's yield of 2.45%, we get an equity risk premium of only 2.69%. This very low premium suggests that equity investors expect continued earnings growth and are willing to pay for it. In our opinion, equities will be challenged if interest rates start to drift up towards 3.25%. At those rates, investors will be more apt to sell their stocks to buy bonds, especially if earnings growth disappoints. See chart below.

PARADOX OF VOLATILITY

Options pricing helps us measure investors' desire to protect against volatility. The volatility index (VIX) gauges the level of fear in the markets. High VIX levels suggest investors are expecting volatility, while low VIX levels suggest little expectation of volatility. The chart below shows the VIX is near lows not seen since 2007, suggesting there is little fear in the stock market. The phenomenon known as the Paradox of Volatility suggests that when investors are complacent, they often suffer unexpected volatility shocks.

BULLS AND BEARS

Further, the Bullish Percent Index is at elevated levels, supporting the belief that investors seem confident about the stock market's future. Currently 84.2% of market participants are bullish. Levels over 80% are often a good signal to trim winning positions, while levels below 40% consistently lead to attractive buying opportunities.



A STOCK PICKER'S MARKET?

The term *stock picker's market* refers to the phenomenon of stock prices moving more and more freely in relation to one another rather than moving up and down together in lock step. This is often seen during the final stages of a bull market. During what we call the *melt-up stage* of a bull market, corporate earnings growth starts to slow at different rates. Companies which continue to demonstrate earnings growth are richly valued while companies which show slowing earnings growth are punished, leading to lower stock correlations. Investors concentrate their buying into a declining number of evermore expensive companies. The epitome of this phenomenon occurred on July 26th, 2000 when Nortel at $124.50 accounted for 32% of Canada's TSX Composite Index – greater than all the listed Canadian Oil & Gas and resource stocks combined! We all remember how that spectacle ended.

Correlations also exhibit a paradox. Periods of low correlation during melt-ups lead to periods of high correlation during meltdowns. The more you hear the term stock picker's market, the more you should be looking for the exit door.

Mutual funds, ETFs and indexes are often pained by such moves as the increasing prices of momentum stocks make them a larger portion of the index on a cap weighted basis. Many pool managers not wanting to "miss out" on the momentum trade find themselves the last buyers of the cycle in a last-ditch effort not to underperform the markets. Unfortunately, institutions using sophisticated risk modeling also err on the side of risk taking as correlations fall.

THE THREE NATURAL PHASES OF THE STOCK MARKET AND WHERE WE ARE NOW...

It is crucial to manage investments in accordance with the current phase of the stock market. The 3 phases in sequence are:

1. The *Normal* phase is where investors buy stocks based on fundamentals like discounted cash flows and other sane metrics. Here stock prices are driven by earnings growth, share buybacks and accommodating government policies (sound familiar?). This phase typically lasts about 3 to 5 years.

2. The *Irrational Exuberance* phase sets in as investors rely less on sane measurements of value which say investments are fairly valued. Instead they apply linear logic to the recent years' growth and buy stocks regardless of valuations in fear of missing out on more growth. Here we enter the dangerous realm of the Greater Fool Theory ...buying stocks in the hope that a greater fool will come along and pay an even greater price. This phase typically lasts 12 to 18 months – and never ends well.

3. The *Despair* phase eventually follows. The greater the irrational exuberance, the greater the despair. Stocks prices tend to quickly fall back below the lowest values of the Normal phase. This process while painful only lasts 9 to 18 months.

The stock market is presently entering Phase 2: Irrational Exuberance. As tempting as it is, this is not the time to be chasing momentum stocks or investing in assumed future earnings growth. This is a time of caution. It is now prudent to give up some potential upside to reduce the risk of the looming downside.

We are taking profits on our more expensive investments like CN Rail at an earnings yield of 3.8% (initially bought it July, 2010 at $30.70 and sold it July, 2014 at $74.70), and replacing it with better bargains with less economic sensitivity like Rogers Communications trading at a 7.4% earnings yield – and a dividend yield of 4.3%.

Thank you for taking the time to read this. We write this SAGE Page whenever we see significant, noteworthy shifts in the investment environment. We look forward to your comments.