RGA
INVESTMENT ADVISORS LLC

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"In order to form an immaculate member of a flock of sheep one must, above all, be a sheep."

-- Albert Einstein

Were one to look at the S&P 500 or Dow Jones in April, the month looked fairly tame with the indices tacking on 0.70% and 0.75% gains respectively. However, April was by no means a calm month, as the Russell 2000 experienced significant pain, shedding 3.75%. There were many stocks around the market down over 10% in the month alone. All this was masked in the major indices by outperformance in defensive sectors like Utilities, which added 5.36% on the month. We had been calling for a "momentum flush out" for several months running, and the spread in performance between the Russell and the more senior indices is the clearest sign that this flush out is underway.

It is unlikely for the major market indices to stay completely free of the pain while momentum gets punished; however, longer-term we view this action as extremely healthy. Had these egregiously valued technology stocks continued their march higher, it would have created an increasingly unstable market environment. What these flush outs do is remind overconfident traders that gains in markets should not be easy, and pain is natural every now and then. As such, this should help reign in risk management and make market participants once again more sensitive to valuation.

Markets work whereby such events are disorderly and emotional. This is an important fact, for we all must be aware that things can and often do get messy. The broader economy has little exposure to the noise brought about by these problems and given this, we would label this more of a "valuation correction" than a repricing of risk in the economy. Although our portfolios are more conservatively postured than the market, we will not be able to avoid the impact of rising volatility. Though fear not, as such volatility is the catalyst out of which opportunity is born. Indiscriminate and emotional selling is exactly what creates value-driven investments.

We think it is important to note that we entered this period with a detailed watch list of potential investments, with target price alerts set and our research largely finished. Some other managers start their research as opportunity arises, but we start our action. Our research has been done in anticipation of just such an event, and we will patiently await the right kinds of situations to step into, in the right kinds of companies.

Although US markets have been a bit shaky to start 2014 (as evidenced by the Russell 2000), we continue to find value in Europe. Many European markets remain at depressed valuations. Further, Europe has a large population of extremely high quality global companies owned and operated by their founding families. These families have a long-term focus, and operate their business from the perspective of how best to increase the value of the equity and keep their businesses immune from the principle-agent problem we see so often in US-based companies.

Most important, since we are first and foremast sensitive to valuation, these companies trade at valuations half those of their US peers. While US markets have largely recovered from the Financial Crisis, and European economies continue to improve from their own woes, values remain far more favorable across the pond than they do here. When we make investments, often our aim is to make money both on the high free cash flow yield these companies offer and on multiple expansion (see our January and February commentaries for a deeper conversation on market multiples as this is an important recurring theme).[1][2]

We are hopeful that given this spate of volatility, some extremely attractive long-term investments will hit our target prices. While we think some of these companies are already at points where long-term investors can generate positive expected returns, we do not think the tradeoff between risk and reward is favorable enough. Should the balance shift further in our favor, we will be ready to act accordingly. Most of the time in markets the key to making money is to do nothing, and considering some of the portfolio balancing we did earlier this year, we by and large think this is the case right now.

[1] http://www.rgaia.com/emerging-markets/
[2] http://www.rgaia.com/pockets-of-momentum/

Thank you for your trust and confidence, and for selecting us to be your advisor of choice. Please call us directly to discuss this commentary in more detail – we are always happy to address any specific questions you may have. You can reach Jason or Elliot directly at 516-665-7800. Alternatively, we've included our direct dial numbers with our names, below.

Warm personal regards,

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