



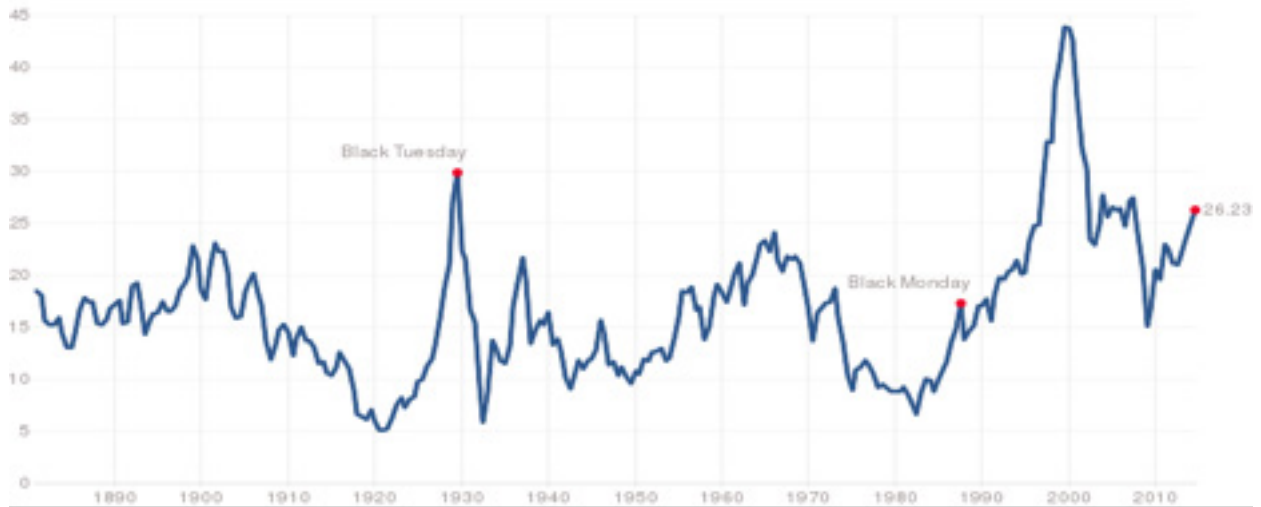
# Summer 2014

## The evidence is clear!

Equity valuations are approaching bubble like levels. As in every other period of excess, market sentiment is buoyed by proclamations of further gains and the fear of loss is replaced by the greed for more gains. These excessive market valuations are being fuelled by central bankers around the world who are intent on keeping interest rates at all-time lows. Investors who are continuing to maintain and increase their equity exposure are implicitly putting their faith in the ability of central bankers to keep the “game going”. Historically such confidence has been misplaced. While central banks can artificially maintain elevated markets for some time the irrefutable properties of mean reversion **always** prevail.

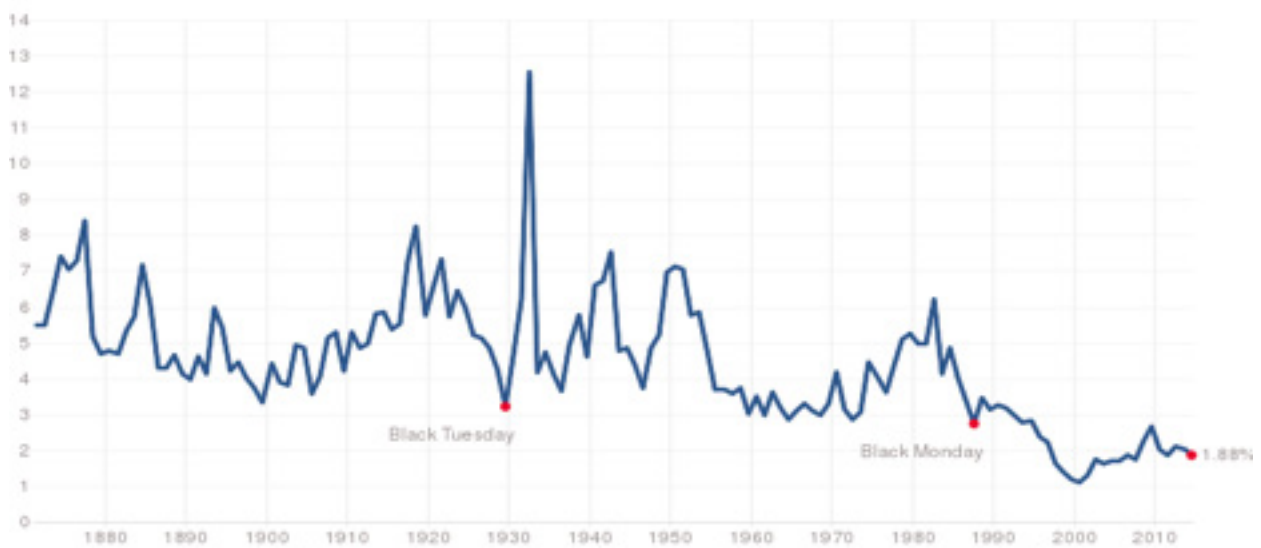
The following charts on the next pages vividly show that equity market valuations are substantially above their long term averages and are at a point where **long term** returns are likely to be minimal and possibly negative. We are quite confident in stating that **long term** potential equity returns are not justified by the current level of risk.

## Shiller P/E Ratio



Source: Multipl.com

## S&P 500 Dividend Yield



Source: Multipl.com

**Chart 3**  
**Market Capitalization/GDP Ratio 1950 – Present**



Source: Vector Grader

The following highlights, evident from the above graphs, illustrate the stark reality of the situation that investors find themselves in today:

- The Schiller P/E Ratio has only been higher just prior to the financial crisis of 2007, the 2000 technology bubble and the 1929 stock market panic
- The dividend yield on the S&P 500 has never been lower
- The Market Cap/GDP Ratio was only higher in 2000 and is now above the level just before the financial crisis of 2007

Other less quantitative measures of market peaks but definite indicators of risky markets abound.

- Increasing prices on low trading volumes
- Increased merger and acquisition activity at aggressive valuations
- Increasing numbers of initial public offerings

- An extended period of time without a significant market correction
- A “buy on the dips” mentality

Several of our holdings have hit our price targets and we are now in “sell mode.” In addition, we can’t find any candidates that meet our investment criteria. Consequently our cash balances are near historic highs. In the past when we have been in a situation where our cash balances are at very high levels, equity markets ultimately experienced a steep future decline.

To us the evidence and eventual outcome is clear; it is only a matter of time before equity investors suffer a very large loss of capital. At PCM we strongly believe in avoiding an oncoming freight train well before it arrives.

Our profession, if practiced properly, can be a noble one; the prudent investment of client assets can help individuals and families meet goals that will make their lives much better in a fundamental way. We as investment professionals can assist clients in meeting retirement goals, family plans, and philanthropic objectives, to name just a few. In short, we as an industry can help others to meet their hopes and dreams. However in many instances this is not the case. For a multitude of reasons the vast majority of investment professionals fail to protect their clients at times of extreme risk. In our view this lack of prudence and breach of trust is unconscionable.

Now is the time to act decisively. Now is the time to be willing to “look wrong”. Now is the time to protect clients’ capital.

... and we are doing just that.

Vito Maida



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