

SUMMER 2014

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HOW HIGH IS HIGH

by Ted Cronin, *Chairman of the Investment Committee*

In our January newsletter article titled “The Market Everyone Hates,” we wrote about the consensus view that stocks were too expensive and were likely to suffer a decline. The S&P 500 index was trading around 1,500 and approaching the highs reached in October 2007 and March 2000, both of which preceded traumatic declines to a S&P below 700. Investors had been so scared by those terrifying crashes that many sought the safety of cash, where they have been hiding. Indeed, many had sold out during the crashes and missed the rebounds. Injured, angry, and frustrated, they weren't about to be fooled again.

We argued that while we felt their pain, their view violated a cardinal rule of investing and ignored fundamental financial truths. Instead of trying to limit short-term pain, we believe that investors should focus on the long-term perspective. The Federal Reserve has suppressed interest rates to a point where cash costs the investor purchasing power. Cash is a decaying, rather than an appreciating, asset. And there are real, albeit modest, signs of an economic recovery. Stocks enjoy a favorable outlook compared to bonds. By June of this year, the S&P had appreciated to 1,960 in one of the strongest bull advances of recent market history.



Many investors have missed these gains and now face the tormenting question of whether it is too late for them. A recent survey of wealthy investors revealed that many hold cash positions of 30% to 40%, have minimum stock exposure, and continue to favor bonds as an asset class despite early signs of inflation and a Federal Reserve that is scaling back its stimulus plans. Recent articles in major national newspapers hint that the stock market and bond market are approaching a bubble status, offering drama to help sell papers rather than a critical review of the facts.

J.P. Morgan recently tabulated stock market valuation metrics, and while different firms and market commentators often use somewhat different numbers, J.P. Morgan's analysis can be considered as honest a representation as

possible. J.P. Morgan calculated the key metric, the price of stocks compared to their expected corporate earnings going forward (P/E ratio), to be 15.6x. This compares very well with the 25-year average of 15.6x, and is modestly higher than the one- and five-year averages of 13.8x and 13.4x, respectively. Stocks aren't cheap, as they were back in March 2009, but it is inaccurate to declare them grossly overpriced.

Our new Federal Reserve Chairman, Janet Yellen, recently described market valuations as a little stretched, especially as they relate to stocks in the social media and biotechnology sectors. But investors should be reminded of Alan Greenspan's talk of "irrational exuberance" in 1996, when he and others argued that stocks were richly valued. The market proceeded to advance another 125%.

If we look at other metrics, we find similar conclusions. The Shiller P/E ratio, which uses the average inflation-adjusted earnings from the previous 10 years, indicates a current stock market level of 25.6, while the 25-year average is 25.1 and the five-year average is 21.7. Current dividend yields are 1.9% versus a five-year average of 2.0%. Price-to-Book is 2.8 versus a five-year average of 2.2. Price-to-Cash Flow is 11.0 versus a five-year average of 8.9. The metrics are appropriate for a recovering economy and are not alarming.

The modestly higher current numbers compared to long-term averages reflect that common phenomenon seen in an economic recovery whereby analysts' projections trail the increases in corporate earnings. Stock analysts, like their macroeconomic buddies, spend more time looking in the rearview mirror than at the road that lies ahead of them. Their mirror view is also often distorted by their political or professional biases that dictate their opinions more than the facts of the market.

So how should the average investor respond? First, accept that the stock market has had a fantastic run since the lows of 2009, and those who have been fully invested should examine the merits of rebalancing, bearing in mind the tax consequences of taking gains and the difficulty of reinvesting moneys in areas with greater promise. Often the best course of action is to make modest changes. As contrarian investors at heart, we would look to those areas that remain depressed, such as emerging markets or commodities, but do so cautiously.

Investors who have missed the stock market gains of the last several years need to accept that, yes, the market is ready for a correction and consolidation, but when and by how much is impossible to predict. If investors want to pursue competitive risk-adjusted performance for portfolios over

the next decade, then they need to, as one of my colleagues would say, “hold their nose and step into the market.” A measured program of dollar-cost averaging is the only solution, or else they could find themselves missing a Greenspan “irrational” 125% gain. We expect a correction, at which time investors will be able to achieve proper portfolio allocations.

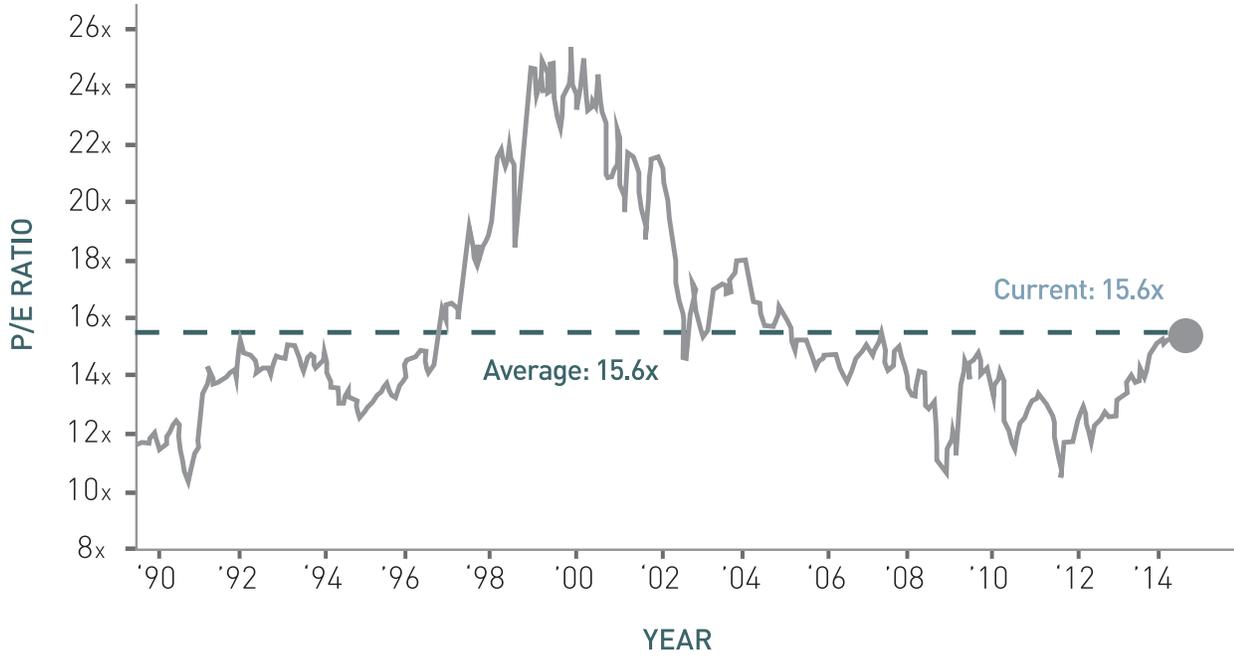
The history of the stock market is that it retreats between 10% and 20% every five years. The history of our economy is that we have

dramatic blow-ups every decade. But more importantly, the history of the stock market is an upward trend, even if there is one step down for every two steps up. The trend remains intact because the stock market reflects the inherent growth of corporate profits. Despite setbacks, creative destruction, and unexpected exogenous events, people wake in the morning with an innate desire to create, to innovate, and to improve their lives.

We recognize that global economic growth will be below the fast pace

of the 1990s, and we could easily detail a long list—a very long list—of challenges facing humanity. But we also note solid progress with transformative technologies, the unwavering energy of innovators and entrepreneurs, and more positive developments than negative. Sitting on the sidelines is not an option for any investor hoping to grow their wealth.

S&P 500 Index: Forward P/E Ratio



THE DAWN OF THE ROBO-ADVISOR

by Drew Beresford, *Wealth Manager*



The year is 2114, and you've just finished waxing your flying Tesla on a hot July summer afternoon, when the phone chip inside your head starts ringing. You answer the call by double-tapping your right temple, and discover that your daughter just had her baby—it's a girl!

Thirty seconds later, you get another call—this one is a prerecorded message from your investment advisor, Hal 9000, who is calling to congratulate you on your granddaughter and inform you about the benefits of setting up a college savings account for her. (Hal continuously trolls the Internet for news of life-changing events in the lives of his 7 million clients.)

You disconnect and reflect fondly on the old days when you used to actually be able to have a conversation with your investment advisor. Unfortunately, the SEC outlawed all human advisors back in 2050 and everyone's money is now managed by robots, whose combination of emotional detachment and raw processing power were deemed to be ideally suited for this task.

Sound farfetched? Well, back in 2014

we're just starting to see the dawn of the era of robo-advisor firms.

These companies are developing innovative business models that minimize, and in most cases, fully eliminate any human interaction with their clients. They are able to do this by taking advantage of the significant advances in technology over the past several years that help them provide low-cost investment management services. These companies all have a slightly different process, but the common theme is that they are all Internet based. Most of them build portfolios using a pure algorithm-driven approach, based on the inputs provided by the customer over the web with little or no human interaction. Some of them allow phone, email, or video chat access to a human for an additional fee.

A typical experience for customers of one of these firms involves filling out an online questionnaire, using their mouse to set their own risk tolerance along a sliding scale, and then pushing a button, as the web-based system buys a diversified portfolio of ETFs or mutual funds in their account.

So far, these companies are small and, in aggregate, manage only a couple of billion dollars (a small sliver of the \$20 trillion wealth management industry), but they

have received some meaningful venture capital backing, and we believe they are well positioned to help an underserved portion of the population.

One big unknown is how investors with these companies will do in a downturn. They have emerged only in the past five years, during a time when nearly all investments around the globe have appreciated. Therefore, it is not a huge surprise that initial customer satisfaction surveys have shown positive feedback. But what happens when markets turn south and the investor doesn't have anyone to call? This will be a big test for these companies and their investors.

Fortunately, we don't foresee these machines leading to the demise of the human advisor and are actually optimistic about what they are doing for the industry. With account minimums as low as \$5,000, many of these companies offer a great solution for those individuals without much money to invest. These individuals are likely to be far better off than if they tried to do the investing on their own or hired an expensive broker to do it for them. We view these new Internet-based investment advisors as a huge innovation that should be able to provide a good service by taking away the mystery of investing for

countless low- and middle-income households across the country.

Core to our culture and philosophy at Manchester Capital is spending time with our clients. Building an appropriate investment portfolio for families with complex needs requires a thorough understanding of the family's risk tolerance as well as their goals and objectives, which may evolve over time. Without a strong relationship with regular communication, we could miss an important life event that requires attention.

Beyond wanting to ensure that the investments we select are appropriate for a particular family, we enjoy being able to assist with a wide range of other issues that fall under the broader umbrella of "wealth management." This goes beyond just managing the actual money to include aspects of education, estate planning guidance, family dynamics, insurance advice, cash flow planning, and just about any other area that falls under our broader definition of "wealth." A significant drawback to the cookie-cutter approach of the robo-advisors is that they cannot navigate complex financial situations such as these. Indeed, a fairly common set of goals that might include the objective of saving for both college and retirement is too complex for most of these systems.

As any reader who knows Manchester Capital will appreciate, we are the antithesis of the robo-advisor.

Compared to some of our peers who pride themselves on maximizing profit margins, our low client-to-employee ratio means that our professionals have the bandwidth to properly serve our client families. This leads to a high level of trust and comfort that can be developed only over years of interactions. We value getting to know each of our clients personally and believe this is the only way to successfully serve the complex families we work for.

Personally, I spend much of my time traveling around the country meeting with Manchester clients. As I reflect on the time and experiences we've had together, it is hard for me to imagine being fully replaced by a machine. For example, a recent trip had a group from Manchester out West at the end of June for the family reunion of one of our client families. The Manchester team spent the majority of one day updating the family on investments and also leading them through an exercise of sharing their individual experiences and values with the wider group. We had a fun exercise where volunteers from the family engaged in various role-playing scenarios depicting common trustee/beneficiary relationships.

Fortunately, we are at least a hundred years away from sending out Manchester robots to meet with clients.

Despite the clear distinctions outlined above, I believe the rise of the robo-advisor will help drive important technological developments that will benefit us humans in better serving our clients. I see a world in which we can use technology to improve what we already do, much like surgeons who have benefited significantly from robotic enhancements but have not been replaced by robots themselves.

I'm still waiting for my flying car, but in the meantime I've already started employing video chat in lieu of ad hoc phone calls. By being fully paperless, all Manchester professionals can operate fully functionally from any location, so long as they have their laptop and a reliable Internet connection. I'll never give up spending time with clients at their homes, but each year brings technological advancements like these that free up more of my time, allowing me to focus on the tasks that I'll never be able to outsource to a machine.

ISRAEL'S INNOVATION ECOSYSTEM

by Michael Warszawski, *Senior Managing Director*



Speaking before a large audience at the Israel Deal Makers Summit in New York in 2013, Jeff Immelt, the CEO of GE, summed

up Israel about as well as anyone can: “You can’t be in Israel without having—it just drips with—a sense of pride in their nation, a sense of needing to do more, needing to do better.”

When asked which sectors he sees Israel dominating in the future, Immelt told the crowd, “Cybersecurity is a natural for them... In [data] analytics and cybersecurity, Israel is going to have a massive position.”

Fast-forward to today, and that future can already be felt in Beersheba—inside the Advanced Technologies Park, nicknamed “CyberSpark,” that is rising from the sands of southern Israel. For it is there that Israel is creating what it hopes will be one of the world’s greatest hubs for the cybersecurity industry. In addition to the Ben-Gurion University of the Negev established in 1969, and CyberSpark, launched in 2013, Beersheba will soon host the staff and facilities of Israel’s military intelligence division, which is moving there in 2015.

On a hot morning in June in CyberSpark, we are seated in a conference room in an R&D facility owned by EMC, one of the world’s leading companies in information infrastructure solutions. A debate is brewing between Liran Tancman, founder and CEO of CyActive—a “predictive” cybersecurity startup—and Dr. Orna Berry, EMC’s corporate VP of Growth and Innovation (and a former chief scientist of Israel). “The malware that succeeded in stealing millions of credit card numbers from Target was a mutation of a previously known software,” insists Tancman, who posits that his company’s tools might have been able to predict the attack in advance—and thus prevent it.

Dr. Berry disagrees with part of Tancman’s characterization of the Target attack, and—although the nature of their disagreement goes over my head pretty quickly—it’s clear that she’s holding the young entrepreneur’s feet to the desert fire. Tancman (a former head of an elite Israel Defense Forces intelligence unit), accepts a correction from his esteemed mentor, and continues pitching CyActive’s predictive software to our audience of investors and business leaders who have flown in from the U.S. for a three-day tour of the “Startup Nation.”

One of our hosts, Richard Hirsch, the chairman of the Development Corporation for Israel (commonly known as Israel Bonds), asks whether there exists “some overarching effort to coordinate the work” of the estimated 220 cybersecurity startups in Israel. Not a priority, he’s told. The preference is to allow a broad variety of ideas to “independently germinate and progress” until the best ones win.

The “innovation culture” in Israel has yielded a cornucopia of success stories going back to drip irrigation in 1965; reverse osmosis desalination (1967); network security (Check Point Software, 1993); capsule endoscopy (Given Imaging’s PillCam, 1998); USB flash drives (M-Systems, 2000); and more recently, ReWalk—a bionic exoskeleton that allows paraplegics to stand, walk, and climb stairs (Argo Medical Technologies, 2011), and Waze, the “social GPS” navigation system bought by Google last year for \$1.15 billion.

We have journeyed to Israel to explore what else is cooking in the fertile minds of the residents of this country built from a desert. And we are not disappointed. Our intimate delegation of 18 visitors has been organized by Israel’s Ministry of Finance, together with

the Israel Bonds organization, to expose a select group of U.S. investors and executives to the country's innovation ecosystem, enhance cross-border connectivity, and encourage direct or indirect investment. It is a terrific opportunity for a short trip off the beaten path and into a world of innovation that is certain to broaden our horizons.

Our tour includes a visit to "Campus Tel Aviv," an accelerator designed to promote startup companies that is hosted in Google's new (and spectacular) Tel Aviv headquarters—occupying eight of the 45 floors of the Electra Tower skyscraper. We receive an overview from Roi Bar-Kat of Genesis Partners, as well as a rapid-fire set of presentations from young CEOs in a diverse array of startups. The "Campus" brings together the uniquely energizing Camenzind Evolution architecture with the resources of Google, along with the expertise and connections of the local venture capital community.

A similar panoply of entrepreneurs is eager to present to us at the Interdisciplinary Center (IDC) in Herzliya. IDC, the first private institution of higher learning in Israel, was established in 1994 as a not-for-profit corporate entity "dedicated to the pursuit of excellence in education and

research." Most of our presenters are current students or alumni from the Zell Entrepreneurship Program, which, in its 13 years of existence, has yielded 252 graduates and 58 ventures. The companies presenting include Wibbitz (automated video summaries of text articles), Recardo (a marketplace for gift cards), and Segoma Imaging Technologies (high-quality 3D rotatable images of diamonds enabling inter-dealer transactions without shipping). In Jerusalem, we are treated to a beautiful evening tour of the Old City and visits to JVP (Jerusalem Venture Partners) and OurCrowd (a leading equity crowdfunding platform).

Our group remains optimistic, perhaps thanks to the infusion of enthusiasm we have experienced during our three-day immersion into Israel's innovation ecosystem. Optimism is "at best, a mixed blessing," according to Prof. Daniel Kahneman, an Israeli recipient of a Nobel Prize in Economic Sciences for his work in decision making. According to his book *Thinking, Fast and Slow*, "the main benefit of optimism is resilience in the face of setbacks." A country with poor natural resources, few regional trade possibilities, and severe security challenges is a crucible of innovation with 90 companies valued at \$40 billion on NASDAQ

(second only to China in the number of non- U.S. firms listed on the exchange).

Dan Senor and Saul Singer, authors of *Start-Up Nation: The Story of Israel's Economic Miracle*, attribute this extraordinary productivity to several factors, starting with the "tight proximity of great universities, large companies, start-ups, and the ecosystem that connects them—including everything from suppliers, an engineering talent pool, and venture capital." They also credit military R&D spending on cutting-edge systems and elite technological units, and the spillover from this investment in tech and human resources into the civilian economy.

In conclusion, the journey has been thought-provoking and energizing. For me, the most valuable aspect of the trip was the opportunity to interact with these talented individuals, some younger and some more experienced, who are simultaneously courageous leaders and great team players, working closely in trusted relationships to tackle challenges and opportunities both large and small. To the extent that we will bring some of that energy, creativity, and discipline home to our respective colleagues and clients, our visit to the "innovation nation" will pay dividends for years to come.

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Some recent firm highlights:

- After being honored as one of Barron's Top 100 Independent Financial Advisors, Ted represented Manchester Capital at Barron's Top Independent Advisors Summit this past spring.
- We were recently recognized by the *Financial Times* as one of their 300 Top Registered Investment Advisers.
- We are looking forward to our upcoming annual Investment Committee Retreat, in which all 13 members of our Investment Committee, various members of our Operations team, and typically a member of our Board of Advisors gather for two full days at a remote camp in the Adirondacks to debate and discuss the market and ways we can best manage our clients' portfolios. The annual Investment Committee Retreat is something we all look forward to every year—to gather in person as a group, away from the distractions of the office, and focus on what we're doing and how we can improve.
- We are happy to announce the additions of Cynthia Larson as an operations associate and Karen Dreiblatt as our office administrator. Please join us in welcoming them to the firm's Vermont office.
- For personal and professional reasons, Drew Beresford has relocated to our Charlottesville office, and Jeff Laffond has transitioned from Charlottesville to our NYC office. Drew's and Jeff's respective roles and responsibilities with the firm will remain the same. Even though they will be missed in the offices they are leaving, they have been warmly welcomed in their new offices and look forward to continuing to serve MCM clients from their new locations.



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