"One of the funny things about the stock market is that every time one person buys, another sells, and they both think they are astute."

William Feather

The investment topic of the year, so far, seems to be the elevated level of the US stock market. In May 2013, the S&P 500 achieved an all-time closing high of 1669. Despite a correction in June, the index closed at the highest quarter-end level in history. Over the years we find that at new highs (and new lows) emotional involvement increases with each session. Experience tells us that the key factor at these high and low points should not be emotional reaction to what has happened but a strong conviction about what is coming next.

Let's stick with the new highs we have witnessed of late, aware that we are all influenced by our own current positioning. For those who remained invested in the stock market, through the financial crisis, they have recovered all losses from the 2008-2009 bear market and then some.

For those who have watched from the sideline there are generally three reactions. First, "the market has gone too far, too fast and I'll wait for the correction before getting in." Second, "I can't sit on the sidelines any longer. I need to get in now to make up lost ground." Third, "I've missed it, I'm going to do nothing." The common theme here is an ability to discern the direction of the market over the short term.

From an historical perspective the 140% move in the US stock market from the lows of 2009, without a material correction, has been impressive. Let us assure you, with 100% confidence, that there will be a correction and it will hurt. However, the timing and the magnitude are beyond the capabilities of anyone's crystal ball. In our opinion, it's always best to look at the fundamental drivers of the market and understand their potential influence. So here is a brief look at a few factors we're watching:

1. The Fed. In our opinion, the Fed is very likely to reduce or eliminate its bond buying program indicating a stronger job market, a more stable economic environment and/or a concern about managing future levels of inflation.
2. Interest rates. Yes, eventually interest rates will move higher. But this is not necessarily bad for the stock market. Over the last 30 years, during the three periods where interest rates rise modestly, less than 2.5 percentage points on the 10 year Treasury, stocks have increased an average of 34%. Also, in the three periods where interest rates have risen more than 2.5 percentage points, stocks are essentially flat.

3. The economy. While GDP growth for the past year has been modest, the recovery has been steady and followed a very orderly path. Private employment trends have been positive for the last four years for small, mid and large employers. Gains in housing could provide a continued boost to the economy.
4. Corporate balance sheets. Cash levels are historically high and debt is at modest levels, which provides options for management. Credit markets remain positive for corporations looking to raise capital, make acquisitions, reinvest in their business, repurchase stock or increase dividends – all positive for the market.
5. Market valuations. Reasonable at around 14 times S&P 500 earnings, given the outlook for interest rates and inflation.

The question is what to do at this point? Market corrections are an expected, though not welcome, risk of investing in the stock markets. During such periods it's important to have a longer term conviction about investment opportunities. We have been overweight stocks versus fixed income and, based on our current outlook, will maintain this positioning. We continue to be positive on the long-term opportunities for the stock market and think this is a "tap the rudder environment", making modest shifts in our equity portfolios both in terms of industry sectors and individual names. We believe that the economy has the ability to continue this slow, but steady, recovery for some time, a reflection of how individual businesses are delivering consistent earnings growth.

In all market environments it is important to avoid chasing the most recent top performing asset class. Risk and return are equal elements in managing investment portfolios. Prudent diversification provides effective risk management, allows exposure to asset classes with higher return potential (and higher risk) and reduces portfolio volatility over the long-term.