

*The following contains a brief discussion of the equity markets and an outlook for the coming year from Chief Investment Officer and Senior Portfolio Manager, Ryan E. Crane.*

## MARKET OVERVIEW

There is a famous quote: “Experience is a hard teacher. She gives the test first and the lessons afterwards.”

This year’s experience should teach us several lessons. Among them is the rule that markets overreact on the upside and on the downside. By definition, markets peak when confidence is peaking, and they trough when there is no confidence at all. This early spring was such a time. The language describing the economy had shifted from “recession” to “depression”, as the pundits and the press laid out all the similarities to the Great Depression. Investors responded by continuing to pull out of the market, ironically putting their money in cash or money market accounts, effectively earning zero interest. The appetite for risk was gone.

It is this very sort of capitulation that makes the bottom. When no one wants to buy risky assets, their price is suddenly much more attractive (stocks were very cheap), and when everyone wants the safety of a treasury, their price becomes less attractive (yields were almost at zero).

Eventually, the economy showed small signs of improvement – green shoots. Stocks reported surprising levels of profitability, due largely to aggressive cost cutting and inventory management. The combination of incrementally better news and very low valuations set the stage for a powerful rally.

Consequently, simply noting the S&P 500’s one year return of 26.46% belies the range of market action, volatility, and sentiment. Within the gyrations of the market, there was a strong performance bias towards lower quality companies. Off of the market bottom, the best performers were the stocks that had the most debt, the lowest profitability, and the least growth – those that had lost the most in the downturn. The rising tide lifted all boats, but those that were about to sink had more to gain (in percentage terms).

## OUTLOOK

In our previous Market Perspective, we knew better than to specify a narrow time frame, but we tried to focus on the prospect of things that could get better. Things got better – much better – the easy money from bouncing off the bottom has been made. So, where do we go from here?

The economy is more stable now and on the road to recovery, but there are still uncertainties on the horizon: inflation, a weak dollar, the burgeoning national debt, the chance of a double-dip recession, etc. But differing opinions and multiple uncertainties are what make a healthy market.

We believe that further gains will require improving fundamentals. Valuations aren’t cheap anymore, and the positive earnings reports from cost-cutting won’t last much longer. We believe the stocks that will warrant higher prices will be the ones that are growing.

It is quite possible that there is more fuel to this market rally. The market has gone up very reluctantly, with many investors waiting for the pull-back. Since March ‘09, there were only a few brief moments that might be deemed to be a pull-back. Consequently, there are a lot of investors who are underweight in equities. As that money comes back into the market, it could provide a powerful tailwind.

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We still believe that although the economy is bouncing, and there are some easy year-over-year comparisons, the tailwind of booming markets and synchronized global growth has subsided. Real, sustainable, organic growth will be relatively scarce, and investors will be more willing to “pay up” for companies that can deliver.

While we recognize the many risks, we are generally optimistic about the market’s prospects. One of our primary concerns from an economic perspective is inflation, but equity strategies are in some ways a hedge against inflation. We think the risk versus conventional wisdom are to the up-side – that the virtuous cycle of improvement can be more powerful and robust than we remember. With even greater confidence, we believe that higher quality stocks will outperform their counterparts; that growth will outperform value.

The other lesson that this past year’s experience should teach us is that predicting the market is incredibly difficult, if not impossible. It happens of course, but it may just be good luck rather than skill. Given enough time and a million monkeys at a million typewriters, one will produce all of Shakespeare’s works. And similarly, among millions of market pundits making market predictions, one will “predict” the market.

Of course we know that investors aren’t just monkeys hammering away randomly, hopefully we’re all smarter than that! But as humans, emotions and bad habits sometimes cause us to behave worse than randomly. Unfortunately, those emotions and heuristics seem to rear their heads at the worst possible times. But these same actions are the foundation for behavioral finance, and ultimately they help create the inefficiencies which in part, we seek to use to our advantage.

Rigorous discipline might be the best tool to eliminate the bad decisions that arise from the human condition. And for us, discipline is a mantra. In the midst of the fear and turmoil, we remained diligent, fully invested, and constantly seeking new opportunities.

We remained disciplined in our search for the best and fastest growing companies and adherent to the philosophies and investment principles we have followed for years.

Ryan Edward Crane

*Opinions expressed are those of Ryan Edward Crane and are subject to change, are not guaranteed and should not be considered recommendations to buy or sell any security.*

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