2015 - February Newsletter

Hello and Happy Winter,

Last year left many of us in the investment community scratching our collective heads. It's not that many investors didn't have positive gains in 2014. Most (certainly not all) investors in U.S. stocks made money in 2014. What leaves us bewildered is the manner in which this stock market keeps dodging bullets with so many potential pitfalls in the economy, both domestically and abroad. But first, let's review the good news: The S&P 500 did return 13% for the year with the average domestic mutual fund gaining 7.6%(1). Unfortunately, the foreign markets weren't quite as lucky, most notably Japan and Europe who continue to play catchup with the Quantitative Easing game in order to spur economic growth. Specifically, healthcare and real estate were the top domestic sectors, with commodities and energy at the bottom of the barrel (pun intended). Below are some important benchmarks in the industry and the returns for 2014.

Average U.S. Stock Mutual Fund	+7.6%	Average International Fund	-5.0%
Average U.S. Bond Fund	+2.3%	Dow Jones Average	+10.0
S&P 500 Index	+13.7	Nasdaq	+10.9
Mid cap 400	+9.8	Russell (Small Caps)	+4.9 (1a)

Action of the Federal Reserve

In general, most economists predicted the Fed would bring the Quantitative Easing program (QE – asset purchase program) to an end in 2014. However most felt that interest rates almost had to move up in 2014, and instead the 10-year government rate fell to 2.2%. The bottom line is that the action of the Fed over the past six years has been focused solely on the short term by 1) Artificially providing liquidity to the market in the form of QE and 2) Keeping rates low to promote economic growth. As much as it feels normal right now, the country and world remains in unchartered waters relative to the massive amount of government debt. Much of the volatility in the markets *may* revolve around the action of the Fed in 2015. The end of QE in October of 2014 may also exacerbate concerns about liquidity and lead to increased volatility in the fixed-income markets. This is perhaps why you are seeing this very large degree of uncertainty and volatility in the stock market as we enter 2015. Volatility has been higher the past two months.

Valuation of Stocks

Many clients inquire about whether there is still room for growth in the stock market following 6 years of positive returns. The current Price Earnings ratio of the S&P 500 is 20+, versus a historic measure of 15. (2) This is a signal that perhaps investors should reassess their outlook to a lower return environment in the coming years. The market is probably not overvalued to the extent of the levels observed in 1999-2000 whereby the technology sector was perhaps predictably overvalued. But as interest rates climb and the strengthening of the dollar, domestic companies will likely face larger hurdles without the help of an easy monetary policy environment they have become accustomed to. In our 2009 newsletter (when the recession had induced serious fear in investors), a Warren Buffet quote was most relevant, *"Be greedy when others are fearful, and be fearful when others are greedy."* In 2014 and 2015, the latter of this advice is perhaps more relevant for a time of prudence and patience. Timing the market is a fool's errand, and would deviate from core beliefs and your individual game-plan. But one should be open-minded to the possibility that the economic future could be more challenging than we think today. Therefore, selective stock investing is as important as ever. We are comfortable in this environment, where lower expected returns for the past year were achieved in an attempt to mitigate risk first, and achieve returns second.

Why not just sell bonds since they pay nothing? - An investor can barely keep up with inflation if one just buys a 10 year Treasury yielding 2%. But longer term bonds are more volatile via interest rate movement, and depending on the individual situation, won't necessarily fit the risk/reward tradeoff. It is certainly not prudent to simply chase yield, and forget risk. One should not underestimate the value and safety of short term bonds/cash currently or avoiding bonds and moving into stocks to try to achieve return. Bonds remain an important ingredient to a healthy, balanced portfolio.

Why not just buy and index fund similar to the S&P 500? In 2014, the S&P 500 index, (which is often used as a performance benchmark), outperformed 88% of all domestic mutual funds. Over the past 10 years, only 24% of professional investors/mutual funds have outperformed the S&P 500 index. (3) But in 2014, over 50% of the return for the S&P 500 was attributable to 34 of the 500 stocks because of weighting and performance. (Disclosure: the S&P 500 is a capitalization-weighted stock market index based on the market capitalizations of 500 large publicly traded companies).

Two points to consider…. #1: The S&P 500 index is often used by fund managers and the general public as a benchmark. But it is important to note that the stocks in the index may be much different from other securities or risk held by a given investment. Many times comparing the S&P can be an “apples to oranges” comparison depending on the type of the investment one is comparing.

Point #2: Perhaps the S&P isn’t what you think. Stocks in the S&P are added and deleted annually to reflect a more current snapshot of our economy. Since the S&P 500 index was formed in 1957, only 86 of the original 500 companies still remain. A study done by Jeremy Siegel (Wharton School) pointed out that *the stocks that were removed from the Index actually outperformed the ones that were added to the index over the equal timeframes.* This included the stocks that went through bankruptcy, buyout, or just simply were removed. This validates the thought process that even the S&P 500 is somewhat guilty of essentially buying and selling at the wrong time. Why? Because they are adding those companies into that index perhaps after the company has experienced significant upside in stock price. They are consequently deleting companies that are not as “valid” any longer, when perhaps that company’s stock price had moved downward or was out of favor. To be clear the S&P isn’t a mutual fund. It is their job function to add/subtract companies that simply reflect the health of the current economy. *But one could argue that the timing of the events is very similar to the Classic Buy high, Sell low mentality*. The performance would have been better by keeping the companies that were removed. It is a reminder to own both quality companies with a focus on reasonable stock valuation and prices.

Other Quick Points

- Household savings are at new generational lows while the government is still in a fiscal-tightening mode. There has been no real deleveraging in overall debt level worldwide, whereby there are actually higher amounts of debt currently than what preceded the last financial crisis.
- Oil prices are low and the unemployment levels have dramatically decreased which was a very large boom to the market in 2013-2014. But a closer look reveals that the heart of the workforce (people ages of 25-54) has not recovered to its December 2007 peak level. (4)
- Over the past 10 years China’s economy quadrupled but over the past 8-10 months, however, their economy has slowed dramatically which has helped force global commodities and oil into a downward spiral. A concern for some is whether China can contain an economic and potential debt bubble without severely damaging the global economy. The global economic infrastructure is as complex as ever before. (5)

Conclusion

Perhaps it is simply a time to step back and stress the importance of liquidity more, especially those in the early stages of retirement or closing in on retirement. Cash is not only important for unexpected life changes, but an important asset that provides the investment opportunity to buy other securities at good prices when the time is right. This is similar in philosophy to 2009 when markets were in major distress and decline, when many value managers found stocks that were "on sale" given the climate and price. Lastly, the market does not coincide with the economy and the market is not static or efficient, quite the contrary. Some of our equity fund managers will attempt to take advantage of the market when they see "potential" opportunity, given the level of risk. But they will *not* make the mistake of chasing returns for clients just because they underperformed the S&P in the short term. That is not in n your best interest, and doesn't work over longer periods of time.

I will leave you with a quote from Warren Buffett. In his 2006 chairman's letter about qualities a successor to him should have, he says, "A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed **to recognize and avoid serious risks**, **including those never before encountered**." The important take away is that although history "rhymes at times", it is important to try to recognize developments that have not occurred, and to simply be aware of potential risks.

The future remains uncertain and we are more concerned with a defensive approach versus playing offense. We look for management teams that have long term track records with a history of performing well in sideways and difficult markets, and that employ a more value oriented investment philosophy that is strict and disciplined. We are being cautious and selective and will not chase returns, forsaken risk.

Thank you to our staff, our fund managers, our business associates, SIGMA, and our clients.

Corey and Dan

(1) Morningstar – January, 2015
(2) Robert Rodriguez – November 2014
(3) Investment News – January 2013 / 2015
(4) Robert Rodriguez – November 2014
(5) First Eagle Newsletter – September, 2014

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