Second Quarter 2015

Quarterly Letter to Clients

By Scott A. Wendt, CFA

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As the 2nd Quarter of 2015 came to a close, investors around the globe were trying to divine whether the final chapter would be written on the multi-year old Greek saga and what the possible impacts might be on Europe if the "kick-the-can" policy was replaced with a "kick-the-bums-out" alternative – aptly called the "Grexit". If that wasn't enough to deal with, the Chinese Stock Market, that began the month in record territory, declined over 30% in the final two weeks of the month, echoing the market behaviors seen in the 1929 U.S. Stock market crash, as the Chinese government took actions to avert a further decline. Finally, the governor of Puerto Rico announced that they were not going to be able to make their $72 billion in upcoming debt payments, providing another jolt to the municipal credit markets that are still healing from Detroit filing for Chapter 9 bankruptcy last year.

There is a common thread in all of these regional crises. From the Mediterranean to the Caribbean to the Far East – investors are experiencing the fallout from the excessive reliance on DEBT. As a top Mediterranean tourist attraction, Greece has definitely seen better times. As the country enters the equivalence of bankruptcy by missing its June 30th debt payment, the Greek people had an inside view of the unfolding Greek Tragedy that followed an all too familiar plot with numerous delays, twists and turns that spiced up the action. The plot is one that has been played out many times in countries and in corporations around the world. Politicians make bold and generous promises of future benefits. An interim crisis plus fiscal mismanagement cause deficits to mount. Deficits are funded with additional copious amounts of debt, in effect making a similar promise of payment at some future date. Repeat the cycle numerous times, making even larger promises as you go along until the inevitable occurs: the inflows cannot cover the outflows. The Greek Tragedy, now being played out between the Greek finance minister and the European Central Bank (ECB) is like a high stakes, no peek poker game, and now has two possible endings: 1) The Greek people suffer additional pain and economic hardship as additional austerity measures are put in place to allow their impossible large debt to be paid back over a generation, causing social unrest and higher unemployment or 2) The Greek people get no further help and suffer additional pain and economic hardship as the economy goes further into major depression, causing social unrest and even higher unemployment than option 1. Not really much of a choice.

In the Caribbean, Puerto Rico's governor recently announced that the commonwealth government would not be able to make good on its $72 billion in upcoming debt payments and that, because they are only a territory of the U.S. they have no formal process to declare bankruptcy the way U.S. municipalities can. According to the ***New York Times***[1]

> "The governor, Alejandro García Padilla, and senior members of his staff said in an interview last week that they would probably seek significant concessions from as many as all of the island's creditors, which could include deferring some debt payments for as long as five years or extending the timetable for repayment.
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> "The debt is not payable," Mr. García Padilla said. "There is no other option. I would love to have an easier option. This is not politics, this is math."
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> ...It is a startling admission from the governor of an island of 3.6 million people, which has piled on more municipal bond debt per capita than any American state...
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> ...Residents began leaving for the mainland in droves, and Puerto Rico's credit was downgraded to junk, making borrowing extremely expensive."

With the combination of less taxpayers and higher borrowing costs, the math makes it even more difficult for those who are left on the island. At an 8% current yield for Puerto Rico Bonds, the 3.6 million people on the island carry about $20,000 per person in debt (including children) and would in effect owe about $1,550 per person per year, *just in interest costs*, putting a significant burden on a country where 40 percent of its residents live below the poverty line.

Both of these situations highlight the misuse of debt and what happens when it can't be repaid. (More importantly, the fallout of the default and restructurings will most likely mean that someone doesn't make that high return coupon that they thought they could reach for but didn't realize the associated risk(s) with that higher than market rate of return). In Puerto Rico's case, bondholders will be sharing the pain of any restructuring to get the Caribbean Island back on a more secure economic footing.

Finally, the Chinese situation continues to play itself out. Basically, the Chinese market has seen a 30% price drop and the Chinese Government is pulling out all the stops to retard the decline. The central bank lowered rates, reduced bank reserve requirements and prohibited short selling to try to reduce the panic selling and reverse the downward spiral. While the government is encouraging the growing Chinese middle class to invest in stocks, many of the

[1] Puerto Rico's Governor Says Island's Debts Are 'Not Payable' by Corkery & Walsh ***New York Times*** June 29, 2015.
http://www.nytimes.com/2015/06/29/business/dealbook/puerto-ricos-governor-says-islands-debts-are-not-payable.html?_r=0

90 million Chinese retail investors are poorly educated folks who are caught in the euphoria of a market that is up over 130% in a year and don't want to miss out. Add to this the fact that margin debt on the Chinese Stock market has tripled since June 2014, with 80% of margin financing going to retail investors, many of whom are novice traders. Trading on the momentum of the market has driven stock prices to levels where they are now disconnected from underlying economic fundamentals. Valuations are extreme and rising. When you combine these two trends with the high levels of margin debt used for stock purchases and the high turnover in stocks bought and sold by retail investors, one has all four of the signs that define a price bubble.[2] Certainly the Chinese middle class may be impacted if the Chinese stock market falls further. How much for how long are imponderables at this point. Global investors will be watching with great interest to determine if there is any contagion that occurs in other markets as a result of the downward slide in Chinese shares.

The **U.S. Economy** continues to grow at a below-trend rate, reflecting the anemic recovery that, despite massive government stimulus, has posted sub 2% Real GDP growth. This can be attributed to a number of factors, with the saucer-shaped recovery in the job market being near the top of the list. It has taken the better part of the last six years to regain the jobs lost in the 2008 Great Recession. In addition, the consumer has spent much of this time restructuring his balance sheet and taking the moderate improvements from reduced energy costs to add to savings. This might partially explain the uninspiring retail sales figures, despite the improvements in the consumer confidence reports. It appears that more than the extreme weather of the first quarter is playing a part in the lower level of economic activity.

As a result of the soft levels of consumer demand, corporate America continues to defer spending on new plant and equipment, choosing instead to do more with less and to call upon their existing workforce to meet the supply requirements. Industrial production numbers have been mixed over the past quarter, with purchasing manager surveys showing some improvement since the port strike resolution. Nevertheless, the year-over-year data is showing a downward trend, which if not reversed may be a precursor to additional softening in manufacturing activity. This is not welcome news, as the manufacturing sector provides about 1/8th of total wages and could put additional downward pressure on demand for goods and services.

Housing remains in the neutral category. While current sales have seen mixed results over the past quarter, weather and regional factors have produced some bright spots. Housing permits were up significantly in the Northeast, while the Midwest showed the most improvement in current sales and buyer traffic. With the widely anticipated change in the Federal Reserve's

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[2] "China's Stock Plunge is Scarier Than Greece" by Ruchir Sharma ***The Wall Street Journal*** July 7, 2015. http://www.wsj.com/articles/chinas-stock-plunge-is-scarier-than-greece

policy before the end of 2015, and the potential for rising interest rates, potential home buyers may accelerate their buying plans over the next 6 to 12 months.

Bonds & Stocks

Over the past six years, the domestic capital markets have focused on Federal Reserve Policy to the exclusion of almost everything else. Back in 2008, the Fed instituted their Zero Interest Rate Policy (ZIRP) as an emergency measure to provide Markets with an additional stimulus and to support an ailing financial system. The hope was that low interest rates would allow banks to return to profitability and inject new life into their capital starved balance sheets. With improvements in the financial strength of the banking system and both of the Fed mandates near target levels, it is more difficult for the Fed to justify keeping rates at these historically low levels. Recently, Federal Reserve chairwoman Yellen publically stated that the markets can expect the Federal Funds Rate to increase sometime before the end of 2015. The **Bond Market** appears to be anticipating the return to a more normal environment, as the yield curve begins inching upward. Nevertheless, Chairman Yellen has cautioned that the transitory nature of the U.S. economic slowdown may cause the Fed to adjust their timing on raising rates, popularly referred to as "liftoff", and that the up cycle will most likely be very gradual, cautious, and data dependent. As Mohamed El-Erian recently stated, this cycle may end up "being the "loosest tightening" in the modern history of central banking".[3]

Investors that have reached for yield face a new set of risks after rates begin their rise. The first relates to interest rate risk. Longer duration portfolios will see larger declines for every 1% increase in rates than shorter duration portfolios. In addition, corporate bondholders who recently purchased credits with narrow spreads will face the additional risk of corporate downgrades and defaults if there are rapid changes in global economic conditions (i.e. Oil price falls further, faster or European collateral damage from Grexit or some other exogenous shock). As corporate spreads widen out to more normal levels, corporate and high-yield bonds will have downward pricing pressures.

The second, more elusive risk is liquidity risk. This is the risk that there may not be sufficient liquidity on the other side of the trade if an investor decides that he needs to exit a position. To most investors this seems counterintuitive, given that the Federal Reserve has flooded the markets with liquidity as a part of their policy actions. However, there are a number of structural changes in the bond markets which occurred over the past few years that have contributed to reducing the risk taking appetite of market makers and other intermediaries. Increased regulatory intervention has pushed many bond market broker-dealers to avoid holding inventory, so as not to put their firm's capital base at risk. Thus, liquidity risk becomes greater at times of market stress, usually when the "herd" decides to shift their collective

[3]"El-Erian on Yellen Economy Speech" ***Business Insider***, May 22, 2015.

investment strategy, causing more severe market price responses. The net result of this will be a marketplace that will exhibit great price swings and may see wider bid / ask spreads during transitional periods of change.

As the performance of the bond market in the tables below demonstrates, riskier and long-dated securities have underperformed the less risky, shorter-duration credits. Corporate bonds underperformed relative to the similar maturity government bonds, as spreads widened on softening global economic news.

Morningstar Bond Indexes

Broad Market	Quarter	1-Year	3-Year	5-Year
Core Bond	(1.52)	2.17	1.99	3.47
Intermediate Core Bond	(0.66)	2.57	2.30	3.49
Short-Term Core Bond	0.10	1.05	1.11	1.48
Corporate				
Corp Bond	(2.77)	0.87	3.41	5.08
Intermediate Corp Bond	(0.86)	1.76	3.86	5.17
Short-Term Corp Bond	0.07	1.14	2.39	2.87
Government				
Intermediate US Govt Bond	(0.70)	2.35	0.99	2.87
Short-Term US Govt Bond	0.11	0.99	0.72	1.06

Source: Morningstar Index Review

The risk and return dynamics of the bond market continue to favor a focused strategy of preserving capital over reaching for yield. As such, our fixed income strategy will focus on matching your risk tolerances to the investments we are making. We continue to favor a shorter-duration portfolio that is constructed with high-quality issues that can withstand the imminent changes in fixed income markets.

The **Stock Market** provided mixed results in the Second Quarter of 2015, with the major indices posting a wide range in performance. The geopolitical risks continue to provide above average levels of uncertainty, while oil prices slowed their rate of descent and the U.S. dollar continued to show improvements versus other major currencies. Healthcare stocks were up during the quarter, followed by consumer discretionary stocks. These gains were partially offset by declines in energy and basic industry stocks.

The wide variance in the second quarter returns, when compared in the Lipper Quarterly Performance Table below, shows a further divergence in the performance trends experienced over prior quarters. The major indices were flat to slightly down for the quarter, while smaller and middle capitalization stocks gave back part of their gains from the prior period. Generally riskier companies outperformed the blue chip quality names, while interest sensitive stocks

underperformed for the quarter. The widening divergence most likely signals a potential change in market leadership is on the horizon.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, July 13, 2015

	Qtr	1 year	5 year	10 year
S&P 500	0.1	6.7	16.7	7.4
S&P 500 Index P	(0.2)	5.3	14.9	5.7
Dow Jones Ind. Averag	(0.9)	4.7	12.5	5.5
Equity Income	(1.1)	1.7	14.3	7.1
Large-Cap Growth	0.6	10.5	17.2	8.3
Large-Cap Value	0.4	4.1	15.2	6.4
Mid-Cap Growth	0.5	9.4	17.2	9.0
Mid-Cap Value	(0.8)	3.3	16.4	8.0
General Equity	0.0	5.2	15.0	7.4

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

The paltry performance of stocks during the 2nd Quarter reflected the continued deterioration in profit trends, with analysts reducing their estimate of 2nd Quarter S&P 500 Earnings per share to $28.70, down 4.5% year-over-year. This would be the first negative quarterly earnings report since the 3rd quarter of 2012, placing more pressure on the back half of the year to make up the short fall and meet annual earnings expectations. This will put additional upward pressure on the already extended valuation measures that we've outlined in prior quarterly letters.

The ability of corporate America to continue to maintain its profit growth is waning as profitability metrics are approaching 25-year highs. The past improvements to profits have been the result of a combination of the following:

- Companies have significantly improved their supply chain management and sourcing, reducing the cost of goods sold.
- Since the 2008 Recession, companies have been quick to fire and slow to rehire, thus improving the ratio of labor to capital, resulting in improved productivity.
- Historically low interest rates have allowed corporate treasurers to reduce the cost of capital, reducing interest expense.
- The wise use of technology has allowed companies to improve expense control.

Morningstar estimates these factors have contributed to a 2.3% increase in the S&P 500 net profit margin since 2004.[4] It is hard to imagine that a similar magnitude of increase in margins could be attained in the next 10 years given the increasing margin pressures from competitive and regulatory forces. Thus, multiple expansion from this point appears to be somewhat capped from the earnings side of the Price to Earnings (P/E) equation.

While valuations are notoriously known as a poor timing indicator for directional changes in stock markets, they are a much better indicator of the potential magnitude of reversal that can occur. It has been 44 months since the stock market has seen a correction of 10% or more, which works out to be about twice as long as the historical average time between 10% corrections, which is 18 months. Valuations as measured by operating earnings and GAAP earnings on a trailing P/E ratio basis are all higher than they were a year ago, while stocks are trading at 18 X projected 2015 earnings per share – almost 33% higher than last year's projected P/E level.

Our strategy of focusing on stocks that can be purchased below our estimate of their fair value has a built-in conservative bias, which is apparent given the current market dynamics. When valuations are at the high end of their range, there are fewer stocks available to buy at a discounted price to fair value. As more stocks reach or exceed our fair value estimate, they will be trimmed or sold. Cash balances grow as a result of the process, retarding performance of the account in the near-term, but likewise conserving capital to be redeployed when the next stock idea presents itself.

For those investors with the patience and persistence to wait for cheaper stocks, long-term returns can be more than satisfactory. In addition, the patient investor will preserve capital over the long haul, by allowing cash to build during periods of market euphoria, and thus experience less of a decline in their portfolio when the inevitable market downdraft finally occurs. Conversely, for investors that are chasing returns and buying today's stocks at higher valuations, the math is clear – by purchasing stocks at inflated or above average valuations, the investor will experience returns that are below the long-term average over the foreseeable future.

Finding value, without sacrificing quality, in a high and rising valuation environment is always a challenge. However, we will continue to be disciplined in our process, purchasing those stocks that can be bought at prices that meet our investment standards while providing an adequate margin-of-safety. Similarly, we will sell those stocks that exceed our estimate of fair value, irrespective of the rotations of the markets.

[4] "U.S. Corporate Earnings: Are Current Profit Margins Sustainable?" By Nielson, Zhang ***Morningstar*** 5-13-2015.