First Quarter 2016

Quarterly Letter to Clients

By Scott A. Wendt, CFA

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The last few months have turned out to be challenging for many investors, coming on the heels of a rocky finish to 2015. We find ourselves in a world inundated by social, political, and economic drivers that are resulting in extraordinary change. The pace of that change seems to be accelerating at a rapid rate. The convergence of engineering breakthroughs with advanced computing power is making many ideas that were considered science fiction a real possibility in our lifetime. (Think of affordable space travel or a self-driving car). We can literally watch a live sporting event or communicate with someone halfway around the world on a wrist watch. Technological advances provide us with the ability to access information on almost anything with literally the touch of a finger. Yet, with all the marvels and advancements that technology provides, we still can't seem to avoid the randomness of outcomes that changes bring about. Economists often described this observation as the L*aw of Unintended Consequences*, which can be loosely defined as causal factors that have unanticipated impacts that lead to unplanned results.

In the time that has passed since the Great Recession of 2008, nothing has captured the attention of investment strategists, analysts, and market participants more than the impact of *unusually low interest rates*. A direct result of policies implemented by the Federal Reserve Bank – and what began as a part of extraordinary measures to shore up a critically wounded banking system – has become an ongoing accommodation to an economy that appears unresponsive to the treatment. Commonly referred to as the Zero Interest Rate Policy, or ZIRP, the intention was to reduce the cost of borrowing, in order to spur lending activity and jumpstart consumer spending. But in accordance with the Law of Unintended Consequences, banks didn't lend as freely as expected. Instead, scarred from their default experiences in the downturn and faced with an increasingly strict regulatory environment, they retained capital to rebuild their balance sheets.

Consumers also did not spend as expected. Burdened by high debt levels, consumers redirected more disposable income towards debt repayment and savings, thereby spending less than had been experienced in prior economic recoveries. In fact, the evidence seems to support the belief that low rates have not provided the expected boost to real economic growth, but have instead provided additional liquidity that flowed into the capital markets. This caused the price of financial assets to rise, artificially propping them up in hopes that the "wealth effect" would provide a boost to confidence and cause consumers to be less fearful about making big ticket purchase decisions.

As ZIRP has dragged on for what has almost been a decade, the impact on savers and investors has been significant. Low rates on safe investments have caused retirees, endowments, and those dependent on dividend and interest income to reach for yield in riskier investments. Many are either unaware of, or otherwise ignoring, the fundamental risks imbedded in these types of securities – risks that could result in either significant temporary or permanent loss of the capital invested.

These trends mask what could be the most challenging unintended consequences of these policies – the trend away from time-tested, sound investment-oriented principles towards a more casino-like mentality by professional and individual investors alike. As a result, market participants have embraced "Fed Speak" as the divining rod for whether they should own bonds and stocks, while shunning more fundamental methods that focus on profits and growth from sustainable business models. As time passes, more and more market participants are lulled into a false sense of security that the actions of global central banks will be enough to maintain the upward momentum in asset prices. But there are consequences of these actions as demonstrated over the last 6 months. The market's reaction to the *potential* increase in the Fed Funds Rate announced by the Fed in the 3rd Quarter of last year was followed by a rapid decline in stock prices. Similarly, the actual increase in the Fed Funds Rate by ¼ percent (25 basis points) in December 2015 set the market on another mini roller coaster ride.

In a recent Business Insider article, Mohamed A. El-Erian, formerly of PIMCO, eloquently and succinctly outlined the challenge faced by the Federal Reserve when he stated, "The last few years have been defined by two major characteristics. One is that, while growth has been insufficient, it has been relatively stable. And the second is that central banks were willing and able to buy time for the system by borrowing growth and financial returns from the future… These are now coming under pressure."[1] This pressure comes from an overreliance on the central banks around the world to provide support for economic activity, when the reality is they don't have the right policy tools for what they are trying to achieve. The failure to achieve the desired outcomes has resulted in central bankers using untested policy actions, such as the aforementioned Zero Interest Rate Policy (ZIRP), Quantitative Easing (QE), and – not to be underestimated the latest iteration – the Negative Interest Rate Policy, or NIRP.

In essence, NIRP moves the short-term interest rates into negative territory, which means you would pay your banker to hold your money instead of the banker paying you for the use of your money. This policy is currently being used by the Japanese and European Central banks and may have dangerous financial and economic consequences, as it puts additional pressures on savers and investors. There is no

[1] The Mohamed A. El-Erian interview: How bad a slowdown do you need for a real wake-up call? By Ben Moshinsky, **Business Insider**, 4-12-2016.

evidence that a negative interest rate policy will stimulate economies and encourage borrowing and saving any more than a ZIRP would. Lower rates mean more capital needs to be invested for retirement and therefore, increases in discretionary income will be used to further reduce debt and to invest for retirement, while less will be spent on current consumption. At a minimum, this will provide an additional headwind to economic growth, as long as no other impacts from the Law of Unintended Consequences kick in.

So what is the bottom line? The Federal Reserve has said it is in the process of trying to normalize interest rates, or basically removing their extraordinary interventions from the bond market. Yet, if the economic growth continues to be characterized by sub 2% real growth, and inflation remains below the Fed's target level, ***normalization will take years to accomplish***. Failure to generate higher and broader growth will only aggravate a consumer and saver base that is already frustrated with policies and politics that fall significantly short of expectations. Capital markets would have to face the difficult choice of what happens when the artificial force that has levitated the market for so long is removed. Parts of the current investment universe don't even make sense for long-term investors because they're so distorted i.e. Why would anyone buy a European bond at a negative interest rate that, if held to maturity, guarantees a loss? If the 2008 market correction taught investors anything, it was that diversification, while necessary, is not enough for controlling all the risks that can enable a portfolio of investments to meet a future need. And, as the risks of policy failure increase, the odds of a recession and additional market contractions also increase. Combine this with a market that continues to trade at lofty valuations, with a top-line and bottom-line declining and negative growth comparisons, and you are left with investment alternatives with limited upside and the potential for significant downside. Thus, Cash and Cash Equivalents may begin to play a larger role in asset allocations as investors grapple with this increasingly distorted investment environment.

Stock & Bond Performance

During first quarter of 2016, stock prices continued the swoon and surge pattern seen in the last half of 2015. The S&P 500 index fell almost 5% in January, traded flat during February, and then recovered most of its losses in the month of March. As the Lipper Mutual Fund chart below shows, larger capitalization stocks underperformed their smaller brethren. The average mutual fund, represented as General Equity in the chart below, saw a loss of -0.4% for the quarter. On a total return basis for the quarter, the Dow Jones Industrial Average increased +2.1% and the S&P 500 was up +1.3%, while the tech-heavy NASDAQ posted a loss of -2.5%. International stock funds fell -1.7%, while intermediate bond funds appreciated +2.6%. Most measures of stock performance remained in negative territory for annual comparisons, as confirmed in the 1-year return column below.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

MONDAY, April 4, 2016

	Qtr	1 year	5 year	10 year
S&P 500	1.2	1.3	11.0	6.5
S&P 500 Index P	0.8	(0.4)	9.2	4.8
Dow Jones Ind. Average P	1.5	(0.5)	7.5	4.8
Equity Income	2.9	(1.5)	8.6	6.0
General Equity	(0.4)	(4.9)	7.6	5.4
Large-Cap Core	0.3	(1.2)	9.8	6.0
Large-Cap Growth	(2.8)	(1.4)	10.5	6.9
Large-Cap Value	0.3	(3.7)	8.6	4.9
Mid-Cap Core	1.5	(6.3)	7.7	6.0
Mid-Cap Growth	(2.1)	(8.5)	7.6	6.0
Mid-Cap Value	2.9	(4.6)	8.7	6.0

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

The bond market posted solid returns for the quarter. As the bond performance chart below shows, intermediate corporate bonds gained 3.3% for the quarter, while intermediate government bonds posted a 3.2% quarterly gain. A further examination of the bond performance chart confirms that longer maturity bonds performed better than shorter ones, while poor quality (riskier credits) underperformed the higher quality paper.

Morningstar Bond Indexes

Broad Market	Qtr	1-Year	3-Year	5-Year
US Inter Core Bd TR Bond	2.60	3.08	2.90	3.94
US Lng Core Bd TR Bond	6.20	1.79	4.20	7.42
US Shrt Core Bd TR Bond	1.28	1.36	1.14	1.50
Corporate				
US Inter Corp Bd TR Bond	3.32	2.44	2.97	4.91
US Lng Corp Bd TR Bond	5.85	0.08	3.81	6.93
US Shrt Corp Bd TR Bond	1.51	1.62	1.81	2.59
Government				
US Inter Gov Bd TR Bond	3.17	3.18	1.90	3.52
US Lng Gov Bd TR Bond	6.64	3.62	4.95	7.93
US Shrt Gov Bd TR Bond	1.17	1.23	0.91	1.16

As of 3-31-2016

While the average investor's performance measurement time horizon has shortened from quarters and years to weeks and days, our attention will continue to be on tailoring portfolios to meet your long-term goals while minimizing risks of permanent capital loss. This strategy remains consistent with our disciplined process of purchasing stocks that can be bought at prices that meet our investment standards, while still providing an acceptable margin-of-safety.