Second Quarter 2016
Quarterly Letter to Clients
By Scott A. Wendt, CFA
July 20, 2016

I had a longtime friend call me a few weeks ago with a question that may be on many folk's minds: "How am I going to retire when rates are so low, the stock market doesn't make sense, and the events occurring in the world scare the heck out of me? It seems like the wheels are coming off the bus! I don't know how you do what you do without losing your mind." I assured him that even if the wheels came off the bus, that there were folks who knew how to fix the axle and put the spare back on and that it might mean a delay waiting for parts, but the more important point was making sure that the bus was going to where you wanted it to go in the first place. If you're going cross country, you will have detours, bad weather, mechanical problems, and your bus driver might have to slow down or speed up depending on the driving conditions – but with some patience and persistence, you'll eventually reach your destination.

This phone call summarized many of the sentiments that clients are expressing to us as they look to save and invest for the future. The uncertainty and fears of a world with such significant social, political, and economic change is starting to frazzle nerves and challenge investors to stay on the course with their investment "bus". If history teaches us anything, it is that changes continually come and need to be embraced with the perspective and knowledge that both good and bad things may happen. We just tend to focus on the latter. Sure, the current investment environment has its share of potholes and roadblocks that need to be avoided. However, we believe that our strategies for your account will allow us to avoid the vast majority of the "potholes", while preserving capital to opportunistically invest for the future. So as we drive the metaphorical investment "bus" through the midst of the fog of change surrounding us, we'll attempt to provide some perspective along the way by reviewing the current economic, interest rate and stock market "scenery" for the Second Quarter of 2016.

Economic Overview

The U.S. Economy, beginning its eighth year of expansion, continues to limp along at an annualized growth rate around 2 percent, underperforming the consensus expectation of 2.5 percent. The lackluster pace of growth appears to reflect a consumer that has reduced spending to the slowest rate in the last two years, combined with the drag on U.S. exports due to the relative strength of the U.S. dollar. The challenges to our domestic economy have been well documented in our past few quarterly letters. Most prominently, shifts in the economic trends in housing, autos, and the energy patch have provided alternating support to keep the economy just above stall speed. In addition, "U.S. companies are facing a toxic combination of dismal productivity growth, accelerating wages and sluggish demand, raising the risk they will slow hiring and cut spending further and weaken an already fragile economy".[1]

In past recoveries, autos and housing were the cornerstone in rebuilding economic growth. However, while auto sales have done their part to prop up economic growth, the housing side of the ledger has been mixed. Low interest rate mortgages have not been sufficient to offset the trend of declining home ownership. In fact, in the first quarter of 2016, the home ownership rate was at 63.5%, not far from the 48-year low of 63.4%, recorded in the second quarter of 2015.[2] A myriad of factors may be responsible for this record low rate of ownership including higher lending standards, lower income levels, the lack of a down payment, high level of other debt – i.e. student loans, delays in marriage and childbearing, the rapid rise in affordable, lower priced home prices, and the prevailing millennial opinion that one might as well rent, because rapid price declines, like those that happened in 2008 could occur, and they well remember the consequences of that event.

Global growth measures mirror the subpar growth patterns experienced in the U.S. economy, with forecasts being reduced in many of the developed economies. For example, Japan cut its 2016 GDP growth forecast to 0.5%, down from 1.5%; while, China's growth has fallen from low double-digit growth to around 6.5 percent. Emerging markets are seeing increasing deficits and increasing levels of debt that have yet to further stimulate their economies. Trade growth, a measure of overall international commerce, is significantly below pre-2008 trends and has fallen to an estimated 3.1 percent. This trend is not helped in any measure by the fact that a low-growth environment is fertile ground for increased political rhetoric, which many

[1] "Weak Productivity, Rising Wages Putting Pressure on U.S. Companies" by Josh Mitchell, **The Wall Street Journal**, July 8, 2016.
[2] "The U.S. Homeownership Rate Falls Again, Nearing a 48-Year Low" by Laura Kusisto, **The Wall Street Jo**urnal, April 28, 2016.

times leads to a more protectionist stance on trade by nations, which in turn further weakens international commerce.

Central Bankers around the world continue to wage all-out, "anything-it-takes" stimulus programs in an attempt to jump-start their respective economies. As a result, many European and Japanese savers, who have experienced years of zero or near zero-interest rate policies, are now the guinea pigs for the next central bank experiment called the negative interest rate policy (NIRP). NIRP is a coordinated effort to force interest rates into negative territory, which means investors pay their banker to hold their money instead of receiving interest for the use of their money. There continues to be no evidence that a negative interest rate policy (NIRP) will stimulate economies and encourage borrowing and saving any more than a ZIRP would. Lower rates mean more savings are needed for retirement and therefore, less will be spent on current consumption. In fact, this "ultra-loose" monetary policy tool is being used more liberally across the globe and as of June 27th, $11.7 Trillion of global sovereign bonds were trading at negative interest rates, up from just $1.3 Trillion at the end of May.[3]

BREXIT

If low and negative interest rates weren't enough for the European Central Bank (ECB) to deal with, the citizens of Great Britain voted to leave the European Union (EU) at the end of June. This event was considered highly unlikely by most of the major strategists and pundits. However, the unexpected did happen and the capital markets around the world are still dealing with the aftershocks as of this writing. It was our belief that if the vote turned out to be to EXIT the EU, the capital markets would react similar to other disasters, i.e. the Japanese Tsunami, with a brief correction followed by recovery. Here are a few points to put some perspective around the BREXIT event:

- **Poor Political Leadership**. The vote was a result of poor political leadership combined with the EU's widely known structural flaws. Prime Minister David Cameron played a game of brinkmanship and lost.
- The Catalysts: **Regulation and Immigration**. The catalyst for the vote was a deepening sense by many of the British people that they were giving up their sovereignty, as more regulation and restrictions were being placed on them by the EU governing authority in Brussels. In addition, as a part of membership in the EU, member countries are required to open their border to

[3] "Government Bond Yields in U.S., Europe Hit Historic Lows" by Min Zeng & Christopher Whittall, **The Wall Street Journal,** July 5, 2016.

allow free immigration between member countries. Given the massive migration of Syrian refugees from the Mid-East conflict, many Brits feel they are losing control over who can enter their country, as well as the difficulty of absorbing these folks into their economies, cultures, etc.

- **Economic Impact**. In the short run, the economic impact should be minimal. This might shave off ½% to ¾% from Great Britain's GDP. ***This will only have a minor economic impact to the US.*** Longer term, there could be some dislocations and delays in goods being transferred / sold between borders as new trade agreements are negotiated. BUT THIS WILL TAKE YEARS, and could actually benefit all EU members in the long run.
- **Bond / Stock market reaction – *driven by fear.*** The aftershock of the vote created additional uncertainty within the capital markets, as media did its best to make BREXIT into a crisis of greater magnitude than it should be. While the actual impact to the economies of the world should be very manageable, the political and social implications could cause additional follow on impacts – which ***no one can predict*** at this time. As such, the **fear of what "could be"** may drive the markets into a more volatile state over the next few months.

While BREXIT held the spotlight for a short time, the focus of the European community quickly turned towards Italy, where many of its national banks are facing a tidal wave of nonperforming loans (NPL's). Cautionary flags are flying, although again the outcome of this situation is difficult to predict. The end game will be some variation on the themes already played out in the Greek & Cypress Banking Crises during 2013, where some sort of "bail-in" arrangement will be used (EU regulations prohibit members from using taxpayer money to bail-out financial institutions). Expect Germany to play a pivotal role in the resolution process. As the chief exporter of Europe, Germany dominates the Euro (€) monetary system and will do all in its power to maintain its longevity. Nevertheless, the balancing act between "following the EU's rules" and taking "unilateral actions" is only getting more difficult for the Italian government to preserve the financial system of Europe's 3rd largest economy. While the proverbial Greek "can" has been retrofitted for additional kicking, the focus of European leaders will be on stabilizing multiple economies so they can kick the new and improved can down the road. But as a good friend and mentor of mine reminded me recently, there is a point where one cannot kick the can down the road any further. Either the can is destroyed, or you run out of road.

All of these events leave the data dependent Federal Reserve Open Market Committee (FOMC) in a bind. They would like to raise interest rates, and have stated their intent to do so, "sometime" this year. The data shows that the U.S. economy is undergoing some modest improvements in many economic areas. The ultra-loose policy characterized by extraordinary measures should not be required at this point in the economic cycle. The Fed really needs to move rates to a higher level to get the ball rolling on replenishing its empty quiver with additional arrows, so it will have some ammo to fight the next downturn. The challenge is to get rates up without stalling the economy. However, as the events of the past few months have demonstrated, the global financial community is so interlinked, that a change in one system can have significant impact(s) on other areas. Time is running short and this is leaving the voting members of the FOMC with little in the way of options going forward to re-stimulate the system, should another major global economic shock occur.

Bonds

The bond market posted solid returns for the quarter. As the bond performance chart below shows, intermediate corporate bonds gained 2.4% for the quarter, while intermediate government bonds posted a 1.6% 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) outperformed the higher quality paper.

Morningstar Bond Indexes — **As of 6-30-2016**

Broad Market	**Quarter**	**1-Year**	**3-Year**	**5-Year**
US Inter Core Bd TR Bond	1.48	5.30	4.10	3.72
US Lng Core Bd TR Bond	**5.21**	**13.40**	**7.92**	**7.85**
US Shrt Core Bd TR Bond	0.82	2.10	1.55	1.42
Corporate				
US Inter Corp Bd TR Bond	**2.36**	**5.77**	**4.77**	**4.87**
US Lng Corp Bd TR Bond	5.52	11.97	7.73	7.53
US Shrt Corp Bd TR Bond	1.17	2.74	2.41	2.56
Government				
US Inter Gov Bd TR Bond	**1.65**	**5.62**	**3.33**	**3.20**
US Lng Gov Bd TR Bond	**4.94**	**15.06**	**8.49**	**8.22**
US Shrt Gov Bd TR Bond	0.65	1.78	1.25	1.06

Stocks

During second quarter of 2016, as the Lipper Mutual Fund chart below shows, larger capitalization stocks outperformed their smaller brethren. The average mutual fund, represented as General Equity in the chart below, saw a gain of +1.8%. On a total return basis for the quarter, the Dow Jones Industrial Average increased +2.1% and the S&P 500 was up +2.5%, while the tech-heavy NASDAQ posted a loss of -0.6%. International stock funds fell -1.8%. Many measures of stock performance remained in negative territory for annual comparisons, as depicted in the 1-year return column below.

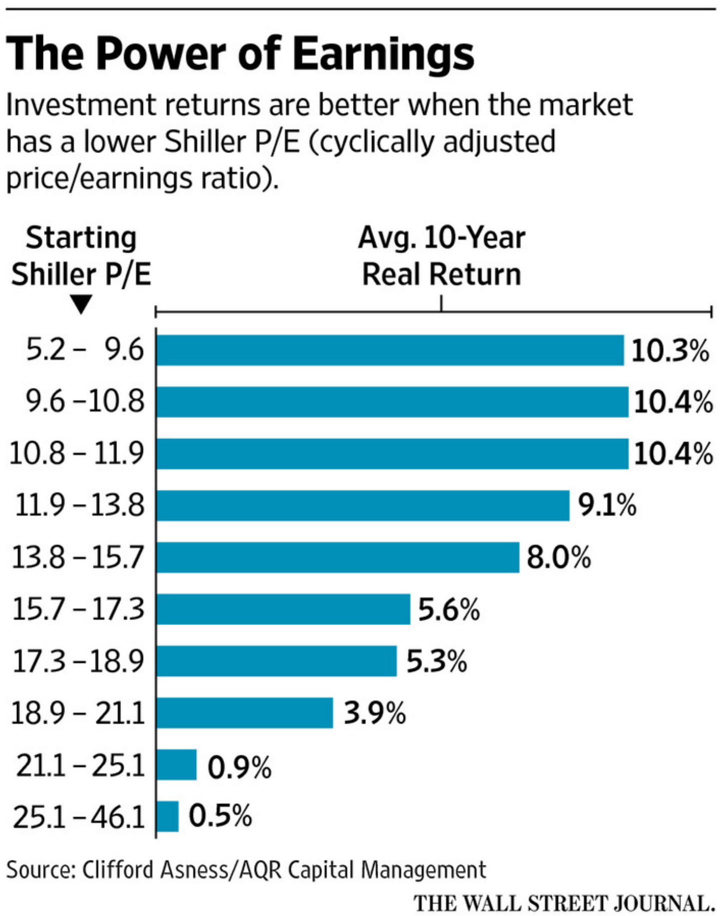
LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

TUESDAY July 5, 2016

	Qtr	1 year	5 year	10 year
S&P 500	2.3	3.4	11.5	6.9
S&P 500 Index P	1.9	1.7	9.7	5.2
Dow Jones Ind. Average P	1.4	1.8	7.6	4.9
Russell 2000 IX P	3.4	(8.1)	6.8	4.7
NYSE Composite P	2.8	(2.9)	4.8	2.5
General Equity	1.8	(3.2)	8.1	5.9
Equity Income	3.4	3.1	9.3	6.4
Large-Cap Core	2.0	0.7	10.2	6.5
Large-Cap Growth	0.4	(1.7)	10.4	7.4
Large-Cap Value	2.6	(1.2)	9.3	5.3
Mid-Cap Core	2.1	(3.6)	8.4	6.6
Mid-Cap Growth	2.2	(6.7)	8.0	6.8
Mid-Cap Value	2.2	(1.9)	9.1	6.3

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

Finally, sometimes a picture is really worth a thousand words. Take a look at the chart below, which was printed in a recent Wall Street Journal Article, and depicts an investor's expected return when the S&P Index was purchased at various valuation levels, using the Shiller P/E valuation measure. It shows that if an investor purchases stocks at low valuations, that their returns over 10-years will be superior to those who purchase stocks at high valuations.[4] For example, purchasing the S&P 500 Index when the Shiller P/E is below 12X, gives an investor a superior return of 9% to 10%. Purchasing stocks at the long-term average valuation of the Shiller P/E at 17X gives the investor an expected 10-year return between 5% and 6%. However, for those folks that buy the market at the current Shiller P/E of 25X, the expected 10-year return is less than 1%. The morale of the story: **For investors with a long-term time horizon, valuations do matter.**



As I stated last quarter, "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. " Our 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.

[4] "Three Ways Investors Can See The Future" by John Coumarianos, **The Wall Street Journal**, July 4, 2016.