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Your Capital

Quarterly Report- 2nd quarter 2015

On the Markets...

Some headlines of interest:

Barron's, Nov. 2009: "The Easy Money's Been Made"
Morningstar, Dec. 2010: "The Easy Money Has been Made"
Marketwatch, Nov. 2011: "The easy money's has already been made"
TheStreet, May 2012: "The Easy Money Has Been Made"
Morningstar, Dec. 2013: "The Easy Money Has Been Made"
Barron's, Oct. 2014: "The Easy Money Has Been Made"
CNBC, Mar. 2015: The easy Money has been made"

For the record, we strongly disagree: none of it was easy money- it never is.

Nonetheless, client portfolios have seen persistent annual gains, much of it enhanced with carefully selected income-producing securities including, REITS, MLP's, CEF's, Preferred, ETF's, corporate, municipal and Treasury bonds, option premiums and dividend-paying stocks. Almost 40% of the S&P 500 gains since 1926 have come from dividends. In the last decade it was even higher. From Jan. 1- June 30, this year, the S&P 500 has registered a meagre gain of .1%. With dividends included, the gain is 1.2%: twelve times greater.

We have deliberately eschewed trying to forecast short-term security prices. Instead, we have focused our efforts on adding value by properly identifying intermediate term market and sector trends with reasonable success, and by correctly responding to longer term macro-economic trends, keenly sensitive to probabilistic risk and reward. Our wardrobe has long been stripped of the cape and tights of the Superhero. And there once was a shelf where we kept a polished crystal ball and a tall and pointed conical hat adorned with stars and magical numerals. Those were donated to the Goodwill long ago.

Though it might sound like Yogi Berra, it was Niels Bohr, a Nobel prize-winning Danish physicist who made foundational contributions to the understanding of atomic structure and quantum theory who is credited with saying: "Prediction is very difficult, especially about the future."

The inability of investors to correctly predict the future has had dramatic consequences for their short and long term portfolio returns as demonstrated consistently over the past 30 years of the DALBAR Study. DALBAR analyzes individual investors' market timing successes and failures through the purchases and sales of mutual funds. They do this by comparing the returns mutual fund investors actually achieve in contrast to the net returns of the mutual funds those investors select during the same time period(s). The results are depressing. Over the past 30 years, poor timing decisions by individual investors created an average annual return of 3.79%, barely beating the average inflation rate of 2.7% and badly trailing the average stock mutual fund performance of 11.06% over the same period. And this was not an averaged result distorted by the extremes of a few bad years. There was not a single year in which retail investors achieved even 60% of the performance that their mutual funds actually delivered. This massive underperformance clearly demonstrates that despite the best of initial intentions, investors are handicapped not only by poor predictions of the future, but grievously misled by the emotional and cognitive biases that drive accumulations and liquidations at inappropriate times to produce a contrary result: buying high and selling low.

It may come as meagre comfort to know that even Sir Isaac Newton, whose achievements in virtually every extant field of Science and Mathematics remain unparalleled in human history, lost a small fortune in the markets-despite his towering intellect. With the collapse of the South Sea India Company, he is reported to have said: "I can calculate the movement of the stars, but not the madness of men."

More than 2000 years earlier Lao-Tzu expressed it this way: "Those who have knowledge, don't predict; those who predict, don't have knowledge."

Our approach to market timing is not driven by the goal of trying to pick market tops and bottoms- that is a fool's errand. We have learned the hard but enduring lesson that nothing is more dangerous than focusing on peak or trough prices because this inevitably arouses the most destructive of emotions: greed or fear. Instead, our approach to market timing aims at protecting your capital. After all, it's not how much money you make, but how much you keep. Our advice to clients is this: you have hired us as risk managers. When you check your account to see how it's going, try to maintain a long-term perspective and *measure from your initial value, not from some illusory, temporary peak.*

We confess that we were not surprised to see the results of a recent survey conducted by Fidelity Investments. The firm analyzed their best performing client accounts. These fell into (2) categories. The best performance belonged to those accounts in which no trades occurred because owners had forgotten about the account. The second best performance was in accounts where the account owner was deceased.

While this sounds comical, we find some important takeaways embedded here. At a minimum, it suggests that the virtues of longer holding periods may be underappreciated, especially in rising markets. But more fundamentally, we believe it reveals that the essential challenge in reaching sound investment decisions with rewarding consistency lies in properly recognizing genuinely useful information. We swim in a crowded sea of data and widely disseminated opinion disguised as fact. Consequently, it is critical to avoid being distracted from what is truly significant or misled to an erroneous conclusion.

As three decades of DALBAR quantitative analysis demonstrates, investor sentiment is a useful *contrarian* indicator: investor optimism rises into market peaks and plunges into a despair which coincides nicely with market bottoms. We use this, along with a number of other coincident and leading indicators to mark and re-calibrate sector and market trends. So how do we measure Investor Sentiment and what is it telling us today?

The American Association of Individual Investors ("AAII") is a group of assertive individual investors who pay an annual membership fee and participate in a wide variety of online and in-person events to self-manage their investment accounts. For more than 30 years, they have described themselves by saying: "At AAII, we believe that individual investors can and should outperform the market indexes and most mutual funds."

They conduct a weekly membership sentiment poll which is freely available on their website, AAII.com. The survey measures the percentage of investors which are bullish, bearish and neutral on the stock market looking out over the next six months. Currently, there are fewer Bulls today than at any time since the 2008 market collapse that accompanied the Subprime/Global Financial Crisis. The weekly reading shows that just 22.6% of individual investors are bullish vs. the long-term average of 38.8%. These are comparable sentiment numbers to those which accompanied the bottom of the bear market in 2002-2003 after tech stocks got crushed in the three preceding years and the market as a whole had fallen more than 40%. To find investor sentiment at this level, today, makes it rather unlikely that we are at or near a market top.

Most tellingly, neutral sentiment has been running at historically high levels now for many weeks.

We have described this as the "most hated bull market" in history, and others, not afraid to date themselves, call this the "Rodney Dangerfield Economy" since it gets no respect.

Yes, the economic expansion has been painfully slow, and there is a long list of difficult, deeply embedded structural issues that need urgent attention in order to make meaningful, long-term progress. But as Jeffrey Sault points out: "The equity markets do not care about the absolutes of good or bad, but only if things are getting better."

And they are getting better. The June Institute of Supply Management (ISM)service sector report came in as expected, continuing to show moderate growth in the biggest sector of the U.S. economy. Meanwhile, a similar report for the Eurozone shows conditions have been slowly improving for the past two years. Greece may be the media's current focus, but as it represents less than 2% of GDP for the entire Eurozone, it shouldn't be our focus. China's economy does exercise a significant influence on global and U.S. markets, and their growth has slowed, but as a centrally-directed, command economy they have levers with which to exert substantial internal controls over markets, prices, and investment and they are highly motivated to do so. And here at home, there is a tired complaint that the U.S. stock market is over-valued, artificially propped up the Federal Reserve zero interest rate policy ("ZIRP".)

We've had more than six years of these historically low interest rates but their origin, purpose and influence is widely and commonly misunderstood.

Here is the real, if oversimplified account. In 2008, from a universal delusion of greed, cynicism, a supreme overconfidence in the ability to algorithmically quantify risk, and a lethal overdose of subprime debt injected into the heart of the intimately entangled, global financial system, the earth cracked open and world financial markets slid to the very edge of a crumbling abyss. And in the words Mario Draghi, President of the European Central Bank, was later to use in describing the tools of salvation, the financial masters of the universe determined to do "whatever it takes" to desperately claw their way back. And we were saved from an horrific depression, not because they were nice guys, but because they too had too much skin in the game.

Central banks around the world, including the U.S. Federal Reserve Bank faced a terrifying and entirely unique scenario without a historically-proven playbook to draw from. But the one thing they were determined not to do was to follow the playbook used by economists and bankers in the epic financial crisis of the 1930's. Ben Bernanke, Chairman of the Federal Reserve had built his academic career on analyzing the "gross mistakes" of economic policy which exacerbated and prolonged the Great Depression. As a result, he was determined to take the George Costanza approach and do just the opposite. Instead of tightening monetary policy as they did in the 1930's, he would loosen it, dramatically, if necessary. And, as the weeks went by, and markets remained frozen and illiquid, and nothing else seemed to be working, he went on to earn the nickname "Helicopter Ben" as in resupplying the economy by dropping dollar bills from the skies.

But here's the thing. You can rescue the banks and the insurance companies and the investment houses and the over-indebted- with low interest rates- at the expense of savers of course. But you can't stimulate growth. Growth comes from productivity and genuine investment (as opposed to financial engineering.) Growth is the result of ingenuity and hard work and the willingness of businesses and individuals to take on the risk of investing capital and resources in their enterprise.

But the world was risked-out. Even if you didn't begin to understand what had happened to cause what came to be called "The Great Recession," you understood that it was pretty bad and you weren't sure when it would end and you knew you needed to be very careful. In short, the world became risk-averse. Corporations chose to re-direct their profits into buying back more of their own stock rather than expanding their businesses. Investors were similarly cautious. Despite the fact that savings accounts, CD's and U.S. Government Treasury Bonds payed almost nothing, and in most cases, payed less than the rate of inflation, demand for these "safe" assets became intense. Bank savings deposits have doubled since the end of 2008. They have quadrupled in the past 14 years, yet they pay almost no interest. In Europe, as we told you in our last newsletter, banks are charging depositors to hold their deposits and Government Bonds with maturities out to 7-10 years have a **negative yield.**

Central banks around the globe, including the U.S. have nurtured the mythology that increasing the money supply and keeping interest rates low will stimulate the economy because (a) although that is not entirely correct, it remains the most effective policy tool they have, and (b) they realize that it is important to foster the public perception that they are making things better. After all, what motivates humans, and moves markets is not necessarily what is happening but what people perceive is happening.

And now the Federal Reserve has a new and growing problem. We are 6.5 years into this recovery and no one has repealed the business cycle. While there is still no indication of a near-term recession, there is one out there waiting for us, for all the usual reasons, (it is a cycle, after all.) Before it arrives, the Fed has to reload its most effective weapon- the ability to nurse the economy with lower interest rates. Because rates can't go any lower than they are now, it has to raise them, so it can lower them later when it needs to. But the fragility of this recovery has stayed their hand. It has forced them to be uncomfortably cautious, or, as they prefer to put it, "data dependent." This has prolonged the frustration of economists and forecasters who predicted that rates would start to rise as early as 2014

While we continue to expect a "typical" 5-10% pullback in the equity markets, we feel that it is Bonds that are overvalued and Stocks are not as expensive as you might think, especially relative to inflation. Corporate profits, which drive earnings, which in turn drive stock prices, are up- if you strip out energy, which we believe is a temporary situation which will self-correct. We believe that the Fed will raise rates, if only to maintain some credibility, but they will do so in a very careful and very gradual fashion. Rates will stay lower for far longer than most everyone expects. The last time the Fed raised rates was June 2006. This is such a distant memory for most people, even a mild rate hike is a disturbing thought and much of the most recent market action has been driven by this anxiety. Modest rate hikes, however, will not bring an end to the economic expansion or to the bull market. (That will be the handiwork of the next, inevitable recession.)

The interest rate cycle is extremely long, so long, that most people live through a single cycle in their investment lives without notice: the last two interest rate cycles each lasted 40 years!

In summary, the trend is still our friend, and we remain wary and alert, respectful of your principal and your trust. We welcome your feedback.

Sincerely,

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