Prepared Comments from 10/15/2015 Conference Call

The S&P 500 is down over 4% from three months ago, yet remains up 198% since its March 2009 low.

US stocks fell over 7% in the past quarter, with large-caps down 7½%, mid-caps down 9% and small caps down almost 11%. Health-care stocks fell over 13% while financials fell 7 ½%, about the same as tech. Natural resource funds lost 20%, utility funds lost less than 4%, while real estate rose, just over 1%.

The growth versus value battle was mixed, with large growth outperforming large value, but with small value outperforming small growth. This confusing result could have been related to energy companies, which all were clobbered. The large oil companies are large value stocks, while there are small growth stocks of oil exploration and service firms.

Foreign stocks also fell during the quarter, with large-caps losing over 10%, smaller-cap funds falling over 8%, and emerging market stock funds falling almost 16%.

Most bonds generally inched upwards, with the best results from longer term bonds, and from municipal bonds. Taxable high yield bonds fell 4½%, while municipal high yield gained about 1½%. Multisector bond funds fell over 2%.

The S&P 500's earnings for the 2Q15 rose compared with the first quarter, but are down from 2Q14. Despite the turbulence, S&P earnings are expected to grow in the third quarter, and reach record levels in 4Q15. Corporate health is quite strong, with cash levels, profit margins, capital expenditures, merger and acquisition activity, dividends and buybacks all at high levels. Cyclical sectors housing and autos are performing well.

The price of oil fell a further 22% to under $48 a barrel. This is less than half its price from 15 months ago. This is **Important Factor #1**, and led to a 20% three-month loss in natural resource stock funds. While a decline from $61 to $48 is notable, the decline from $113 to $61 was more significant, and the global economy is adjusting to this earlier shock. While energy companies have seen their earnings plummet, starting this quarter, their year-on-year earnings comparisons will be more stable. Furthermore, other sectors in our economy benefit from lower oil prices. Additionally, there are many oil-dependent countries which are just now posting measurable benefits tied to the oil price decline. There are several silver linings to this Important Factor.

The US dollar's rise slowed, gaining only 2% during the quarter. Yet it remains 15% higher than a year ago, which is a VERY steep rise. This is the **Important Factor #2**. As was the case with the first factor, the worst appears to be behind us, and the affected parties are adjusting to the new 'normal' level. Also as was the case with the first factor, the dollar's rise has produced both winners and losers. The most significant economic impact should be increased sales from large, foreign companies selling globally, and decreased sales from large, US firms selling globally. Fortunately, the US economy is pretty solid (I will repeat the 'plow horse recovery' label, not fast but VERY hard to push off course), and many foreign companies could use the boost.

Important Factor #3 is the Fed, and when they will begin boosting the Fed rate, when they will get us 'off zero.' All indicators called for a boost at their September meeting, but the Fed bucked the expectations and kept the rate at zero. Their minutes indicated their concern over a slowdown in China, and concern for the US economy's health. I have two counter-arguments. The US exports to China comprise less than 1% of our GDP. It is a rounding error. Furthermore, unlike the Fed, the Chinese central bank has an extremely large amount of stimulus that it could introduce to prevent their economy from making a hard landing.

Secondly, while Fed rate increases are designed to cool a hot economy, that describes when, in the past, the rate was boosted to 5% or 6%, not when it was boosted to 0.5% or 0.6%. I agree with many analysts who feel that the Fed goofed in September, and who wish the Fed to get off zero NOW.

The US Leading Economic Indicator Index rose in the past quarter (up in June and August and flat in July). Consumer Sentiment (from the University of Michigan) fell 5% in September but remains up 3% from last September. The Conference Board's Consumer Confidence Survey rose in both August and September (less so in September), and stands at an eight-year high. One of the reasons for this positive consumer view is a consequent of Factor #2's consequent: much lower prices at the gas pump.

While the job gains in August and September were both under 150,000, the unemployment rate fell to 5.1% and has remained there. It has fallen steadily for six years. The Fed expects it to fall to 4.8% next year—some analysts see levels even lower.

Core inflation (without food and energy) stands at 1.8%, while headline CPI is at only 0.2%, reflecting the positive impact of VERY low energy prices. The 50-year averages of these figures are both above 4%. While inflation is not dead, is has been AWOL for years.

OK, enough with the economy, what do we see for investors?

Let me start with a new strategy. In response to the fairly sharp market decline in late August, tied to news out of China, here at Mallard we have sought a fairly simple method to benefit from the fear of others. Specifically, we sought a system to automatically purchase stocks when the markets fall sharply. We call this strategy **Drop and Give Me Five™**.

We already have a strategy for surviving a lengthy, sharp market decline (20% or more), called **Firewall Investing™**, which we introduced in early 2009. This new **Drop and Give Me Five™** strategy is for short-term declines.

The strategy calls for entering a limit order for a global stock exchange-traded fund (ETF), at a price 5% below the current market price. The trade amount is for 5% of the portfolio (such as $25,000 for a $500,000 portfolio). This trade creates an automatic purchase when stocks fall, an automatic rebalancing action. We are presenting this to our clients, for them to determine if they would like to opt-in to this strategy.

This strategy reflects our view of the market—it is emotional, overly emotional. As such, there are opportunities to be greedy when others are fearful, and fearful when others are greedy. Many investors are fearful at this time. This has led to attractive stock prices.

We like US stock prices and foreign stock prices, and we are unimpressed with most bond prices. We are favoring stocks over bonds an extra 4%; thus a portfolio with a 60% stock allocation target is currently getting 62.4% stocks. We have an extra preference for large stocks, and are maintaining a 56/44% balance between US and foreign stocks, which has been unchanged for several years. Globally, economic growth is often higher beyond the US, and foreign stock markets have much more room to recover than the US stock market (which, as I noted, has risen almost 200% since March 2009).

We are keeping technology and healthcare a bit high, while ensuring that financial companies are at normal levels. While there remains much political risk for financial companies, they are well positioned to benefit from the Fed getting off zero.

We have given up on precious metals, which we introduced about a year ago. We thought that we were buying at bargain levels, but found that the prices simply kept falling. We are waving the white flag and selling our holdings.

We are also reducing our natural resource positions, from 3% to 2% of stocks. While long-term we like investing in the future of energy, the current storm clouds are simply too over-powering.

Overseas, we have eliminated a global infrastructure stock fund we have held for several years. Most foreign economies are not able to maintain an above-average level of infrastructure spending and building. That sweet-spot appears to have ended. We have added to our Europe weighting.

Our foreign stock weights are 20% developing (mostly in diversified emerging markets), 17% in international smaller-cap, and 63% in developed markets (half through global stock funds, and the other half in broadly diversified, plus a bit in Europe specifically, and a lesser amount in a new position, Japan). Japan is a beneficiary of **Important Factor #1**, the oil price collapse.

We have made many changes in our bond strategy. We retain our 65% quality/35% opportunity overall balance. Quality is now made up of 5% cash (a new position), 35% short-term, 20% intermediate-term, 5% long-term. We have eliminated the inflation-linked bonds, and the emerging market corporate bond positions.

The opportunity position is now comprised of 14% in each of high yield and multi-sector, plus 7% in unconstrained bonds. We have eliminated Asia bonds, emerging markets unhedged bonds, and non-core high yield.

With the quarter's sell-off, our conviction is greater for high-yield bonds, and we have therefore boosted the weight of this position. We have given up on the inflation-linked bond fund after years of disappointing results. Some of those results were due to the unexpectedly, persistently low rate of inflation the past few years. We have introduced a cash position, not for their returns (as they yield essentially zero), but rather as 'dry powder.' Should interest rates rise faster than we expect, we want to have VERY handy cash to shift to the resulting bond bargains.

Investors continue to make poor decisions. The US Treasury has recently sold bonds at an auction, with a zero percent yield. Why would an investor give money to the US Treasury so that they can get the same amount back in 3 months? Similarly, this year investors have continued to make sizeable net purchases of bond funds, with bond yields near all-time lows and prices at very high levels. These are poor decisions.

In the first nine months of 2015, cash earned 0.0%, and was the second best performing asset class, after bonds with their 1.1% gain. Commodities were in the basement with losses of more than 15%. This year has been a very difficult time for investors. We believe that this has set the stage for attractive prospects going forward, for investors who remain calm, and make good long-term decisions.

Questions?

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