Prepared Comments from 1/15/2016 Conference Call

The S&P 500 is down over 7% from three months ago, most of that from this month. It remains up 176% since its March 2009 low.

US stocks recovered in the past quarter, with large-caps up 5½%, and mid-caps and small caps up about 2½% each. Health-care stocks rose over 8% financials rose 3½%, and tech rose about 9¼%. Natural resource funds fell another 1% (ending the year down 22%), utility funds lost a fraction, while real estate rose 6½%.

The growth versus value battle was won by growth, outperforming value by 2% during the quarter (6.7% vs 4.7%) and by over 7 ½% for the year (+3.6% vs -4.1%)—mid-caps and small caps had similar results.

Foreign stocks also recovered during the quarter, with large-caps rising 3½%, smaller stocks rising over 4¼%, and emerging market stocks earning almost ¾%.

Bonds had a mixed quarter. Taxable quality bonds lost money, with long-terms down 0.7% and short term down 0.6%, while municipal quality bonds made money, 1.7% for long-term and 0.3% for short-term. Opportunity bonds had a tough quarter, with multisector bonds and global bonds down ½%, taxable high yield bonds down 2%, although municipal high yields rose over 2%.

The S&P 500's earnings for the 3rd calendar quarter were lower than the prior quarter, and the 3rd quarter of 2014. The good news is that 4th quarter results are expected to recover nicely from 3rd quarter levels, but remain below 4Q14 levels (this is a change from expectations a month ago). Corporate health remains strong—cash, profits, capital expenditures, merger activity is all well above average. Cyclical sectors housing and autos have been improving very steadily from 2009 lows.

The **price of oil** fell a further 39% to under $30 a barrel. This is less than 30% of its price from 18 months ago, and down 23% in just one month. Frankly, the drop is bad, but what is worse is the uncertainty of how low it will go. The oil industry, the US economy, and the global economy can adapt to just about any level of oil prices, but no one knows right now where it will land. A year ago we expected it to solidify at $50 a barrel, and to rise $10 barrel a year for five years. The most people are hoping for now is a solidifying at the $25 to $30 a barrel range, with some predictions for prices as low as $10 a barrel. This uncertainty is paralyzing.

In 2015 the oil industry suffered significant losses, and this single industry's troubles prevented the S&P 500 from seeing its earnings grow. Even at a low level, stabilized oil prices will help the S&P 500 regain its footing, and resume growth. Major events such as the freefall of oil prices lead to both winners and losers—in many cases the losers show up early, and it takes awhile for the winners to emerge.

The **US dollar's rise** slowed, gaining only 2.6% during the quarter. Yet it remains 11.6% higher than a year ago, continuing a climb that began in mid-2014. While the rise has slowed, investors and markets are anxiously awaiting stabilization in the US dollar, and would welcome its reversal (weakening). The strong US dollar was another factor that led to slower 2015 earnings in the US, and a weakening dollar, whenever it occurs, will provide a tailwind. One challenge is the non-uniform nature of the economic recovery and central bank policy (raising rates in the US and UK, near zero/negative in Japan and Europe), the dollar is unlikely to fall much in 2016, but could at least stabilize.

The **Fed** took the first step, and took the US off zero, raising its range to ¼ to ½%. This step begins the march back to normal rates. As one analyst noted, you need to have your firetrucks return to the station after a fire to be ready for the next fire. The US economy is no longer in intensive care, and the Fed can back off and is doing so, and will likely continue this path, steadily, for several years. Although some investors may be fearful of such Fed action, while interest rates remain substantially below normal, these early Fed rate hikes should not hamper US economic growth.

The news this month, however, has centered on **China**, and the news has been bad. Chinese stock markets have plummeted, have exhausted various 'circuit breakers,' and there is little clear skies in sight. I have often noted that China helped pull the world out of the 2008-2009 recession, and there are those who worry that China is leading us all down into the next recession.

China's economy has indeed been slowing, and this fact is more worrisome due to the lack of trust that the market has in the government's economic reports (considered by many to be more fiction than non-fiction). Nonetheless, while the magnitude of China's economic growth rate is in doubt, there is little doubt that they are growing, and at a rate greater than the US, Europe, or most countries.

There has been a lot of 'contagion,' declines in non-China markets due to investor concerns of the impact of China on other economies. Yet the facts indicate that this is likely an overreaction. About 1% of Europe's economy involves sales to China, and less for the US. So why is the S&P 500 index down 8% year-to-date?

There are some analysts who are drawing parallels between the current situation and 2008/2009. It appears to be hogwash. In 2008 the Conference Board's LEI, Leading Economic Indicators had been declining for two years. The index has been rising, sharply and steadily, for over six years. The Fed rate had been 5% in 2007; it is under ½% now. 10-year Treasury bonds yielded 4.7% in 2007; they yield 2.0% now. Stock PE levels (a measurement of how expensive they are) are the same as they were in 2007 that is to say that they are reasonably priced, NOT expensive.

The **worried analysts** point to another credit crash. Consumer's debt service level, what proportion of their disposable income goes to paying off household debt has fallen from 13% to 10% since 2007. FICO (credit scores) for mortgage borrowers have risen sharply since 2008, from about 695 to 745.

There is simply too little support for the warnings that some analysts are making.

Are there challenges, and is the US economic growth only modest? Certainly. However the economic data simply does not support the current broad selling that investors have been executing the past two weeks.

So what are we doing? Our investment committee met this afternoon. We agreed on a three-pronged approach. First off, we see the current market conditions to be 'normal,' well within the range of normal market nervousness/selloffs—high volatility that long-term investors should accept as a normal part of investing. **We feel that our regular, broken-record approach of regular rebalancing and steadily sticking to long-term levels of stock allocation as being perfectly well suited to today's markets.**

Secondly, we recognize that some investors may feel unconvinced by our 'stay calm' recommendations. Some may feel compelled to sell stocks and make broad changes to their asset allocation. We encourage such investors to resist that temptation. In 2009 we created our **Firewall Investing™** program, in which we provided a two-way promise. For clients under the **Firewall Investing™** program, we would promise to not buy stocks (so that they could sleep well at night knowing that we were not buying stocks, even to rebalance, 'behind their backs'), but that in return, the clients would promise to not compel us to sell any of their stocks. This deal is designed to protect investors from themselves, to help them hold onto their stocks even when fears are heightened. In 2009 and 2010 this enabled our clients to keep their stocks and to benefit from the eventual steady and strong stock market recovery, which began WELL before the markets appeared to be safe again.

Finally, we recognize that some investors may be so comfortable with the market volatility, that they may wish to ‘ramp it up’ and buy stocks at today’s levels, down 8% in two weeks. For those clients, I suggest that you consider opting into our **Drop and Give Me Five™** program which we established last year. In this program, we examine the level of stock prices during your last rebalance, and should the prices decline by 5% or more before your next scheduled quarterly rebalance, we will automatically purchase 5% more stocks for you. This is designed to buy stocks when they are cheaper, and to provide a quick, auto-rebalance, potentially enabling clients to purchase stocks before they recover from short-term fears.

Again, our overall view is that the recent market decline is painful, yet appears to be unjustified by the underlying economics. That does not mean that it will end today and recover next week. Unjustified market declines can continue, deepen, and last a long time. We are not saying that it won’t worsen, but that it shouldn’t. Regardless, we know that patient, relentless, disciplined rebalancing to a long-term steady level of stocks has always enabled long-term investors to survive the very gut-wrenching bad markets, and we see no reason why this won’t be the case in 2016.

Our investment committee met last week to set the policy for January’s rebalancing. We did not change much, as we feel that the long-term outlook is little changed. One change we made to stocks was to increase our existing dedicated position in European stocks. The one change we made to bonds was to create a ‘sleeve’ for preferred stocks (and convertible bonds) in our opportunity bond area.

Questions?

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