Prepared Comments from 4/15/2015 Conference Call

The S&P 500 is up 4% from three months ago, and up over 200% since its March 2009 low over six years ago.

US stocks rose in the 1st quarter, with smaller stocks outperforming large-caps 3% to 1%. Foreign stocks did better, gaining almost 5%. Health stock funds did best, jumping over 10%, while precious metals funds did poorly, falling almost 4%. Natural resource stock funds slowed their slide, losing less than 1½%.

Bonds had a solid, if boring, quarter, with taxable bonds rising 1½% and municipal bonds up less than 1%. High-yield bonds rose over 2%. Continuing to surprise, long-term government bonds returned 3½%, despite the near-certain interest increases to begin by year-end.

One major story of the quarter was the S&P 500's earnings decline in the 4th quarter, both quarter-on-quarter and year-on-year. US companies have been able to grow their overall earnings, at least year-on-year, with very few exceptions since 2009. This tree is no longer able to grow unimpeded. At some point, gravity has a role.

Investors have taken notice, and foreign stock prices rose much stronger than US stock prices during the quarter. This is not a reflection of foreign economies being stronger than the US economy, but rather that recent surprises have been more positive overseas than in the US.

The sharp drop in oil prices since last summer has a very modest overall impact on the US economy—we have a near equal list of winners and losers from this development. Many foreign economies are strong net importers of oil, and the tumbling prices are a strong unexpected positive development, strengthening their governments, corporations, and consumers.

The sharp increase in the US dollar, which began last year and continued steadily during the past quarter, is a considerable headwind for US companies whose goods and services are 20% more expensive than they were a year ago. Conversely, foreign companies' goods and services are bargains, and thus foreign stock markets are enjoying a significant tailwind.

The US dollar's move did harm results for investors' foreign stock holdings in 2014. Even though foreign stocks made money in their local currencies in 2014, when translated back into dollars, most US investors suffered modest losses. So far this year, the US dollar's continued increase has been dwarfed by much stronger foreign stock market price increases.

US consumer confidence fell back in the past quarter, but remains healthy, solidly above average. This makes sense, for inflation is low, interest rates (including mortgage interest rates) are low, unemployment is low, and asset values have recovered (for all but housing, and housing is getting there).

While the employment report earlier this month was soft (good, but not as good as we have come to expect), unemployment stands well below the 50-year average rate of 6.1%. Wage growth, however, remains anemic, at 1.6% it is under half the average 4.3% level. In this case, the 50-year wage inflation figures are drastically affected by the inflation spiral of the 1970s. this figure has averaged closer to 2% over the past 30 years, coinciding with notably lower inflation rates.

Part of the story behind low wage growth is the baby boomers. They have begun to retire, and this will continue for years and years and years. We are not filling each 65-year old retiree position with someone with 30 years of experience, and the pay to match it. Another significant factor is globalization. Some of our medium-income positions have been outsourced, while few of our lowest-income positions are outsourced. These are not short-term trends, or results of a single, reversible policy decision. This is part of 'the new normal.'

While these economic factors paint a mixed view of the US economy, ours remains a very solid, and growing economy. The recovery has been characterized as a plow-horse recovery, one which is slow but steady. One harsh headwind does not stop the progress of our plow-horse.

Investors have more choices than just US stocks, and the US economy. Foreign economies offer a wider range of choices. Europe is enjoying some recent benefits as mentioned earlier, lower energy costs and benefits from a stronger US dollar. However, some economic weakness overseas has occurred in the past year, including in natural resource-rich countries such as Australia and Brazil, Canada, and Russia. While China has just announced today a slow-down in its growth to 7%, 7% is more than double the US' growth rate. Several major foreign economies benefit sharply from lower energy costs, with Japan and India near the top of the list.

Greece continues to earn bad headlines. The most recent analysis I have heard is that the risk of Greece departing the European Union has increased to be non-trivial, however the expected impact has diminished to be near-trivial. Regardless, the most likely case is that Greece drifts along within the European Union.

US interest rates continue to be the big story, but always the big story for tomorrow, never for today. Interest rates have largely done nothing but fall over the past year, with bond prices rising from expensive to ridiculous. The reasons are numerous. At the base is the confidence that the US Federal Reserve bank, and the US economy are on very solid ground, more solid than most foreign developed economies. This is why the US central bank can consider raising their overnight rates, while other central banks are reducing theirs.

Yet this encounters a stark disconnect. Raising rates will produce falling bond prices, which is bad for bond investors. Why would an intelligent bond investor purchase bonds which will fall when interest rates rise, based on the confidence that these bonds are in the US which is strong enough to raise their interest rates? It makes no sense, and has not made sense for over a year.

Regardless of whether it makes sense, investors must deal with the investment environment we see today. At the highest level, stocks are fairly valued while bonds are overvalued. For this reason, we have a modest preference for a little extra stocks and a little less bonds than our long-term levels.

While we like the US economy, US companies, and US stock prices in general, we continue to feel that there is greater opportunity for positive surprises for foreign companies and stocks than for US companies/stocks. For this reason, we are maintaining a fairly non-US-centric 57%/43% balance between US and foreign stocks. While this is much heavier in US stocks than the overall market (which is closer to a 50/50 balance), 57/43 has a much greater foreign stock allocation than the average US investor. We have maintained this preference for years, and while it worked against us in 2014, so far this year it has worked in our clients' favor.

We have returned to a neutral stance amongst large/mid-cap/small-cap stocks, which we define as a 70/20/10 balance. At times one area gets expensive or cheap, but at this time their relative values seem comparable. Growth stocks, however, have been recovering lately, and we expect that that can continue, due to continued attractive valuations. Health care and technology stocks have done quite well, and while we like both, we are mindful to avoid letting all of those profits roll. We recommend cutting back healthcare before portfolios get too heavy in this volatile sector.

Bonds continue to challenge investors, and we are not immune. We continue to feel that interest rates will begin rising for quality bonds later this year, and will likely continue to rise for a few years, hopefully at a gradual (plow horse) rate. This gradual pace of interest rate increase can serve to moderate the pain of falling bond prices. We wouldn't be surprised if quality bonds avoid losses in most years, however gains should be VERY muted. We continue to keep quality bonds pretty short-term. Currently, the 65% of client bond money we direct into quality bonds is being held at 33% short-term, 16% intermediate-term, 4% long-term, 10% inflation-linked (a recent reduction, due to our view that inflation should not be a concern for years), and 2% in dollar-denominated emerging market corporate bonds.

We therefore believe that opportunity (economically-driven) bonds are more attractive now than typical. We have left them at our maximum level, with 35% of client bond allocations. We have made some shifts, and this 35% is spread 8% traditional high yield, 5% higher quality high yield, 12% multisector (including multisector municipal bonds for higher tax-bracket clients), 5% unconstrained, 3% unhedged emerging market bonds, and 2% asia bonds.

The first quarter (and early April) has brought some strong and weak results. Investors' portfolio have shifted. It is a good time to examine your portfolio and review what has become larger than you had initially planned, and what stands smaller. Diversification requires not only the initial distribution of your dollars amongst several types of investments, but also maintaining that diversification, rebalancing periodically. When all markets move the same way, there is little need to rebalance. The recent quarter has produced a range of results, and a good justification for an intentional review and rebalance.

As it is April 15th, I would like to briefly discuss income taxes and investing. 2008 and early 2009 brought the worst stock market in generations. Most investors with taxable accounts made some sales and captured those losses, which produced a bank account of losses, capital loss carryforwards. This enabled years of earning gains without paying income taxes on those gains.

Those days of tax-free returns has come to an end for most investors. It is important to remember that tax-free gains are the exception, they are not the rule. We are now in normal times, where sales produce gains, and investors need to pay taxes on those gains. We made a lot of lemonade in 2008 and 2009, and we have enjoyed the taste of that lemonade for several years. The pitcher is now empty.

Taxes are a pain. No one likes to pay taxes, regardless of their view of whether government is on 'the right course.' However they are a necessity. Fighting this reality leads to a bad outcome.

I am a busy guy. I hate to sleep. I would much rather be productive 24 hours a day. Well, sleep is a necessity. If I fight this reality, the outcome is bad.

Investors can be tempted to let the tax tail wag the dog, to avoid investment activities which generate taxable income, and taxes. It makes sense on first blush, but fails over time, and fails big time.

The dot-com boom and bust hurt one type of investor the most, the buy-and-hold investor who refused to sell their winners and rebalance the after-tax sales proceeds into diversifying investments.

Managing your portfolio is like sailing a boat across the ocean. If a strong wind takes you off course, if you don't adjust your course, you will not reach your destination. Certainly it takes effort to adjust your rudder, and your sails, but this is necessary to execute your route.

Selling overpriced stocks and sectors, paying income taxes, and then purchasing investments which are cheaper is necessary to keep on an investing path. Five years of living off capital loss carryforwards did not change the reality that rebalancing is just as necessary when taxes are due as when they are covered by past losses.

You are only paying income taxes on your results because your results are good. The US stock markets have tripled since March 2009. If you are paying taxes today, it is because you have been able to benefit from that strong rebound. Congratulations!

Questions?

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