Third Quarter Outlook 2015

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

"Waste your money and you're only out of money, but waste your time and you've lost a part of your life. "

~Michael Leboeuf

Mid-Year Conversation With ISG

Client: Thank you for meeting with me today to review the first half of the year and discuss your outlook and investment tactics for the balance of the year. In looking over my investment results, it was a yawner of a first half. Nothing lost…but not much gained either. One of your start-of-the year themes was "working harder for less" and unfortunately, that prognostication came to pass. If I may, I'd like to paraphrase your main points from our conversation earlier this year: 1) expect more volatility and a slower pace to U.S. stock advances, 2) global diversification will show its better side in 2015, 3) European stocks could rally if things over there stop getting worse, 4) lower oil revenues and a stronger dollar (which makes U.S. exports more expensive and less competitive) will reduce earnings in many U.S. companies and put a crimp on GDP growth in the first half, and 5) conventional bond strategies will be challenged as we approach a change in Fed interest rate policy. Most, if not all of these prognostications played out as you expected, but do you have any further comments before we move on to the second half?

ISG: We do have a few things to add and, as always, it is a pleasure to visit with you today. You are correct, most clients could have snored through the first half - and woken up to find little had changed. In between, there was lots of jittery activity, with potential debt defaults by Puerto Rico and Greece (along with its possible Eurozone exit), slowing growth and a massive stock market sell-off in China, and continued investor obsession on the timing and magnitude of Fed interest rate hikes. As we suggested in January, global diversification was an important tactic to smooth out the ride: lessor mainstay asset classes like smaller and mid-sized U.S. stocks climbed 2% to 4.5% and foreign developed stock markets combined for a 6.5% result… but sub-par performances by the heavier weighted asset classes like larger U.S stocks (up 1.2%) and bonds (down .1%) were enough to keep results subdued for most investors.

Client: Not a great showing and along those lines, I am hearing and reading more and more lately about bonds and stocks –particularly U.S. stocks - running out of steam with lower returns expected for the near future. Do you agree with this and, if so, how does ISG expect to navigate through such an environment?

ISG: I think we'd be blindly optimistic not to say there could be some truth in your assessment. Prices of higher quality bonds – which are held in our core bond strategies- are negatively affected by rising interest rates so it makes a bond manager's job that much harder to deliver reasonable returns when rates are rising. But we must point out that future returns from these kind of strategies will hinge on the severity of the rate increases, ie. how much rates rise and over what time frame. Along those lines, the labor picture is getting closer to normalizing – which is one of the important developments the Fed has been waiting for – but there remains enough softness in the overall economic data that we expect –at least in the early going- a very gradual rate rise regime.

Client: Starting when?

ISG: Most likely before year-end. But if the rate increases are gradual as expected, conventional bond strategies can often navigate reasonably well through such an environment.

Client: How so?

ISG: After suffering price declines (and low or negative total returns) in the early going, a bond fund's mix of holdings (through incoming cash or turnover) begins to include more and more higher interest-paying bonds until an inflection point is reached where the higher income streams from this "new inventory" more than offsets the price declines. The ride is never smooth and certainly more challenging today than during the previous thirty years where every time rates declined a bond manager's holdings appreciated in value. Is it more challenging today because the start point for rates is historically low? We'd say, "yes," but not insurmountable.

News Notes

*****DATE CHANGE*****

The date for our 2015 Annual Investment Update and Luncheon has been changed to **Wednesday September 2nd.** Our guest speaker this year will be **Mr. Michael Townsend** from Charles Schwab & Co., who specializes in assessing the political and policy environment in Washington, and its effects on investors.

More details coming soon.

Client: So you're advocating holding on to these kinds of strategies despite their diminished outlook?

ISG: To a degree and for most clients, yes. An important rationale for holding these higher quality bonds is that they tend to hold up well whenever the stock market misbehaves, thus providing an important counter-balance for your portfolio.

Client: The difference being that the "premiums" for holding this portfolio insurance has gone up in the form of lower bond returns than what we've been accustomed to in the past.

ISG: Precisely.

Client: I know from my statements and our meetings that ISG has been channeling some money away from this lower returning asset class into what you call "bond alternatives" or "hybrid" strategies, and you have written about them in previous newsletters. Do you see this trend continuing?

ISG: We have to be careful here in our zest to improve overall return not to lose sight of our commitment to better protect our clients' portfolios during periods of economic and stock market weakness. Remember, we tend not to swing for the fences here unless we're staring at a fat pitch where an asset class like U.S. stocks can be bought at price levels which afford us a reasonable margin of safety and increased odds of higher returns. This is not the environment we are presently in and, therefore, we'll stay with an approach that seeks singles and doubles, maybe a triple now and then. For most clients, this is the sensible way to reaching and sustaining your lifetime financial goals.

Client: But do you have any new potential bond alternatives or strategies in your workshop?

ISG: We're close to initiating a position in a portfolio of conservatively purchased, income-producing real estate that is bundled in a liquid format, unlike some of our real estate plays in the past. Most of the real estate is privately owned which means pricing is not dictated by the whims of Wall Street and the income streams produced are presently higher than bond equivalents and have the potential to rise along with a strengthening economy. Another strategy we are considering is to take some of our remaining higher quality bond assets and reallocate among: 1) higher yielding (but lower quality) bonds which are less negatively impacted to rising rates (and more prone to perform better in an improving economy) and 2) cash or high quality short-term bonds. If executed properly, this "barbell" strategy as we call it may provide a better overall return with no appreciable increase in risk from where we were before.

Client: Sounds interesting. When might you know about the barbell strategy?

ISG: The devil is always in the details and that is always determined in our weekly investment committee meetings where we will be examining the risk/return trade-offs of executing such a tactic.

Client: Could we switch over now to your views and tactics on stocks?

ISG: Certainly. Taking a thirty thousand foot view, current U.S. stock valuations are starting to look a little long in the tooth…and could be challenged should earnings growth fall off. There are concerns that as interest rates and labor costs rise, corporate profitability may get squeezed…especially since CEO's have been putting off important productivity enhancing capital investment projects in favor of plowing more cash into share buybacks and dividends. And based on history alone, we are overdue for a market correction, as the S&P 500 has now gone almost four years without at least a 10% decline, the third longest stretch since World War II.

Client: Wow, that doesn't sound very encouraging. Are there any silver linings here?

ISG: Sure there are. The U.S. has demonstrated time and time again a stubborn resiliency and its brand of capitalism which rewards hard work , risk-taking, and innovation remains the envy of the developed world. Growth looks to remain slow but it continues to move forward. The real test, of course, will be how it will fare without the Fed support . As far as U.S stocks go, interest rate "liftoff" may create some short-term volatility (and buying opportunities) but history shows that until rates get significantly higher, the longer-term impact on the markets is benign. In short, we think it makes sense to take a cautious and opportunistic approach with regard to U.S. stocks.

Quickly, around the rest of the world, European stocks are no longer cheap but as long as we see some continuance of their economic recovery and improving corporate earnings, it remains a favorable space for investors. The Asian growth story is intact and with stock prices reasonable, patient, longer-term investors should be rewarded. We expect both Europe and Asia to notch decent performance relative to U.S stocks and this view is further supported in light of the easy money policies that continue at many foreign central banks.

Client: Are you not worried about China's slowing growth and their recent stock market stumbles?

ISG: China's stock market has made a huge run to frothy levels so the sell-off was not unexpected. We also think their policymakers are doing the right things to steer their economy from one dependent on infrastructure investment and cheap exports to a more balanced one which is equally driven by the consumer. But keep in mind, these transitions never go in a straight line. Lots of volatility and second guessing by the "experts" is to be expected. We think they're headed in the right direction…and once the Chinese consumer gets in the game, the rest of the world will capitalize !

Client: Well good. Any final thoughts to part with?

ISG: Sure. Bottom line, we think we're in for a "plodding higher" mode with regard to U.S stocks with special care being given to managing the defensive side of the portfolio. Foreign stocks look more attractive to us but since most investors prefer a "home base" bias, our split between U.S and foreign stocks rarely goes below 50/50 (which is where we are now for most clients). Treading carefully remains a top theme as many questions remain: Has the Fed's artificially low interest rate policy –the longest period between Fed tightening cycles since at least the 1940's – had distortive effects, allowing corporations to be more profitable and pushing up stock and bond prices? What might happen if the economy is unable to reach "liftoff velocity" without Fed support? What are the longer-term implications of resource bottlenecks and limitations and have economists adequately factored these limitations into their models? What about the social impact of growing income inequality here in the U.S.? How will aging populations in the developed world impact future GDP growth?

Client: Wow, lots of questions.

ISG: This is just a short list of the subjects we discuss at our investment committee meetings.

Client: I'm glad you're doing it and not me.

ISG: It is our pleasure. We look forward to sitting down with you again at year-end.