First Quarter Outlook 2016

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

> ***"I finally know what distinguishes man from the other beasts: financial worries."***
>
> *Jules Renard*

Client Q&A With ISG

Once again, we offer up our views and strategies in Q&A format, based on discussions from client meetings and other correspondence.

Client: It's always good to sit down with you at the beginning of every year to sort out your outlook and planned investment tactics for the year ahead. But before we do that, I'd like us to go over last year's results. I know you warned me at this time last year that 2015 would be a period of "working harder for less," but I must admit to you that I was underwhelmed by my results for the year.

ISG: We're always delighted to visit with you at this time of year and, yes, 2015 is a year to which we're happy to say goodbye. On the macroeconomic front, things were "decent." The U.S. economy muddled along, growing at a 2.2% rate (year over year through the third quarter)…nothing to write home about but still better than most other major economies which continue to recover from the financial crisis. Both the Eurozone and Japan grew by less than 2%. Emerging market economies grew around a 4% rate but that has come down from an 8% rate earned prior to the financial crisis. Overall global GDP growth last year was about 3%, below the 3.5% average growth rate of the past 35 years. Here in the U.S., the labor market has continued to gradually improve, inflation remains subdued, and the Federal Reserve started raising rates. The big story abroad was the economic slowdown in China and unraveling of its stock market which negatively affected global markets more than expected.

Despite the decent macroeconomic picture, actual results from financial assets were poor across the globe and across most asset classes (stocks, bonds, cash, commodities, etc). U.S. stocks were mixed, with larger stocks (S&P 500 Index) earning 1.2% while smaller stock indexes generally declined anywhere from 2% to almost 8%. Developed foreign stocks generally turned in positive results but those gains were lost when translated into U.S. dollars, ending the year down around .4%. Emerging market stocks turned in a forgettable year, falling almost 16%. The core U.S bond index was up a meager .55%.

It was an ok year for many of our active equity managers whose price sensitive, fundamental investment strategies were challenged in last year's "momentum" environment. By my count, four out of seven of our equity strategies held at year-end outpaced their benchmarks (this includes one real estate fund). Our "passive" equity strategies generally tracked their indexes except for one which got bogged down some by having some additional exposure to the energy sector.

Client: Can we go back to this phrase "momentum" environment? What do you mean by that?

ISG: Certainly. It's a stock market where the "hot stocks" get hotter (and more expensive) and the attractively valued remain ignored. We went through this kind of environment –in a more pronounced way back in the late nineties. Today, if we examine last year's return on the five hundred companies included in the S&P 500 index we find that most of the return came from only a handful of companies, like Facebook, Amazon, Netflix, and Google ("FANG"). In fact, if we equally weight all the companies comprising the S&P 500 index, we find that the index actually **fell** 2.2% for the year. In other words, the index's results are being propped up by a handful of very large companies which in our opinion are getting pricy.

Client: Is this something I should be concerned about?

ISG: We think so…which is why we are steadfast in keeping a portion of your equity exposure out of the S&P 500 index.

News Notes:

Change in Newsletter Format
We are moving to a twice-a-year format. Newsletters may drill down a little deeper into macroeconomic or specific investment issues… which mean they may sometimes be longer. (Of course, you'll have an extra three months to get through them!). In between the semi-annual publications, we'll give you a reprieve from the investment speak and fill in with other pertinent financial planning topics. Happy New Year, happy reading!

ISG Advisory Fees
Please note that any ISG fees deducted from your Schwab accounts are summarized in your Schwab 1099 Form, coming in February.

Client: Are you worried about a serious bear market unfolding in U.S. stocks?

ISG: Bear markets are difficult to predict but the conditions commonly associated with them do not seem to be currently present: recession, short-term interest rates higher than long -term rates (inverted yield curve), excessive stock valuations, and irrational exuberance amongst investors. But we will remain vigilant for any changes brewing in these conditions.

Client: Ok. I guess I can live with that for now. How did our bond strategies do?

ISG: Quite well. If I include our two StoneRidge products along with our three core fixed income strategies, all but one outpaced our fixed income benchmark (Barclays Aggregate Bond).

Client: Good. Looking back on the past year, were there any major disappointments in your investment selections or strategies?

ISG: Yes, we were disappointed with an energy holding of ours.

Client: Are you talking about Eagle MLP Strategies?

ISG: Yes. As a quick primer, this active strategy seeks out income-producing investments that tend to be tied to the energy infrastructure sector. The original premise was that the businesses held by the fund (pipelines, storage facilities, etc.) were reasonably insulated from oil and gas price changes due to the "toll booth" qualities of their business models which generate revenues on volume, not price. Unfortunately, as the energy sector tanked, it took down everything energy related, regardless of the business model. The large decline on this one holding detracted significantly (up to 2%) from our portfolios which were already compromised by the poor investing environment last year.

Client: And the outlook going forward?

ISG: Near-term, we expect additional volatility, but later in the year we think we'll see some stabilization in prices and in the energy sector overall. At current valuations and yields, this is likely not the time to exit the space. We track an index which follows these kinds of businesses and we note that since 1995 there have been five instances when the index fell from 30% to 45%. The average return following these drops was close to positive 35%/yr for the next three years.

Client: Let's hope history repeats itself! Can we turn our attentions to your views and tactics for the coming year?

ISG: Certainly. Starting with a thirty thousand foot view, we think the global economy could see a slight uptick in growth in 2016 for the following reasons: 1) We'll continue to see pro-growth, easy money policies in both the Eurozone and Japan, 2) We should experience some increase in spending by the U.S. consumer, thanks to low energy prices and some wage gains and 3) China's deteriorating growth rate looks to be leveling off.

Client: I can agree with your first two points but I wonder about China. Their stock market lately hasn't exactly been signaling any stabilization in their economy, has it?

ISG: No it hasn't. But we know that stock markets and economies don't always move in synch. China, in our view, looks to avoid the hard landing that the stock market seems to be signaling. Yes, the manufacturing sector is in recession and this will not change until excess capacity gets worked off over time. Fortunately, China has a lot of policy room to maneuver should additional stimulus be needed and the fact that monetary and fiscal policy moves thus far have been limited suggests the government is not overly concerned about the current pace of growth. The Chinese authorities understand that their policy to transition the economy's growth drivers from exports and infrastructure build-up towards one dependent more on consumer spending and services will not be a smooth one and will play out over many years. We do our best to monitor the data which is telling us they are moving in the right direction.

Client: What's your view here at home?

ISG: The U.S. economy seems stuck in a low growth rut.

Client: How so?

ISG: The main factors behind GDP growth - productivity increases and workforce growth- have both slowed down considerably.

Client: Are you sure about slowing productivity? It seems like I read about some new tech innovation almost every day that's making workers more efficient.

ISG: The data that measures productivity growth bears this out and while we agree that tech innovations abound, we question the degree of impact most are having on business models and the overall economy. Take 3-D printing; it is an amazing new technology that will simplify some production processes and lower costs. But it is not in the same league as the mega breakthrough innovations like the Internet itself was.

Client: So you're saying the economy could use some help from the next "NEW BIG THING?"

ISG: It would certainly help out the cause. We would also add that there are other impediments to growth like high debt levels, an aging workforce (which puts pressure on our entitlement programs), and a strong dollar which continues to pressure the earnings of globally focused companies.

Client: And your outlook for U.S. stocks?

ISG: We suspect the markets may look a lot like last year unless we see an unexpected recovery in earnings growth….which we've already said is a lower probability scenario due to the sluggish economy. Add this to rising labor costs and continued costly regulation and the corporate profits picture starts getting cloudy.

Client: You're not painting a particularly rosy picture. Are there any silver linings here?

ISG: We think so. Given this sluggish growth, we think the Fed rate increases will proceed more gradually than they project. And should consumers start spending more, thanks to wage increases and lower energy costs, this could offset some of the "structural constraints" to growth previously cited.

Client: Let's hope so. I take all of what you have said to mean that you remain underweighted to U.S. stocks?

ISG: Slightly so. Overall equity exposure is still slightly biased towards U.S. companies but we remain committed to a globally diversified equity portfolio.

Client: Don't the foreign stocks expose me to more risk, given the added wildcards of currency exchange issues and the ongoing affairs of so many other local economies?

ISG: An argument could be made for that but we've managed those risks by having LOWER TOTAL STOCK EXPOSURE (U.S/Foreign combined) than what might be recommended in a textbook from your local library.

Client: What's a library?

ISG: I'm sorry. I've just given away my age!

Client: Could we very quickly go over your views/tactics on foreign stocks, and then finish with bonds?

ISG: The economic picture for both the Eurozone and Japan remains mixed. Both are maintaining pro-growth monetary policies, but both suffer from the same U.S. growth impediments. The jury is still out on whether "Abenomics" is working in Japan and the Eurozone faces yet another political challenge from the migration crisis. Stock valuations (ie. stock prices relative to expected earnings growth) in both places look better than the U.S. and when combined with stock market-friendly monetary policies, low currencies which benefit exports, and massive relief from low oil prices to meet these countries' greater import-dependent energy needs, there's a case to be made that these markets will outshine the U.S. in 2016.

For emerging markets, younger workforces and greater potential for more productivity increases make a general case for attractive longer-term equity returns relative to other asset classes. Emerging market regions have been in the doldrums lately but many "experts" argue that these markets could surprise to the upside in 2016 should China and commodity prices stabilize. Our view is that a better buying opportunity lies ahead as many near term wild cards remain in place in the form of global trade patterns, monetary policy uncertainties, and skittish investor money flows in/out of these regions. We are also reexamining whether some of our clients are even suitable for the inherent volatility associated with this asset class. So, bottom line, stay tuned.

On bonds, we have discussed in several past meetings our tactics to look for bond-like alternatives given the view that conventional bond strategies would be challenged in the rising rate regime imposed by the Fed. But to quote (sort of) Mark Twain, "the rumors of the death of bonds have been greatly exaggerated." Historically, higher quality bonds in our core strategies have held up well during stressful stock market episodes. Given fragile geopolitics, China's growth slowdown, a creeping up of U.S. recession risk, and the low inflation environment, bonds still have their place in most portfolios.

Client: Sounds pretty boring.

ISG: "Boring is Beautiful" may be the mantra for 2016.

Client: We've been at this a while. Do you have any final comments for me to take away from this meeting today?

ISG: We'd add that income-producing private real estate remains attractive to us. For the bold and adventurous, the energy sector may be a place to ante up later this year. And the high yield bond sector could enter "fat pitch" territory this year but prices need to fall some more. And if U.S. stocks decline enough, we will consider increasing our stake there when the expected return – using conservative metrics – is attractive enough to compensate us for the increased exposure.

In closing, the return of stock market volatility to historically normal levels has not been welcomed by investors who have become accustomed to a calmer ride during the Fed's easy money regime following the financial crisis. It is easy for me to say volatility creates opportunities but the reality is that it can be stressful when one is experiencing it in their portfolio. We are ultra- sensitive to our clients' pain thresholds but at the same time we must maintain the discipline to balance this "short-termism" with investment decisions that need to play out over time frames that are sometimes longer than what investors use to evaluate their results. It's a tug-a-war for us at times but as effective stewards, we are up to the challenge and take the job very seriously.

Client: I'm glad you do. Thank you for your time today and I will look forward to sitting down with you again at mid-year.

ISG: Always our pleasure.