MARKET UPDATE

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WHAT INSIGHTS SHOULD INVESTORS GLEAN FROM RECENT MARKET PERFORMANCE?

As Ben Graham pointed out, and Howard Marks reminded us in his latest letter, *"the day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment"*. Investor has turned decidedly negative since the Federal Reserve began raising interest rates on December 16th. While blaming the market's current troubles entirely on the Federal Reserve policy would be inaccurate and overly simplistic, there is a correlation. The seemingly always full punch bowl that was the Federal Reserve's monetary policy, enticed investors to assume more risk by paying a premium for yield and/or potential earnings growth. With the Fed's monetary policy having changed, so has investor behavior.

Prior to December's rate increase (the first in nearly ten years), lackluster economic data was generally viewed positively by market participants since it meant the Fed was more likely to continue re-filling the punch bowl. In this environment, investors were enticed to take additional risk since safe, liquid alternatives were not capable of generating the returns investors sought. Much of the return achieved in the market since 2013 has been as a result of price multiple expansion. Multiple expansion refers to the increase in the ratio of the price of the stock to its earnings. Over time, the rise in price should be met with a corresponding rise in earnings. If the earnings don't move higher with the price, an investor would be viewed as simply paying more to get the same result. Not all stocks benefitted from this multiple expansion, however. In fact, the average US stock has been underperforming the market averages for much of the last 2 years. Consider the following:

- *The most expensive stocks in the S&P 500 (those where investors were paying a premium for earnings or revenue) returned 13.97% while the least expensive stocks returned -9.84%.*
- *On a capitalization weighted basis, meaning each company is weighted by size, the Russell 3000 Index returned .48% in 2015. When those same companies are weighted equally, each representing 1/3000 of the total, the return of that index falls to -6.17%.*
- *The S&P 500 returned 1.38% on a cap weighted basis in 2015. However, that return was largely influenced by a very small number of holdings. Facebook, Amazon, Netflix and Google (who's collective P/E was 225 times earnings) represent less than 5% of the index but collectively contributed 2.09% to the index return. Said differently, without their contribution, the index would have declined .71%.*
- *Over 55% of the stocks in the S&P 500 are trading more than 20% below their 52 week high with the median stock down nearly 22%. In other words, the median stock in the US has already entered a bear market.*

Today, with the punch bowl slowly being drained, investors are no longer embracing statistics showing slow economic growth. Those same statistics are causing fear and concern. Add to that concerns surrounding China's economic growth and inconsistent monetary policy, geopolitical concerns, and stretched securities valuations and you end up with a very pessimistic environment. The party is ending, it's last call.

So, what does all of this mean for your portfolio? Below are some key conclusions that came out of our recent investment policy committee meeting:

1. Markets are expected to remain volatile throughout much of 2016. While the volatility we are experiencing was expected, the speed with which sentiment changed was not.

2. We believe the Federal Reserve raised rates to maintain their credibility, not because it was the appropriate time. For that same reason, we feel there are additional small rate increases likely to happen this year. A "*one and done*" rate move would send mixed messages and show a lack of indecision on their part. We are focused less on if and when, and more on the terminal rate and how quickly we will get there. We feel the global economic concerns will translate into a *"slower and lower"* rate increase policy.

3. While we do not believe a US recession to be likely, we feel the possibilities have increased.

4. We believe this to be one of the more uncertain market environments we have witnessed in our careers. As a result, we believe proceeding with a heightened sense of awareness to be prudent. Consistent with that philosophy, we believe fundamentals will again begin to matter and that focusing on quality investments with reasonable valuations to be prudent given the current market climate. We further believe this will create an opportunity for active managers to add meaningful value over the coming years. The proliferation of index funds, and algorithmic trading strategies that trade in and out of those funds in large volumes, has distorted the relationship between the price of a stock and the underlying value of the company. When money flows into the index fund, the index constituent's stock prices rise, regardless of that company's fundamental value. When assets flow out of the index fund, the opposite occurs.

   Over time, active managers can exploit the discrepancies between price and value. Doing so, however, requires ample patience as opportunities to recognize the hidden value often occur at inflection points in the market. During periods where fundamentals carry less weight (as they have over the last 3 years), these active managers are likely to trail, at times by significant margins. Not surprisingly, in our regular evaluation of investment management firms, we seek to identify those who have demonstrated an ability to consistently add value to a portfolio. Over the last 15 years, the 97 managers who passed our initial screens delivered meaningful positive value 78% percent of the time. However, only 23% were able to do so over the last three year period.

Most importantly, navigating this environment will require a disciplined, steady hand. The range of market outcomes that could transpire is sufficiently diverse. We believe a strategy for managing wealth should take into consideration not only one's tolerance for risk and one's need for return, but also the timing for when portfolio funds will be distributed.

In this environment we feel communication to be essential and we will continue to provide updates as we have notable commentary. As always, we thank you for the continued trust and confidence you place in our firm. If you would like to discuss any of these points in greater detail, please contact me or any member of our investment team.

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