Noland's Notes

A Publication of LBWM

Noland's Notes 2015 Re-cap / 2016 Outlook

For those of you who are new clients or those who are reading this note for the first time, I should explain. Each year I sit and write you a detailed note. In it, I try to analyze the prior year in my own words so that you have an idea of what environment your accounts with me were active in. I also try to give you an idea of how I see the investment landscape as we enter the New Year. In our brief discussions throughout the year, time does not permit me to extol all of my thoughts and analysis with you. My hope is that in the 20 minutes or so, it takes you to read it, my note helps you gain a better feel for how we here at Left Brain Wealth Management view the investment climate and how we think about Investment Markets, in general. ***Welcome aboard, or welcome back and I welcome your feedback!!!!***

Left Brain WEALTH MANAGEMENT

Before I forget, feel free to send our note to your inner circle of family, relatives or friends should you think it appropriate. Though we write this note for you, should you think of introducing us to your circle, this will be a good way for them to get a "feel" for our work. Let's get started:

Here are the official returns from 2015:

Index	Return
Dow Jones Ind. Average (U.S. Stocks)	+ 0.21%
S&P 500® (US. Stocks)	+1.4%
Russell 2000 (Small Companies)	-4.4%
MSCI EAFE® (Intl. Stocks)	- .4%
MSCI Emerging Markets	-14.6%
MSCI REIT (Real Estate)	+2.8%
Aggregate U.S. Bond Index	+.5%
Gold	-11.78%

(Source: J.P. Morgan Asset Management)

(For those of you wishing for the abridged version of this note, feel free to jump straight to the summary which starts on page 8. For everyone else, we have lots to discuss it has been a whole year. So, let's jump right in!!!)

What's Going On?

It makes sense to start with the question that's so top of mind "What's going on?" 2015, was not a good returns year. And, 2016 has gotten off to the worst start in modern history. Many investors are asking "What's going on?". Well the markets started the first half of 2015 on cautious, but positive footing. But, the summer did us in. There were a confluence of events that produced negative reactions that started the selling which lasted into year-end. What were those events you ask? Well for one, The Federal Reserve Board promised to start raising interest rates and then backed off. The second is that the Emerging markets stumbled when China acknowledged it's economy was slowing down and devalued its currency. The third, and final event, was the health care sell-off that started when Hillary Clinton promised to go after Health Care companies because they were charging too much. Though the headline returns for the S&P500® don't look so bad (+1.4%), a more comprehensive look tells more of the story. As of January 20, 2016 more than 60% of the S&P stocks were 20% below their 12 month highs. 37% of the stocks are down over **30%!!!**

As we start 2016, those issues are still top of mind for the markets, but there are a couple of other items of note that the markets are contending with:

1.) Oil Prices-The markets are sometimes a very strange place. It usually holds that when oil prices fall, investment prices firm. This makes sense as consumers and businesses (outside of the oil patch) get a huge boost from spending less at the pump. Which means there is more money that can be spent elsewhere (the movies, restaurants, travel, shopping, etc.). Remember, the economic crisis of 2008 coincided with unbelievably high oil prices (over $140 per barrel, to be exact). The pain felt at the pump caused a pullback in travel, especially driving. It caused a pullback in the sales of trucks and SUV's. High oil prices cause a pullback in discretionary spending as the higher gas price acts as a tax. So, we are sitting here with recent lows at the pump and the markets are interpreting that not as a positive, but as a big negative. **Strange!!!** At least for now. At some point investors will start to see straight and things will go back to normal.

2.) Company Profits- We'll get to our Investment Lens in just a bit, but you know that company earnings are extremely important to investment returns. The earnings estimates for company profits have been falling. There are many reasons for it, but this is a problem. Sales growth has been elusive for some time. But, companies have cut costs so that profits had increased anyway. Now that costs have been stripped bare, profits are harder to come by. In my mind, companies that can deliver sales **AND** profit growth should be rewarded with much higher share prices!!!

I expect that when the markets settle down, we'll start to see the share prices of above average businesses be rewarded.

3.) Are we headed toward a recession? Listening to the nightly news, or watching share prices you'd think that we are either headed for a recession or that we are in one already. The funny thing is that there is nearly no data which point to a recession. But, for a second let's consider that we are headed for recession (recessions are only known after the fact!). Recall the events of 2008-2009. The violent portion of the sell-off started in September 2008 and we bottomed in March 2009 so it lasted about 7 months. By my count, our current downturn started in July 2015 so we are already in about 7 months. So even if we are in or headed to recession, which we strongly doubt, it's possible that we have seen the worst as far as prices are concerned!!

Sizing up the Investment Climate

I am often asked what I think of the markets. I think it is important for you to understand how we size up the investment landscape at any given time. Here is the lens that we view the investment climate through. The lens never changes, but quite often, the view does:

1.) Interest Rates- I am sure it comes as no shock that interest rates are low. They are unbelievably low around the world. Believe it or not, many countries now have NEGATIVE Interest rates. If that sounds strange to you, it should. When I was in grad school, our economics text books told us that there was a zero bound on interest rates. Not anymore. All of the finance and economics principles are being re-written, **in real time!!** Finance Chiefs and Federal Reserve Boards, the world over, have lowered interest rates to stimulate growth in their economies. However, instead of stopping at 0, they are finding ways to get them even lower. It's very uncertain what effect this will have on growth or propping up economic conditions, but you'll have to give them credit for creativity!! Normally, we'd say when rates are going lower that is a positive backdrop for investment returns. So, we'll check the favorable box on this one.

2.) Inflation- Inflation is also low. One of the reasons that Central Bankers around the world have resorted to negative interest rates is to fight this low inflation environment. The only thing scarier than high inflation is deflation!! One of the mysteries of the present economic environment is why is inflation so low? Again, in our investment lens, we'd have to chalk this one (low inflation) up to a positive backdrop for investment returns.

3.) Earnings- As I mentioned earlier, earnings estimates have been falling. That means that businesses are expected to earn less in 2016 than it was thought they'd earn in 2016 just a few months ago. That's another way of saying that earnings will be Less Good than what was recently forecast. For the S&P 500® 2016 earnings are expected to come in at $124.25 per share (Fact Set). The troubled sectors are Energy and Materials which are reporting negative earnings growth. Outside of those two sectors, earnings look OK. Not great, but OK. However, corporate earnings have never gone straight up. Throughout history there have been many periods when earnings contracted only to shoot up to record levels during strong economic periods. The fact that we have earnings growth at all is good sign as it provides a nice base for the next leg up. So, we'll rate this metric as modestly favorable at this time.

4.) Valuations- Valuations are also OK. Not extraordinarily cheap, nor extraordinarily expensive either. The 10 year average P/E (Price to Earnings) ratio of the S&P 500® is a little over 14. As I write, the S&P 500® P/E ratio is a little over 14, so right about average. However, the average ratio has occurred in more hostile economic environments. That is, when Interest rates, Inflation and Valuations were much higher. Given the current period of falling interest rates and low inflation, I'd expect for valuations to be higher. Especially, given the fact that the alternatives for investment dollars are so unappealing. We know that companies themselves find current stock prices attractive as we just set a record for the dollar amount spent on stock Buybacks by corporations. Another way to look at values is to view the yields. For Government bonds the 10 year yield is about **2%**. For Corporate bonds that yield is about **4%** *(again 10 year Investment Grade Bonds)*. For stocks, the earnings yield is about **7%** (the inverse of the P/E ratio is 100/14.2=**7%**)!! We'll rate valuations as being favorable!

Now What?

This is NOT 2008-2009!!! You certainly wouldn't know that from looking at current investment prices. There is little doubt that we are a long ways from the market highs we reached last summer. Anything with a smattering of risk attached to it has been marked down dramatically. So, it looks like we have just entered a Bear market. For those of you who've always wondered, a bear market occurs when prices retreat 20% from their highs. The violence and swiftness of the declines are more than a little baffling, though. Prices are acting as if we are in recession. The problem is that no one has told the data that it is supposed to weaken. As I write, Auto sales just finished a record setting year. Home prices have firmed. We are at near full employment. Wages have firmed. Inflation is low, not high. Normally, when there is a downturn the cause lay in excesses somewhere in the system. i.e. excess inventory (the 80's). The 2008-2009 recession was caused by excesses in the housing system. As far as the eye can see (outside of the commodities), there are no excesses anywhere. Corporations are healthy. The banks are in good shape. Housing is in a good place. It seems to me that if we were in a recession that the sell off should have run its course. So, we have priced in one already. However, if this was a false alarm, which it certainly looks like, we should experience a Space Shuttle type rally at some point. Being that many investors, and funds for that matter, have more cash than usual, they'd better hope I am wrong. It's surprising how fast the markets can take off and leave those who are on the sidelines behind.

"You Big Dummy"

"Sanford and Son" was a sitcom that debuted in 1972. The main character, Fred Sanford, was played by comedian Redd Foxx. When he got upset with his son Lamont, played by Demond Wilson, he'd often ball up his fists and yell "You Big Dummy". We are dedicating this section of Noland's Notes to my less than brilliant investment idea of 2015. I am often attracted to holdings that are cheap where my figuring leads me to believe that the downside is low, but the market is overreacting in some way that could lead to substantial upset potential. This proclivity led me to the coal industry a couple of years ago. It's no secret that there has been a war on coal here in the U.S. However, we still get more than 30% of our energy needs from coal and that number is projected to stay substantial for decades to come. In emerging markets that number is much higher. We (the United States) have been called the Saudi Arabia of coal producers. Humans have been burning coal for fuel for millennia and it is projected this will continue forever. Though coal causes carbon emissions, it is among the cheapest forms of energy the world over. This was the framework that led me to look at the coal industry. Now, I wasn't foolish enough to consider the stocks of coal operators, of course they fall first should business turn for the worse. However, I found the bonds to be irresistible. At the time, I figured locking in yields of 9%-10% too good to pass up. Let's just say, the only thing that I did right was exiting the coal bonds before they went to zero. Looking back, there were a few things that I hadn't counted on like:

- Natural gas prices continuing to decrease in price.
- A constant and continuing war on coal because of social and environmental factors.
- An over supply of coal coupled with a unprecedented decrease in demand.

What’s the lesson here? There are many:

1.) Cheap alone, is NOT enough of a reason to buy!!!

2.) We want to have exposure to businesses/Industries that are getting better.

3.) We’d never buy bonds of a company where we wouldn’t buy its stock.

Here’s hoping this section is empty in next Year’s letter!!

“The Rise of the Machines”

Now, I have my own theories of why the markets have been so wacky. In the 1980’s, blockbuster movie, “Terminator” futuristic cyborg’s were sent here, to earth, to stop events today that would lead the world to ruin in the future. In the future, machines would rule the world and Sky Net was the computer program that would try to take over the world. In my mind, this is a very similar description to what’s going in the markets. The trend has been going on for some time, but has grown in activity recently. Today, some billions/trillions of investment dollars are controlled by computer programs. As more money has left active management (funds with a manager) and migrated to index funds or ETF’s (passive management), the market activity doesn’t have to move rationally. That isn’t the worst of it. The biggest slug of activity comes from Hedge Funds that buy and sell based on algorithm’s. These are called quantitative strategies. That’s an expensive computer code that determines whether to buy or sell a security based on “Who knows what?” Which would explain why prices have been moving irrationally without explanation recently. For better or worse, it looks like this trend is here to stay. There has been record amounts moving from active management to passive vehicles and computer based trading has only increased. The good news is, for those of us with a brain, calculator, and a stoic disposition, there should be plenty of opportunities to make money from the wreckage. I often say “shares take the stairs up, and the elevator down.” This would explain it.

Building Wealth, The Long View

I’d like to spend some time exploring this idea of what to do given the current investment climate that we find ourselves in. We here at Left Brain Wealth Management generally put investors into one of three categories: The Creating Wealth group, The Building Wealth Group and the Preserving Wealth Group. We define the Creating Wealth Group as those investors who are early in the portfolio building stage of life. It seems obvious to me that the recent market action should bring nothing but smiles to the face of these investors. You see, high prices are a detriment for this group. They should welcome low prices as they are able to buy more shares at lower prices. Because they won’t be using the monies for years, or decades, current market fluctuations should be of no concern. I’ll go a step further and say they’d do themselves a favor by buying, but never looking. Sadly, this isn’t the behavior that I’ve witnessed recently. All too often, I notice the **Creating Wealth Group** becomes tepid and timid as prices decline. Let’s take a look at a simple example:

Mary spends $10,000 to buy shares at $100. So, she can buy *($10,000/$100=100)* **100** shares
But, if prices are $70 per share then Mary could buy ($10,000/$70=142.8) **143** shares
Now, imagine 30 years later, when Mary is thinking of retirement those shares are $1,000 each.
Assuming Mary bought and never sold, or added to her holdings she'd have the following:
If Mary bought at $100 per share she'd have **$100,000** (100x$1,000 p/share)
If Mary bought at $70 per share she'd have **$143,000!!!** (143x$1,000p/share)
Would anybody like to explain to me why Mary would like to see higher prices?

Now, for the **Building Wealth Group**, their best action should depend on their investment timeline.
If they have many years before they need the money and are still contributing to their investment accounts (IRA's, 401k's,etc.) then they should do an Investment check-up (which includes retirement, college planning and an estate plan). If they are on track then they should proceed as normal. There's an old saying on Wall Street, "Buy if you can, hold if you can't!" The thing that makes most investors act is looking. In my experience, the more an investor watches the market action, the worse off they'll be. Biology has hard wired us humans with this fight or flight mechanism. This may have been helpful for us on the plains of Africa, but is not helpful whatsoever in the markets. Now that we get prices tick by tick on our phones, on our computers, in the elevator, it's nearly impossible not to look. Imagine having to be awake during surgery. I do feel bad for those that can't resist. They look, they scare, they act. Unfortunately, I've been on both sides of these events. And, the pain of watching shares purchased at $100 go to $65 is dwarfed by the pain of going to cash at $70 and watching the shares zoom back to $100!! The former can be managed, the latter, Intolerable!!! It happened in 2000. It happened in 2008, and it's happening now. Predictably, in each case, investors would have been better off closing their eyes and buying.

Now, the most vexing decisions to be made reside with the **Preserving Wealth Group**. These are normally those who have already retired and are trying to coast into comfort mode. This is the group that has been most impacted by recent economic conditions.

- In 1995, investors could own a $1,000,000 portfolio of CD's and generate $50,000 per year in Income from interest (5%).
- 10 years later, in 2005, that $1,000,000 CD portfolio would still have generated annual income of $36,000 (3.6%).
- Today, that same $1,000,000 CD portfolio generates less than $15,000 in annual income!!!!

It's hard to argue that lower interest rates around the world have been the friend of the Preserving Wealth Group. The question becomes what should retirees do given today's low interest rates and volatile equity markets. Even normal "go to's" like annuities and real estate have been impacted by the low interest rate environment. It looks like the playbook has been to buy dividend stocks, no matter the price, as dividend payments have normally increased annually. This acts as bond substitute but with a rising income stream. This seems somewhat rational given the high prices, fixed coupons, and low yields of Government bonds. We are all aware of what happens when, and if, interest rates finally rise. Current 10 year government bond yields are just under 2% and the dividend yield of the S&P 500® is over 2%. The problem is that the shares of these targeted dividend payers have been bid up to almost never before price levels. In my experience, paying out of sight prices for investments of any kind doesn't usually end well.

What I'm Watching for

As 2016 gets started there are a few things that I'll be paying attention to. Here they are in no particular order.

1.) Persistent Pessimism- It seems that since we hit the lows of the Great Economic Recession in March 2009 that there has been this big universal cloud of disbelief that has surrounded the investing public. Indeed, I have heard it said that this has been the most hated bull market in history. My experience would suggest that this may well be a true statement. It seems that nearly everyone, everywhere has been waiting for the "big pullback". Now, that the markets are in retreat I can hear the big collective **"I knew it"** coming from the "I told you so" crowd. What concerns me is the thought that if investors are cautious during one of the great bull markets in recent history what will happen when we enter a true bear market? Should pessimism persist, the outcome could become self-fulfilling. That is, investors expect an economic collapse so they act accordingly. That is, they slow down their spending, they start saving more, they start borrowing less. Business owners anticipate decreasing orders so they start laying off workers. They discontinue plans to expand and enter new lines of business. You get the idea. That is what has happened in Japan over the last 20 years or so. The Japanese economy and markets were booming throughout the 80's. They entered a bear market and persistent recessions in the 90's for which they are still attempting to recover. This is what can happen when bad economic policy meets persistent pessimism among a countries citizenry. The good thing for us is that has never been our style here in the U.S. We are a nation that maintains those animals spirits. We are nation full of hard workers and optimists. And, since the Hoover administration, we have generally not made any egregious policy blunders.

2.) The Election- My next minor worry is the upcoming elections. Why? For one, it is common for the campaigners to trumpet their ideas for reshaping the country. Because most voters, vote on pocketbook issues, it is not uncommon for hopefuls to cast our present economic and financial condition as miserable. The only hope we have is to elect them into office with their economic proposals that will catapult us all from imminent misery to imminent prosperity. This spreading of doomsday can take a toll at the same time we are already feeling uneasy as the markets are off to a rough start and there is talk of an upcoming recession. One more thing on the election, do you feel good about any of these candidates? Can you imagine the country in the hands of any of these characters? Good thing the framers of our constitution had the foresight to foresee that one day this country would be ran by someone less than fitting. As such, our founding father's installed our system of checks and balances. We should all feel good that the damage that can be wrought should one of these clowns get elected, should be limited.

3.) This volatility- Not only are the markets off to a rough start, but the volatility (violent moves up and down) has been stomach churning to say the least. There have been a record setting number of days this year of over 1% moves in the markets. In my opinion, the unpredictable market moves are the result of confusion on the part of investors. In the markets, investors hate uncertainty!!

Summary-Our 2016 Playbook

There is a popular Asian saying "May you live in interesting times". Well we should all be pleased for these days are interesting!!! Unlike most TV commentators and investors we here at Left Brain Wealth Management are optimistic about 2016! We are not in the camp of those that think we are headed for recession. There is an overwhelming sense of caution everywhere among nearly everyone. These aren't the conditions under which terrible things have happened historically. Indeed, it is normally when there is universal optimism that busts which causes problems (The 2000 tech bubble, the Real Estate bubble of 2006, the Peak oil theory of 2008, The Roaring 20's, etc.). It strikes me as ironic that Main Street investors are selling in record numbers (Stock mutual fund redemptions had their 3rd straight month of outflows) while companies themselves are buying back their own shares in record numbers. Is this a case of the smart money buying from the dumb money?

Shares are priced attractively, in my opinion. But, Corporate fixed income, specifically Corporate High yield bonds (those rated below BBB) look like an absolute bargain to me at these prices. And, it wouldn't surprise me at all to see them return more than stocks (shares) by year-end. Also with the financial world utterly confused by unconventional monetary policies around the world, i.e. negative interest rates and currency devaluations aplenty, I wouldn't be surprised to see Gold shine this year. We have a few ideas on the best ways to get exposure.

Because of the universal pessimism coupled with the massive increase in computer trading and passive investing (indexing), I think the environment has never been better for investors to do well. I doubt the markets will go straight up or that the road will be smooth. But, in the end, I look for 2016 to be a very fine year indeed!!

The markets are pricing in a recession, or worse. Funny thing is that there are no economic data points forecasting a recession. So either the upcoming data will weaken to catch up with weaker share prices or I expect a massive rally at some point!!! What have we been doing during the sell-offs? We have been doing what we always do. That is, we have been keeping track of first rate securities. We have been comparing their current share prices with our estimates of what they should be selling for. And, we have been using this opportunity to "High Grade" portfolios. That is, when there is an opportunity to "trade up", we have been taking it. Everything today is a "show me" story. The good news is that when companies do "show", prices can move up A LOT!

No matter what happens, I'll be here manning the ship on your behalf.

As always, I will be looking for opportunities to profit this year and in the years ahead!!!!