Fourth Quarter 2015 Commentary

Happy new year! We hope that your 2016 is off to a healthier and more prosperous start than the stock market's first moments of the year.

As of this writing the stock market is off to its worst annual start, with major market indexes falling 6% to 7% in the first week of trading. Ever-lower oil prices, which fell for the second straight year in 2015 and have so far continued their slide in 2016, are taking stock prices down with them. Oil is currently at a 12-year low, having fallen more than 70% since mid-2014.

The fourth quarter saw the first hike in interest rates by the Federal Reserve in nearly a decade, with the U.S. central bank raising its benchmark interest rate by a quarter of a percentage point. Equities responded by rebounding from their third quarter fall, with all major averages posting strong gains. The S&P 500 increased by 7.0%, while the Dow Jones Industrial Average experienced a 7.7% increase.

For the full year, though, U.S. stocks had their worst annual performance since 2008, with the Dow losing 2.2% and the S&P 500 falling 0.7%. If dividends are taken into account, the major averages eked out small gains, as the S&P 500 and the Dow gained 1.4% and 0.2%, respectively.

One market trend that stood out in 2015 was the strong performance of a handful of large-cap technology companies, like Facebook, Amazon, Netflix, and Google (the so-called "FANG" stocks). Without these high-flying stocks, the S&P's return would have been considerably worse. Large value-oriented mutual funds, which tend to avoid expensive technology related issues such as FANG stocks, saw an average decline in 2015 of 4.1%.

As a reminder, though, unless you are planning to cash out of all of your investments any time in the near future, tumultuous times such as this one should be considered as all just part of the ride. The stock market is an inherently volatile place, and an investor should not expect their account value to increase in a smooth fashion over time. After all, the drop in market prices we've seen so far in 2016 is coming on the heels of seven consecutive years of gains: from 2009 through 2015, the S&P 500 posted a positive gain in each and every year. That's the first time such a long stretch of gains has happened since at least the 1800s, so we should not be too surprised to see the current pullback.

What's the Opposite of "Resolution"?

This is the time of year when many of us resolve to live better and do more, or perhaps live more and do better, or some other fun such combination. Some investment pundits come up with financial resolutions we should make, or creative ideas to help us save more and spend less.

Since you may already have more than enough resolutions for one person to handle in 2016, we thought it might be fun to come up with some ways to balance it out. In other words, we have

some great ideas for "anti-resolutions" regarding your investments, or what you should *not* do with your portfolio this year.

While the following list is certainly not exhaustive, here are some of our ideas of things that would be great to avoid.

Make a Big Change at the Beginning of Each Year

Usually each January we see several articles with titles along the lines of, "Which Stocks Will Do Well in 2016" or "What to Buy and What to Sell to Prepare for the New Year." It strikes us that the stock market is not a sentient being and therefore has no idea what month or year it is. Companies are out there every day selling everything from fizzy soda water to airplane parts to consulting services, and they don't usually change their strategies or tactics based on the fact that their executives have started using a new desk calendar. So why should stocks be expected to react on the human-constructed time frame of one revolution of the Earth around the sun?

Sure, sometimes it makes loads of rational sense to make a big portfolio change based on external factors. Perhaps a certain sector of the economy has been recently beaten down beyond what it deserves, and the stocks of that industry are trading at bargain levels, prompting you to over-weight that sector in your portfolio. But we should be completely ambivalent regarding whether that over-weighting occurs in late March or mid-September or early January. These decisions should be made on their economic merit, not the calendar.

Believe Someone When They Guarantee You a Return of X%

We recently read of an adviser who was being interviewed by a potential client. When asked by the client for the adviser's best guess at their potential prospective returns, the adviser balked at naming a specific target but instead made a careful examination of history. She showed the potential clients how stocks had behaved over the previous decades, and did the same for bonds, cash, commodities, and so on. By devising an asset allocation of those various asset classes, they could then have a rough idea of what sort of returns *might* be expected in the future, but that range would only be a guideline and not at all a guarantee.

As she later learned, the potential clients hired someone else who had put them into some unsuitable illiquid investments. When they later needed quick access to some cash, they called her again to ask for help in unwinding those investments, which the adviser was happy to do. After it was all said and done, she asked them why they had hired the other adviser and they said it was because he had promised them an annual return of 12%.

In the realm of investments, there simply are no guarantees. Unless the "someone" is the FDIC, and unless the "x%" is 1% at the very most, it's best to simply never believe someone when they say they can guarantee you an annual return of x%.

Buy Something With a Big Sales Commission

This point is actually a direct corollary to the previous one. What were the unsuitable illiquid investments bought by this adviser's unlucky clients? One of them was a variable annuity, which are notorious for paying the sales broker a generous up-front commission.

Variable annuities are contracts with insurance companies, and we believe they should only be properly thought of as insurance products. It may well be that variable annuities serve a great purpose when it comes to insuring a steady stream of eventual payouts during the purchaser's retirement. But the insurance company selling the product generally charges high fees for its services (the terms "sky-high" and "nosebleed" come to our mind when we think about variable annuity fees), and in addition to those high ongoing fees there is also the matter of that generous up-front commission which the insurance company pays to the sales person.

There are a number of other financial products that are more "sold" than they are "bought." While we'll refrain from commenting on whether they are compelling investments in and of themselves, we will say that we think the sales commissions charged on these products is typically onerous. When you plunk down a certain chunk of money into an investment, and the sales person immediately scrapes 10% of that chunk into his or her pocket, that puts your investment into a sizable hole out of which it must crawl.

Don't Diversify

This advice is primarily for those of us fortunate enough to either work for a publicly-traded company, or to be a significant owner of a company. With various inducements such as 401(k) matches made using your employer's stock, or a discounted stock purchase program, or stock-based compensation, it can be easy for one investment to very quickly make up a sizable portion of your net worth. Sometimes such investments are forced into an illiquid state, such as lock-up periods on selling stocks, or vesting periods, or simply a private investment that lacks short-term marketability.

But if you do have a significant part of your portfolio wrapped up in one particular investment, and if you have do have the ability to readily sell that investment, we think it's a wise idea to come up with a plan to sell off small portions of the investment at regularly defined intervals. For instance, perhaps if half of your net worth is currently tied up in your employer's stock, you may want to sell, say, 3% or 4% of your current holdings each month going forward until the stock makes up a more manageable proportion of your portfolio.

Invest on Margin

What exactly is margin? It simply means borrowing money to invest. Let's say you only have $100,000 cash to buy a particular stock, but you'd really like to invest $500,000 in it. You simply call up your broker, ask to borrow $400,000, and then put the full $500,000 to work. If the stock goes up, it's great. You simply pay back the $400,000 to the broker, but the return on your investment is multiplied by 5, because you had 5x as much money invested. If the stock in

question went up by 40%, then your return (ignoring the interest cost of the $400,000 loan) would have been $200,000. A $200,000 return on a capital base of $100,000 is, to use the technical financial term, *really good*.

But what if the investment doesn't go up 40%? What if it goes down 20% instead? Well, that's a horse of a different color. Now you're completely wiped out, because a 20% loss on $500,000 is exactly equal to how much money you started with: $100,000. So now you're left with nothing.

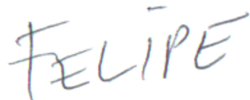
We've obviously chosen these numbers to show the extreme variations possible when using margin, but we believe the lesson remains the same: just don't bother with it. Getting rich slowly may not be quite as fun as getting rich quick, but it makes the journey much safer.

Conclusion

What's a good opposite for the word "resolution," anyway? Refrainment? Abstainitude? Eschewing? Maybe we should just stick with "anti-resolution." Whatever we call them, though, it is important to remember to not do them. After all, in order to finish each investment plan (such as paying for retirement or college tuition), one must first ensure that investments survive long enough to get there.

We thank you for your referrals, your confidence, and your support. We look forward to reporting to you again in three months.

Sincerely,



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