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JC Investment Management

Month-end Snapshot
4th Quarter 2015
(January 5, 2016)

Composite Performance

INDEX	2015 Return
S&P 500 (large cap domestic stocks)	**-0.73%**
Dow Jones Industrial Average (large cap domestic stocks)	**-2.23%**
Russell 2000 Index (small Cap domestic stocks)	**-5.71%**
Barclay's Aggregate Bond Index (ticker symbol AGG)	**-1.92%**
Gold (ticker symbol GLD)	**-10.67%**
Dow Jones Commodity Index	**-24.70%**
MSCI Emerging Market Stocks (emerging market stocks, ticker symbol EEM)	**-18.07%**
MSCI EAFE (developed international stocks, ticker symbol EFA)	**-3.48%**

The Year

Diversification: Do. Or do not. A review of the table above shows that investors who chose to "do not" would have made out okay in 2015. That is if one invested in domestic large cap equities (S&P 500) and if you think okay brings as much excitement as ringing in the New Year while watching Janet Davies on Chicago's Channel 7.

Oh diversification, you failed us once again. The numbers just extended the string of consecutive years whereby large cap domestic equities handily beat the likes of small cap domestic equities, European stocks, emerging market stocks, gold and a basket of commodities. To highlight the recent performance disparity, check out the table to the right that compares the S&P 500 to other areas of the market—both equities and non-equities—over the recent six year period.

Total Return from 2010 – 2015	
S&P 500	83.3%
Emerging Market Stocks (EEM)	-22.4%
Developed International Stocks (EFA)	6.2%
Barclay's Aggregate Bond Index (AGG)	4.7%
Gold (GLD)	-5.5%
Dow Commodity Index	-43.6%

Fortunately, we've been heavily underweight non-large cap U.S. equities for several years now in client portfolios. That strategy has paid dividends. But it also doesn't mean that investors should abandon portfolios that are diversified by asset class, geography, size and sector. This is especially true for those who have 401k accounts at work. Investors have very short memories at times, so it's easy to forget that everyone hated U.S. stocks during the middle part of the last decade as foreign stocks, led by emerging markets, beat the pants off of their domestic counterparts—especially large cap domestic stocks. The table to the left shows the huge performance differential during that six year period.

Total Return from 2002 – 2007	
S&P 500	27.8%
Russell 2000 (Domestic Small Cap)	56.8%
Emerging Market Stocks (MSCI)	353.4%
Developed International Stocks (EFA)	121.3%

Major 2015 Themes: both emerging market equities and commodities struggled as a seemingly unstoppable rise in the U.S. dollar as well as fears of a hard landing in China stymied global growth. Developed international markets hung in there (down 3.5%) as the stalled recovery mainly continued and the European Central Bank provided some artificial stimulus. In the U.S., the energy complex was crushed as crude oil prices fell 35% during the year. The size of this precipitous drop coupled with uncertainty about the prospects of global growth presented enhanced volatility during the year. The S&P had a swift 12% correction in a matter of weeks during the month of August. Added to this was the lingering concern of a Federal Reserve that provided mixed signals about their appetite to tighten (i.e. raise interest rates, which could be very bad for stock prices). The Fed finally raised interest rates in December for the first time in nine years. Given the relatively long list of problems, a flat year in large cap U.S. equities showed signs of a very resilient market.

At the same time, the resilience in the S&P 500 wasn't distributed evenly. It's important to note that the S&P's return would have been greatly hampered if it wasn't for the contribution of a handful of stocks. The latest issue of Barron's notes that by excluding only eight names in the index—Amazon, Google, Microsoft, Facebook, along with four other big-cap gainers— the S&P 500 would have been down over 4% during the year.

Once again, some diversification was better than none. Investors who maintained a concentrated stock book that did not include some of the previously mentioned names ran the risk of a rough year. Ask the top hedge hogs known for concentrated portfolios whether, given hindsight, they would have created more broad-based investment portfolios during 2015. Some of these big name hedge fund managers such as Larry Robbins, Bill Ackman and David Einhorn have reportedly been down north of 20% going into the year-end.

Market participants take diversification for granted because it can be frustrating at times and is decidedly un-sexy. But in face of uncertain macro headwinds and index returns that are being generated by a limited number of stocks, it is important to weather these storms with a diversified portfolio.

Perspective #1: "time"

I'm rarely late. My wife, on the other hand, is punctually tardy. Her tardiness, then, becomes my issue for all couples-related events. But, she regularly and wisely asks me how I'm measuring belatedness? For example, she posits that although we're never the first to arrive at a party (or extended family get togethers, sporting events, kid events, church, etc.) at the pre-announced time, we certainly aren't the last. The point is that although we're technically late, we're relatively on "time". In this case, the distinction is mainly harmless.

Perspective #2: "time"

True story. In 1993 I had an idea. In retrospect, not a good idea, but one that was predicated on a statistical norm. The simple fact is that if you flip a coin enough times then the resulting tosses would land half on 'heads' and half on 'tails'. What if, I thought, I could take this simple statistical phenomenon and develop a way in which to profit? This led me to the roulette wheel. Here was the strategy: wait until the ball lands a few consecutive times on either red or black. Then, bet $5 on the opposite, doubling the wager for each loss and collecting the proceeds for each win. The reason this is a seemingly sound strategy is that one is fooled into thinking that with each consecutive spin you increase your odds of landing on your desired color to make your original $5 profit. The problem, however, is that the roulette wheel has no memory. Given an unlimited amount of spins/"time", then the strategy would work. But the fact remains that with each spin you still only maintain a 50% chance of winning (not increasing odds, which is also known as the *gamblers fallacy*) and that you would need a potentially infinite amount of time and money to make your original $5 profit. So, this strategy known as the gamblers fallacy is technically sound, but only short-sighted because of an impractical perspective on "time".

Just like in gambling, the world of investing requires analyzing data using the proper time horizon. We'll revisit this concept shortly.

2016 Outlook

The Santa Claus rally that wasn't became a post New Year's Day hangover as the markets started off decidedly in the red to kick off the first trading day of 2016. What's in store for the rest of 2016? Maybe we should wait in our response as the big banks and brokerage houses will soon be trotting out their 100 plus page 2016 outlooks. But as history has taught us, no matter the length of the forecast, almost all these predictions will be wrong. The false sense of precision conveyed in these reports is mind boggling. And you can bet your bottom dollar that the default positions in these prognostications will be extrapolated from recent concerns or crises. The usual suspects being: the Fed raising rates, a downturn in China's economy, crude oil prices falling sharply leading to widespread credit problems, and finally, geopolitical problems like ISIS. In other words, these forecasts will be calling for the likelihood that existing worries will worsen.

We agree that all of these issues are extremely important as to the direction of equity markets. However, we also believe that not one of these issues should impact the amount of risk we are taking with our investment portfolios. Here's why: first, the *fear of the Fed*. Talk about mind boggling? Does anyone who has been closely following financial markets over the past decade honestly believe that the Fed will have the audacity to derail the S&P? The Fed's so-called data dependency is solely based on the price of the S&P. If this benchmark is faltering or even flailing, the Fed will remain on the sidelines.

Next, a *China slowdown* and *crude oil prices*. We group these concerns together not based on the fact that they are slightly related, but only because they are similar in that they can be forecasted with a 0% confidence level. Show me the person who can divine the thoughts and future deeds of Chinese central bankers. In fact, other than Chinese president Xi Jinping, please tell me who has access to reliable data? The direction of crude prices is just as uncertain. Trust me, I read dozens of research reports on the energy complex each year. They never get it right. Yes, there is some correlation to the price of oil and global growth, but the actions of OPEC remain mostly unpredictable.

Next, we have *geopolitical problems* such as terrorism, ISIS or the Middle East. To this, I'll once again succinctly respond to this concern with a quote from the always esteemed Josh Brown,

> "I'm going to hold off on investing until the Middle East gets straightened out."
> -guy in 1967 who died broke

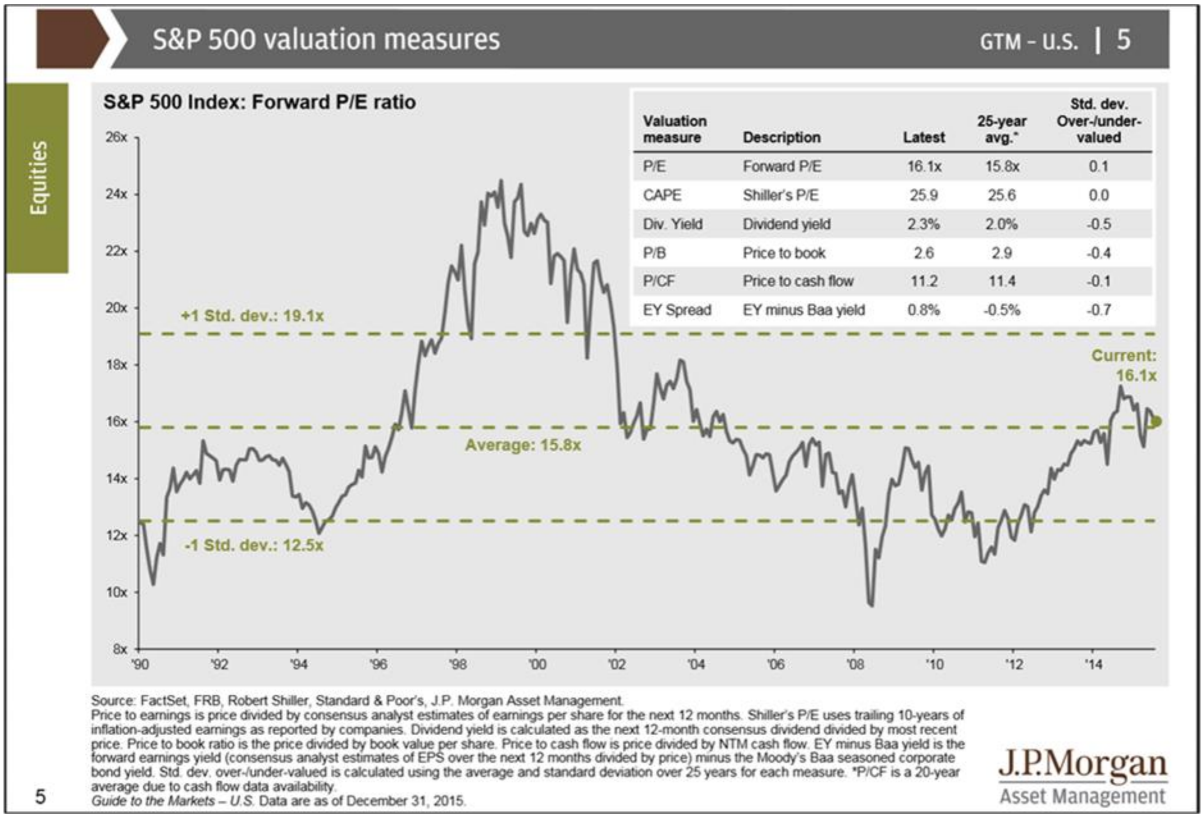
Thankfully, successful investing doesn't require being able to predict the next geopolitical disaster or the next tick in the price of crude. Certainly the direction of the Fed is of utmost importance, but again, the Fed has given us not one shred of evidence that they will act to raise rates on any other indicator than the price of the S&P.

Annual Return	
Last 3-years	13.4%
3-year rolling average since 1950	7.9%
Last 5-years	10.6%
5-year rolling average since 1950	7.5%

One concern that we haven't yet discussed, which is by far and away the most popular among the so-called market pundits is the thought that future equity market returns must be muted due to the rise in the markets over recent years. These pundits are factually correct in saying that the market's rise has been exceptional over the last several years as compared to historical averages. This can be seen in the table to the right. The table would seem to imply some mean reversion (what goes up must come down; what goes down must come up) is in order. We do subscribe to the concept of mean reversion. However, just like in our perspective examples on "time" in the previous section, we'd argue that it is imperative to use the proper time frame in any relative analysis. Otherwise one runs the risk of falling into a gamblers fallacy trap with a perverse perspective of "time". In this case, pundits, as well as investors, have a tendency to anchor their perceptions to the trough of the bear market and view everything through this lens (this is known as the *recency effect*). This skews the data to produce inaccurate findings. To correct this bias, we can extend out the time horizon to a ten and fifteen year period. This is also a more meaningful stretch of time for retirement investing. The results can be seen in the table to the left whereby the recent returns pale in comparison to the historic averages. Thus, the recent period returns can be considered grossly underwhelming. With the proper perspective on "time" we can see that the equity market actually has a lot of catching up to do, which is both technically and fundamentally accurate.

Annual Return	
Last 10-years	5.2%
10-year rolling average since 1950	7.5%
Last 15-years	3.1%
15-year rolling average since 1950	7.3%

Valuations. The slide on the next page shows the S&P 500's valuation against a variety of metrics as compared to their long term averages. The slide shows that the market is actually reasonably valued. These valuations, coupled with the long term underperformance of the market, a domestic economy that is still slowly improving (including wage growth that is finally rearing its head), central banks across the globe that have just begun their accommodative programs, a Fed that we're convinced won't tighten unless equity markets are strong, a Chinese government that will do whatever it can to prop up markets, and a domestic consumer that will eventually spend some of its oil savings, are reason enough for us to maintain solid equity exposure that is consistent with client risk profile.



Of course, equity markets don't just go straight up. Before last year's 12% correction, the S&P experienced a 10%+ correction over four years prior. This is not the norm. We expect there to be enhanced volatility during the year. We're also concerned about the narrowing breadth in the market. Further gains will need to be generated by more than a handful of large cap domestic companies. If and when these companies roll over, we will be watching for some rotation. If that rotation doesn't come, we will consider this a time to get much more defensive with client positioning.

But this is not a time to hyperventilate after some volatility in the equity markets. Few, including us, see an economic recession in 2016. And it is important to note that most bear markets have been caused by recessions. 2015 was a boring year, that's for sure. 2016 might be boring as well. But at this juncture we feel that it is prudent to maintain solid equity exposure that is accompanied with diversification both within the asset class (by geography, sector, size) and outside of the asset class (bonds, cash and commodities).

As always, feel free to call, write or e-mail with any comments or questions.

Chris