Tuesday, January 05, 2016

Happy New Year!

All of us here at Responsive Financial Group Inc. (RFG) wish you a healthy, happy, and wealthy 2016. 2015 was a year of great change for us. Susan Theus has moved on and is happily working much closer to her home. Sadly, Kendra and I have divorced and have each moved on with our own children. So as of year-end Kendra is also no longer with RFG. Michael, Trevore, and I are holding down the fort and I have outsourced most of the work Susan and Kendra did for us. These changes have made us more efficient and allow Michael, Trevore and I to work more closely and in concert with each other.

2015 also brought a great deal of change in the "back office" systems and technologies that we use to support our work for you, most significantly in the areas of integration between our different applications and in the speed of the development of those applications towards further integration and greater effectiveness. Only one of the systems that we use remains installed on a local server in our building. One of the great experiences we have had as we have transitioned the rest of our systems to cloud-based or web-based applications is what I have come to call "internet speed". I am not referring to the speed of the applications which is about the same as before, but the speed of development of applications and the integration of those applications. With web-based applications, our vendors no longer have to worry about maintaining and supporting a multitude of different servers that their clients may operate from, nor do they need to be concerned about sending out updates to those applications. They now simply update their own server, and when we login the next day, we immediately have access to new capabilities and interactions. The impact of this is truly transformative to the way we do business. We will see even more of its impact in the coming years, and I fully believe that it will be a tremendous experience for all of us.

2015 also marked the seventh year of the economic recovery from the crash of 2008 and 2009. Investment markets in 2015 were notable mostly for the vast inconsistency of results. US stocks were largely flat for the year, although large caps were up and small caps generally down. International stocks were, on average, down slightly for the year, although continental differences were significant with European stocks down more than 5% and Asian stocks up almost 5%, and emerging markets down more than 15% for the year. Among the more significant sectors of the market, real estate had a very strong fourth-quarter making up for the year's losses and finishing with a gain of slightly less than 5%. Commodities fell more than 15% in the fourth quarter alone, creating a loss in excess of 30% for the year; oil and gas investments were major contributors to this loss. Gold was down 10%, making it the big winner in metals, beating silver, copper, platinum, and palladium by more than 20% in 2015!

In bond markets, the widely predicted and long-awaited rise in interest rates, never showed in the corporate sector in 2015, where rates actually dropped slightly over the year. Treasuries at the long and short end of the yield curve finished essentially where they began the year, while the middle of the curve in the 2 to 10-year space yields increased slightly. The Federal Reserve did increase the discount rate from 0 to 0.25% at their last meeting, having virtually no discernible effect on most of us. Interestingly, this was the first rise in the discount rate since June 2006. Jeff Gundlach of Doubleline Capital noted recently that 64% of hedge fund managers today have never seen an increase in the discount rate in their careers! While I do believe that the Federal Reserve increase in the discount rate was a good idea, as I am not a fan of the corporate welfare that it is indicative of, it is only the beginning of the steps necessary to bring our economy, and particularly bond markets, back to normal operations. The Treasury Department continues to rollover, (or reinvest) the debt securities that it purchased through its quantitative easing activities, namely QE1, QE2, and QE3. This substantially decreases the supply of long dated government and other government guaranteed debt securities in bond markets, keeping demand and prices in that space artificially high (and rates low). Until such time as the Treasury Department allows these bonds to begin to run off the federal balance sheet, federal intervention in these investment markets will continue to distort their natural operation.

The US dollar strengthened significantly in 2015, creating particular stress for those nations that have significant debts denominated in dollars. This represents a significant stress for those nations as the cost of their loan repayments have increased. In some cases, by more than 30%. This is expected to worsen going forward, and could cause some international debt defaults. This does help in keeping US rates from increasing rapidly, as it makes the US dollar a relatively stronger place to maintain reserve capital. Inflation in 2015, while measurable, was not enough to cause Social Security to increase its benefit payments for 2016, and remains muted around the world. In fact, the greater concern globally is that of deflation. For governments deflation is extremely scary. Their ability to collect taxes is reduced in a deflationary environment, and their ability to fund past debts is diminished. Expect governments around the world to deficit spend, and otherwise attempt to stimulate their economies in order to prevent deflation. This has created what is often called a “race to the bottom” among different currencies as many countries attempts to weaken their currency, in order to strengthen exports and aid the local economy.

Moving from the economy to back to markets. Major US market indexes, such as the S&P 500, did reasonably well, or at least not too badly in 2015. But the way they did so is worrisome to me. The reason is that these are capitalization-weighted indexes, meaning that the larger the market capitalization of the company, the larger its representation in the performance calculation for the index. As this year wore on,

market and earnings leadership among the stocks in these indexes became narrower and narrower until the vast majority of the positive performance and earnings of the major indexes came from the top ten or so names in the index. This has not been a one-year process, either. Going back five years in the S&P 500, the vast majority of earnings growth came from those same top five or ten names in the index. The last time we have seen anything like this was the run up in the NASDAQ index through 1999. I am not predicting a crash in the S&P 500 as we experienced in the NASDAQ, and global markets in 1999 and 2000. But extreme narrowness in markets, and particularly among the names that most drive market indexes does tend to fool investors into a false sense of security and to create substantial feelings of regret when their portfolios do not keep up. Unfortunately, this happens to be a good segue into the discussion of our model portfolios performance in 2015.

As we maintain very strong diversification in our portfolios, we experience the effects of virtually all of the markets that I described earlier in the letter. In addition, because we do not follow a capitalization-weighted indexing strategy in our global diversification implementation, we lag market indexes when cap-weighted indexes performance is dominated by fewer and fewer names. The performance of the indexes against which our portfolios are compared, has been driven by fewer and fewer names in every year since 2010, getting to an extreme state this past year. This is not the natural state of markets and is counter to the history of markets going as far back as there is market data. History shows us that the best performance among stocks in global markets will be found among those stocks which are represented by smaller capitalizations as opposed to larger, value stocks as opposed to growth, and high-quality stocks as opposed to more speculative stocks, as represented by a measure called profitability, indicating efficient and effective operations as opposed to rapid growth perhaps fueled by large amounts of debt. These factors are proven to be reliable and repeatable ways to gather small amounts of extra return which compounds in a portfolio over time.

Our portfolios are characterized by all of these factors, all of which have caused our portfolios performance to suffer in comparison to the indexes in recent years. Remember, more and more index performance has become been momentum based and focused in fewer and fewer stocks in the indexes. This underperformance is in the long run good news for our clients who still have a need to grow their assets in order to transfer purchasing power from the present to the future. The reason is because as you invest or re-invest capital in these portfolios, they continue to invest in more shares of unloved and low priced securities which will eventually accurately represent their value. This does include even those of you who are currently using your portfolios to generate current income, if your current income need is for five years or more.

Our portfolios have also suffered from two errors I have made over the last two years in some allocations to a Swiss gold ETF, and to a larger extent to an ETF and mutual fund,

which invest in midstream (meaning transport of) oil and gas MLPs (Master Limited Partnerships.) The latter being the costliest, reducing our returns in some models by a percent or more. My expectation was that these MLPs would be less sensitive to changes in the price of oil than traditional oil and gas investments, and while essentially correct in that they did decline less than other oil and gas investments, they still declined substantially. These investments are now largely out of our portfolios, and until such time as markets begin to function more naturally, or absent so much government intervention, our exposure to markets will continue to be very broad, and our investment in specific sectors limited to 5% of the equity allocation of a given model. Our choice of sectors is characterized by being able to buy historically low prices or good values in those sectors. For example, you will likely not see sector fund or ETF exposures to commodities, natural resources or oil and gas investments in our portfolios until such time as for commodities that you would see the Chinese economy actually growing, or the Indian economy, taking its place as a growth engine in the world. For oil and gas, it could be that Iran's production will have been fully ramped up from its current 2 million barrels a day to its expected 4 million barrels a day, and the world has absorbed this production. In either case, until such time as those factors would occur, I believe it highly unlikely that there would be substantial positive performance available in either of those investment arenas. The factors that will actually drive our decision to invest in a sector will be "fat pitches" specific to that time, these are not triggers I am waiting for.

A sector that has done extremely well for us over the last five years has been healthcare, where our primary exposure has been a mutual fund managed by Prudential investments. We have largely eliminated our holdings of this investment as well, as valuations in this area have become fairly high, and uncertainty in the health care sector has increased due to the negative effects of effects of Obamacare on many of the market participants, and the potential disruptions in the health care economy coming throughout this next election season. Due to those factors, we have felt that the risks in that sector have come to dominate the potential outperformance it might continue to demonstrate.

We like very much our bond or debt investments; they have done very nicely over the last several years. We have identified some of what we feel are excellent managers, and continue to use them to identify and invest in bond markets as they see value in opportunities, as opposed to trying to craft specific exposures ourselves.

Overall, our portfolios have continued to lag the indexes that we publish their performance against, and those that you see on the news. Know that the reasons they do so are sound and based in the implementation of theories well proven by academic research and practical experience in the markets. Our faith in the logic of the implementation of our portfolios has been reinforced by the awarding of the Nobel

prize in economics to Eugene Fama in 2014. Our large holdings in Dimensional Fund Advisors (DFA) funds, are the most direct and effective implementation of the theories that we have built our portfolios around since the beginning of my investment management work for clients in 1990. Portfolios I have managed for clients have always tilted towards a value and a small cap overweight compared to market indexes. DFA has allowed us to expand the number of stocks in our portfolios from 1,000 or less, to well more than 10,000. This makes our portfolios more reliable and durable vehicles for getting the performance over time that you and we expect. The hidden benefit that you and we both gain from investing in portfolios structured as ours are is that as we lag and you invest you are purchasing more and more shares at lower prices, or better values than people who are experiencing on a current basis much better performance, but are purchasing assets at much higher prices and worse values. The aim of the game is to accumulate many shares at low prices, not just to have a few shares that you have purchased go to very high prices.

So we thank you all for sticking with us, and with your portfolios. Your discipline will be rewarded. Please do keep us informed and engaged in assisting you in making the financial decisions that you face, and if you are having any difficulty using any of our resources to assist you in the management of your financial life, please let us know. We can make it easy.

It is an honor and a privilege to be your financial advisor.

Sincerely,

Benjamin G. Baldwin III, CFP®, ChFC
President