June 1st, 2015

The 8th wonder of the world…

With five months of the year now in the books, equities continue to aimlessly drift within a tight range – a trend which has so far epitomized the 2.5% return generated by the S&P 500 for 2015. Investors have been relegated to exhibiting patience with the closing levels in the S&P 500 over the last 10 weeks, bound by a very tight 40 point trading range – even more, the S&P 500 ended May at the same level it was trading at in late February. Volume is light, momentum is very weak, and breadth indicators suggest the uptrend is running on fumes. Not a particularly encouraging

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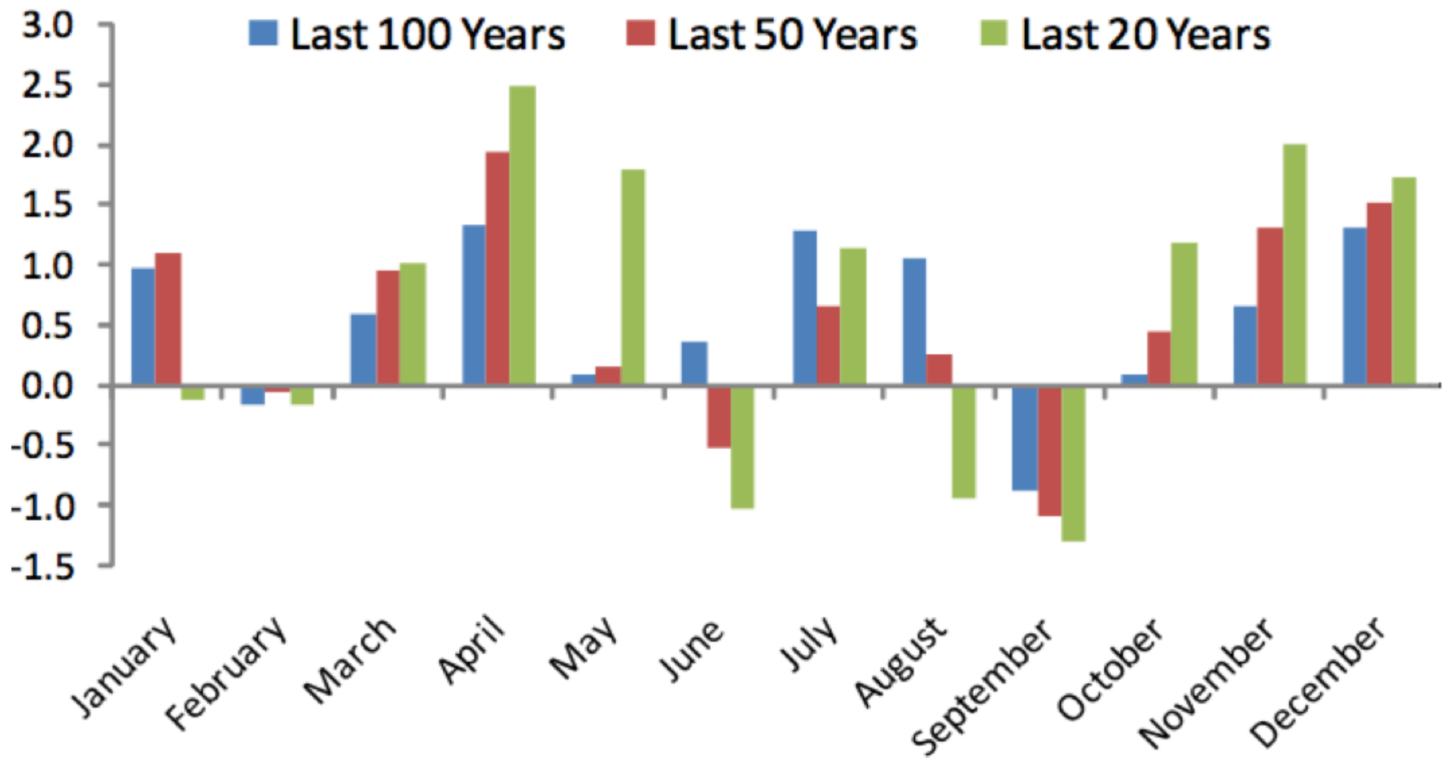
backdrop as we enter a month (June) which has historically been the second weakest month of the year for returns.



The setup for this year's stagnant capital market backdrop is sluggish global economic growth, flat EPS and revenue growth, high valuations, complacent investor sentiment, anticipation of a Fed rate hike, volatile foreign exchange rate movements, a precipitous decline in oil prices,

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and a bull market that is moving into its mature stages.

This has created a tug-of-war environment between the FOMO (Fear of Missing Out) investors and the FOHB (Fear of Holding the Bag) investors, where the former don't want to be left behind if stocks take another leg higher while the latter don't want to be the last ones in before a significant market decline. Market psychology is a funny animal, isn't it?

Today's environment is ripe for impatient investors who are willing to journey into markets that are less well known to them in an effort to generate higher returns. However, the flipside of pursuing this strategy is that more times than not it ends up working against investors as losses pile up given that the risk/reward paradigm just is not conducive for a capital appreciation objective.

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The business cycle is such that at certain times it warrants and rewards investors for swinging for the fences, at times it requires that investors batten down the hatches and take their lumps, and sometimes it justifies playing some defense – executing prudence, and patiently waiting for that next fat pitch. It is my belief that the prevailing investment environment is suited for investors willing to adhere to a strategy that is calibrated for the latter.

Those willing to take a more simplified view of investing during times of elevated complexity tend to gravitate to what they know, account for what they know they don't know, and everything else is removed from the equation so as to eliminate unnecessary noise. A basic principle of investing that has been clearly demonstrated throughout the archives of history is the fact that the capital markets have been a

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great forum to compound wealth. In the words of Albert Einstein, "Compound interest is the eighth wonder of the world. He who understands it, earns it… he who doesn't…pays it".

However, to capitalize on these wise words requires a leap of faith that the past is prelude to the future. With a fundamental capital market backdrop that is cloudier than it has been for some time, this leap of faith is understandably more difficult to make today. Many investors and market prognosticators (myself included) have brought increased attention to the above average valuation levels that accompany both the equity and fixed income markets today. After highlighting this point they shift their attention to describe an environment where potential future returns will be much lower.

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With this in mind I wanted to look at previous low return environments to gauge the frequency of occurrence and the magnitude of a low return profile. The following table summarizes the worst 10-year rolling calendar returns for stocks going back to 1928.

10 Year S&P 500 Returns	
Ending Year	**Annual Returns**
1937	-0.6%
1938	-1.7%
1939	-0.9%
1940	0.8%
1974	1.3%
2008	-1.4%
2009	-1.0%
2010	1.4%
2011	2.9%

Source: Damodaran, my calculations

Two things stand out when evaluating this data: 1) underwhelming performance periods tend to cluster around economic calamities (The Great Depression –'37,'38,'39,'40, run-away inflation

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–'74, Tech-bubble and The Great Recession – '08,'09,'10,'11) and 2) they are not that frequent in occurrence (in the 86 years of data, negative 10-year rolling calendar year returns occurred five times).

Taking this evaluation a step further, I was interested in seeing what the worst 10-year rolling calendar year returns where for a balanced 50/50 portfolio allocation (50% S&P 500, 50% U.S. Treasury Bond). The worst 10-year period of an equal weighted stock bond portfolio (rebalanced annually) was just shy of 2.5% per annum.

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10 Year 50/50 Stock/Bond Portfolio Returns	
Ending Year	Annual Returns
1938	2.4%
1974	2.7%
1939	2.8%
1937	2.9%
1940	3.6%
2008	3.7%
2009	3.8%
1946	3.9%
1975	4.4%
2010	4.4%

Source: Damodaran, My Calculations

When comparing the two worst rolling 10-year periods for the S&P 500 (a -1.7% per annum return through 1938 and -1.4% per annum return through 2008) to the same time interval for the 50/50 portfolio (a 2.4% per annum through 1938 and 3.7% per annum through 2008) you can truly get a sense of the value diversification brings to a portfolio.

So as you can see, low return environments do occur, but when they do it's not the end of the

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world. They are as much (although not as frequently) a part of the fabric of investing as stock market corrections and significant market rallies – it's all part and parcel to investing. One other thing this data and Mr. Einstein's words reinforce is the fact that successful long-term investing has more to do with "time in" the market and not "timing" the market.

In a market that has failed to go much of anywhere since December of last year it is important to remember to be patient, because a market that is checking time is much preferred to a market that cascades lower to only recover and get back to where it started. Furthermore, this has been an environment which has lacked a catalyst to ignite a trend in one direction or the other. The incoming economic data hasn't been strong enough to compel investors to believe that a robust pick-up in demand is on

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the forefront, nor has the data been weak enough to cause elevated concern.

One group that isn't sitting on their hands is corporate executives who authorized a staggering $141 billion in stock buybacks in the month of April. This is the highest level ever authorized in a single month and is 121% higher than April 2014. If the current pace of buybacks as of the end of April continues through the balance of the year, total buybacks will be approaching $1.2 trillion – far outpacing the all-time high of $863 billion set in 2007.

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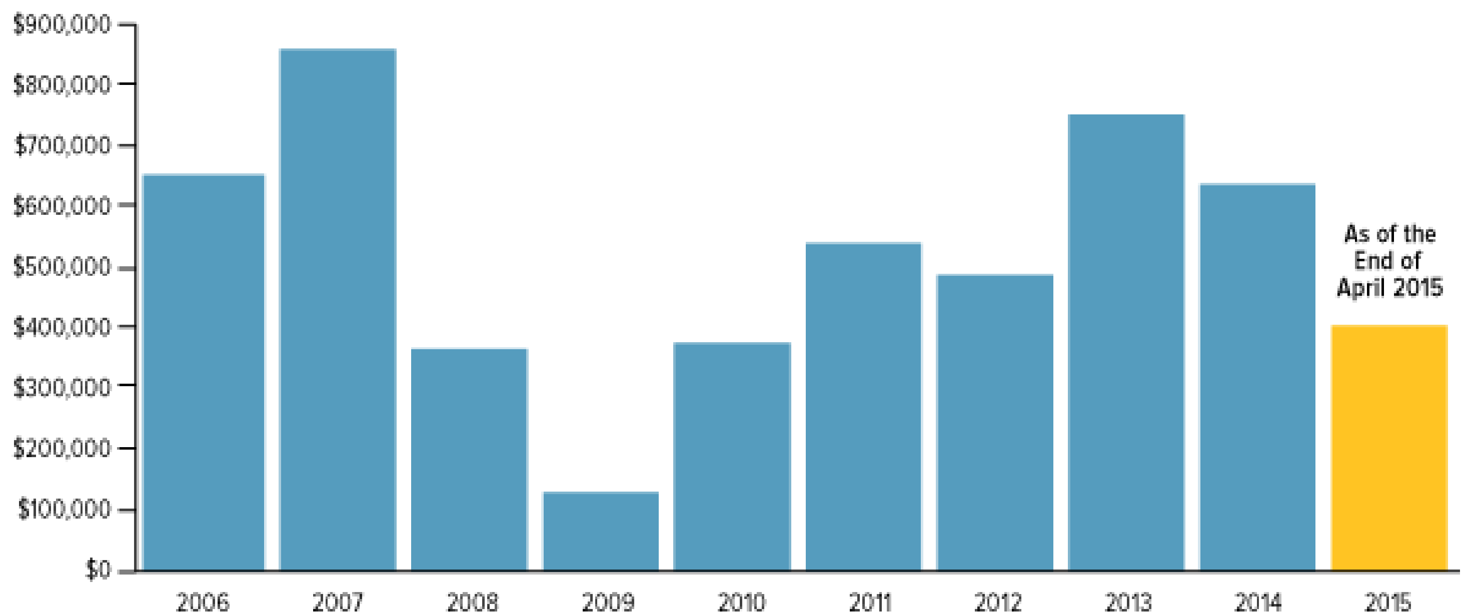

Furthermore, corporate managers are not just throwing their money at their own stock, they've also been actively on the hunt for other companies which according to data from Bloomberg has sent global M&A activity to an eight year high. Both the number of announced global M&A deals and their size in U.S. dollars in April surged to their highest levels since April 2007.

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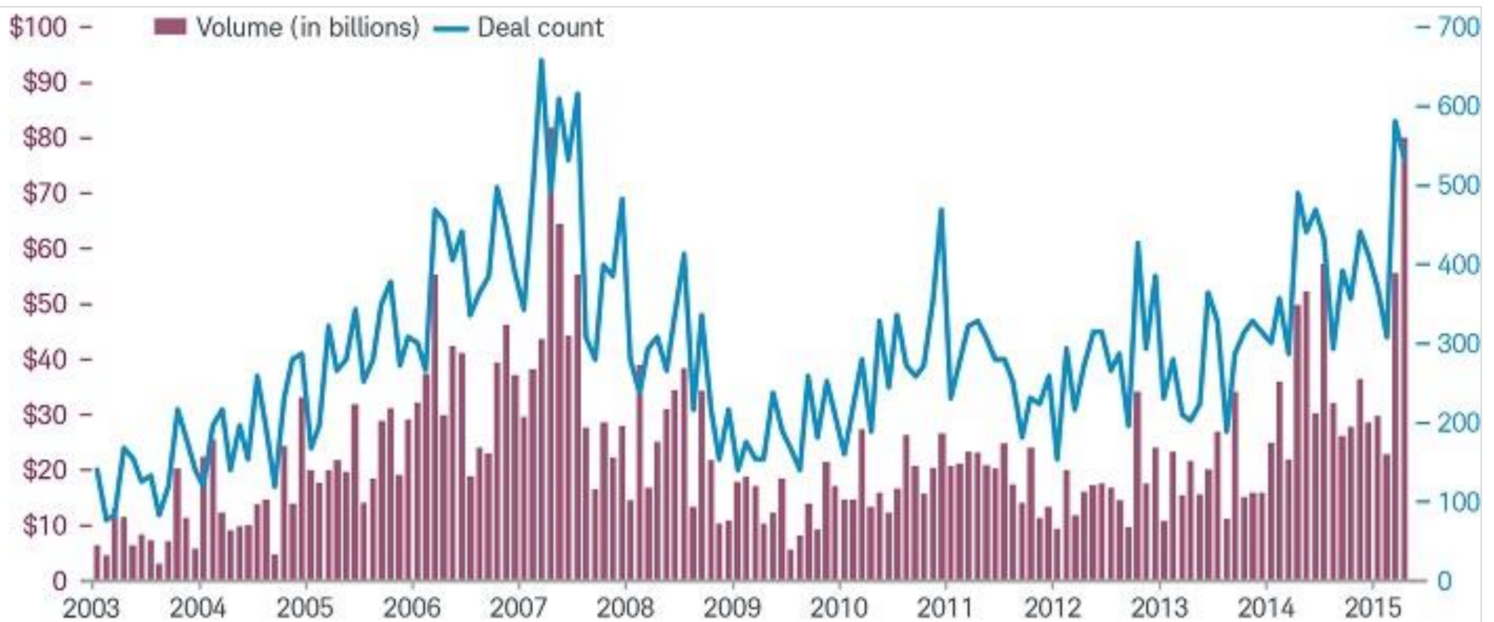

This level of corporate euphoria should be viewed with a bit of a contrarian slant as this level of activity in the past has often times coincided with equity market peaks. This isn't a strong enough variable to solely base an investment decision on, but it is a data point that should be stored in the back of an investor's mind and not readily dismissed.

This week, being the first week of the month, brings with it the latest check-up on the pulse of the economy:

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- Monday: PMI's from around the world, German CPI, U.S. Personal Income and Spending, Construction Spending, and ISM Manufacturing.
- Tuesday: Euro area CPI, U.S. auto sales.
- Wednesday: Euro area retail sales, U.S. ISM Non-Manufacturing, ADP employment report and Fed Beige Book
- Thursday: Jobless claims, Non-farm Productivity, and UK Central Bank meeting
- Friday: Non-farm employment report

We'll attempt to ferret out the good, bad, and important information from this data deluge and highlight what we believe is noteworthy in next week's missive.

Corey Casilio
Partner, Portfolio Manager
101 Ygnacio Valley Road
Suite 211
Walnut Creek, CA 94596
corey.casilio@clpwm.com
925.448.2215

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