# Volatility Returns
## <u>3rd Quarter 2015 Commentary</u>

Since our last quarterly commentary, a fair amount of volatility has returned to the financial markets. A variety of culprits are blamed…China, the Federal Reserve, Option Expiration, GDP growth, etc.

Most of the "noise" is complete non-sense. However, because of this noise both the Dow Jones Industrial Average and the S&P 500 declined by 11% between August 17 and August 25.

Although this is often disconcerting, we have to take a step back and determine whether these are short term issues (which are irrelevant) or truly structural long term matters.

Since we typically invest in assets designed to be held long term (multi-decades) we welcome short term volatility as it often offers up good value for the long term investor.

***Furthermore, it is important to recognize that although a portfolio may be down for the year, the profits of the individual companies, as a whole, continue to increase as do dividends. These are the components that will typically deliver long term value***.

***China*** should continue to struggle. Their economy is heavily indebted and growth is slowing. However, their impact to the U.S. is minimal. ***We only export about 1% of GDP to China***. As such, China will continue to be an issue for the emerging markets, but not to the U.S.

The emerging markets are down 17% year to date and the Shanghai index is down more than 40% from its peak.

***The Federal Reserve*** chose to keep interest rates unchanged. Whether short term interest rates are at zero or 0.25%, the general level of interest rates remains very low. Although this makes it difficult to find good value in the fixed income market, it offers tremendous flexibility to equities.

Even if the Fed raises short rates to 0.50% within the next six months it will continue to be a non-event—certainly not the type of thing that produced a 700 point swing in the Dow from Thursday to Friday.

***This type of volatility is induced by traders looking to drum up commissions***. Although it is unsettling to investors, a long term investor should welcome this irrational behavior.

Recognizing this, it is always important to know that ***stock markets do NOT offer fair pricing***. Rather, ***they offer liquidity***—prices at which things can be sold or bought at that instant. ***It says nothing to the profitability of any given business***.

Although valuations are on the high end for the markets as a whole, we have taken recent opportunities to increase the quality of portfolios, but at cheaper prices. In doing so we sold out of lower quality and/or expensive names in favor of cheaper names with better balance sheets and better dividends.

We continue to believe that the combination of "growth + income" allows our clients to better match spending needs while still pursuing growth in excess of inflation.

Furthermore, we know that if we continue to buy "above average" businesses for "below averages" prices, over the long term, we give ourselves the best opportunities for good returns.

For these reasons, the equity holdings in the portfolio continue to skew towards very high quality in terms of balance sheet, income statement and cash flow statement.

We don't know when something bad will happen, but we anticipate it will at some point. Owning companies that are "built to last" allows our clients to absorb volatility, produce current cash flow and live to fight another day.

***As always, thank you for the opportunity to work for you--it is truly appreciated. Please let us know how else we can help you.***

Sincerely yours,

Dave Warren

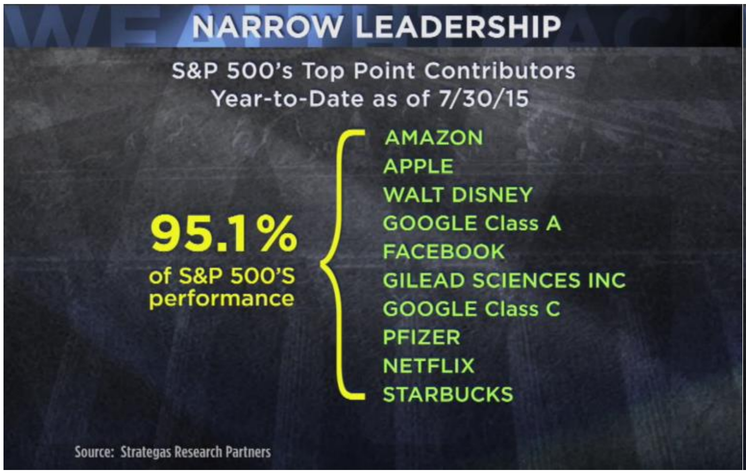
Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

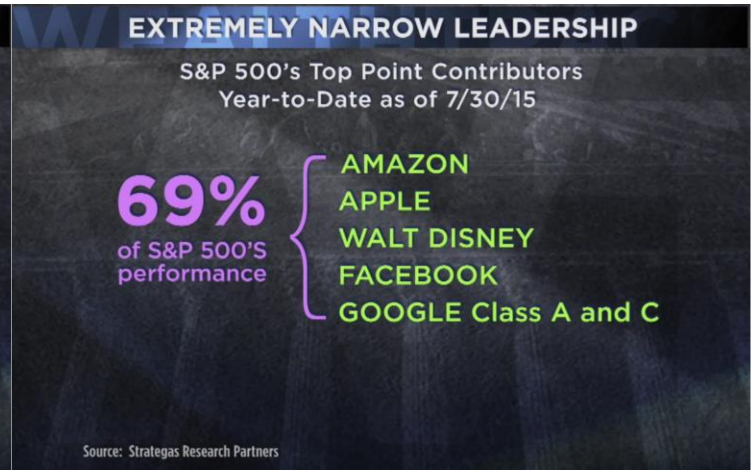
Warren Udd, Portfolio Manager
CERTIFIED FINANCIAL PLANNER™

In the first 7 months of 2015 there were only 10 securities that comprised more of the returns of the entire S&P 500 index. ***These 10 companies trade for an average Price to Earnings ratio of 60 times earnings!***

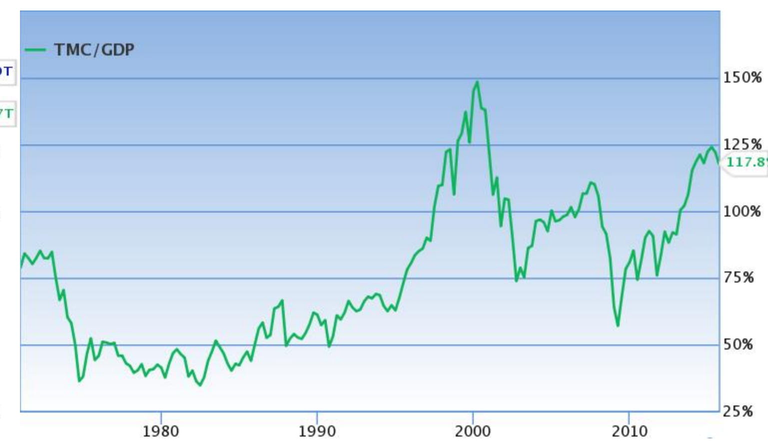
The top 3 (Amazon, Google and Apple) comprised 50% of the gain of the S&P 500 through the first 7 months of 2015. ***These 3 companies trade for an average Price to earnings ratio of 41.61 time earnings.***

We will gladly avoid these popular companies as they are clearly expensive and their futures are difficult to predict. There are far easier decisions to make for a patient investor.




Despite the recent pullback in the financial markets, they continue to be on the expensive side of history and economic productivity. Unfortunately, there are not many viable alternatives.

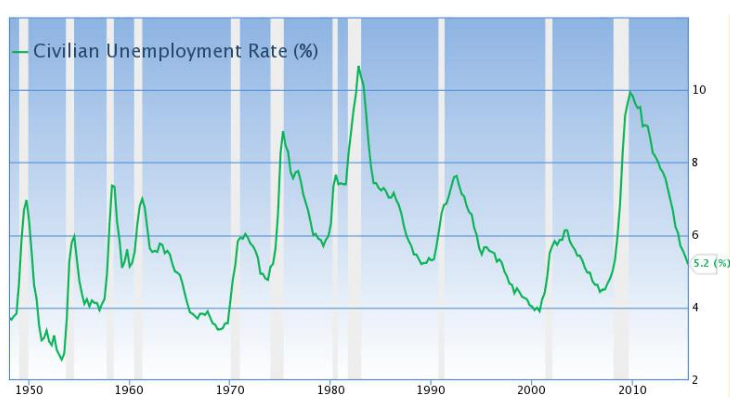




Given the thin leadership in "popular" stocks, and meager projected gains for the entire market, we continue to emphasize quality and value. This will quite often result in our strategies underperforming for periods of time. However, the focus on quality will improve regular cash flow and give us the best opportunities for a viable portfolio decades from now.

It is at times such as these that we observe the saying ***"To finish first, one must first finish."*** Our mandate to our clients and the logical investor is to avoid permanent losses…don't blow up. In a world of increased volatility we continue to think that this ideology will continue to provide the best long term returns with the lowest level of risks.

We have been told repeatedly that the economy has fully recovered from the 2008 downturn. Frequently, the official unemployment rate is used to document this accomplishment.

As the chart shows, we are, indeed, at a low historical unemployment rate. This should indicate a strong economy. However, it is important to remember that the "official unemployment" rate excludes many categories of people.



**Labor Force Statistics from the Current Population Survey**

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Series Id:            LNS11300000
Seasonally Adjusted
Series title:         (Seas) Labor Force Participation Rate
Labor force status:   Civilian labor force participation rate
Type of data:         Percent or rate
Age:                  16 years and over
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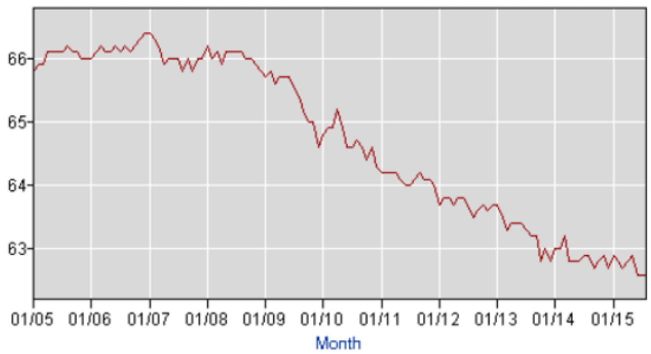



A better measure in our opinions is to use the Labor Participation Rate which measures all people living in the U.S. that are age 16 or older and working.

Although this measure has its limitations due to immigration and people retiring, it paints a very different picture.

Currently, the Labor Participation Rate is at a 38 year low.

The weakness in the general economy resulted in the Federal Reserve leaving short term interest rates at zero. This decision was mildly surprising to us.

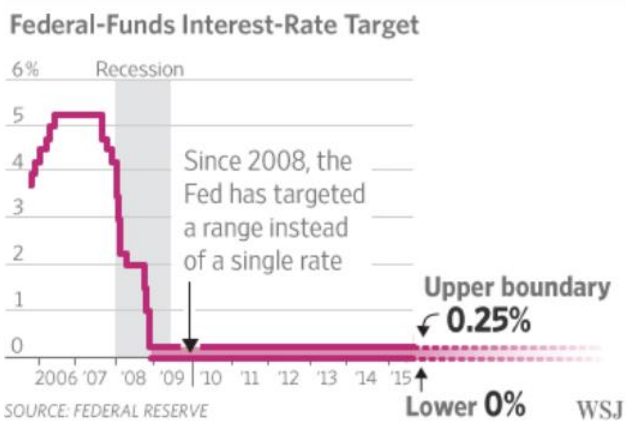
Often, the Federal Reserve is under significant political pressure from the Office of the President or the controlling portion of Congress. Since both factions are constantly running for re-election, there is often pressure upon the Federal Reserve to adopt policies that will promote their mandates.

We applaud Fed Chair Janet Yellen for  establishing independence of the Federal Reservce. Unfortunately, this resulted in Yellen acknowledging the economy is quite weak. The stock market reacted with a sell-off.

A secondary consideration is that if the Federal Reserve had increased interest rates, it would further strengthen the US Dollar relative to other world currencies. Since this valuation dynamic is already stretched, the Fed may have given this consideration.

It will not surprise us if short term rates are held at zero through the end of the year.

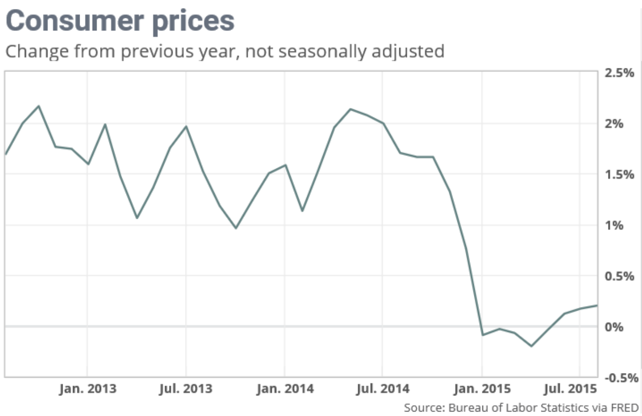
As of the end of the third quarter the US Treasury yield has fallen back down to 2.05% (a 17% drop over 52 weeks).

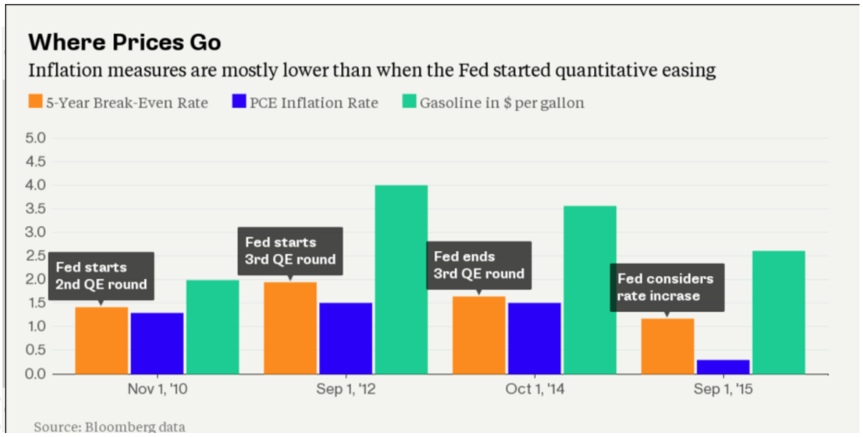




Weakness in the economy is showing up in declining consumer prices. Although this sounds like a good thing, it is indicative of deflation. We have not see meaningful deflation since the Great Depression and this is an economic condition that both the Federal Reserve and the US Treasury seem determined to battle.

Amidst a backdrop of declining consumer prices, indicating weak demand, the last thing the Fed and Treasury want to do is increase rates which in turn can slow the economy down.

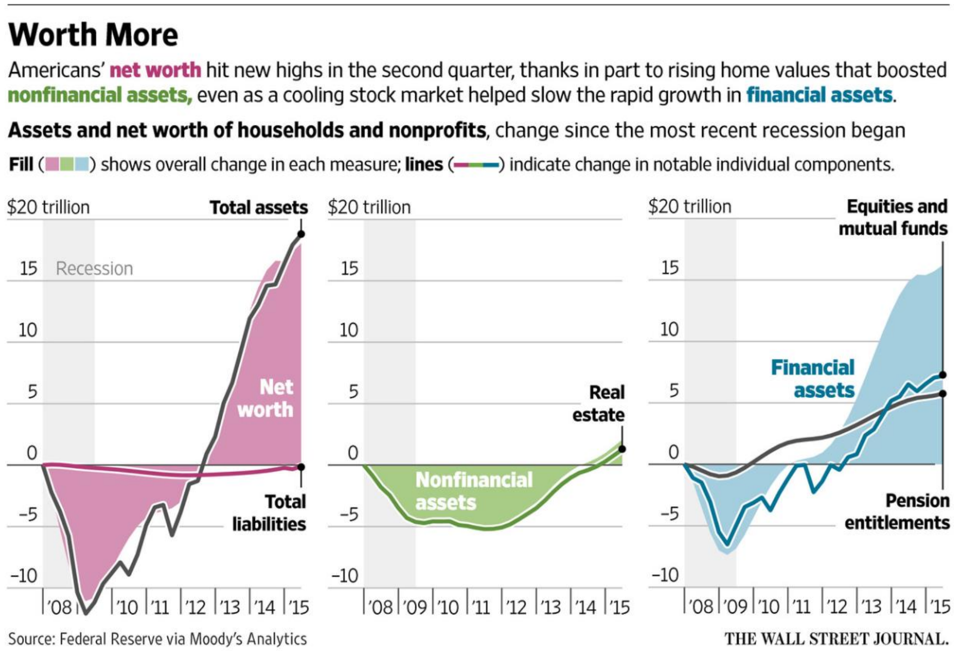


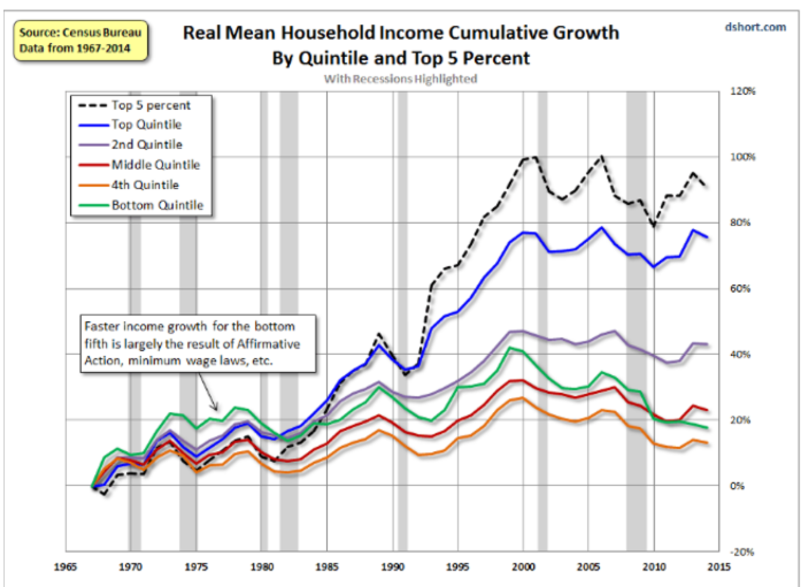




The value of increasing home values has helped the net worth of the average American.

This is welcome as salary wage growth continues to be quite stagnant.

The inflation adjusted household income is lower today than it was in 1999/2000. This reinforces the logic and analysis of the Federal Reserve in recognizing general economic weakness.




| Real Household Income Declines from Peak Year | | | | |
|---|---|---|---|---|
| Household Segment | Peak Year | Peak Income | 2014 Income | Percent Change |
| Top 5% | 2006 | $349,215 | $332,347 | -4.8% |
| Top Quintile | 2006 | $197,466 | $194,053 | -1.7% |
| 2nd Quintile | 2007 | $90,331 | $87,834 | -2.8% |
| Middle Quintile | 2000 | $58,058 | $54,041 | -6.9% |
| 4th Quintile | 2000 | $34,863 | $31,087 | -10.8% |
| Bottom Quintile | 1999 | $14,092 | $11,676 | -17.1% |
| *Source: Census Bureau, chained in 2014 dollars* | | | | |

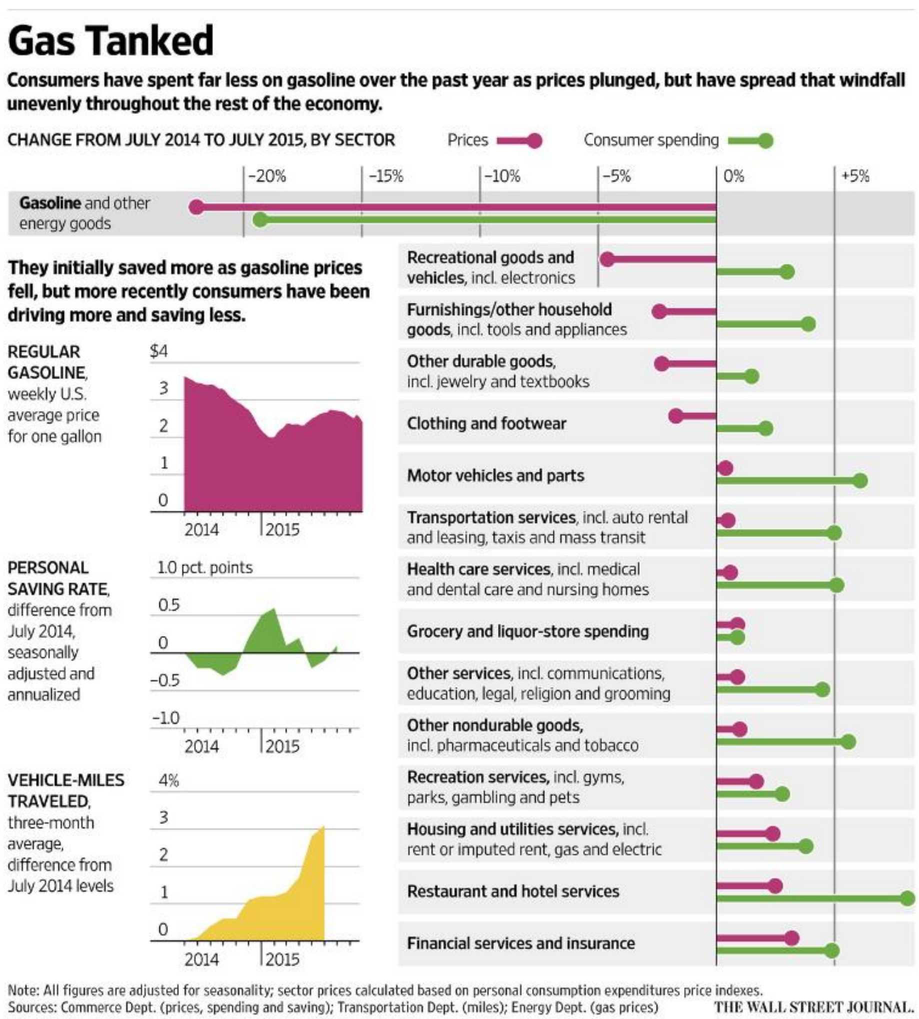
The precipitous decline in the price of oil continues to be a double-edged sword for those of us in Texas. West Texas Intermediate is down 50% over the past year.

The default rate among U.S. energy companies has accelerated in recent months to 4.8%, the highest level since 1999 and up from 3.3% in August, according to Fitch Ratings.

Within that group, exploration and production companies like Samson are defaulting at an even higher rate, 8.5%, Fitch said. Default volume for such companies is the highest it has been in five years, at $10.4 billion in debt.

The broader U.S. corporate default rate is 2.9%, according to Fitch. Despite the significant decline in the price of a barrel of oil, supplies have not subsided. World supplies are nearly million barrels per day higher today than compared to a year ago when prices were more than $90 per barrel.


On the positive side, the drop in oil has resulted in lower energy costs for the average household and corporate consumers.



Although logic would suggest that falling prices would lead to reduced production, that has not been the case.

Furthermore, we must recognize that many of the players in the world oil market are not “capitalist/entrepreneurs”, but rather governments that are prone to making foolish decisions designed to prop up unsustainable social programs. This is certainly the case with nations like Saudi Arabia and Venezuala.

Production is finally slowing down in the U.S., however, world production may not slow for another 12 to 15 months.

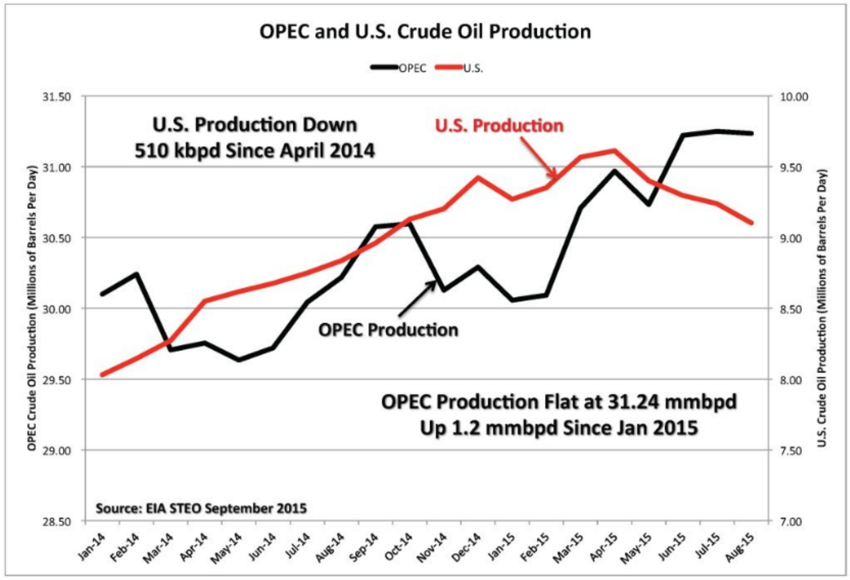
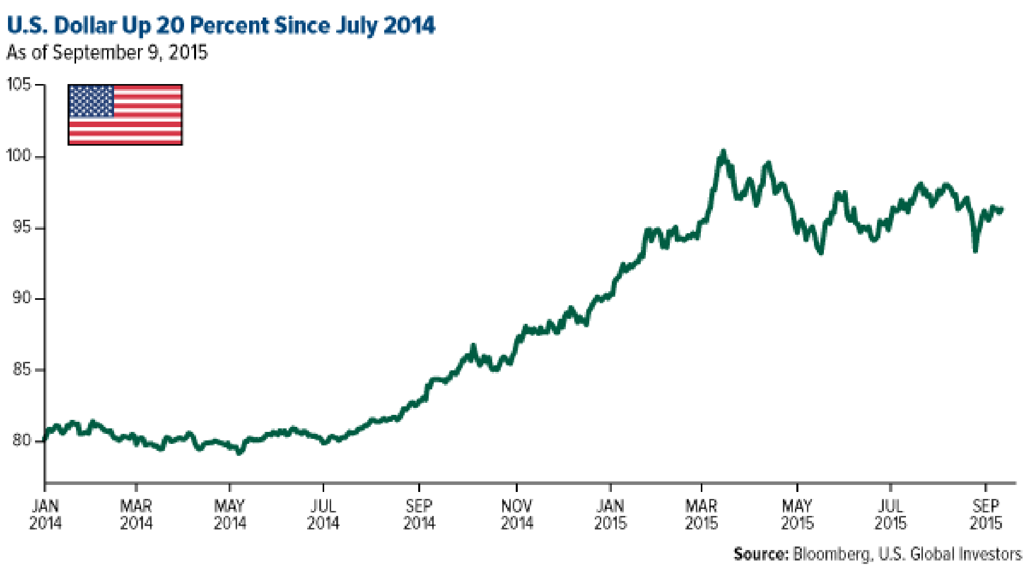



**Figure 4.** OPEC and U.S. crude oil production. Source: EIA and Labyrinth Consulting Services, Inc.

It appears that OPEC is winning the contest with U.S. tight oil producers to see which can continue to over-produce oil at low prices. IEA ended its September Oil Monthly Report saying,"On the face of it, the Saudi-led OPEC strategy to defend market share regardless of price appears to be having the intended effect of driving out costly, "inefficient" production."

The U.S. Dollar has surged 20% against the yen in the past two years and 17% versus the euro as the prospect of higher U.S. interest rates contrasts with monetary easing in Japan and Europe. The Fed’s dollar index, which tracks the greenback versus 26 currencies of U.S. trading partners, has climbed more than 18% since the end of 2013, approaching the record high set in February 2002. It’s heading for its steepest two-year advance since 1984, which saw it surge 32%.




The US Dollar was another consideration in the Fed not raising rates. If the Fed raises interest rates, it increases the value of the Dollar when compared to other world currencies.

With a strong dollar it is easier/cheaper for Americans to buy imported goods/services and pay for travel abroad. Unfortunately, this also means that exports by US companies are more expensive and therefore less competitive. A strong dollar also gives less of an incentive to foreign companies looking to build factories and plants on US soil.

From an accounting perspective, the strong US Dollar also hurts the reported earnings of US based multi-national companies when they account for profits earned in other currencies and translate them into US Dollars.