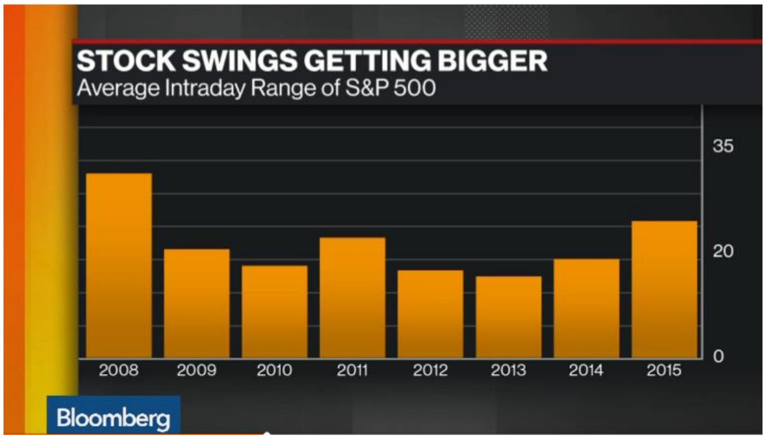
2015 End of Year Commentary
Running Hard To Stay In Place

This past year will go down as one of the most unusual in history—a year in which stocks, bonds and cash all produced returns of essentially zero.

Stocks: Although stocks in the S&P 500 experienced little volatility in the first half of the year, the second half was much bumpier. It was the worst performance for the Dow Jones Industrial Average and the S&P 500 since 2008. Despite the volatility and negative sounding headlines, the US stock markets ended with a ***slight*** loss.

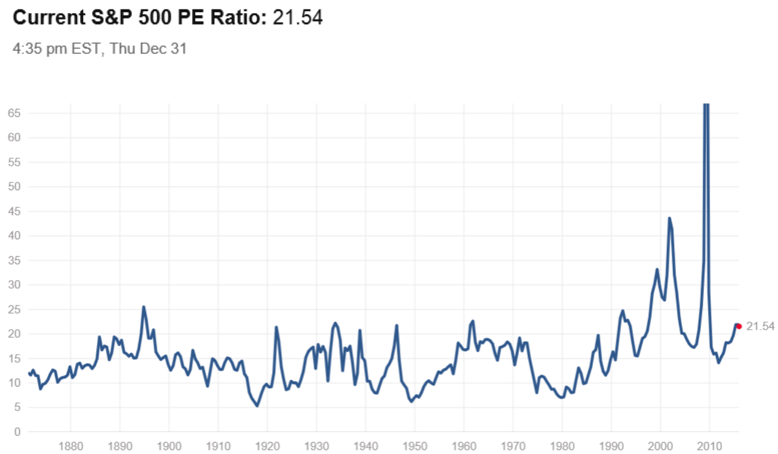


The performance of stocks has been rather misleading, however, as a small number of large stocks did much better than the overall market. The largest 50 companies did quite well, while the smallest 1,000 companies suffered double-digit declines on average.

Further confirming this divergence is the fact that out of the 3,000 largest stocks, as measured by the Russell 3000 index, the smallest 2,500 companies experienced double-digit declines for the year. Again, outside of a statistically small population, most stocks struggled in 2015.

Valuation for stocks also tell a confusing and conflicting story. Large stocks, as represented by the S&P 500, have a Price to Earnings ratio of 21 and a Shiller (10 Year) Price to Earnings Ratio of 26. Both of these figures would reflect full, if not high, valuations.

Making matters worse, the earnings for the average company in the S&P 500 actually declined in 2015.



The oddities in stocks were not just in comparing a handful of very large stocks versus smaller ones, but also in comparing "growth" companies versus "value" companies.

We have not observed this type of disparity in the stock market since the tech, telecom and internet boom of 1999. During that time frame, it was not unusual to see all of the returns in the S&P 500 come from just 10 companies. Today, we are seeing similar behavior—but this time the obsession is from the "FANG" stocks (Facebook, Amazon, Netflix and Google). In general, whenever market leadership is this concentrated, it is not a good thing.

With such narrow leadership and large stocks collectively trading at 21 times earnings, it is instructive to break them into two different camps.

The "growth" camp trades for 23 times earnings, while the more stable blue-chip type companies are much more reasonable. The stable stocks in the Dow Jones Industrial Average and the Russell 1000 Value Index trade for 16.5 times earnings. Furthermore, they produce a dividend yield of 2.55%, which is above that of "growth" companies and the 10 Year US Treasury bond.

Since the 1870s the average Price to Earnings ratio has been about 16.6. This indicates the valuation on more stable, blue-chip companies are right in line with historical valuations and produce better dividend cash flow.

Fortunately, for us, investing in more stable companies is what we are most comfortable with as they are predictable and consistent. Although this has us owning many boring names, they are relative bargains.

Dividends: Despite the higher valuations for the S&P 500 stocks, the average dividend yield of 2.06% is nearly the same as you would receive if you invested in 10 Year US Treasury Bonds (2.28%).

Another benefit to investing in blue chip type stocks is that their dividend yield of 2.55% is above what can be earned in Treasury bonds and high quality stocks will often increase their dividends over time. A Treasury bond will not change its payout before maturity. As such, long-term investors looking for cash flow will still find opportunities in stocks—especially higher quality ones.

Interest Rates: Although the Federal Reserve increased short-term interest rates for the first time in nine years, it is obvious it did not do much to change the over-all yield of the fixed income markets.

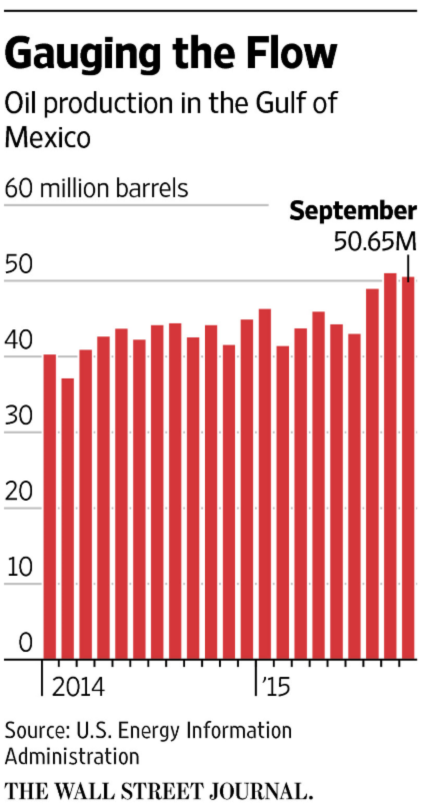
We do not see interest rates improving anytime soon.

Furthermore, unlike traditional Federal Reserve rates hikes, we do not think that this one is indicative of a strong economy.

Energy: No financial discussion in Texas would be complete without addressing the precipitous drop in the price of crude oil.

For the year, the price of oil fell by 34%.

The energy sector was the biggest decliner in the S&P 500, falling 24%. Chesapeake Energy fell 77% and was the biggest decliner in the S&P 500.



Despite this, the flow and supply of oil continues to be rather strong both domestically and globally.

As one of our favorite investors has stated, "If you can tell me the future price of oil, I can tell you whether or not it is a good investment."

We chalk this up in the "too hard to determine" pile.

Since we cannot tell the future, especially on that topic, we keep very limited exposure.

Some of the implications of oil are difficult, while others are quite positive.

Obviously, the negatives are that oil employs many people in Texas and petro-dollars circulate through our economy rapidly.

Seasonally adjusted unemployment in Texas is 4.6% through November. Although this is an increase from the 4.4% rate in October, it is unchanged from a year ago. In the Victoria metropolitan area unemployment has increased from 3.9% to 4.4% on a year-over-year basis.

As such, a couple of observations can be made. First, low oil prices give consumers more money to spend at retail stores or eating out. Secondly, although Texas still has a very strong energy presence, its economy is far more diverse today than it was in the 1980's.

Currency: The US Dollar continued to be strong relative to other currencies, increasing more than 11% relative to the Euro.

Although this allows Americans to stretch their purchasing power on things imported to the US and to vacation outside of the US, it makes it harder for US based manufacturers to export goods to the rest of the world.

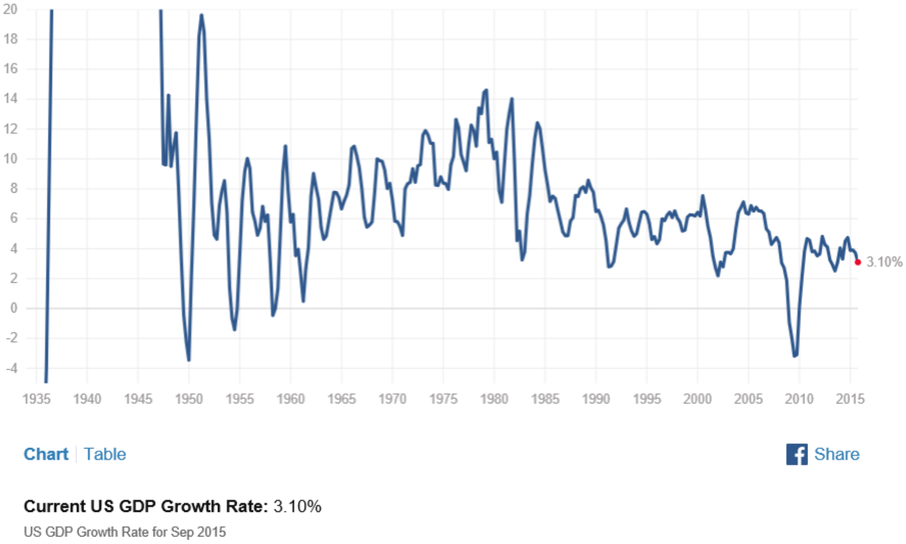
Ironically, we continue to be stuck in a currency war in which the central banks of Europe, Japan and China are all attempting to devalue their currency to stoke export demand.

Unfortunately, although the US Dollar is "winning" this battle currently, it is ultimately a "race to the bottom." There are no real winners in this currency battle.

Individual investors need to recognize that this battle weakens the purchasing power of their currency.

Economic Output: U.S. Productivity has been averaging 1% per year since 2009. This is the worst productivity and capital spending cycle since 1950.

GDP continues to be substandard. We expect inflation adjusted GDP growth of about 2% with inflation adding another 1% point.



Given this backdrop, we find ourselves with an environment in which:

1. The average stock is expensive, but older, more stable stocks are priced at historical averages.
2. Stocks offer decent cash flow via dividends.
3. Organic earnings growth is low.
4. Although we continue to be comfortable owning certain stocks, we are becoming increasingly selective.
5. The stock market will probably be more volatile in the future, testing investors ability to focus on long-term goals.
6. While many view stocks as expensive, the bond market is more expensive.
7. Although the Federal Reserve may have raised interest rates, savers will not experience any material increase in interest income.
8. The major central bankers around the world continue to devalue their respective currencies. This erodes the purchasing power of cash.
9. Economic growth is weak at about 2%.
10. Inflation hovers between zero and 1%.

This is possibly the most difficult investing market we have witnessed since 1999.

Now is a time for prudence and discipline.

Now is a time to tighten the belt, live below your means, avoid debt and know why you own the assets you have.

Should you have questions about your portfolio and how we have your assets positioned, give us a call so we can sit down and discuss. In an ever-challenging world, there are no dumb questions.

Lastly, we wish you a healthy and prosperous 2016.

Sincerely,

Dave

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

Warren

Warren Udd, Vice President
CERTIFIED FINANCIAL PLANNER™