CAPSTONE PACIFIC
INVESTMENT STRATEGIES INC

# Third Quarter 2015 in Review

**Investment Review**

Your accounts are down for the year with most of the drop in value happening this last quarter. In August, the U.S. stock markets took one of their biggest hits in 4 years. In fact, in August we had one of the biggest 3 day point drops in the history of the markets.(1) As client accounts were coming down, we sold off approximately 50-60% of clients' stock funds to protect the principal. We put that money in cash. The markets have been "ranging" (more or less trading sideways) since we sold off the stock funds, so it's still too early to tell whether or not we would have been better off riding out this recent sell-off. While we may not know for a while if we should have just stayed in, what we do know is we reduced the risk in your portfolio by selling 50-60% of the equities. If the markets continue down from here we'll come out of the stock funds the rest of the way and take a short term position in cash and/or look for things that are going up in a falling market. If the markets go up from here we'll come back in. Nobody can catch the exact top or bottom and we'll probably miss the bottom (because we need to see a trend develop first), but whatever we do we'll probably come in gradually.

One of our primary objectives in investing is to try and avoid as much of the brunt as possible of major market declines. Typical investment strategies tend to recommend diversification as a way to soften the blow of down markets with the idea that if you have some investments going down in your portfolio that, because you have diversified, you hopefully also have something going up. But that approach would have done little to protect investors so far this year. Our strategies have kept us focused on US stocks and bonds. Diversifying outside of the U.S. stock and bond markets would have been costly. While US stock markets as measured by the Dow and S&P 500 are down around 10% and 9%, respectively, from their highs this year, asset classes like emerging markets are down a little over 24%, and developed international investments are down over 15% from their highs. As for those who like to preach that gold will save them, gold as measured by the exchange traded fund "GLD" is down more than 13% from its high in January. Bonds have continued relatively sideways thanks to the Fed's low interest rate campaign.(2)

**Current Investment Stance**

As mentioned above, we've sold off approximately half of the money that was in stocks. So for example, if your risk tolerance was to have a maximum of 60% of your money invested in the stock market, we sold off approximately half of that and now you have around 30% in the stock market. If you apply that ratio to your situation, you get an idea of approximately how much of your stock funds we sold off and how much you still have invested in stocks. If you have questions on your investment mix and risk tolerance, please don't hesitate to give us a call. If you have bond funds in your account, we have not made any changes with those.

For those who follow the markets more closely, you may have noticed some rather substantial one day gains in the markets in recent weeks. Of course no one likes having a large cash position when markets are surging, but we think it is worth being cautious here and not attempting to jump back in too soon. You may have also noticed the big one day surges were often followed by down days. In a research report titled, "Where the Black Swans Hide & The 10 Best Days Myth", Mebane Faber went back and looked at market volatility since 1928 and found that between 60-80% of the best one day moves in the stock market occurred after the market was already declining.(3) In other words, you can often get the best one day returns in the markets while the markets are in an overall downtrend. It's hard to know the reason for this—it could be that investors are trying to catch the bottom and often failing, or maybe it just has to do with the fact that investors are human beings driven by emotions, and once investors nerves are rattled by bad news or a big sell-off, volatility tends to cluster in the markets as investors trade more on emotion as opposed to logic. We are resisting the temptation to respond to these big one day moves and instead are looking for established trends to suggest it's time to buy more equities. This is why we did very little to change our exposure to the stock markets in September after selling in August. Even though there were some eye popping one day gains, the markets overall were down in September.(4)

**Where Do We Go From Here?**

There was a lot of big news last quarter such as oil's continuing freefall and China's crashing stock market, but the most recent significant news item this quarter, in our opinion, was the Federal Reserve's decision to not raise interest rates on September 17, 2015. The Fed didn't raise interest rates, 8 years into their low interest rate campaign, due to concerns over a slower than desired inflation trend, weak global economic growth, and heightened financial volatility. Since the Fed's announcement to keep rates low, stocks are down. For example, the S&P 500 (large US company stocks) is down over 3% and the Russell 2000 (small US company stocks) is down a little over 6% since the Fed's decision on September 17.(5) Stocks continuing down may have not been the reaction many expected because, by not raising rates, the Fed is communicating that the money printing stimulus is alive and well. But perhaps, if instead of continuing to enjoy the punchbowl of liquidity created by money printing, maybe this last little leg down is because investors are thinking, "If the Fed doesn't think we can handle a rate hike, then maybe our problems are bigger than we thought." We think it may very well be the case that we have some big problems on our hands (runaway government debts, deteriorating demographic trends, etc.), which means we may have more of a downturn to go before we get our next round of opportunity in the investment markets. However, once we get some clearer direction of what kind of market we are in (Up? Down? Sideways?), we'll be able to position our portfolios to try to take advantage of the trends, whichever way the trends are going.

**Financial Planning**

The Federal Government requires IRA owners to take required minimum distributions (RMD) after reaching age 70.5. The penalties are stiff for not taking your RMD so please don't forget to do so by the end of the year. We try to remind our clients to take their RMDs from their accounts held at TD Ameritrade but please note you must take all your IRAs into consideration when calculating the amount of your RMD. There are some variations depending on the age of your spouse and whether or not certain kinds of retirement accounts can or cannot be grouped together for purposes of the RMD so please consult with your accountant as they are the ones in the best position to help you determine your RMD. Please let us know if you have any questions about RMDs.

Thank you for your business. We look forward to our next meeting or conversation with you.

Sincerely,

The Team at Capstone Pacific

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(1) Evelyn Chang, "S&P 500 closes in correction," *CNBC,* August 24, 2015,

(2) All returns are from *Yahoo Finance.*

(3) Faber, Mebane, "Where the Black Swans Hide & The 10 Best Days Myth". *Cambria Quantitative Research Monthly*, August 2011.

(4) *Yahoo Finance.*

(5) *Yahoo Finance.*