CAPSTONE PACIFIC
INVESTMENT STRATEGIES INC

2nd Quarter 2016 Newsletter

Markets in Review

The US stock market as measured by the Dow Jones Industrial Average entered a period of historical volatility beginning in August of 2015 (1). Below is a picture of the Dow from May 2015 through March 2016. As illustrated in the chart, you can see that in August 2015 the Dow had a quick substantial drop in one day. In fact, on August 24, 2015, the Dow had its biggest one-day point drop ever in the stock market's history (2). After some more sell-offs, the stock market made up some lost ground by the end of the year 2015. Then in January 2016 the stock market had the worst January in more than 100 years (3). The market has moved up since hitting its most recent bottom in February, 2016, but things are still below where they were last summer.

*DJIA Performance, May 20, 2015—March 31, 2016. Source: *Morningstar*

Our clients' portfolios are diversified and are not entirely tied to the Dow Jones Industrial Average but we reference the Dow because we believe it paints a picture of what is happening in the investment markets overall. As far as the overall global investment markets over the last 8-10 months, some types of investments have done better than the Dow over the period of time we are looking at here, and some things have done much worse.

Hardest hit during this period of time were commodities, international investments and small company investments. We avoided commodity and international investments altogether (and have been avoiding those asset classes for years now) and sold off any small company exposure when the trends began to weaken.

During both of the recent downturns we decreased clients' equity exposure in their accounts to protect principal in the event of a further drop in prices. For clients who own bond funds we made very few changes with the bond portion of clients' portfolios as the bond funds we have positioned clients' accounts in have held up fairly well. We are always glad to discuss the specifics of your accounts so please don't hesitate to reach out if you have questions.

What appears to have caused the sell-off in global equity markets were at least two things: the falling price of oil and international turmoil (particularly in the Chinese economy and investment markets) (4). We discussed concerns about oil in our April 2015 newsletter, so we won't revisit it here suffice to say we still feel oil's future is uncertain in large part due to geopolitical factors. As for China, while we think their economic future is tenuous at best due to poor demographics and government manipulation in their economy, it appears market concerns about China have subsided. We'll see. Presently, trends are strengthening in the US investment markets and it appears the worst may be over for now. While we still have longer term concerns about the US's increasing debts, the economic impact of retiring baby boomers and government borrowing and spending, we believe the US economy is doing "OK" for the time being (5).

Looking Ahead

With all this volatility, is the party over with US stocks? While no one of course knows for sure what the future holds, investment strategist Sam Stovall thinks a clue can be found in one pattern that he sees in bull markets that have lasted longer than three years. According to Stovall, bull markets that last longer than three years have tended to "go out with a bang" (6).

Believe it or not, even with the negative lackluster returns in the market as of late, we are still considered to be in the midst of a bull market based on conventional definitions of bull (up) and bear (down) markets (7). Until the Dow Jones or S&P 500 officially drops by 20% from their all-time highs, (which didn't happen in the recent sell-offs, though we were very concerned it might), we can't officially call the end of this bull market that began in March of 2009. Of course history is no guarantee of what could happen in the future, but Stovall's point about how bull markets tend to end suggests to us that this recent volatility doesn't necessarily mean the party is over in the stock markets.

While we haven't had this kind of volatility in the markets recently, our recommendation is stay the course with your strategy. Lighten up on your equity exposure if it will help you sleep at night or if your financial circumstances have changed, but overall we think this could be a great time to invest, especially if you have cash on the sideline. Staying the course is exactly what we are doing with our personal investments. We invest right alongside with our clients and experience all the bumps and bruises along the way when the markets bounce around. We are right here, working harder than ever given the current state of the markets, looking for opportunities and ways to try and mitigate risk if markets dictate.

An Update on Our Strategy

Our primary objective is to avoid large market declines. However, we feel one of the greatest risks in our strategy is the risk of being "whipsawed." For us being "whipsawed" means exiting positions in a downtrend only to have the trend quickly turn, forcing investors to come back in at higher prices—in which case you would have been better off riding out the downtrend (8). A classic definition of "whipsaw" happened in May 6, 2010 when the Dow Jones Industrial Average dropped 998 points within minutes, only to recover most of those losses by the end of the day (9). Traders and investors who had automated sell mechanisms on their investments (sometimes known as stop losses) were automatically sold out at lower prices while the market recovered without them. A flash crash like this is one of the reasons we do not have automated stop losses on any of our investments.

Instead of automated stop losses, we have a sell side discipline where we establish an exit point based on the percent of loss or price our investment committee determines is acceptable. If the security price is violated, then the investment is deliberated as to whether or not to be sold. We believe having a pre-determined exit strategy is a key way to mitigate risk during market downturns. While we believe having our exit points not automated minimizes the risk of being whipsawed, it doesn't eliminate the possibility.

Because of the historic volatility we have experienced since August of 2015, we have been forced to expand the range of where we would previously have exited a position. For example, investments that we might have sold after a 5-6% drop in value, we might hang onto until a 7% or so drop in value in case the trend quickly reverses. For more aggressive sector funds, we have expanded our sell targets even further. In other words, what was a light switch for us, where we quickly exited positions once it hit its trigger point, has become more of a dimmer switch, where we have to rely more on discretion and evaluate positions as to whether or not we believe they can trade on their own merit in the current environment.

This approach has helped us already in 2016. While market returns and investment performance has been lackluster year to date, the US stock market as measured by the S&P 500 dropped by more than 10% at one point during the quarter. In the past, this would have forced us to sell all positions, but in the case of this year's downturn, we only reduced a portion of clients' equity exposure which means we were able to participate in the bounce back up over the last month and half. We believe investment management is as much art as it is science, and while we can never be certain that a down trend will turn into a bear market or crash, we believe the most important aspect of our strategy is to avoid the brunt of market implosions where account values suffer lasting damage. By using more discretion in this market of historic volatility, we hope to keep clients' accounts positioned in what appear to be overall up trends even though the ride can get pretty turbulent.

Financial Planning

We get a lot of questions this time of year about IRA contributions. Even though we try to bring it up earlier in the year in our conversations and reviews, nonetheless as the deadline approaches for IRA contributions, we get more and more questions. Here is a list of some frequently asked questions we get this time of year. This is by no means an exhaustive list; you can find complete info on www.irs.gov and also in IRS publications such as Publication 590.

When is the deadline to make contributions for last year? You have until the tax filing deadline to contribute for last year.

How much can I put away? $5,500 if you are under age 50, and an additional $1,000 if you are over age 50. Please note, you have to have earned income in at least the amount of your contribution.

What if my spouse isn't working? You can open up a spousal IRA and fund an IRA for your spouse. Please consult with your tax professional.

Are there any limiting factors on what I can contribute? If you are covered by a plan at work you may be limited on how much you can deduct with a traditional (before tax) IRA contribution. Also, if your income is up over a certain amount, you may not be able to put way into a Roth IRA. Again, please consult with your accountant.

What if I am taking required minimum distributions, can I still contribute to my traditional IRA? No. You can however contribute to a Roth IRA as long as you have earned income equal to the amount you contribute to the Roth IRA.

Around the Office
Did you know we have special training to work with federal employees? Casey Morris traveled to Chicago last month for training in federal employee benefits. If you know of any federal employees who could use help understanding their benefits, we always appreciate it when you pass on our name.

Jon Teran was quoted in the online person finance magazine, *Grow* magazine in an article called "A (Nearly) Foolproof Way to Hit Your Savings Goals". While we of course can't vouch for all the opinions or products and services recommended in this magazine, it's always an honor to be quoted in the media. Here's the link--https://grow.acorns.com/2016/03/a-nearly-foolproof-way-to-reach-your-savings-goals/

Capstone Pacific was a proud sponsor of the Covina Rotary Fun Run. The Covina Rotary Fun Run raises funds for teacher mini-grants, as well as veterans and kids in need.

Finally, we are hosting a seminar on April 20th, 2016 in Loma Linda to educate federal employees on their benefits. Please pass the word along if you run across anyone you think might like to attend.

We appreciate your business and look forward to our next meeting or conversation.

Sincerely,

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Notes:

(1) You cannot invest directly in an index.
(2) “After historic 1,000-point plunge, Dow dives 588 points at close,” Matt Egan, *CNN Money*, August 25, 2015.
(3) “U.S. stocks post worst 10-day start to a year in history,” Joseph Adinolfi, Barbara Kollmeyer, *MarketWatch*, January 15, 2016.
(4) “World markets plunge as China stocks crash,” Mark Thompson and Charles Riley, *CNN Money*, August 24, 2015.
(5) “Despite Market Turbulence and Rumors to the Contrary, the Economy is Kicking Into Gear,” Mark Zindi, *The Street*, January 20, 2016.
(6) “Happy Birthday, Bull?” Sam Stovall’s *Sector Watch: Standard & Poor’s Equity Research*, March 8, 2016
(7) “Bull Market Definition” and “Bear Market Definition” *Investopedia.*
(8) “Whipsaw Definition,” *Investopedia*.
(9) “2010 Flash Crash,” *Wikipedia*.

Opinions expressed in this newsletter are general in nature, are not intended as investment advice tailored to any individual, do not represent the solicitation of a security, and are subject to change without notice. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for a client’s portfolio.