

# Portfolio Management, LLC

*Building Wealth Wisely*

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## “Bumpy and Lumpy”

January, 2016

The past year was difficult, but not disastrous for investors. After all of the ups and downs, most financial markets -- and our investment accounts -- finished with a modest decline for the year. The primary headwinds for U.S. equities were a sluggish economy, weak corporate earnings, and plummeting oil prices. It was a second straight disheartening year for energy, as domestic oil prices slumped an additional 35% in 2015.

The rout in energy stocks showed no signs of letting up. The S&P 500 energy-sector index was down 25% last year. The CRB commodity index fell 23% last year. The price of oil and key commodities influences the value of a wide range of assets, both real and financial. Hence, it was no surprise that declines in 2015 weren't limited to just tangible-oriented assets.

Over one-third of all stocks in the S&P 500 were down 20% or more from their 52-week highs last year. More sectors fell than rose, and more individual stocks fell than rose; the average stock in the S&P 500 fell 4%. For smaller stocks it was even worse, as 55% of the stocks in the Russell 2000 fell 20% or more.

For investors seeking refuge in stocks that pay dividends, 2015 offered no solace. Stocks in the S&P 500 Index that started out the year with a dividend payout were down an average of 5% for the year. The 74 stocks in the S&P 500 that didn't pay dividends as of the start of the year were up an average of about 4%. Across the board, growth clearly trumped value in 2015.

Overseas markets impacted the U.S. more than usual last year, with a decelerating Chinese economy and a surprise devaluation of the yuan triggering a correction in U.S. equity markets this past summer. Emerging markets suffered a drawdown, but not a meltdown in 2015. While our portfolios had some exposure to energy and emerging markets, fortunately we managed to completely avoid the huge calamity experienced by the high yield bond and MLP sectors.

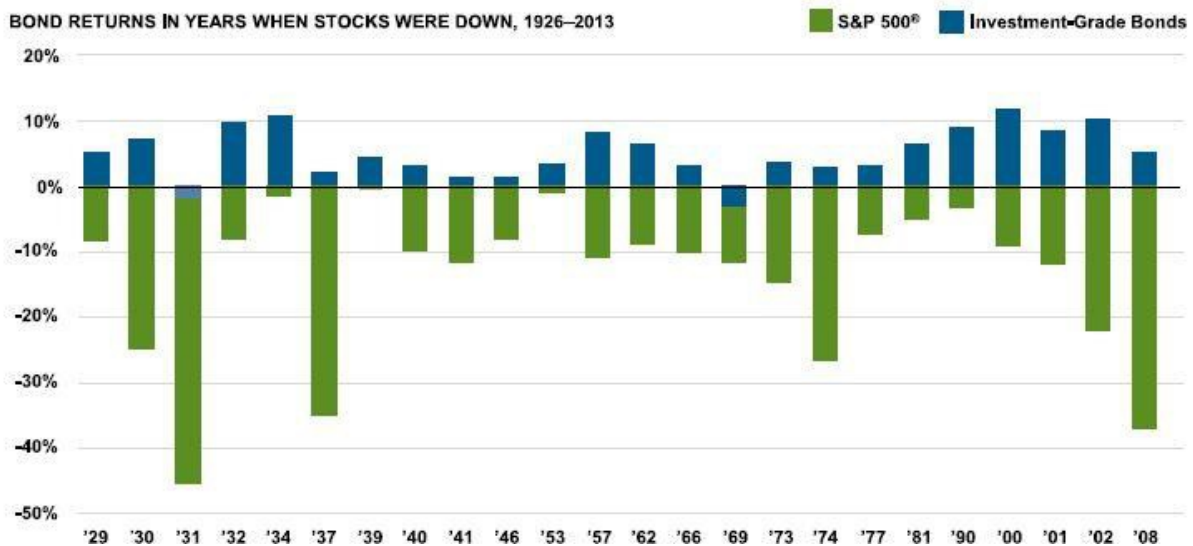
Investment-grade bonds were one of the few bright spots in 2015. Municipal bond returns were particularly strong. Without our allocation to fixed-income investments, our portfolios would not have held up as well as they did. The performance outlook for fixed-income remains positive, yet muted (due partly to credit concerns and partly to concerns over how fast the Federal Reserve will raise interest rates in 2016).

As my clients know, many categories of bonds come under pricing pressure when interest rates rise.

I remain committed to an allocation of fixed-income in all client portfolios. Bonds are much less volatile than stocks and also serve as a source of income. As the chart below shows, investment-grade bonds are almost always up in value in years that stocks are down in value; last year was no exception. Bonds offer us an excellent opportunity to periodically rebalance our portfolios back to target allocations when stock prices drop down to more attractive levels. As I have stated before, I think rebalancing is the only free lunch left in town; if executed correctly, it offers us a disciplined way to buy low and sell high.

## INVESTING ENVIRONMENT

### Bond returns helped offset stock market declines



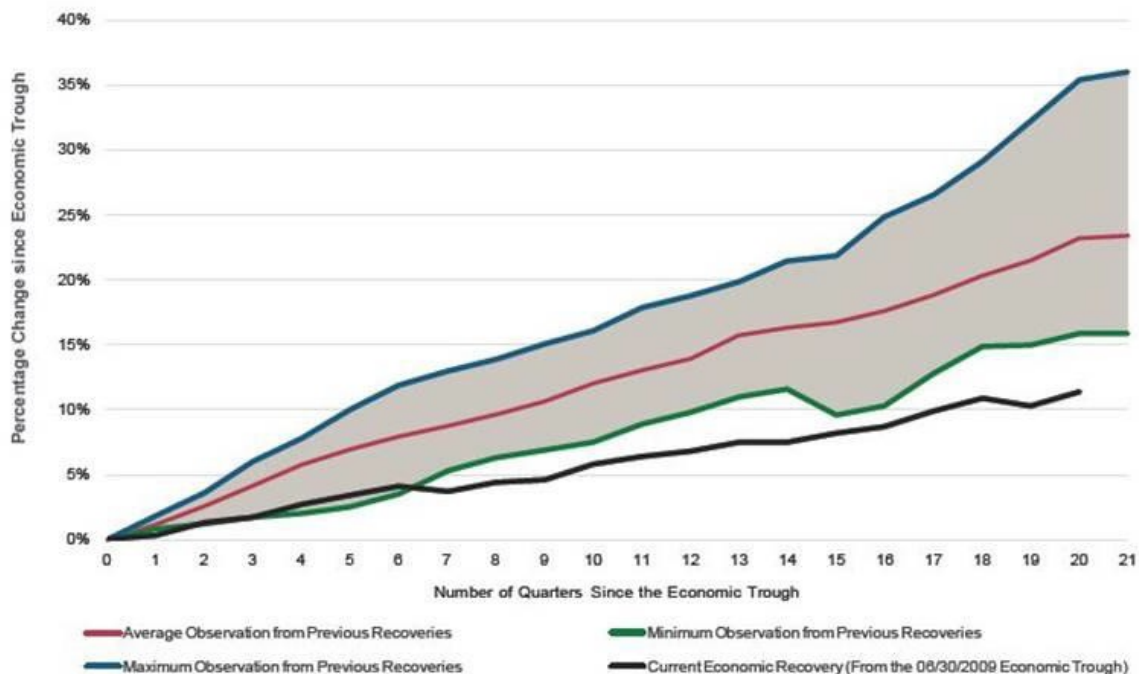
All of the deteriorating financial news of late comes on top of the worst economic expansion our country has experienced in the post-WWII era. The chart below shows all of the economic expansions in modern history. The best, worst and average expansions are all depicted in this chart.

The bottom black line represents the current economic expansion. It is the weakest expansion our nation has experienced in 60 years. Without going off on a political tangent, I think much of the blame for this weak expansion can be laid at the feet of those in Washington who have elevated our debt burden and restricted our growth opportunities.

## U.S. Real GDP

06/30/1954 - 06/30/2014

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Given this backdrop, it's no surprise that investment returns have been low in recent years. Economic growth has been low, inflation has been low, interest rates have been low, and the cost of money has been low. Investor rate of returns reflect the confines of this environment.

All of the recent weakness on top of the prolonged economic softness begs the question- is our economy currently in a mid-cycle slowdown or are recessionary clouds starting to form? Weakening global trade and the recent string of punk ISM manufacturing reports certainly raise a note of concern.

Adding to the angst, credit spreads are widening in the fixed-income market, and breadth is narrowing in the stock market. These are conditions often seen before a recession and a stock market decline. Although most leading indicators for the economy are positive, 4<sup>th</sup> quarter GDP will probably come in at paltry 1%.

Despite the uncertainty and negativity, there were quite a few bright spots in the economy in 2015. The U.S. economy managed to grow modestly, and unemployment declined significantly. The housing and banking sectors improved measurably. Consumer spending remained strong. The federal deficit fell sharply. And equity markets proved to be relatively resilient, despite all of the downward pressure.

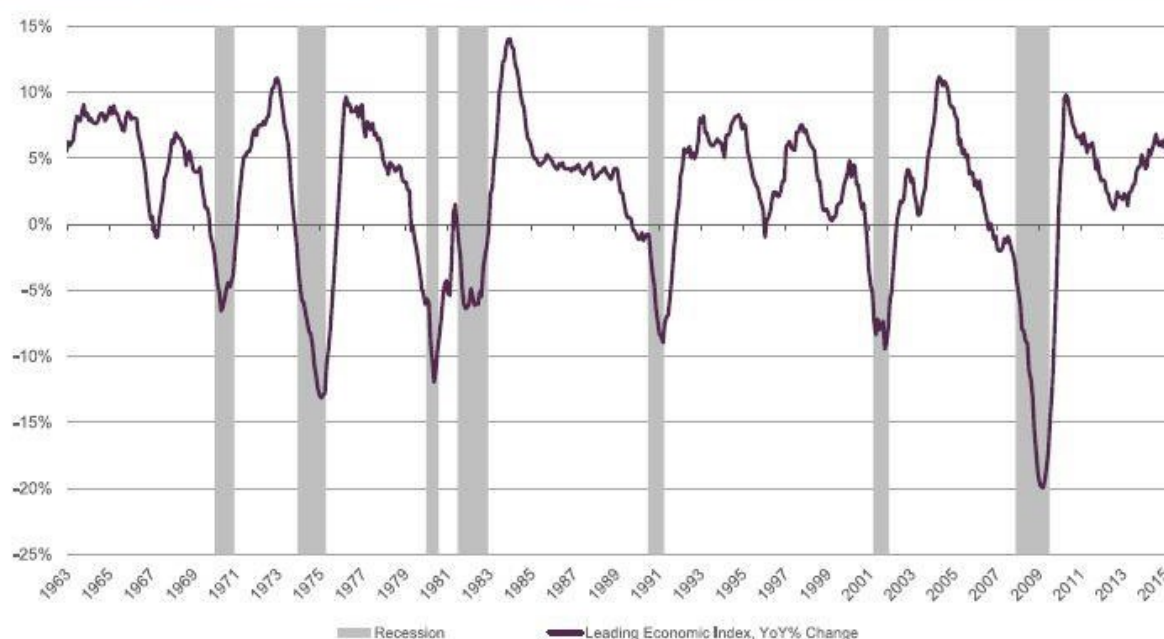
While weak manufacturing reports are important and shouldn't be ignored, it's important to note that manufacturing represents only 12% of our domestic economic

activity. And although a continued slowdown in China is not without consequences, our export market is a relatively small part of overall domestic GDP. The services side of the economy (representing the other 88% of U.S. activity) remained healthy throughout 2015 and looks to continue that performance entering 2016. U.S. consumers seem to be in pretty good shape.

Moreover, although the Federal Reserve did raise interest rates last month for the first time in nine years, skittish markets got the assurances they were seeking that the future path of interest rate hikes will be gradual- and the Fed will not raise rates at a pace that will threaten the current expansion. The monetary environments in other parts of the world are even more supportive, as the European Central Bank, the Bank of Japan, and a number of emerging market countries continue to pursue stimulative policies.

## Leading Indicators Suggest No U.S. Recession Ahead

The Conference Board Leading Economic Index and U.S. Recessions

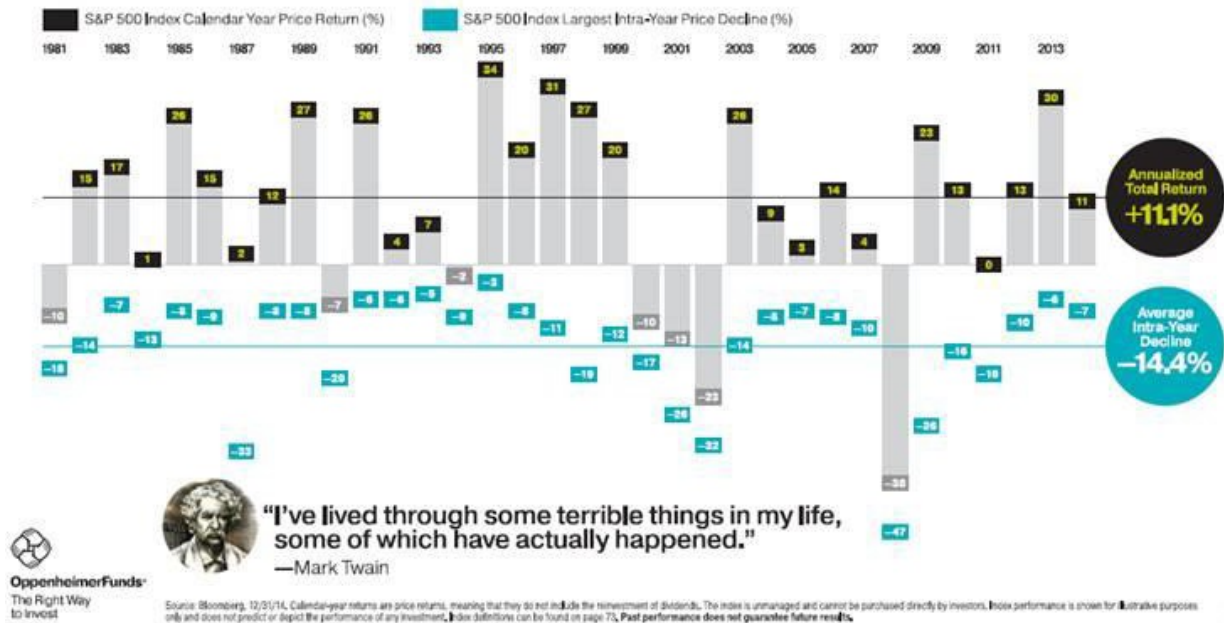


A number of smart strategists I follow expect modest improvement in fundamentals next year. Many also believe the current economic expansion, while painstakingly listless and uneven in nature, might last for several more years. We will probably have choppy returns along the way. An important reminder for investors is that financial markets can often be bumpy and lumpy.

Successful investing takes a heck of a lot of patience. No one likes the up and down nature of markets, but volatility is a fact of life that investors must learn to deal with if they want to achieve long-term financial success. Anyone can hold the helm while the sea is calm.

While times like these put investor fortitude to the test, trying to time markets is pure folly. The stock market is an expensive place to figure out you're not a good long-term investor. To be successful, we must continually remind ourselves that volatility does not equal loss unless we sell.

### Volatility Does Not Equal a Financial Loss Unless You Sell



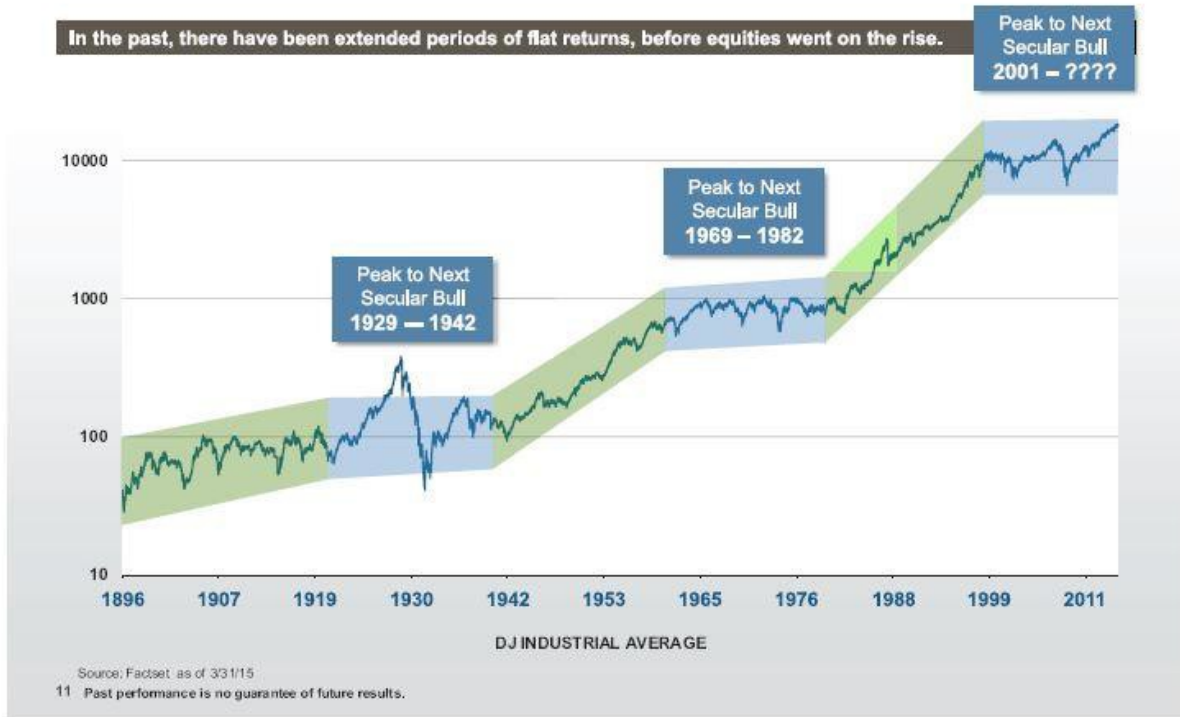
As the chart above shows, from 1981 to 2014, the S&P 500 Index experienced at least a -5% intra-year decline in every year but one. The average intra-year decline over the past 34 years has actually been -14.4%. But also notice the following: equities still posted positive returns in 26 of these last 34 years, with annualized total returns over that stretch of more than +11%.

The lumpiness of returns can be as equally challenging for investors to handle. We all seem to understand markets can go up and down, but sometimes we forget that markets can meander around within a trading range for long periods of time while investors do their best to sort out the important information from the financial noise that bombards us. Positive returns can come in short, unsuspecting streaks. If you're not invested at the time, you miss out on the gains when they come.

The following chart depicts how markets have tended to not only go through shorter-term cycles of up and down movements, but have also tended to go through longer secular stretches of gains, only to be followed by long, secular periods of disruption and consolidation. At some point in the future, maybe soon, I think we will be able to look in the rearview mirror and mark the beginning of another long-term period of prosperity. I hope my clients will stay the course until such time.

## Have we entered a new secular bull market?

In the past, there have been extended periods of flat returns, before equities went on the rise.



As we move forward, growth should continue to be rewarded - and investors will likely be willing to pay for sustainable, high-quality growth. Equity appreciation will probably have to come from earnings growth instead of P/E multiple expansion. Earnings growth should be possible as long as economic growth holds up. In my opinion, over the long haul virtually all equity gains are a function of earnings growth and interest rates. You can quote me on this.

On the favorable side, current equity valuations reflect a subdued reality compared to the exuberance of prior bullish periods. As we work through this prolonged period of market gyrations and ambiguity, the good news is many companies are financially well positioned, with solid balance sheets. We aren't seeing a large disconnect between valuations and fundamentals, especially compared to prior bull markets. I am also encouraged by the continuing quest of competition and innovation I see from many entrepreneurs and businesses, both new and old. Free enterprise is not dead.

From a market perspective, it's interesting to note how the S&P 500 Index has performed in years following a mostly flat result similar to last year's returns. The market has been relatively flat in six years since the end of World War II (defined as a -2% to +2% index return). As the chart below shows, in each case stock returns the following year were positive by double-digits.

Year	S&P 500 price return	Next year return
1970	0.1%	10.8%
1978	1.1%	12.3%
1984	1.4%	26.3%
1987	2.0%	12.4%
1994	-1.5%	34.1%
2011	0.0%	13.4%

Corporate earnings were under pressure throughout 2015, due in no large part to the crash in oil prices and slowdown in manufacturing. If oil prices stabilize in 2016 and global economic growth gradually improves, companies should be able to make acceptable profits for shareholders.

A number of factors should also support improvement in the disposable income of households, including cheap commodities, low interest rates, and gradually rising wages. U.S. fiscal policy also remains modestly supportive of growth, and the housing market continues to make progress. Taken together, the economy might not make it out of the doldrums in 2016, but we will probably avoid a recession.

I know it's difficult to stay the course with a long-term strategy during unsettling and unproductive times. The economy might turn fragile next year, and 2016 could end up being a negative year for the financial markets. We might have a exasperating wait for the next period of sustained prosperity. Yet, no matter how bumpy or how lumpy the markets might get, I am fully convinced that a sound and balanced investment strategy is the best way – if not the only way -- for us to achieve our long-term financial goals.

Regards,

Richard Kranz

Portfolio Management, LLC