Money Manager Newsletter

September 30, 2016

Investment Consulting Group, Inc.

"The Four Horsemen Of The Investment Apocalypse Are Fear, Greed, Hope and Ignorance. Only One Is Not An Emotion—Ignorance. These Four Things Have Accounted For More Losses In The Market Than Any Recession Or Depression, And They Will Never Change. Even If You Correct Ignorance, The Other Three Will Get You Every Time."
James P. O'Shaughnessy (Chairman and CEO at O'Shaughnessy Asset Management)

Many actively managed funds have recently underperformed their indexes and, as a result, fund inflows have favored passive funds. Our research suggests relative returns between active and passive are cyclical, depending on the market environment. We identified nine test factors we thought might explain active/passive return cycles. Looking back to 1991, we isolated 33 quarters where active managers appeared to have the clear advantage over the index. There were 39 quarters where the index had a clear advantage. During each window of time, we calculated the return spreads for the factors and tallied whether or not the positive or negative reading we assigned to it was correct. Market cycle, styles cycle, environments cycle, and today's 0-fer tally will change. Size, valuation, and breadth will swing and the day will come when most of our active indicators will again be in the green. The wise investor will avoid concentrating in a winning style during times when it is experiencing unusually favorable weather. "Active and passive" is the right approach; investors should be diligent in identifying their favorite active managers and sticking with those commitments. Scott Opsal — Leuthold Group

Where does GDP growth come from? One of the problems we face around the world is the stubbornly slow recovery following the 2008 recession. GDP in the U.S. has averaged about 2.2% over the last six years. A look at the formula for calculating GDP can give us clues on how to boost growth. The formula is C+I+G+X, (consumption plus private investment plus government spending plus net exports). When policy makers talk about government stimulus, they are in favor of increasing G. Those that talk of capital gains tax cuts hope to increase I. Those that talk of income tax rebates or cuts are trying to increase C. Those that want lower corporate tax rates here are trying to increase I and X. All growth is the result of risk taking. In order for something to be consumed, we must create it first. The formula makes it easy to see that a dollar can be used for consumption or investment, not both. The Fed is the little engine that can't (raise rates), and that is probably for the better. There are few signs of inflation and growth is sluggish, so why give investors something else to worry about? We would be happy if the Fed started reducing their bond buying by ending their program of reinvesting the proceeds from maturities in their portfolio. Dana Investment Advisors, Inc.

"The expansion that began in July 2009 is now seven years old, making it the fourth longest since WWII. That does not necessarily mean it will end soon, but recession risk rises after years of expansion. It is difficult to time recessions, but there is no harm in planning for it early. Think about portfolio changes that can be made once a recession is underway, and changes that should come before it starts, even if it means a small risk it could be two years before it starts. We think there is a particular value in forward planning this time because the recession is likely to be severe. Chris Low

The great irony of 401(k) plans is that they suffer from the same problem of the system that they replaced, defined benefits. This fact has escaped many 401(k) critics, who pine for a return from today's frying pan to the earlier generations' fire. Both 401(k)s and their defined-benefit predecessors serve those who least need the help: higher-paid employees at larger companies. Those further down the workplace ladder are, for the most part, left behind. Ivory Towers — John Rekenthaier

09/30/2016	Growth Median P/E	Value Median P/E	Historical Growth Avg.	Historical Value Avg.
Royal Blues	26.0x	14.2x	24.7x	11.4x
Large Cap	22.4x	12.3x	19.9x	10.8x
Mid Cap	24.9x	13.4x	23.3x	11.9x
Sm Cap	28.2x	14.1x	27.4x	12.0x

Dear Pension Trustees Everywhere: Do you ever experience feelings of self-doubt or guilt, brought on by acting on bad investment advice? Are you concerned about your fiduciary responsibility to your beneficiaries? You should be. Most of you have been taken in by pension consultants. Have you noticed that since the stock market selloff in 2008, these folks have consistently advised clients that they reduce exposure to U.S. stocks? Their advice has been consistently wrong, as the tough-to-beat Standard & Poor's 500 hit new highs last year. While the stock market is near all-time highs and employment is at supposedly acceptable levels, this has been a timid economic recovery and joyless bull market. It's important to note that the stock market is a leading indicator. Business investment is at very low levels. Currently, the only net new money coming into stocks is from companies themselves buying their own shares. That will change eventually. Here is a prediction. A gigantic market move to the upside is coming, as investment committees assess their costs and reach the conclusion that the stock market is their best and only hope to meet their obligations. Frederick E. Rowe — Greenbrier Partners Capital Management (Barron's)

When recessions are about to begin, demand for labor pulls back. Data released last week reveal that, far from declining, demand for labor is on the rebound. Other jobs data are emitting the same signal: no recession in sight. Gene Epstein — Barron's

The World Equity Market Cap from Largest to Smallest: Billion $
United States — 19,731
Japan — 3,006
United Kingdom — 2,691
France — 1,313
Switzerland — 1,275
Germany — 1,194
Canada — 1,156
China — 889

25.75% is the percentage of Americans who are in school right now (well, in 2014) according to the U.S. Census Bureau. About 9 percent of the nation is in elementary school, 8 percent in middle or high school, a little more than 7 percent in undergraduate or graduate studies, and 1.5 percent are in preschool. Overflow Data

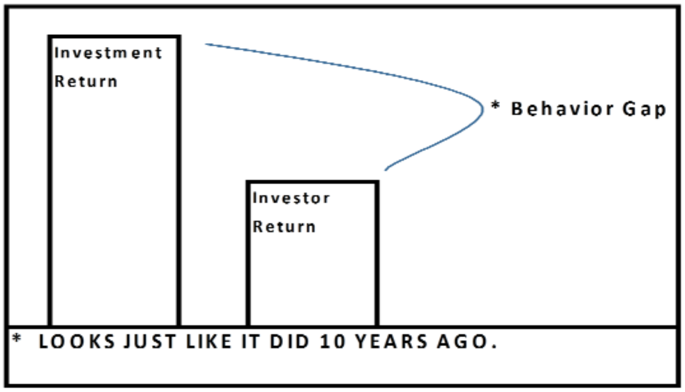
28.4 years is the average age of highways and streets in the United States. Both major party candidates have promised higher spending on infrastructure improvements, which could be a boon for the nation's power grid, roads and public transit systems. The New York Times

Companies are breaking themselves up at a faster than ever pace: 19 Russell 1000 companies have announced spinoffs this year, the highest level of the past 20 years. But will that translate into a stronger market? Not necessarily. A spinoff spike usually accompanies the peak in the profit cycle. That's a sign "aggregate spinoff activity is likely a consequence of decelerating corporate profit margins, and not the other way around," says Evercore ISI's Pankaj Patel. The move can juice returns, however. The parent outperforms the Russell 1000 by an average of 6.5 percentage points during the year following a split, while the spun off unit outperforms by an average of 10.9 points. Barrows

There is only one side of the market, and it is not the bull side or the bear side, but the right side. Jesse Livermore

The most valuable commodity I know of is information. Gordon Gekko

DJ IA	Nasdaq	S & P 500	Russell 2000	MSCI EAFE	Crude Oil	Euro	10 yr Treas.	Fed.Fund Rate	Prime Rate
18308.15	5312.00	2168.27	1251.65	6519.89	48.24	0.89	1.60	0.25-0.5	3.50



Learning to Stand Still

One of the most important things that we can do as an industry is to teach people to do absolutely nothing. Of course, this goes against everything they hear on the investment networks, but that might make it even more true. We think it's our job to find the best investment, and the public thinks it's our job because they occasionally see that circus clown on the TV yelling about buying and selling. Of course, investors think they should be doing something. There are multiple TV channels with dozens of people talking about it! But that's "entertainment," and we are in the very serious and sacred role of helping people build dreams and avoid nightmares. In that very serious and sacred role, we should earn our keep by telling people to do nothing when doing nothing is the right thing to do. We close with this little gem from Warren Buffett: "Benign neglect, bordering on sloth, remains the hallmark of our investment process." Or this one from John Bogle, "Don't just do something, sit there." It's time to stop diving. So, the next time you're tempted to appease clients' desires to do something, kindly and patiently explain to them that the best piece of advice you have is for them to do absolutely nothing! They'll thank you for it, eventually. Carl Richards

The biggest, most immediate obstacle to a vigorous recovery for the U.S. and global economies is the disastrous monetary policies of the major central banks, most notably the Federal Reserve, the European Central Bank (ECB), the Bank of Japan (BOJ) and the Bank of England (BOE). Their policies of quantitative easing (QE) and zero interest rates have massively distorted global credit markets and severely hobbled recovery from the 2008-09 economic crisis. Their actions have not only stood in the way of a genuine economic revival but also persuaded governments to put off badly needed structural reforms, because stimulus from easy money would do the job instead! Steve Forbes

While there isn't one set framework for defining the different market caps, here are the widely published standards for each capitalization:

Mega cap — A market cap of $200 billion and greater.
Big/large cap — A market cap between $10 billion and $200 billion.
Mid cap — A market cap ranging from $2 billion to $10 billion.
Small cap — A market cap between $300 million to $2 billion.
Micro cap — Market capitalizations between $50 million to $300 million.
Nano cap — Market caps below $50 million.

An Oxford University study of ten years of Chinese infrastructure spending found it is doing more harm than good to the economy because it cost more to build than it returns in economic benefits, mostly because it is built in the wrong place. Highways and railroads are either overcrowded or empty, neither of which is desirable. You are not likely to hear it from an Oxford economist, but this is a known problem in command and control economies. Central planners are rarely as good at allocating resources as markets.

Stanford economist John Taylor, the man behind the eponymous Taylor Rule, believes negative interest rates may do more harm than good. He believes they chill financial intermediary functions, the channel linking savings to investment, and result in outcomes not predicted by econometric models. "The macro models we have don't really incorporate that financial sector behavior, so it's hard to give a magnitude to it," he explained. In other words, as so often happens when policy makers rely on models, a variable left out because it was irrelevant has become not only relevant but perhaps most significant as policy was pushed to an extreme. FTN Financial

The unpleasant reality is this: Even if we taxed everyone making over 250,000/year at 100%, marginal rates and confiscated every dime of profit from every Fortune 400 company we couldn't raise enough money to run the government at its current burn rate for more than 6 months. So the government must tax the masses or heap more debt on our children. Brad Schaeffer — The Blaze

Treasury Market Yields	09/30/2016	12/31/2015	12/31/2014
2 Year	0.77%	1.06%	0.67%
5 Year	1.14%	1.76%	1.65%
10 Year	1.60%	2.27%	2.17%
30 Year	2.32%	3.01%	2.75%
SP 500	2.13%	2.14%	1.92%
Commodities			
Oil ($bal)	$48.24	$37.04	$53.27
Gold ($/oz.)	$1313.30	$1060.30	$1183.90
CRB Index	$186.32	$176.27	$229.96