Money Manager Newsletter

December 31, 2015

Investment Consulting Group, Inc.

"Lack Of Money Is The Root Of All Evil"
George Bernard Shaw

Reflecting on fiduciary duties, many plan sponsors don't realize they fall under the fiduciary umbrella to begin with. For example, many plan sponsors believe that just by hiring an adviser they do not have a fiduciary obligation to understand the investments in their plans. This is fundamentally wrong. What plan sponsors should remember, however, is that as fiduciaries, they have an obligation to act as a prudent person would. That means that they have a duty to understand the rationale of their decisions and be able to justify it through documentation and committee minutes if called upon.
John Ludwig—Employee Benefit Adviser October 2015

The reason monetary policy is so fundamental is that the way we live and progress is through the transactions we carry out with one another countless times a day. Life would be chaotic and our standard of living far lower if weights and measures weren't fixed—60 minutes in an hour, 16 ounces in a pound and 23 inches in a foot. We assume, for instance, that a gallon of gasoline is the same volume each day. What most observers don't understand, thanks to John Maynard Keynes, is that the same concept is true for money: It works best when it has a fixed value. Money makes the buying and selling of things infinitely easier. But when money's value is unmoored, the economy functions badly. Certain sectors benefit a weak dollar always creates a potent but false commodities boom but most are hurt because productive investment shrinks. Investors and business executives don't know what the value of the money will be when it's time to be paid back, a 100 cent dollar, a 10 cent dollar, etc. The policies of the Fed have been toxic, first weakening the greenback and then, since 2013, inadvertently strengthening it. Like a watch that runs either too fast or too slow, a yo-yoing dollar is disruptive. If Richard Nixon hadn't severed the dollar's link to gold in the early 1970s and we had maintained our gold-standard average growth rates, the U.S. economy would be 50% bigger than it is today. A country doesn't need a pile of gold to make a gold-based arrangement work any more than a builder needs to have a warehouse full of measuring tapes to construct a skyscraper. Gold is like a measuring cup in a kitchen. Tying a currency to it means that a country's money will have a stable value. Steve Forbes—November 2015

"I contend for a nation to try to tax itself into prosperity is like a man standing in a bucket and trying to lift himself up by the handle"
Winston Churchill

In the "good old days," investment managers had two shots at winning. They could beat their index or they could beat the median manager in their peer group. That peer group thing doesn't work anymore. Due to the popularity of passive ETFs and the emergence of Robo Advisors, there is only one pertinent yardstick, beating the benchmark. Unfortunately, less than 20% of active managers achieve this measure of success. So the new definition of "success" is beating the benchmark, but there's more to winning than this simple measure. We want to know that success is not just luck. A facsimile of a peer group is created by forming all the portfolios that could be formed from the stocks in the index. A ranking against these Success Scores in the top decile is significant at the 90% confidence level. We ca be 90% sure that it wasn't just luck. Ron Surz

"Autonomous vehicles will be one of the most important tech developments of our lifetime. Don't get left standing at the curb." Jon D. Markman

12/31/2015	Growth Median P/E	Value Median P/E	Historical Growth Avg.	Historical Value Avg.
Royal Blues	25.9x	13.4x	24.7x	11.3x
Large Cap	20.6x	12.4x	19.8x	10.8x
Mid Cap	22.2x	12.4x	23.3x	11.9x
Sm Cap	26.0x	13.4x	27.4x	12.0x

"Inflation is the modern way that governments default on their debt."
Mike Epstein—MTA, MIT, Sloan

Today, annual trade between China and the United States exceeds US$500 billion, making China the United States' second-largest trading partner (Canada is the first). China has undergone huge growth over the past three decades and has transformed its economy. For emerging market investors, China is a destination that cannot be ignored.
Mark Mobius, PHD — Once Forbidden Frontiers

The market is like the ocean. There are tides, waves, and ripples. We need to focus on tides. Too often we focus on ripples and waves.
J.C. Bradford

- Ride the long-term tides
  Orient in line with fundamentals
- Navigate the short-term waves
  Utilize discipline to walk a path
- Ignore the media ripples
  Much ado about very little

Many industrial company managements have noted a slow but steady decline in business from the early part of 2015 through October. The year began with modest growth but is now in negative territory.
Anticipated consumer spending strength, as a result of lower energy prices, has yet to materialize. Some have attributed higher rents and healthcare costs (both direct and higher deductibles) as offsets to gas savings.
Chinese auto inventories are believed to be depleted and restocking will need to occur soon, but Chinese construction is expected to stay slow for some additional time.
35% of banking consumers would prefer to resolve an issue online versus over the phone or in person.
Many banks mentioned the need to continue to add expenses associated with regulatory and compliance efforts.
Auto loans are particularly competitive as more lenders are increasing their exposure to the category, many moving into sub-prime originations. This has caused some lenders to scale back, as the terms are no longer attractive.
Heavy demand and high profitability may cause refiners to rethink regularly scheduled outage maintenance.
As we hit peak shipping season, one intermodal broker noted they are seeing volume levels that are 20-30% above normalized levels out of southern California. LaSalle Street Capital Management, LLC

The market might have learned a simple lesson: Don't make loans to people who can't repay them. Instead it learned a complicated one: You can keep on making these loans, just don't keep them on your books. Make the loans, then sell them off to the fixed income departments of big Wall Street investment banks.

Long Beach Savings was the first existing bank to adopt what was called the "Originate and sell" model. This proved such a hit, Wallstreet would by your loans, even if you would not! That a new company called B & C Mortgage, was founded to do nothing but originate and sell.
Michael Lewis, The Big Short: Inside Doomsday Machine

DJ IA	Nasdaq	S & P 500	Russell 2000	MSCI EAFE	Crude Oil	Euro	10 yr Treas.	Fed.Fund Rate	Prime Rate
17425.03	5007.41	2043.94	1135.89	6379.34	34.04	0.9208	2.27	0-0.25-0.5	3.50

S&P 500 In An Earnings Recession

Today's earnings recession is also unique, given that it is not (yet) being tied to an actual economic recession. While we don't think we're on the precipice of economic calamity, the longer that profits and revenues (which have also contracted for the past three quarters) fall short of their peaks, business activity will be adversely affected. A feedback look of lower revenue and earnings leading to decreasing investment in capital and labor could develop.

What's to blame for the current lack of earnings growth? An examination of year-over-year aggregate net income shows that although there were five sectors with negative, or near negative reported year-over-year growth, Energy clearly receives the lion's share of the blame for the absolute decline in earnings.

We have argued that we've been in a tightening phase since the QE tapering began in January 2014. Given current Fed policy and our still ultra-low rates, this jolt to margins won't be possible. But wait, rates are still near record lows, couldn't firms still refinance their credit and take advantage of lower interest expenses? We'd argue that much like mortgage pool burnout, firms that could refinance their debt in the past seven years have already done so.

Based on the December 16th meeting, it appears the Fed is intent on moving interest rates higher on an absolute basis. Unfortunately, for many bond holders and leveraged firms, rates have been drifting higher on a relative basis for the last year and a half. These higher borrowing costs, relative or absolute, will no doubt put a crimp in the last decade's most fashionable way to boost EPS: share buybacks.

Employers slashed workforce expenses as sales and earning plummeted during the Great Recession. And, for awhile into the economic recover, they seemed quite satisfied not increasing workers' earnings. After finding a generational low a few years ago, annual growth in average hourly earnings now appears headed toward normalization.

The four absolute worst industry performers; Coal & Consumable Fuels (-60.1%), Steel (44.3%), Oil & Gas Drilling (-40.3%), and Diversified Metals & Mining (-40.2%). The Leuthold Group—January 2016

Treasury Market Yields	12/312015	12/31/2014	12/31/2013
2 Year	1.06%	0.67%	0.38%
5 Year	1.76%	1.65%	1.75%
10 Year	2.27%	2.17%	3.04%
30 Year	3.01%	2.75%	3.96%
Commodities			
Oil ($bal)	$37.04	$53.27	$99.29
Gold ($/oz.)	$1060.30	$1183.90	$1203.10
CRB Index	$176.27	$229.96	$282.57