Individual Asset Management

750 Menlo Avenue, Suite 200
Menlo Park, CA, USA 94025
Tel: (415) 358-0138
Fax: (415) 948-2136
Email: iam@iamadvisors.com
Web: www.iamadvisors.com

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2015 Year-End Review

The Year in Review

2015 was a very difficult year for investors, especially investors who maintain diversified portfolios containing a variety of asset classes.

The chart below shows the performance of various types of investments over the course of 2015. There are a number of curves on these charts but the sense is clear. Here is a key to what each curve represents:

SPY: US Stocks (S&P500 index)
DJP: Commodities (Dow Jones – AIG Commodity index)
EFA: Non-US Developed Market Stocks (MSCI EAFE index)
EEM: Emerging Market Stocks (MSCI Emerging Market index)
GLD: Gold
TLT: Long-dated (20 year+) US treasury bonds
AGG: US Bonds (Barclay's aggregate bond index)

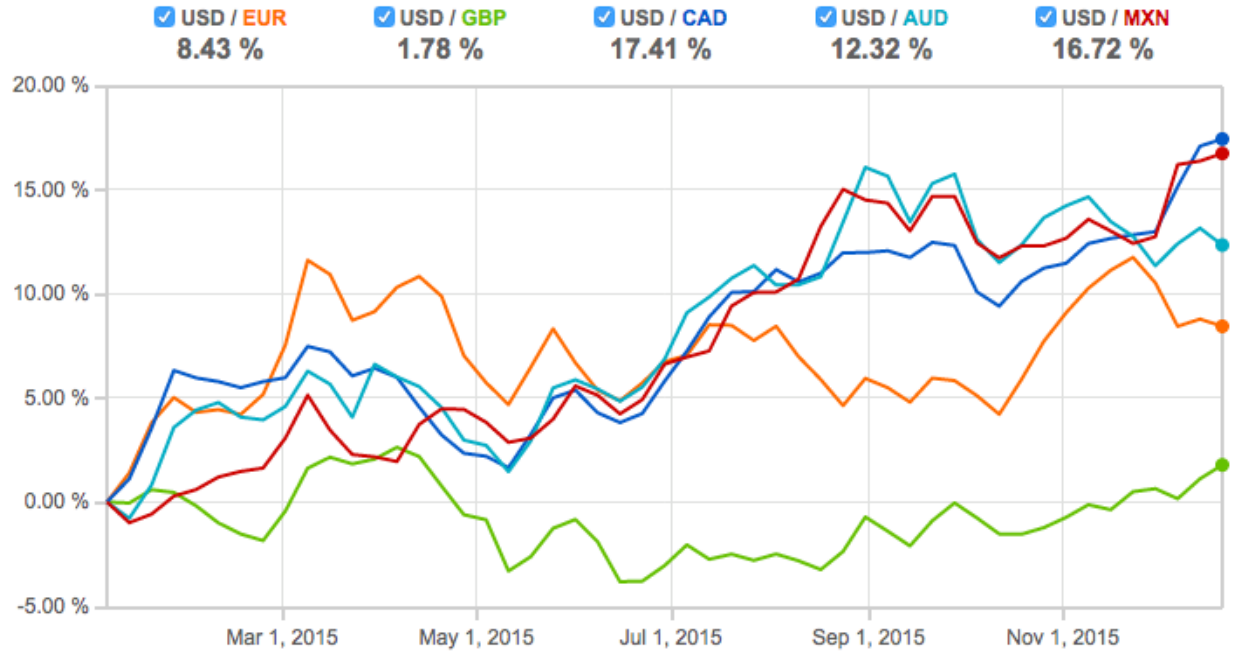
Basically there was nowhere to hide in 2015 – none of the asset classes shown turned a profit. The big loser was commodities, down almost 30% as a result of falling oil prices.

I must admit that the selloff in oil caught me by surprise. At the beginning of the year I wrote that I expected oil prices to stabilize around $60-$80 since these prices had already come down from over $100. Now here we are at around $30 oil to start off 2016 and the

investment markets are jittery partly because of the possibility that many oil-related businesses might go bust and that this could also affect the banking institutions that have leant money to these firms. At the beginning of 2015 I advocated putting some money into commodities, including gold, which had also sold off substantially over the last few years. Commodities provide diversification benefits to a portfolio because they do not go up and down lockstep with stock markets; at least most of the time they don't. Unfortunately lately, especially since the beginning of 2016, there has been a strong correlation between oil prices and the stock market, and both have been doing poorly.

While we want to hold a variety of asset classes in an investment portfolio, it is obviously more important to hold asset classes that will increase in value. At the beginning of 2015 I felt that gold and other commodities would not only provide good diversification but that we would also be investing at a good time since prices had come down so much. Clearly it would have been better to wait, as commodities fell another 30% and gold was down about 10% on the year.

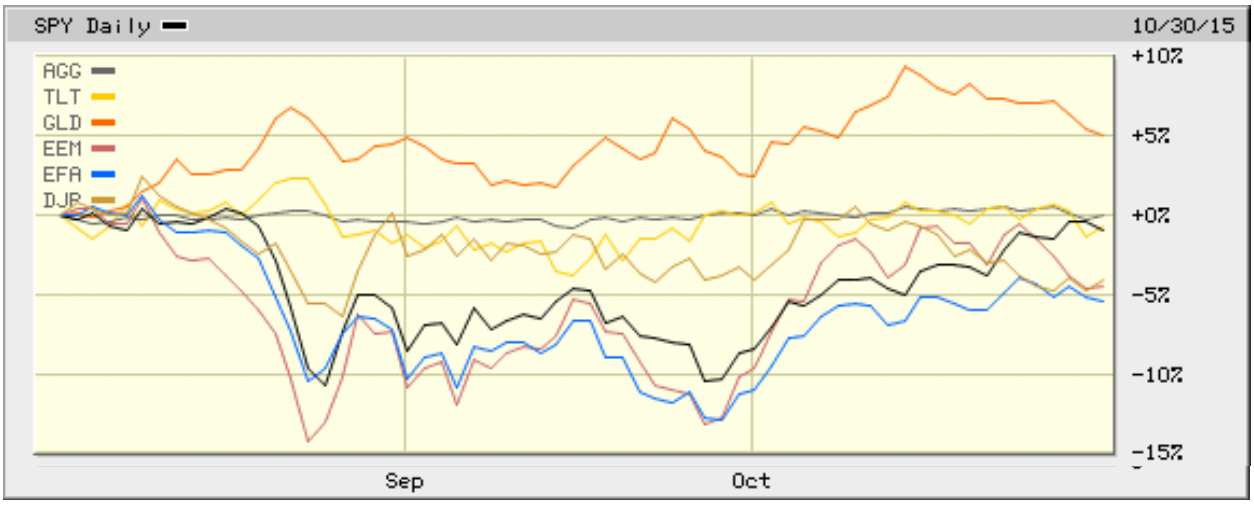
I also wrote last year that I expected the US stock market to outperform non-US developed markets and emerging markets but that I didn't expect the US market to do as well as in 2014. I also expected the US Dollar to continue strengthening vs. most currencies. On these predictions I was correct with the US market roughly flat for the year while non-US developed markets were down about 2% and emerging markets were down about 15% in US Dollar terms. As can be seen from the chart below the US Dollar did strengthen against most currencies.



Finally I predicted that the outperformance of conservative bonds would come to end and indeed the US bond market was about flat to down 5%, with high-yield bonds doing substantially worse than that.

Unfortunately being correct on most of the predictions doesn't help much in a year like we had in 2015.

We also had two pretty substantial selloffs during the year, in August and again in September. The chart below shows how many asset classes dropped by about 10% in August, recovered a bit and then fell again at the end of September, before recovering again in October.



It is interesting to note that long-dated bonds (TLT) and gold (GLD) provided some diversification benefits during these downturns. Also holding commodities during these periods would have mitigated the downside a bit since commodities (DJP) were down only 5%, whereas US, non-US, and emerging market stocks were all down over 10%. So diversification benefits are real but unfortunately when everything is down for the year diversification doesn't help much.

Two concerns drove markets down in 2015 and continue into 2016: The huge drop in oil prices and a slowing economy in China.

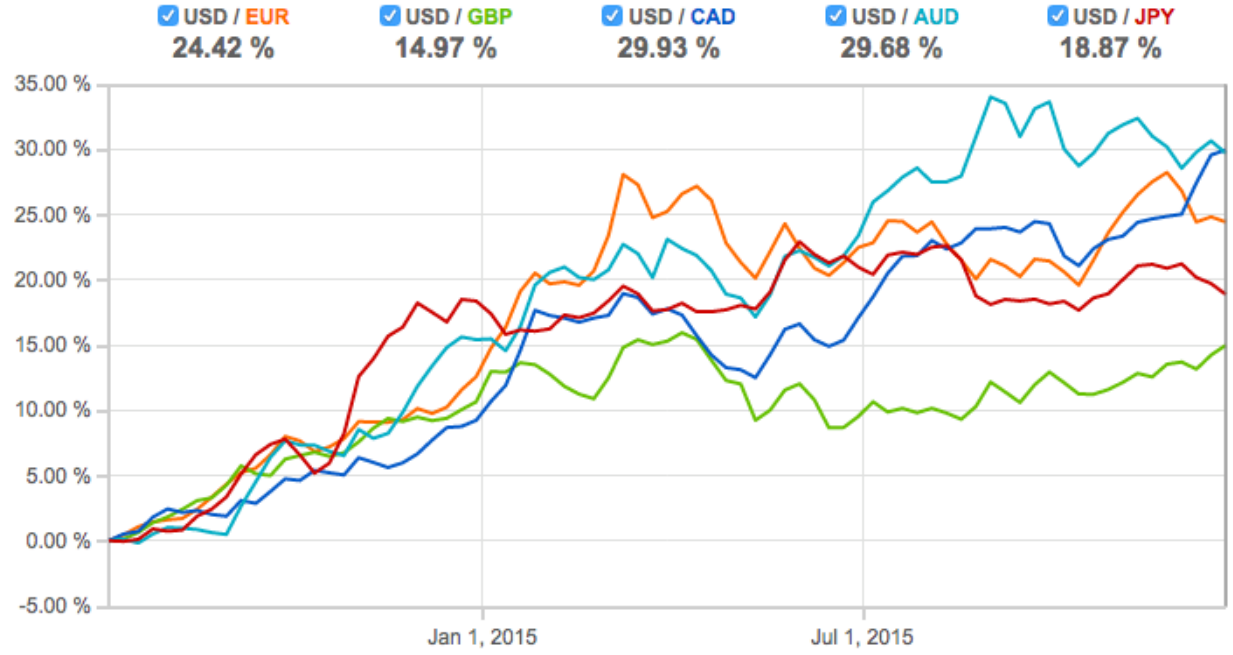
While it is true that such a dramatic decrease in oil prices, and in many commodities, will affect the fortunes of oil and commodity-producing companies (and the banks that lend to them), low oil prices are generally good for consumers who benefit from lower gasoline and energy prices. Also companies that have commodities as inputs to whatever they manufacture should benefit. These benefits are not immediately reflected in the economy and in earnings reports but I would expect to see the benefits manifest over the course of 2016. We may also see some bankruptcies in the oil business later in 2016 if oil prices don't increase because the affected companies will run out of borrowing power and hedges they have put in place on their oil price positions will expire forcing them to sell at much lower prices.

It is worth talking about hedging in the oil business a bit because I think that might have a big influence of how this sudden price decrease plays out in 2016. Saudi Arabia is the big dog in the world when it comes to setting oil prices. It is in large part the fact that Saudi Arabia has taken the position that they will not curtail their oil production in the face of low prices that has led to an over supply in the market and this dramatic decrease in the price of oil recently. It seems this is as much a political as it is an economic decision for Saudi Arabia – they would like to drive out higher cost producers around the world and perhaps they also feel that low oil prices will hurt countries like Iran and Russia more than they hurt

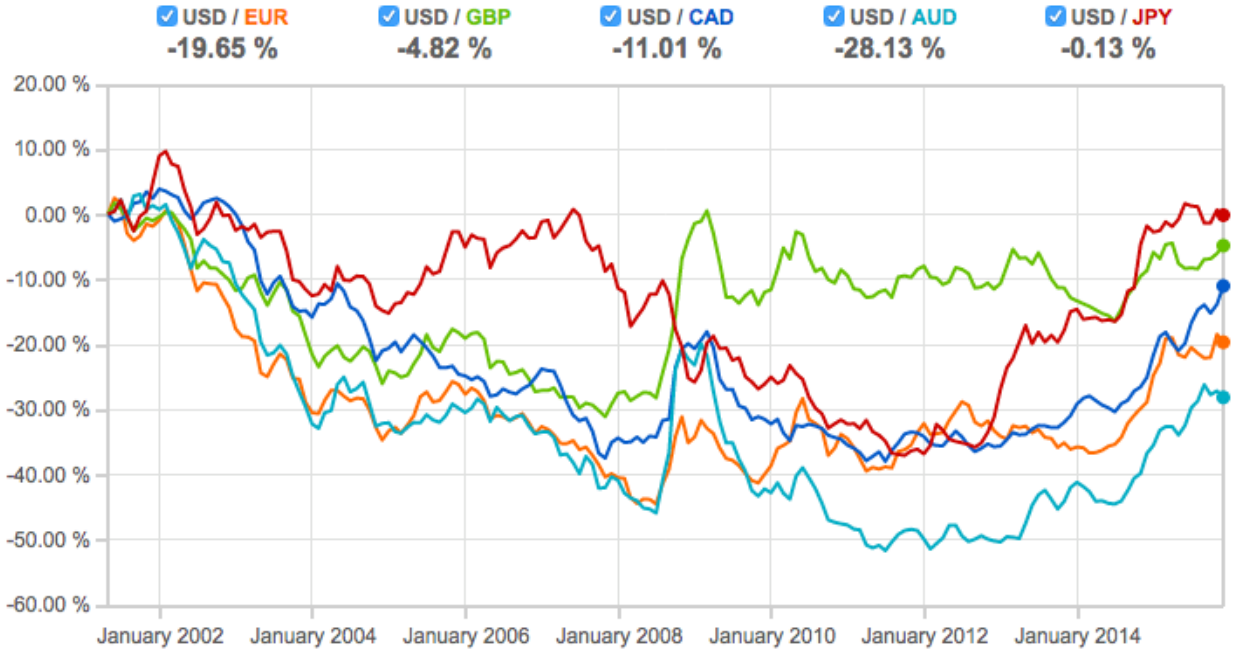
Saudi Arabia. Saudi Aramco is the company that controls all this – it is the national oil company of Saudi Arabia. It wouldn't surprise me if Saudi Aramco hedged most of their oil production early in 2015 when prices were much higher, locking in the higher prices of the day at that time. Hedges are typically for one or two years so if this is the case I wouldn't be surprised if Saudi Aramco curtails production and the price of oil starts to increase again towards the middle of 2016 as their hedges start to expire and they face the prospect of selling their oil at much lower prices.

With respect to the concerns about the Chinese economy: This is difficult to comment on since clearly Chinese GDP is slowing but then again nobody thought that the country would be able to grow at 10% or even 7% per year forever. Economists have spoken for years about the likelihood that China will change from being almost an entirely export driven economy to one more internally driven by consumers as wealth in China increases. It seems to me that this is exactly what is happening now. So what this should mean is that China becomes less commodity-intensive and, given that there has been huge investment in mining and other commodity-producing businesses over the last decade to fuel China's demand, we should see a slump in this industry and in commodity prices – which we have already seen. However, we should also see demand increase within China in areas related to services and consumer goods – this should be good for companies that export to China to feed these markets. I believe we are also seeing this occur – for example Apple's business in China is doing very well – unfortunately in their case this is somewhat offset by a weaker Chinese currency vs. the US Dollar. The biggest losers from China's slowdown will likely be commodity-exporting countries like Australia, Canada, and especially certain emerging market countries like Indonesia.

This leads us to the last issue I would like to touch on here, which is the dramatic strengthening of the US Dollar over the last year and a half. Below is a chart of the US Dollar vs. the Euro, British Pound, Canadian and Australian Dollars, and the Japanese Yen. As you can see we are talking about a strengthening of between 15% and 30% in just a year and a half for the USD.



However if we take a longer-term look, like say from the end of the recession that occurred after the tech bust of 2001, we see a different story:



So what does all this tell us? First of all it tells us that exchange rates can be quite volatile and so they need to be considered in an investment portfolio. The second thing it tells us is that exchange rates are mean-reverting; meaning that they go up and down unlike, for example, the stock market which longer term tends to go up, or inflation which also tends to increase. So for investors with a very long time horizon it may be possible to ignore currency effects but for most of us this is a consideration. Finally, the US Dollar is not incredibly expensive compared to historical values and with the Federal Reserve starting to increase interest rates, albeit very slowly, while in other places like Europe interest rates are being driven downwards, we may yet see more US Dollar strengthening.

From an investment perspective this will be a drag on the profits of US companies that rely strongly on exports since the profits they repatriate will be smaller when converted to US Dollars. We are seeing this in first quarter earnings calls from companies like Apple, Ford, and other such exporters. However the share prices of these companies have already come down substantially so in my opinion there may be good value in certain of these companies. Having said that it may be wise to focus on US companies that are doing well in the USA and not so reliant on non-US markets or on companies based outside the USA that export to the US – but in this second case we need to consider that share prices denominated in non-US currencies will suffer if the US Dollar strengthens so there is a trade-off there. One possibility is to invest in non-US companies but hedge out the currency exposure in the share price, which is what we have been doing through the use of certain exchange-traded funds.

Looking Ahead

So this brings us to the point where we need to decide how to invest in the year ahead. I've started this discussion in the paragraph above where I say that in my opinion companies that sell within the USA may be a good consideration. Also, with the dramatic selloff we have seen at the beginning of 2016, which was the worst selloff to start a year in history apparently, there are some pretty good deals out there. In particular it is possible to find blue chip companies with dividends in the 4% to 5% range whose share prices have come down 30% or so over the last few months but whose sales are doing quite well. Since I think it might be tough sledding for investments in general in 2016, I would suggest a focus on dividend-paying investments.

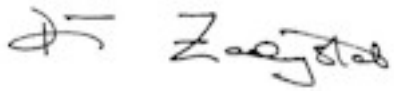
I am not expecting an economic meltdown in 2016, at least not in developed markets. The USA is doing OK it seems, and parts of Europe seem to continue to recover although there is some uncertainty there. Other countries like Australia and Canada are suffering because of their commodity-based economies but share prices and currencies have already fallen dramatically so perhaps there is some value to be found. I think there is risk in emerging markets – it could get ugly if the Chinese economy slows faster than expected or if investor flight out of these markets continues; so I would avoid emerging markets until things stabilize despite the fact that some seem cheap at the moment from an investment perspective.

I would think that with the Federal Reserve starting its tightening and the US economy doing better than many other developed markets we might see continued strength in the US Dollar but probably not as dramatic a move as in the last two years.

There continues to be considerable interest rate risk in fixed income investments, especially low-yielding or long-dated bonds and so I would advocate dividend-paying investments instead. There is more volatility and greater stock market correlation in such investments but I think at this time of extremely low interest rates I would rather take on such risks than interest rate risk.

Finally commodities: I'll go out on a limb and say that I expect the price of oil to start increasing towards the middle of 2016 and that we may see a 30% increase by the end of the year. If this manifests then oil-related companies will probably be a better investment then a broad basket of commodities such as an exchange-traded fund because these companies' share prices have been beaten down so much recently and also because some of them pay pretty good dividends, whereas just investing in the commodity pays no dividends.

Best wishes in the New Year,



Tom Zachystal, CFA, CFP©
President,
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