CAPITAL STRATEGIES
FINANCIAL CORPORATION
Navigating Financial Security

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Financial Markets Commentary 1st Quarter 2017

Summary

Stocks gained a little over 6% last quarter while bonds rose 0.82%.[1] Stocks continued the momentum from late 2016 as corporate profit expectations remained high, while bonds benefitted from the idea that the economy would not grow at an inflationary pace. There is a bit of a contradiction here – corporate profits probably cannot meet expectations without the economy growing fast enough to force interest rates higher – but for the quarter at least, investors got to have their cake and eat it too. They also were treated to a rebound in foreign markets. Currency traders sent the dollar lower last quarter as fears of a soaring dollar through protectionist trade policies faded. Emerging markets, which lost the most post-election, gained the most last quarter.

Technology and health care became market leaders once again as investors observed that the economy under Trump wouldn't be much different than the economy under Obama – slow and steady. Sectors where expectations were higher, such as energy and financial services had a disappointing quarter. Real estate struggled because tough times in the retailing industry are leading to soaring shopping mall vacancies. Utility stocks were a beneficiary of flight-to-safety buying when economically sensitive stocks faltered.

As mentioned, foreign stocks performed well versus U.S. stocks last quarter for the most part. It was no more than a reversal to some extent of the "Trump trade" that investors put on last November when they sold foreign stocks and bought U.S. small and midcap stocks. Emerging markets gained 11.45% while developed foreign markets gained 7.25%.[2] See Figure 1.

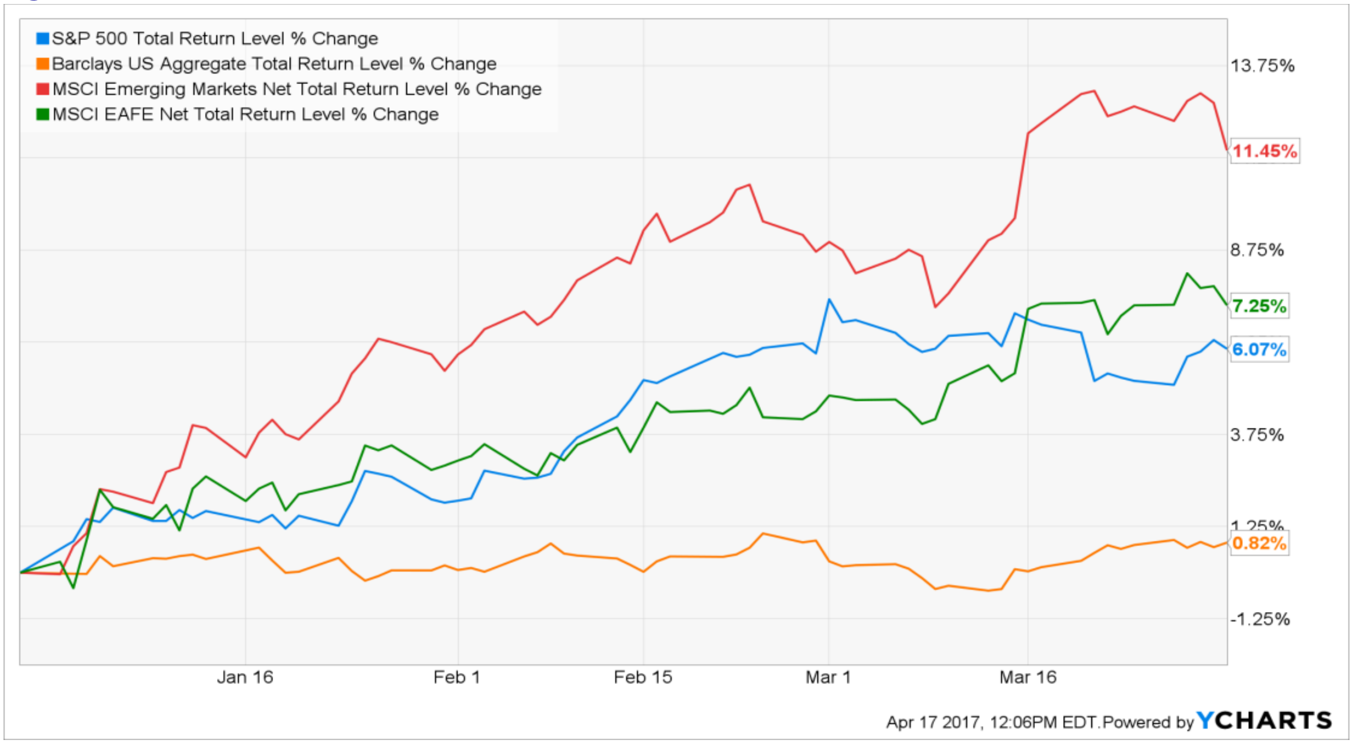
Bonds earned a little bit more than their coupon payments last quarter as interest rates declined. Again, it paid off for bond investors to take extra risk, either in the form of high yield bonds (credit default risk) or foreign bonds (currency and

[1] Stocks as measured by the S&P 500 Index (6.07%) and bonds as measured by the Barclays US Aggregate Bond Index. Source: YChart.com

[2] Emerging markets as measured by the MSCI Emerging Market Index and Developed Markets as measured by the MSCI Europe, Asia, Far East Index. Both indices include dividends and are stated in U.S. dollar terms. Source: YChart.com

sovereign risk). Investment grade U.S. bonds returned 0.82%, while high yield debt rose 2.70% and emerging market debt gained 3.28%.[3]

Figure 1



The 30,000 foot view of the markets over the last 12 months is that various narratives have, at different times, pushed particular parts of the market higher or lower depending on whether that sector benefits from a stronger dollar or a weaker one or whether it benefits from a weaker economy or a stronger one. In the end, none of the narratives have had staying power. The market continues to meander upward because more money is coming into the markets than there are attractive places for it to go. We believe that a decent percentage of it is from formerly bearish investors finally throwing in the towel.

Activity

At the margin, the realization that a lot less is going to happen legislatively in the first half of 2017 than first thought makes bonds, gold, foreign stocks, and "defensive" U.S. stocks more attractive. It makes inflation protected bonds (TIPs), the U.S. dollar, and economically sensitive U.S. stocks somewhat less attractive. We did not make profound changes during the fourth quarter of last year, so we didn't have to undo them this quarter. Most of our activity centered around "intra-category" performance.

[3] High yield bonds as measured by the Barclays High Yield Corporate Index and Emerging Market Debt by the Barclays EM Aggregate Index. Source: Morningstar Adviser Workstation

Outlook

Humans are incredibly adept at pattern recognition. It is how our ancestors survived when we were not at the top of the food chain. So when we observe the market rising despite relatively slow economic growth, we rightly conclude that economic growth does not drive stock prices. For the same reason, we can rule out corporate profits – they have been relatively stagnant for close to three years in a rising market. We are left with low interest rates. When interest rates are low enough that it is profitable to borrow money to buy stocks, stocks are probably going to go up. Lack of economic growth or profit growth did not stop the S&P 500 at 2000 or 2200 so why would it stop the S&P now as it approaches 2400?

Similarly, we observed that every time something unexpected happened in the world over the last several months and the market opened sharply lower, someone (or more likely some computer program) bought stocks and the market actually finished higher. If we are all conditioned that the correct response to a market sell-off is to buy it, who fears a protracted downturn?

It is widely believed that market over-valuation is not a sufficient catalyst to cause a market downturn. However, while markets may stay above or below fair value for very long stretches of time, ultimately value wins out. If liquidity remains ample (and I don't see it changing in the near term) and volatility remains low then stocks will probably grind higher even though just about every non-interest rate-related valuation metric tells us the market is considerably over-valued. There just aren't enough reasonably safe, reasonably liquid (meaning easy to sell) investment alternatives out there.

Commentary – Indexing and Active Management

We honestly hope the Outlook section you just read made you a little nervous. We hope you were thinking something along the lines of "how does this end", or "it can't be that easy". Just about everyone is buying the market (stocks through index funds and ETFs) because it has worked over the last several years and they believe it will continue to work (and let's be honest, what else are you going to do)? For the first time in our investment careers, the investment community has basically given up on beating the market. "If you can't beat the market, join it" many say. If there is one thing we have learned, however, it is that no investment idea works when it is embraced by everyone.

There are two primary reasons why indexing has worked especially well over the past ten years (1) it is an inexpensive way to invest in capitalization weighted benchmarks that have disproportionately benefited from the low interest rate environment and (2) superior performance among active fund has not persisted.

Indexing is based on the belief that taking the cost of trading into account, it is difficult (if not impossible) to outperform the market over time. All investors together by definition are the market, thus for any given period some do better than the market as a whole and some do worse. Even the better performers see their advantage eroded when the costs involved in buying and selling are taken into consideration. Why take the risk of underperformance in an actively managed fund?

Active management is based on the belief that investment management is a skill that is difficult to master and as such, superior returns are available to those who do. The argument centers on the idea that the most skillful can add value through security selection and are therefore worth paying for their superior knowledge and process. The "skill" argument was taken for granted until roughly ten years ago because it was so easy to cite the returns of Warren Buffett, Peter Lynch, Bill Miller or several others. Today, however, nobody's recent record looks all that spectacular. The Fairholme and Sequoia funds, once revered in the fund industry, have suffered mightily. As a result of the lack of high profile success among active managers lately, indexing through exchange traded funds (ETFs) has captured the lion's share of new investment.

While we understand why this has happened, we are becoming increasingly nervous. As long as you make the assumption that the stock market is reasonably valued such that one can expect to earn a very high single-digit annual return by buying and holding a market based ETF, it is hard to argue with indexing as a strategy. If you also assume that the past ten years are better indicators of the future than the previous twenty five in terms of the inability of one year's best performers to sustain their edge, then once again indexing is the way to go. On the other hand, if you see the market as being so overvalued that mid-single digit annual returns are a best case scenario going forward, then your ideal strategy might well change. Especially if you believe that as returns slip, investors will be more inclined to look at alternatives to S&P 500 stocks.

We want to emphasize that high valuation is not a sufficient catalyst by itself to cause stock prices to fall. That said, however, valuation is the best long-term guide to stock price performance. As we have argued many times in past commentaries, high valuation tends to lead to low subsequent long term performance and low valuations lead to high future performance. It is true that when you buy at levels that are expensive relative to history, you are not necessarily punished by an immediate loss of principal. Often in fact the market goes on to make new highs over the next several months or even years.[4] On a fifteen year basis or longer, however, valuation is hard to beat as a predictor. If you bought the S&P 500 in late 1999, only in the last three years or so would you have a gain in inflation-adjusted terms.

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[4] Alan Greenspan made his famous "irrational exuberance" comment in December 1996, more than three years before the market peaked.

We also want to emphasize that active managers may not have merited the acclaim (or paychecks) the best of them received in the 1990s, but they aren't idiots either. The more that stocks are purchased due to their inclusion in a size-based index as opposed on their individual merits, the more scope there is for a manager to outperform by doing deep analysis but the longer it may take for their discovery to be rewarded. In addition, it is much more difficult to add value when you are one smart person competing against a hundred or a thousand other smart people trying to determine what Apple is going to earn next year than it would be if indexing reduced your competition to fifteen or twenty (and maybe only two or three if you were researching Donaldson or Fastenal). The skill of stock picking is bound to matter a lot more if the market as a whole is performing poorly (as it was in the 1970s and early 1980s) such that the extra value that someone who can read a balance sheet and income statement can provide is valued once again.

Finally, <u>it's important to state that this commentary is not to argue against indexing per-se</u>. We use index ETFs in certain areas. The point is to observe that historically anytime a sector or investing style or strategy becomes almost universally applauded in the investment arena it tends to end badly. Its relative merits are well-known while its drawbacks are minimized or ignored altogether – until they become glaring. We are in the ninth year of an upturn that began in March, 2009. It stands to reason that a strategy that has kept investors fully invested with minimal investment costs would be popular. And as suggested at the end of the Outlook section, we are not looking for this bull market to end imminently (typically the market makes a top over several months, and that is nowhere in evidence today). What we are saying is that <u>at some point in the not too distant future this bull market will end, and success at that point will probably require a different approach</u> than the one that has been so successful over the past eight years. We stand ready with both the historical knowledge and the intellectual flexibility to modify our approach to the active-versus-passive debate to take advantage of different market environments. We thank you, as always, for your confidence in us.

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