

To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Planning for Certainties in an Uncertain World

Dear Client,

Pundits have been predicting a stock market correction, i.e., a decline of 10%, or more, for close to two years all the while stocks followed a jagged upward path to record high levels by the middle of May. While we've had two close calls of 9%, we haven't yet crossed into official correction territory as stocks seem to be defiantly climbing a "wall of worry" given the backdrop of economic and geopolitical uncertainty. Perhaps we're on the verge of a correction this time with the Greek crisis and the Chinese stock bubble adding to fear and uncertainty.



Of course, another big concern is the impact of higher interest rates once the Federal Reserve begins tightening (which might happen as early as September). With the list of uncertainties growing, the media is doing its part (rather, disservice) to hype the sensational and ignore the rational (one needs to do quite a bit

of digging to uncover the complete picture). We've posted several insightful articles in the Chart Room of our website (aequitas-inv.com/chart-room) covering Greece, China and the Federal Reserve's interest rate dilemma, so I'll only touch upon some of the highlights given the limited space of this letter.

Should We Fear a Correction?

The father of value investing, Benjamin Graham, stated, "In the short run, the [stock] market is a voting machine but in the long run, it is a weighing machine." What this means is that investors *react* to news events typically by buying stocks when the news is positive and selling when news is negative, i.e.

a *voting machine*. However, voting on stocks, or rather, trading stocks based on news events or speculation about the future seldom pays off and exposes one to market timing risk. Instead, Graham encouraged investors to buy stocks which had lower prices relative to their intrinsic worth, i.e., value investing, and to allow time for the selected stocks to appreciate in monetary value. By participating in the growth of the overall economy, Graham concluded that the stock market ends up being a weighing machine, i.e., one can *weigh* his or her monetary return (or compute the rate of growth).

What does Graham's message have to do with stock market corrections? Essentially, a correction provides an opportunity to buy shares of a corporation's stock (or more shares) at a relative discount. Warren Buffet, a disciple of Graham, advises investors to "be greedy when others are fearful," i.e., to be a buyer when others are selling out of fear. The media, of course, plays right into the hands of value investing given that fearful headlines cause some investors to sell irrationally. While corrections are unnerving when they occur, rather than being feared, they provide an opportunity for buying stocks at lower prices through portfolio rebalancing.



Should We Be Concerned about Higher Interest Rates?

Since the bottom of the Great Recession, the Federal Reserve has been trying every trick in its book, including Quantitative Easing, to stimulate the economy and boost job growth. Although progress has been slow, the Fed's policies have probably run their course; and with the unemployment rate now at 5.3%, the Fed may begin raising interest rates later this year. The Fed doesn't want to fall behind the curve by keeping interest rates too low for too long and allowing inflation to get out of hand (raising interest rates is one tool the Fed deploys to

keep a lid on inflation). We have generally supported the Fed's actions over the years and believe their plan of gradually raising rates is the appropriate course. However, there's a camp of investors who believe that stock and real estate prices have been artificially propped up by the Fed's low interest rate policies and that asset values will fall precipitously when rates finally rise. While it's true the Fed designed its policies to propel stock and housing prices higher in order to stimulate economic growth, we believe they understand the long-term risks and are committed to maintaining stable asset prices. With inflationary pressures remaining low for the foreseeable future, we believe the Fed stands a good chance of staying ahead of the inflation risk curve. Furthermore, higher rates will provide investors with an opportunity (*finally*) to earn better yields on their bond portfolios (we've been recommending short-term bonds as a strategy in preparation for rising rates).

The Greek Tragedy

This past weekend, Greece and the European Union, after contentious debate, agreed to a bailout plan to keep Greece afloat for another three years. As you undoubtedly know, Greece is essentially bankrupt and unable to secure credit to finance their economy. The banking system has been virtually shut down for several weeks and life has been desperate for most Greek citizens. Having been elected to reject additional austerity demands from the EU, Prime Minister Tsipras had to swallow his pride and abandon his political promises in order to obtain the financing necessary for Greece to function. The conditions of the bailout require the Greek legislature to promptly approve key elements of the agreement which will be challenging for Tsipras to pull-off. However, there are no viable alternatives other than leaving the Eurozone, i.e., a Grexit; an outcome most Greeks would rather avoid.

While a Grexit appears unlikely at this time, should Greece fail to live up to its side of the agreement, they may end up exiting the Eurozone in one form or another. The big concern about a Grexit is the precedent it might set for other weaker European Union countries, e.g., Spain or Portugal, to also leave the EU. However, the fear of "contagion" was probably a more likely threat a few years ago when Spain and Portugal were originally compelled to implement politically unpopular austerity measures. Having swallowed the bitter austerity pill, Spain appears to have made a remarkable turnaround. Their economy on track to grow by more than 3% this year and Spanish consumer confidence is climbing. Spain's Prime Minister, Mariano Roy, announced they might be in a position to deliver on promised tax cuts sooner than planned. Even Portugal's economy has emerged out of recession resulting from their fiscal belt tightening.

By demonstrating budgetary discipline, Spain and Portugal have regained investor confidence which has provided them with very low borrowing costs on government debt (Spain's 10 year bond rate now stands at about 1.8% with Portugal's at 2.4%).

The Chinese Stock Market Bubble

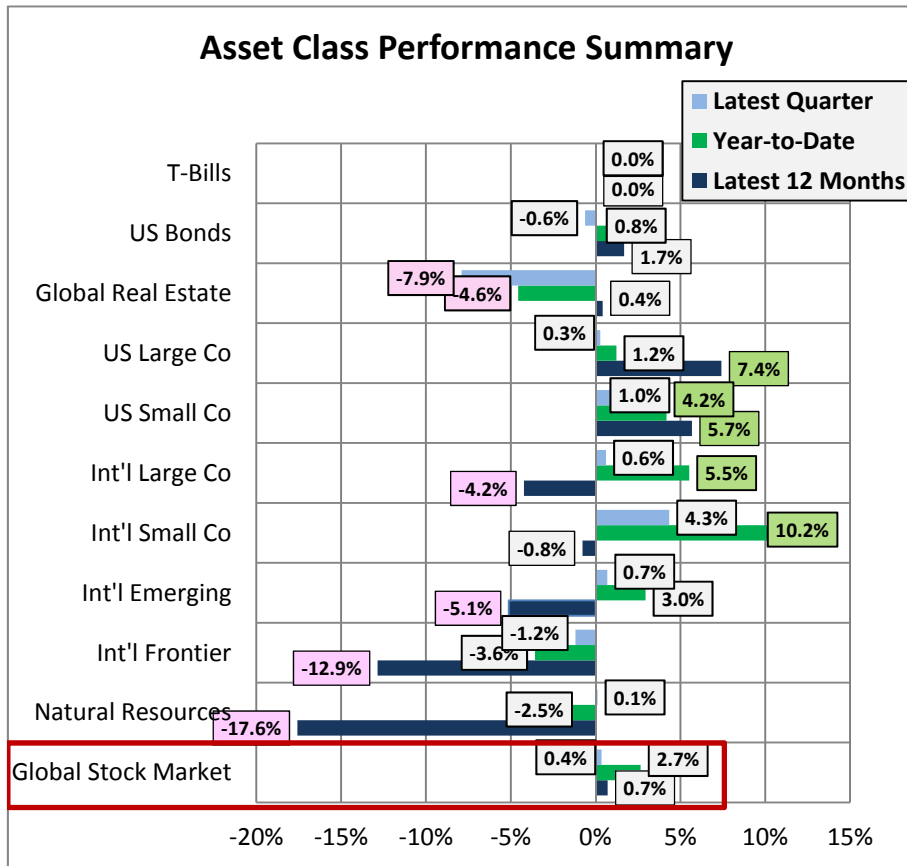
Playing second fiddle to the Greek crisis, news of the Chinese stock market bubble has emerged as another big story and cause for more uncertainty. The headlines are pretty scary with the Shanghai Stock Exchange having plunged by close to 30% with the government stepping in to implement emergency measures in an attempt to stop the rout. Despite the recent nose dive, Chinese stocks are still up by 15% for the year and about 82% compared to a year ago! The fact is that Chinese stocks were bid up to astronomical price levels which were unsustainable; the bubble was bound to burst. Just how extensive is this problem and does it pose a risk for investors outside of China? As it turns out, only 4% of China's population is invested in the stock market and the entire financial sector accounts for just over 7% of their GDP (contributing just 0.4% of the total GDP of about 7%). The China experts we communicate with see only a modest negative impact on the Chinese economy. Furthermore, they now see better values in Chinese stocks traded on the Hong Kong exchange (H-shares). For long-term investors, this may represent a buying opportunity. (Note: we have recommended the Matthews Pacific Tiger Fund for most of our client portfolios. This fund invests exclusively in Asian stocks with the largest country allocations being China (30% in H-Shares), India (19%) and South Korea (16%). The fund is up 6.9% through July 10th).

Asset Class Performance Review

Globally, stock market performance over the trailing twelve months was essentially flat with the MSCI All Country World Index returning just 0.70%. Stocks in the US fared better than foreign stocks with US Large Co's up by 7.4% and US Small Co's gaining 5.7%. US Bonds were surprisingly positive (+1.7%), but Global Real Estate cooled off (+0.4%) and T-Bills provided no return (once again). The biggest loser was Natural Resources (-17.6%) reflecting the collapse in oil prices. Overseas, the returns were negative largely in reflection of the US Dollar's strength relative to other currencies. Int'l Small Co's were down by 0.8%, followed by Int'l Large (-4.2%), Emerging Markets (-5.1%) and Frontier Markets (-12.9%).

For the first quarter, the Global Stock Market advanced by a mere 0.4%.

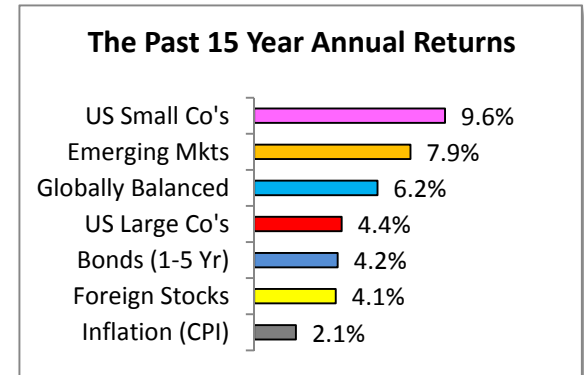
Looking Back over the Past 15 Years



Leading the way were International Small Co's (+4.3%), US Small Co's (+1.0%), Emerging Markets (+0.7%) and Int'l Large Co's (+0.6%). Natural Resources, T-Bills and US Large Co's were flat for the quarter. US Bonds were slightly negative (-0.6%) followed by the Frontier Markets (-1.2%). The biggest loser this quarter was Global Real Estate which shed 7.9%.

I've included the year-to-date period (the green bars in the graph above) to indicate that some asset classes have posted relatively good returns so far in 2015 despite all of the uncertainty. Leading the way were Int'l Small Co's (+10.2%), Int'l Large (+5.5%) and US Small Co's (+4.2%). Emerging Markets were up by 3.0%, but the Frontier Markets lost 3.6%. US Large Co's advanced by 1.2%. Global Real Estate (-4.6%) and Natural Resources (-2.5%) were the biggest losers. US Bonds gained 0.8% and T-Bills were flat. The Global Stock Market gained 2.7%.

The trailing fifteen year period ending June 30th was the worst period for stocks since the Great Depression. While the historic average annual return for the S&P 500 has been 10% since 1926, over the past fifteen years the S&P 500 delivered a paltry 4.4%. Surprisingly, bonds performed almost as well with a 4.2% annual return. A balanced portfolio with 40% in Bonds and 60% in the S&P 500 would have gained just 4.3%; far below the return most investors need to meet their long-term objectives. Of course, the past fifteen years includes a major terrorist attack, the Afghanistan and Iraq Wars and two severe bear markets, including the 2000-02 Tech Wreck, which saw stocks fall by more than 40%, and the Great Recession during which stocks fell by 58% around the globe. While the S&P 500 and Foreign Large Cap stocks underperformed,



US Small Co's and Emerging Markets stocks picked up some of the slack with annual returns of 9.6% and 7.9% respectively. Adding these two relatively risky components to one's portfolio helped the globally diversified investor earn an average annual return of just over 6% annually (allocated 40% in bonds and 60% in globally diversified stocks). Not a bad return during one of the worst periods in stock market history.

Planning for Certainties Amidst So Many Uncertainties

While we might accept the concept that *uncertainty is the only certainty*, the notion provides little value when planning for our financial futures. After all, we have real needs such as securing adequate retirement income, paying for our children's educations and providing cash flow from our endowments to fund operations. The most effective method for dealing with life's uncertainties is to prepare for both negative as well as positive events, i.e., an all-weather portfolio. We believe that a globally balanced portfolio meets that criterion by balancing low risk investments (i.e., short-term, high quality bonds) with higher risk investments geared for long-term growth (i.e., stocks); blended according to each investor's individual risk tolerance and long-term financial needs.

