

AEQUITAS INVESTMENT ADVISORS

INVESTMENT REPORT - THIRD QUARTER 2015

To: Aequitas Client

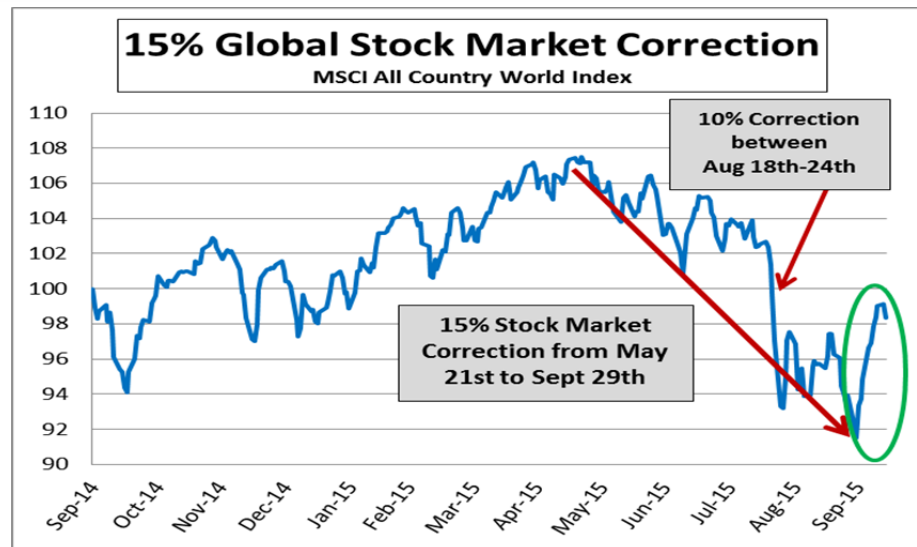
From: Aequitas Investment Advisors

Subject: Time is on the Investor's Side

Dear Client,

In our last quarterly letter, we discussed the possibility of a stock market correction given concerns about a possible Greek exit from the Eurozone, worries about China's slowing growth, uncertainty surrounding the impact of rising US interest rates and growing geopolitical turmoil. While the stock market had already been drifting lower from its May record high level, a surge of fear hit the market in the middle of August sending global stock prices downward by close to 10% in a matter of five trading days. The sudden plunge followed China's surprise move to devalue its currency which investors interpreted as further evidence of slower growth in the world's second largest economy. An additional leg downward occurred in late September after the Federal Reserve announced it would *not* be raising rates after all. While investors were probably prepared for a rate hike announcement, the Fed's postponement created concern about the health of the US economy (a rate hike would have been perceived as a vote of confidence in our economy's strength). Given all of the aforementioned concerns, the global stock market gave up 15% of its value between May and the end of September; clearly qualifying as an official stock market correction (i.e., a decline of 10% or more) and just five percentage points from being classified as a bear market (i.e., 20% or more).

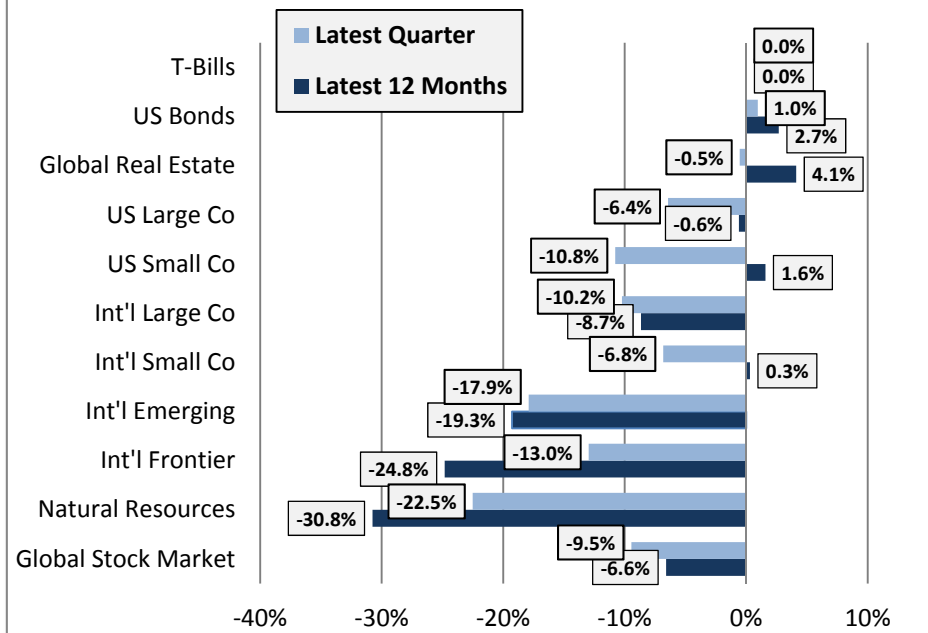
While overly simplified, stock market corrections are periods when investors weigh new information causing them to "correct" their assumptions about future corporate earnings and stock prices. For example, as news of slower growth in China emerged, not only did Chinese shares fall, but earnings expectations for companies which export to China were adjusted downward as well. Apple stock presents a good example. Even though Apple is based in the US, a significant component of its future earnings depends upon sales to China. The correction which sent China's stock market down by 18% during the third quarter also carried Apple's stock price down by 13%.



Stock market corrections can be short lived, or they can be a precursor to a bear market which typically accompanies a recession. Based upon the most recent economic reports we follow, signs of a recession are not evident at this time. To the contrary, many economists are forecasting *slightly* stronger growth for the US and the global economy in 2016 (low inflation, low energy prices and low interest rates are positive ingredients for consumer spending worldwide). Perhaps, then, the recent 15% correction will be of the short lived variety. Recent evidence (note the green circle in the graph above) might point in that direction as the global stock market has climbed by about 7% in early October (regaining close to half of the 15% loss).

While the markets have rebounded as of this writing and made up some lost ground, it's clear the global economy faces many difficult challenges which will take *time* to overcome. Without reciting the litany of problems around the world, suffice it to say investors must prepare for a variety of events and outcomes. Portfolios need to be constructed with safe haven investments to protect against negative events as well as investments which capitalize on long-term growth opportunities. Allocating one's portfolio according to future "time horizons" is one way to manage risk and deal with uncertainty. Later in this report, we'll discuss investment time horizons in greater detail, but first, let's take a look at the latest performance results which were mostly dismal.

Asset Class Performance Summary



Asset Class Performance Review

For the latest quarter, the only asset class which posted a positive return was US Bonds. The entire Global Stock Market fell by 9.5% as unfolding news of China's slowing growth and the Fed's interest rate decision weighed on the minds of investors. Natural Resource stocks were down by close to 23% reflecting falling demand for oil and other commodities (lower oil prices represent *good news* for consumers, however). Stocks in the Emerging Markets (-17.9%) and Frontier Markets (-13.0%) were hit by slower growth concerns as well as falling commodity prices. (Stock prices in commodity and energy *importing* countries, especially in emerging Asia, fared better over the quarter.) US Large and US Small Company stocks also moved sharply lower, down by 6.4% and 10.8% respectively. International Large (-10.2%) and Int'l Small Companies (-6.8%) were in similarly negative territory. Global Real Estate avoided most of the carnage (-0.5%) while US Bonds were the only gainer (+1.0%). T-Bills were at zero percent once again (compared to stock returns for the quarter, zero looked pretty good).

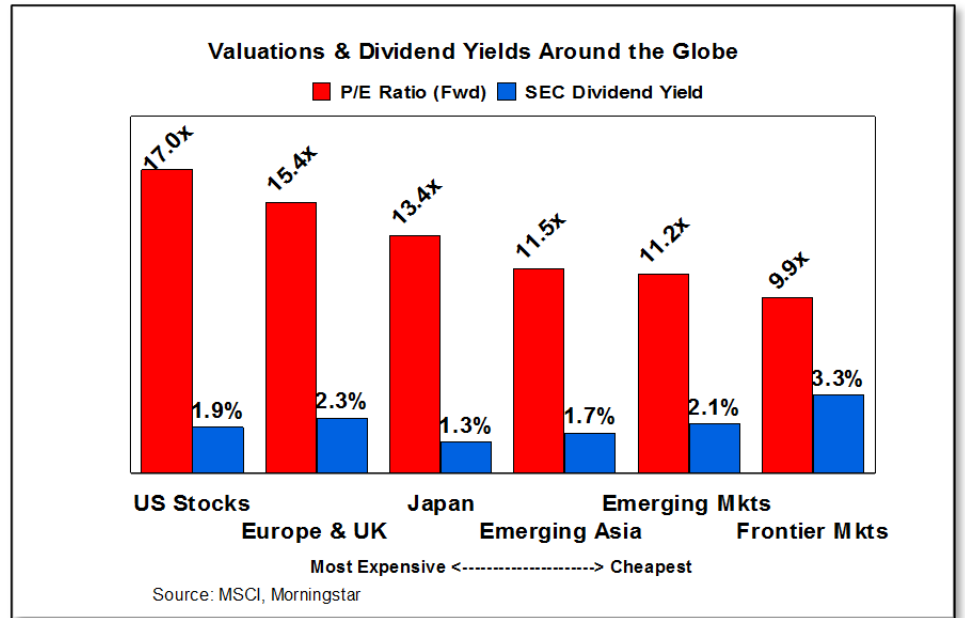
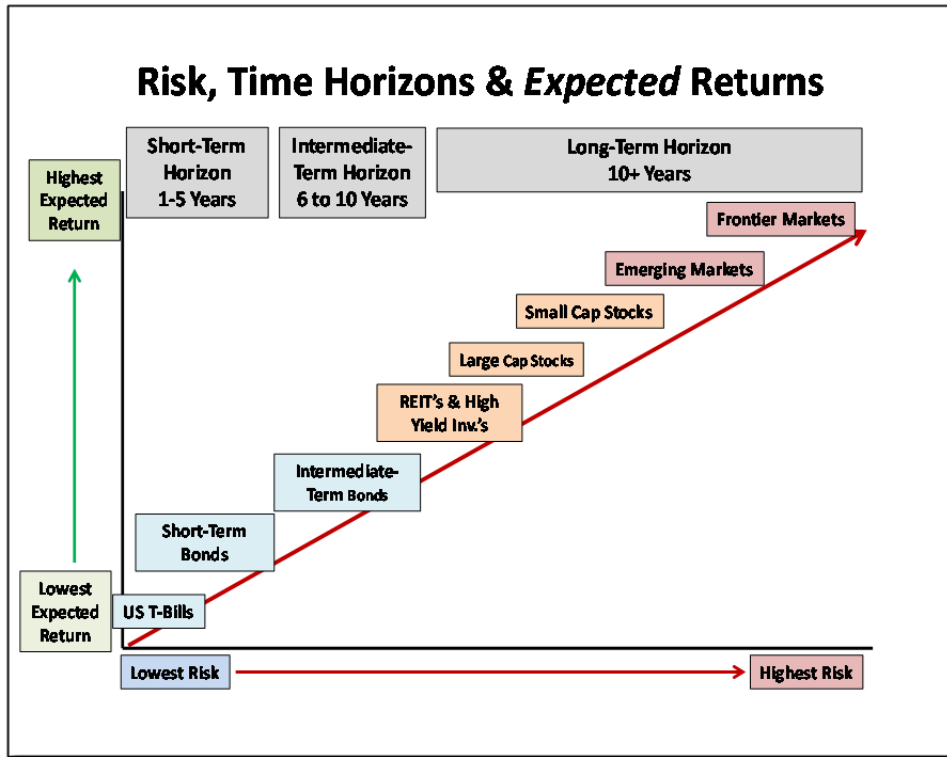
Returns for the trailing twelve months were only slightly better with the Global Stock Market down by 6.6%. The largest losses were seen in Natural Resources (-30.8%), Frontier Markets (-24.8%) and the Emerging Markets (-19.3%). Most

of those losses, however, occurred in the third quarter. International Large Co's gave up 8.7%, but Int'l Small Co's eked out a positive return (+0.3%). US Large Co's fell by about 1% while US Small Co's gained 1.6%. US Bonds (+2.7%) and Global Real Estate (+4.1%) were the only meaningful gainers. T-Bills were flat.

Using Investment Time Horizons to Manage Risk

While we would all prefer our portfolios to deliver low-risk *and* high-returns, unfortunately, that's not how the capital markets work. History has demonstrated that higher returns generally come to those who are willing to assume greater risk. A good example of the risk and reward trade-off is to compare the returns of US Small and US Large Cap stocks over the past 80 years. Over that timeframe, US Small stocks have outperformed US Large stocks *on average* by about 2% per year. In exchange for that higher return, Small Cap stock investors had to withstand about 50% greater price volatility (e.g., when Large Cap stocks were down by 10%, Small Cap stocks were down by about 15%). For investors with longer time horizons, higher volatility may be more tolerable than for investors with a shorter time horizon. In the chart at the top of the next page (**Risk, Time Horizons and Expected Returns**), we've arrayed some of the major asset classes along a Risk and *Expected* Return line. In our analysis, US T-Bills are considered to be the least risky and Frontier Markets stocks the most risky; between the two extremes are other asset classes, each with a certain level of risk, or volatility, and an *expected* return (the word *expected* is italicized to emphasize that the relationships between risk and return for the various asset classes are based upon historic performance; in other words, while not guaranteed, one would "expect" a higher return for taking greater risk based upon past performance patterns).

In practice, most investors structure their portfolios with a variety of asset classes arrayed across the time horizon and risk spectrum. While riskier asset classes offer the potential for higher returns, given the unreliability of the timing of those returns, one shouldn't invest dollars required in the short-term in such asset classes. Ideally, one's portfolio should be invested in accordance with the timing of portfolio withdrawals. For example, cash and short-term bonds are appropriate investments for dollars required to be expended over the next five years. For dollars required in years 6-10, intermediate-term bonds are generally appropriate, especially for more conservative investors. For dollars required in more than 10 years, it's appropriate to invest in riskier asset classes which offer higher *expected* returns (the theory being that riskier assets should be allowed sufficient time to perform as *expected*).



had a strong run over the past 5 years and is now over-valued on a relative basis. Considering current valuations and other risk factors, our recommended model portfolio for equities is now allocated 52% in US stocks, 33% in Foreign Developed Markets stocks and 15% in the Emerging and Frontier Markets.

Current Stock Valuations around the Globe

In surveying the global markets today, stock market valuations appear to reinforce the Risk and *Expected Return* relationship, i.e., in assuming more risk, one should *expect* a higher return in the long-run. In the chart in the upper right, we've compared the Price-to-Earnings Ratios (red bars) for stocks in the US, the Foreign Developed Markets (primarily Europe and Japan) and the Emerging Markets (the MSCI indices we used in this study are market cap weighted which means they primarily reflect prices of large cap stocks in each region). What the figures tell us is that stocks in the US are the most expensive, i.e., their prices are quite high relative to projected earnings (a P/E Ratio of 15.5 is about average for US stocks), stocks in Europe and Japan are considerably less expensive and stocks in the Emerging Markets are relatively inexpensive. There are good reasons why US stocks have become overvalued; (1) investors see the US as a relative safe haven and are willing to pay higher prices and (2) US stocks have gained 85% cumulatively over the past 5 years (Foreign Developed Markets stocks have gained just 22% and Emerging Markets stocks have declined by close to 20%). Other valuation measures, including the Shiller CAPE 10 P/E Ratio, point in the same direction; i.e., the US stock market has

Time is on the Investor's Side

Returning to the **Risk, Time Horizons and *Expected Returns*** chart, the first step in putting time on our side is to carefully review one's future cash flow needs and risk preferences in order to determine what portion of the portfolio should be invested in Short and Intermediate-Term Bonds (i.e., Fixed Assets). The remaining portion of the portfolio (subject to personal risk preferences, of course) can then be invested in Equities across the various stock asset classes with greater confidence knowing we've allowed 10 years for the higher *expected* returns to materialize (hopefully, they'll materialize much sooner). Furthermore, we can improve the odds of a successful outcome through portfolio rebalancing which applies the discipline of regularly trimming over-valued asset classes and adding to under-valued asset classes (i.e., selling high and buying low).

In closing, while time is an investor's ally, let us hope that time, coupled with international efforts, will help create a more stable and peaceful world.

P.S. For some good performance news, please turn to page 4.

October Update

Given the dismal performance for the third quarter and trailing twelve months, we thought we would end on a high note with a performance update for the first few weeks of the fourth quarter. Note that all of the returns are quite strong, especially for the Emerging Markets and Natural Resources which were two of the biggest laggards in the third quarter.

