

AEQUITAS INVESTMENT ADVISORS

INVESTMENT REPORT – SECOND QUARTER 2016

To: Aequitas Client

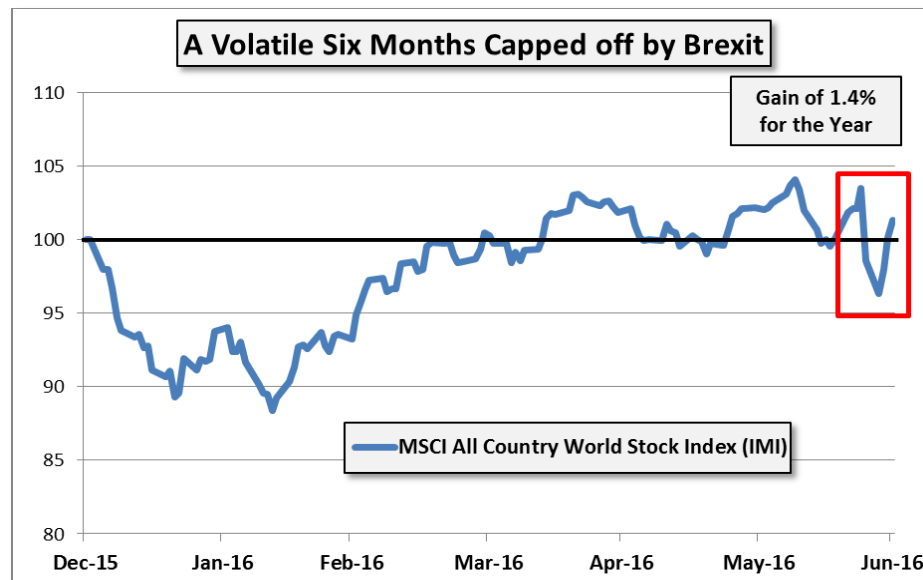
From: Aequitas Investment Advisors

Subject: Stocks Seem to be Climbing a Wall of Worry

Dear Client,

With all of the problems around the globe and here at home, the stock market has demonstrated remarkable resilience, especially following the Brexit plunge as the UK and European Union entered uncharted territory. As of early July, the MSCI USA Stock Index has climbed to a new record high. If, as the great value investor Benjamin Graham believed, the stock market in the *short-term* is a “voting machine” where investors react to market events, why have investors been voting in favor of stocks and apparently ignoring a spate of troubling news? Is it because the US economic picture looks relatively bright as evidenced by a strong jobs report (287,000 new jobs in June)? Is it because the fear of Brexit and its aftermath seem to have subsided as investors recognize the long-term nature of its resolution? Is it because consumer spending remains strong (a recent University of Michigan Survey found that consumers are the most “upbeat about their personal finances” since late 2000)? Or is it because stocks are the only game in town with bond yields at historic low levels (many stocks today are paying higher dividend yields than bond interest rates, plus offering the potential for long-term capital appreciation)? Perhaps all of the aforementioned reasons are sufficient to tip investor psychology more toward the “greed” side of the psychological curve rather than the “fear” side.

The term “Climbing a Wall of Worry” refers to multiple political or geopolitical challenges confronting investors which create fear and uncertainty, but which are deemed resolvable at some point in the future. For instance, the surprise Brexit vote created immediate fear and questions as to the future of the UK and European Union (EU). Within a few days, however, the markets began absorbing the reality that disengaging from the EU would take time and might end up with a “Brexitlite” outcome where the UK would retain access to the European “single market” which is a core element of EU membership. While negotiations between the UK and EU have yet to begin, investor sentiment is leaning toward the expectation that an agreement will be worked out which



might make the best of an unfortunate situation (the markets appeared relieved now that the steady-hand Theresa May has taken the helm as Prime Minister).

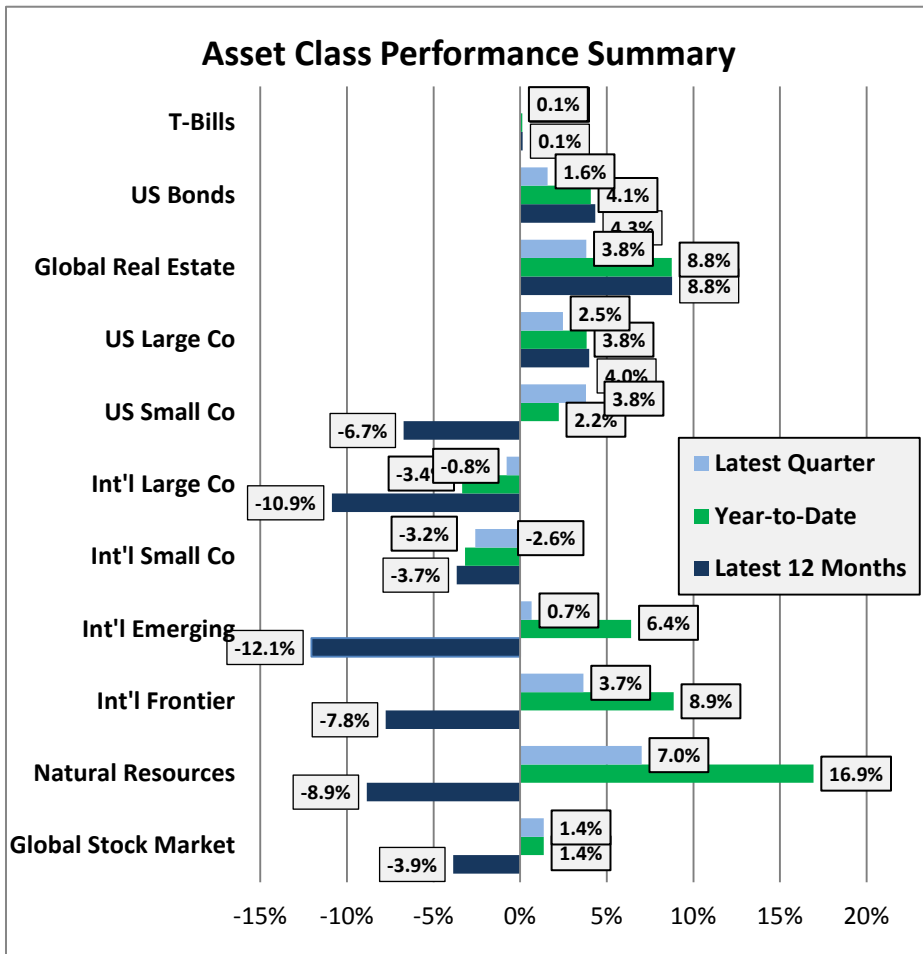
Asset Class Performance Review

For the quarter, the Global Stock Market gained 1.4% with most of the major asset classes posting positive results. The biggest gains came from Natural Resources (+7.0%), US Small Co's (+4.0%), Global Real Estate (+3.8%) and the Frontier Markets (+3.7%). Next in line were US Large Co's (+2.5%), US Bonds (+1.6%), Emerging Markets (+0.7%) and T-Bills (+0.1%). The only losers for the quarter, due in large part to the Brexit debacle, were International Large and Small Co's with respective losses of 0.8% and 3.2%.

For the trailing 12-months, the Global Stock Market lost 3.9% with only four asset classes ending up in positive territory; Global Real Estate (+8.8%), US Bonds (+4.1%), US Large Co's (+3.8%) and T-Bills (+0.1%). The biggest losses were registered in the Emerging Markets (-12.1%), Int'l Large Co's (-10.9%), Natural Resources (-8.9%), Frontier Markets (-7.8%), US Small Co's (-6.7%) and Int'l Small Co's (-3.7%). Clearly, the foreign markets were hardest hit over the past year, but US Small Co's were also out of favor with investors.

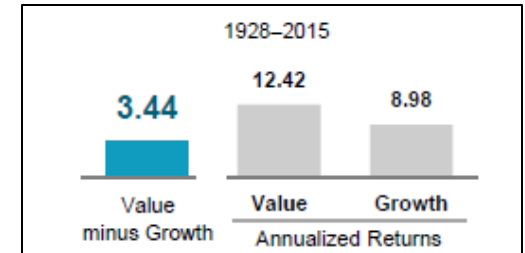
As seen in the chart below, positive returns came from the less risky asset classes toward the top of the chart (T-Bills through US Large Co's), while negative returns came from the more risky asset classes. *Risk aversion* was the best descriptor of the latest 12-month returns; however, in the long-run, the riskier asset classes would be expected to deliver the highest returns.

Included in this report are the year-to-date performance numbers indicated by the green bars. Generally, one can see a possible shift in investor risk appetite as some of the poorest performers over the past 12-months ended up sharply higher; notably, Natural Resources (+16.9%), Frontier Markets (8.9%) and Emerging Markets (6.4%). While most of the returns for 2016 have been positive, Int'l Large and Int'l Small Co's stubbornly remain in negative territory (thanks in part to Brexit).



The Value Stock Premium

One of the most persistent determinants of stock market performance has been the “value premium”, or the tendency for low-priced stocks (i.e., value stocks) to outperform high-priced stocks (i.e., growth stocks) over time; the *premium* being the higher “expected” return from value stocks. While this concept might sound intuitive, human psychology tends to drive investors toward higher-priced stocks since they have likely been the best performers *in the past*. There are various methodologies for measuring stock valuations, including Price-to-Earnings (i.e., P/E Ratios), Price-to-Book Value and the Shiller CAPE Valuation metric (summary definitions are provided on the last page of this report). Academic studies by Nobel Laureate Eugene Fama (University of Chicago) and Kenneth French (Dartmouth) have presented strong evidence supporting the existence of the value premium (their research defined value stocks as those with low prices compared to their book values). For the period of 1928 to 2015, Fama and French found that value stocks outperformed growth stocks by 3.4% annually. Further, in 15 out of the last 18 five-year periods since 1928, value also outperformed growth. There have certainly been periods where growth has outperformed; most notably between 1995 and 2000 when the Technology Bubble sent growth stocks to astronomically high and unsustainable valuation levels. More recently, in 2014 and 2015, growth stocks have outperformed value as well, but over long periods of time, the evidence is so compelling we believe it is sensible to construct portfolios with a strong bias toward value stocks.



Valuations are More Favorable Outside of the US

A recent study published by Norbert Keimling, of the German investment firm Star Capital, examined whether or not the Shiller CAPE and Price-to-Book methods *combined* could be utilized to help forecast future returns of different countries and regions. Keimling found that the Shiller CAPE and Price-to-Book Ratios were fairly reliable in predicting future returns for the US stock market over periods of more than 10 years. In measuring performance in the foreign stock markets since 1979 (the year foreign stock data became widely available), Keimling found that low stock market valuations were also generally followed by above average returns. Importantly, he found the opposite to be true as well, i.e., high stock market valuations tended to lead to lower future long-term returns with higher risk.

In the table below, Keimling lists the “expected” future returns for various countries and regions based upon the current CAPE and Price-to-Book Ratios as well as a combined average forecast. The message is pretty clear; other than Denmark, US stocks have the highest valuations as measured by CAPE and Price-to-Book Ratios. This makes sense given the significant outperformance of US stocks over the past 5 years during a time when the US stock and bond markets were deemed to have been relative safe havens in the face of turmoil and slowing economic growth abroad. Perhaps the US can maintain its lofty valuations relative to non-US stocks (we wouldn’t bet against it in the short-run), but the research suggests that non-US stocks may have significantly more upside potential over the next 10-15 years.

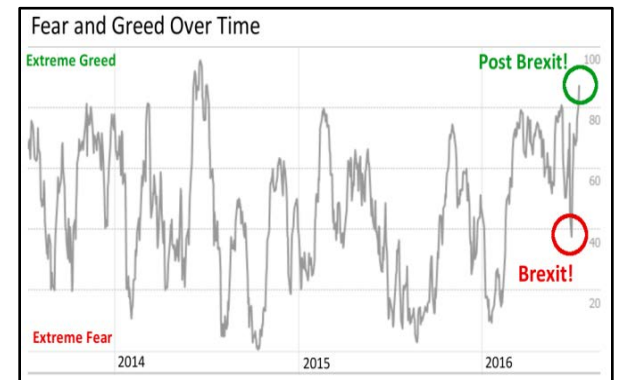
In looking at Keimling’s Expected Returns chart, one might conclude that investing in Italy, Singapore and Spain would provide the highest future returns.

Expected Returns over the Next 10-15 Years Ranked from Highest to Lowest					
Country	CAPE	ROR Forecast	Price to Book	ROR Forecast	Average Forecast
Italy	10.1	10.7%	1.0	11.6%	11.2%
Singapore	11.4	9.9%	1.1	10.7%	10.3%
Spain	9.9	10.9%	1.3	9.6%	10.3%
Norway	11.3	10.0%	1.3	9.4%	9.7%
Hong Kong	14.4	8.3%	1.2	10.0%	9.1%
France	15.5	7.7%	1.4	8.9%	8.3%
Japan	20.7	5.7%	1.1	10.6%	8.1%
United Kingdom	13.2	8.9%	1.8	7.3%	8.1%
Germany	16.0	7.5%	1.6	8.3%	7.9%
Australia	15.4	7.8%	1.8	7.1%	7.4%
Netherlands	17.3	6.9%	1.7	7.7%	7.3%
Canada	18.4	6.5%	1.8	7.4%	6.9%
Sweden	18.1	6.6%	1.9	6.8%	6.7%
Belgium	20.6	5.7%	2.2	5.8%	5.8%
Switzerland	20.5	5.7%	2.4	5.4%	5.5%
United States	24.7	4.4%	2.8	4.2%	4.3%
Denmark	36.6	1.6%	3.0	3.7%	2.7%
Regional Summary					
World AC	19.1	6.2%	1.8	7.2%	6.7%
Developed Markets	20.0	5.9%	1.9	7.0%	6.4%
Developed Europe	14.7	8.1%	1.6	7.9%	8.0%
Emerging Markets	13.6	8.7%	1.6	8.2%	8.4%
Source: StarCapital Research, January 2016: "Predicting Stock Market Returns Using the Shiller-CAPE: An Improvement Toward Traditional Value Indicators?"					

While this *might* be the case, there are various country specific risks, including political risks, which must be considered in the diversification process. To minimize such risks, our approach is not to select specific countries (other than the United States); rather, we construct portfolios using regionally diversified mutual funds. For example, the DFA International Vector Fund, one of our core holdings, invests in more than 4,500 companies doing business in more than 20 countries across non-US Developed Markets. The fund’s current global allocation is 56% in Developed Europe, 24% in Japan, 12% in the Asia Pacific region, including Hong Kong and Singapore, and 8% in Canada. According to Keimling’s research, each of these countries and/or regions offers the potential for higher rates of return over the long-term. In addition, the DFA Int’l Vector fund has a strong overweight to value stocks which, we believe, further improves the fund’s appreciation potential.

Investing in Volatile Times

We’ve had a string of bad news recently with Brexit a few weeks ago and, more recently, social and political unrest here at home. Given these and the many geopolitical challenges a round the world today, it’s no wonder investor pessimism has been steadily rising over the past few months as evidenced by mutual fund flows out of stock funds into bond funds (and other safe haven assets). Investor psychology, however, is quite fickle and can turn very quickly as seen in the *Fear and Greed Index* graph below (source: CNN Money). The Index is comprised of various technical stock market indicators which measure investor fear and greed on a daily basis. When fearful, investors tend to move money out of stocks; when feeling more optimistic, greed drives investors to move money into stocks. The problem with acting on emotional reactions to market events is that many investors end up selling at lower prices and buying at higher prices (a sure formula for failure!). In looking at the Index over the past few weeks, note how sentiment turned sharply lower following the surprise Brexit vote (red circle) and how rapidly the Index turned toward extreme greed within a matter of days (green circle). Also note the remarkable swings in market psychology between fear and greed over the past three years.



Given the inherent volatility of the stock market and knowledge that human emotions can often lead to costly mistakes (e.g., reacting to events in counterproductive ways), our approach is to structure portfolios with a combination of both safe haven assets as well as assets with capital appreciation potential, i.e., a *balanced* portfolio. The allocation to high quality bonds provides a safe haven in times of market turmoil as well as a source of liquidity and cash flow during prolonged down market periods. At the other side of the equation are globally diversified stocks (with a bias toward value!) which provide an opportunity for long-term capital appreciation. By establishing an appropriate balance between the two, we believe one's portfolio is better able to weather the inevitable economic storms in the future while improving the chances for a successful investment outcome over the long-term.

Closing Thoughts

Let me close with a quote from Warren Buffett who cautioned investors about letting emotions drive their investment decisions, "To invest successfully does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding the framework."

Finally, as we appreciate summertime and all of our life's blessings, let us not forget those who are suffering at home and around the globe. Here's to a more just and peaceful world.

Definitions from Investopedia:

- **Price-to-Earnings Ratio:** The price-earnings ratio (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings. In essence, the price-earnings ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. This is why the P/E is sometimes referred to as the multiple because it shows how much investors are willing to pay per dollar of earnings. If a company were currently trading at a multiple (P/E) of 20, the interpretation is that an investor is willing to pay \$20 for \$1 of current earnings.
- **Price-to-Book Value:** The Price-to-Book Ratio (P/B Ratio) is a ratio used to compare a stock's market value (i.e., Price) to its book value (or net worth of the business). It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. Stocks with lower the P/B Ratios are less expensive than stocks with higher P/B Ratios.

$$\text{P/B Ratio} = \frac{\text{Stock Price}}{\text{Total Assets} - \text{Intangible Assets and Liabilities}}$$

- **Shiller CAPE Ratio:** Devised by Nobel Laureate Robert Shiller of Yale, the Cyclically Adjusted Price-to-Earnings Ratio, commonly known as CAPE, Shiller P/E, or P/E 10 ratio, is a valuation measure derived by dividing the price of stocks by the average of ten years of earnings (moving average), adjusted for inflation. As such, it is principally used to assess likely future returns from equities over timescales of 10 to 20 years, with higher than average CAPE values implying lower than average long-term annual average returns.

Norbert Keimling's study (Star Capital): *Predicting Stock Market Returns using Shiller CAPE*,
www.starcapital.de/files/publikationen/Research_2016-01_Predicting_Stock_Market_Returns_Shiller_CAPE_Keimling.pdf