

AEQUITAS INVESTMENT ADVISORS

INVESTMENT REPORT - FOURTH QUARTER 2015

Date: January 15, 2016

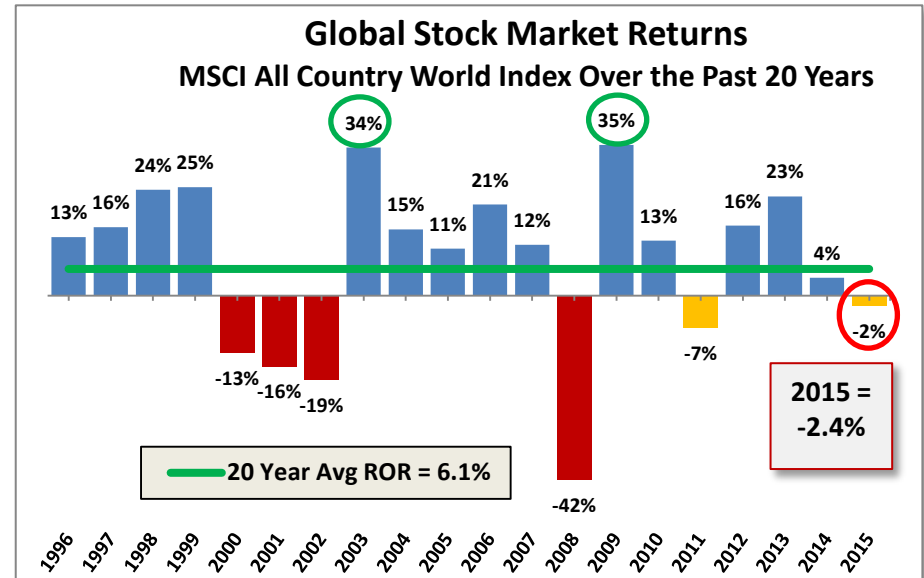
Subject: Outlook for 2016 – A Year of the Bull or Bear?

Greetings,

Investment historians have divided the jagged path of stock prices into either Bull or Bear Market periods. A Bull Market represents an extended upward movement in stock prices usually accompanied by an economic expansion. Over the past 85 years, Bull Markets have lasted an average of about 8 years with an average cumulative gain of 130%. A Bear Market, on the other hand, represents an extended period during which stock prices decline by at least 20%. The average length of a Bear Market is 18 months with an average cumulative loss of 40% (Bear Markets have usually coincided with recessions). The last Bear Market was during the Great Recession when stocks declined by 42% in 2008 (they fell even further in early 2009 before bottoming). The current Bull Market began in March of 2009 and has lasted for close to 7 years. Stocks have climbed around the globe by more than 150% since 2009 and now sit about 16% below their record high which was reached last May. In looking at the past 20 calendar years (refer to the graph at right), we've experienced two Bear Markets covering a total of four years (the Tech Bubble in 2000 through 2002 and the Great Recession in 2008); the other 16 years would be considered Bull Markets (a ratio of 4 Bull years to 1 Bear year which is close to the historic average ratio of 5 to 1). We've had two slightly negative years (2011 and 2015), but those declines occurred within the current Bull Market.

Over the past 20 years, stocks have delivered sub-par performance with an average annual gain of just 6.1% compared to the 85 year historic average of close to 10%. Note, however, there has never been an *average* return in any one of the past 20 calendar years; the range of returns has fallen between a loss of 42% and a gain of 35%. Importantly, the two biggest gains (green circles on the graph) followed the two largest losses which is one reason why attempting to time the stock market is a perilous endeavor (i.e., stocks tend to register their biggest gains very quickly following the end of a Bear Market).

In looking at performance on a non-calendar year basis, during the current Bull Market there was one four month period in 2011 when stocks fell globally by just about 20% (April through September of 2011 during the European and US Debt Crises), but they quickly regained sustained upward momentum, thus disqualifying the period as a Bear Market. We've had numerous 10% corrections during the current Bull Market; the most recent being last August and September when stocks retreated by almost 14% before moving upward. A troubling sign is that 2016 has begun on a "bearish" note with the Global Stock Market down about 8% given reactions to China's economic slowdown and worsening geopolitical tensions. We now find ourselves very close to crossing



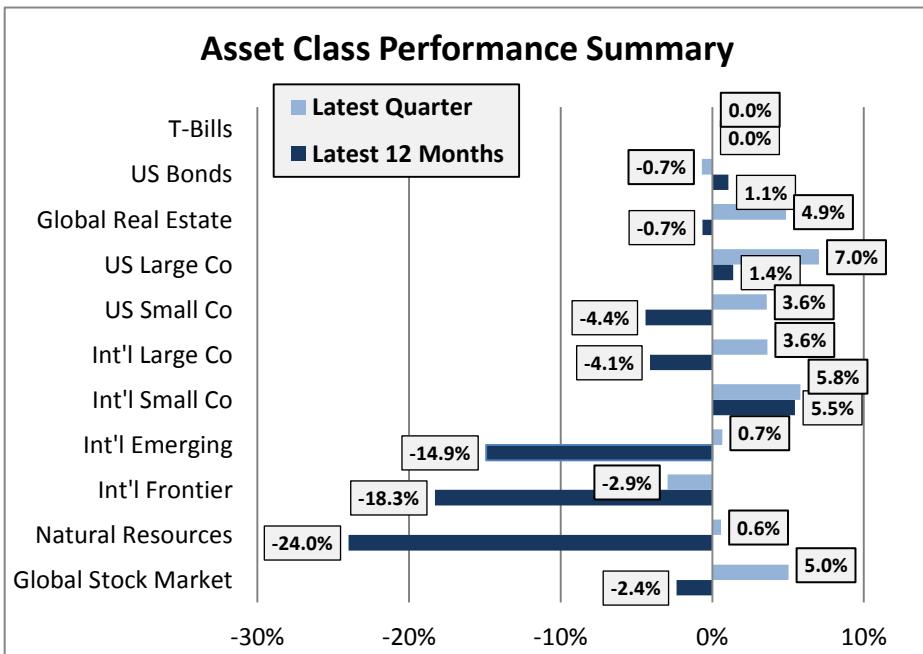
into Bear Market territory when measuring how far stocks have fallen since their record high of last May (stocks have declined by 16% since that point). While it appears the odds of falling into a Bear Market have increased (we're just 4% shy of the 20% threshold), it's not clear whether or not this represents a precursor to a recession. Most economists are forecasting continued slow growth in 2016 which is an outlook supported by current economic data, including the better than expected December US jobs report. Later in this letter we'll review some of the predications for 2016 from the prognosticators, but

first, let's take a look back at 2015; a very volatile year, but one which ended about 2% lower than where it began.

Asset Class Performance Review

The latest quarter ended up being positive for most of the major asset classes following the 14% stock market correction in August and September. Investors appeared to view the correction as a buying opportunity and seemed to shrug off initial signs of China's slowdown as well as the Fed's decision to raise interest rates. The Global Stock market advanced by 5% led by US Large Co's (+7.0%), Int'l Small Co's (+5.3%), Global Real Estate (+4.9%) and Int'l Large and US Small Co's which were tied +3.6%. Emerging Markets and Natural Resources posted minor gains (+0.7% and +0.6% respectively). US T-Bills were flat. The only losers were US Bonds (-0.7%), reflecting an adjustment to higher interest rates, and the Frontier Markets (-2.9%).

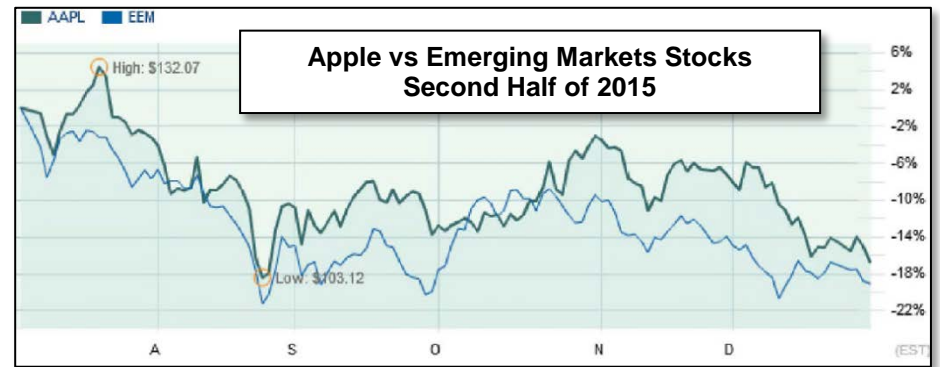
Performance over the latest 12-Months was a different story with most of the asset classes landing in negative territory. The best performance for the year came from Int'l Small Co's (+5.5%), US Large Co's (+1.4%) and US Bonds (+1.1%). The biggest loser was Natural Resources (-24%) as depressed oil and commodity prices weighed heavily on producers. Emerging Markets (-14.9%)



and Frontier Markets (-18.3%) were also dragged lower by falling commodity prices, although those emerging economies which import oil and commodities fared much better (e.g., Emerging Asia). International stocks in general were negatively impacted by the stronger US Dollar which shaved about 5% off their performance when adjusted for currency exchange rates. Int'l Large Co's and US Small Co's fell by 4.1% and 4.4% respectively. Global Real Estate lost 0.7% and US T-Bills were flat. The Global Stock Market was down 2.4% for 2015 following three consecutive years of gains.

Has Apple Become An Emerging Market Stock?

With Emerging Markets stocks performing so poorly in 2015, it's instructive to examine how Apple stock did in comparison (this may help explain why stocks have been sinking around the globe of late). As sales in the US and other Developed Markets have been slowing in recent years, Apple has focused much of its marketing toward the growing pool of middle class consumers in China and other emerging economies. Their strategy makes sense given the estimate



that the world's middle class will swell from 2 billion currently to about 5 billion by 2030 with most of the growth coming from Asia and other developing economies (according to the Organization for Economic Co-operation and Development). Apple's Asian marketing strategy has been highly successful so far as revenue from China in the fourth quarter grew by 99% year-over-year; in fact, China produced 62% of Apple's \$51.5 billion in iPhone sales according to a recent earnings report. (Vietnam has also been one of Apple's fastest growing markets with sales having tripled in the first half of the 2015 fiscal year.) While Apple may be somewhat unique in its commitment to expanding in the Emerging and Frontier Markets, the growth of multinational corporations in general will depend more and more on the growing pool of middle class consumers in the developing world.

Looking Into the Crystal Ball

While pundits over the ages have attempted to predict the future path of stocks, the collective track record of the prognosticators has been dismal. Nonetheless, akin to the ritual held each year in Punxsutawny, Pennsylvania (i.e., Groundhog Day), at the beginning of each year pundits come out of their burrows to offer a range of stock market forecasts typically running the gamut from pessimism to



optimism (while we have not seen a statistical tabulation of the accuracy of such prognostications, our guess is it might be close to Punxsutawny Phil's 39% success rate at predicting the end of winter). For 2016, the range of forecasts seems particularly divergent, perhaps due to the larger list of uncertainties (i.e., geopolitics, national politics, etc.). While we do not recommend basing one's investment plan on speculation, each year we offer a representative sample of thoughtful forecasts from various strategists and economists.

A Bear Market Case

Given that stocks have already fallen by more than 16% since their record high last May, it wouldn't be a stretch to predict we'll enter a Bear Market, especially given the slowdown in the Chinese economy and worsening geopolitical conditions. A bigger concern, however, is not that stocks will fall another 4% to cross into Bear Market territory, but whether or not this would be indicative of a global economic recession. Such is the fear of Larry Summers (former US Treasury Secretary) who sees the slowdown in China and the falling demand for oil and other commodities as possible catalysts for a global recession. In the past, according to Summers, "international developments have had only a limited impact on the US and European economies because their impact could be offset by monetary policy action." For example, during the Asian Financial Crisis in 1998, the Federal Reserve lowered interest rates to stimulate growth which served to offset the negative impact on our economy of Asia's economic slump. With interest rates at zero, or near zero, the ability of the Federal Reserve (and other central banks around the globe) to further stimulate the economy is limited (i.e., fewer arrows in the quiver). Such a predicament makes us more vulnerable to China's economic slowdown.

Middle Case Forecast

The most thoughtful and detailed forecast we studied was that of BCA Research, a highly regarded independent provider of global macroeconomic research. Their 2016 forecast includes both a 12 month and 10 year estimate of future investment returns based upon conservative valuation methodology as well as global economic data and trends. The following are some key bullet points from their outlook:

- The era of rapid economic growth is probably behind us given the aging population in the developed world (i.e., fewer young workers entering the labor market). According to BCA, investor expectations need to adjust to the fact that sub-par growth and low inflation will persist for many years.
- High levels of debt will constrain income growth; however, on the plus side, consumers will benefit from low energy prices and low inflation.
- BCA predicts another mediocre year for the global economy and the stock market (their base case does not call for a recession). Stocks may appreciate by 5% on average, but better returns may come from European and Japanese stocks which are more attractively valued than US stocks.
- From a geopolitical perspective, BCA believes additional terrorist attacks are likely, especially as ISIS continues losing the conventional ground war. However, while disturbing, the effects of such events on the economy would be largely psychological and transitory (an unfortunate reality in our world today).
- Over the next 10 years, BCA forecasts annual returns of 4.5% for US stocks, 6% for non-US Developed Markets stocks and 8.5% for Emerging Markets stocks, although they see continued near-term pain for the Emerging Markets (although they happen to like Chinese H-Share stocks following the last few weeks of decline). They expect bonds to average just over 3% with inflation remaining low at 2%. (All in all, not a discouraging long-term outlook, but significantly lower expected returns for stocks than the historic averages.)

A Bull Market Case

One of the most optimistic forecasts came from Jim Paulsen, Ph.D. and Chief Investment Strategist at Wells Capital Management. The following are some of his key bullet points:

- The global economy may see a “bounce” in activity in 2016 from a lagged response to a “powerful trio” of stimulus: (1) lower energy and commodity prices providing the equivalent of a major fiscal tax cut for consumers and businesses; (2) favorable monetary conditions (i.e., continued low interest rates for borrowers) and (3) large currency devaluation benefiting just about every country except the US (i.e., weaker currencies can create a competitive advantage for foreign corporations).
- The US household sector is in “far better” shape than at any time during the current recovery. Unemployment has dropped from 10% to 5%; consumer confidence levels are close to post-war highs; net worth has risen by more than 50% from the 2009 low point; and wages are now growing faster than at any time during the recovery.
- Paulsen expects the US Dollar to weaken slightly against foreign currencies as US growth benefits less from the global economic bounce.
- Paulsen forecasts US Large Cap stocks to end the year flat (with a lot of volatility, similar to 2015), but he sees better returns from foreign stocks, commodities and, to a lesser extent, US Small Cap stocks.

The Investor’s Dilemma

Given all of the uncertainties around the globe and the diverse range of predictions from the prognosticators, how should investors prepare for the unknown? Should we put our money in a mattress and wait it out until the global economic picture settles down? That approach might feel good initially, but sooner or later we’d have to pull money out of the mattress and put it to work in order to achieve our financial goals (also, mattresses are not FDIC insured). Furthermore, if we wait until things “settle down”, we may never end up getting back into stocks as the world will always be filled with uncertainties. The antidote to this dilemma, we believe, is to invest across a spectrum of diversified investments ranging from safe haven assets (in case the pessimists are correct in their forecasts) to higher risk assets which offer the potential for superior long-term appreciation (in case the optimists are right). After all, investing is not an all or nothing exercise; not the black and white game of “risk on” and “risk off” that’s played by the talking heads on CNBC and other financial news outlets (we do find Jim Cramer entertaining, however). Investing is all about finding the right “balance”, i.e., an appropriate mix of safe haven assets (high quality bonds) and stocks which have the potential over the long run to achieve the investor’s lifetime financial goals under a wide range of potential economic developments.

The Balanced Approach

While we can neither predict nor control the future path of the investment markets, history has taught us valuable lessons which can guide us during volatile times like these and improve the odds of a successful outcome. Perhaps the most important lesson is to structure our portfolios with an appropriate balance between Fixed Assets and Equities; i.e., between safe haven assets and growth assets. Having a sufficient allocation to safe haven assets, including high quality short-term bonds, shields a significant portion of our portfolios from market risk and provides liquidity and cash flow when needed. History has demonstrated that a balanced portfolio has successfully weathered all past recessions, including the Great Depression and Great Recession. Furthermore, we know from recent history that a balanced portfolio doesn’t just help to limit downside risk, but importantly, also provides the opportunity to rebalance and buy stocks when prices are depressed (i.e., following the principle of buying low, or Warren Buffett’s approach of being greedy when others are fearful). Finally, while living through volatile times and Bear Markets is unpleasant from a psychological standpoint, we know that buying stocks at depressed prices is one of the most profitable actions an investor can take. A balanced portfolio provides that opportunity.

Twenty Five Years!

Aequitas was founded in 1991 based upon the belief that serving our clients’ *best interests* was the ideal way to create a successful company. We believed then, as we do now, that we can best accomplish this mission by providing independent and objective advice with a genuine concern for our client’s wellbeing. We believed then, as we do now, that we can provide high quality and highly personal service at a fair cost. The name Aequitas (The Roman Goddess of Fairness) was suggested by the founder’s father given its meanings in Latin which include honesty, fairness and equanimity*. At this important twenty-fifth anniversary of our founding, we would like to offer our appreciation for your continued trust and confidence!

* The dictionary defines “equanimity” as “mental calmness, composure, and evenness of temper, especially in difficult times.” Amen.