



October 2015

## Market Commentary and Review

by Brad Bickham, CFA, CFP®

### SUMMARY:

The economy will continue to grow in the low 2% range for the next few quarters.

Earnings growth stalled in 2015 due to low oil prices and a strong dollar, but should grow in 2016 by 5% to 10%.

Inflation is low and will not change much in the near future. The Fed may or may not raise rates this year – now 50-50 odds.

Model Equity portfolio is outperforming the S&P 500 by 6%. Actively managed mutual funds slightly better than index funds on average.

Have you made sure your assets are protected? It might take more than an umbrella policy.

Read on page 6 how SBL is giving back to our community.

### In This Letter

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*The line it is drawn      Will later be past  
 The curse it is cast      The order is rapidly fadin'  
 The slow one now      And the first one now will later be last  
 Will later be fast      For the times they are a-changin'  
 As the present now      – Bob Dylan*

Dear Clients and Friends,

Following are returns for the last one, five, and ten years.

Returns as of September 30, 2015	3rd Qtr 2015	Year to Date	Last 12 Months	Last 5 Yrs. Annual	Last 10 Yrs Annual
60/40 Balanced World Index	-4.3	-2.6	-1.3	6.8	5.4
World Stock Index (ACWI)	-9.6	-6.8	-6.2	7.0	4.8
Large Cap U.S. Stocks	-6.4	-5.3	-0.6	13.3	6.8
Small Cap U.S. Stocks	-11.9	-7.7	1.2	11.7	6.6
Foreign Stocks – ACWI ex U.S.	-12.2	-8.6	-12.2	1.8	3.0
Foreign Stocks - Emerging	-17.9	-15.5	-19.3	-3.6	4.3
U.S. Bonds – Taxable	1.2	1.1	2.9	3.1	4.6
Hedge Fund Index	-2.3	0.3	1.3	3.0	2.6
Gold	-4.8	-7.6	-8.4	-3.1	8.9

Are the times a-changin? Has the bull market ended?

After the brutal 3rd quarter, this is a valid question and one that is on many people’s mind. As usual, we need to review the six investment pillars. Before doing so, however, we’d like to describe our approach to financial analysis. We call it quantitative, qualitative, and technical:

- Quantitative – “Just the facts ma’am”.  
By definition this must be backward looking.
- Qualitative – What we think about the facts.  
What nuances are in the facts? What do we think about the future based on the facts?
- Technical – analysis of charts and trends.  
What can momentum and relative performance tell us?

Most firms specialize in only one of these three methods. We try to use all three, and we do this for each part of our process including asset allocation, stock analysis, and mutual fund selection. For example, the six pillars are part of our asset allocation process. As a reminder the pillars are:

- I. The Economy
- II. Earnings Growth
- III. Inflation & Interest Rates
- IV. Valuation
- V. Financial Stress
- VI. Political / Geo-political Risks

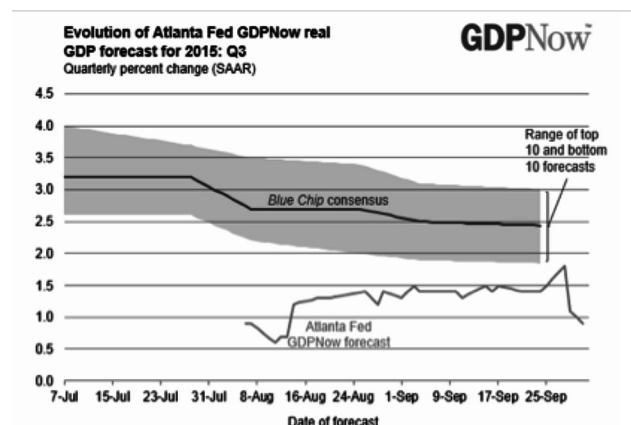
**Let's begin with the facts ma'am.**

1. The economy grew 3.9% in the 2nd quarter, 0.6% in the first quarter, or about 2.25% average for the first half of the year.
2. Trailing 4th quarter earnings for the S&P 500 through June 30th were \$108, which is down from \$113 in 2014.
3. Trailing 12 month inflation (Consumer Price Inflation CPI) was 0.2% through August 2015.
  - a. 2 Yr. Treasury yield is 0.6%, up from 0.5% a year ago.
  - b. 10 Yr. Treasury Yield is 2.0%, down from 2.4% a year ago.
4. The P/E on the S&P 500 at 9/30/15 was:
  - a. 17.8x on trailing earnings
  - b. 15.2x on estimated forward earnings
5. The St. Louis Financial Stress Index was most recently at -0.65, which is in the 'all clear' zone; however it has been rising for over a year. In July 2014, it was at -1.5. Fears about Greece have been replaced with fears about China.
6. In regards to politics and geo-politics, Syria and Russia are in the headlines; and the U.S. presidential race has begun. Because there is so much uncertainty about the eventual outcome, and because the policies of the candidates are very different (consider for example the differences between Bernie Sanders and Donald Trump), the market will have more uncertainty than normal about future tax and government spending policies.



**Now, let's go through the same exercise from a qualitative point of view.**

1. The economy appears to be doing fine. However, the recent jobs report for September was weaker than expected and there have been several other indicators pointing to a slowdown in economic growth. The Atlanta Fed's GDPNow forecast is for 0.9% growth in the 3rd quarter. That would be a significant decline from the 2.25% average for the first six months of 2015.



2. S&P Earnings are projected to rise by 10% to 15% in 2016 vs. 2015. The main source of that rise is a partial recovery in the earnings from energy companies. It seems plausible but it is certainly not guaranteed. Here is the history of the earnings of the S&P 500 Energy sector over the last few years along with the average price of oil.

Year	Earnings	Oil Price
2008	50.93	91
2009	17.26	53
2010	35.21	71
2011	47.94	87
2012	44.30	86
2013	42.35	98
2014	42.93	93
2015 Est.	6.89	49
2016 Est.	20.37	54

\*from Standard & Poors, Energy Information Agency and InflationData.com

3. Inflation is not expected to change much. The core rate is closer to 2% than the headline rate reflects. Whether and when the Fed begins raising rates has been a big pre-occupation in the financial press and for investors generally. For everyone else, it is hard to see how a ¼ % rise in rates makes much of a difference. After the recent Jobs Report, it looks like Brad will lose a burrito to Steve (the Fed won't raise in 2015); but we cannot be sure. They would probably be doing themselves, the economy, and the markets a big favor if they would go ahead and raise by a quarter and include an announcement that they would likely leave things alone for six months. The uncertainty is bothering everyone more than anything.
4. There are a number of ways to look at valuation, and we don't follow just one. In general, we think the market is fairly valued. The P/E ratio is actually a little lower than it has averaged over the last 27 years. Since 1988 the S&P 500 P/E has averaged 18.7 vs. 17.8 today. For those unfamiliar with P/E it is the Price divided by Earnings ratio. The current price of the S&P 500 is 1,920 and the last 4 quarters of earnings was \$108; thus  $1,920/108 = 17.8$ .
5. Financial stress (uncertainty) has definitely increased recently, but there is not any indication things are going to spiral out of control.
  - a. The U.S. banking system has been increasing capital and is under more scrutiny than ever before. It is arguably safer than it has been in decades.
  - b. Having worked through the Greek crisis without imploding, the Europeans are in a better position than they have been for many years.
  - c. Japan is undergoing a monetary experiment of easing monetary policy while restricting fiscal policy. The ultimate outcome is uncertain, but Prime Minister Abe has the confidence of the people and the markets.
  - d. China announced they were going to allow the Yuan to float more freely and the currency was devalued by about 2%. This is not an earth shattering change. There are other uncertainties about China however, including how fast or slow the economy is really growing, whether there is a real estate bubble, and whether their stock market is overvalued.
6. Finally, the political landscape has started shifting.

It is common for the equity market to take a wait and see attitude during an election year – especially when the outcome is uncertain and the differences are wide. Hillary Clinton and Donald Trump are the current front runners, but things are likely to change and will continue adding uncertainty and volatility to the markets in the coming months.

We will save a discussion about Technical Analysis for another day. What then can we conclude by combining our quantitative and qualitative analysis? First, the economy is growing in the low 2% range and likely to keep doing so. Earnings should improve over the next year, but it is uncertain how much. Analysts might be overly optimistic about the rebound in energy earnings. Valuation is ok, but not great. There are risks and uncertainties in the political and geo-political landscape, but when aren't there? This should not drive investment returns, but does add to the uncertainty level. The Fed has also contributed to the level of uncertainty with their public dithering over policy. The sooner they give the market some clarity the better.

So to answer the question from the beginning... Are the times a-changing? A little bit maybe, but not that much. We think the market probably got a little ahead of itself last year, and this sort of consolidation period is to be expected. For stocks to be down 5% considering the issues and uncertainties listed above, and considering the gains over the last 5 years seems about right. This economic and market cycle probably has room to go further, albeit with set-backs from time to time like we endured last quarter.

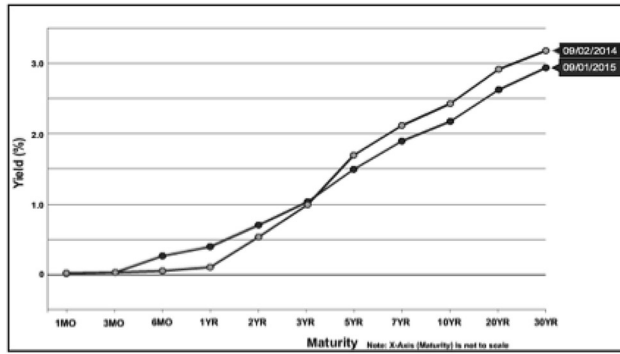
## Market Environment and Strategy

### Equities

We have not changed any of our equity targets yet. Once again, U.S. large cap stocks have outperformed foreign stocks. In the 3rd quarter, the ACWI-ex U.S. index fell -12% vs. the S&P 500 losing only -6%. Similarly, small caps fell -12% and emerging markets fell even more -18%. We are not, however, anxious to re-allocate. Foreign equities have appeared undervalued relative to the U.S. for some time, but every time we have increased our allocations some foreign crisis or another has led to underperformance.

### Fixed Income

Bonds will probably continue the path they have over the last year or so, with short term rates rising slightly and long term rates remaining flat or falling. The chart



above shows the changes in the yield curve over the last 12 months. One might ask why, if we believe this, wouldn't we invest in longer term bonds. After all, their price rises when rates fall. The answer is that the risk-reward does not seem balanced to us. Longer term bonds, such as the 10 Year U.S. Treasury bond, yield only 2% today. If interest rates rise or fall by 1%, the prices of these bonds will move 7% - 8%; and what do you think is more likely for 10 year bonds... 1% yields or 3% yields? As value investors, we cannot agree with arguments for longer term bonds. We will continue to lean toward a more conservative approach to investment grade fixed income, even though the much anticipated day of rising rates never seems to get here.

### Alternative Strategies

We continue to refine our approach to liquid alternative investments. Our research has led us to make some changes to categories this year. For example, we have invested in real estate investment trusts (REITs) and master limited partnerships (MLPs) from time to time. These were included in our Alternatives category as they have characteristics of both stocks and bonds – growth and higher income. However, the risk profile of both groups has exceeded what we are trying to accomplish in our Alternatives Strategy, so we have re-classified them as equities. We have also re-classified structured CDs and notes, and certain bond funds as alternatives.

Why the changes? We want to be able to communicate with Clients effectively about the characteristics of their portfolios. This includes return *and* risk. The objectives of this strategy for most portfolios is to a) outperform bonds, b) do so with less risk than stocks, and c) attempt to outperform bonds on a risk adjusted basis. The strategy has accomplished the first two goals with flying colors. The third goal has been more difficult. By focusing on the risk of the strategy, we were led to re-classify certain investments and make some changes that effectively 'de-risked' the group. This should help the Alternatives Strategies Group hold up better during

corrections. The changed classification only meant a couple of actual trades in portfolios.

### Strategy and performance

Our allocation targets have changed a little from last quarter, but not by much. We have lowered our targeted allocation to international equities by 2% - 3% and for now are comfortable holding that in cash. We hope the international sector begins outperforming again and then we would increase our targets back to where they were, but after a series of false starts we would rather wait for some clear signs international investments have turned the corner before adding to holdings.

Regarding performance, most balanced portfolios are down this year between 2% and 4% (depending on client preferences and specifics). This is right in line with, or slightly better than, the 60/40 Balanced World Index we track. Our best performing strategy on a relative basis has been our individual stock portfolio. Our Model Equity portfolio was up 0.9% vs. a drop of -5.3% for the S&P 500, giving us a ytd advantage of 6.2%. We are not popping champagne yet, however, as we know things can change before year end. Our actively managed mutual funds are generally having a better year versus their indexes, but this correction has leveled the playing field.

### Financial Planning

*By Gary Powell*

#### Broad Issues to Consider in Asset Protection Planning

##### What is Asset Protection Planning?

Asset protection planning has become a topic of amplified interest, especially after the Great Recession. Folks are evaluating their risk of loss at mid to late career ages to conserve their family's wealth. As one expert in this field wrote, "Asset protection planning is best analogized to "net worth planning insurance." The most effective and legally supportable options available to you are before the crisis exists. So let's start today. Many believe that asset protection is analogous to insurance. We agree that the first line of defense of traditional asset protection planning is the purchase of liability insurance – automobile, homeowner, umbrella, officers and directors, malpractice and the like. Unfortunately, liability insurance may actually encourage lawsuits since it is perceived as "easy money". Moreover, liability insurance often has "gaps in coverage", policy exclusions and the hassle of dealing with claims with insurance companies. Additionally,



the coverage that you may require may exceed what the insurance carriers are willing to underwrite.

With that as groundwork, let's turn to the broad issues to consider when evaluating your asset protection plan. Keep in mind, that the information in this newsletter is not specific to you or your family's situation. The concepts included here do not cover all circumstances and are never a substitute for consulting with an experience professional.

### **Relying on Your Estate Planning:**

A common response is, "I've got this covered. I have my home, cars and investments all titled in my "Trust". Usually the "Trust" is a Revocable Living Trust and it is not an effective protection. This trust will simply be ignored in a legal proceeding. While we encourage everyone to complete a personalized estate plan, it is important to realize that this is "*death planning*". What have you done about your life planning? This includes your exposures practicing your profession, driving a car, having children (who may also be driving a car) or having employees.

### **All Your Eggs in One Basket**

We often see Limited Liability Companies (LLC) used as a barrier between individuals and their investments. The LLCs are commonly used in residential and commercial real estate. The risk develops when the individuals fail to adequately segregate and subdivide assets so that they are protected from the owner and each other. For example, combining under one LLC dissimilar properties such as property with a mortgage, property with no mortgage, raw land, a duplex, and a commercial strip mall may expose all the properties to a liability emanating from just one of the properties. A single event could wipe out the entire real estate portfolio. It is also important to adhere to the legal formalities of a separate entity (LLC, corporation or limited partnership) to avoid risks to personal assets.

### **Rolling Liability into Your Plan:**

Separate business legal entities, LLC and S-Corporations, that are used to safe guard attractive personal assets (such as cash, stocks, bonds and other liquid assets) can be easily compromised. If you lease or own your personal vehicle or your business vehicles through your business entity, you have linked the most dangerous asset, your car, to the source of your wealth. You are actually un-doing the protection and legal segregation of risks these structures may have provided.

### **A Word on Umbrella Policies:**

As one expert in this field explains, "To you, your

umbrella policy means everything (hence the name – umbrella policy); to your insurance carrier, it means specific events in the base policy, covered to specific limits and governed by a specific set of exclusions detailed in the fine print of your policy". Clearly two diverging definitions. The lesson here is that there is no real way to insure yourself against a universe of possible exposures and have every single one covered to an unlimited dollar amount, nor is this reasonable to expect of your liability coverage.

### **Can the Impossible Become Possible?**

Imagine the shock awaiting the well-intentioned parents who went away for the weekend leaving their teenage daughter in charge of their multi-million dollar home when, upon their return, they discovered that she had thrown a party at which a friend of a friend had died. Cause of death: drugs brought onto the property by the deceased friend. Consequence: wrongful death lawsuit.

The unimaginable becomes reality at the most unexpected time. You may feel that your business and family's exposures are low because of your profession, the care that you take with your financial affairs and your awareness of the "impossible". However, we encourage you to review your risk in a balanced and professional manner.

### **Company News**

*By Patty Meneley, COO*

October will be an interesting month for SBL. We have TWO employees who will be married on October 3<sup>rd</sup>. We know you'll want to wish Jordan and Christiana (who are NOT marrying each other, by the way) and their new spouses the best of luck and happiness. As a result of all this merriment, we will have some significant vacation schedules to cover for as you might imagine. Both Jordan and Christiana and a few other employees will be on vacation for parts of October and we will be fairly short staffed during these times. If you happen to encounter more recorded greetings than you are accustomed to, at least now you know why. Our apologies for any inconveniences this might cause. We'll be back to full strength in November.

Another big piece of news for SBL is that we have had a few personnel changes. As many of you already know, Lindsay Boylan left us last month to continue with her swim coaching/teaching career. We have missed her but will be welcoming a new employee, Shannon Knight, on November 2<sup>nd</sup>. Shannon will be our new

client service manager and we are confident she will be a great addition to the team.

SBL recently participated in a build day with Habitat for Humanity. We assembled a team that worked on a jobsite in Jamestown, Colorado. Jamestown suffered extensive damage in the flood of September 2013 and is still in the process of rebuilding. We were excited to help with one of the houses being built. It was a great day to get outside and work with our hands. We were pretty proud of the amount of physical work a group of desk jockeys can actually do! Look to [www.sblfinancial.com](http://www.sblfinancial.com) for photos of us in action.

## The Last Word

*By Rick Lawrence, CEO*

As I write this, the stock market has already recovered almost half of what was given up over the course of the entire third quarter. But, it has been a hard year to make money with any kind of balanced investment portfolio. Just look back at the chart at the top of the newsletter. This kind of market performance raises questions.

Brad's section of the newsletter is right on point. He summarizes our approach to looking at investment opportunities, using quantitative, qualitative, and technical analysis approaches. Then he explains how we apply that work to the selection of the various investments in each of our portfolios and overlays that explanation with a review of current market data and conditions. Good update.

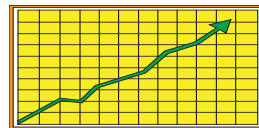
If you have questions about the performance of your account, I encourage you to contact your advisor. He or she is ready to discuss our strategies and how they have

been applied to your particular portfolio. You don't have to wait for your regular review session if you have questions or just want an update on how your account has responded to the conditions of the last several months, and how it is positioned for the future. Talking together about these things is part of our service, and those sessions help us to make decisions that match up well with your goals and tolerance for risk.

In his section on Financial Planning, Gary has reviewed a number of strategies associated with Asset Protection Planning. This work goes hand in hand with creating your financial plan, and managing your investments. There are a variety of actions you can take to protect the assets you have. This section is worth a review.

Building long term relationships and helping clients invest in portfolios that can weather the ups and downs of the markets, and grow over time, is what this business is all about. More than 40% of our clients have worked with us for 10 years or longer, and have seen several bull markets, corrections, hiccups, bubbles, etc. A good part of the growth in our company has come from creating success for these long term clients. We value your loyalty, and look forward to building for the future, with you.

*Many happy returns,*



*Sargent Bickham Lagudis*

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