KWAG August E-mail Update

Good Afternoon. One of the reasons I absolutely love being a register investment advisor (RIA) is there never seems to be a dull day or week. There always seems to be something interesting and exciting going on around the globe from an economic and/or political standpoint. For example, over the last month, the broader based news has revolved around Argentina's Debt, Afghanistan's Politics, the ongoing clashes in the Middle East, the Russia/Ukraine war and numerous plane crashes. Just when we think it can't get any worse, another crazy global "event" occurs again. Interestingly, as all of these global events have unfolded over the last six weeks, the stock market (as measured by the S&P500) has continued to hit all time highs.

Last week, we finally got a reprieve from all of the global nonsense, when we were given some excellent financial news! On Wednesday, the Government announced the economy had grown at a healthy rate of 4.0% during the second quarter of 2014 - which was much higher than almost every economist and market pundit predicted. You would think this was great news…right? After all, the increase in economic activity during the second quarter was broad based, it showed a huge rebound in consumer spending, and it was the exact type of positive economic news we have been yearning for, for over five years now!

So, what happened? The stock market experienced it's worst day and its worst week in over two years. Many of you are probably wondering, "What on earth is going on here?" First, we get terrible global news for weeks on end and the stock market trends higher to all-time records. Then, we get excellent economic news and we have the biggest sell off

in over two years!! That seems so counter-intuitive, which is precisely why I love my job so much! The truth is, things are a little more complex than they seem on the surface. More often than not, the daily news cycle has nothing to do with stock market movement. There are many other things going on "behind the scenes" that are much more important to long-term stock prices than the current days news cycle. If those two examples above don't convince you of that…nothing will.

Of course, the general media and market pundits have no incentive to share this little secret with you. After all, they have to give you incentive to tune in each and every day to see how things play out. Otherwise, they can't pay their bills.

The challenge (of course) is three-fold. First, you have to identify what "new" information is important to long-term asset pricing. Most events are transitory and thus unimportant to long-term asset pricing and the stock market. Second, you have to identify if the "event" will have a negative or positive effect on pricing and cash flows. Finally, you have to identify how much of an impact the event will have on the financial markets over the long run. These things are not easy to do without proper training…which is precisely why many investors make a lot of bad choices over time.

The Big Picture

For years now, we have identified a number of broader macro-economic trends that will have a huge positive effect on assets prices over time. As a reminder, they are low interest rates (or inexpensive capital); an educated inexpensive labor force; amazing new technologies which create huge economies of scale; a growing global

middle class; free capital markets; and a new worldwide energy boom. These macro-economic items will have a much bigger impact on asset prices (and cash flows) over time than any of the recent negative global news stories.

If you are truly interested in whether or not your portfolio will be affected by a certain political or economic news event ask yourself the following questions. How does this affect the macro-economic trends listed above? If it does NOT affect the macro-economic trends above…the issue is moot. If it does affect any one of them, will it be in a positive or negative way? Finally, how big will the net effect be? Will it really affect earnings, cash flows and profits in a significant way over time…or will the effect be minimal?

The Answers

So, let's examine some of the recent news stories (in a new light) to see what kind of a long-term effect they will have on your portfolio over time. However, before we do so, we'd also like to remind our readers that 70% of all daily trading is executed by computer programs which have nothing to do with the daily news. So, if you want to know why the market went up or down on a given day, it honestly has nothing to do with that days news…it has more to do with whether or not computers were buying or selling on that day. This exercise attempts to look at the effect on the financial markets over the long-term. In truth, some global events do drive short term pricing, but in today's day and age where computers execute most of the daily trades…it's impossible to tell whether it was that days event or computer trading…which is why we know (and argue) that short-term market movements are completely random.

Prior to last week, the Argentinian Debt crisis, the Ukraine/Russia war, Plane Crashes, and Palestinian-Israel war made the headlines. And yet, the stock market continued to rise. Why? Plane crashes are transitory and have no long term affect on stock pricing or corporate cash flows. Argentina is a very small economy, so even if it did default, the impact would be minimal. Although war is a terrible thing, the truth is wars have more of a positive long-term effect on the economy in the form of new weapons and new technology. (It's sad, but true…) Lost in all of that negative news was also the fact that 2/3rds of all American companies have reported stronger than expected earnings in the second quarter…which is much more important to stock prices.

So, why did a significantly positive GDP have such a negative effect on the financial markets? Many traders believe a strong GDP implies the economy is back on track. If this is so, inflation and higher interest rates are just around the corner. Higher interest rates lead to a higher corporate costs of capital (bad news)…and thus lower profit margins (bad news). Since corporate America has built many of their record cash flows off of cheap debt and high profit margins, one could make the argument that a stronger economy will lead to higher interest rates, higher costs of capital, and lower earnings, profit margins, and cash flows. Short-term this may have a negative effect on pricing. Over the long-term, significant growth is music to our ears…

The take-away: If you really what to understand if a piece of news is noteworthy to your long-term portfolio, think about how the news event may affect corporate cash flows over time. If the event affects any of the macro-economic trends we outlined above, then you have to

determine if the effect is positive or negative. If the event is transitory and/or has no logical effect on long term corporate cash flows…you have nothing to worry about.

Unfortunately, the biggest problem facing investors (when using this methodology) is they often make connections that just don't exist over the long run. They often think things like the current political climate, the US debt load, and things like the value of our dollar affect corporate cash flows over time. They forget that many of these things are transitory in nature, which is precisely why the stock market has rallied over the last five and half years.

In Closing

As usual, if you have any questions about this update, our quarterly newsletters, your statements or our managers, please feel free to call or e-mail us at any time. The recent referrals are very much appreciated, and as always we remain 100% committed to your financial well-being.

Enjoy the remainder of your summer…

- **Joe and The Gang at KWAG**

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