KWAG January 2015 Update

I have always loved the first weekend of the New Year, since it gives me a chance to look back (and reflect) on what happened in the previous year. As a person who plans people's futures, I find it is hard to stay in the moment. I'm always thinking about future interest rates moves, corporate cash flows, the global economy, and our managers. It's a good thing I love what I do, because I seem to think about numbers all of the time!! (Would you be shocked if I told you I'm also addicted to Sudoku's and Kukuro's?)

During that first weekend, I always set aside time to prep our client dinners. All of us at KWAG really enjoy our dinners because they give us an opportunity to say "thanks" to all of our clients and friends in a really nice environment. In addition, I love giving a "state of the financial markets" address by covering what happened in the previous calendar year, addressing how it affects our diversified portfolios, and then laying out what we're going to do in the future to embrace market opportunities and/or protect against market threats.

In general, I'm very optimistic when I look out into the future. The innovative changes that are taking place in every single American industry will significantly change the way we all live our lives twenty years from now. Medicine will lengthen our lives and we'll be monitoring our health at home using diagnostic devices and smart phones. Energy will be cleaner, cheaper and more abundant. In 50 years, fossil fuels will be a memory. Transportation will become safer and more community based with shared ownership. Soon, driverless cars will share the road with you. I don't know how anyone could look into the future and not be excited about the prospects. We are all fortunate to live in these exciting times.

Of course, that doesn't mean the markets accurately "value" those changes in the short run. As everyone knows, the markets can often behave like the ocean's tides in their ebbs and flows. When the tide is out, the economy looks bleaker and prices tend to be much lower than they should be. When the tide comes in, the economy looks much brighter and prices tend to be higher than they should be. Right now, the tide is in, and therefore there are parts of the stock market that are overvalued. We need to be careful…and prudent.

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If you go back and re-examine our year-end newsletters over the last few years, you'll notice a general trend in our message…at least up until last year. Between 2009 and 2013, we discussed how "undervalued" the stock market was and how optimistic we were about its prospects. Even though no one ever knows what the stock market is going to do from year-to-year, it was

pretty obvious that the stock market – by any measure – was undervalued between 2009 and the end of 2013. Last year, the tenor of our message changed.

After a significant 30% (plus) rise in stock prices during 2013, it had become clear that the stock market – by any measure – was fairly valued, and in some cases, maybe a bit overpriced. In addition, we mentioned the lack of any real stock market volatility in 2013, which really had us somewhat concerned. Specifically, we said the S&P500 had not experienced a normal 10%-15% decline in almost three years! A decline, which has still NOT occurred.

This general concern drove our portfolio construction from being more "offensive" to being much more "defensive" in 2014. As long-term investors, we will always believe the stock market is a prudent investment. In fact, over longer time periods, we believe there is no better long-term investment for individuals. However, there will always be short-term periods, when the markets "value" gets ahead of supporting cash flows and profits. Given the significant rise in the stock market between the beginning of 2009 and the end of 2013, we said there was an equal chance that the stock market's value could end the 2014 calendar year up, down or flat. In addition, we said there was a significant "probability" that the stock market could experience a significant (and much overdo) decline.

This significant "probability" guided our decision making in 2014 and it continues to guide our decision making today. The truth is the stock market (particularly in the large cap space) is due for a significant decline. We have no idea when that decline will occur, but we do know it will be driven by the exact same things that every market decline is driven by – leverage and investor hubris. It's hard to predict what type of hubris will trigger a sell-off and we honestly don't obsess about when it will inevitably happen. What we do constantly obsess about is a balance between the many possibilities and then we let our disciplined investment process be the guide. Over time, this has worked wonders for our client's portfolios by capturing most of the upside market returns, and protecting portfolio's when the inevitable market declines occur.

Unfortunately, the average investor does the exact opposite.

During the later stages of bull market rallies, many investors become so obsessed with staying up with overpriced market indexes in the short term, that they inadvertently allow "greed" to drive their short-term decision-making…often at the expense of their long-term portfolios health. They forget that it's just as important to "protect" your portfolio on the downside, as it is to capture returns on the upside. Obviously, we all want excellent portfolio returns each and

every year, however, at some point, PRUDENCE should be the guiding principal. In essence, it's okay to own a conservative portfolio that hits singles and doubles consistently.

If you look back at the stock market in 1999, and again in 2007, many investors let their greed and hubris drive their short-term decision making by trying to squeeze blood out of a stone. They got caught up in the moment and paid dearly for this poor behavior. Unfortunately, we are seeing many signs that this type of behavior is occurring again. If you find yourself becoming too focused on your current short-term portfolio return, you need to take a deep breath and seek help immediately. We are here for you…

Let us be clear. We love the stock market as a long-term investment. In fact, we believe every investor (who has a long-term horizon of at least five years) should have a significant portion of their investible assets in the stock market. And, we believe those portfolios should be balanced across small, medium and large cap stocks, with a decent portion allocated to international. That said those same long-term investors should be cognizant about current corporate cash flows, current corporate price levels, and the probabilities associated with any number of different and sometimes very negative outcomes. Why? Because the numbers and the probabilities are pointing to an inevitable market dip in large cap stocks. And this comes from an optimist (me) who is known to look at the world through rose-colored glasses!!

The Numbers

The stock market behaved about as we thought it would during 2014, with two exceptions - and those two exceptions have us somewhat concerned. Small cap stocks (as measured by the Russell 2000 price index) increased 3.83%. The NYSE composite, which measures the performance of ALL common stocks trading on the New York Stock Exchange, increased 4.22%. The world stock index increased only 2.76%, and if you take out U.S. stocks it was negative for the year. In fact, the EAFE (Europe, Asia and Far East) Index was down -4.90%. When you examine the six stock market style indexes that make up small and mid-cap stocks, they were up 5.64% in aggregate. Through the middle of October 2014, most of these broader market benchmarks were in negative territory and almost all of them have experienced significant healthy declines during 2014. Thankfully, a nice year-end rally pushed these indexes into positive territory. (We should note, the year-end rally was led by small caps which finished up 8.8% for the quarter…)

The two exceptions we mentioned above were the S&P500, which finished 2014 up 11.39%, and the NASDAQ composite, which finished the year up 13.40%. Both made daily headlines as the S&P500 continued to hit all-time highs, and both will undoubtedly drive poor short-term decision making as we go forward…since many investors believe the S&P500 defines the stock

market, even though it ignores 90% of the market. It is no coincidence that the S&P500 and the NASDAQ (which is heavily reliant on tech stocks) rallied together. In fact, if you take a close look at the sectors that drove the NASDAQ and the S&P500 higher this year, you'll see the technology sector increased 19%. When you dig a little bit deeper, you'll find 46 stocks out of the S&P500 increased more than 40%. When you eliminate those 46 companies from the mix, the S&P500 index was basically flat.

Keep in mind the following…

Every major decline over the history of the U.S. stock market has been driven by one of two items – leverage (think overpriced stocks) and investors hubris (think chasing index returns in the later stages of a multi-year rally).

Look, we see our role with our clients NOT as predictors of events and specific time frames. The short term is too unpredictable and greed can last for a long time. Instead, we see ourselves as sizing up probabilities, weighing them intelligently, and allocating capital without much regard to the calendar. If you examine history, the NASDAQ outperforming the NYSE by a significant amount has been a warning sign of trouble to come. When? Who knows? But when the world markets are up 2% to 5% across the board and then a small group of stocks - which ignores 99% of the stock market - is up more than 40%, something is slightly amiss.

That type of divergence in performance should be raising red flags, <u>not encouraging additional risk taking</u>. At this point, we hope our clients know that we have already contemplated and plotted an approach that will PROTECT us if the bottom falls out after six spectacular strong stock market years. This approach will also capture the broader market returns - like we did in 2014 - if the stock market continues to rise.

It's unfortunate, but history is littered with portfolio's that were destroyed by investors who tended to become too obsessed with staying up with overpriced indexes, particularly in the later stages of multi-year rallies. Obviously, we understand that the broader markets didn't do as well as the S&P500 in 2014. (Remember, we manage portfolio's for a living…) We also understand that this type of aberration typically occurs at the end of multi-year stock market rallies under periods of very little volatility. We have now gone over 1,200 calendar days without a 10% drop in the S&P500 – the fourth longest stretch in the last 50 years. Neither aberration will last, which is why we'll let history be our guide and we'll continue to take the more reasoned long-term conservative approach to our client's portfolios.

The Newsletter

Our quarterly newsletter will be mailed out on Wednesday, January 21st. This will give you a full weekend to read, contemplate, digest, and think about our broader message before the client dinners. In the meat of the newsletter, we'll go over the commentary of many of advisors and managers who are little concerned about some valuations and we'll let them explain (in their own words) why they don't want to buy overleveraged and overpriced stocks in today's environment. We'll also let them explain why they're holding decent sized "stashes" of cash. As usual, we'll cover the stock market, the bond market, and the global economy. Over the long term, we're very optimistic about the stock market. Unfortunately, there are a number of economic "red flags" to be concerned about over the short term - including the significant "un-orderly" drop in oil prices. The decrease in gas prices is great for consumers, but it also creates a number of problems and potential disconnects globally. We'll finish the newsletter with 10 excellent questions from our readers.

Year-End Dinners

Over the next month or so, we'll be holding four large client dinners and a number of small intimate lunches for people in our various markets. For those of you who are out of state, we are taping the first dinner at Sunset Beach. Last year, we posted the dinner video on youtube.com. We'll do the same this year, within a week of the Sunset Beach presentation. Please mark your calendars, RSVP, and feel free to bring a friend who may be interested in our common sense message. You can RSVP by calling our main office in Greenville, NC: (252-439-1888)

Sunset Beach, NC | Monday, January 26th | Sea Trail Convention Center | 6:00-8:30PM
Greenville, NC | Tuesday, January 27th | Brook Valley Country Club | 6:00-8:30PM
Asheville, NC | Thursday, January 29th | Country Club of Asheville | 6:00-8:30PM
Ithaca, NY | Tuesday, February 10th | Hilton Garden Inn | 6:00-8:30 PM

In Closing

As usual, if you have any questions or concerns regarding our updates, your portfolio or any of our investment strategies, please feel free to contact us immediately. We always look forward to hearing from you and appreciate all of your continued kind referrals.

- **Joe & The Gang at KWAG**

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