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Market Commentary

Summer 2017

Ten people who speak make more noise than ten thousand who are silent.
- Napoleon Bonaparte

In this quarter's missive, we decided to break away from our commentary that examines the markets, and focus more on some issues in fundamental investing. We have, however, put a brief synopsis together reflecting our thoughts on the markets in the appendix. Our respite from the "usual" newsletter comes at a time when the markets have been quite stable and, frankly, there hasn't been a lot of news since the previous quarter. Let us re-phrase that; perhaps there hasn't been much news of quality.

In prior newsletters, we have criticized the short-term focus from the media on the markets. Rarely is there a week that goes by that we don't read a doomsday prognosticator calling for a bear market in the coming months. In fact, as we write this, on our desks is one of those letters and the first line says "This unprecedented bubble just doesn't want to die." The market is at 10% premium to its historical forward 12-month price-to-earnings ratio. That's unprecedented? Television, newspapers and the internet have all intensified the coverage of financial markets over the past decade, and it is further amplified to the investor since the news flow is being literally directed to their fingertips via the cell phone. Ninety-nine percent of this is what we would call "noise." There is a plethora of information available; knowledge is another story.

In the investing world, two common investment approaches are those who invest from the "top-down" and those from the "bottom-up." Never did we study about an investment approach that starts with reading the latest newspaper headline, or watching cable news. A top-down approach starts with an analysis of the economy by examining variables such as GDP and interest rates. Based on this analysis, an investor tries to identify which sectors of the market will benefit the most and allocate assets accordingly. For example, if one expected interest rates to rise, one would allocate capital to banks as their profits are closely correlated to interest rates. A bottom-up approach starts at the company level and usually starts with a fundamental screen to winnow the universe down to a manageable level and fits the investment strategy. For example, at Northern Oak, one screening criteria among many is that the yield for a stock has to be at least 1.5%. If a company doesn't pay much of a dividend, we prefer not to waste our time looking at it.

In our opinion, both approaches are valid, and many professional investors use both. The key, however, is to have an investment process and the discipline to follow that process. This is much easier said than done. You may have heard the phrase "that style is out of favor," meaning that sector of the market is not currently performing well. A great example of this was back in the late 1990s when large capitalization stocks were rallying, but small cap stocks materially lagged behind. Imagine being a small cap manager trying to explain to clients why the market is rallying, but their fund was not up very much. Markets go in cycles, and styles within the markets do as well. Following the "dot com" crash in the early 2000s, small cap stocks materially outperformed large cap stocks over the next decade. Guess what many investors did in the late 1990s? They sold their small cap funds and bought large cap funds at exactly the wrong time. So many had poor performance in small caps and then rotated into large caps at the cusp of poor performance in that sector. Chasing performance is the worst choice an investor can make. As one of our first mentors was known to say, "Investors shoot where the ducks have been."

As we said, it is important to have the discipline to follow a process. The small cap managers that "stuck to their knitting" enjoyed an extended period of outperformance versus large cap stocks following 2000. However, many investors didn't have such fortitude. In fact, there is a popular study by a company called Dalbar that examined mutual funds over the past 20 years and found that while the average return of the S&P 500 was near 10%, the average return for many of those who owned mutual funds was just over 2%. That is a difference of 4.5x your money

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over a 20-year period! Imagine having 4.5x less money in your retirement! Much of the underperformance was due to selling at the bottom, buying at the top, and rotating out of the poorly performing sectors and into the "hot sectors" at the wrong time. Process and discipline trump noise and emotion!

We have all heard that the markets are driven by fear and greed and we are certain that both of these emotions are exacerbated by what one sees in the media. It is human nature to want to sell when the markets are declining when all you hear or read is an analyst making a dire prediction, or buy when it seems good times will last forever. According to Oppenheimer, since the 1920s, the markets have increased 95% and 99% percent of the time over any rolling monthly 10 and 15-year period. Oppenheimer also pointed out that except for 1995, the market has experienced a 5% or more drop in every year over the past 37! A 5% pullback is likely in 2017, but don't let the media scare you into making poor investment decisions (see appendix for our thoughts on the market outlook).

We believe for most of our clients, investing should be, and is, based on achieving a financial objective (i.e. "goals based") versus trying to outperform a benchmark. Typically, the primary goal is having enough savings to live in a comfortable lifestyle in retirement, but there are many others, such as financing college for your children or grandchildren, taking care of elderly parents, funding your own future health care expenses, purchasing a home, or simply financing a car, to name a few. Recently we spoke to a couple that celebrated hitting $1 million in their portfolios by sharing a bottle of champagne. That is goal based investing. The bad news is the next day the portfolio fell below $1 million. The good news is we told them they could have another bottle of champagne when it goes back above a million, which it subsequently did.

If someone were to guarantee that your money would last longer than you, would you care what the market indexes do? A major risk of comparing returns to a benchmark is that it's usually not an apples-to-apples comparison. The S&P 500, for example, is a market capitalization weighted index dominated by the largest companies. As of June 30, 2017, the top ten names comprised almost 20% of the entire index! Why would one track the progress of his retirement savings to 10 names out of 5,000 liquid stocks in the U.S. market (and thousands more globally)? The Dow Jones Index, another flawed index, is based on the actual price of the securities so that changes in higher priced securities have more impact on the index than changes of smaller priced securities. In other words, stocks with higher share prices have a greater weight in the index. So, if you had two identical companies having the same market value, the one with the higher stock price would have a higher weight in the index. That doesn't make any sense to us.

If one did want to follow an index strategy (and we implement this in many of our client portfolios), what makes the S&P 500 so special? In his 2014 letter to shareholders, Warren Buffett advised most investors to have 10% cash and 90% in the S&P 500. This is an index dominated by large capitalization stocks with a few names accounting for a large portion of it. What about mid and small capitalization stocks and developed and emerging markets? The S&P was down nearly 60% from 2000-2002 and nearly 40% in 2008. How do those returns align with your risk tolerance? Due to the popularity of ETFs, there are now hundreds of indexes out there. If one is to index, how can one avoid all of these other market segments? Also, what about taxes? Index "huggers" need to trade fairly often to reflect changes in the index. This frequently leads to taxable gains, and thus a tax bill. Remember, it's not just what you *make*, it's what you *keep.*

Most of us want to maximize how much we can live on in retirement, and possibly consider leaving funds to children or charities, but this objective must be balanced with the risk that is taken in the account. One thing we pride ourselves on at Northern Oak is the great effort we make in matching the risk of the portfolio to that of the client's personal risk tolerance. The excess volatility experienced in 2008 can influence investment decision making, and emotional investment decisions do not typically turn out well. It is so very important to have a properly constructed

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portfolio that matches one's risk profiles and allows for sound nights of sleep. More importantly, however, it increases one's odds of reaching financial goals, in part, by preventing one from "chasing" hot sectors of the market or make ill-formed decisions based on emotions.

A portfolio should be built around the desired objective (goal) of the funds, not artificial, man-made indexes that are arguably flawed. If one wants growth, buy into areas of growth. If one wants income, construct a portfolio of securities that produce income. At Northern Oak, we use both individual securities and indexed ETFs to achieve these results. In our opinion, goals-based investing, while controlling risk, provides the most likely path to successful investing. The approach must have a process and the discipline to follow that process, even when some part of that portfolio may be out of favor. A disciplined process filters out the noise that not only serves as a distraction, but also can adversely affect the financial aspects of your life.

APPENDIX – MARKET OUTLOOK

There are so many "experts" out there surprised by the market rally in 2017. The only thing that we are surprised at is why they are surprised. For years, we have discussed in these letters that the markets follow earnings growth and are more likely to do that if the valuation of the market is reasonable. Earnings growth of over 10% is expected for 2017 and 2018 and the market, based on a forward price-to-earnings ratio, is just 10% above its 25-year average. In a growing economy in the U.S. and globally, shouldn't it be higher than the average? The pundits say this is a hated bull market. That is because the fund managers don't believe the sustainability of it and hold cash waiting for a material drop in the market.

However, the market has been resilient and just bounces back right after a decline as cash flows into it. And why not? In Q2, revenues were up almost 5%, while earnings were up just under 10%. What's wrong with that? We think the next 12 months look good for the equity markets. A correction of 10%, of course, could come at any time, but a bull-ending bear market of a 20% decline is unlikely. Bear markets are usually associated with recessions and with the U.S. experiencing stable growth and the international markets picking up speed, we just don't see a recession anytime soon.

Having said that, we do believe corporate America needs to deliver on its earnings growth expectations. We think further upside in the market will be more dependent on earnings growth compared to recent returns which have been driven not only by earnings growth, but also expansion in the P/E ratio. In fact, we estimate the expansion in the market's P/E ratio has accounted for nearly one-half of the S&P 500's return over the past five years. Eventually, higher interest rates, if they ever come, will limit multiple expansion making future returns much more earnings dependent. If earnings disappoint, the story changes.

Finally, forecasting interest rates is a tough task. We have held in previous letters that we expect rates would gradually rise over time and we are sticking to that. Despite rates rising post-election based on an expected pick-up in the economy, rates have fallen back as Washington appears to be in gridlock. However, we still expect the economy to grow, perhaps not as what was expected six months ago, but grow nonetheless, leading to higher rates in 2018.

CLIENT NOTE

Northern Oak is excited to announce that we are in the process of updating our reporting system. This will allow a new interface for our clients to login at Northern Oak's website to retrieve account information and quarterly reports. This will replace the distribution of these reports via email and mail via US Postal Service. This will make the distribution of these reports more secure. Please watch for further updates.