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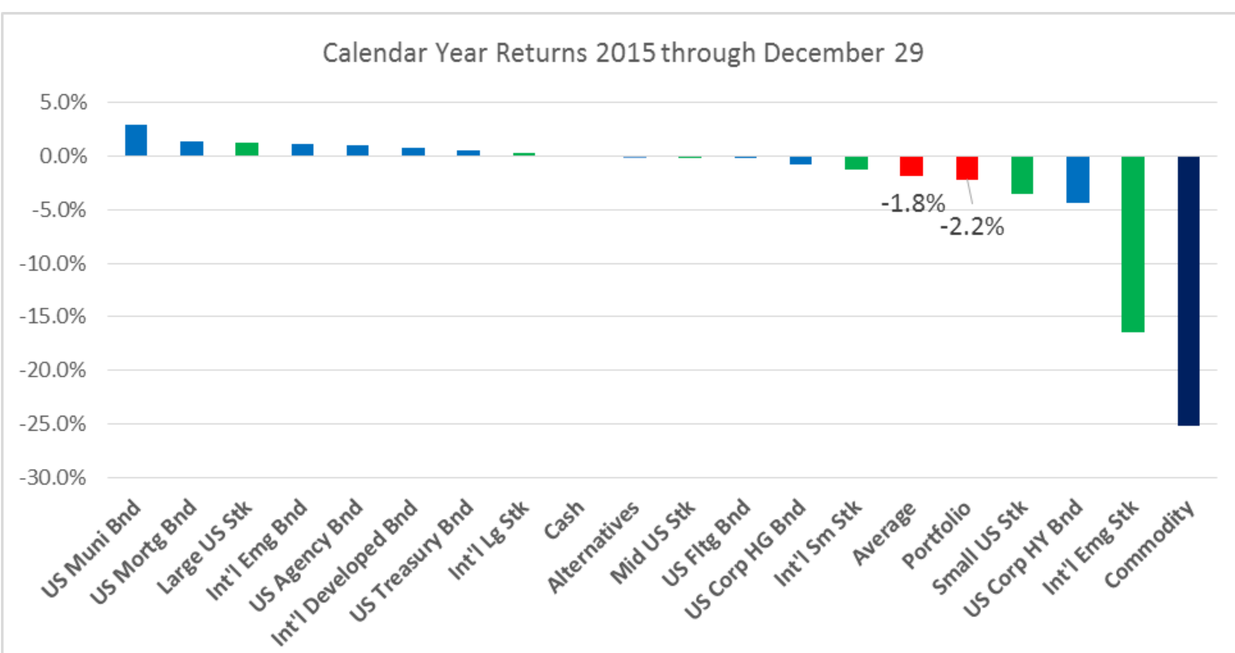
Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

Gains Elusive in 2015

As of December 29th, the most commonly used investment categories have estimated total returns from a high of 3% in the case of US Municipal Bonds, to a low of -25% in the case of commodities. It has not been a banner year for most diversified indexes, and a truly terrible year for some of them. Below is a chart showing the returns of most bond categories in blue, stock categories in green, commodities in dark blue, and diversified portfolios in red:



A 50/50 stock-bond portfolio with even just a 5% commodity exposure and with exposure to foreign stocks and bonds has returned around -2.2% for the 2015 calendar year through December 29th. That exact return number does depend on how much exposure to the various asset classes a diversified portfolio has. The 44 different Morningstar diversified portfolio indexes have an average return of -1.8%, with a high return of -0.8% and a low return of -3.0%. Portfolios with more bonds than stocks, or a smaller exposure to emerging market stocks or commodities may see returns closer to break-even by the end of the year. With only one and a half days of trading left this calendar year, it is highly unlikely the returns for diversified portfolios will be much above or below this -1.8% to -2.2% estimate.

It is safe to say all investment categories underperformed their long-term averages in 2015, and as a result diversified portfolio returns were underwhelming. They can't be positive every single year, and though we don't like negative years, they are still preferable to the major negative years we are trying to avoid.

Active Management in Tough Markets

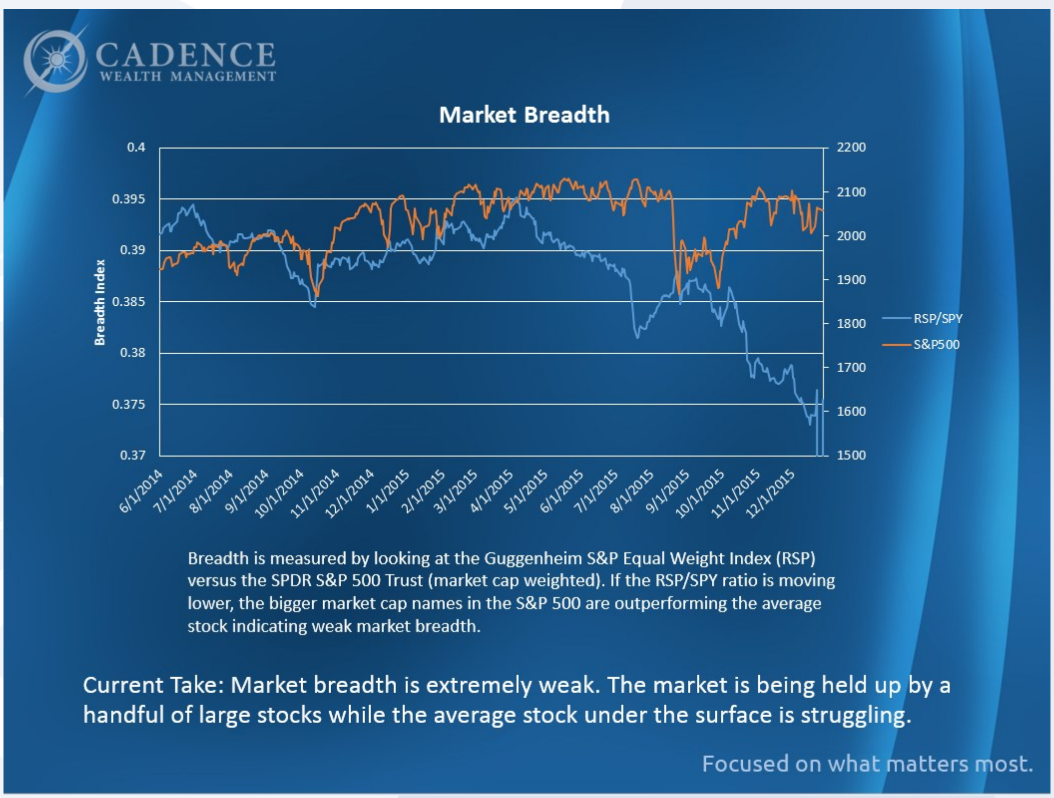
We've touched on how many investment asset classes have struggled in 2015, but the last two years weren't much better. In looking at 2014 and 2015, a half-stock half-bond portfolio would have returned just under 1% annually. Being more aggressive wouldn't necessarily have helped with global stocks also averaging 1% annually and even a more bond-heavy portfolio (25% stock/75% bond) would have averaged just a smidge over 1%. No matter how you slice it, a well-diversified portfolio has nearly stood still over the last two years from start to finish and not without a good deal of drama along the way. Large cap U.S. stocks have been just about the only asset class to buck the trend averaging around 7% annually, which only serves to help clients feel like they somehow missed the boat. It's not realistic for any investor to assume they could have or even should have gotten this return. Doing so would have required a good amount of luck and a portfolio strategy wholly lacking in diversification and safety. In fact, we feel U.S. stocks continue to be one of the least attractive asset classes to invest in over the coming years, which means at some point those 7% annual returns have to turn south. Investors chasing returns in 2015 will likely experience this unpleasant change of course. Diversification continues to be the prudent approach – especially now.

Those familiar with our philosophy at Cadence, and certainly clients of ours, know that a big part of our investment approach is to incorporate active management into our portfolio strategies. Our belief is that over time markets are rational and will follow the fundamentals, but over shorter periods of time, markets can be anything but. It's these shorter-term periods where active management can help to maximize returns while reducing risk. We're delighted to say that over the last two years, the two active strategies we manage at Cadence have met this objective. Our trend-following strategy has averaged just over 6% annually and our contrarian sentiment-based strategy just under 7%. Most important, these returns have been achieved within a framework where risk management is a top priority. In other words, when (not if) the S&P 500 finally turns lower and seeks more "average" valuations, these two strategies are designed to avoid as much of that return trip as possible. As always, there are no guarantees when it comes to investing, but that's the objective.

When incorporating these two actively managed strategies into a diversified portfolio, we find that our roughly 1% return for that diversified portfolio jumps to over 3%, with risk actually dropping. What that means to the investor is that the 3% annual return comes in a much steadier, more evenly distributed fashion, while the 1% return would have had bigger ups and downs along the way. This is always the goal of active management – to get the good without all the bad. Our expectation is that as we move into 2016, this approach will help us preserve principal in a much more meaningful way than would be possible without it, leading to much greater opportunity to invest for growth from a much lower, and much safer, level. Returns over time are all about the entry price we get on our investment. The more money we have when prices become more attractive, the greater our return over time. That's what makes principal preservation so important right now – not chasing returns.

2016 Outlook

In reflecting on 2015, with respect to the markets and our commentary on them, we've been pretty consistent about our message – markets are dramatically over-priced and as a result will provide well below-average returns going forward. Not much has changed over the last two years in that regard. As we just discussed, markets as a whole have stood still while a host of asset classes such as commodities, emerging market stocks, emerging market bonds and high yield bonds have suffered outright declines. Even the indexes that have performed the best such as the S&P 500 are a bit of an illusion as more weight is placed on the largest companies in the index. Without those big companies doing the heavy lifting, the index would be up much less. The chart below illustrates how much better the cap-weighted S&P 500 is doing relative to its equal-weighted brethren. A declining line means those few really large companies in the cap-weighted index are doing much better than the majority of them. As we've noted before, this is familiar behavior near market turning points.



It's our opinion that major market turning points occur when extreme market valuations meet deteriorating market internals and divergence across asset classes. Lofty valuations alone aren't enough to topple markets since as long as investors are in a risk-seeking mode, prices can continue to get pushed even higher. The above-average length of the current bull market illustrates this very well. When investor appetite shifts toward risk-aversion however, this sets up a potentially very nasty risk-reward scenario for capital markets. What we have right now are extreme market valuations based on a number of different measures that are being met by really ugly looking market internals and divergences. Not to say that these things can't change, but we certainly wouldn't recommend any significant exposure to stocks until they do. Here's a list of what we're seeing that implies a potential shift in risk appetite toward more risk-averse investor behavior:

- Very weak market breadth as illustrated by the cap-weighted S&P 500 divided by the equal-weighted S&P 500.

- A diverging On-Balance Volume line on the S&P 500 as measured by SPY. This indicates bigger volume on down days than on up days. This has been a trend since late 2014.

- Continued weakness in the NYSE, Dow Transports, and Small Cap Stock indices.

- A recent and sudden two-month spike in CCC junk bond yields to over 18%. This represents a dramatic shift away from risk in this part of the credit markets.

- Record brokerage account margin levels have started to come down a bit. Similar to what happened in 2000 and 2007.

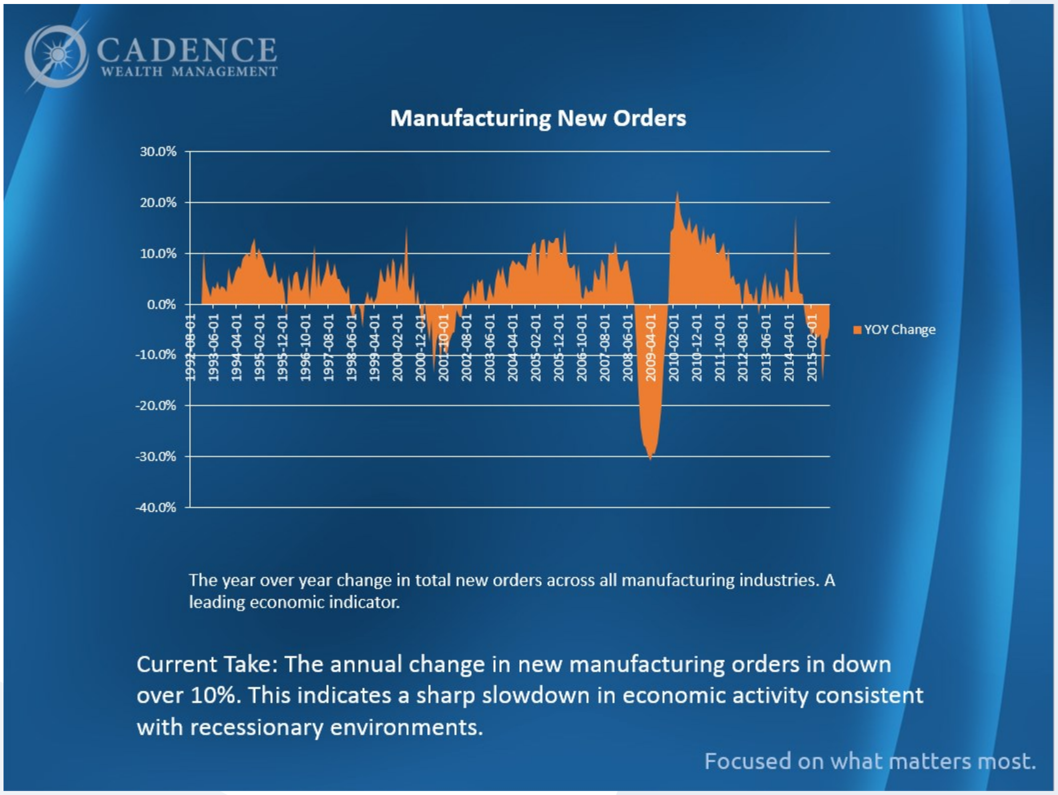
A Word on Earnings Growth

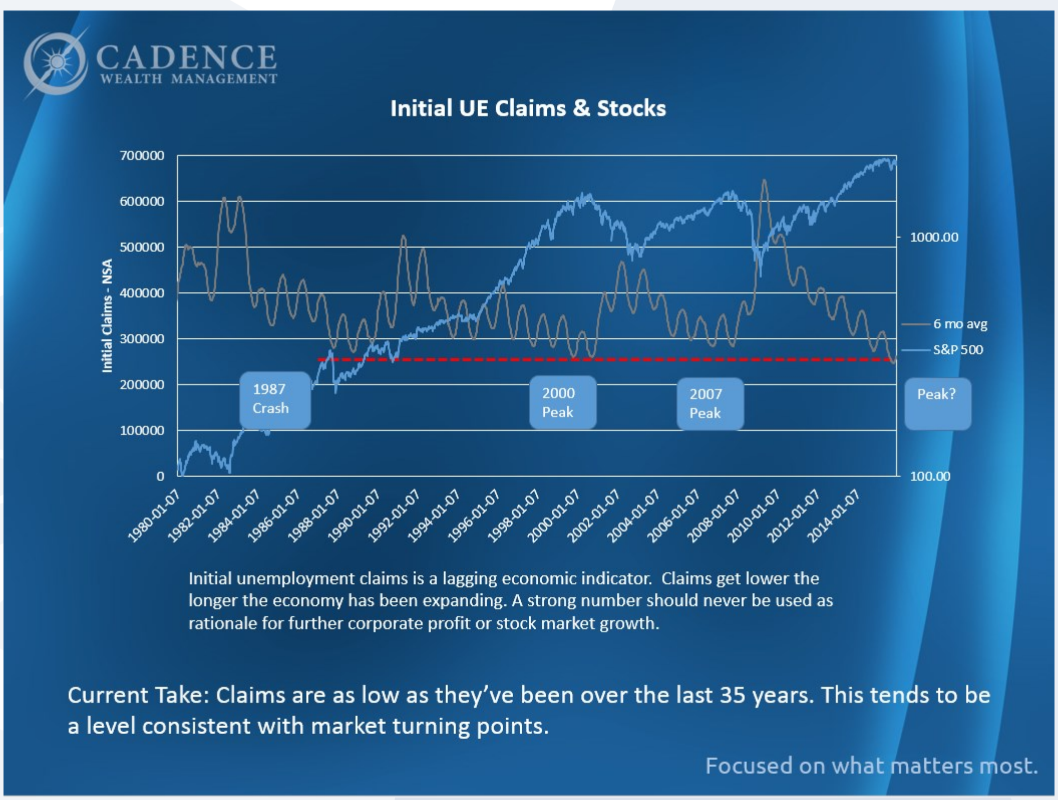
We've witnessed both revenues and earnings across public companies decline over most of 2015. According to Factset, estimated earnings for Q4 this year are set to decline 4.9% versus a year ago, which would mark the third consecutive quarterly year over year decline in earnings. More important, the consensus projection for earnings in 2015 coming into the year was $137 per share. What we're ending up with is closer to $104 per share. This not only shows a slowdown in earnings, but a dramatic shift between expectations and reality. What's also important to keep in mind is that these earnings reflect an "ex-items" methodology of reporting and not the GAAP (generally accepted accounting principles) that used to be reported. If companies were still following the GAAP or pro-forma method more common before the 2007-2008 financial crisis, 2015 earnings on the S&P 500 would be closer to $90 per share – not the $104 most are talking about now. A big difference.

In addition, public U.S. companies have bought back over 3 trillion worth of their own shares since the financial crisis funded almost entirely with debt – money borrowed at unusually low rates of interest due to the zero interest monetary policy of our Federal Reserve. Those share buybacks have reduced share counts, propping up earnings per share numbers. Without these share buybacks, earnings per share would be much lower than they are now, exposing a much difference picture than is being seen at the moment by most. With credit markets tightening, these share buybacks could well be affected as cheap money wouldn't be so easy to come by.

Economic Issues

In addition to these market-based data points, we're also witnessing a dramatic slowdown in manufacturing activity within the economy. Manufacturing new orders is one of the most leading economic indicators as opposed to the much talked about unemployment claims, which is among the most lagging. New Orders are in recessionary territory, while UE Claims are at cycle lows. We hear all the time analysts citing strong employment numbers as a reason for stocks to perform well over the coming months and years, but a quick look at history tells us that really low UE Claims is more a sign that stocks are about out of steam and turning lower than it is they're going higher. See below.





Summary

So as we move into 2016, our feeling is that markets dodged a bullet in 2015 and may be just about out of luck. Record stock valuations meeting up with ugly market internals and divergences along with really weak and actually recessionary leading economic indicators are not a good thing. The categories that haven't gotten hit that hard over the last year or two are at greatest risk – mainly U.S. and developed European stocks. Other categories have already started to become more attractive such as commodities, high yield bonds, and emerging market stocks and bonds, but there will likely be more selling to come when the broader markets begin to weaken. Principal preservation is undoubtedly warranted here.

It's important for us to mention that we don't view any of these circumstances as bad or negative – they just are. Although historically we're looking at a really pretty awful time to invest in capital markets over a 7-10 year timeframe, that doesn't have to be a bad thing for the prepared investor. Remember, it's all about your entry price. If one can minimize losses as we move through the downside of the current market cycle by recognizing where we are in the grand scheme of things and the associated risks, then they're more likely to get a better entry price with a bigger chunk of money at some point down the line. Whether that's sometime in 2016 or later, it doesn't much matter. We'll get that better price eventually and we're really excited about it. It's all about the entry price. If we're disciplined and patient, there's much to be optimistic about.

Key Takeaways:

➲ In addition to markets being historically and nearly unprecedentedly expensive, market internals have weakened dramatically over the last few months while economic leading indicators are suggesting a slowdown. This implies there is much more risk of significant stock market losses than most would appreciate.

➲ Corporate earnings are in decline and could decline much further if credit markets continue to tighten and the economy weakens. Expectations still haven't shifted adequately to account for this likelihood.

➲ Investors should continue to focus on principal preservation until they can get a better "entry price" on riskier investments. The more money one has to invest at a better entry price, the better their long term returns will be. We remain very optimistic that discipline will allow us to realize much better returns over time than current market valuations imply.

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