The Year That Nobody Made Money?

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The title above pretty much sums up 2015 – it was a disappointing year for investors. Large U.S. stocks, as measured by the S&P 500 Index, fell 0.7% in price but with dividends reinvested managed a 1.4% total return. The Dow Jones Industrial Average fell 2.2%, while the S&P Midcap 400 fell 3.7% and the S&P Smallcap 600 fell 3.4%. World stocks also fared poorly, with the MSCI EAFE Foreign Developed Markets Index falling 0.8% and the MSCI Foreign Emerging Markets Index falling 17.0%. Commodities experienced sharp declines, with the CRB Commodities Index declining 14.6%. Real estate as measured by the Dow Jones Select REIT Index gained 0.8%. Bond yields that began the year at very low levels, ended the year at relatively the same levels so that returns from bonds were generally close to zero. High yield bonds issued by entities with weak financial conditions, dropped some 10%. Even legendary long term investment icon Warren Buffett had a difficult year in 2015 as his Berkshire Hathaway holding company declined by over 12%.

But contrary to our title above, it was of course possible to earn positive returns in 2015. The so-called FANG stocks provided strong positive returns with Facebook returning 34%, Amazon.com 118%, Netflix 134%, and Google 46% (Google changed its name in 2015 to Alphabet). These four stocks aided by Activision Blizzard, Avago Technologies, Microsoft, and Starbucks helped propel the technology-laden NASDAQ Index to a 5.7% gain in 2015.

This action reminds us of 1999, when a short list of large cap stocks and a host of unknown technology companies (many now long gone) soared in valuation and led the market to large returns - just prior to the collapse in technology and certain large cap stock prices that began early in 2000. Even though the NASDAQ and other indices showed large drops in 2000, many stocks that had been shunned in the build up to 2000 actually did very well in 2000 and beyond.

To illustrate how narrow the leadership was in the S&P 500 in 2015, if you exclude the advances of the FANG stocks and four other large cap stocks with positive returns, the index would have been down 4% in 2015. As the S&P 500 is a capitalization weighted index, these eight large stocks had a significant positive effect on the index. Expressed somewhat differently, the average stock in the index was down 4% and even more disheartening, 23% of stocks in the index were down by over 20% for the year.

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	Trailing Price/ Earnings Ratio	Trailing Price/ Sales Ratio	Dividend Yield	Return on Equity	Net Profit Margin	Projected 5 Year Earnings Growth
A	11.4	2.5	2.0%	42.9%	22.8%	13.9%
B	301	7.6	0.0%	8.2%	2.5%	24.5%

A fair question to ask is why didn't my portfolio hold the "FANG" stocks? With the benefit of hindsight, it should have, at least for 2015. However, at Knox & Downing Advisors, we seek to build diversified equity portfolios for our clients holding the stocks of good companies trading at reasonable valuations. In the table above, we present the stocks of two companies that for now we simply call A and B. The stock of company A trades at modest price relative to its earnings and sales, pays a 2% annual dividend, earns a 42.9% return on the equity on its balance sheet, produces 22.8% net profit on its sales, and is expected to grow earnings at nearly 14% annually for the next five years. In contrast, the stock of company B trades at a very high valuation, pays no dividend, and is marginally profitable – yet it has a higher expected rate of future growth. An investment of $1000 made today in company A buys $87.70 in current annual earnings and $20.00 in annual dividends, an annual return of close to 10%. The same investment made today in company B buys $3.32 in annual earnings and no dividend, a return of less than one-half percent!

So the question becomes how much more should a potential investor in company B be willing to pay for a higher *expected* rate of growth? In our opinion, over the long run, the extremely high valuation afforded stock B will lead to sub-par returns for an investment made in this company, at least relative to a similar investment in company A. In the table above, the data for company A is from Apple Computer and the data for Company B is from Netflix, both as of December 31, 2015. We might also have used Amazon.com as our B stock, an incredible success story but a company that produces little cash for investors and trades at very high valuations. The other two FANG stocks, Facebook and Alphabet, are much more reasonably priced relative to earnings and cash generation.

Obviously, the market was more than happy to pay up for Netflix shares in 2015, as its stock returned 134%! Apple, on the other hand, despite a hugely successful history and a relatively cheap stock, had a return in 2015 of negative 3%. Apple has products and services that generate a huge amount of cash, with a brand so widely recognized that future products will surely continue to produce strong profits. It seems that the market is enamored with the recent growth of Netflix and its potential, while largely ignoring the strength of Apple's franchise. Netflix is an incredibly innovative company that is

transforming the media industry, but will investors see a significant cash return from the company?

Probably yes, eventually, but we prefer a bird in the hand as opposed to a hope for the future. Hence many of our client portfolios currently hold shares of Apple and do not hold shares of Netflix, and we expect Apple shares will provide good returns over time.

Let's shift our discussion to foreign stocks, which have on average underperformed U.S. stocks for three years running. Add in the currency effect from a rising dollar, and U.S. investors have suffered from holding foreign stocks. Emerging markets have fared worse than developed markets. Hence, it is reasonable for clients to ask if they should own foreign stocks, particularly those in emerging markets.

	Price/ Earnings Ratio	Price/ Book Ratio	Dividend Yield
US Large Cap Stocks	18.6	2.5	2.0%
Foreign Large Developed Market Stocks	16.0	1.6	2.9%
Foreign Large Emerging Market Stocks	12.2	1.5	3.2%

From the table above, one can see that large foreign stocks trade at lower valuations than do large U.S. stocks, and also pay a higher dividend yield. The dichotomy is even greater between the stocks of smaller foreign companies compared with smaller U.S. companies. As the dollar has appreciated over the past three years, the value of foreign earnings translated back to U.S. dollars has declined, yet this trend will not last forever. Eventually, and maybe soon, higher cost goods and services trading in U.S. dollars will be shunned in lieu of lower cost goods and services denominated in foreign currencies. This is a natural economic process that will lead to an appreciation of foreign currencies relative to the dollar, and provide a tail wind for the returns of foreign investments. It is our belief that given the superior valuations of foreign stocks, the likelihood that the dollar is near a peak valuation vs. a basket of foreign currencies, and for the benefits of diversification, prudently managed stock portfolios should own a considerable exposure to foreign stocks. The portfolios of Knox & Downing clients typically hold foreign stocks through exchange traded funds and/or mutual funds that hold portfolios of individual foreign stocks.

The year just ended also saw a collapse in oil and natural gas prices, as supply outgrew the demand for oil and gas. A barrel of oil which not long ago fetched over $100 now trades for less than $40, and many expect further price erosion. We certainly didn't

expect or anticipate such a sharp drop in oil and gas prices, and neither did most other investors. While beneficial to us as consumers, the damage to investors has been significant, and a big drag on investment portfolios. The stocks of oil and gas companies now trade at fractions of their value from a year ago, and some companies are so burdened with debt that they must sell assets at deep discounts in order to survive. This creates opportunity for stronger companies in the industry. It's virtually impossible to predict when the price of oil and gas will hit bottom, but the forces of the market will eventually bring supply into equilibrium with demand. When prices stabilize, and eventually begin to move higher, we believe the stocks of higher quality energy companies will rebound and could move considerably higher than today's prices.

In summary, 2015 was a disappointing year. As investment advisors each with over 30 years of experience working with clients and managing their portfolios, it is always disappointing to report upon declines or even sideways moves in portfolio valuations. Yet we have experienced such periods several times, and from the disappointing results always have risen periods of good performance. We are cautiously optimistic for positive returns from equities in 2016, albeit our optimism is tempered by the reality that much of the developed world is burdened by debt and slow growing economies. It is our belief that it is reasonable to expect mid to upper single digit average annual returns from stocks over the next few years, along with a significant dose of volatility. We will continue to build diversified client portfolios comprised primarily of good companies trading at reasonable valuations that pay a growing stream of dividends.

We wish you all the very best in the New Year and we deeply appreciate your confidence in Knox & Downing Advisors.

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