RBC Wealth Management

Spence Partners
805 SW Broadway, Suite 1800
Portland, OR 97205
Phone: 503-833-5228
Toll-Free: 800-547-4006
Fax: 503-833-5243

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"Double, double toil and trouble, fire burn, and cauldron bubble…"

Chant of the three Witches in Shakespeare's *Macbeth*

Dear Friends,

Three pivotal characters in Shakespeare's Macbeth are witches. It's their role to induce Macbeth to behave badly (including murder); the witches cleverly use predictions to achieve their ends. So successful are they that after Macbeth becomes king he returns to the witches frequently to have them predict the future. Fortunately, no fires, bubbling cauldrons or witches are required for us to conjure up a few *predictions*. We are well stocked in that department. Your chief concern should be that we will stop at a few. Let us assure you, unlike poor Macbeth, any intent we may have to induce certain behaviors on your part is purely benign.

Double Toil and Trouble?

How about the combination of a slowing economy and high valuations for stocks in relation to what they are earning, especially in the face of waning profitability? That's exactly where we were as recently as December when the S&P 500 was trading at 23.5x trailing four quarters earnings. This lofty multiple has been attained on only three other occasions over the past 45 years: 1970, 1987 and 2000. In each instance, things ended badly for stocks, often the case when good things end. A way to assess this is, what's normal? The answer for most cycles is about 17-18x. The arithmetic therefore tells us that stocks have been trading about 30% above valuation norms. Think of this 30% as excess risk; that amount over and above that which we must normally tolerate. (As an aside, where possible we have attempted to blunt this elevated risk by holding in reserve significant amounts of cash in CDs and short term high quality corporate notes.) That leaves the operative question, how may this problem resolve itself?

1. Earnings can grow while stock prices mostly stay the same: grow your way out of it.
2. Stock prices go down while earnings remain the same or go up: shrink your way out.
3. Both stock prices and earnings go down but stocks fall faster: the free-fall solution.

At this writing stocks have pulled back 10% from their December high. The trailing twelve months' P/E ratio has shrunk to 21x earnings. We are now well into the reporting season; Q-4 earnings are trending down over 4% with the result the outlook for 2016 is being revised downward. Referring to our menu above, we are tracking in the direction of #3, the free-fall solution. If there is a silver lining to this cloud, it would be that excess risk would likely tend to be taken out more rapidly than with other alternatives. Recognizing that scar tissue from the bear market of 2008-09 is still healing, the kind of volatility we are experiencing is certainly upsetting. Complicating the issue is the fact that we invest in a market of stocks, not the stock market. Some stocks "de-risk" earlier than others. If we are to succeed, we need to be prepared to acquire good companies as they reach bargain valuations, regardless of the behavior of the stock market at large. No one said this Double Toil and Trouble business would be easy.

Burning Fires

Think the Kuwaiti War (aka Operation Desert Storm) in early 1991, the incredible spectacle of burning oilfields as far as the eye could see. Basically the same thing is occurring today except the venue is world commodity exchanges where the price of a barrel of oil has fallen from $110 in May of 2014 to as low as $27 in mid-January, *a slide of 75%.* To put this event in perspective, it's informative to look at other commodity price collapses over the years.

Commodity	Year	Peak	Bottom	% Decline
Crude Oil	2014	$110	$ 27 (thus far)	-75%
Gold	1980	$850	$280	-67%
Lumber	2005	$420	$140	-67%
Copper	2008	$3.90	$1.40	-64%
Aluminum	2010	1.30	$ .68	-48%

What makes these statistics even more startling is that each of the price collapses with the exception of oil was accompanied by a *decline* in demand. *Growth* in demand for oil for the two year period 2014-15 worldwide slightly exceeded 5%. While demand is expected to grow at a slower rate in 2016 than the earlier years, there will most likely be an increase in consumption. The point of this information is simply to provide color as to the magnitude of what is taking place with oil and natural gas and the anomaly that the collapse is accompanied by growth in demand.

Carnage is widespread. We have seen estimates that well over 100,000 jobs have been lost already in the US alone. Lenders are adding rapidly to their loss reserves for energy loans while credit ratings are falling in this space nearly as rapidly as prices. What is the future of this industry which led virtually all others as we emerged from the Great Recession of 2008-09?

We start by assuming there is more pain to come as the law of the jungle plays its way out. As always, the strongest and most strategic companies will be left to pick over the bones. It's our guess that the consolidation game begins well before mid-year but that prices do not have to decline much further to trigger the process. Older marginal wells are already being shut in; many are simply not economic to continue producing at $27 a barrel. Successful new wells are often not being completed in preparation for going into production. The potential for supply interruptions is always there since leading countries producing oil include Russia, Venezuela, Nigeria and much of the Middle East. Offsetting some of this potential for supply interruption is the fact that Iranian production will slowly come back into the market. We also should not forget that costs in the industry are coming down rapidly. Taken together, this process of creative destruction may well allow the best companies in the industry to produce a 20% profit margin on oil at $50 a barrel, something which was unthinkable as recently as a year ago. There is a saying in the commodities business that the cure for low prices is low prices. We certainly have that.

Like other investors, it would have been helpful had we the foresight to see this collapse coming. We did not. Energy stocks have been a productive part of our portfolios for over forty years with the ups in the business eclipsing the downs. It is our view that it is far too late to be a seller. We are more interested in finding profitable ways to heal the wounds by acquiring quality distressed energy assets. It may be that less leveraged infrastructure plays such as selected pipelines where there is little excess capacity will eventually become the most appropriate way to bottom fish.

A Bubbling Cauldron

At this point in time, it would be more accurate to make reference to a bubbling crock pot. First of all, we are not certain there is still a manufacturer of cauldrons in business. Secondly, we respect the fact that it takes *time* for excesses to slowly work their way out of the system. It rarely happens as quickly as we might like, although there is precedent; 1987 "featured" a 23% down day. Finally, the corrective process is not homogenous. Some companies become dirt cheap far sooner than others affording an early opportunity to attain significant value for your capital.

Transparency also helps. At the risk of stating the obvious, it is helpful if a business and its assets are not difficult to understand. Understanding enables us to compare the value the stock market is placing on the company with what we believe is the intrinsic value of the business. As a metaphor, allow us to offer up a company we are accumulating, New Senior Investment Group (NYSE: SNR). New Senior owns and operates 152 primarily independent senior living facilities around the country. The industry is substantially owned by smaller operators: properties sell regularly. This factor along with the ability to meet directly with management allows us to become comfortable with putting a reasonable value on the properties SNR owns.

Much like owning a four-plex, we can also evaluate the rental income received and contrast that to expenses including debt service. To the extent that income exceeds expenses, we have a measure of the health of the business as well as its ability to distribute income to us. Finally, as is true with most things financial, some is preferred to none and more is preferred to less. Therefore we are interested in occupancy trends and the extent to which rents can be increased. When it all comes together coupled with the added input that the stock is down 50% over the past year, there is a foundation to conclude we have identified a mispriced asset. Another indication of deep intrinsic value is the fact that New Senior presently yields 11%. Insider buying and a significant effort on the part of the company to repurchase stock (in lieu of buying properties), further buoys our confidence in the relationship between risk and reward being tilted in our favor. And there you have it! Our version of a bubbling crock pot surprise.

In closing, we would like to thank you for the many constructive comments we received in response to our last letter, The Rant. We view it as a great privilege to help you prepare for a comfortable retirement, to stay retired successfully and to be in a position to cascade wealth to your family to the maximum extent possible.

Warmest regards,

Steve Spence	Marcia Hull	Kip Acheson	Chris Klavins
Senior Vice President	First Vice President	First Vice President	First Vice President
Sr. Portfolio Manager	Financial Advisor	Financial Advisor	Financial Advisor
Financial Advisor			

The Klavins Report – Thoughts From Outside the Corner Office

2015 – A year when little worked…As proud residents of the good ol' US of A, we often focus client discussions on domestic indices like the S&P 500 or the Dow. The reality is that we live and invest in an increasingly global world, made up of companies ranging in size. Many of our domestic companies have earnings overseas, and we also own foreign companies headquartered abroad. Though we tend to focus on large companies, we also own some small- and mid-cap companies, both for diversification and to try to take advantage of opportunities. So, let's broaden our view and look at how a wider selection of indices fared last year on a total return basis (including dividends):

Domestic Markets

- The **Dow Jones Industrial Average** (30 large-cap US stocks) returned **+0.21%**
- The **S&P 500** (market-cap weighted basket of 500 large-cap, US stocks) returned **+1.37%**
    - <u>The **Equal Weight S&P 500** returned **-4.11%**</u>
- The **Russell 2000** (US small-cap index) returned **-4.41%**

Foreign Markets

- The **MSCI EAFE** (large & mid-cap companies in Europe, Australasia & Far East) returned **-0.21%**
- The **MSCI Emerging Markets** (23 countries / 13% of world market cap) returned **-14.83%**
- The **MSCI Europe** returned **+8.89%**

Let's drill down a bit more on the US market. Even the mediocre +1.37% return of the S&P 500 was driven by a very small collection of the biggest companies. If you were to remove the so called FANG stocks (Facebook, Amazon, Netflix, and Google (now "Alphabet")) the total return of the S&P would have been lower by about 2.55%, taking its positive 1.37% return down to -1.18%. Remove another six huge stocks and it would further reduce the total return to -2.81%. *Looked at differently, if you evaluated the return of the S&P 500 on an equally weighted basis* the total return was -4.11%.

Another characteristic of 2015 returns which has received little attention is the relative performance of growth versus value. The Russell 1000 Growth Index returned +5.67% in 2015, while the Russell 1000 Value Index returned -3.83%, a performance differential of 9.5%. Some of this had to do with energy, the ongoing weakness of which is well known, but more broadly value and deep-value stocks lagged. Higher dividend stocks, which are often viewed as defensive, also lagged non-dividend paying peers.

So, what are the takeaways? Last year was a disappointing year for most indices. However, if you didn't own a very small handful of the very biggest winners, particularly a collection of stocks with high to exceptionally high valuations, your experience with stocks was probably worse than "the market". Furthermore, if you owned some international stocks, or small- and mid-cap names, as one typically should for purposes of long-term diversification, it tended to be a drag on returns rather than a help.

For our part, while it doesn't work in every period, we remain of the firm belief that valuation, dividends, and asset allocation matter, and that investing around these themes is the most sensible long-term strategy. With markets down since year end, and fear levels escalating rapidly, we expect to identify opportunities and have the courage to buy at times of market stress. Stay tuned.