Investment Manager Meetings Recap

Rarely do we see times when there is a clear indication of the changing of the guards. However, that is what has happened within the last 12 months. In October of last year, the Federal Reserve stopped pumping $80 billion dollars into the U.S. economy under the argument that the U.S. economy is performing well enough on its own. In a sense, this is good for the economy and the markets. It also indicated a changing of the guards.

During the prior five years, an investor did well by owning all of the market. The adage of "a rising tide raises all ships" was very accurate. Since October, however, we have seen a separation between the winners and losers.

What Are Investment Manager Meetings?

At Strategic Income Group, we believe in reviewing detailed investment research. Every 90 days we set aside a week during which around 7 to 10 investment managers give us recommendations on our current portfolios as well as share their firms' current views on the market and economy. This recap is our commentary on the most recent meetings.

As of the end of 8/7/15 the Dow Jones was down (2.26%) YTD while the technology and healthcare-heavy NASDAQ was positive 6.76% YTD. The S&P 500 was sitting in the middle at positive 2.31%. We believe October marked the shift from one market cycle to the next. In this cycle, active management will become much more crucial to our clients' portfolios.

We feel strongly that our ability to gather information from our quarterly investment manager meetings and make timely appropriate changes in our Strategic Portfolios will help position clients in these areas that we continue to favor.

We met with Fidelity, JP Morgan, Natixis, Zacks, Mainstay, Janus, and Franklin Templeton to listen to their research regarding the markets to help us make the best possible decisions for our clients.

There was a unanimous consensus from the managers that equities will outperform fixed income and that while we have and will continue to see a three-steps-forward-two-steps-back market, we are still moving in a positive direction. None of the managers could point

to a catalyst for a recession or bear market however many
of the managers believed several 5% or a 10% correction will happen. They further commented that any of these selloffs should be considered a buying opportunity.

Active vs. Passive Management

Many investors have recently been pouring money into passive investments using exchange-traded funds (ETFs). One of the big reasons for this is the belief that active managers are not able to beat the indices, so they believe it's reasonable to own index funds. As with many things, the real answer is not that simple. Consider this: "As of this writing, 399 of the S&P 500 companies have reported second quarter earnings and total earnings are down (2.3%) from the same period last year on (4.2%) lower revenues, not the picture we want to see. Strip away 'Energy,' and earnings are positive. Total earnings for the Energy sector in the S&P 500 index are down (60%) from the same period last year. So, when you take the energy sector out of the equation, total earnings for the rest of the S&P 500 are up 5% which is reasonable growth." (Zacks Research, August 10th)

Sources of S&P 500 earnings

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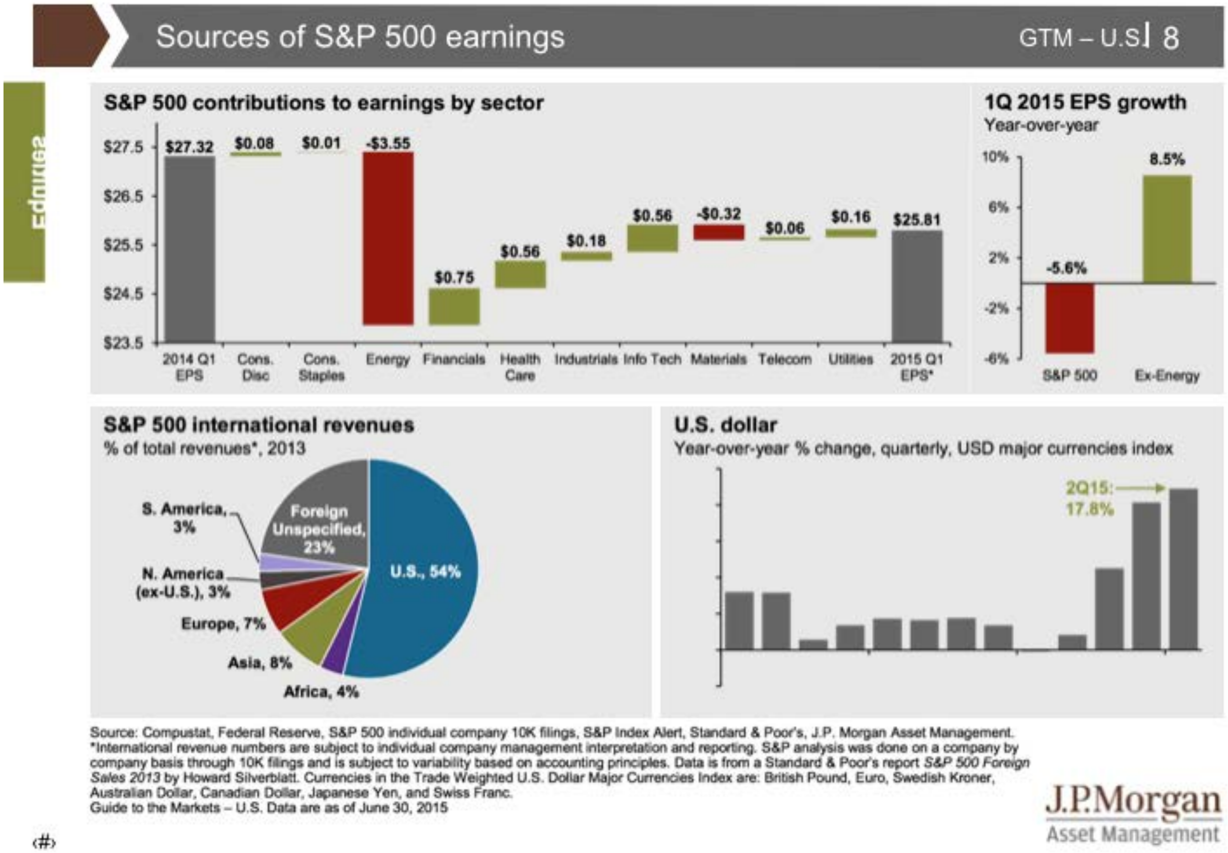
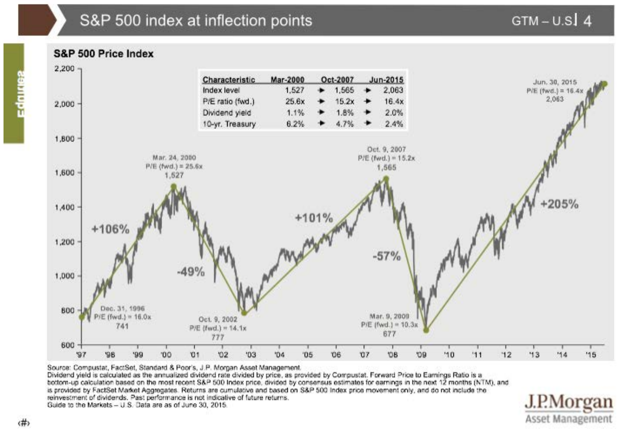


Source: Compustat, Federal Reserve, S&P 500 individual company 10K filings, S&P Index Alert, Standard & Poor's, J.P. Morgan Asset Management.
*International revenue numbers are subject to individual company management interpretation and reporting. S&P analysis was done on a company by company basis through 10K filings and is subject to variability based on accounting principles. Data is from a Standard & Poor's report *S&P 500 Foreign Sales 2013* by Howard Silverblatt. Currencies in the Trade Weighted U.S. Dollar Major Currencies Index are: British Pound, Euro, Swedish Kroner, Australian Dollar, Canadian Dollar, Japanese Yen, and Swiss Franc.
Guide to the Markets – U.S. Data are as of June 30, 2015

U.S. vs. International Investing



S&P 500 index at inflection points

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S&P 500 Price Index

Characteristic	Mar-2000		Oct-2007		Jun-2015
Index level	1,527	→	1,565	→	2,063
P/E ratio (fwd.)	25.6x	→	15.2x	→	16.4x
Dividend yield	1.1%	→	1.8%	→	2.0%
10-yr. Treasury	6.2%	→	4.7%	→	2.4%

Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
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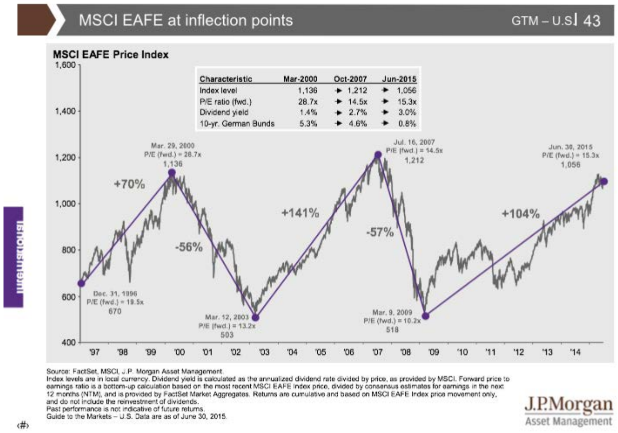

MSCI EAFE at inflection points

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MSCI EAFE Price Index

Characteristic	Mar-2000		Oct-2007		Jun-2015
Index level	1,136	→	1,212	→	1,056
P/E ratio (fwd.)	28.7x	→	14.5x	→	15.3x
Dividend yield	1.4%	→	2.7%	→	3.0%
10-yr. German Bunds	5.3%	→	4.6%	→	0.8%

Source: FactSet, MSCI, J.P. Morgan Asset Management.
Index levels are in local currency. Dividend yield is calculated as the annualized dividend rate divided by price, as provided by MSCI. Forward price to earnings ratio is a bottom-up calculation based on the most recent MSCI EAFE Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on MSCI EAFE Index price movement only, and do not include the reinvestment of dividends.
Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2015.

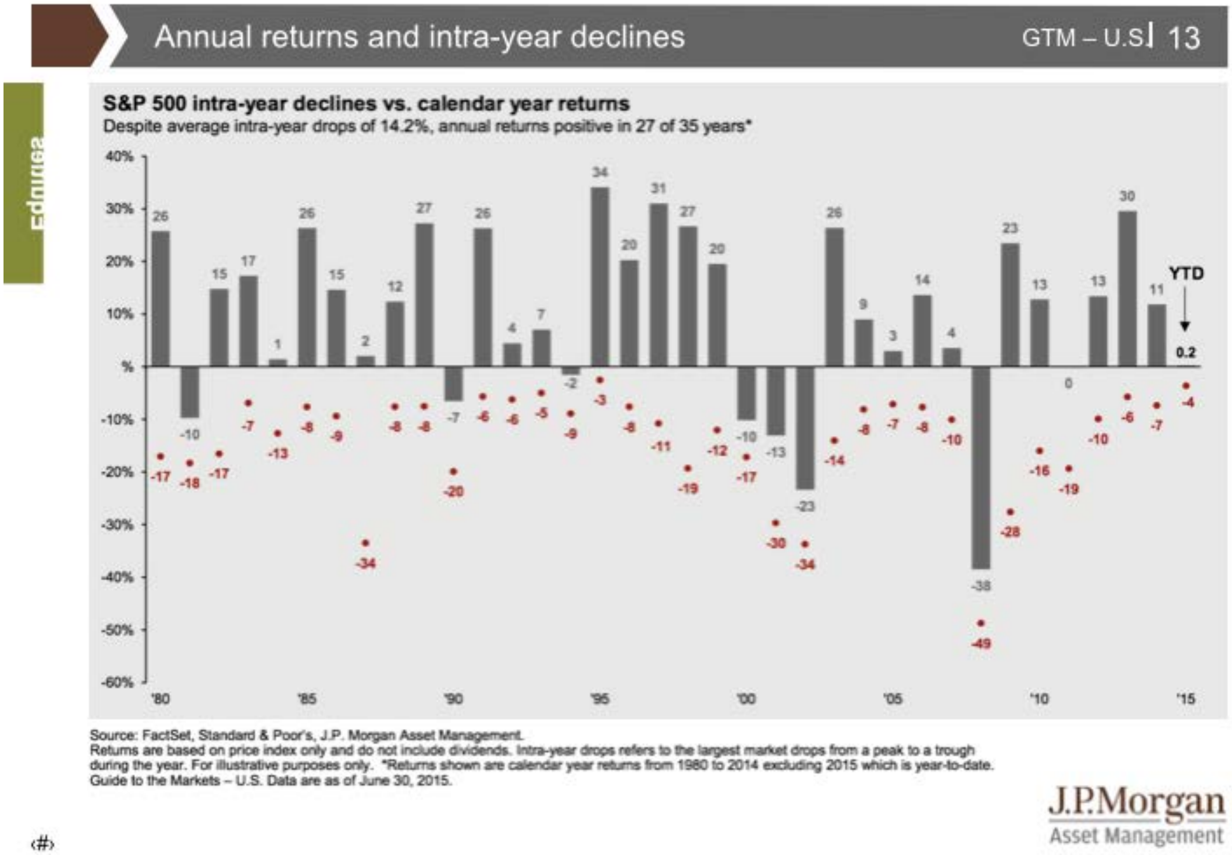
Many of the managers that we heard from continued to see more opportunities overseas than in the U.S. As you will see from the charts above, the one on the left shows the performance of the S&P 500 since 1997 with the major inflection points. You will notice that not only is it up 205% from the low in 2009, the S&P 500 has also hit all-time highs recently. If you compare that to the MSCI EAFE (Europe, Asia, Far East), you will notice that the recovery overseas has been less than robust. The EAFE is up 104% since 2009, returning half of that of the S&P 500 as well as not even reaching the 2007 peak yet.

For this and many other reasons – such as the strength of the dollar and quantitative easing by the European Central Bank – the investment managers are seeing additional growth opportunities overseas.

Volatility

For many investors, they do not know what is more frustrating: having their portfolio go up by 10% and then seeing those gains wiped away with a quick three-week selloff of 8% or a market that is three steps forward and almost three steps back where almost no progress seems to be made.

One thing to remember is that in mid-October, 2014, the S&P 500 was flat for the year. It finished the year up 11% with all of that return happening during the final 10 weeks of the year. The old adage of "it is time IN the market, not timING the market is what builds true wealth" is definitely true. The longer you stay in the market, the better your chances of being in the market during short periods of substantial gain. Imagine if you were in the market the whole year except for those final 10 weeks. It would be devastating.



Annual returns and intra-year declines

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Equities

S&P 500 intra-year declines vs. calendar year returns

Despite average intra-year drops of 14.2%, annual returns positive in 27 of 35 years*

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. *Returns shown are calendar year returns from 1980 to 2014 excluding 2015 which is year-to-date.
Guide to the Markets – U.S. Data are as of June 30, 2015.

J.P.Morgan Asset Management

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Consider the above chart showing not only the year-end performance of the S&P 500 but also and more importantly the intra-year low. Many people like to talk about the 23% return in 2009 and forget that at one point during the year it was down 28%. Or, more recently in 2012 when the market finished the year with a nice 13% positive return however they forget that earlier in the year it was also down 10% for the year.

Majority Investment Managers' Consensus Points

- Maintain an overweight allocation to equities and international investments.
- Active management and sector rotation will become more important in this next market cycle.
- Commodities will still be a struggle.
- Energy results in a lag on sectors, however, they have a longer-term positive outlook and could even be opportunistic.
- Consumer discretionary is looking very positive.
- Be prepared for 5%-10% pullback at any time (pullbacks are buying opportunities).

Final Thoughts

We are in a time when our equities need to be equities. We acknowledge the challenges that we are facing in this environment (raising rates, China, Greece, slow growth, quantitative easing). We still feel that we are in a recovery with signs of volatility but not recession. The next 12-18 months should be a bumpy ride, however, you would most likely be further ahead to participate in the slow bumpy growth rather than to try to time the market or avoid it. For example, all 11% of the return of the S&P last year came in the last 10 weeks of the year. We are expecting mid to high single digit returns over the 12-18 months, however, it can all happen within a period of a few weeks.

Questions?

If you have any questions whatsoever regarding our investment manager meetings or any of the notes, give us a phone call or stop by our office:

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Interesting Facts

- 2014 was the first year in 20 years that the S&P 500 was the best performing index.
- In mid-October 2014 the S&P was flat for the year. All of the returns (11%) came in the final 10 week period.
- The #1 performing individual stock within the S&P 500 during the first 7 months of 2015 has gained +134.2%. That same stock lost 7.2% in 2014, ranking #430 of 500 stocks (source: BTN Research).
- The #1 performing individual stock within the S&P 500 during calendar year 2014 gained +124.6% last year. That same stock lost 14.5% in the first 7 months of 2015, ranking #415 of 500 stocks so far this year (source: BTN Research).

Strategic Income Group LLC is a Registered Investment Adviser

Interesting Facts Continued

- 7 years ago, the euro peaked at $1.6038 (on 7/15/08). Last Friday (7/31/15), the euro closed at $1.0987. A weaker euro (which means a stronger U.S. dollar) has a negative impact on U.S. exporters, critical to most major American companies since 46% of the revenues of the average S&P 500 company come from foreign sales (source: Standard & Poor’s).
- In spite of 29,000 physicians that are completing their graduate medical education each year, the United States is anticipating that its demand for physicians in 2025 will exceed its supply by at least 46,100 doctors to as many as 90,400 doctors (source: Association of American Medical Colleges).
- The European Central Bank and the International Monetary Fund own 80%-90% of the debt of Greece. This is similar to TARP (Trouble Asset Relief Program).
- The total debt in Greece is $350 billion which is what the U.S. spends every 33 days. It is 3% of gross domestic product of Europe. This is numerically insignificant. J.P. Morgan believes they have contained the problem of Greece.
- Our J.P. Morgan manager covers 3,500 advisors and said that he goes into more detail with our team than any other advisor/team he works with.
- U.S. Manufacturing: Volkswagen saves $8k per car by having it produced in TN vs. Germany.