ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
October 8, 2015

Dear Clients:

At long last, the pricing for global stocks was adjusted in the third quarter as a cloudy path to continued prosperity took a bit of the air out of expectations for future earnings. We limit the cause to earnings as the prices of high quality bond and non-energy, income-oriented assets actually rose in the most recent quarter, suggesting continued low interest rates for a while longer. The view of the future is always a bit cloudy but we characterize the dampening of overly exuberant expectations for equity returns as a good thing. Long term investors, as distinguished from short term traders, should always embrace the adjustment of securities prices to levels which increase the odds of higher future returns. The challenge advisors face is identifying the inflection points that separate the under-valued from the over-valued and constructing portfolios with a reasonable margin of safety if asset prices are severely and unexpectedly marked down. We all know the rules of thumb: “buy low, sell high” or “sell the loved, buy the unloved” or “be afraid when others are greedy, be greedy when others are afraid”. Suffice it to say, one-liners are easier to utter than to implement.

Investment Market Returns as of September 30, 2015

For the third quarter, the S&P 500 Index had a negative total return of -6.4%, while the MSCI World ex-US Index experienced a net loss of -10.6% in USD terms. For the twelve months ended September 30, the respective total returns were -0.6% in the US and -10.1% outside the US. The decline in stock prices was even more severe for US small cap stocks and non-US emerging markets stocks; the quarterly losses on these stocks were -11.9% and -17.9%, respectively. The returns on international stocks continued to be diminished by a strong USD, but USD strength versus other currencies was less in the most recent period. The returns from specific economic sectors in the US were particularly weak for energy, industrials, and materials; but that weakness broadened out to heath care and financials in the third quarter, suggesting a slowing overall economy is weighing on future earnings. That returns for US utility and REIT stocks were positive during the third quarter and over the last twelve months support the outlook for continued lower-than-normal interest rates.

Bond returns both in the US and abroad were positive in the third quarter, reversing the trend seen in the second quarter. Annualized yields for investment grade bonds across the globe remain close to 2% for durations of between 6x-7x. For the twelve month period, the total return on the Barclays US Aggregate Bond Index was 2.9%, while the Barclays Global Majors ex US Bond Index lost -6.3% in USD terms, reflecting the relative strength of the USD. For the quarter, aggressive “Quantitative Easing” activities by foreign central banks and a lower currency burden lifted the non-US bond index to a positive return of 2.1% in USD terms compared to the comparable return on US investment grade bonds of 1.2%. Still, total returns exceed yield, reflecting the benefit of rising bond prices.

Commodities remained in a decidedly bear market as indicated by the Bloomberg Commodity Index showing declines of -14.5% and -26%, respectively, for the recent quarter and twelve months. The trend in gold was less negative but still headed south. Suffice it to say, there is no signal of impending inflation from this corner of the investment world.

Our Look Forward

Let us be clear; neither we nor any investment analysts we regard favorably knows where stock, bond, and commodity prices will go from this point over the next couple of years (a period we believe to be quite short). There are simply too many variables and unknowns that determine the precise future course of securities prices over short time periods. That said, we must make judgments about the relative attractiveness of different investment asset classes to position your portfolios to benefit from outcomes we deem most likely.

As these comments go to press, the S&P 500 Index sits around 2000, while the trailing twelve months earnings for the index is now about to drop below 100. The resulting annual earnings yield of 5% on stocks might be attractive if corporate earnings maintain a 3% **real** growth trajectory, bond yields stay at historically low levels (2% today on the 10yr UST note), and annual inflation is lower than 2%. A combination of these factors would suggest a 7%-8% annual return on US stocks. Such a return expectation is not unattractive given current bond yields but it offers a very thin margin of safety given very high earnings multiples. If history is any guide to evaluating margins of safety, one need only consider the history of earnings multiples and bond yields during the period 1870-2015. During the period, the trailing twelve month earnings multiple for the S&P 500 Index averaged 15.6x, while the median observation was 14.6x. Slightly less than 50% of the observations were at 15x or less with a low of 5x. At today's 20x, we think downside price risk is somewhat higher than upside opportunity. Similarly, the history of the 10yr UST note yield shows an average of 4.6% and a median of 3.9% versus the current yield. This yield has been less than 3% only about 20% of the time since 1870. While our current situation may be "different" from the past, we do not like the odds of current valuation factors remaining stable.

No doubt recent observations for earnings multiples and bond yields may help explain the "hand-wringing" over whether the Federal Reserve Board raises the over-night funds rate by 0.25% or 0.50% next month or next quarter or next year. We see the Federal Reserve Board pursuing a "Goldilocks" scenario of a "just right" outcome from the Quantitative Easing experiment and hope it is successful. On the other hand, government actions based on the best of intentions often fail due to unintended consequences. The concepts of mean reversion and wisdom of the crowd frequently overwhelm, so your portfolios are constructed with these consequences in mind. As you review your investment portfolios, you will find a common theme of under-weighted equity exposure, global diversification, low duration bond positions, alternatives with a defensive, non-correlated bent, and a small cash cushion.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meeting your expectations.

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