The Force Awakens…

By Dave Denniston, CFA

I have a confession to make…

I am a nerd!

Well, you probably already knew that…

=-)

I love Sci-Fi movies, fantasy books, comic books, self-development books, and yes, all things Star Wars.

Now, I'm not <u>that</u> <u>crazy</u>- dressing up in costumes and stuff. **I'm too self-conscious to do such things.**

Anywho, in the latest Star Wars movie, you sense that something is happening in the universe, "The Force" is being awakened.

The last few years I've doubled down and done more and more research. This year was no exception.

I feel like my eyes have been opened. <u>In a weird, fun way, my "internal" force has been awakened.</u>

I feel more empowered than ever before. In 2016, we are going to add more tools in our tool belt. I am going to implement a new system.

Many folks have asked, "Can we have more US stocks? Can we act more like the index?" The answer is "yes!" and we will. Yet, I don't want to have all of the downside risk.

In the coming year, I am grappling with the following questions:

What will happen in the next year? Are stocks safe?

<u>How much will the Fed raise interest rates and how are we protected against it?</u>

Should we continue to have international investments in the mix?

<u>What am I doing to best position you in the next 12 months (& beyond)?</u>

In the next few pages, I am going to reveal to you these sweet new strategies as well as how it effects our current systems.

Of course, there are no guarantees, but know that I will continue to push the envelope, to challenge myself because I want to be the best possible financial advisor and investor, to have the best possible experience for clients.

SELL IN MAY & GO AWAY? THE POWERFUL MACD STRATEGY

Let's get right into it!

One of my favorite resources is the Stock Trader's Almanac by Jeffrey Hirsch. There's a new version every year. Make sure to check it out!

This is where we have pulled a number of great ideas including the January effect mentioned in last year's newsletter.

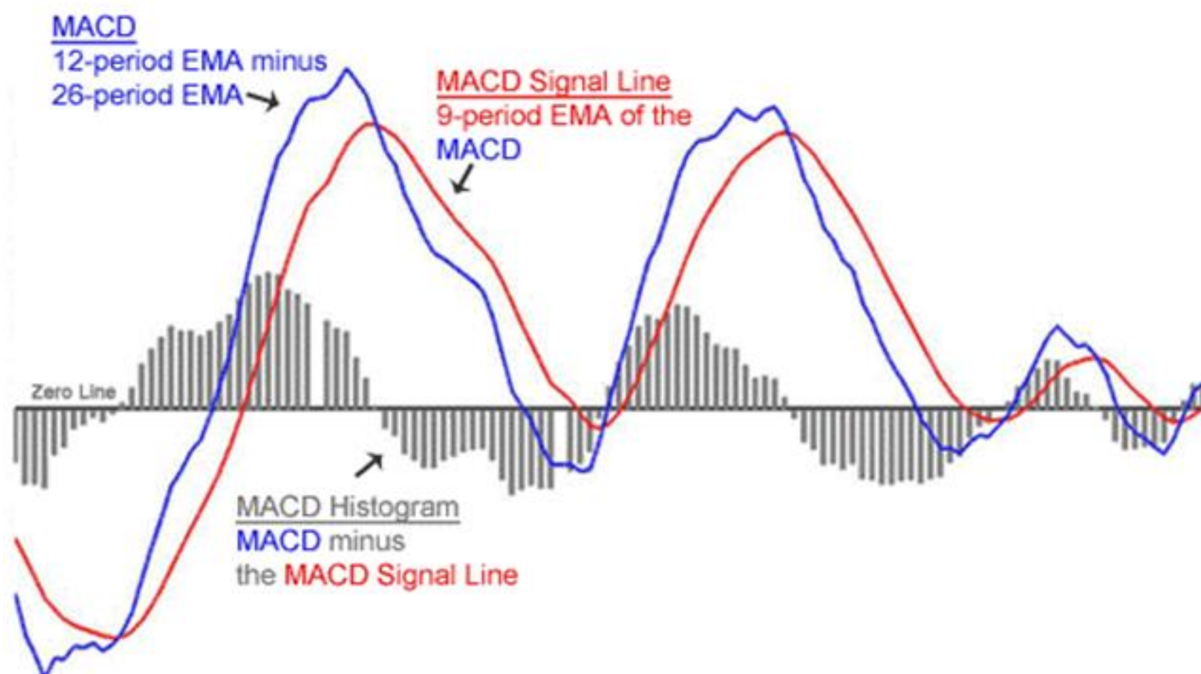
Anyhow, one of the other approaches they mentioned and I double-checked was a strategy where you get more aggressive for about six months and get more conservative for about six months. Many folks refer to this as "Sell in May and go away".

The concept is really quite simple. You're in for about six months and you're out for about six months.

You start looking in mid-April to get more conservative. It may be April, May, or June depending upon the market. If things are going great, you stay in. If things start to suck, you move out.

You have to be patient for at least four months, maybe six months. Then, you start looking in mid-October to get more aggressive. If things are sucking, you are patient. If the market is go-go-going, then get involved.

It uses an indicator called the MACD to figure out the timing of when to pull out and get back in. How does it work, you ask? Below is an example of MACD indicator. The blue line is the MACD, the difference between the 12-day and 26-day EMAs of the index.



Source: Wikipedia.com

Exponential moving average (EMA) is a price-weighted moving average which attaches more significance to recent data. The red line is the average or signal series, a 9-day EMA of the MACD series. The histogram bar graph shows the divergence series, the difference of those two lines. A "zero crossover" event occurs when the MACD series changes sign (goes negative-Sell or positive-Buy), that is, the MACD signal line crosses the horizontal zero axis. This happens when there is no difference between the fast and slow EMAs of the price series.

I can't take credit for any of these ideas. A gentleman named Sy Harding did the original research. He wrote *Riding the Bear - How to Prosper in the Coming Bear Market* (Adams Media, 1999) as well as *Beat the Market the Easy Way* (Wheatmark, 2007).

He published that the best time to sell is April 20th or later combined with a bearish MACD (negative MACD) signal.

Meanwhile, you buy after October 16 arrives AND the MACD is positive, or the next time the MACD line is greater than the signal line (positive MACD histogram), then enter the market the next day.

Why Does The Seasonal Timing Strategy Work?

My partner, Brett Machtig, cited Sy Harding in saying that it has to do with the flow of funds into the markets, from November to May and money flowing out of the markets from May to October.

Consider these examples:

- Most mutual funds have fiscal years that end October 31, so they can get their books closed and make their capital gains and dividend distribution to their investors in November and December. Additionally, most investors have their mutual fund distributions tagged for automatic reinvestment. Source: http://news.morningstar.com/articlenet/article.aspx?id=715686

- Corporations pay third and fourth quarter dividend distributions to investors in the period known as the "Earnings Season," between November and March. Since most investors have their brokerage accounts tagged for automatic re-investment of dividends, money flows into stocks. Source: www.investopedia.com/ask/answers/08/earnings-season.asp

- Many DJIA Stocks have purchased shares back, reducing the number of outstanding shares. Warren Buffett has many of his companies use excess cash flow earmarked to buy back their stocks. In 2014, companies in the S&P 500 spent $564.7 billion on share repurchases over the past 12 months, which was a year-over-year increase of 18%, according to FactSet Research. In fact, 72% of all companies in the index bought back shares in the fourth quarter of 2014. Source: www.nasdaq.com/article/are-record-stock-buybacks-too-much-of-a-good-thing-cm463261#ixzz3s9J9L2Gs

- At year-end investors begin receiving their employers' year-end contributions to their 401(k) and pension plans, which are usually automatically invested in the market. In fact, the number of companies making year-end 401(k) company matching is on the rise. Recently AOL, IBM,

JPMorgan Chase & Co., Charles Schwab Corp., Citigroup and a host of other major companies have decided to offer annual lump-sum 401(k) matching contributions at year's end. Source: www.bankrate.com/finance/retirement/lump-sum-401k-matching-contribution.aspx#ixzz3s9M2Rs4H

- Investors receive checks from their employers' profit-sharing plans, from Christmas bonuses, year-end bonuses, and income-tax refunds in the spring. Much of these extra chunks of money also find their way into the stock market as investors fund retirement plans and savings.

- Highly paid hedge-fund managers collect their generous year-end fees after the end of the year which will also find their way into the stock market.

- Small business owners close their books at the end of each year, and once they know what their profits were for the year, they distribute those profits to themselves. Much of that extra cash also finds its way into the stock market as investors fund retirement plans and savings.

- Wall Street institutions, money-management firms and knowledgeable investors, aware of the market's seasonal pattern, also begin buying more heavily, often in October, in anticipation that the market will make its usual impressive gains in the favorable season.

- Other investors, perhaps reluctant to invest in October, November, and December, still fearful of the market decline that has typically taken place during the unfavorable season, find their courage and interest return after two or three months of rising stock prices. They begin adding their money in January, February, March, and April.

Disadvantages of the Sell In May & Go Away MACD Strategy

Tax consequences from short-term trading are the primary drawback of these STS trading strategies. Since holding periods are less than a year, capital gains are short-term and are taxed as earned income.

This can double your taxes and applies to taxable accounts like an individual, jointly-held, and corporate brokerage accounts.

A person could apply this philosophy and go 100% in stocks after the signal in October, November, or December and then have 0% in stocks after April, May, June.

I don't buy that! Why?

The cost of being wrong is too high. What if this is the year that doesn't work? What if the market is great in July, August, in September or sucks in November, December, January, and February?

In doing a study of the last 20 years, this did occur several times. It happened in 2000, 2005, 2009, and 2013.

That's about 1 out of 5 years.

How Am I Going to Use This Strategy for You?

I think this is an awesome strategy and I am going to use it. Here's how I am going to implement it:

- For positive time periods (i.e. October to April), put approximately 80% in the S&P 500 or other stock indices, 20% in bonds or fixed account
- For negative time periods (i.e. May to October), put approximately 30% in the S&P 500 or other stock indices, 70% in bonds or fixed accounts
- I am going to use this as ONE SLEEVE in our strategy. For example, if a client has 3 brokerage accounts. One brokerage account will be buy & hold, another account will use the January effect and the 200 day moving average, and the other account will use this MACD indicator.
- I will favor the MACD indicator in annuities, IRAs, and Roth IRAs, but may use it from time-to-time in non-qualified accounts as well.

Interest Rates

In the next few pages, I am going to reveal to you how interest rates could effect the bond portion of your portfolio- or perhaps not at all- and my exclusive strategies to help protect your portfolio in a rising interest rate environment.

There's two basic things to keep in mind with bonds:

First, traditionally, bonds are usually thought of as the "safe" part of the portfolio. This has played out time and again over the last 30 years. When the tech crash occurred and the housing market crisis spread, investment grade bonds helped to cushion the volatility.

Secondly, we've been in a lowering interest rate environment for the last 30 years. As interest rates have gotten lower and lower and lower, bonds prices have risen and risen and risen. Truly, the last 30 years have been a great time to own bonds.

Alternatively, when interest rates rise, bonds lower in price. But, how fast and by how much?

One of the questions we've been grappling with in our investment committee meetings is what would happen if bonds weren't safe any longer? What if we have a rising interest rate hurting bonds AND stocks are going down over an extended period? What will we do?

Since the beginning of 2015, the good news has been that 10 year interest rates actually stayed the SAME despite the Federal Reserve taking their foot off the gas of quantitative easing & raising rates. Although, 2 year and 5 year interest rates have RISEN just a little bit.

10 Year Treasuries started out 2015 at about 2.2% and here at the end of December, they are close to well, 2.2%.

2 year treasuries started at about 0.7% and ended at 1%. 5 year treasuries started at 1.65 and ended at 1.7%.

We call this the "flattening" of the yield curve. Basically, this means that interest rates across a variety of maturities are getting closer to one another.

Frankly, I've been shocked by this happening, but here it is anyhow.

I can’t help but think that interest rates are going to be headed back up for the next 1 to 2 years.

Well, what effect could this have?

Through the curriculum provided by the CFA institute, if we take the duration times the change in yield you get an approximate change in price.

So, if you take a 10 year maturity bond for example- duration of about 9, if yields move up 2%, that means a potential 18% change in price down. A 2% change would be huge- 18% downside, ouch!

If instead, that same bond, yields move up 1%, that means a potential change of 9% in price. Pretty painful, but easier to stomach than a 2% change.

Or what if it is a slight interest rate move, yields move up 0.2%, that means a potential change of only 1.8%. This is virtually no change when you consider the current interest rate paying 2.2%. it’s basically, a break-even scenario.

So, the question as investors and financial professionals, how are we going to handle this?

I have three specific actions that you can take.

First, review over the options for your 401k or other employer sponsored plan. There may be a “fixed” or “principal” or “stable value” option which pays a stated interest rate while the principal stays unchanged no matter how interest rates fluctuate. Consider allocating a large chunk to your 401k in that category. I had one client who had very few choices available in her 401k and the stable value option was not one of them. If this is not available and low duration bonds are not available, consider having part of the bond allocation in money market.

As you review over your asset allocation, look for other areas that may be interest rate sensitive. For example, real estate investment trusts or REITs tend to be interest rate sensitive. This is because buying real estate tends to involve putting down some equity as well as acquiring debt. When interest rates are low, this can give investors higher returns for the same amount of rent than when interest rates are higher. Consider lowering your exposure to those types of investment classes and instead consider other ones that are not as sensitive to changes in interest rates.

Lastly, check out my video from a year ago- “5 Actions to Take in a Rising Interest Rate Environment” for 3 other strategies that you’ll want to consider.

So, there’s a number of different ways you can protect yourself in a rising interest rate environment. You don’t want to wait until it has already happened to be there.

Should We Have International Stocks? Or Not…

This can be confusing because it depends on what country, what region, or how you put which one in what bucket.

So, let's ignore individual countries you guys and instead focus on big classifications of international stocks.

There are four main areas to be aware of: global, international developed, emerging markets, and frontier markets.

Global is a bit confusing because you think of other countries, but in fact most indices that are categorized as global include about 50% US companies.

So, if you have a global fund or a global ETF, it is likely dominated by US companies- but you can still get a taste of international companies.

In comparison, international developed indices don't have US companies, but they focus instead on developed areas- mostly Japan & Western Europe with a couple other countries here and there.
Then, emerging markets or EM as we like to call them- are really where most of the population of the world is contained and has been up and coming- the majority of those indices are filled with B-R-I-C… BRIC for Brazil, Russia, India, and China.

As you can imagine, emerging markets has been beaten up pretty badly lately with China's economic rockiness.

Lastly, frontier markets are the up and commoners stretching to make it into EM- think of countries like Vietnam, Saudi Arabia, South Africa, Argentina, & Kenya.

What's frustrating about international investing even in a broad, diversified play is that performance can be so much better than domestic stock at times, but then can really really suck sometimes.

Check this out first.

S&P 500 versus a Global Index. Remember that 50% of the global index is US companies- so we should expect some similarities.

Index	2008	2009	2010	2011	2012	2013	2014	2015
S&P 500	-38.3%	23.49%	12.84%	-0.2%	13.47%	29.69%	12.86%	-8.49%

FTSE Global Allcap	-45.5%	32.65%	13.08%	-7.5%	17.12%	22.95%	3.67%	-8.08%

Source for all tables: Morningstar.com & VectorVest.com

So, definitely, there's a lot of similarities here, but a few differences too. 2008 was crappier for the global index, but then it recovered more in 2009. It lost a bit more in 2011, but recovered in mostly in 2012.

However, in 2013 and 2014, the S&P outperformed it in both years by nearly double digits. So, domestic stocks are doing better lately, but since global stocks have the S&P 500 in them- it can't stray too crazy far.

I think you can see where I'm going with this.

Next, let's look at EAFE, a developed markets index vs the S&P.

Index	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
S&P 500	-38.3%	23.49%	12.84%	-0.2%	13.47%	29.69%	12.86%	-8.49%
EAFE	-41.0%	26.92%	8.15%	-12.3%	18.82%	21.39%	-6.20%	-5.85%

Here's where we start to see some significant differences you guys. 2008 and 2009 look pretty similar to the Global Index. But then 2011 until today has wider swings- the lows are lower- for example -12% in 2011 and -6% last year in 2014.

This year, the EAFE is actually doing a little better- which is interesting given the stimulus they have going on- their stocks doing relatively better despite the Greek drama over the summer.

Index	**10 Year Average**
S&P 500	6.60%
EAFE	2.75%

Here's where the rubber meets the road- the 10 year average.

I was actually a bit surprised that the S&P was this low when I pulled up the number. I would have thought it would have been higher.

Yet, EAFE is even lower- MORE than half of the S&P. You would have lost out 4% every year by being invested internationally rather than domestically. Ouch!

Alright, let's move onto emerging markets.

Index	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
S&P 500	13.7%	3.24%	-38.3%	23.5%	12.84%	-0.2%	13.5%	29.69%	12.86%	-8.5%
FTSE Emerging Mkts	29.4%	37.3%	-52.2%	75.3%	19.46%	-18.8%	19.2%	-4.92%	-0.07%	-17.5%

This is where things get a big crazy.

I squeezed in a couple of earlier years to explain the allure of EM. Check 2006 and 2007. EM was flying- killing US equities. Then, they dropped like a rock. Way worse 2008.

Then, took off like a rocket in 2009- tripling what the S&P did, followed by another great year in 2010, 2011 was a really crappy year for EM- but NOT for US stocks, followed by a make up year in 2012.

Since then, it's been very frustrating to be in EM stocks. US equities zoomed up 30% in 2013 & 2014, EM went nowhere followed by a really crappy year again so far in 2015.

Yet, the GDP of India & China have continued to climb over this same period. Whether it is due to accounting fraud or government manipulation or bad actors all around, that growth has not helped their stock markets.

Index	10 Year Average
S&P 500	6.60%
FTSE Emerging Mkts	3.81%

Check out the 10 years averages- it's actually beat EAFE, but lost ground to the S&P 500, not quite as badly as EAFE- but still by nearly 3% per year- or 30% over the last 10 years- which we know now is mainly because of the last couple of years.

To be honest, I've had money in EM and it's pissed me off.

However, on the other hand, it seems due for a bounce in a big way if you look at the past.

Ah, but will it?

That's the conundrum.

Anyhow, lastly, let's move onto Frontier Markets.

Index	2009	2010	2011	2012	2013	2014	2015
S&P 500	23.5%	12.84%	-0.2%	13.5%	29.69%	12.86%	-8.5%
BNY Mellon New Frontier Index	33.9%	33.89%	-22.4%	12.3%	-14.57%	-11.8%	-18.2%

What we see here with Frontier Markets is very similar to Emerging Markets. It's been even more volatile the last few years. Negative double digits in 2013, 2014, and so far in 2015.

What's interesting to me was that 2009 wasn't nearly as good as emerging markets.

So, there's a ton of opportunity here- but even more risk. There's more geo-political risk and instability in a lot of these places.

I've personally never invested there and don't intend to.

Alright, so where does all of this lead us?

We really have to ask ourselves- do we really want to have international stocks in our portfolios?

How would we feel if having international stocks causes us to underperform when domestic stocks are up?

One could make the case that with the Fed raising rates and countries like Japan and the Eurozone adding stimulus- that stimulus is equal to better stock markets.

We could add a global index in put a foot in the door, but mostly stay domestic.

We could add in developed markets believing the stimulus story.

We could add in emerging markets thinking that they finally bounce back or even Frontier markets.

Personally, I think Japan & the Eurozone are going to have a very hard time growing their economy and while exports might do better in the short-term due to the dollar appreciating, I don't like the long term picture.

Emerging markets continue to be very attractive- I think there's a lot of potential there- and they are moving towards increasing the power of the consumer in China & India & they are implementing many reforms. I like the long-term picture there. It just comes with a lot of risk over the short-term- but also a very large potential reward.

I think staying focused on US Markets keeps managing a portfolio simpler and easier to understand. After all, how many of us track how EAFE is doing or how emerging markets is doing? But many opportunities could be missed.

Overall, I'm personally committed to emerging markets in the next few years until they've bounced back significantly. The potential is too much to give up.

However, I'm come to realize that it can lead me to stray too far away from what happens at home and so over time, I am planning to keep some of that index in our models for more aggressive investors- but will make sure to eliminate or lower it for others.

But, I'm not going to do it until we get that growth back. To sell now and never buy back would be foolish in my opinion when they are so relatively low.

Final Thoughts

As I've reviewed over extensive amounts of data and have tweaked our models, I came to several conclusions:

1) We need more domestic stock exposure on a go-forward basis.

2) Emerging markets stock exposure may not be reliable on a go-forward basis and could lead to drastic underperformance compared to domestic stocks, even in an up year. However, we will wait to sell at a higher price point sometime after it breaks its technical trading range. In my opinion, it is due for a big bounce back in the next year or two and catch up.

3) Selling at higher prices is still a reachable goal and buying at lower prices is still a reachable goal

4) We need to have a strategy that can ride out short-term bumps, but avoid long-term swings down. Although, no system is completely infallible

5) We will utilize the best practices that we have learned that last decade: the January effect, the 200 day moving average, the sector rotation strategy, and the MACD Seasonal trading strategy

6) We will start to utilize a 3 pronged strategy on a go-forward basis. We will utilize buy & hold. We will utilize the 200 day moving average combined with the January effect. Lastly, we will utilize the MACD seasonal trading strategy.

We use these technical indicators to assist us with making solid, research-based decisions rather than relying on our guts & emotions.

It's better that way, trust me! I am just as emotional as the rest of us. =-)

Conclusion:

While I don’t know what is going to happen over the next 12 months, I do feel that there are many aspects- both positive and negative- that we have to balance within the worldwide economy. There is good reason to have hope, but we also need to be realistic about the long-term prospects for the developed world.

I thank you for your trust and giving us the opportunity to be of assistance to you. If you have any questions, please feel free to contact me at any time.

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