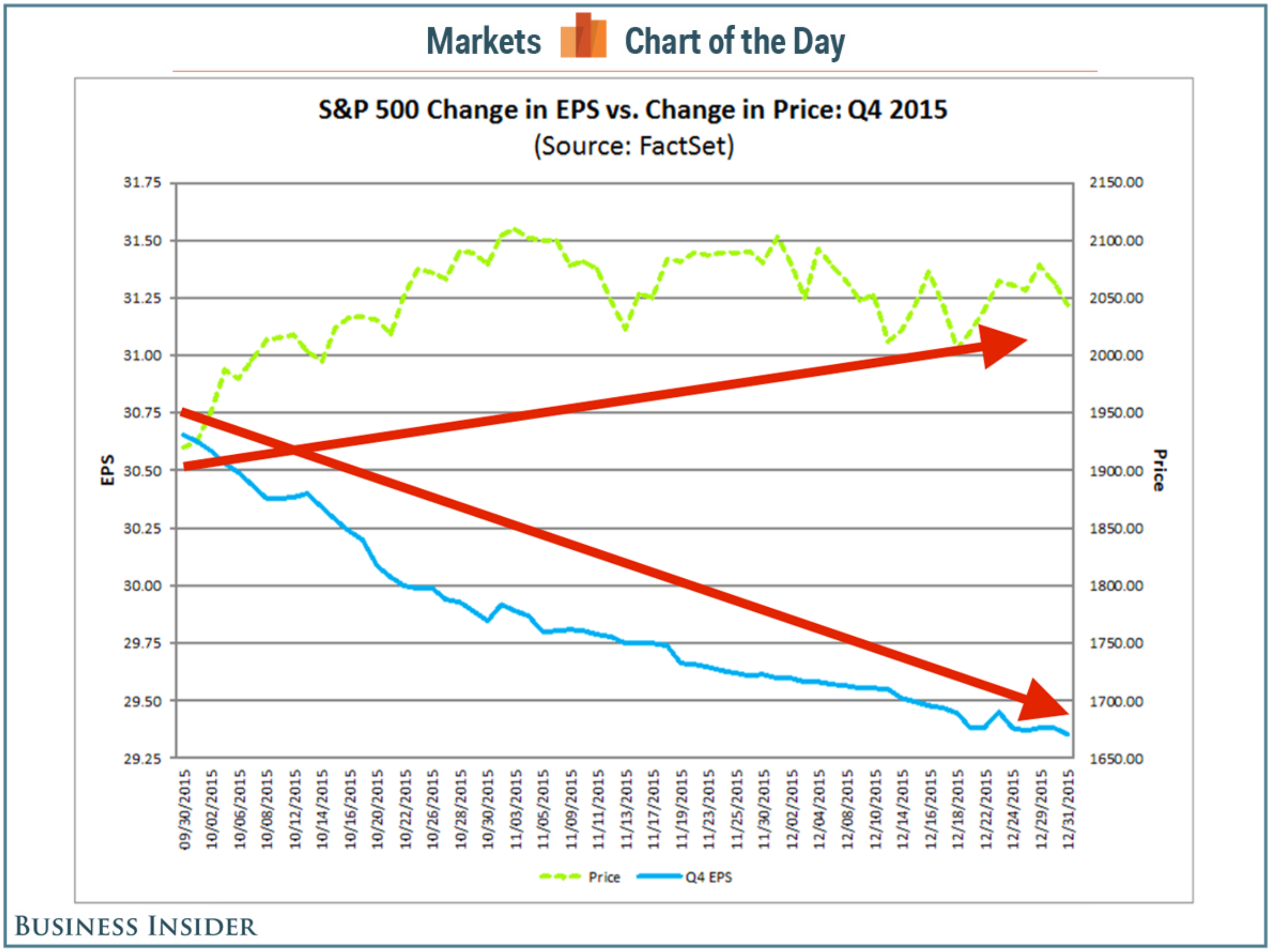
Investment Perspectives
2015 Q3

Pictures Help to Tell the True Economic & Investment Story

Sometimes a picture can say a thousand words. However, I hope to use far less words and only utilize three pictures (graphs actually) in which to explain the story behind the price declines within the U.S. equity markets. Let's begin with the two graphs below which from my viewpoint tells of the correlation between the drop in equity prices over the past 6 weeks and the continued deterioration in earnings per share estimates.

The first chart from Business Insider demonstrates how 2015 equity prices and Q4 earning per share estimates were moving apart during Q4 2015.



The second chart, compliments of The Earning Scout, shows the drastic slide by month beginning in July 2015 of Q4 earnings estimates.

Sector (1Q16)	11-Jan-16	4-Jan-16	1-Dec-15	1-Nov-15	1-Oct-15	1-Sep-15	1-Aug-15	1-Jul-15
Consumer Discretionary	10.79%	11.53%	13.75%	15.43%	16.45%	16.68%	17.08%	16.30%
Consumer Staples	4.19%	4.16%	4.64%	5.66%	6.94%	7.41%	8.04%	8.38%
Energy	-70.03%	-58.90%	-46.97%	-43.54%	-38.34%	-23.85%	-16.51%	-3.97%
Financials	2.35%	2.88%	3.88%	4.09%	6.19%	6.74%	5.20%	5.16%
Health Care	4.65%	4.70%	4.40%	4.95%	5.40%	5.66%	6.27%	7.52%
Industrials	2.47%	2.62%	3.15%	4.53%	8.14%	8.69%	8.90%	8.50%
Information Technology	-2.68%	-2.49%	-0.90%	1.10%	1.91%	1.60%	1.83%	3.84%
Materials	3.40%	3.99%	4.61%	6.77%	12.11%	13.68%	13.55%	13.09%
Telecom	5.95%	6.32%	6.69%	6.69%	7.06%	6.69%	5.20%	5.20%
Utilities	-2.43%	-2.43%	-2.74%	-1.86%	-1.95%	-1.99%	-1.38%	1.29%
S&P 500	**0.60%**	**1.28%**	**2.47%**	**3.83%**	**5.91%**	**6.28%**	**6.43%**	**7.36%**

Source: The Earnings Scout

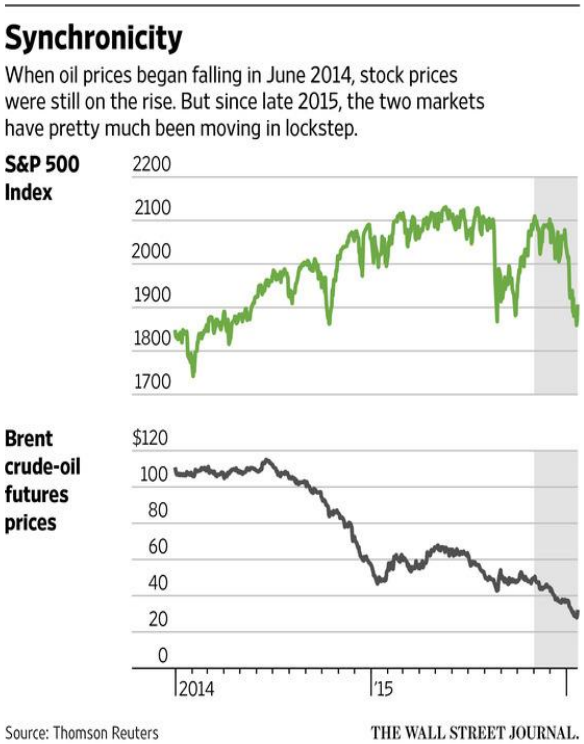
According to these two charts, we could have seen going back to the early Fall of 2015 timeframe that something was amiss within the fundamentals of the biggest U.S. Companies and the prices that they were trading at. The right call at that time would have been to underweight equity and overweight cash or bonds which is precisely what we did at TAMMA Capital.

But what are the driving forces (or noise in my opinion) behind expert's explanations of why equity prices have dropped so far this year? A decline in oil prices and an economic slowdown in China. Let's take a closer look at each individually starting with oil to determine if either are a driving force or just market noise.

Decline in Oil Price

- While consumers are benefiting greatly from the drop in oil prices (it is estimated that consumers are saving $80M per day) oil companies that spent big money in capital projects years ago to bring on new capacity and build new pipelines when oil was near or over $100 per barrel are definitely hurting right now. Economics would tell us that there are winners and losers in this game, but is this current situation a net positive or negative for the existing economy? I am not sure if anyone really knows the answer to this questions.

- With the graph to the right, you can see that as the price of crude oil began to drop, equity prices did not. The drop in oil prices were likely due to a decline in demand which also began showing up in U.S. companies revenue and earnings estimates. This chart is another illustration of how the correction of equity prices downward is beginning to catch up with the downward revision in both revenues and earnings per share.



<u>Economic Slowdown in China</u>

- The drop in crude oil prices probably has some direct correlation with the slowdown in the Chinese economy. However, as I have listened to reports from Bloomberg over the past few weeks, China has potentially begun to stock pile tankers full of crude oil in order to take advantage of this dramatic decline in crude oil prices. If this is indeed the case, this type of situation could give a false sense of what the actual price of a barrel of crude should be. If Chinese interaction such as this were occurring, it would make the price of crude oil artificially high.

- While the slowing China economy could be a reason why oil has fallen, it should not have a material impact on the US economy. According to Howard Marks at Oaktree Capital, “China doesn’t play a pivotal role in the U.S. economy (other than as a provider of finished goods). It is estimated to account for only 1% of the combined profits of the S&P 500 companies. Exports account for about 13% of U.S. GDP, and in the first eleven months of 2015 less than 8% of our exported goods went to China ($106 billion of goods, versus an annual GDP approaching $18 trillion – again, well below 1%).”

As we have noted in previous articles, we believe that there are several reasons as to why revenue and earnings estimates have slowed which include the following;

- Consumers are saving more, this could be for a variety of reasons which could include, paying down debt, increase retirement savings, or increase overall savings for emergency purposes. People may still be planning for an uptick in oil prices and have taken alternative savings measures to take advantage of the drop in gasoline prices.

- Although the government CPI data shows little to no inflation, there are pockets of the economy that are increasing their prices. We see inflation in both the education and health care sectors.

So at the end of the day we are back to focusing on the continued deterioration of revenue and earnings estimates by U.S. companies. By understanding some of the underlying trends within the various sectors that make up the U.S. economy, we can carefully try to identify those potential winners while trying to avoid the potential losers.

State of the Portfolio

Sometimes in the world of managing assets even when you are right, you can still be wrong. This was the situation I found myself to be in during 2015.

While I never try to time the markets, there are times when asset allocation decisions must me made based upon data that I analyze. As I have been talking about for the past few quarters, I had been seeing companies continue to report lower revenue growth which concerned me greatly.

As most clients and readers know, I manage portfolios at TAMMA with a tilt towards quality. What constitutes quality in my eyes are companies that possess the following traits/characteristics;

- Low or zero levels of debt; a total debt to equity ratio of below 1 to be exact is a good measure for me
- Strong cash flows which means a high economic margin; economic margin is calculated by taking operational cash flow, subtracting a cost of capital, and then dividing economic income by gross property/plant/equipment. Here I am not only looking for a positive absolute number but a sustainable positive trend with catalysts to keep that trend going
- Reasonable levels of revenue growth; back to the notion of catalysts, a company should have reasonable reasons for sustainable revenue growth and not be one hit wonders

These are all traits that in most years, the market would reward. However, in 2015 the market sought to reward companies that primarily drove top line growth without much regard for the other crucial parts of their financial health. While I love companies like Amazon and Netflix, I just could not build an acceptable analysis to justify owning these companies at their current valuations.

While the aforementioned companies may continue to prove me wrong, I believe that there are other companies out there with more compelling valuations that can be bought at a more acceptable price.

So while I was wrong on some of my specific stock selections and holdings in 2015, I was absolutely correct to switch to a more conservative asset allocation which meant holding more cash.

Since flipping the calendar to 2016, we have only begun the year with one of the worst starts in U.S. stock market history. Not exactly what most of us hand in mind to begin the new year but we have to play with the hand that we are dealt which is currently a very volatile and uneasy market. This is why I am continuing to stay with my decision to hold a larger portion of cash in my client portfolio until I see some specific company and market data improve.

Insider Trading

$6.6 trillion...the amount American workers are short of what they need to retire comfortably (source: Boston College Center for Retirement Research).
$24,671... total average health care costs for a typical four-person family in 2015, up from $13,382 in 2006 (source: Millman Medical Index/Money.com)
$104,000...median savings for households headed by somebody between 55 to 64 (source: Government Accountability Office)

Personalized Investing; Tax Planning to Begin the New Year

One of the best times of the year for tax planning is at the beginning of a new year. By understanding changes in tax codes and knowing important dates, you can put together a plan that should integrate well into your overall long-term wealth management plan.

2016 Important Tax Figures

- IRA contribution limits (Roth or traditional): $5,500 under age 50/$6,500 over age 50.
    - Income limits for deductible IRA contribution, single filers covered by a retirement plan at work: Modified adjusted gross income under $61,000--fully deductible contribution; between $61,000 and $71,000--partially deductible contribution; more than $71,000--contribution not deductible.
    - Income limits for deductible IRA contribution, married couples filing jointly who are covered by a retirement plan at work: Modified adjusted gross income under $98,000--fully deductible contribution; between $98,000 and $118,000--partially deductible contribution; more than $118,000--contribution not deductible.
    - Income limits for nondeductible IRA contributions and IRA conversions: None.
    - Income limits for Roth IRA contribution, single filers: Modified adjusted gross income under $117,000--full Roth contribution; between $117,000 and $132,000--partial Roth contribution; more than $132,000--no Roth contribution.
    - Income limits for Roth IRA contribution, married couples filing jointly: Modified adjusted gross income under $184,000--full Roth contribution; between $184,000 and $194,000--partial Roth contribution; more than $194,000--no Roth contribution.
    - Contribution limits for 401(k), 403(b), 457 plan, or self-employed 401(k) (traditional or Roth): $18,000 under age 50/$24,000 for age 50 and above.
    - SEP IRA contribution limit: The lesser of 25% of compensation or $53,000.
    - Health-savings account contribution limit, single contributor under age 55: $3,350 / age 55 and above: $4,350.
    - Health-savings account contribution limit, family coverage, contributor under age 55: $6,750 / age 55 and above: $7,750.
    - Section 529 college-savings account contribution limit: Per IRS guidelines, contributions cannot exceed amount necessary to provide education for beneficiary. Deduction amounts vary by state, and gift tax may apply to very high contribution amounts.
    - Coverdell Education Savings Account contribution limit: $2,000 per year per beneficiary.
        - Coverdell Education Savings Account income limit, single filers: Modified adjusted gross income under $95,000--full contribution; between $95,000 and $110,000--partial contribution; more than $110,000--no contribution.

- Coverdell Education Savings Account income limit, married couples filing jointly: Modified adjusted gross income under $190,000--full contribution; between $190,000 and $220,000--partial contribution; more than $220,000--no contribution.

2016 Important Tax Dates to Remember

- April 18, 2016:
  - Individual tax returns (or extension request forms) due for 2015 tax year.
  - Last day to contribute to IRA for 2015 tax year (contribution limits: $5,500 under age 55; $6,500 for age 55 and above).
  - Last day to contribute to health-savings account for 2015 tax year (2015 contribution limits: $3,350 for single coverage, contributor under age 55; $4,350 for single coverage, contributor age 55 and above; $6,650 for family coverage, contributor under age 55; $7,650 for family coverage, contributor age 55 and above).
- Oct. 17, 2016:
  - Individual tax returns due for taxpayers who received a six-month extension.
- Dec. 31, 2016:
  - Retirees age 70 1/2 and above must take required minimum distributions from traditional IRAs and 401(k)s.
  - Last date to make contributions to company retirement plans (401(k), 403(b), 457) for 2016 tax year.

For questions about any asset and wealth management topics, do not hesitate to reach out to us to find out what options may be best for your own personal situation. Remember at TAMMA, we help to personalize investing for your future.

Paul Fenner, CFP®, ChFC
President
Registered Investment Advisor