

By: Scott Walker, CFP®



Market Update – Including a 2.2% drop today, the S&P 500 index is down 8% for the first ten trading days of the year. There have been only five other years since 1928 when stocks dropped 5% or more over these 10 days. On four of those occasions, the index was higher at the end of the year, with the exception being 2008. Corrections are never pleasant, but come with the territory. Maintaining a 3-5 year+ perspective for stock holdings can be tough. We are not panicking, and are comfortable with our balanced client accounts. Dislocations present an opportunity to upgrade holdings by weeding out the laggards and selectively establishing new positions at a more favorable price point. High quality bonds have been rock solid, and we are holding an above average amount of cash for safety.

Portfolio Update – Last year we underestimated the extent of the oil and commodities rout. The weakness spilled over into high yield bonds where price declines more than offset the monthly cash flow from these funds. Over the course of the year we exited all energy-related holdings and high yield bond funds, believing that these areas of the market would continue to be challenged. Over the last three years there has been a record amount of high yield debt issued, with a meaningful amount from U.S. energy related companies. Defaults have just begun and prices have collapsed. There will be periodic rallies, but the trend is clearly down for junk bonds. Energy stocks have been decimated and values are emerging, but we have to avoid catching a falling knife as the upcoming earnings reports will not be pretty. Look for oil and the energy complex to have brief rallies, but the supply glut is a major headwind. Saudi Arabia showing no restraint, the U.S. shale plays and enhanced drilling techniques have increased domestic production, and Iranian production is coming. I think it's too early to bottom fish with energy, but that time will come.

The economic miracle in China has hit the pause button with growth slowing, excess capacity, and factory layoffs increasing. Chip suppliers for the **Apple** iPhone have seen

reduced orders amid softening demand. We still like Apple which has \$25/share in cash and another iPhone upgrade cycle coming later this year. We have greatly reduced our international stock fund exposure, and recently decided to cut Japan due to the regional slowdown and close economic ties to China. Our only foreign stock exposure currently is with the **Grandeur Peak Global Reach Fund**. Lead manager Robert Gardiner has an excellent track record of uncovering value in global small cap stocks.

U.S. stocks have been led by large cap growth stalwarts. Last year's winners for us included **Visa, Inc.** and consumer discretionary stocks **Costco, Amazon.com,** and **Starbucks**. **General Electric** and **Boeing** paced the industrials, while **AT&T** and **Verizon** eked out gains in the wireless space.

Detractors included our largest holding, **Berkshire Hathaway** which was down 12% in 2015. Mr. Isenberg and I continue to believe that the sum of the parts of this massive holding company is worth more than the current share price. Warren Buffet is now 85 years old, but still going strong drinking Coca-Cola and working a full-time schedule while collecting his modest \$100,000 annual salary. His succession plan is in place. Utilities struggled under the threat of higher interest rates, so we were fortunate to sell ½ our shares in **Sempra Energy** last January after it had doubled in price. Wholly owned S. CA Gas Co. has hurt the shares recently due to the leak in Porter Ranch. We are not buying more, but holding the residual shares and closely monitoring the situation.

Please Note: Stocks held in separate client accounts will vary due to client start date and risk tolerance level.

Outlook for 2016 – It's always challenging to forecast the market or which areas might outperform in the year ahead. We prefer to take a longer term view and build an all-weather portfolio, then make adjustments along the way on an individual security basis. Increased volatility is a fact of life, and return expectations may need to be rechecked in light of projected forward returns. Bullish sentiment readings have reached lows last seen in 2005. We could easily go lower as market moves can go to extremes, but we are comfortable owning solid profitable companies, many of which pay quarterly cash dividends. Remember Mr. Buffet's wisdom to be greedy when others are fearful, and fearful when others are greedy. Clients know that we use a blend of individual securities (stocks & bonds), actively managed funds, and exchange-traded funds (ETF's). Dividends and interest play an important role in our total returns. We want to see earnings growth to drive equity performance. We continue to like the previous names mentioned and are looking to expand our technology holdings beyond Apple for risk tolerant accounts. **Microsoft, Intuit,** and **Stamps.com** are three new tech names we like.

Recent addition, **PowerShares QQQ**, is an exchange-traded fund that is based on the Nasdaq-100 Index. This ETF owns the 100 largest non-financial companies listed on the Nasdaq, and will spice up any portfolio, so it's best used in small doses.

Interest Rates – Lower for longer, with a slight upwards bias throughout the year. The Fed may well bump up short-term rates again, but that does not mean that long-term interest rates will necessarily follow at the same time.

Bonds – Municipal bonds were our top performing asset class for 2015. There is a strong demand from banks, insurance companies, and high net worth individuals for securities with tax-exempt interest. We have been buyers of bonds issued mainly by Community Facilities Districts in Orange County. These bonds are also referred to as land-backed, or Mello Roos bonds and are used to provide the money for infrastructure in new developments. We have a relationship with one of the largest underwriters of tax-free bonds in the State. Although we don't expect any further price appreciation in 2016, collecting the tax-free coupon via semi-annual interest payments is just fine.

Bond Funds & Exchange Traded Funds (ETF's) – Our largest fixed-income holding continues to be the **Doubleline Total Return Bond Fund**. This actively managed titan is led by L.A. based Jeffrey Gundlach. The fund made money last year and acts as an excellent portfolio buffer to stock market volatility. A low duration, or short-term maturity structure keeps interest rate risk in check. Using primarily mortgage-backed securities, the fund pays a monthly dividend with a current yield of 4%. For high quality corporate bond exposure, we own two low-cost Vanguard ETF's which also pay monthly dividends. The **Vanguard Intermediate Term Corporate Bond** (VCIT) has a current yield of 3.3%, and the more conservative **Vanguard Short Term Corporate Bond** (VCSH) with a 2% yield for a good cash alternative. Both ETF's carry an expense ratio of 0.12%.

Retirement Plan Contributions – The maximum annual 401(k) salary deferral for 2016 remains \$18,000 per person, plus an additional \$6,000 catch up if age 50 or older. Deductible employer contributions may still be made for the 2015 tax year, up until the company tax filing deadline in 2016.

IRA to Charity Distributions – Congress passed legislation in December that permanently extends the Qualified Charitable Distribution (QCD) provision. This allows people over age 70 ½ to transfer up to \$100,000 annually from their IRA directly to a charity. The QCD can count as the account owner's required minimum distribution without increasing taxable income. This is a good strategy for an individual that has more than enough money and is charitably inclined.

Estate Planning – Have you had your revocable living trust, will, and health care directives reviewed in the last five years? Have you considered an LLC to hold your investment real estate? It may be time for a tune up with an attorney who specializes in estate planning. If the professional who drafted your original documents is no longer an option, we have received good client feedback regarding a local Mission Viejo attorney. Feel free to contact our office for further discussion.