



The Long & Short of It

Quarterly Newsletter

Fourth Quarter 2015

It is unsettling that stocks and other investments offered negligible-to-negative returns in 2015 while the Federal Reserve's monetary policy, despite an uptick in Fed Funds in December, remained deeply accommodative by historical standards.

Return-Free Risk

In the First Quarter 2015 issue of *The Long & Short of It*, we stated that a positive return in 2015 would mark the first time on record (since 1871) that the US stock market rose seven consecutive years in a row. As we close out 2015, the S&P 500 Index return of 1.4% for the year means the record was technically broken. But with such a meager result, "injured" or "insulted" may be a better description.

We also wrote in the First Quarter 2015 letter: "Another characteristic of an aging bull market is narrowing leadership." This narrowing leadership was exemplified in 2015 by the extraordinarily strong positive returns of just four mega-cap, non-dividend-paying growth stocks. The so-called FANG (Facebook, Amazon, Netflix, and Alphabet [formerly known as Google]), with their oversized weighting and impact on the cap-weighted S&P 500, added a combined 3.6% to the S&P 500 return. In other words, without its FANGs, the market's return would have been approximately a toothless 2% loss.

For most of 2015, the US stock market seemed to be topping. It drifted without rising through August, when a nearly unnoticed and sharply rising stock market bubble burst in China. The subsequent sharp decline in global markets drove a brief panic stateside that quickly fizzled. The rest of the year was choppy—volatile days leading one way then the other, but never forming any lasting trend. Most investment categories offered low single-digit losses, although growth stocks beat value stocks by more than 9%. Junk bonds and emerging market stocks fared even worse, as reflected by SPDR Barclays High Yield Bond ETF (JNK) falling about -6.8% and iShares MSCI Emerging Markets (EEM) losing -16.2%. The old adage to "take more risk to earn more return" did not hold true. For 2015, riskier investments produced lower returns.

In addition to putting pressure on the stock market, the economic slowdown in China kept commodity prices low. Strong US supply and unfettered production from OPEC dropped the price of a barrel of oil into the high \$30s during the fourth quarter. As oil weakened, the dollar strengthened. Even if Americans did not get much return on their investment assets, their global purchasing power benefitted from a 6% rise in the US dollar against a basket of other currencies.

Interest Rates & Fed Policy

Over the last two years, the Federal Reserve's ongoing tightening has driven the dollar higher while the world's other central banks continue to loosen their interest rates. As the US moves into a rising rate environment, we do not view it as a change to a tighter Fed Policy but rather the next step in tightening that began with the end of Quantitative Easing. Typically, a shift to more restrictive monetary policy adds some volatility to stock markets but still allows for positive results. Resource limits eventually bring inflation, which forces the Fed to tighten more aggressively. When the Fed Funds rate is pushed above the interest rates offered by longer-term Treasury bonds, the environment for stocks becomes toxic. With Fed Fund rates presently more than 2% below long-term Treasury rates, a toxic environment for equities is not necessarily an immediate concern.

Confidence is Credit

Any event that disrupts investor and consumer confidence could slow credit creation and thus economic growth. Without demand growth from debt creation, deflation could take hold. Most investors expect higher interest rates in 2016 with continued steady improvement in the economy; however, the markets face other potential risks in the New Year.

First, while the employment picture in the US has improved enough to justify tighter monetary policy, inflation has yet to present any convincing upward trend. With an aging population and large indebtedness hindering

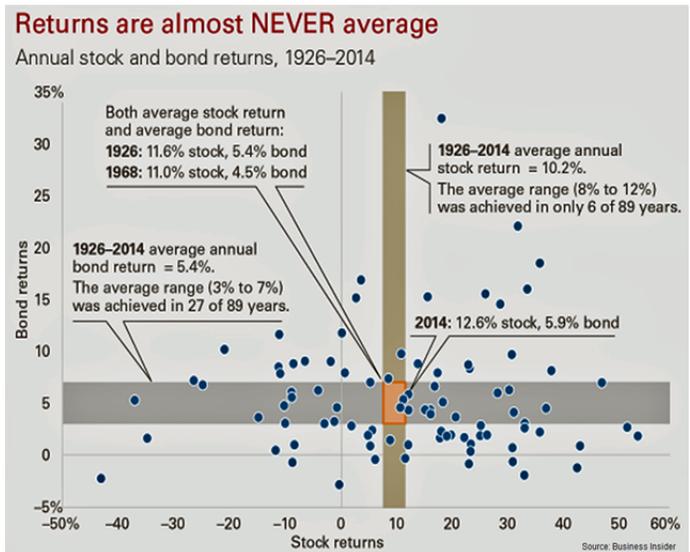


aggregate demand growth, combined with downward pressure on oil prices and commodities, one has to wonder if the Fed's recent tightening will prove to be a policy mistake. One potential scenario is that inflation slips lower—perhaps descending into deflation—driving GDP down and forcing the Fed to reverse its policy stance. The 1930s saw a similar environment with competitive currency devaluations taking place across the globe. Let's hope current stimulus programs underway in many foreign countries revitalize those weaker economies such that competitive currency devaluations are not necessary. Note that because crude oil affects pricing for so many other products, new declines in crude oil will create a broader deflationary influence for up to a year after crude's price stops falling.

Second, terrorism is taking place at rates that are disturbing but not disruptive to most business activity thus far. If terrorist activity accelerates or even develops into war and/or broader civil disobedience, then it would rattle the stock markets.

Third, policy risk out of Washington could begin to escalate. This would be an unusual result in an election year, but 1) President Obama has promised to be very active in his last year, and 2) with a two-term administration coming to an end, a different agenda will be established in DC. When the coming uncertainty begins to be discounted, stock prices will turn down until the new policy has been clarified.

While stock and bond returns have historically averaged about 10% and 5% respectively, there is rarely a calendar year when returns are actually close to the average. Winning in the long run means staying invested through both good and bad times. The names we invest in for the long run are those companies built to withstand the difficult years, though they may be less exciting in optimistic periods. In stable-to-good times like these, where low interest rates offer rewards to companies that take on excessive leverage, our high-quality, dividend-paying defensive companies look more like frogs than princes. When the stock market reverses and turns down, many of the high flyers will be punished for enjoying the short-term success afforded them through debt. Recently issued debt is pulling future consumption and investment into the past. Valuations appear a bit stretched, though not extreme. As records are set in this rising market, we continue to move incrementally toward defense.



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