KMS

Client Quarterly

Fall 2015

Compliments of
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Published Sept. 2015, by KMS Financial Services, Inc.
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • www.KMS.com
Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

Yes, a Correction, Swift and Sure

For long-term investors, the best strategy may have been to spend August camped by a wilderness lake with no cell phone reception. The broad U.S. equity market, represented by the Standard & Poor's 500 Index, started the month a few percentage points up on the year and ended it several points down. No cause for panic, and the time away would have been refreshing.

Those who stayed close to the market day to day may have had a different impression. As of the close on August 24th, the Dow Jones Industrial Average, Nasdaq 100, and the S&P 500 had all fallen more than 10% from their highs at the end of July, qualifying as a market correction. Historically, broad market declines of 10% or more, including those that turn into full-fledged bear markets, occur about every 18 months. But until August it had been nearly four years since a 10%+ correction, among the longest such periods on record.

Of course it wasn't just U.S. stocks taking hits. Oil, copper, and other key commodities continued their steep sell-offs. China's surprise currency devaluation (see accompanying article) prompted fears of competitive devaluations by other emerging market export competitors. And it fed growing concerns about weakness across the global economy. Equity investors in China as well as the U.S. saw some of their largest one-day moves, up as well as down, in several years.

Volatility, especially downside volatility, is often portrayed as the bane of investors' existence. But it is the necessary companion to opportunity and usually reflects a sudden shift in perceptions more than a sea change in underlying realities. Either way, it's not a bad time to check your portfolio's participation in that volatility and your relative comfort with that positioning. ■

Past History of U.S. Market Declines (1900 – 2014)

Declines of	*Avg Frequency*[1]	*Avg Length*[2]	*Last Time*	*Prior Time*
– 5% +	3 times a year	46 days	Dec. 2014	Oct. 2014
– 10% +	Once a year	115 days	Oct. 2011	July 2010
– 15% +	Every 2 years	216 days	Oct. 2011	Mar. 2009
– 20% +	Every 3½ years	338 days	Mar. 2009	Oct. 2002

[1] Assumes 50% recovery rate of lost value. [2] Measures market high to market low.
Source: Capital Research & Management

With an Eye on the Economic Indicators

There's an old one-liner that allows as how the stock market has predicted nine of the past three recessions. Joking aside, market weakness *can* signal trouble in the real economy. Given this summer's market volatility, it's worth checking those key economic indicators.

Last Winter's *Quarterly* discussed the Conference Board's Leading Economic Index (LEI), a long-running data set with a respectable record for assessing the odds of a downturn on the near horizon. The LEI measures ten key numbers reflecting trends in labor conditions, manufacturing, home building, consumer sentiment, as well as the major stock and bond markets.

Those readings are distilled down to a running year-over-year percentage increase (or decrease). Ten months ago the Index had risen into a positive range that implies quite low odds of a recession in the near term. Its latest readings are modestly lower but still in the range that supports a positive outlook based on historical comparisons.

Another long-running publication that economists and market strategists look to is the Federal Reserve's *Beige Book*. This page-turner is issued eight times a year and brings together reports from the twelve Federal Reserve Districts detailing economic conditions in those regions of the country.

On the heels of August's turmoil, the Fed's latest *Beige Book* appeared September 2nd and reported continued expansion across most regions and sectors during the period from July to mid-August. Those reports drill down on such components as manufacturing activity, retail sales, demand for services and staffing, credit quality trends, agricultural and energy production. Notwithstanding some variability across different sections of the country, the report portrayed a steady-as-she-goes backdrop for the U.S. economy.

Many years ago, Benjamin Graham, the father of value investing, explained that "in the short run, the market is a *voting* machine, but in the long run, it is a *weighing* machine." A given day's gyrations reflect current popularity of different companies and shifting views on our economic future. But in the aggregate and over time, the market relentlessly assesses the substance and performance of companies and their prospects as the economic cycle plays out.

Investing calls on us to look patiently past those short-term swings in the popularity contest and count on the longer term assessments. ■

Another Illustrative Commodities Cycle

The elasticity and cyclicality of commodity prices has been a recurring theme in these pages for a couple decades, with oil and gas the focus in recent years. As often stated, the solution for high commodities prices is high commodities prices as they drive increased investment to produce greater supply.

In the case of oil, that investment hasn't simply thrown the same old technologies at the same old proven reserves. It has spurred development of new technologies to find and/or extend the development of resources previously viewed as not economically recoverable.

With that foothold, further technological advances and operational refinements have worked to reduce the marginal cost of finding and/or developing those deposits. Examples of this kind of elasticity include such regions as the Permian Basin spreading across a huge section of southwest Texas and into southeast New Mexico, as well as the Bakken formation occupying about 200,000 square miles underlying parts of Montana, North Dakota, Saskatchewan and Manitoba.

The first commercial well in the Permian Basin was completed in 1921. By 2007, annual production had been slipping for years to just over 300 million barrels. Higher prices and new technologies turned that tide in 2008; by 2014 the Permian's production had doubled.

Oil was first found within the Bakken in 1951, but even at 2008's high prices, estimates of recoverable oil using readily available technology ranged from just 2.1 billion barrels (state of North Dakota) to 3.65 billion (U.S. Geological Survey). With today's technology, some estimates place total Bakken reserves, recoverable and non-recoverable, at up to 24 billion barrels. The USGS has raised its estimate for ultimate recovery to 7.4 billion barrels. Recent production is up eight fold from 2007's level.

Seven years ago the U.S. produced just five million barrels of oil per day, and the number had fallen for years. Recently the daily total passed nine million barrels. With the price touching multi-year lows, the sustainability of some newer, higher cost production is hotly debated, and the International Energy Agency does expect a small pullback. Exploration and development projects launched when prices were high may struggle to meet debt obligations and investor expectations. But while oil and gas deposits aren't exactly mobile, improved recovery methods and economics are. ■

China's Yuan Reset Reflects New Realities

Ten years ago this month, these pages focused on China's decision to allow a little appreciation in its currency. U.S. manufacturers and sympathetic politicians claimed China had suppressed the yuan's value to boost its exports. That modest move launched a ten-year run that saw the yuan gain more than 30% versus the dollar. As we noted then, "exporting remains the key, and Chinese authorities will be watching for any indication that a stronger yuan is undercutting its competitiveness."

The past year prompted just such a reassessment, given an apparent slowing in global growth and in Chinese manufacturing. Maintaining a close tie to the dollar, the yuan had risen even more against the euro, the yen, and currencies of other trade competitors. In mid-August the People's Bank of China (PBoC) announced a surprise devaluation of about 2% in the value of the yuan and indicated that it would accommodate daily fluctuations of 2% up or down. The currency slipped further over the next couple days before appearing to stabilize.

China hopes to see the yuan join the dollar, euro, yen and pound sterling in the basket of currencies that make up the International Monetary Fund's Special Drawing Rights. The currency needs to be internationally usable, convertible, and marketable. A transparent mode of valuation aligns with China's deregulation of interest rates and capital mobility, the opening of more overseas clearing centers for the yuan, and growth in China's outbound investment.

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Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Selected Mutual Fund Categories *	**--- Annualized as of Sept. 9, 2015 ---**			
	1 yr.	***3 yr.***	***5 yr.***	***10 yr.***
Large-Cap Stocks (Blend)	− 2.0 %	12.0 %	12.9 %	6.1 %
Mid-cap Stocks (Blend)	− 2.5	12.7	13.0	6.7
Small-cap Stocks (Blend) †	− 2.2	11.4	13.0	6.4
Foreign Stocks (Large Blend) †	− 8.0	5.9	5.0	3.4
Diversified Emerging Markets †	− 23.0	− 3.1	− 2.1	4.3
Specialty Natural Resources	− 30.2	− 7.0	− 1.0	1.2
Specialty Real Estate	− 2.1	5.9	10.4	5.5
Moderate Allocation	− 2.6	7.0	8.2	5.2
Long-term Bond	1.2	1.8	3.4	4.2
World Bond †	− 5.2	− 0.5	1.8	3.7
High-Yield Taxable Bond †	− 2.3	4.1	6.3	6.1
Long-term Municipal Bond	2.5	2.7	4.1	4.0

* Source: Morningstar. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

An Urbanizing World Indicates a Growing World

In the immediate aftermath of World War I, one of the most popular songs of the era asked the musical question, “How ya gonna keep ‘em down on the farm after they’ve seen Paree?” The lyric portrayed a genuine concern that soldiers returning from the European conflagration might find farm life a little dull.

At that time, about half of all Americans lived in rural areas, and 30% lived on farms. But both of those figures already had dropped by about ten percentage points in just the first two decades of the twentieth century. By the year 2000, just over 20% of Americans lived in rural areas, and the percentage living on farms was below 3%.

Migration from country to town is neither new nor uniquely American. It has typified the advance of civilizations and empires for thousands of years. It accompanied the rise of Europe and the U.S. through the industrial revolution and into the digital information age. In a recent white paper, Capital Research and Management traced the rise of wealth that has accrued to developed nations as their populations became more urban.

This process entails myriad stresses and challenges for individuals and the larger society. Along with relocation’s disruptive effects on families and established traditions and patterns of living, cities themselves are faced with new demands on housing, transportation systems, utilities, law enforcement, and environmental quality.

But cities have been meccas for skilled workers and business formation. Researchers suggest that increased population density creates economies of scale that tend to enhance that population’s overall productivity. Rising productivity is the most basic ingredient in raising a society’s living standards.

The developed world got to be the developed world by leading this process, but the pace of urbanization in *developing* nations has quickened dramatically. Cities are adding 65 million inhabitants annually, with the world on pace to have more than 40 cities with more than 10 million inhabitants by the year 2025, up from 18 such cities in 2007.

Last year saw the completion of more than 97 buildings over 200 meters (656 feet) tall. More than 100 such skyscrapers are expected to be topped off this year and next. And 28 buildings over 1,300 feet tall are slated for completion by the end of 2018. Many of these landmark towers are rising in such places as Dubai, Shenzhen in China, and Jeddah in Saudi Arabia.

The infrastructure demands implied by these trends represent a dynamic, long-term investment theme. The total tab could run to $57 trillion by 2030, spread across the whole panoply of modern transportation systems, water and energy utilities, and telecommunications. More than half a trillion dollars of airport construction projects are in progress today.

The nature and scope of those investments will be enormously varied to meet the needs of such disparate places as China, Central and Southeast Asia, parts of Latin America, and emerging Africa. It will call forth the talents and resources of thousands of new, innovative companies as well as large multi-national enterprises. At a time when the financial headlines are dominated by concerns that the global economy is slowing, it may pay to remember the remarkable transformation that continues all around us. ■

What to do, what to do? Pension managers ponder allocation and prospective returns.

***The** Wall Street Journal* reported recently that the nation’s second-largest pension fund, the California State Teachers’ Retirement System (“Calstrs”), is considering a substantial shift out of traditional corporate stocks and bonds in favor of Treasury securities, hedge funds, and other more complex investments. The fund’s website, notes that such “risk-mitigating strategies” have been discussed for months and may involve shifting as much as $20 billion of the system’s $191 billion.

Meanwhile, just a mile up the road, trustees of the nation’s *largest* public pension fund, the California Public Employees’ Retirement System (“Calpers”), are in the midst of a well-publicized *exit* from hedge funds in favor of more traditional, broadly diversified equity and fixed-income holdings. Maybe the two funds’ managers should meet under a buttonwood tree[1] and swap portfolio assets to save transaction costs.

According to Wilshire Consulting, state pension plans hold 72% of their assets in stocks and bonds. Six months ago the *Quarterly* suggested that “Pensions Have It Easier than People,” as their obligations to retirees are driven primarily by the fairly predictable *average* life expectancy of millions of plan beneficiaries. Still, the stakes are high, and there is persistent pressure to optimize risk-adjusted returns.

Speaking of returns, pension fund trustees across the country have been trimming those expectations. Just a few weeks ago the New York State Common Retirement Fund announced plans to cut its assumed return to 7% from 7.5%, which was a cut from 8% five years ago. That followed a vote by the San Diego County Employees Retirement Association to drop its assumed return from 7.75% to 7.5%.

History can both inform and obscure one’s view of the future. Knowledge may be power, but it does not confer clairvoyance. The rest of us may have all of life’s uncertainties to consider, but at least we don’t have to manage our investments in a fishbowl. ■

[1] The history of the New York Stock Exchange begins with the signing of the Buttonwood Agreement by twenty-four New York City stockbrokers and merchants on May 17, 1792, outside at 68 Wall Street under a Buttonwood tree. *Source:* Library of Congress

Are golfers better investment managers?

A "groundbreaking" study from a pair of academics at Singapore's Nanyang Technological University's claims that investment managers located near prestige golf courses produce par-beating risk-adjusted returns. Presumably they gain valuable information and insights interacting with other golfers from the world of business and finance.

Mind you, the study couldn't reliably determine whether the outperforming managers actually *play* golf. It simply adopted the premise that the closer to golf courses those managers *worked*, the likelier they were to be active golfers.

The authors also hypothesized that higher-value information would be gleaned by hanging out at the most prestigious courses. So they factored in the average distance from the workplace to golf courses with the highest greens fees.

The study notes that the managers' performance tends to "spike" in years when a major championship such as the U.S. Open or PGA Championship is held in the state. And it appears to suffer when it rains a lot. Pretty compelling, eh?

Studying this kind of "linkage" probably won't win the Nobel Prize in Economics. But if you're looking for reasons to play more golf, search for "Heard on the Green" at the Social Science Research Network's website. The study is available for free, a bargain at twice the price. ■

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China's Yuan Reset...

After the sudden devaluation, the PBoC pledged to seek stability through a more market-oriented approach to setting the yuan's daily reference rate. Easily spooked financial markets saw one more reason to question global growth and financial asset prices, but China's economy does *not* appear to be falling apart. Retail sales were up 10.5% in July versus a year earlier, with a number of U.S. companies citing China as a key growth market. Chinese are buying more movie tickets, toothpaste, jeans, cars and travel than ever.

Through its long, export-led expansion, China has accumulated large foreign exchange reserves, lending it flexibility in managing the yuan's exchange rate. In the long run, giving market forces a bigger role in that process should help balance its economy and rationalize its trade relationships.

Sudden currency moves coupled with authorities' apparent mishandling of the parabolic rise and fall of China's domestic stock market may have tarnished an image of technocratic competence built over a quarter century of remarkable growth and development. But for most investors, government missteps in managing markets shouldn't come as a big surprise. ■

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