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The Intelligent Investor—May 2016

Quick Market Update:

The month of April was relatively flat for the markets, and saw a small reduction in volatility compared to the previous 3 months. The old adage "sell in May and go away" has started up again and even though history has shown this doesn't work, it seems to start fresh every year.

We think the markets are pretty close to fair value right now, and earnings season wasn't as bright as we had hoped. The economy seems to be on solid footing, but in a very slow growth environment. We don't believe the Fed to be in a hurry to do anything.

Our allocations remain stable and we continue to remain slightly defensive until we see the next catalyst for markets to break out. While we don't see recession in the near future, we certainly saw a slowdown in earnings this quarter and remain cautious ahead of what 2nd quarter's earnings will bring. We believe Q2 earnings will provide a clearer picture of where markets are headed.

Custom Investment Solutions

Last month, we talked about stocks and how the collective wisdom of the market values, or prices different companies. Continuing with that theme, it's important to understand why we may recommend a particular fund manager, or overall allocation for one person and not another.

We've often compared a carefully crafted investment plan to a financial roadmap. When you embark on a vacation, a roadmap is the essential tool that keeps you on the road to your final destination. The same holds true for your financial destination, or what we like to refer to as your Financial Independence.

What's necessary to get one individual to his or her destination may not be appropriate for someone else. Everyone starts at a different place and has different needs. Customization of both a financial plan and investment lineup are a necessity.

Simply put, an investment selection and allocation should be customized based on a client's Financial Independence roadmap.

The Hot Trend

By taking such an approach, we may choose to avoid stocks "hot" stocks.

Each investment sits in your portfolio for a reason, much like a piece in a puzzle. A piece that fits into one puzzle may not be right for another puzzle.

Whatever your goals may be, the asset allocation we recommend is designed with your objectives and plan in mind. Choosing investments outside the chosen strategy can lead you astray and lower your overall probability of success.

Key Themes

Let’s take a look at recent financial events. There have been a number of factors that have dulled interest in stocks over the last year.

We've touched on a number of these in recent letters and won’t rehash. We do, however, want to touch on a couple of the broader themes that have had an influence on stocks in recent action.

Table 1: Key Index Returns

	MTD %	YTD %	3-year* %
Dow Jones Industrial Average	+0.50	+2.00	+6.25
NASDAQ Composite	-1.94	-4.63	+13.03
S&P 500 Index	+0.27	+1.05	+9.03
Russell 2000 Index	+1.51	-0.44	+6.26
MSCI World ex-USA*	+2.82	+0.07	-1.34
MSCI Emerging Markets*	+0.40	+5.80	-6.85

Source: Wall Street Journal, MSCI.com
MTD returns: March 31, 2016-April 29, 2016
YTD returns: December 31, 2015-April 29, 2016
**Annualized   **in US dollars*

The Economy

Let's start with the economy. Economic growth drives profit growth, and profit growth is the biggest factor that drives stock prices over the longer term.

On the one hand, fears of a recession that were present in January have receded. This helped shares recover from a modest sell-off early in the year, but economic growth has been far from impressive.

A quick look at the latest data on Gross Domestic Product (GDP), the largest measure of goods and services in the economy, confirms this.

Preliminary data released late last month shows that first quarter GDP grew at an annual pace of 0.5%, down from a sluggish 1.4% rate in the final quarter of 2015.

Yes, we'll get two more revisions when more complete information rolls in, but it is not reflective of an economy that is moving ahead in high gear.

But did the economy really slow as much as the preliminary report suggested? In reality, that's up for debate.

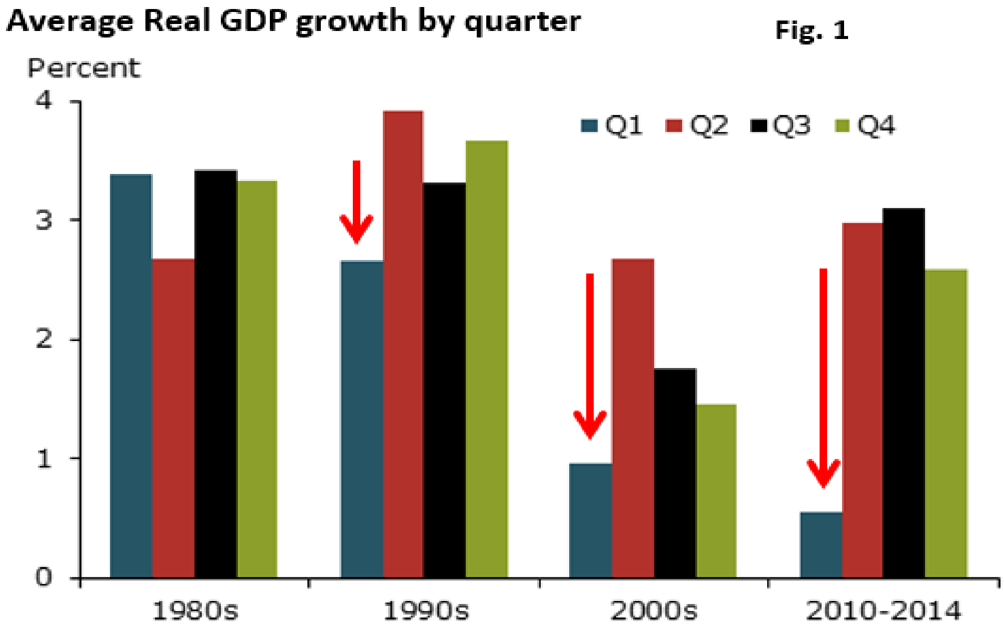
Gross Domestic Product

There is another piece of research that suggests first quarter GDP may be inherently weak thanks to an apparent deficiency in the complex models that adjust for seasonal influences.

Looking at the raw data from month to month, volatility makes monthly and quarterly comparisons very difficult.

Think about it this way: sales at stores jump in November and December and tumble in January. If the data isn't "seasonally smoothed," we'd get wild gyrations that would exaggerate strength and weakness over a short period.

Over the last 25 years, we've witnessed a statistically significant drag on first quarter growth, which is graphically illustrated in Figure 1 on the following page.



Source: Federal Reserve Bank of San Francisco

The longer-term data would suggest we may see a bounce in reported activity in the current quarter and by year's end, it all washes out. The conclusion is that seasonal distortions that aren't accounted for in current models may be overstating 2016's lackluster start.

Dollar Headwinds

A second drag on stocks over the last year has been strength in the dollar. For companies doing business primarily here in the United State it doesn't have much of an effect; however, for those larger multinationals that depend on a significant amount of sales from overseas, the strong dollar has hurt their margins.

While a U.S. citizen traveling abroad benefits from a strong dollar, a U.S. corporation must translate foreign sales back into more expensive dollars, which reduces their revenue. Although headwinds from the dollar remain, they have receded.

Take a look at the table below (which we are strictly using for educational and informational purposes only). The table illustrates that the dollar has weakened and while still a headwind is much less so than it was a year ago.

Percentage points the stronger dollar shaved from revenue in Q1 2016 vs. Q4 2015

	Q1 2016 vs. one year ago	**Q4 2015 vs. one year ago**
Illinois Tool Works (ITW $105)	3 percentage points	6 percentage points
McDonalds (MCD $128)	4	9
Coca Cola (KO $45)	5	7
IBM (IBM $145)	3	7
Microsoft (MSFT $51)	3	5
3M (MMM $169)	3	6
DuPont (DD $66)	4	8
United Technologies (UTX $104)	2	4

Source: Investor Relations of each firm
Price as of the close on 5.2.16

As we entered May, the dollar slipped to its lowest level in over a year against several major currencies (MarketWatch).

While the reason for the reversal has been debated, we think it is most tied to the Fed being reluctant to follow through on an expected series of gradual rate hikes in 2016. Sure, the Fed says it is eyeing an increase or two later in the year, but the language in its statement following the April meeting suggests it is in no hurry to follow through.

Could we see tailwinds to S&P 500 revenue in Q2 if the dollar remains at today's levels? It's a distinct possibility.

Looking Ahead

The Fed appears to be on the sidelines right now, so our attention moves to Europe. In June, Britain will vote yes/no on a referendum to remain in the European Union (E.U.). Coined "Brexit," a vote against remaining in the 28-nation federation could create a new round of uncertainty in Europe.

The latest polls put those who want to remain in the E.U. in a slight lead *(Reuters)*, which suggests this issue may get more coverage in the days and weeks ahead.

Markets hate heightened uncertainty, which could add to volatility in stocks, especially as the date nears. As we've consistently counseled, please look past short-term events that can create short-term waves. If anything, these waves can serve as an opportunity for active management and shouldn't scare you.

Over the medium and long term, U.S. markets take their cues from what's happening at a company specific level, not a macro-economic level.

This leads us to our final point.

Stick with the Plan

Markets will go through cycles that take us to new highs and markets will also enter periods of volatility. Making decisions in haste based on an emotional reaction to current circumstances is rarely profitable over the long term.

The customized investment solutions we have tailored for you and your families is one we are consistently monitoring and tweaking based on both your situation and market opportunities. We know markets can be volatile and our goal is to smooth out the ride for you, while achieving returns that meet your individual planning goals.

In summation, we remain humbled by our clients' trust and confidence in us, and we take our stewardship roles very seriously. As always, if there are any questions, we encourage you to contact any of our team here.

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