WOODSTOCK

QUARTERLY NEWSLETTER

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Winter, 2016

By now most of you know CNBC is our favorite cable news channel[1]. If we thought we would get away with it, their beautiful peacock-style logo would be on our newsletter in all its color. We received a bit of derisive laughter at Woodstock's holiday party this year when we said that we felt CNBC's criteria for their award were just right. But we do. The detailed formula is not public, but the criteria lend themselves to rewarding firms that try to provide all three legs of the financial management "stool": investment management, custody and accounting, and tax services. A comprehensive approach. Over the past 30 to 40 years other financial services firms[2] have cut back on their commitment either to being comprehensive or to doing the actual hands on work to get the job done right. The pool for the award covered 30,000 registered investment advisors in the US and managed to pick one in Boston and four in New England. In discussing how world financial markets need to evolve to both protect our financial systems and to get the results we, as citizens, should want, John Kay[3] describes the "investment channel," in circular motion with the "deposit channel," as requiring "the promotion of asset managers with skills in search and stewardship of the physical and intangible – rather than [solely] financial – assets of the real economy." We at Woodstock are dedicated to trying to do just that.

We were recently reminded of one of the dangers facing world financial markets of concentrating solely on the financial, by a chart showing "money and markets"[4]. In $100 billion blocks it shows, in ascending order, the value of above ground gold ($7.8 trillion), all world stock markets ($70 trillion; US stock market: 52%), global debt ($119 trillion with $60 trillion of sovereign national debt), and worryingly, $630 trillion of derivatives. The public debate is whether derivatives are "financial weapons of mass destruction" or zero sum trades that will offset over time. We prefer to look for clues on how this may turn out in the residential real estate market; in which market a great variety of professionals from real estate agents, to lawyers, to bankers work very hard to close deals with contracts standardized by state. World derivatives contracts are not standardized, in fact they are usually custom made between willing parties. In a crisis, enforceability of their provisions may be impossible and thereby extremely disruptive. The protection for individual investors? We believe it is investing in high quality, US companies whose managements understand the dangers and whose balance sheets can withstand the disruption.

We also look around the finance literature to see what other managers think about the current situation and the recent past. What's happened? While Woodstock clients have tended to capture the financial rewards of the last six years, most other US investors have not. The have nots list includes "large university endowments," the "largest diversified mutual funds," and hedge funds, whom one author suggests have become a "hedge against attractive returns"[5]. If the author's discussion of the reasons for weak returns reflected an emerging consensus agreement with our philosophy, we'd be worried that too many passengers were about to board our ship. However, he blames central bank induced low interest rates, short periods of high volatility and investor risk aversion. Low interest rates means it's cheaper to take aggressive financial positions, supposedly a benefit. Whether the "trading models" are actually wrong or not, perhaps, it's just best to invest other people's money rather than trade it. High volatility panics investment professionals? Risk aversion needn't apply to investing in high quality, US stocks. I think we're safe for a while longer and Woodstock clients should receive the benefit.

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We thank you for your support and want you to know that we are dedicated to serving your best interest.

William H. Darling — *Chairman & President*

Adrian G. Davies — *Executive Vice-President*

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[1] Woodstock was named to the Top 100 fee-only investment management firms in the US for 2015 by CNBC. www.cnbc.com/2015/06/03/cnbc-charts-the-top-100-firms

[2] Banks, insurance companies, broker/dealers and investment management firms

[3] Kay, John Other People's Money, 2015 p. 202

[4] www.marketwatch.com Comparing World's money and markets

[5] WSJ, 12/18/15, p. A17

The Oil Drag of 2015 Reverses in 2016

Thomas C. Stakem

The dollar, oil prices and China were three factors that had a major influence on economies and capital markets in 2015 and will again in 2016. The dollar's 27% rise from May 2014 to March 2015 exerted downward pressure on commodity prices (particularly copper and oil), affected foreign economies and capital flows and caused translation losses for multinationals in their revenues and earnings reports to shareholders. The negative effect of the dollar's rise on oil prices turbocharged the (now very clear in hindsight) relentless OPEC strategy of defending market share rather than oil price which began Thanksgiving 2014.

Economists and retail analysts await the stimulative effects of the oil price "tax cut" on U.S. consumers. (Global consumers will see less of an effect because higher energy taxes and currency changes mute the impact of the ~75% decline in crude oil price ($105 to $25). The higher energy industry related unemployment, wage and capital spending reduction effects get less attention than the price effect but sluggish U.S. economic data point to these negatives being very real headwinds in 2015 and they will likely persist into 2016.

During 2015 the 10-year Treasury yield rose 10 basis points to 2.27% from 2.17% while the shorter maturity 2-year Treasury note yield rose 38 basis points to 1.05% from 0.67%. Market volatility was about unchanged year-to-year (18 vs 19 on the VIX Index after spiking in Q3 on China economy and devaluation worries). U.S. stocks declined in price (dividends drove a positive total return) during the year but outpaced even worse performing Europe and Emerging Markets. It was a tough year for Brazil and Russia down 21% and 17%, respectively. Their ties to commodity prices told most of the story although political scandals, international bad behavior and depreciating currencies also contributed mightily to their disfavor.

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Estimated S&P 500 equity capitalization and net income sources

	% of Equity Capitalization		% of Net Income	
	12/31/15	12/31/14	12/31/15	12/31/14
Consumer Discretion	12.9%	12.1%	11.1%	9.9%
Consumer Staples	10.1%	9.8%	9.0%	8.8%
Energy	6.5%	8.4%	4.1%	10.0%
Financials	16.5%	16.7%	20.1%	19.6%
Health Care	15.2%	14.2%	14.1%	12.2%
Industrials	10.1%	10.4%	10.5%	10.4%
Information Technology	20.7%	19.7%	22.5%	20.9%
Materials	2.8%	3.2%	2.7%	2.8%
Telecommunication	2.4%	2.3%	2.9%	2.5%
Utilities	3.0%	3.2%	3.0%	2.9%
	100.0%	100.0%	100.0%	100.0%
	$17,321,481	na	$1,130,266	$1,145,059

source: Woodstock calculations based on share count/EPS data inputs of S&P 500 constituents as of 1/19/16.

Currency depreciation was a major negative in 2015 with the Euro, Canadian and Australian dollars, Brazil real and Russian ruble all down double digits in a range of -10% (Euro) to -33% (Real). The dollar rose over 9% for the year and 2.5% in Q4 on a trade-weighted index basis.

The table on the previous page clearly shows the influence of lower oil prices on the Energy sector - cutting its contribution to earnings by ~60% and its contribution to equity capitalization by 23%. By and large an economic sector's weighting in the S&P 500 parallels its contribution to net income. P/E premiums and discounts to the overall market are suggested by comparing the two sets of data with the two greatest variances between Energy (premium) and Financials (discount). Energy stocks trade at a premium to their depressed earnings contribution because investors anticipate a rebound in earnings as oil prices normalize. The S&P 500 equity capitalization was 15.3x 2015 net income at the end of the year. The dollar, oil prices and China again loom large in the outlook and direction for S&P 500 earnings in 2016. While estimates have been coming down modest positive progress is expected for the year as recession fears wane and as oil prices reverse higher. The latest EPS estimate of $122 is about 15% up on 2015's $106 with nine of ten sectors participating led by Health Care (+29%), Information Technology (+14%), Consumer Discretionary (+12%) and cyclical rebounds in Energy and Materials.

Sowing the seeds of the next oil upcycle

Over the 13 years presented in the chart below OPEC's oil price averaged ~$73 a barrel. December 2015 averaged $34 a barrel, less than half of this average. Yet global oil demand is stable and growing, spare capacity in OPEC is a fraction of what it has been in the past - perhaps 5% of OPEC production and/or 2% of global oil demand. Both are pretty slim margins of safety and non-OPEC production is in the process of rolling-over led by the U.S. now in its ninth month of decline. In short, the cushion or margin of safety for being optimistic about future oil prices is quite attractive. The seeds of the next oil price upcycle are falling into place.

Marginal cost of production and OPEC countries budgetary breakeven prices

The marginal cost of oil production likely falls in a very wide range depending on whether it is onshore, offshore, domestic, international (varies considerably between Middle East, Brazil or Russia), conventional or unconventional. But it is undeniable that the high end of this range is well above the current oil price of $30 per barrel. (With transportation and quality differentials today's $30 per barrel translates into sub $20 oil in many parts of the world). Sustained prices below marginal cost mean the world would not replace its annual

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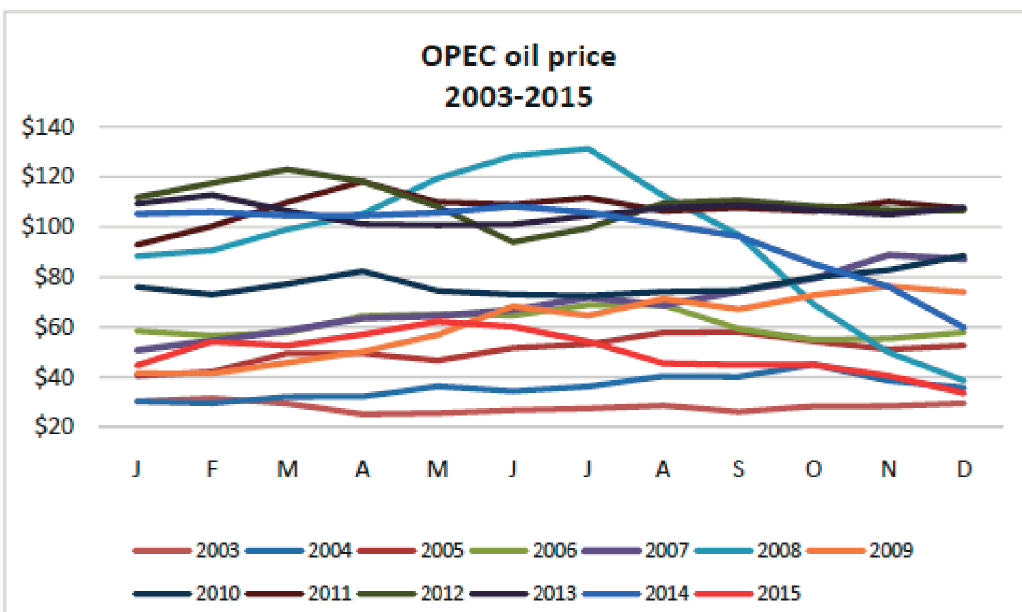

source: www.opec.org

consumption (around 35 billion barrels) and reserves would dwindle. This would be in addition to the negative reserve revisions that will occur in the future because eroding prices translate to less economically recoverable reserves. One recent study cited $400 billion of capex capital expenditures involving 27 billion barrels of reserves slated for development and production as having already been cancelled. And the amounts will grow with further capital expenditure cuts in 2016. These barrels would likely have been produced in the 2017-2020 timeframe, well beyond the current oversupply condition. Some existing non-OPEC production must be generating losses at current prices as well. Having dropped below $30 per barrel, some of the estimated 400,000 b/d of "stripper" production in the U.S. is thought to be at risk for abandonment. Since peaking in April 2015 U.S. oil production has declined about 100,000 b/d per month. Losing stripper production (wells that are producing less than 10 barrels per day) as well as other high cost production would accelerate the decline. This is integral to the OPEC game plan of letting the market rebalance on its own.

As if oil industry economics weren't disconnected enough at the present time there is the well-known fact that the OPEC producing countries all need substantially higher oil prices to balance their financial budgets. While it is true that marginal production costs don't drive financial breakeven prices (and vice-versa), fiscal deficits would support the notion that higher prices over time are in best interests of many constituents – producing governments, Treasury departments and private oil producers.

Breakeven oil price for OPEC producing countries

	price per bbl	% of OPEC		price per bbl	% of OPEC
Algeria	$115	3.5%	Libya	$105	1.3%
Angola	$80	5.6%	Nigeria	$115	6.1%
Ecuador	$120	1.7%	Qatar	$50	2.1%
Iran	$125	9.1%	Saudi Arabia	$95	32.0%
Iraq	$110	13.6%	UAE	$90	9.1%
Kuwait	$70	8.6%	Venezuela	$105	7.5%
				$100	100.0%

source: RealClearEnergy, Oct 20, 2012 (http://www.realclearenergy.org/charticles/2012/10/20/opec_median_budgetary_break-even_price_106748.html)

excludes recently re-admitted Indonesia; % figure based on Dec 2015

These figures are likely conservative as few if any of these countries have tightened their spending belts the last three years. From a fiscal perspective, triple digit break-even oil prices are a safe assumption.

U.S. shale oil – thorn in OPEC's side for the last nine years

OPEC's war on U.S. oil shale can be appreciated in the previous chart. U.S. shale oil production and total U.S. liquids (crude, condensate and natural gas liquids) have, as the world knows by now, had an amazing, nine year run, as annual oil shale production rose from Jan 2007 (start date for EIA data on shale oil production) to the March 2015 peak accounting for 87% of total U.S. liquids production growth. Now both data series are declining. This new supply essentially matched annual global demand leaving volumetric crumbs for OPEC. From OPEC's perspective the high cost producers were given priority in the market when it should have been the low cost producers. This changed Thanksgiving Day 2014 when OPEC announced it would leave production unchanged and would intentionally glut the market as supply exceeded demand by at least 1 million b/d. The message was clear to non-OPEC producers: stop developing new supply and shut-in existing production until the market balances out again. Oil prices have collapsed from $105-$110 per barrel to $25-$30 per barrel. The low price signal has resulted in massive declines in rig activity, employment and capital spending. Time lags are long and variable in the oil business but oil shale production has now dropped for nine months and another year of decline seems in prospect given low oil prices. "The cure for low prices is low prices" is being played out.

The importance of oil shale to the U.S. and to OPEC's thinking can be glimpsed from the chart on the next page, which shows the almost uninterrupted ramp up from 2007 to the peak earlier in Q1 2015. It drove overall U. S. liquids and increased its share by 30-35 percentage points to 58% in June. Now the U.S. is quite vulnerable to decline because over 50% of its production has a very high natural depletion rate (60%-70% first year) which should become visible with the dramatic decline in drilling activity over the last year.

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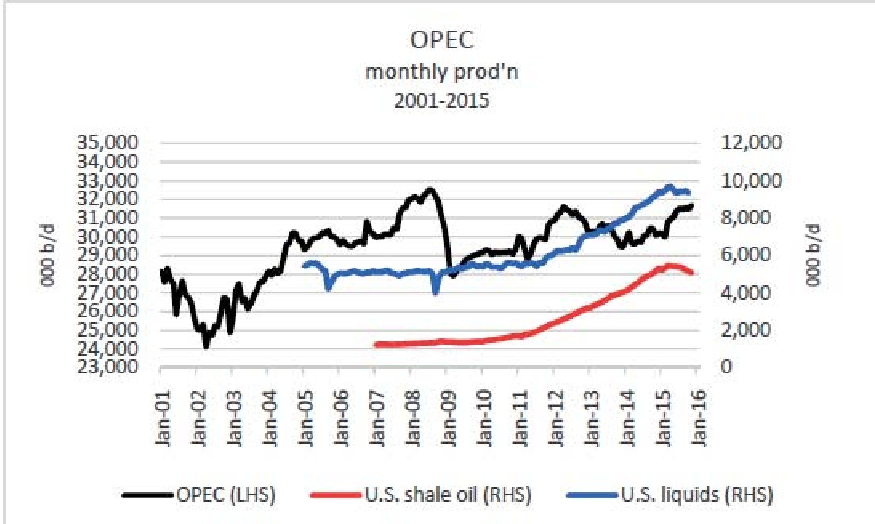
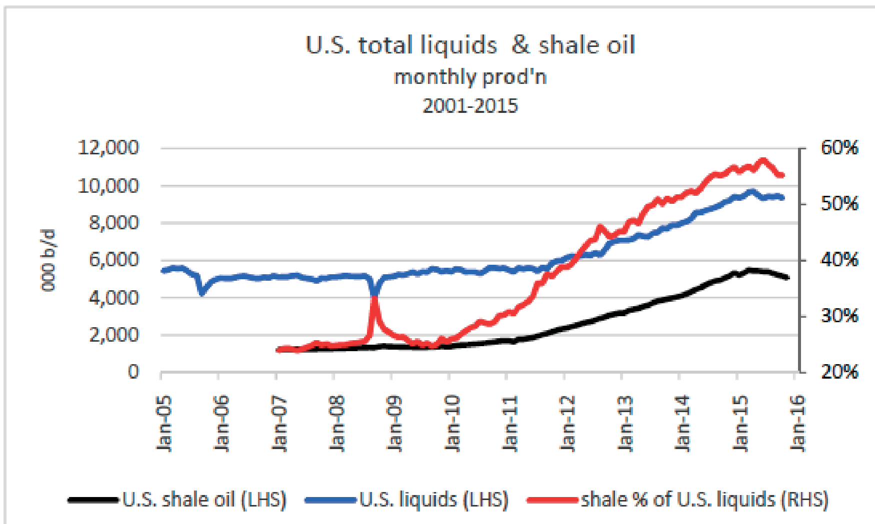


Source: www.opec.org



Source: Woodstock calculations based on www.eia.gov data.

OPEC seems intent on giving cartels a bad name

From the looks of the graph on the next page, you would be on sound ground thinking that OPEC is giving cartels a bad name. From an annualized revenue run rate of nearly $1.4 trillion in Q2 2008 OPEC is now running at a $340 billion rate, a trillion dollars less than eight years ago and a $100 billion less than the previous low of Q1 2009 that occurred during the global economic and financial panic.

Like the Federal Reserve OPEC, a cartel of 13 producing countries, has a dual mandate. They seek to minimize competition and maximize price/revenue. Where these objectives may clash is probably over time horizon. Whether to sacrifice $1 trillion in the short-run to defend market share rather than target a price level closer to financial break-even will be a strongly debated issue within and outside of OPEC in the years ahead.

With annual global oil demand expected to grow each year over the balance of the decade and non-OPEC oil supply likely to decline for a year or two it is not difficult to be optimistic on oil prices inasmuch as OPEC's ability to increase production materially is in question. The following table contains the key macro assumptions that lead to a favorable conclusion on oil.

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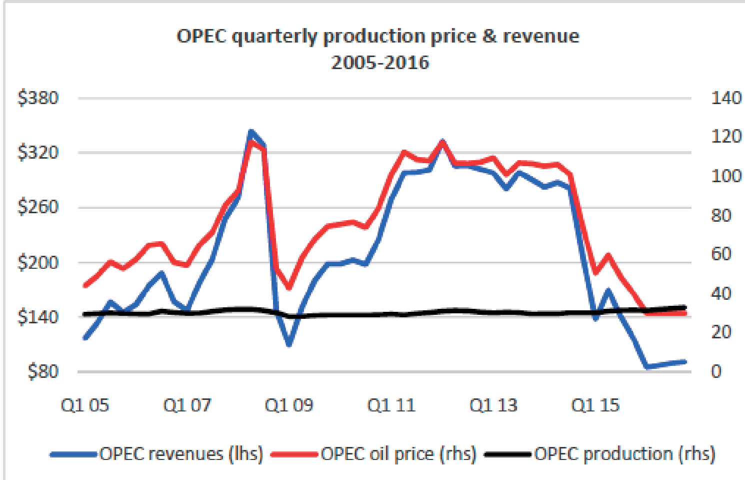

The future should brighten considerably

For the last six months the only thing that has mattered is the current level of OECD crude oil inventories, not their potential future trend. The strong dollar has reinforced the downward price pressure inflicted by 300-400 million barrels of excess OECD crude oil inventory. These are inventories made possible by OPEC overproducing 1mm b/d over the last fifteen months. But 2016 promises a brighter outlook because of the indicated material drawdown (411 million) of inventory in the table below based on the assumptions shown. A quarterly look at this 2016 experience would reveal that this drawdown begins in earnest in Q2 and accelerates in Q3 and Q4. Thus, the prospect of declining U.S. production and global inventories should communicate a very positive price signal to the oil futures market beginning in a few months. And it should last several years as the supply outlook is fairly stagnant.

Conclusion

Tracing out a long and painful oil price "V bottom" has been the job of 2014-2016. We are still on the downward sloping part of the V. However, in all this financial pain the seeds of the next price recovery are being put in place. Normalization of oil prices must occur over the next several years as prices today are unsustainably low by a factor of at least two if not three. Therefore, current conditions present an attractive opportunity to invest in energy stocks for the longer term. ◆

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Global Oil Demand/Supply equation
Assumptions - change in millions of barrels per day

	--------est.--------		-----------forecast-----------				
	2014	2015	2016	2017	2018	2019	2020
Global Oil Demand	1.6	1.8	1.3	1.3	1.1	1.0	1.0
non-OPEC Supply	2.4	1.4	-0.4	0.3	0.7	1.0	1.0
OPEC Supply	0.0	1.1	0.6	0.7	0.1	0.0	0.0
Global Oil Supply	2.4	2.5	0.2	1.0	0.8	1.0	1.0
Inventory	0.8	0.7	-1.1	-0.3	-0.3	0.0	0.0
(mm bbls per year)	292	265	-411	-109	-110	0	0
est. OECD inventory (mm bbls)	2,700	2,965	2,554	2,445	2,335	2,335	2,335

source: Woodstock estimates and calculations