WOODSTOCK

QUARTERLY NEWSLETTER

Spring 2015

In This Issue:

Earnings, Economy Slow But Long Term Still Positive

Our regulator, the Securities and Exchange Commission ("SEC"), has just issued a proposed rule for defining the level of service provided by the financial community to people planning financially for retirement. As with other current regulatory approaches to various parts of our economy (healthcare, electricity generation, student loans) the work product is voluminous and utilizes "carve outs" for parts of the regulated area exempted from the particular regulatory structure proposed. Our attempt to review this SEC work product foundered on the rocks of too much to wade through except to understand that Woodstock fits one of the carve outs. However, a review of the SEC site housing the documents revealed a study by RAND Corporation[1]. Its listing probably means that the SEC believes in its theory and conclusions. Also, besides the word "risk", the word "trust" is one of our favorite financial industry words. What does RAND say about trust that our regulator seems to agree with?

- Unsolicited advice has little impact on behavior
- People who don't seek financial advice about retirement think either that the advice is too expensive, or they don't have the time, or they don't know who or what source to trust
- A RAND definition of "financial trust" can be correlated with seeking and using financial advice but causality can't be established
- Although there is a positive correlation between "trust" and "financial literacy" and a negative correlation between "trust" and "risk aversion", "trust" measurements seem to be accounting for other underlying human characteristics separate and apart from financial knowledge or risk tolerance.

Our conclusion? The original intention of financial regulation may have been to structure an environment enabling investors to trust their advisors, in the knowledge that the regulatory authority safeguards investors' interests. All too common financial scandals regularly threaten the trust that has been created. However this research does not seem to be the strong foundation needed to justify the regulator's more recent efforts to pile on near-debilitating levels of rules, processes, conditions and exceptions.

We did learn that out of the four categories of financial advisors (banks, insurance companies, brokerage firms and investment advisors, the last including Woodstock) that only 3% of respondents knew that only investment advisors have a fiduciary duty to act in a client's best interest. Only 5% knew that only investment advisors are required to disclose conflicts of interest. A reassuring insight from our perspective might be that financial industry advertising in which firms seek to become a client's "trusted advisor" may not be as successful as advertisers hope. We at Woodstock should concentrate on making sure potential clients understand our fiduciary duty and conflicts disclosure requirements. We should continue to do the hard work of building portfolios for our clients consisting of high quality stocks which have the potential to outperform our benchmarks in order to earn the hoped for referrals from our existing clients.

The link we see between the words "trust" and "risk" is that both have narrow, simple regulatory or industry definitions that seem to hide the complex or worrisome aspects found in real life. "Risk" is a real concern but volatility does not capture its essence.

However, the SEC has come to our aid with an expanded definition of "risk". In discussing enhancements to the SEC's regulatory program, its Chair defined "risk" as the "the mix and impact of investments, liquidity and leverage on an investment portfolio and separately the investment firm's operations".[2] Now that's complex and varied enough for real life. Low risk on this scale might generate trust in the investment advisor.

Continued on Page 2

Our portfolios are made up of primarily high quality, US stocks. Stocks are held in our client's name, are readily tradeable and we don't use leverage. We audit ourselves under SEC guidance and regulations which is the fishbowl that our clients should appreciate. Obviously, we think Woodstock fits that low risk advisor profile.

We know that you are the most valuable business development tool that we have. Your referral of a friend, colleague or family member to us is the most important way that we grow.

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

William H. Darling, Chairman
Adrian G. Davies, Executive Vice-President & CIO

[1] *Trust and Financial Advice, RAND Corporation working paper, January 2015.*
[2] *IAA Newsletter, January , 2015 page 1.*

Earnings, Economy Slow But Long Term Still Positive

Thomas C. Stakem

Q1 2015
After 2014's spectacular performance (+11% in an +3% world equity universe), the S&P 500 was effectively unchanged (+0.4% price only) in the first quarter of 2015 as foreign equity markets (China, Germany & Japan) took the leadership baton and rose double-digits while U.S. equities rested. Investment grade and long term Treasury bonds returned 2.3% and 3.9%, respectively, outperforming domestic equities and boosting balanced portfolio total returns.

Oil prices and the dollar were the story in the quarter (and going back to mid-year). U.S. crude oil prices fell another 11% (down 56% since their June 2014 peak) and this rout prompted forward earnings estimates for the Energy sector to slump 43% during the first quarter. Since forward EPS estimates for the S&P 500 peaked in November they've fallen about $8 per share. We would attribute $4 per share to the dollar (40% of S&P 500 earnings foreign times a -10% change in the dollar) and $4 to energy sector earnings erosion (8% of S&P 500 earnings down 50%). Both are sure to influence earnings over the balance of 2015.

King Dollar
The dollar was essentially unchanged during the first half of 2014 (Q1: 0%, Q2: -0.4%). But over the last nine months the dollar has appreciated 23% or better than 2.5% per month. The first chart on the insert is a historical look at the dollar over the last forty-one years. On four occasions the dollar has appreciated 15% or more Year-over-Year - 1981, 1985, 2009 and 2015. In three of those instances the dollar subsequently declined. In the first instance (1981) the decline was prolonged while in the other two the correction was sudden. It can also be noted that recession shadings are linked to two of the episodes. Using the chart as a price momentum oscillator could embolden one to think a reversion to the mean lies ahead for the dollar which would be favorable for S&P 500 earnings. While dollar bulls don't see the strength ending anytime soon they're also not sobered by forty-one years of history.

Recent GDP and Employment Economic data during this expansion have tended to be less consistent than during any of the past cycles that we can recall. Weather, the Affordable Care Act implementation, tax changes, a sixteen day government shutdown (Q4 2013) have all been cited by economists as factors that have induced volatility to the real GDP data series. It almost seems like each quarter is a stand-alone fiscal period unconnected to the previous one or lacking much of a link to the subsequent quarter. Whether short-term stimuli or contractions, the volatility in the data is consistent with an economy that lacks the long term drivers or "animal spirits", as economist Larry Kudlow might refer to them, of past expansions.

To illustrate this point here are the last ten real GDP quarterly growth rates starting with the fourth quarter of 2014 and moving backwards to the third quarter of 2012: 2.2%, 5.0%, 4.6%, -2.1%, 3.5%, 4.5%, 1.8%, 2.7%, 0.1%, 2.5%. Instead of representing a nation's real GDP growth pattern, these figures could just as easily be a random list of numbers. Confident that Q1 2015's real GDP growth will fit well within this time series will only further reinforce the point that the U.S. economy has by no means passed "escape velocity" and is dependent on short-term influences. But as will be discussed in the next section the above ten quarter average of 2.5% is just slightly

Continued on Page 3

higher than our estimated long term growth potential of 2% based on labor force growth (0.5%) and expected productivity (1.5%). Two percent will increasingly be seen not as an aberration, but the norm, without a big surge in future worker productivity.

The latest April employment growth data point (+223,000; in-line with estimates) was a welcome rebound from March's weak reading.

Annual real GDP growth potential trending toward 2%

Uncertainty about near-term economic growth should also extend to the next decade. The fact that one quarter's economic performance often bears little resemblance or correlation to the previous quarter is evidence that there are little or no "multiplier" effects rippling through the economy. While the U.S. economy may be the envy of many economies around the world our growth is anemic by historical standards, and it is because the multiplier effects just have not been engaged. For years it's been thought that this is due to the fallout from the economic recession/financial crisis of 2008/2009 but it just may be a secular change as well.

As the second chart in the insert shows – population and civilian labor force growth have been in a secular downtrend for years with the population growing at a 0.7% annual pace and the labor force at or below that rate depending on the participation rate. The participation rate has declined about five percentage points since 2000 with four percentage points of that decline coming since 2007. The Bureau of Labor Statistics forecasts another 1.1% point decline to 61.6% by 2022 as a result of further baby-boomer retirements.

An economy's potential growth rate is the sum of its labor force (population times participation rate) growth rate and its productivity growth rate. With a labor force growth rate of 0.5%-0.7% our potential real GDP growth rate in the future could even be shy of 2% without a healthy contribution from productivity. Michael Feroli, a JP Morgan economist, calculates that U.S. real GDP potential growth is about 1.75% per year (0.5% of labor force growth plus 1.25% of overall economic productivity). To this one would then add an inflation assumption to arrive at a nominal (in money of the day) GDP growth forecast.

Productivity growth is therefore a very critical assumption which also has implications for wage inflation, profit margins, education/skills training, and capital spending. Training and capital spending are inputs enabling the productivity which can yield dividends for the overall economy. As can be seen in the same chart (green line) there was a spurt in productivity coming out of the 2008/2009 recession to over 5% but that has receded to below 1%, and more recently even into negative territory (-0.1%). Since 2010 there has been only one quarter when productivity was 2.0% or better. In the sixth year of an economic expansion productivity usually degrades with the maturing of the business cycle.

While productivity is a volatile data series, the trend in productivity is down to 1.0-1.5% (hopefully) over the next decade according to several economists. It will turn on education, continuous job skills training and investment spending levels rising. Capital spending is the only lever that can sustain the high level of productivity necessary for the U.S. economy to achieve a 2% real growth rate. U.S. tax policy can play a role in encouraging capex spending over many years but the "stop-start" tax policy approach witnessed so often in the past will not produce the sustained capital spending outcome that is necessary. To impact the economic growth and employment potential ten years from now requires long-term oriented spending plans to begin now. Otherwise the country's growth potential will be limited to 1% or only slightly higher.

Share buybacks, dividends, capex and R&D

Some may be tempted to argue that share buyback programs, increased dividends and higher CEO compensation over the past six years have siphoned away resources that otherwise could have gone toward capital spending and research and development (R&D) which are the "life blood" of productivity gains. If the data supported that contention that notion would be factual. However, analyzing the consolidated financial information for the current S&P 500 constituents counters that point of view. The only two income statement expense items that had a higher share of the revenue dollar in 2014 than in 2008 were depreciation and amortization (D&A) and research and development (R&D). D&A (5.09% vs. 4.48%) and R&D (2.10% vs. 1.65%) each grew faster

Continued on Page 4

than revenues over the six-year period thereby rejecting the notion that they were sacrificed in favor of buybacks and dividends. Similarly capital expenditures (capex) rose as a percent of revenues (6.54% vs. 5.98%) over the six year period and were nearly 30% higher than D&A. Higher capex relative to D&A expense is normally a sign that reinvestment spending levels are quite healthy.

So scrimping on R&D or capex has not been a factor in the growth of S&P 500 after-tax profit margins by 5.45 percentage points to 2014. Over the six years operating margins improved 3.95%, interest expense declined 1.27%, and other expenses dropped 1.02% yielding a 6.24% pretax margin increase of which 0.79% went for higher taxes leaving a net margin increase of 5.45%. While D&A and R&D each rose as a percentage of revenues during the six years, operating margin improvement occurred in both cost of goods sold (COGS) and selling, general and administrative (SG&A) expenses – indications of more efficient operations and stringent expense control.

Positive earnings revisions will return

While the dollar has only weakened 2% from its mid-March peak, the oil price has rallied 38% since its $42 per barrel low. Thus, there is some movement in the direction of positive earnings revision where negative revisions have dominated. Therefore, some of the estimated $8 per share of S&P 500 EPS estimate erosion since November may begin to be added back during the second half of 2015. And from the deflated Q1 level of real GDP growth we are apt to snap back to the country's long-term potential of 2% in upcoming quarters which should also add to S&P 500 earnings. If confidence in these trends can be sustained, it would augur for some P/E multiple enhancement. A combination of rising earnings and P/E multiple expansion is always an investor's best friend for capital accumulation.

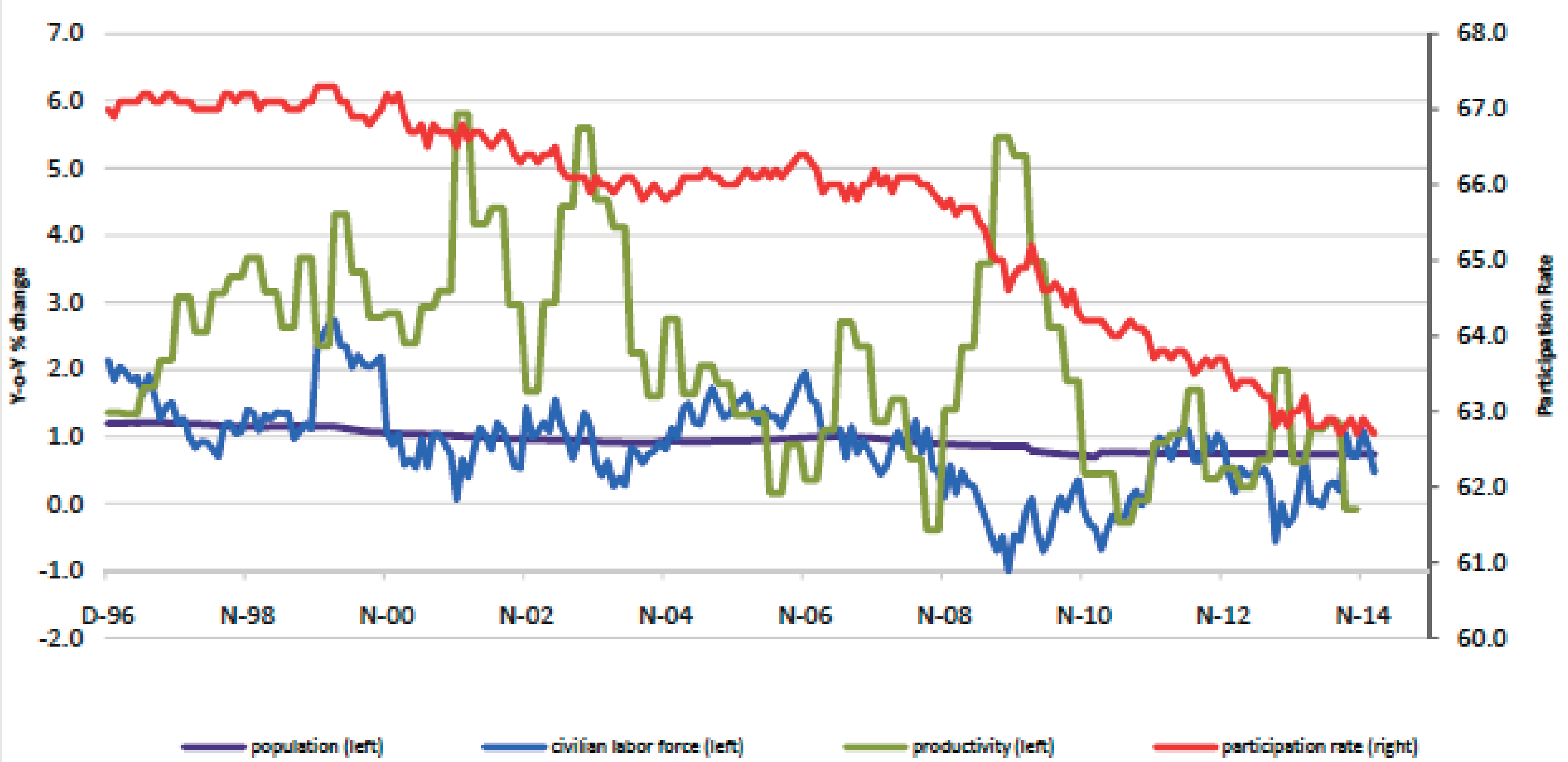
We continue to believe that the Woodstock approach of managing diversified portfolios of high quality US stocks is the best way to generate long term returns. As always, good stock picking and careful risk management will matter.◆

Tom Stakem is Vice-President & Director of Research at Woodstock Corporation. You may contact him at tstakem@woodstockcorp.com.

WOODSTOCK


FRED
Trade Weighted U.S. Dollar Index: Major Currencies
(Percent Change from Year Ago)
20
15
10
5
0
-5
-10
-15
-20
1980
1990
2000
2010
Source: Board of Governors of the Federal Reserve System (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org

Population and Labor Force Growth, Participation Rate and Productivity



Source: Federal Reserve Bank of St. Louis