WOODSTOCK

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Although Exchange Traded Funds (ETFs) can be useful investment vehicles, our preference at Woodstock is to invest directly in stocks. While maintaining diversified portfolios, we'd rather pick only the best stocks rather than employing a shotgun approach. Beyond that, what makes ETFs attractive – their ease of use – introduces an element of danger to which many investors may not be attuned.

The implicit message in ETF investing is that investors don't need to understand the companies in which they are investing. The sheer number of companies in any given ETF precludes diligent fundamental research. Who wants to do homework when they don't have to? Fundamental stock analysis involves comparing companies' operating results and growth expectations to their market prices. If a company can't beat the expectations implied by its valuation, the stock is unlikely to outperform over a longer period of time. There would not be a risk of overvaluation if stocks were efficiently priced, meaning that market valuations rationally discounted all available information. Two major market corrections in the past 15 years indicate to us that markets don't always efficiently, rationally price in available information.

Being removed from company fundamentals and valuation, it's all too easy for ETF investors to focus on the information that is available to them -- price momentum. With momentum as their guide, their allocation decisions are likely to be swayed by market sentiment. ETF investors are therefore susceptible to trend following, which over the longer term can leave investment performance lagging behind the market. We submit that a careful study of fundamentals and valuation are a much more likely path to successful investing: stocks are cheapest when others are selling and they are most expensive when others are buying. To quote Warren Buffett, one has to "be greedy when others are fearful, and fearful when others are greedy." To go against the herd takes conviction, and to have conviction about an asset, one has to understand it well.

Our outlook might change quarter to quarter, but our investment philosophy remains the same. Stocks should be held for the long term, as long as their fundamentals remain solid and their valuations remain reasonable. While ETFs can be useful, investors tend to sacrifice an understanding of fundamentals and valuation in the name of diversification. Direct ownership of stocks enables a better understanding of fundamentals and valuation, and therefore a better understanding of return and risk potential.

We believe your team of well-tenured Woodstock portfolio managers and analysts can outperform the market. We don't always beat the market, but the point is that we can and we do. Our approach may be old-fashioned, and we don't mind that. The more investors give up on fundamental analysis, the more opportunities are available for us to beat the market.

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 to know that we are dedicated to serving your best interest.

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

A Look At Wages

Adrian G. Davies

Financial issues making headlines in the second quarter included Greece threatening to exit the Eurozone, Chinese stocks entering a bear market, and Puerto Rico announcing that it is unlikely to pay its creditors. We would like to say that the market sailed through these issues unaffected, but the S&P 500 Index was down 0.2% during the quarter and closed up only 0.2% for the first half (returning 1.23% including dividends). The Shanghai A Share Index was down 17% from its peak through mid-year, having been up over 150% prior to that. The consequences for the Chinese economy of the stock market unraveling have yet to be determined. The US market could have been impacted by any or all of these geopolitical issues. While we will continue to monitor these global pressure points and they may continue to impact particular stocks, we don't expect them to have a meaningful impact on the US market as a whole.

Markets worldwide may have also been impacted by rising long term interest rates, as the 10-year US Treasury rate rose from a very low 1.92% in March to 2.35% by the end of June. The Fed has held the Federal Funds rate between 0.0% and 0.25%, a level appropriate for when the economy was in a deep recession, for more than six years now. Fed Governors have been communicating for about two years their intention to raise rates. The economic impact of the first rate increase, expected to be 0.25 percentage points (25 basis points), should be fairly minimal. In fact, expectations of rising rates have already had a tightening influence on the economy via currency exchange rates. The stronger US Dollar has already impacted our export competitiveness and our proclivity to import. At the margin, a 25 basis point increase in rates will impact some borrowing decisions, but we expect that the economy is growing strongly enough to overcome the impact of losing these marginal borrowers.

The decision to raise interest rates is still contentious. One point of view is that rates should stay low because inflation is still below the Fed's targeted level of 2%. The other camp is watching employment growth. If employment is strong, the thinking goes, the Fed should start the process of returning rates to a more normal level with or without evidence of inflation. The Fed is also keeping a close eye on wage growth, considering it a signal of how entrenched inflation expectations are. By the time wages start to increase, inflation can't be far behind or at least the economy would be considered strong enough to withstand a few rate hikes. Although the national statistics for wage growth are still modest, up +1.9% year-on-year at last count, there are anecdotal signs wage growth is starting to accelerate. Wal-Mart, Target, TJ Maxx, and Ikea have all announced that they will start paying their entry level workers more than the minimum wage.

While some economists would cite other measures of unemployment such as the labor participation rate or unemployment including marginally-attached workers (U6) as indications that labor conditions remain weak, the Bureau of Labor Statistics' establishment employment survey shows that the economy created 2.95 million jobs in 2014, the most since 1999. Job creation has continued at a strong rate into 2015, with the unemployment rate ticking down to 5.3% in June and an average of 208,000 payroll jobs being created per month in the first half of this year. Still other employment statistics (job openings and the quit rate for instance) show generally improving trends.

Considering that rates have stayed near zero for more than six years with no meaningful inflation, the financial landscape appears to be substantially different from how it was 20 years ago. Even as the economy continues to grow, interest rates are likely to stay low by historical standards. At the same time, with real economic growth of 2%-3% and inflation of 1%-2%, near 0% rates are probably too low. A normal Federal Funds rate could be more like 2%, as opposed to the 4% normalized rate the Fed had been forecasting for some time. Inflation isn't likely to go much above 2% in the intermediate term precisely because the threat of rising rates will have a dampening effect on economic growth.

What if a September rate hike signals the start of a series of rate increases? The Fed has emphasized that the future path of interest rates will be "data dependent," meaning they will determine when to increase rates and by how much based on incoming economic data. They have suggested that they are likely to increase rates only gradually, probably more gradually

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than when they increased rates by 25 basis points every six weeks through the 2004-2006 rate cycle. The Fed's stance leaves room for further rate hikes of course if economic conditions warrant them. One can speculate that not disrupting the capital markets is an important consideration. If the capital markets absorb a 25 basis point increase will little disturbance, the Fed will feel free to continue raising rates as needed. If, on the other hand, the markets react poorly, the Fed may further temper its plans for rate normalization.

The accompanying graph plots the unemployment rate, wage growth, and the University of Michigan's Consumer Sentiment Index going back 30 years. Two relationships stand out. First, consumer sentiment and wages have tended to move together, although they're more correlated at some times than others. Wage growth has not been the only variable influencing sentiment. While the two data series have shown low correlation since the Great Recession, sentiment has been in a steady upward trend and this trend has accelerated over the past year. If sentiment and wages maintain a degree of correlation, it suggests upward pressure on wages from here.

The second relationship that stands out on the chart is that wages and consumer sentiment are inversely correlated with unemployment: when unemployment falls, sentiment and wages rise. The correlation between unemployment and wages has also diminished over the past five years. Despite unemployment falling, wage growth has not recovered proportionally. Some economists may cite changes in government policy or income inequality as reasons the correlation has broken down. The relationship may have broken down on a more permanent basis, but given 30 years of history, it is more likely the statistics have only temporarily decoupled. Insipid wage growth could be a result of more low wage jobs being created than high wage jobs. It's certainly possible this is characteristic of the current phase of the economic cycle, causing the unemployment rate to lead wage growth. A similar situation developed in 1993 and 1994,

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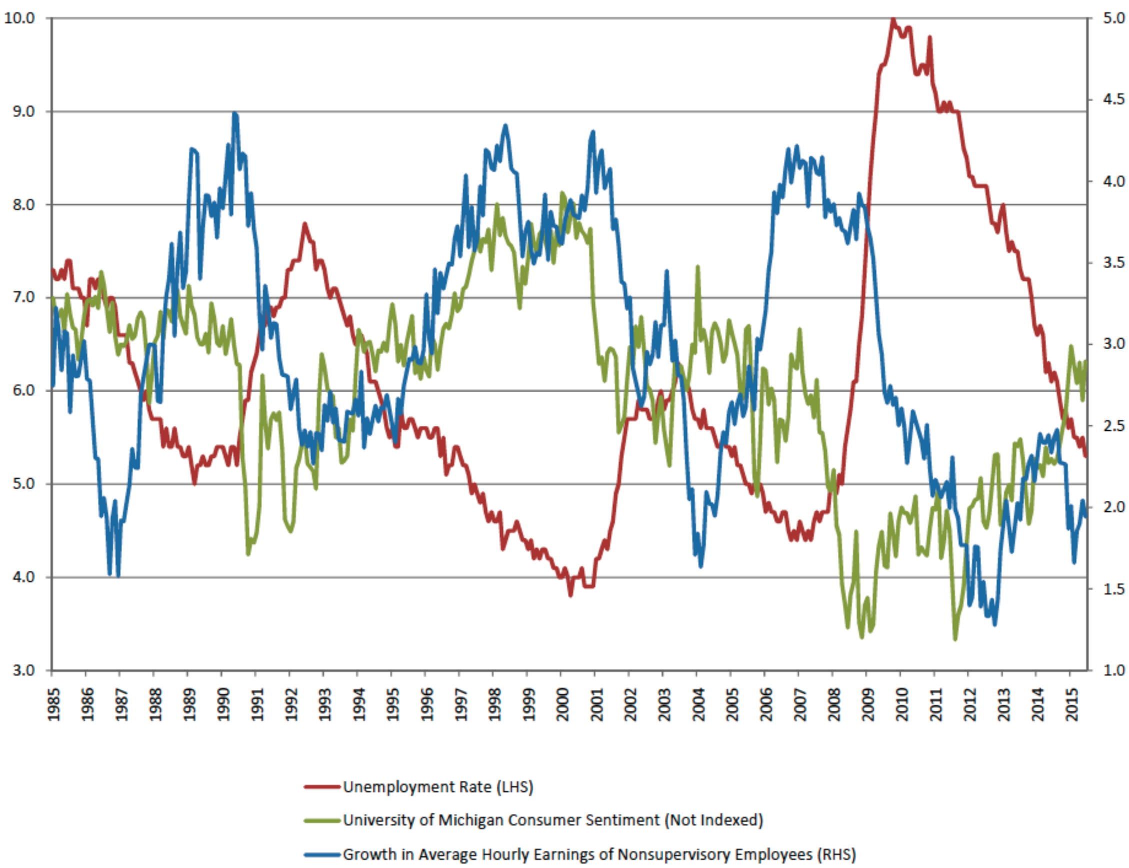

Source: St. Louis Federal Reserve

suggesting wage growth could pick up over the next twelve months. We see a reasonable likelihood that wages accelerate somewhat from here, and rising wages in turn would put upward pressure on interest rates.

Even if interest rates rise by a moderate amount, we emphasize that this would be the result of a healthier economic environment. Stocks tend to advance during rate increase cycles, but they tend to advance by less than they do under other monetary conditions. If we are on the cusp of a new cycle, we expect it to be much more gradual than previous ones, lessening the force of the interest rate headwind. Moderate economic growth and relatively low rates can prove to be an attractive environment for stocks. We envision stocks remaining attractive relative to bonds, even as we have entered the seventh year of the bull market. However, the market could still have some difficulty digesting rate increases, particularly in light of valuations which are already somewhat above average. In a more challenging market environment, stock picking becomes more important.

At Woodstock, we expend much effort adding attractive, high quality stocks to our clients' portfolios, and believe this is a very good time to be a client here. ◆

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