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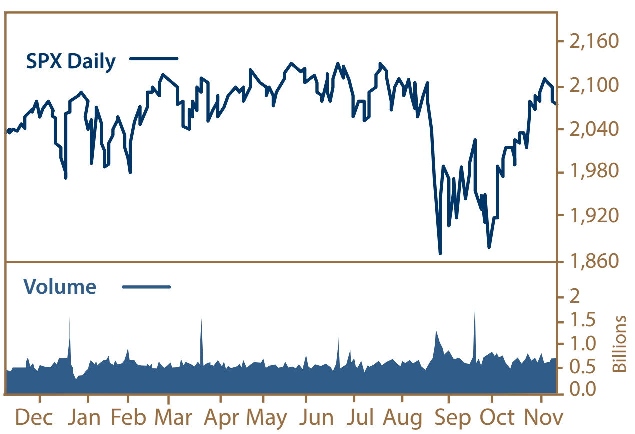
THE HEADINVEST QUARTERLY

MarketComment.

The combination of high stock market valuations and sluggish growth can be volatile. Following four years of steady advance, in August the stock market succumbed to a correction, popularly defined as a price decline of 10% or more. As shown in the accompanying chart, the S&P 500 declined 260 points from its peak, or 12%, before recovering most of its losses. For the full year, the US stock market is now flat to up slightly.

In order to reap the potential rewards from investing in stocks, it is necessary to accept volatility. Still, it is instructive to review the factors surrounding this correction for insight into the underlying health of the market.

S&P 500 INDEX YEAR-TO-DATE



Source: BigCharts.com

ANATOMY OF A STOCK MARKET CORRECTION

Since at least the summer of 2014, the stock market had been seemingly impervious to an increasing variety of growth scares. Oil prices fell throughout that summer and the decline accelerated in November when Saudi Arabia announced it would not reduce its oil production in response. Low oil prices threaten to undermine America's booming shale industry; in fact, this is most likely an important objective of Saudi policy.

During the same period, the value of the US dollar rose 25% against a trade-weighted basket of foreign currencies, devaluing the foreign earnings of US-based multinational companies. US GDP growth declined to near zero in the first quarter of 2015, a white-knuckle repeat of 2014's first quarter, though growth subsequently resumed. The anticipated growth rate in earnings of companies in the S&P 500 fell from 11.4% at mid-year 2014 to 1.5% by mid-year 2015. Another Greek crisis came and went with a slight shudder in June of this year, but seems largely forgotten now.

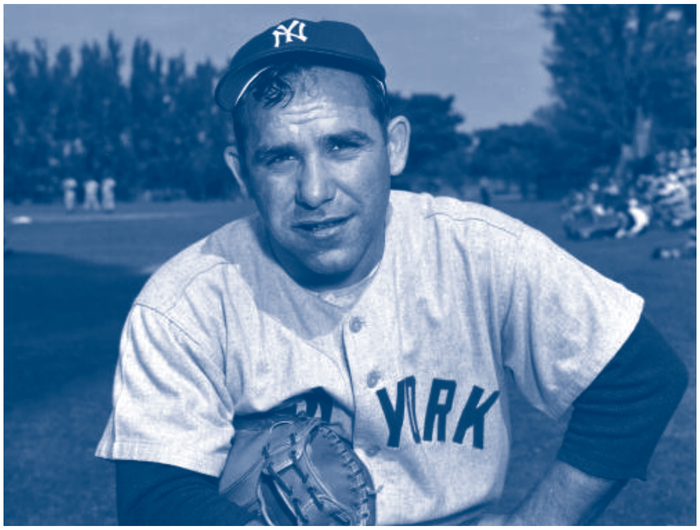
So, neither falling oil prices, a shortfall in GDP nor the dissipation of earnings growth had fazed the markets by mid-summer. What seems to have finally sapped confidence (albeit temporarily) was the Chinese stock market crash. From mid-June to the end of August, the Shanghai Composite stock market index fell 43%. Iron ore and copper prices also fell precipitously. Since China is by far the world's largest user of commodities, these declines were taken as a sign of an impending hard landing of the Chinese economy, a slowdown far worse than the official target of 7% growth.

WHAT SEEMS TO HAVE FINALLY SAPPED CONFIDENCE WAS THE CHINESE STOCK MARKET CRASH

continued on page 3.

PortfolioMatters.

BY CARL GERCKE, MANAGING DIRECTOR & CHIEF INVESTMENT OFFICER



On the occasion of the death of Yogi Berra at age 90, we take the opportunity to review Yogi Berra's philosophy and legacy, particularly how it might relate to the economy and markets, as well as savings and investment.

IT AIN'T OVER TILL IT'S OVER.

There will always be something new to worry about in markets. If ever there is widespread agreement about their direction, markets usually go the other way. In the end, there is no end.

WE MADE TOO MANY WRONG MISTAKES.

If your investment portfolio is properly constructed for your goals and circumstances, there is no reason to fear corrections. Unfortunately, some investors forget this and do not behave in their long-term interest. Often, this means selling stocks when there is no reason to.

Aside from the proper construction of portfolios, there are other ways to avoid behavioral problems. Always focus on your long-term objectives and evaluate short-term fluctuations in that context. Always discuss your concerns with your investment advisor.

I NEVER SAID MOST OF THE THINGS I SAID.

I admire Jim Cramer but it is hard to keep track of his calls. Most of his pronouncements reflect a trading strategy, not an investment one. It is useful not to confuse the two. Whatever is said by traders usually turns out to be irrelevant to investors. Compare to John Kerry's "I voted for it before I voted against it."

I WISH I HAD AN ANSWER TO THAT BECAUSE I AM TIRED OF ANSWERING THAT QUESTION.

Investing in stocks makes sense, even if you have no idea what direction the market is going to take. This is true because businesses exist to make positive returns for their investors and, in the aggregate, if capitalism works, these returns will be realized. In the short term, though, no one can consistently predict what the market will do.

IF YOU DON'T KNOW WHERE YOU ARE GOING, YOU MIGHT WIND UP SOMEPLACE ELSE.

This one offers an opportunity to underscore another important value of our services to clients. How much money do you need to secure your retirement? When should I liquidate my real estate investments? What is reasonable performance to expect from an investment portfolio? What factors threaten the longevity of your retirement savings?

A NICKEL AIN'T WORTH A DIME ANYMORE.

Among the uncertainties individual face, especially at retirement, is how long they need their money to last and what its value will be in the future, after inflation has taken its toll. Today, a dime is worth what a nickel was worth in 1990.

CHINA'S MARKET ECONOMY: NOT READY FOR PRIMETIME

In recent years, policy changes have encouraged private investors in China to shift their investments from real estate to stocks. To combat skyrocketing housing costs, interest rates were raised, down payment requirements were increased, other mortgage restrictions were imposed and the number of homes individuals were allowed to own was reduced. By 2014, the impact of these policies contributed to the slowdown of China's economy, in which housing-related activity had reached 24% of GDP.

Meanwhile, to encourage the development of stock markets, brokerage account rules were liberalized, allowing up to 20 accounts per person (to maximize the chances of participating in new stock offerings) and, for the first time, margin debt was permitted. In response, Chinese stock markets reversed years of declines despite the accelerating economic slowdown. The Shenzen stock exchange index tripled in value from the end of 2013 to June of this year and the Shanghai index rose to a seven-year high. The number of brokerage accounts held by Chinese investors—who are not allowed to invest outside the country—ballooned while margin debt expanded to nearly $300 billion. As a share of stock market capitalization, margin debt rose to levels higher than in the US, where debt is also at record highs.

Cartoon by Nicholson from "The Australian" newspaper: www.nicholsoncartoons.com.au

When Chinese markets turned in June of this year and began to give up some of these gains, the Chinese government moved aggressively to support the markets. Interest rates were cut, new public offerings were halted, state-owned enterprises were ordered to buy stocks and the government even lent money to brokers to buy stocks. The declines were brought to a halt, though some restrictions still apply.

China is engaged in a major transformation of its economy. Its leaders aim to address corruption, environmental degradation, excessive local government debt and industrial overcapacity. At the same time, China's leaders have declared that markets must "play a decisive role in allocating resources." One of the lessons from their stock market turmoil is that China's economy is still a long way away from being "market-driven." Another is that the road to transformation is bound to be uneven. Periodic crises of confidence will likely continue to affect markets, especially since the outcome for this exceptionally large economy remains murky. In the long run, China's transformation could be a very powerful positive force for global markets. But until the transformation is further along, government policy will remain central to the pace of growth and its impact on markets.

IN THE LONG RUN, CHINA'S TRANSFORMATION COULD BE A VERY POWERFUL POSITIVE FORCE FOR GLOBAL MARKETS.

FLASH CRASH 2.0

The impact of increasing concern about global growth also exposed a lingering weakness in the

continued on page 4.

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Market Comment continued from page 3.

structure of the US stock market. On August 24, 2015, stocks suffered another "flash crash", similar to the one that occurred in 2010. Following overnight global declines, the Dow Jones Industrial Average opened down sharply and quickly fell 1,000 points, or 6.7%, before recovering to close down 3.5%.

Though the "flash crash" in 2010 brought public attention to the impact of high-frequency trading, apparently nothing has changed to prevent recurrence. Once again, by withdrawing capital from the markets when they became volatile, high frequency traders seem to have exacerbated the market's intraday decline. Tellingly, Virtu CEO (and owner of the Florida Panthers) Doug Cifu, said, "Virtu…is on track to have one of its biggest and most profitable days in history Monday amid a tumultuous 24 hours of world markets…"

In the end, stock exchange circuit breakers eventually stanched the decline. For the first time in history, all major market stock indices hit their daily limit down levels. The lack of liquidity in the market was evident from declines of 20% or more in major stocks such as Ford, Colgate, JPMorgan Chase, General Electric and Pepsi. Even more unsettling were declines in major stock market ETF's, including a 45% decline in the PowerShares S&P 500 Low Volatility ETF! If you didn't sell, though, then you did not suffer losses, as markets subsequently rebounded. In our view, the SEC must be more assertive and less conflicted in addressing the institutional factors that favor high frequency traders and their computers at the expense of orderly markets.

LOOKING AHEAD

Measured by the cyclically-adjusted PE ratio (just one of many measures of stock market valuation), stocks entered the summer valued at 26 times the 10-year trailing average of earnings, a level exceeded only in 1929, 1999 and 2007. Following a brief correction, they are now back to this valuation level. As we noted before, the combination of high valuations and sluggish growth can be volatile.

The market rebound was powered by relatively few stocks. In fact, a trend toward narrowing market leadership has occurred all year. According to market analysts Strategas Research Partners, the ten largest stocks in the S&P 500 have contributed more than 100% of this year's market performance. By contrast, both 2013 and 2014 saw the ten largest stocks contribute less than 20% of the year's advance. Outside the universe of certain high-priced tech stocks, such as Facebook, Amazon, Netflix and Google, the outlook is more clouded than before.

As in China, the advanced economies of the West also employ government policy to support markets. Never before have the Federal Reserve and other central banks so explicitly targeted stock prices as a policy objective of quantitative easing. As the US Federal Reserve prepares to begin withdrawing this support, the combined uncertainty over policies in the West and in China has made markets jittery. It is helpful that earnings expectations for 2016 are once again at double-digit levels. We can only wait to see what, if any, new challenges appear.

We value your Comments

Please provide us your thoughts and suggestions, including content ideas, by emailing your portfolio manager or info@headinvest.com. If you would like to receive The HeadInvest Quarterly by email, please e-mail: info@headinvest.com