CLIFFORD SWAN
The Investment Counselor
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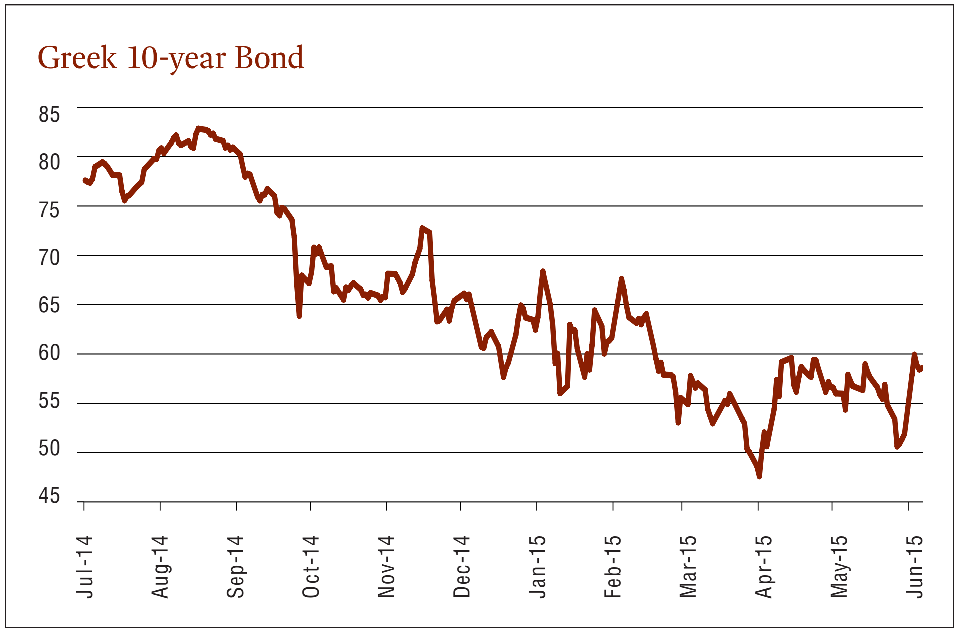
Market Outlook



Source: Bloomberg

By Anil Kapoor, CFA

Throughout the history of financial markets there has tended to be a high level of comfort amongst investors when prices are rising steadily. Everyone is making money, retirement plans are doing well, the economy is humming, unemployment is low, and morale is generally good. Complacency sets in and most feel that nothing can go wrong. Unfortunately, it is times like these when investors should be most cautious. We often never know what might cause the next downturn until it's already in front of us. In this market outlook, we will review the current state of equity markets and provide some color on a few cautionary flags we are monitoring in the current environment.

This past May, the broad market indices reached all-time highs. At Clifford Swan, we tend to focus on the S&P 500 Index as a proxy for the stock market. Comprised of the largest 500 companies in the United States, the S&P 500 is a commonly referenced gauge for the overall health of corporate America. In mid-May, the S&P 500 reached an all-time high of 2,130, up from the Great Recession's low of 666 in March of 2009. That's a total return of 220%. A six year stretch of 220% annualizes to an average annual compound return of approximately 20% per year—an astounding rise. It is evident that the U.S. Federal Reserve's extremely generous accommodative monetary policy has helped the fragile U.S. economy rebound. Although this recovery has lagged others in terms of overall economic growth, the stock market has gained significantly given how depressed prices were.

To review, since 2009, the U.S. has averted disaster, the market has rebounded, the economy appears relatively healthy, and unemployment has been reduced to 5.3% from 10%. This is a strong list of positive variables. On the flip side, there are plenty of red flags to pay attention to—there are now more things that can go wrong rather than go right. We will discuss five of these flags:

1. Valuations are fair

If using the Price/Earnings ratio (P/E)[1] as a valuation measure, the S&P 500 is currently trading at 17.5x P/E. Historically, the P/E ratio has been between approximately 11x and 20x. At 17.5x, the S&P 500 is closer to the higher end of the historic range, which means we are approaching peak historical valuations. On a Price/Book basis (P/B),[2] the S&P 500 is currently trading at 2.8x. Historically, the P/B ratio has been between approximately 1.7x and 3.0x. Again, 2.8x is on the higher end of the historic range. High P/E and P/B ratios imply that it could become difficult for markets to increase more as valuations continue to expand.

2. Greece turmoil

Greece is virtually bankrupt and there is a chance that the country could exit the Euro as its currency. This is commonly referred to as a "Grexit." If there is a Grexit, it can set off negative reverberations around the globe. Additionally, a Grexit could provide the impetus and precedent for other European Union nations to exit the Euro. Also, decreased confidence in the

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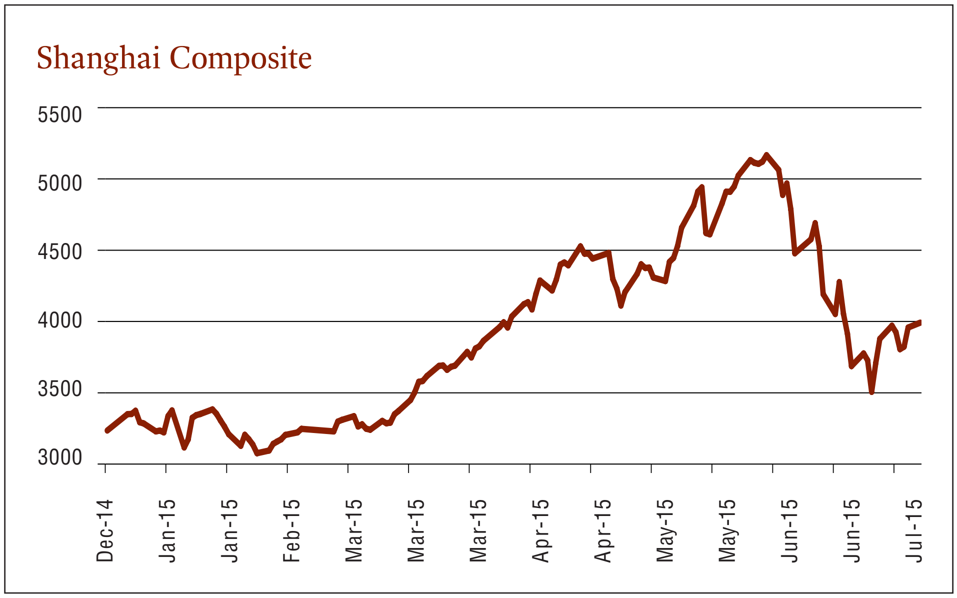
Euro and the European Union could potentially stop some nations from trading with European counterparts. This would hurt some U.S. companies as they rely on revenue from Europe. On the previous page is a chart of the Greek 10-year bond, a reflection of Greece's credit quality, which has traded down from 82 to 58 from July 2014 through July 2015—a scary decline.

3. Chinese stocks are crashing

The Chinese stock market, as represented by the Shanghai Composite, is down almost 30% from mid-June to mid-July. With global markets more interconnected than in the past, this can present difficulties for U.S. investors. There are significant monies that were borrowed to "play" with Chinese stocks after their huge run-up. In the chart to the right, you can see the debt-fueled rise and then the crash of the Chinese stock market. Over 80% of Chinese stocks are traded by individuals or day traders. When these generally unsophisticated investors sense fear, they sell. Selling begets more selling, resulting in a crash. Given China's huge economy, a healthy Chinese market is important for the entire world. If China suffers, the U.S. will likely suffer.



Source: Bloomberg

4. High-Yield Bonds are selling off

High-yield bonds are commonly referred to as "junk bonds." Junk bonds have lower credit ratings than investment-grade corporate bonds, U.S. Treasuries and municipal bonds, and pay a higher yield because of their higher risk of default. Junk bonds are very highly correlated with stocks and are analyzed by credit investors. Credit investors tend to be much more conservative than equity investors. The reason for their conservative nature is that bonds comprise the less-risky portion of a portfolio—their role is preservation of principal. Therefore, at the mere hint of a potential loss, credit investors encourage selling. In an unnerving scenario, junk bonds have traded down over the last few months while stocks have maintained their lofty levels. Often, liquidation of high-yield bonds is a precursor to a stock sell off.

5. Spike in Mergers and Acquisitions

Heightened levels of mergers and acquisitions (M&A) is often a sign of frothy markets. The volume of M&A activity in the first half of 2015 is at the highest pace since the first half of 2007. Companies usually start to engage in increased M&A when the core business has become mature. Thus, they are forced to grow through acquisition. There seems to be a different rumor every day about companies merging. This is happening across all sectors and industries, particularly Healthcare. Stocks are rising even on the slightest rumors and, for the most part, these rumors are coming true and easy money is being made. Eventually, this rumor mongering becomes unhealthy and deals start to fall apart and confidence in markets wane.

As our clients, you are well aware that we are not in the business of making market predictions. The red flags we have reviewed could prove immaterial and stocks could very well continue their march upwards. However, the takeaway point we would like to emphasize is that as price increases, risk increases.

As a part of our research effort, we are diligently searching for secular growth in corporations which can, at times, trump broader market issues. This is a difficult concept to grasp as most investors feel emotionally secure as prices increase and nervous when prices are lower. In reality, one should feel the opposite. It's almost like buying a pair of shoes—wouldn't you rather buy your favorite pair on sale? Same thing with stocks; it's best to buy on sale, and currently most stocks are full-priced.

> **"... we are diligently searching for secular growth in corporations which can, at times, trump broader market issues."**

Because markets are unpredictable, we at Clifford Swan structure portfolios with volatility in mind. We aim to conserve capital and make sure your financial needs are met even during potential crises. Volatility often provides opportunities to buy securities at favorable prices. It is our job to guide portfolios and take advantage of prospective market dislocations. ◆

1 The lower the P/E ratio, the cheaper a stock is relative to its earnings.

2 The lower the P/B ratio, the cheaper a stock is relative to its net asset value.

Message from the Chairman

By Linda Davis Taylor

This year, the term "spring cleaning" took on new meaning for everyone at Clifford Swan. After weeks of organizing, scanning, and packing, we moved into our sparkling new home in suite 550 at 177 E. Colorado Boulevard. Spectacular mountain views and a bright, open floor plan have given us all a genuine sense of renewal and excitement. Keep your eyes open in September for a save-the-date announcement for our "housewarming" event later in the fall. In the meantime, stop by and take a peek anytime you're in the neighborhood. We love our new home!

Our office has also been infused with high energy in the last few months with the addition of two new colleagues. Allen Mercer joined us as an equity analyst in February, providing additional brainpower to our research team. Prior to joining Clifford Swan, Allen worked for Capital Group in Los Angeles as an investment specialist and was an associate at Jensen Investment Management in the Pacific Northwest. When he's not studying stocks, Allen is an avid soccer player.

Erica White began her new role with us in June as assistant portfolio manager. Her prior investment experience includes six years in Boston working with institutional clients at Convexity Capital Management. Erica and her fiancé Tom are looking forward to an August wedding in their hometown in western Massachusetts. Allen and Erica join fellow "next gen" professional Jennifer Loesch, who celebrates her second year as our marketing and business development associate. A Pasadena native, Jennifer came to Clifford Swan from Warner Bros. Pictures. These talented young people help to ensure a bright future for Clifford Swan for many years to come.

We're proud to announce that Clifford Swan continues to be recognized for its excellence in the investment profession.[1] *Forbes* named Clifford Swan to its list of the Top 100 Wealth Managers for this year. On June 1st, the *Los Angeles Business Journal* recognized Clifford Swan in their list of the Top 100 Money Management firms in Los Angeles County. In July, *Financial Advisor* magazine's ranking of independent advisory firms placed us 87th in the nation and 14th in California. *Financial Times* included us among the top 300 Registered Investment Advisors in its annual independent assessment of firms' standing based upon assets under management, compliance record, years in existence, credentials, and accessibility.

All of us are gratified by these accolades, but, of course, we know that the only true measure of success is the trust placed in us by our clients and friends. Thank you for your continued loyalty and support.

Best wishes for a happy and healthy summer season! ◆

Jennifer Loesch, Allen Mercer, and Erica White

1 Ranking Criteria: *Forbes'* ranking is based on assets under management for year-end 2014. Members of the list must manage at least half of their assets on behalf of retail clients, cannot run a broker-dealer or be a bank, and must perform wealth management services. *Los Angeles Business Journal* ranked firms based on assets managed. To be eligible for *Financial Advisor* magazine's ranking, firms must be independent registered investment advisors and file their own ADV statement with the SEC, provide financial planning and related services to individual clients, and have at least $50 million in assets under management.

An Unchanged StockMarket and Low Interest Rates: What's a Portfolio Manager to Do?

By Terrell H. Price

For the first six months of 2015, not much has happened in the investment world as reflected by stock market indices. Although recently setting new all-time highs, as measured by the S&P 500, stocks have returned only 1.2 percent as of this writing. And one percent of that return is from dividends. Likewise, interest rates are just about where they were at the end of 2014. A one-year bank CD returns perhaps only 0.1 percent. Two-year U.S. Treasuries yield 0.6 percent. And five-year municipals yield just 1.5 percent.

So what is the answer to our rhetorical question, what's a portfolio manager to do? It's a fairly simple answer. Because we are long-term focused investors and highly disciplined, we do what we always do. In the case of stocks, we look for individual companies trading at levels we feel offer good long-term values. And for bonds, because we're highly principled, we focus on high-quality and secure issues which will pay us a fair return in comparison to other fixed-income alternatives of lesser quality.

> "In the case of stocks, we look for individual companies trading at levels we feel offer good long-term values."

In the case of equities, it is clear that market indices or averages are just that—averages. So at any given time, some individual companies may be trading at overvalued levels. Others are likely trading at discounted levels. And, like Goldilocks, many trade just right where they should be. But *on average* there's been no change to the whole index. A portfolio manager's job is to sift through the individual investment opportunities and make some changes to specific companies in a portfolio. Some might be sold or reduced, others might be bought, but most will probably be held.

For example, let's examine a company we've recently been buying, which, for compliance purposes, we'll call XYZ Company. XYZ is a high-quality, best-in-class industrial growth company. We feel its management is terrific. They have no debt and pay a 2.7 percent dividend yield. On the surface, this company's products are not too exciting. Again, for compliance purposes, let's say they supply everyday tools and supplies to manufacturers and the construction industry, the types of things you and I would buy at a home improvement store.

But because they are so well managed and are a dominant player in their businesses, we expect XYZ Company's earnings to grow about 15 percent over the next few years. This company is rarely ever cheap. But over the past two or three years, the stock has gone down in value about 10 percent. In that same time period, the "average" S&P 500 stock has gone up 40 percent. During that time, sales, earnings and cash flows at XYZ have continued to grow handsomely. We find value in such a situation and have, therefore, been adding XYZ to portfolios, exactly as we always do.

> "Our principled discipline suggests we don't believe earning nothing in cash is a good long-term strategy."

What about bonds? Isn't the Federal Reserve (Fed) expected to raise interest rates soon? The simple answer is yes, rates will likely rise in the not-too-distant future. So if rates are likely to rise, wouldn't it be okay to simply stay in cash and earn next to nothing? Our principled discipline suggests we don't believe earning nothing in cash is a good long-term strategy. Here's our thinking.

When it comes to fixed income assets, there is generally a trade-off between returns and maturity. If one invests longer, then expected returns are generally higher. But longer maturities also imply greater risks

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when interest rates rise. So, when analyzing returns in the bond market, we prefer to compare returns between one asset and another. For example, as of this writing, we know we can only get a 0.6 percent annual return from a two-year Treasury. But the one-year CD only gives us a 0.1 percent return. At this point, we'd prefer the Treasury to the CD over the next two years.

Yet if interest rates rise, won't we find short-term CD rates higher too? The answer is yes. But over the next year, the Treasury will have returned 0.5 percent more than the CD. And CD interest rates would have to be a lot higher in the second year to make up for that difference.

So in the area of bonds, we must consider alternative investments and opportunity costs of one purchase versus another. Also, because bonds usually constitute the stable part of our portfolio, we look at any credit risks in the bonds we buy. In our simple example, we feel we take less risk in owning the two-year Treasury than the one-year CD. The Treasury is extremely liquid if we need to sell it, and the credit rating of the U.S. government is very high. In fact, the insurance behind bank CDs is the U.S. government itself. Plus, CDs often come with early withdrawal penalties. So overall, we feel very comfortable getting a somewhat higher return from the Treasury than we do from the CD even though the maturity is longer.

> **"... when analyzing returns in the bond market, we prefer to compare returns between one asset and another."**

So, in answer to our question above, we're doing exactly what we always do. The only thing that's changed in the last six months is the short-term results. But we are principled, disciplined, long-term investors who feel we will be rewarded over the coming years by making the same sound investment decisions we always have. ◆

Internship Program Successfully Completes Second Year

Lance Frame and Kaitlyn Kelleher were selected from over 180 applicants for the second year of Clifford Swan Investment Counsel's summer internship program. Lance Frame is a rising senior at Brigham Young University, where he majors in Finance and is a native of La Canada. From Pasadena, Kaitlyn Kelleher is a rising junior at Claremont McKenna College, where she majors in both Economics and Government.

Through the internship program, Clifford Swan aims to provide talented students who have shown interest in the investment and wealth management business a fundamental educational experience in each aspect of our work. In the two-month program, Lance and Kaitlyn worked on several projects and learned about key aspects of the firm, including portfolio management, equity and fixed income research, trading and execution, compliance, and marketing.

Both Lance and Kaitlyn have written about their experience at Clifford Swan. Please see their comments below.

Lance Frame

The culture here is one of intellectual curiosity, and that drive for constant learning is truly contagious. During our internship here, Kaitlyn and I have been provided with a myriad of resources to aid us in understanding the everyday processes that contribute to a successful investment firm.

According to the Chinese proverb, "One hour with an expert is worth one hundred hours working alone." Within a hundred feet of my desk, there are over 200 years of investing experience hard at work. In this flatly-structured organization, every door is open and every counselor is willing to lend their expertise to help me. My most-prized experiences here have been the opportunities to observe research and investment meetings, where real decisions are made. Seeing the process and extensive energy that goes into each and every investment decision has been a sneak peek into the level of expertise needed to manage portfolios.

While observing an expert is key to learning, I have kept in mind the adage that "a teacher can open a door, but the student must walk through it himself."

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The counselors at Clifford Swan have been keen to ensure that each aspect of our education be put into practice. During each week of our internship, we have focused on a specific aspect of the business and spearheaded projects related to each area. We have had the opportunity to research specific stocks and mutual funds, aid in the client service process, and streamline parts of the business development segment.

Kaitlyn Kelleher

Recognizing a historic spike in the trading multiples of hallmark ready-to-eat cereal (RTEC) companies, equity analyst Anil Kapoor asked Lance and me to research two RTEC companies that are industry leaders. Over the next two weeks, we scoured these two companies' 10Ks and quarterly earnings transcripts, determined to understand their financial health and growth prospects. We also spoke with the head of investor relations of one of the companies and asked questions on the company's margins, international footprint, and product pipeline. Throughout these early stages of the project, the Clifford Swan team was an invaluable resource, fielding our many questions and offering numerous research tips.

Using the company reports and our conference call notes, we launched into phase two of the research process: modeling. Focusing on projected sales revenue and EBITDA margins, Lance and I built models for both companies. Arriving at price targets for each company, we determined short and long-term buy/sell recommendations. Intrigued by our research, Anil asked us to present our work at both the research and investment meetings. Lance and I created a PowerPoint to succinctly outline our conclusions. We then rehearsed our presentations and met with Anil to review last-minute details.

Presentation week. The entire Clifford Swan team convened in the conference room. Considering everyone's busy schedules, the firm's full attendance speaks to its genuine interest in developing its younger talent. As I began my presentation, my nerves were initially audible in my shaky voice, but quickly subsided as my comments were greeted with reassuring smiles. After our remarks, research analysts, portfolio managers, and even CEO Linda Davis Taylor asked questions—a perfect capstone to an engaging and rewarding project. ◆

Lance Frame and Kaitlyn Kelleher

CLIFFORD SWAN
INVESTMENT COUNSEL

Professionals

Offices

Pasadena
177 E. Colorado Boulevard, Suite 550
Pasadena, CA 91105
626.792.2228 | 626.792.2670 FAX
Evergreen
P.O. Box 2945, Evergreen, CO 80437
720.746.1244 | 720.294.9896 FAX
www.cliffordswan.com

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