CLIFFORD SWAN
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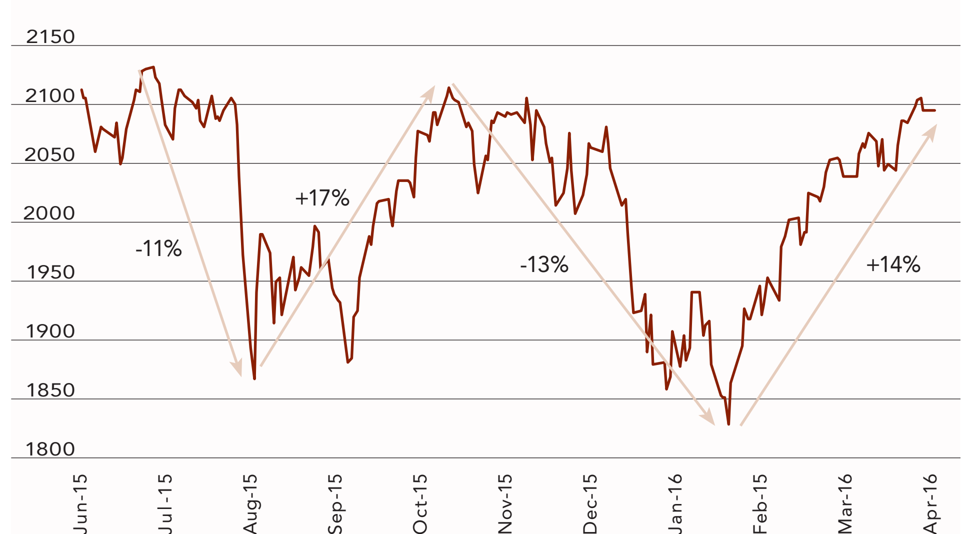
WISDOM *for* GENERATIONS

MARKET OUTLOOK: A ROUNDTRIP JOURNEY

By Anil Kapoor
CFA



Source: Thomas Reuters Baseline

The last market outlook I wrote for this publication was in July 2015. At that time, the S&P 500 Index, which serves as a broad stock market proxy, was trading at approximately 2,100 and approaching all-time highs. The main takeaway of the July 2015 market outlook was that the potential risks within equities outweighed the potential rewards. We discussed many market warning signals and thought this foretold either a price drop or a waning market after the more than six-year-old bull market run that began after the Great Recession of 2008/2009.

Time proved that we were correct in our assessment of the state of the market. Immediately after the publication of our July market outlook, the S&P 500 Index sold off 11% from its highs. Subsequent to that, we saw a 17% rebound back to the highs, then another 13% selloff, followed by a 14% gain. We have observed two complete roundtrips in a matter of nine months! The chart above summaries the story nicely—as you can see, volatility has been quite staggering of late.

The natural question is why are these gyrations occurring? Let's consider a few possible reasons.

FEDERAL RESERVE POSTURING

Over the past year, there has been much debate amongst investors as to whether the Federal Reserve should continue increasing interest rates. There were hints made by officials in mid-2015 that steady increases were on the horizon. Then earlier this year, the Federal Reserve reversed their previous indications and decided to not raise rates any further for the time being. This constant back-and-forth posturing by the Federal Reserve is confusing investors. It is having an even more significant effect on dividend-paying stocks as these securities are more sensitive to moves in interest rates given the dividend income stream. Dividend-paying stocks are often used as substitutes for bonds, which means that their prices can fluctuate as interest rate forecasts ebb and flow.

ENERGY

The price of oil is down from $105 per barrel two years ago to $43 per barrel as of this writing. In between these two prices, there have been many ups and downs. Recently, as these extreme price movements have taken hold, the entire stock market has been taking its cue from the price of oil. The very nature of commodities is that they are driven by supply and demand and thus can exhibit huge price swings. The fact that the market is hanging on every move in the price of oil to the current degree exhibited is bizarre. According to an article published on January 25, 2016 in *The Wall Street Journal*,[1] the correlation between the S&P 500 Index and the price of Brent crude oil has not been this high in 26 years. To review, correlation measures how two variables (in this ex-

1. Stubbington, Tommy, and Georgi Kantchev. "Oil, Stocks at Tightest Correlation in 26 Years." *The Wall Street Journal* 25 Jan. 2016.

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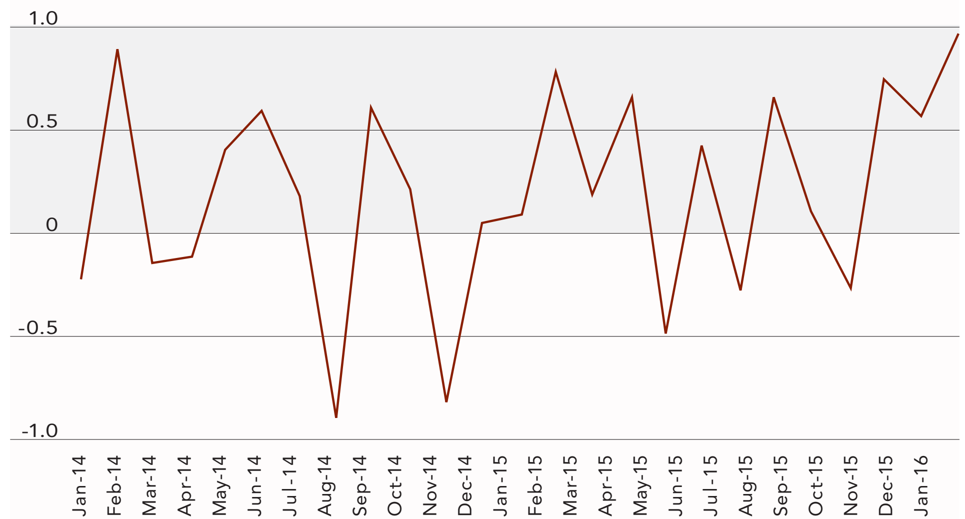
ample, the S&P 500 Index and the price of Brent crude oil) move in relation to each other, with the continuum ranging from -1.0 to +1.0. A correlation of -1.0 indicates that the two variables are perfectly negatively correlated and move in opposite directions, while a correlation of zero shows that the movement of one variable is not connected in any way to the movement of the other. Finally, a correlation of +1.0 means that the two variables are perfectly positively correlated and move in lockstep with one another. Over 20 trading days in January, the correlation reached 0.97 (see the chart to the right), higher than any calendar month since 1990.

Correlation between the S&P 500 Index and the Price of Brent Crude Oil



Note: Correlation for calendar months, except for final data point, which is for the 20 trading days that ended January 26, 2016. Source: WSJ Market Data Group

VALUATIONS

The ratings and target prices of the stocks on our proprietary Clifford Swan stock selection list serve as a good barometer for the valuation of U.S. equities. Under our system, higher stock ratings and target prices represent a "buy," which indicates that a stock's market price is at a substantial discount to the intrinsic value our internal analysis assigns to that stock. At the extreme highs in the S&P 500 Index chart on the previous page, there were fewer buy-rated stocks on our list, while at the nadirs there were more buy-rated stocks. Thus, the valuations at the bottom of the market get attractive and investors step up to participate in market rallies. At the top, investor selling contributes to price declines.

HIGH SHORT INTEREST

Short interest represents the amount of shares that are sold short in a company. When investors sell shares short, they benefit from and are hoping for shares to go down in price rather than up. High short interest indicates a lack of confidence in either a company or market fundamentals. As the global economy struggled throughout 2015, short interest crept up across several economically sensitive industries. High short interest exacerbates price movements as it creates additional trading volume and buying pressure when short positions are closed.

TREND FOLLOWERS

Over the past ten years, trend following has garnered a lot of attention as a trading strategy. Trend following has many fancy names such as "managed futures" but in the end it is simply momentum-based trend following. Momentum refers to buying or selling according to what has been happening in the market. Therefore, if prices are going up the investor buys more, and if prices are falling the investor sells the stock short. This sort of trading strategy leads to rallies and downturns being sharper as investors simply keep piling on quickly as they follow the trend. Once a trend reverses, the price action moves quickly the other way.

HIGH-YIELD BONDS

High-yield bonds, also known as "junk" bonds, represent bonds issued by lower quality companies. These bonds carry higher interest rates commensurate with their risk. The high-yield market has been unstable over the past year as many of the issuers in the market are comprised of struggling energy companies. As bankruptcy rumors swirl, high-yield investors get nervous and bond issuances can dry up. A jittery high-yield market can also unnerve stock investors as risky companies approach bankruptcy; if a company fails, they are obligated to satisfy their debt obligations before paying equity investors. Additionally, as these risky companies lose access to the capital markets and can no longer issue debt, their stock prices suffer. There is currently a great deal of instability within the high-yield bond market, which has carried over into stocks.

It is our hope that the factors discussed above provide a helpful background and rationale behind the recent instability in the market. As we have mentioned many times in the past, we at Clifford Swan Investment Counselors embrace erratic markets like the one we have been currently experiencing. The knowledge base we have acquired over our 100 years of existence is substantive enough that price dislocations do not bother us. Rather, when we combine our experience and appreciation for the relationship between price and value, these sorts of markets provide us with many opportunities.

Looking forward, we expect these choppy markets to continue for the near-term, with a bias towards the downside. Over the longer-term, we believe equities will remain an attractive asset class. With this in mind, we will adhere to asset allocation guidelines and prudently invest within our universe of higher-quality bonds and stocks. ◆

NEW RETIREMENT REGULATIONS MIRROR LONG-STANDING CLIFFORD SWAN PRINCIPLES

By Erica S. White
CFA

On April 6, 2016, the Department of Labor issued new regulations that affect both retirement investors and advisers and provide for sweeping change within the investment industry. For the first time, brokers and insurance professionals offering retirement advice and services will be required to act as fiduciaries, bringing them up to the same standard of care as investment advisers. Simply put, this means that all professionals providing advice for retirement plans, IRA or other tax deferred accounts, and even health savings plans, will now be legally required to act in the best interest of their clients. Here at Clifford Swan Investment Counselors, these new regulations simply reinforce a philosophy and practice we have always held to our core: putting clients first.

The retirement landscape has been evolving for quite some time; over the past several decades we have seen dramatic shifts in how individuals plan and save for retirement. Pensions and other forms of defined compensation offered by employers, which are structured to provide reliable income in retirement, have decreased. Consequently, self-directed 401(k)s and IRAs have become more prevalent and investment risk has been transferred to individuals. Individuals are more responsible for making decisions about their financial futures than ever before, and the number of choices available to them has grown.

Yet, the regulatory landscape has not kept pace. The recently issued rules are the first major piece of legislation broadly affecting retirement investment advice since the 1970s. The new rules, which will be implemented in phases starting in 2017 with full compliance required by the beginning of 2018, aim to eliminate conflicts of interest brought about by certain compensation structures between clients and advisers. At Clifford Swan, we take pride that our fees are transparent, easy to understand, and aligned with your interests. For example, we do not earn commissions from investing your assets in products. We do not have anything to sell other than the investment advice we offer and the portfolios we build from assets we research, follow, and have the highest conviction about.

At Clifford Swan, we have been our clients' fiduciaries well before the issuance of these new rules. We are registered with the U.S. Securities and Exchange Commission as a Registered Investment Adviser (RIA). Legally, all RIAs have been held to a fiduciary standard since the passing of the Investment Advisers Act of 1940. However, looking back even further, acting in our clients' best interests has been at the core of our firm's beliefs since its founding by A.M Clifford in 1915. A.M. Clifford was a pioneer in our industry, stating that "An Investment Counselor... should place himself in a position to consider only his client's best interests to the exclusion of every other consideration." He articulated the fiduciary standard far before it was a legal obligation for investment advice. A subsequent firm leader, Philip V. Swan, carried these beliefs forward, stating in 1984, "We pride ourselves on delivering compelling, customized investment management and advisory services without regard to outside third party influences." Further cementing our commitment to a fiduciary standard, our firm contributed to the founding of, and remains on the board of, the Investment Adviser Association (IAA), which promotes the highest industry standards.

Prior to the implementation of these new regulations which will start to go into effect in 2017, the fiduciary standard has not been required nor embraced industry wide. Rather, many professionals have acted in accordance with a less stringent standard of suitability. Under this standard, professionals only have to fulfill a suitability obligation, which is defined as making recommendations that are simply consistent with the best interests of the underlying client. As long as an investment product sold to a client could achieve a desired outcome, a professional can sell it to the client, even if the product is suboptimal. We can liken this to buying a car. When you go to the dealership, all of the cars will likely get you from points A to B. They are suitable for your goal, but, understandably, the salesman may be incentivized to sell you the car he gets the best commission on rather than the one that performs best for the price (the optimal car for you).

We are pleased that the new rules passed by the Department of Labor acknowledge that incentives exist in our industry to lead investors towards products that may be best for the adviser. The new rules do not eliminate these incentives, but will require that conflicts of interest be made transparent to clients. In other words, if a professional offers advice to retirement plans or IRA holders, he or she has to either avoid payments that create conflicts of interest or provide disclosure of the conflict according to specific guidelines outlined by the Department of Labor.

It is also important to note that, while the new regulations will affect retirement accounts, other investment accounts will not be covered. This is an extremely important distinction. For many clients, assets set aside in tax-advantaged accounts make up only a portion of their overall wealth and financial futures. Many individuals save for retirement outside of covered accounts like 401(k)s and IRAs. Additionally, clients often have impor-

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tant financial objectives outside of retirement that we contend deserve a fiduciary standard. They rely on all of their assets to provide for themselves, family members, future generations, and to aid charitable causes. Financial lives cannot be neatly separated into two buckets—retirement and not—and, consequently, advice on investing those assets should be based on the same overall principles.

Trust between clients and advisers is essential, and in the absence of trust, legislation must do. While we embrace these new rules, we find them somewhat superfluous in our daily work. As a firm with a 100-year legacy of making your financial future our top priority, these new rules neither change what we do nor the relationship we have with you, our clients. Our incentives have always been aligned; it is our pleasure to aid in your financial goals. ◆

SOCIAL SECURITY RULE CHANGES

By Kathleen Gilmore
CFP®

With the passing of Bipartisan Budget Act last November, the Social Security "file and suspend" and "restricted application" strategies we discussed in this publication (Fourth Quarter, 2014) have changed. As a result, there has been a lot of information, and some misinformation, that has bombarded people who are nearing or in retirement, and we hope to shed some light on the subject. As with the original article, divorcee benefits are not covered here.

To determine what impact, if any, these changes have on your household, first understand that there is no change, regardless of strategy used, for those who have already filed for Social Security prior to April 30th of this year.

For those who will be filing in the future, the ability to suspend an individual worker's benefits is still available for the purpose of earning delayed credits (at 8% per year for each year suspended until age 70), but the "file and suspend" strategy as discussed in our previous article is no longer viable. Family members (spouse and dependents) can no longer collect benefits off a "suspended" claim. Specifically, spousal benefits can now only be collected when the worker's benefits are also being received. In addition, the ability to request a lump-sum reinstatement of benefits back to the original "file and suspend" date is no longer available.

The "restricted application" strategy for dual-income households remains in place for individuals who were 62 or older by December 31, 2015. When these individuals reach their full retirement age, and their spouses are either receiving their own worker's benefits or were able to "file and suspend" before the April 30th deadline, they will be able to collect their spousal benefit while suspending their own worker's benefit until age 70 (when it will be worth 132% of their full retirement age benefit amount due to 8% per year delayed credits). We refer you back to our original article posted on our website for more details about this strategy.

For those of us who didn't turn 62 before the end of last year, we will be subject to "deeming" rules through age 70. This means that if we are entitled to both a retirement benefit on our own earnings record and a spousal benefit, we will not be able to file for one and delay the other. At the time of filing, we will be paid whichever benefit is the higher between the two. Remember, we can still delay our filing for earned credits, but once we file, we are locked into either our spousal or worker's benefits.

Importantly, as clarified in an Emergency Message issued by the Social Security Administration on February 18th of this year (EM-16007), individuals may not suspend their own worker's benefits and collect their surviving spouse benefit, even though retirement benefits and survivor benefits represent two different pots of money from the Social Security Administration's perspective. When determining if one spouse (or both) in a dual-career family should delay benefits, individual health and family history obviously factor into this decision. Suffice it to say that every situation is unique and is something to discuss with your adviser. ◆

CLIFFORD SWAN
INVESTMENT COUNSELORS

PROFESSIONALS
Maye Albanez, CFA, CIC
Carolyn S. Barber, CFA, CIPM, CIC
Peter J. Boyle, CFA, CIC
James R. Brown
Kevin J. Cavanaugh
Kenneth H. Dike, Esq., CPA, CLPF
Roger L. Gewecke, Jr., CFA
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Linda Davis Taylor
Ralph E. Weil, CFA
Bruce C. White
Erica S. White, CFA
Lloyd K. Wong, CFA
Randall L. Zaharia, CFA

OFFICES
Pasadena
177 E. Colorado Blvd., 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

cliffordswan.com

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