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- Warren Buffett

## REDUCING RISK TO A SAFER PORTFOLIO SPEED

The summer quarter for the stock market started out in promising fashion but unexpected news of China's currency devaluation abruptly reversed any positive momentum and psychology. Suddenly, continuous overnight news of China's plunging stock market stoked investor fears around the globe. The U.S. stock market was not immune and reacted in kind. The quarter finished with deep declines of -6.9% for the S&P 500, but adjustments in Pring Turner portfolios reduced volatility and the majority of accounts fared much better. Still, many questions arose from the recent global financial turmoil and we will answer some of those in this quarter's newsletter.

In recent special client bulletins, we addressed the surge in market volatility, and explained ongoing changes in our outlook and the resulting lower stock allocation in your portfolio. In the interim, there have been even more incoming client emails and phone calls expressing heightened concerns over current financial market gyrations and future economic outlooks. This newsletter upholds our commitment to keeping you informed of our current thinking and we hope to ease your concerns about recent financial headlines.

### **Q: So, why are problems in China having such an impact on our markets?**

Yes, China's currency devaluation and stock market crash has had an indirect impact on the United States psychologically. But, in actual terms, the impact is not as meaningful as reported in the financial press. The fact is that China depends on the U.S. consumer significantly more than we depend on them. In other words, China's currency devaluation actually benefits the U.S. consumer by lowering the cost of goods imported from Asia. Since consumer spending makes up nearly 70% of our economy, China's devaluation actually provides a boost to household shopping budgets.

### **Q: What happened to your July newsletter view where you were optimistic for a 2<sup>nd</sup> half market rally?**

While we expected stocks would break out of their nearly twelve month trading range to the upside, we also voiced an important concern. Some of our long-term market indicators were starting to flash early warning yellow lights and we suggested that if those lights turned red that we were prepared to move into a much more defensive posture in your portfolio. Indeed, those lights have turned red. As noted in our interim bulletin dated September 23, our stock barometer did in fact trigger a sell signal at month end for the first time since 2011. We also noted that we never know if a sell signal will result in a relatively short and minor decline, as it did in 2011, or a more severe one as in 2000 or 2008. Regardless, we have been taking action to better protect your wealth as the 2<sup>nd</sup> half evidence has changed. In July, we were optimistic about the U.S. economy. Still today, while the economy has weakened somewhat, leading economic indicators show a recession in the immediate future is not likely. This is one positive sign to remember in the midst of recent market volatility. It is rare to have a severe bear market in stocks without an accompanying business cycle recession. Obviously, we are paying close attention to the latest economic data and on alert for any signs of economic slowdown or acceleration. These ongoing observations will help us determine further appropriate actions to take in managing portfolios.

**Q: AM I WRONG, OR HAVE MARKETS BECOME MORE VOLATILE LATELY?**

No doubt, volatility has spiked higher this summer after several relatively tame years and it's very likely we will continue to see flare ups like these in the future. In our opinion, significant structural changes in stock exchange trading rules and systems over recent years have increased market volatility. In the old days, an uptick rule existed where short sellers couldn't continue to drive down stock prices without an uptick in prices. Also, until all trading went electronic, there had been a "specialist" system on the New York Stock Exchange. Specialist firms (real people) were charged with responsibility to provide an orderly market and required, for instance, to buy stock in their own accounts to offset any temporary oversupply by sellers. Both of these structural changes have led to runaway price moves on the downside *and* upside. Finally, the passage of Dodd-Frank Wall Street Reform legislation in 2010 was reportedly designed to strengthen our financial system but there was an unfortunate unintended consequence. Rules designed to improve capital levels and reduce risk also forced financial institutions to eliminate or trim back their securities trading operations. These actions have served to further reduce liquidity in the markets for both stocks and bonds and unintentionally adds to market volatility. Of course, when markets are volatile to the upside there are few complaints but investor nerves get frayed when prices race to the downside. It's important to remember that day to day volatility should not alter longer term investment horizons. Our business cycle strategy is designed to focus on the longer term cyclical trends within the financial markets—trends that often persist for years and are not easily altered by shorter term volatility.

**Q: I HAVE BEEN READING A LOT OF DIRE WARNINGS LATELY ABOUT HOW THE ECONOMY AND THE U.S. DOLLAR ARE ON THE EDGE OF COLLAPSE. THESE ARE STARTLING PREDICTIONS AND A BIG CONCERN, SO WHAT IS YOUR TAKE ON ALL THAT?**

Pring Turner partners have spent nearly fifty years digesting extreme bullish and bearish commentary and everything in between. Lately, the "Chicken Little" crowd has been especially vocal in the media as they always emerge during market declines. We have witnessed far too many "celebrity" perpetual doom and gloom pundits. Mostly, they tend to have two things in common: generate enough alarm to appeal to investors' emotional fears and somehow profit from their dark outlook. Do we have worries about certain aspects of our world like our rising national debt, geopolitical problems, Federal Reserve actions and ongoing budgetary battles? Certainly we do, but rather than listen to those increasingly shrill "gurus" shouting the end of the world, we focus on our own research and disciplines.

Pring Turner depends upon disciplines and risk management tools we developed over many decades. Throughout our entire careers we can honestly tell you there were always plenty of worrisome headlines and we've managed successfully through it all. Our reliable, risk-based market barometers are built on cold hard facts and not our emotions. Over the years, they've served clients well, in part by keeping you from being victimized by sensational claims made by the latest attention-getting doom and gloom prognosticator. We wish we could filter the misleading spam out of your email inbox and mute your television for you from time to time. Our advice is to try to not take these folks too seriously. So no, we do not share the extreme views of many in the "Chicken Little" crowd. Our own current economic views will be answered in the next few questions.

**Q: CAN YOU TELL ME IF THIS IS A CORRECTION OR MAJOR BEAR MARKET?**

Nobody can say for sure at this time whether this is a moderate decline or a more serious bear market. It has been a number of years since investors have experienced either. The fact is that price swings of varying degrees have always been a normal part of the investing landscape. Moderate declines of 10% or more occur on average slightly more than once every year with bigger declines of 20% or more once every 3-4 years. No investor likes these declines but our active investment approach does help navigate them with less risk and volatility. Importantly, we make portfolio shifts to adapt to changing economic and market conditions in an effort to smooth out the inevitable portfolio ups and downs.

**Q: EVERYTHING I READ OR HEAR SOUNDS PESSIMISTIC, SO IS THERE ANYTHING TO BE OPTIMISTIC ABOUT?**

It's understandable that investors have lingering fears from the 2008 financial meltdown and worries about some sort of replay. After all, the chilling banking crisis that resulted from lax real estate lending practices nearly took the entire financial

system down. But today, after nearly seven years to convalesce, the U.S. banking system is actually quite healthy. Banks have plenty of excess capital to lend and are being very careful with whom they lend to. Similarly, corporate America has spent the entire recovery rebuilding cash levels to now record highs. Strong balance sheets allow companies to withstand any occasional cyclical storm and even take advantage of temporary downturns. Lastly, consumers have done a great job paying down debt, saving more, and reducing their monthly expenses. In fact, by many measures, families are now in the best financial shape of the past 30 years. For instance, household net worth has surged to all-time highs while monthly debt payments have shrunk to a multi-decade low. Since the consumer makes up more than two-thirds of the economy, these conditions suggest the U.S. economy can continue to grow despite any possible global slowdown.

**Q: I'VE BEEN SEEING A NUMBER OF STOCK SALES THIS SUMMER, WHAT IS YOUR CURRENT STRATEGY?**

As dictated by the recent cautionary signal from our stock barometer, we have, *at least temporarily*, adopted a much more defensive investment strategy. Securities that were purchased as “tactical” holdings for growth or “offensive” purposes have been reduced now that the backdrop environment has turned less favorable. The plan is to keep a reduced allocation to stocks and to hold only those with high quality and safety ratings, dependable earnings, and above average dividend income. These are “core” holdings that make up the foundation of your account. Many of your core holdings also belong to a select club of elite businesses or “dividend achievers” that have raised their dividends consecutively over many, many years. Historically, these are the types of companies that decline less than the overall market during major bear markets and yet are amongst the first to participate in the new bull market to follow.

**Q: WHY NOT SELL ALL THE STOCKS?**

As mentioned previously, we do not know whether the latest barometer signal will lead to a short and mild decline or something much deeper. There is also the possibility we are experiencing nothing more than a typical correction and that a new bull market could resume relatively soon. However, even during bear market periods there are certain defensive investment sectors that generate dependable income and perform quite well. This is why we are comfortable keeping your core holdings, as well as higher levels of cash in portfolios for the time being.

**REDUCING RISK...**



*To use a metaphor, we are simply reducing risk by slowing down your portfolio driving speed with today's less favorable visibility. Forty miles per hour is a safer portfolio speed under current circumstances, but we look forward to once again reaching the speed limit when financial road conditions improve.*

**... TO A SAFER PORTFOLIO SPEED**

**FINAL THOUGHTS**

We are executing our defensive game plan to successfully navigate the current volatile market environment. Over time, as financial data begins to improve, **and it will**, we will again take advantage of the next low risk opportunity to build wealth for

you. It is important to keep in mind that significant market declines create the opportunity to invest in quality companies at bargain level prices. We are optimistic and look forward to reaching new high wealth benchmarks for you in the years ahead. And last, as best expressed by one of the world's top investors with whom we agree wholeheartedly:

*Indeed, who has ever benefited during the past 238 years by betting against America? If you compare our country's present condition to that existing in 1776, you have to rub your eyes in wonder. In my lifetime alone, real per-capita U.S. output has sextupled. My parents could not have dreamed in 1930 of the world their son would see. Though the preachers of pessimism prattle endlessly about America's problems, I've never seen one who wishes to emigrate (though I can think of a few for whom I would happily buy a one-way ticket). The dynamism embedded in our market economy will continue to work its magic. Gains won't come in a smooth or uninterrupted manner; they never have. And we will regularly grumble about our government. But, most assuredly, America's best days lie ahead.*

-- Warren Buffett, Berkshire Hathaway 2014 Annual Report

Thank you for your confidence and placing with us the important responsibility of protecting and growing your wealth. Please let us know if you should have any questions regarding your portfolio or if your personal circumstances should change.

The image shows three handwritten signatures in ink. From left to right: 'Joe' in black ink, 'Turner' in black ink, and 'Tim' in blue ink. The signatures are cursive and appear to be on a white background.

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