



2015 - What Lies Ahead for Investors ?

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I'm in my 30th year giving investment advice. In investing as with most of life, some things change, some stay the same. Sometimes change is for the better, sometimes worse. I admit to being sort of addicted to this business: I love working with my clients (some of whom I've known for 29 years) and I like the breadth of information I need to absorb. And since reading Alvin Toffler's "Future Shock" in 1969, I really enjoy thinking about what the future will be like.

Investing is all about translating the information available today into a plan for tomorrow. It's a strange combination of skills: accounting and business analysis coupled with an understanding of how humans are likely to react. After all, one important lesson I've learned: investment prices are dictated by buyers and sellers. Prices rise or fall 'exactly' in line with what those holding the majority of the money do. If they rush to sell, prices fall (or plummet) and, of course, vice versa. During volatile periods it often matters not whether a stock or bond is of high-quality, their prices get caught in the swarm and follow the crowd.

Investing would, therefore, seem simply like another form of gambling were it not for this very important countering fact: in the longer-term, investment prices track 'exactly' with their profitability relative to other investments. The erratic short-term behavior of markets acts like a churn, chaos, then eventually the cream rises to the top.

The two paragraphs above are things, I believe, that haven't changed. What is remarkably different is that we live in a much more complex and inter-connected world than before. You and I could probably write for hours about the new medias, mediums, digital tools, eras, global economics, central bank / government actions, high-frequency trading, etc. and their effects on the economy we rely on and the markets that provide pricing for our portfolios. And whatever list we created, a year from now it would be much larger.

This is the backdrop I see for 2015: increased complexity, increased volatility, increased uncertainty. Change will continue to accelerate, and it is likely to be disconcerting to

many / most humans, certainly to investors trying to achieve some acceptable rate of return while holding investments they understand and with which they are comfortable. Sorry, I wish it weren't so.

In the face of this, here's some 30 year's investment advice:

1. Have a plan. My experience is that investors who take the time to plan have much better results and sleep better than those who don't. Make it a New Year's Resolution. An effective plan should take into account your age(s), retirement income needs and sensitivity to price volatility.

2. Listen closely to the world's most successful, long-term investors. These are not the faces you usually see on TV or those inviting you to a free lunch seminar. One benefit of the digital age is access to these investors is easier than ever before. Heed their advice, especially when it is out of step with the consensus.

3. Be a Value Investor. Rather than speculate trying to find the next Apple or Google, focus on

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Energy and Geo-Politics

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I have written in this space several times over the years about commodity markets – i.e. those investments backed by the production, distribution and sale of “real” stuff that’s either consumed directly or used to make higher value goods and services. We’re talking agriculture, metals (both industrial and precious), and the biggest traded commodity of all, energy. Since the invention of steam and internal combustion engines and the creation of massive electrical grids, nothing has been more important than coal, oil & natural gas to power industry, commerce and transportation worldwide. The past decade has produced a lively, and important, debate about the environmental damage that a century of burning fossil fuels has wrought, but that’s a separate discussion from the economics and politics of energy.

Beginning in the early 70’s, when the Arab oil embargo caused gasoline shortages and introduced the idea of using energy supplies and pricing as a political weapon, our fate was linked to the need for oil imports from the Persian Gulf, produced by Saudi Arabia and other members of OPEC. For 30+ years, it was our economic Achilles heel. More recently, Europe finds itself in a similar position with regards to Russian natural gas.

Then new drilling technology created large new production possibilities from previously uneconomic shale formations. I wrote about this in early 2012 in a column titled *Game Changer*, which suggested that rising domestic production of oil & gas would reduce our costs, increase our security and provide a bright spot in the otherwise sluggish post-crisis recovery. Since then U.S. production is up over 50% and we’re on the cusp of being the world’s top energy dog once again. Last quarter, I followed up with a piece titled *Does Middle East Conflict Still Matter to Us?*, which speculated about how recent events might be viewed

differently than in the past due to our lessening dependence on this volatile region. Our long term view is that energy prices will continue to move higher due to rising global demand and depletion of the world’s oldest and largest reserves. This should bode well for N. American oil/gas companies, and we have invested accordingly.

That said, it’s always possible to be wrong (and appear quite stupid) in the short run. Oil prices declined sharply over recent months due to surging supplies, taking down the stocks of companies that produce, transport & refine them. Russian and Persian Gulf oil production has continued despite the Ukraine & Iraq-Syria conflicts; ironically, combatants must keep selling oil at any price to finance war costs, at least for now. This can’t continue, since most global production sold below \$80-\$90/bbl. is uneconomic, while steady depletion drives exploration costs ever higher. Our domestic production boom obviously contributes to this temporary supply glut, while the logistics of pipeline and refinery optimization will take considerable time to work themselves out. High drilling costs and very high depletion rates for shale wells also appear to be on a collision course (hat tip to Bill Mason). In the past, OPEC has cut production in the face of falling prices in order to maintain market share, but the cartel is unraveling, and the Saudis in particular may be keeping production up to inflict pain on the high-cost U.S. shale producers. If this continues for some time, our domestic production bonanza may stall out. Time will tell, but enjoy lower gas prices while you can, because it likely won’t last. Energy geo-politics is helping consumers and hurting producers at the moment. It is also creating some very compelling values in this sector. Hold or add to high quality energy investments at the lower prices that this downturn has produced.

Young Investors - Time Is Your Friend

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Given a long-time frame the U.S. stock market has always finished up. In fact, the general stock market has never experienced negative returns over ANY 15 year period since the great Depression. Example: As of 10/15/2014 the S&P 500 is up over 70% in the last 15 years, despite the bubbles, corrections, and random market events of 2000, 2001, 2007-2011, and the recent market volatility. In no way am I advising you to buy the 'general market' and sit back, just a reminder that stocks can make you a lot of money if you employ a good strategy, and remain patient.

When I started in this business in 2007, I remember being very surprised to observe that people's natural tendencies towards their investments were often opposite of what successful investors do. Older investors were moving cash into equities when the market was setting record highs, and then selling those investments in 2009 while they dropped to record lows. I took hundreds of calls from younger investors who were concerned about their account balance dropping and not wanting to take the investment risk anymore. Their fears cause them to make drastic mistakes and lose out on opportunities to buy low. Low prices are fantastic for young investors who should be buying,

instead volatility chases them away. Yet when the market hits record highs, they are buying back in. Buying high and selling low is not a good strategy, yet it's the most common one people take.

Younger investors need to realize that stocks are the most important part of their portfolios and will be throughout their retirement planning and saving. Investors should continue to find good companies, and buy and hold them for the long haul. The value today will likely be very different by the time you go to retire, so don't let short-term and unpredictable price fluctuations scare you off. Strategy is something you can control; the day to day prices are not. Think about your house, if the price was down, would you sell if you didn't have to? Assuming you like your house, the answer is probably no.

If you have 15 years or more until your desired retirement age, volatility is your friend. Please feel free to give me a call to discuss your accounts, your strategy, current risks and long term retirement plans. A confident, well thought out strategy can help you sleep at night despite the current economic conditions.

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owning high-quality investments trading at a low price. Over 30 years I've seen no other strategy that comes even close to making and keeping as much money. Value investing makes sense, and it works.

4. Be frugal. It takes savings to invest, and to save you need to control your spending. There are lots of millionaires who never made the highest salary, but they deferred gratification and saved a bunch. Of course, being frugal really helps stretch your monies during retirement too.

2015 offers opportunity to those who have a well-thought out strategy and the temperament to think longer-term. Expect markets to be volatile; then you won't be surprised when it happens (it will) and, hopefully, you won't make knee-jerk reactions. And don't hesitate to call on any of us, we love to look at personal portfolios and help investors plan for a successful future.

Wishing you a Happy Holiday Season and a Prosperous 2015!

QE Will End, Now What?

William Mason CFA

Because of Fed money printing being used to prop up the financial markets and the economy I have tried to keep stock exposure very modest in accounts. As the market has risen so have the risks.

As most of you should know by now the Fed is exiting QE3 (QE = money printing) at the end of October. As we already know, the last two exits did not go well. QE2 ended in 2011 and the markets have only gone up with money printing. The following are some excerpts from **Fred Hickey's** October letter regarding money printing:

"There's just one little problem – thousands of years of history that says that not only is money-printing not grand, ultimately it is deadly – even though it always seems to be the new wonder drug when it's first prescribed.

"The Fed has tried to stop printing money twice in recent years and on both occasions stock prices began to plunge, only to be rescued again with promises of more money printing."

Seth Klarman wrote the following in his Shareholder's Letter for The Baupost Group:

"Someday, financial markets will again decline. Someday, rising stock and bond markets will no longer be government policy – maybe not today or tomorrow, but someday. Someday, QE will end and money won't be free. Someday, corporate failure will be permitted. Someday, the economy will turn down again, and someday, somewhere, somehow, investors will lose money and once again come to favor capital preservation over speculation."

Just because QE ends in October doesn't necessarily mean the market will drop this month or next. Money printing was the primary reason the market has only increased since 2011 with no severe correction. And the market is expensive based on many measures. Price-to-

Sales for the S&P 500 went above where it was in 2000 and 2007.

Gold

As Fred Hickey wrote in his October letter:

"A crack in the overpriced stock market (which may already be in progress) and/or disappointing economic growth could be catalysts for a long-term move. Of course, another round of QE money printing (or even hints of it) should seal the deal."

From his September letter:

"An underlying truth is that money printing leads to inflation, first in assets and then in consumer prices. Historically, the best way to protect oneself from the ravages of inflation is to own hard assets."

Bob Rodriguez, the CEO of FPA stated the following in June regarding QE:

"Since the initial implementation in November of 08 subsequent rounds have been larger in scale, like a drug addict their effects wear off and a new round is required."

Will they stop? QE4?

Oil

Oil prices have dropped and that now threatens shale production in the US, which is well deserved.

Since 2008, shale oil production has grown by about 4 million barrels per day in the US. Much of the drilling was financed by substantial amounts of debt that was rained on shale explorers allowing some uneconomic drilling.

Businessweek on October 13:

"So will U.S. oil producers frack their way into bankruptcy? That's a real possibility now. Back in July, Goldman Sachs estimated that U.S. shale producers needed \$85 a barrel to break even."

According to the Energy Information Agency (EIA) the majors were operating at negative cash flow after major uses. According to the EIA: "The gap between cash from operations and major uses of cash has widened in recent years from a low of \$18 billion in 2010 to \$100 billion to \$120 billion during the past three years." That was with oil hovering near \$100. Oil is now near \$83.

My research indicates the shale producers are bleeding cash profusely. US oil production will likely slow and that will be a positive for oil prices. Oil is very expensive to find and produce and the price is not properly reflecting that because of oversupply from shale.

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