QUARTERLY NEWSLETTER

1Q 2016

HFG | TRUST

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"I am convinced that the act of thinking logically cannot possibly be natural to the human mind. If it were, then mathematics would be everybody's easiest course at school and our species would not have taken several millennia to figure out the scientific method."
—Neil DeGrasse Tyson

Portfolio Management—Evidence Based

EXECUTIVE SUMMARY

- Fundamentals of investing - The challenge of behavioral finance
- The history of Value vs. Growth - Price determines future return
- Volatile 1Q - End result is a flat equity market
- Bond returns above average due to slight interest rate adjustment

WHAT YOU SHOULD KNOW

Before we start, let us preface by saying that the practice of portfolio management has evolved considerably over time. What started off primarily as a product driven industry has shifted to an extremely service oriented trade, with a focus on fiduciary responsibility, not much different to a doctor patient relationship. So to begin, I would like you to compare how we view investing to modern medicine. Prior to modern medicine, treatment was likely to be determined by observation and trial and error. In the 17th century, blood-letting was considered a valid treatment for many ailments. Today, it is considered quackery. Research has provided the medical professional practical and successful methods to treat many ailments and disease. For example, if you have colon cancer and visit 5 oncologists, it is unlikely you would find a significant difference in treatment plans. Why? Research has provided the medical field with a proven or evidence based solution to defeating this disease. Their studies have shown the probability of success for each treatment. Logic dictates we follow the most successful plan when it comes to life decisions. There is no room for error. Fortunately, in the world of finance, we too have research to guide investors in making prudent and smart decisions. However, in many cases it is disregarded. Perhaps it is not followed because financial choices are not immediately life and death decisions; one can afford to experiment. Maybe it is the lack of understanding of financial markets that leads inexperienced investors to find creative alternatives. It is difficult to nail down exactly why we do this, but one thing is certain, humans are flawed characters. Due to our natural condition of fear and greed, making logical evidence based choices is often easier said than done. In other words, financial advice is bought and sold with many treatment philosophies other than the most widely researched. As humans we are at risk of buying the advice that we want to hear. Another contributor could be attributed to the media. It teases us with headlines of: Top 10 ideas for 2016 or Invest in these Top Performers. It could be the TV show of the raging Cramer (Get out now!!! Get in Now!!) or a quote from an expert who identified the last market top or bottom. The worst of the reasons may lie in our ego. Some of us are guilty of wanting to find an investment which sounds hip. “My broker has recommended a stock called Dipper. It should replace Twitter and it is up 200% since the IPO.” This compares with, “My advisor has put me in a globally balanced portfolio of value stocks and bonds with low operating expenses.” Really? The purpose of this article is to “ground” investors in understanding the Evidence. In many respects, it is similar to the information we are given to live a healthy lifestyle. The prescription of eating more veggies, fruit and a low fat diet supplemented with 3-4 times per week of intense exercise doesn’t compare with the tantalizing message of false claims and fads. The following contents of this article will discuss the prescriptions of investing that have survived the test of time.

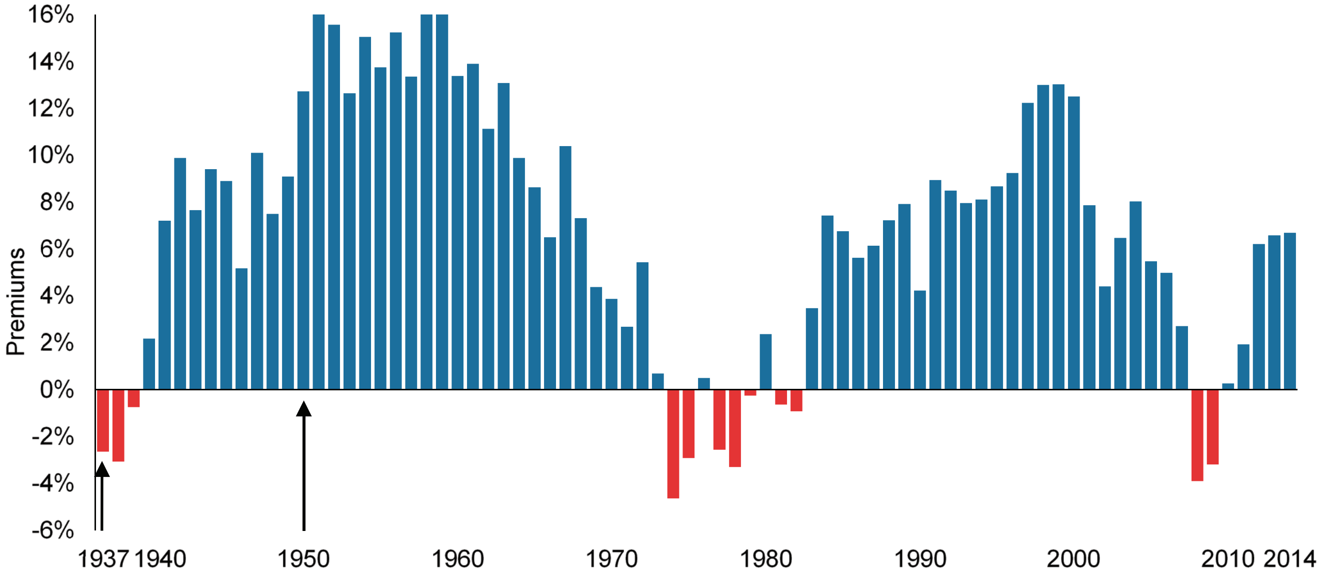
FINANCE 101

Owner vs. Lender

An investor is either an owner or a lender. When we put money in the bank or buy a bond we are lending our money to an institution or company. Generally, this is considered a safe place for our funds and our return is a function of what the market rent is for using money. We call this interest. Purchasing a company (stock) or real estate is considered ownership. With ownership there is no guaranteed or agreed upon return. Our return is a function of what the company pays in dividends and what the market is willing to pay to purchase the stock back from us. Over the last 100 years, returns for being a lender as measured by 10-year Government bonds have averaged 4-5%. Returns on ownership as measured by the S&P 500 stock index have averaged closer to 10%. (Note: These average returns should not be assumed to be indicative of future returns) In summary, over most 10 year or longer holding period ownership assets have provided higher rates of return while having higher periods of uncertainty. Wealth is generally created only in ownership assets. To illustrate this point, Exhibit I shows the difference between Stock Market Returns over a 10 year period vs. Treasury Bills.

Exhibit I

10 year Market Premium vs. T-Bills 1928 - 2014



Legend:
Blue - Stocks win
Red - T-Bills win

The first 10 year period starts from 1928 and ends in 1937 and shows that The S&P 500 stock market under-performed Treasuries by approximately 2%. Likewise, the period between 1941 to 1950, the Stock Market outperformed T-Bills by 12%. Historically, ownership over a 10 year period has provided a better return than being lender to compensate for the volatility risk.

Time is Your Ally

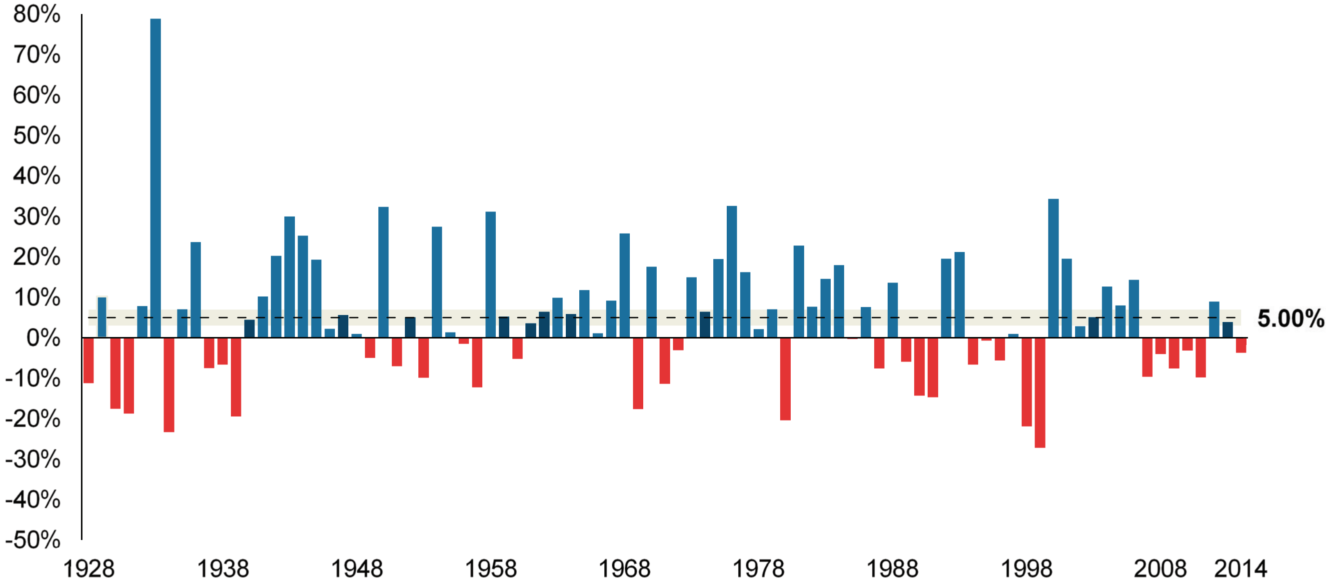
Successful investing generally requires time. Please see Exhibit I above. For example, stocks have had better returns than Treasury-bills 64 of the last 76 decades (84% of the time). However, evaluating yearly returns, stocks beat Treasury-bills only 69% of the time. The longer the time horizon the greater probability of having a positive return and a return greater than Treasury-bills. (Note: Treasury-bill returns are very similar to money market returns)

Value vs. Growth Investments

During the 1970s, professors Fama and French from the University of Chicago concluded what many had assumed, which was stocks that sold for lower valuations, as measured by Price to Book, had higher returns. Price is the current market price of a stock and book value is the net equity of the company. When you hear book value, think of your individual net worth. It is a company's assets subtracted by its liabilities. It is important to understand the summary of the study of value vs. growth investing. Value investing since 1928 has provided higher average returns, however, there has been a significant run of years, such as the last decade, where growth style investing has outperformed value style investing. Remember, there are no absolutes when it comes to investing. Exhibit II illustrates year-to-year comparison between value stocks and growth stocks. There is a good mix of results with a slightly higher percentage of winners for value. Exhibit III illustrates a 10-year average return comparison between value and growth. The first bar shows the decade 1928 - 1937. When we use a longer horizon (10 year observation), it is clear that value has had much stronger performances over the past 76 decades than growth.

Exhibit II

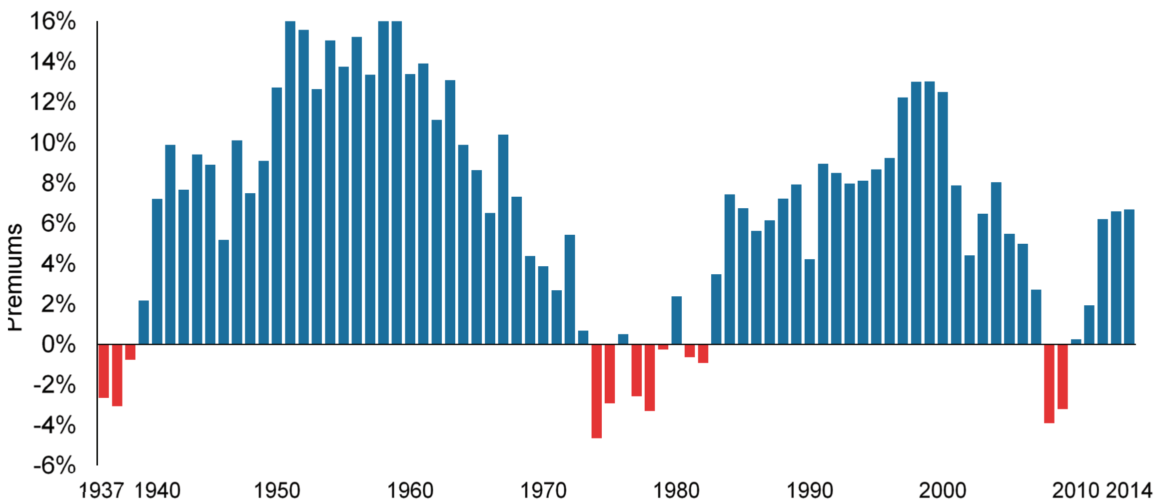
Yearly Value Premium vs. Growth 1928 - 2014



Legend:
Blue - Value wins
Red - Growth wins

Exhibit III

10 year Value Premium vs. Growth 1928 - 2014



Legend:
Blue - Value wins
Red - Growth wins

Diversification

Diversification is the free way to reduce risk. The concept goes back to what grandma told you. "Don't put all of your eggs in one basket." Unfortunately, many investors assume diversity is owning a lot of eggs. The reality is there is a difference between simple diversification and effective diversification. Effective diversification is owning a lot of "different" eggs with the emphasis on different, not a lot. For example, simple diversification is owning 50 stocks instead of 5, but it is important to own different industries, different size of companies and different countries. It is also prudent to diversify across different asset classes as well i.e. stocks, bonds and real estate. Deep level diversification reduces risk because different asset classes can have lower correlations. The lack of correlation is what provides potential offset in the event one asset class has a poor year.

Master the art of fear and greed – Buy low sell high

Behavioral Finance research has found that humans aren't wired to be successful investors. Perhaps it stems from our survival instincts. Evidence of this can be traced back thousands of years ago when our ancestors were in the African savanna trying to avoid lions. Our species succeeded by fleeing from danger. This trait or factor isn't useful for investing. When markets are down how do most investors behave? Did your friends flee and sell their stock funds when the market declined? Or, did they add to their holdings? Most investors tend to do the opposite of what is logical. If investors invested the way they shop they'd be successful. My utopia investment scenario would be experiencing a Black Friday with no one in the malls. No one has made sustainable returns by selling low and buying high. Likewise, when markets perform exceptionally well consistently for a few years, do your friends sell some of their stock funds or do they add to it because the previous year was a good one? The prudent approach is to have a balanced portfolio that can weather a market decline. Bonds in the portfolio provide "dry powder" to purchase companies that are selling at a discount after a market decline. Bonds also provide the cushion in the decline while stocks provide investors with higher returns for growth.

Setting Expectations – Price is the Determinant of Future Returns

Prudent travelers review the weather before they embark on a trip. I think investors would be best served by taking the same approach. The problem with this comparison is a weather report is conclusive only in the short run. When it comes to investing there is no reliable short-term weather report. Rather, the general level of asset prices as measured by Price to Earnings, Price to Book or Price to Sales are indicators of longer-term weather (returns) over the next 7-10 years. To illustrate this point examine Exhibit IV below. We call this our Investment Climate Report.

Exhibit IV

Investment Climate Analysis for the S&P 500 (1950 - 2016)

Investment Climate P/E Ratios	P/E Category	Avg 10 yr Return	Risk Climate
Low P/E	(Under 10)	15.96%	Lowest Risk
Moderately Low P/E	(10-15)	14.78%	Low Risk
Average P/E	(15-20)	10.58%	Average
High P/E	(20-25)	6.55%	Higher Risk
Extreme P/E	(Over 25)	4.46%	Highest Risk
AVERAGES/TOTALS		**10.47%**	

The evidence demonstrates there is a significant relationship with price (Price is defined as Price to Earnings) and decade returns. The price in which an investor pays for an asset today has an impact on long term returns. If you overpay (extreme P/E) for your ownership rights, your future return is likely to be low. If you are able to buy at P/E ratios of under 15, returns have been exceptional. What this research does not provide is an exact timeline in which market changes will occur year to year. There is too much randomness and volatility for an accurate measure of the relationship between price and future returns inside of 7-10 years. That's the *evidence*!

Costs Matter

One of the simple keys to above average results is to keep your costs down. It is no secret that mutual funds and portfolios with low operating expenses and low turnover perform better than one's with high expenses and high turnover. Yes, there can be isolated occurrences, however, this is one example where there is significant *evidence* and many investors and advisors often ignore the information.

Chasing Return

Another area that is ignored is the fact most asset classes are mean reverting. This means asset classes that have achieved above average results over a 5-10 year period of time are likely to have below average results over the next 5-10 years. It works the other way as well. In general, if we are looking at groups of publicly traded companies, their sales will be linked to the US economy. There will be individual success stories and individual wrecks. However, as a group, over a long period of time they will grow at a similar rate. Their pattern of growth however will be different. In some decades there will be better growth and profitability in health care as compared to energy and vice versa. For example, when the price of oil collapses, companies in that asset class will suffer poor earnings. Lower earnings scare investors into selling. The genetic flight response is in full motion and where do they flee to? Likely, they'll leave energy to buy the trending hot asset class. In time, as the price of oil collapses, the supply of the product falls as well. No one is paid to produce. Once supply has fallen below demand the free market goes to work. In order to attract supply the market has to entice producers with higher prices. Now we start to witness the reversion to mean as the price of oil increases, which produces industry profits, which means investors, jump back in. In a future article, we'll illustrate *evidence* from past research that shows this one issue costs investors 1-4% annually on their equity returns because they are likely to chase return.

What Can We Expect by Using Evidence?

What can you expect by using the concepts of being an owner, allowing time to be our ally, using diversification to the fullest, understanding valuations (the weather), keeping costs down and eliminating the temptation to chase return? **You should expect the experience of lonely success.** You should expect there would be years where non-evidence based ideas will seem to be the right approach. However, these "other" concepts are without basis. To be defined as evidence, it requires a concept or theory to weather the test of time and have a large sample group. Almost any idea will have a day in the sun. Evidence-based concepts require investors to find comfort being on the edges of the herd, not in the middle of it. As humans, most of us are not emotionally prepared for this experience. This is one of the many value propositions HFG Trust advisers bring to the investor relationship, helping clients understand why they should follow the evidence and not the herd.

In closing, a prudent portfolio treatment plan should be evidence-based. The hope of finding a smart guy or girl is futile. Today, there are over tens of thousands of Chartered Financial Analyst evaluating companies all over the world. This intense focus creates efficient market prices and very little room to outsmart the market. At HFG Trust, we strive to be the financial doctor that understands and follows the *evidence*. We are here to guide our clients when their fear or greed is turning them in the wrong direction. We are also here to prevent clients from investing their life savings in the next Compaq, Enron or Bear Stearns. Why? Their financial health depends upon it.

FIRST QUARTER 2016 – SUMMARY

Global equity (stock) markets hit their quarterly bottom on February 11th. The S&P 500 declined almost 10% on the nose while international stocks as measured by the MSCI World ex-US index and the Emerging Markets MSCI index declined 10-12% before rebounding by the end of the quarter. Global stock markets appeared to be concerned about the risk of a global recession. The collapse of oil prices added to the concern of bankruptcy risk. However, as the price of oil rebounded and as the US economic news came in better than expected, global stocks rebounded. For the quarter, Emerging Market stocks were up almost 6% while the S&P 500 increased a modest 1.35%. MSCI World ex-US index was still under water for the year by 2%. Fixed Income (Bond) rates declined throughout the quarter, which provided price appreciation for bonds. This was a surprise because the Federal Reserve had raised short-term rates by .25% in December. The general consensus was for rates to continue to rise and thus hinder bond returns. Short-term corporate bonds gained 1.16%, while the BC Agg bond index was up 3% and longer-term bond indices were up 5-8%. In general, it was a good quarter for bonds. Returns for a global balanced investor (50% in stocks and 50% in bonds) would have fallen in a range of -1% to plus 2% for the quarter. The actual return outcome would have been a function of their allocations in US vs. World stocks and the difference in shorter-term bonds vs. intermediate term bonds.

US stock prices as measured by the Shiller P/E ratio or the Price to Sales ratio remain in the top decile since 1929. Valuations remain rich at 24-26 times earnings. During the February bottom US stocks still remained richly valued at 22 times earnings. The 10% drop did little to change overall US stock valuations. Emerging Market valuations remain the cheapest stock asset class coming in at 11-13x Shiller P/E ratio.

Exhibit V

HFG Market Valuation Table

Valuation Metrics	Current	Average	Decline to the Mean
P/E Year Trailing Earnings	23.95	15.55	-35%
Shiller P/E Ratio (CAPE)	26.02	16.63	-36%
Price to Sales Ratio	1.82	0.96	-47%
Market Cap to GDP	1.13	0.70	-38%
Q-Ratio	1.02	0.68	-33%
Wilshire 5000 to GDP	1.11	0.72	-35%

HFG Trust is a financial services corporation specializing in investment management and financial planning. HFG has been providing quality wealth management services since 1983, and currently manages over $325 million in assets for 600 families and retirement plans.

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