GeoVest Advisors

Growing Your Portfolio While Managing Market Risk

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On Course

2014

It was another good year in the markets but 2014 was a little different than previous years. The indexes were all up a good amount but there were many stocks that got crushed in 2014, telling a different story than the strength in the averages. In particular, small companies and cyclical companies experienced some unexpected turbulence as did some of the emerging markets.

We also experienced some major drops in commodity prices with the worst being oil which lost around 50% of its value during the year. But that wasn't enough to spook the stock market, which powered ahead into record territory despite some global economic data reminiscent of the financial crisis.

Our clients had a good year and while we didn't beat the market averages, we were able to successfully add to the value of client accounts while remaining vigilant to the risks that hurt so many others in 2014. We bring the same focus into 2015.

The Global Economy

The primary reason why many global equity and commodity markets are experiencing horrendous losses is that the global economy is weakening. We predicted this back in 2011 but the factors that led to our prediction didn't become obvious until last year.

Historically, copper has been the commodity that has been most sensitive to the global economy. This makes sense when you consider that copper is in a wide variety of manufactured items. The price of copper is

down around 40% since the middle of 2011, evidence that the global economy is slowly weakening. The price of iron ore has dropped a similar amount.

While economists continue to embrace their peculiar brand of wishful thinking, another commodity has crashed in price - one which is far more important for our country. The price of oil has dropped 60% since the summer, adding an exclamation point to the negative signal that copper has flashed.

I've read many explanations for this drop, from analysts that cover a wide variety of disciplines. Some argue that the Saudis want to destroy our burgeoning shale industry. Others argue that it's a way to weaken Russia as we vie with them for control of Ukraine. The only explanation that makes sense is that the world is using less oil than

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was expected a few years ago. In short, there is temporarily too much oil for the relatively weak demand for that oil today.

The drop in commodity prices has been reinforced by the Baltic Dry Index, which measures the cost of moving goods by ship around the world. It's an important measure of shipping activity, which is extremely sensitive to real economic activity. The price of shipping started to drop in 2011 and despite two temporary jumps, it continues to weaken.

The reason so many analysts were unprepared for this weakening of global economic activity is that they continue to miss the most important variable in understanding the global economy. They continue to assume that China will always grow at a breakneck pace.

China

The US may have the biggest economy in the world as measured by GDP but China is by far the most important economy in terms of using natural resources and facilitating trade with other emerging economies. For an economist who relies solely on reported economic data, the place is an enigma because their data is of questionable veracity as well as being little understood.

China is an economy that is dependent on construction projects and trade. Half of their economy consists of one-time projects such as building ghost cities, empty shopping malls, and the factories necessary to supply the material to build.

When the Global Financial Crisis hit in 2008, China faced a far deeper downturn than other nations. Instead of restructuring in a rational manner, they embarked on the greatest construction project the world has ever seen. In three years - 2010-2012 - China used as much cement as the US used in the entire 20th century!!!!

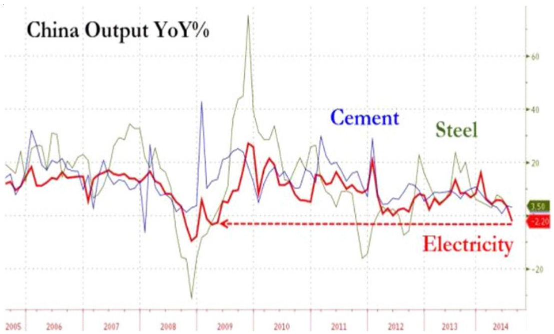
Because they were unprepared for the downturn, they didn't have plans in place for the trillions of dollars of "forced" investment so they copied cities like Paris, London, and Manhattan and simply built empty replicas. They built a replica of Disney World in a corn field.

Source: Nationalgeographic.com

For the most part, these projects aren't generating cash flow. Nobody is paying at the gate to enter this faux Disneyland. Nobody occupies the office building on the river in the faux Manhattan. Most of these projects will simply be written off one day.

The problem is that these projects were funded using bank deposits and wealth management products like mutual funds. There is no money to pay them back. There is no word I can think of that adequately describes the degree of economic insanity espoused in China over the past decade.

But today, there is new leadership. Xi Jinping appears to be trying to move China away from dependence on construction. We can see from the only believable economic statistic - electricity usage - that China has effectively stopped growing their economy.



Source: Bloomberg

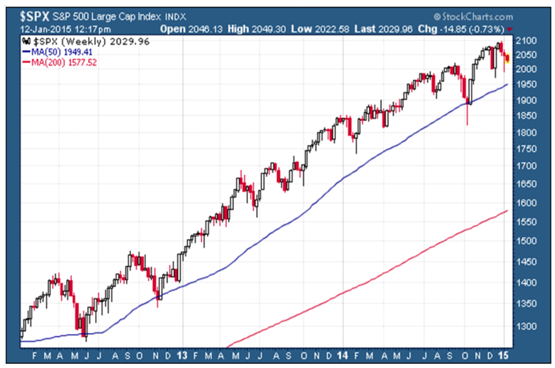
If the engine of the Chinese Miracle has stalled, it suggests that the emerging markets that supply China with the material for growth, are headed for some tough times. Is it a coincidence that Brazil is off more than 30% from its highs?

The secret to understanding an economy is one simple question. What exactly are they doing to create value? In China, they've been putting up ghost cities that will destroy their banking system.

The Stock Market

That's some pretty scary stuff, so why does our stock market keep going up when China represents an enormous risk? It's a good question, one that I've spent an enormous amount of time contemplating. I'll start answering it by saying that it's got nothing to do with the US economy being strong. The best that I can tell, our economy is roughly flat with social spending providing much of the stability.

I believe that the stock market is a policy tool - a project akin to the New Deal. I believe it's an experiment designed to get our economy back on a growth trajectory by manipulating both the cost of money (interest rates) and the perceived risk of our asset markets so corporate investors will start investing aggressively in new projects.



The thing that jumps out at us about the chart of the stock market is that it's gone up with very little volatility. It just keeps going up as if investors don't have a care in the world. Volatility, or the variability of an asset's price over time, is the way that the finance profession measures risk. The above chart is a signal to investors that risk has been virtually eliminated.

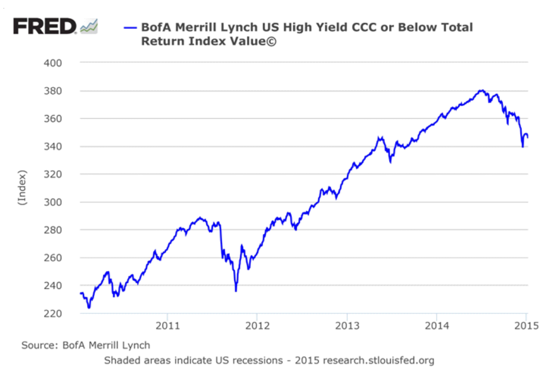
On paper, this should have worked like a charm but corporate chieftains figured out that they could enrich themselves by using this drop in volatility to borrow money to buy back stock, making their personal stock options worth more. Buying back stock allows corporations to maximize earnings per share today at the expense of earnings in the future. It's the equivalent of harvesting a corn field and selling all of your corn without reserving some of the corn to plant the field next year.

I'm not confident about the stock market but I do believe that policymakers have painted themselves into a corner. Keeping the market elevated is critical to maintaining confidence in our economy therefore, I believe that policymakers will do whatever it takes to keep the market from crashing. I believe that the only way they can ensure this is to keep taking it higher.

But there are limits to what policymakers can do and understanding those limits is the key to preserving the value of our client's capital while growing it as much as is feasible and prudent.

Junk Bonds

Over the past five years, investors have reached for yield, often buying bonds that they thought were safe but which will ultimately prove destructive for their portfolios. We've avoided these bonds like the plague.



We adhere to a simple rule at GeoVest which is to never buy low quality bonds unless we expect a strong economy. Well, this rule hasn't helped over the last few years despite getting the economic part right but we're presently seeing evidence that we're about to be proven correct by remaining disciplined.

Besides being the obligations of organizations that are hardly robust enough to pay these bonds back in a good economy, they have a second unattractive quality in being securities that are very difficult to sell once you own them, particularly in stressful times. We believe that this class of bonds will generate big losses for investors in the near future.

Investors have purchased a lot of these bonds particularly in wealth management products like bond funds because the Federal Reserve's Quantitative Easing policies have drained the markets of high quality bonds or made them so expensive that they offer little value to investors.

The GeoVest Approach

Manipulating markets is a temporary policy because the markets are too big to control over the long term. Ultimately, the strength of the economy determines the value of marketable securities.

But for now, we've had to make a few adjustments to our disciplines to stay relevant in this temporary reality and the results were favorable in 2014. Under normal market conditions, our historical returns indicate that we can generate better long term results than the market averages but this is anything but a normal market.

The economic roadmap that allowed us to avoid big losses in 2008 continues to guide us in these uncertain economic times. Over the past five years, we've made it more flexible to accommodate intervention in the markets as well as irrational economic decisions such as those that have guided China for a decade.

We never lose sight of the fact that our decisions impact the quality of our client's lives. Thank you for your continued support and as always, it is our pleasure to serve you.

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