



On Course

# GeoVest Advisors

*Growing Your Portfolio While Managing Market Risk*

Volume 18 Issue 1

January 2016

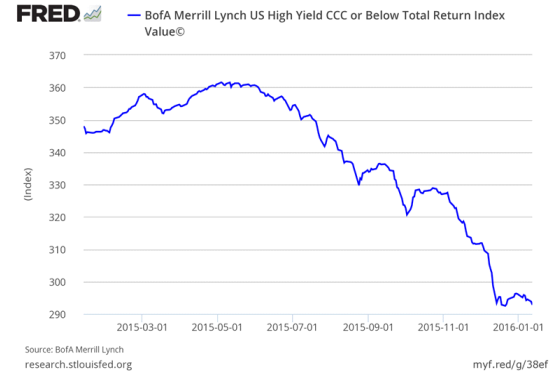
## Changes

“Turn and face the strange.” Those words were written by the late great David Bowie, a master of creating and adapting to change. I can think of no better advice to offer investors heading into 2016.

2015 was a very strange year; probably the strangest of my 49 years. The major stock indexes were largely flat but the typical stock was down - in many cases a lot! We had war - and the threat of nuclear war, collapsing commodity prices, bad earnings, declining global trade, and rising interest rates, yet the major averages were flat?



Confusion reigned among professional money managers and the result is that a large number of hedge funds and mutual funds are liquidating because either they bet wrong or they held securities no longer wanted in the market - like junk bonds. The losses may prove staggering.



## Confusion Reigns

We were early in predicting the global economic weakness and specifically, the impact on China and the rest of the emerging markets. It was this early awareness that allowed us to “turn and face the strange” because based on our work, the equity markets should have started to drop in 2012, not 2015.

While others were enjoying the easy markets of 2012 and 2013, we were bending our brains trying to understand how a weakening economic climate could produce outsized gains. This work allowed us to perform well in 2014 and 2015.

The reason there is so much confusion is that something rather dramatic changed after the 2008 crash. It was more than just intervention in the market; it was a reshaping of our economy with the government as the primary driver.

For long term investors, finding the primary driver of an investment is the most important

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factor of any research effort. After 2008, we had an extraordinary burst of investment from China as they built the aforementioned “ghost cities”, perhaps the greatest example of economic ineptitude in world history.

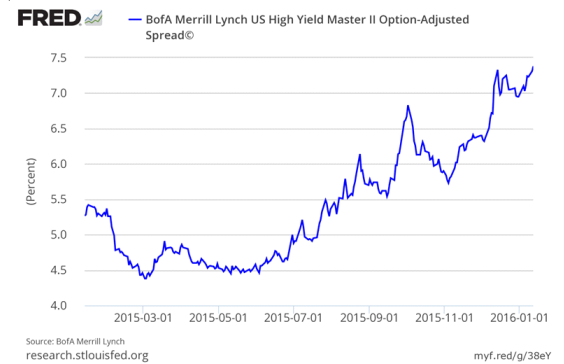
By 2011, this burst of energy started to wane. In its stead, Wall Street engineered the funding of the shale oil bubble, which generated significant economic activity but ultimately led to massive losses. Coincident to the shale bubble, the US government engineered a massive auto buying cycle, which is presently starting to wane.

So now, we’re in a situation where corporations are pulling back from investment and global trade is in decline thanks to China. So what do you do?

We’re betting on the US government. Uncle Sam has a credit card and knows how to use it. The global economy may not be expanding but people need to eat, go to the doctor, turn on the lights, and the government knows how to keep the lights on. Over the past year, we’ve been shifting out of companies subject to the economic cycle and investing in companies that sell necessities.

## Risk

You may recall that for years I wrote that chasing yield into low quality fixed income instruments like high yield (junk) bonds or levered loans would result in big losses for investors. Well it’s happened and right now, it’s so difficult to sell some of the low quality bonds that fund managers have resorted to “gating” or preventing clients from withdrawing their money until the manager has had ample opportunity to sell.



The way to read this chart is that the yield on junk debt went from 4.5% to 7.5%, meaning that if you bought the paper at 4.5%, you’re sitting on a big loss. Some may look at that 7.5% yield as being attractive but our rule is to never buy low quality bonds in weak economic climates. At first, we had to explain to clients why we weren’t earning more money on their investments, now we get to explain to clients why their money continues to grow while their neighbors are experiencing big losses.

The only way to have known to avoid these messes is to understand the risk/reward of what you’re buying.

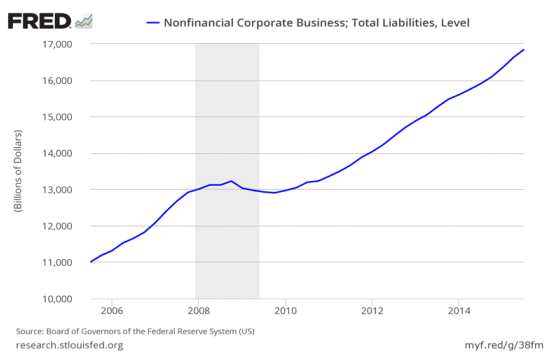
Fund managers and investors are discovering what risk really is - and what it is not. Risk in the markets is always about losing money. It’s not a statistic in a presentation nor is it something that can be accurately quantified. Most risk models run off academic research, research that offered little help in 2008 because the truth is the models measure either volatility or use data sets from time periods that are nothing like the current environment.

The only way to embrace risk is to understand it and if you don’t understand it, avoid it.

China is the biggest risk to the global economy and as we predicted, the Chinese

economy is imploding. But a risk that dovetails with the collapsing junk bond market is the amount of debt on company balance sheets.

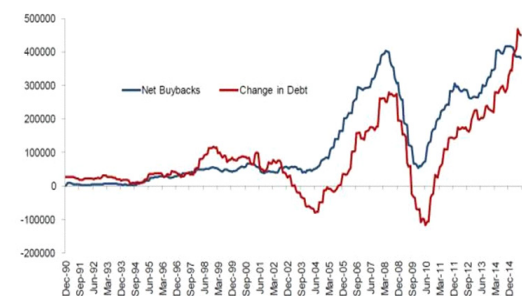
2012 and 2013 were great years in the stock market because companies were busy borrowing money and using the proceeds to buy back stock. It was a great party but now those companies are running into the dual problem of a weakening global economy combined with higher costs of servicing that debt. This means that many can no longer buy back their own stock and in my opinion, it is the real reason most stocks in the market are weakening. Liabilities are what we owe others, such as with debt.



The addition of significant amounts of debt to company balance sheets is a significant risk to both our economy and the stock market. Companies that are hampered by fixed obligations like interest payments generally lack the ability to invest for long term growth. At some point, the long term will catch up to the short term.

#### AND BUYBACKS ARE MAINLY FUNDED BY DEBT

Net buybacks and change in debt from US companies report and account



## Liquidity

We use this term a lot in our discussions with clients, so it's a good time to explain the term and how it impacts risk. Liquidity means how quickly an asset can be sold for cash without adversely impacting the price. The more liquid a security is, the quicker you can turn it into cash; the converse is true for less liquid securities.

In normal investment environments, most assets have sufficient liquidity such that a buyer can eventually be found, but in times of stress, like the present environment, it is often very difficult to sell risky securities without taking a substantial loss. Owners of junk bonds and emerging market are learning this lesson the hard way.

We have done our best to stick with securities in our portfolios that we believe can be readily liquidated in times of stress but more importantly, they're the kinds of securities that we don't mind holding through stressful times because we believe that most have long term sustainable value.

The flip side of our approach is what happened in the movie "The Big Short". Like the "outsiders" in the movie, we too figured out that nobody knew what was in "Collateralized Debt Obligations" or CDO's and that banks writing insurance on those synthetic securities in the form of "Credit Default Swaps" would one day face a liquidity crisis of their own - a short squeeze. This is because the insurance they wrote was effectively a "short sale" on risk. When the markets crashed, there was nobody willing to create more credit default swaps that would have allowed them to offset their own losses - liquidity dried up.





The only way they could protect themselves from paying out huge sums on the insurance they wrote was to buy back that insurance but there were none available for sale in the markets until the price rose to exorbitant levels.

Unfortunately, trading in those securities is outside the purview of our investment agreements with clients; otherwise, we could have done better in 2008 than our already excellent results.

## The Dollar

The US enjoys economic benefits that are unparalleled in the world. No other country can spend as we do because no other country has a currency that is necessary to transact all global trade. Every central bank in the world needs to hold dollars if they hope to buy food and oil and this allows us to borrow money at extremely low interest rates with virtually no limit on how much we borrow.

Not everyone is happy with this arrangement but that's a discussion best left to another newsletter. Instead, I'd prefer to focus on what this means as a "driver" of economic activity. I believe that with the world economy rapidly weakening, companies that do business with the US government will continue to flourish and that's why we are increasingly favoring investments in companies that provide products and services to our government.

Besides, this huge spike in the value of the US dollar makes it extremely difficult for our industrial and consumer companies to compete in global markets. Think of this chart as representing a 25% increase in the cost of producing things in the US. Very few companies can overcome such an obstacle.

## The GeoVest Approach

A lot of people are talking about an impending crash; I think it's already happened. Nucor Steel (NUE) has already dropped 35% from recent highs. Alcoa (AA), our largest aluminum producer, has fallen 60%. This correction does not preclude further drops in stocks but intervention has certainly changed the dynamics of anticipating stock market crashes.

The S&P500 is down about 8% so far this year; while we're doing much better than the averages, we remain vigilant. Fortunately, "we turned and faced the strange" and our work has allowed us to anticipate much of what's already happened as well as to plan ahead for future opportunities.

Thank you. It is our continued pleasure to serve you.

***Philip M. Byrne, CFA***  
***Chief Investment Officer***

