The ACM Journal

Strings Attached

Those familiar with Rochester, New York know about its impeccable musical heritage. We're home to one of the best music schools in the country, a nationally-acclaimed jazz festival, and a philharmonic orchestra much better than a city our size should be able to support.

However, there is another side to the Rochester music scene that is, shall we say, a bit more pedestrian. For example, this year Rochester rang in the Yuletide with its 33rd annual all-tuba (though euphoniums are also allowed) Christmas concert. Lest you think this is some small-scale production, the event is held at the snooty Hochstein School of Music, and it is almost impossible to get seats unless you plan well in advance.

Another happening that would make a true musicophile recoil in disgust is the Rochester Ukulele Orchestra. As the name implies, this is a group of "musicians" who play all varieties of ukulele. Interestingly, there are soprano, concert, tenor, and baritone ukuleles, all having distinct sounds and characteristics. The one commonality is that you have to be a little nutty to want to play any of them.

Accordingly, my middle child,

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The Year in Review

Investment returns in 2015 were not as bad as in 2008. That is the only positive thing I could come up with.

Some parts of the market, such as large-cap stocks and bonds, eked out positive returns for 2015. However, even those returns were anemic. In a further blow to those following the time-tested tenets of investing, diversification mostly hurt rather than helped.

Large-cap stocks, as measured by the S&P 500 index, returned 1.4% for the full year. Mid-cap and small-cap stocks actually lost money for the full year, as did just about any market outside of the U.S. Emerging markets were a disaster, losing almost 15% for the year. See the chart below for the full picture of capital market returns for the fourth quarter and full year.

What happened? Well, a lot of things. First, we were in the seventh year of a bull market that saw the stock market rise well over 100%. This unquestionably has an impact on valuation metrics (such as the price-to-earnings or P/E ratio), which many have argued are at the high end of what is reasonable. Most bull markets don't end because of high valuations, but high valuations do cause investor skittishness, and contribute to the volatility we've been experiencing.

Also, oil prices falling from $75 per barrel to less than $40 during 2015 led to investor unease. Low oil prices may sound like a good thing, but any big, sudden change can be viewed skeptically by the market. Also, because oil profits are such a big component of total stock market earnings, already high stock prices looked even more expensive when viewed against declining profits. Most economists believe there will be a benefit to consumers from falling oil prices, but so far that has not been overly visible in the economic data releases. Perhaps the uncertainty in the capital markets has dampened any potential increased spending that lower oil prices should cause.

The China Syndrome

In addition to oil, virtually all other commodities also fell in value during 2015, as China's economic situation appeared to deteriorate. Government data released from China is notoriously unreliable, but there were definite signs of slowing economic growth, particularly late in 2015. The Chinese stock market also ran into trouble. It fell more than 40% between June and August, and is still down almost 40% as of this writing.

Chinese stock market turmoil led to stock market volatility around the globe. The U.S. market stumbled in August and September, and has gyrated wildly again in the New

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Year in reaction to steep declines in China. However, it is important to point out that China's stock market is not like ours. First, not many people own stocks in China. So, market declines do not cause widespread pain the way that they do in the U.S., where practically everyone has some exposure to stocks either directly or through their retirement accounts.

Also, the relationship between the stock market and the Chinese economy is fairly weak. Plenty of people tell me that investing in the stock market is just legal gambling, but in China it truly is. Speculation, rather than long-term investing, is the norm, and valuations reside at levels rarely seen in the U.S. For example, the average stock on the Shenzhen Stock Exchange trades at a price-to-earnings ratio of over 45, even after the recent market declines. The P/E ratio on the S&P 500 is around 17, by way of comparison. Investing in China therefore has nothing to do with what we think of as smart investing, such as asset allocation, diversification, and a long-term systematic approach. Rather, it is based on the greater fool theory. Assets purchased with outrageous valuations may continue to go to even more outrageous valuations, and hopefully can be sold to someone even greedier.

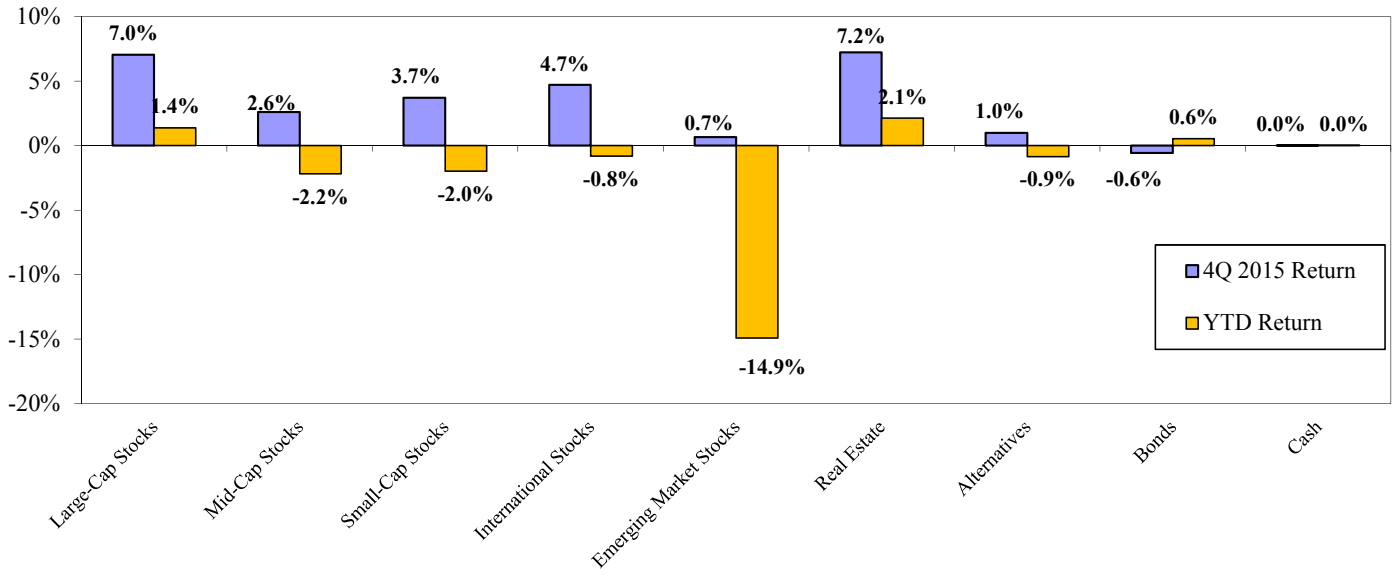
Accordingly, the decline in Chinese stocks shouldn't have much impact on the Chinese economy. So, even with some slowing of economic growth recently, China's economy is still growing faster than much of the rest of the world. There is also still a great transition from agrarian living to the establishment of a more urban middle class. This transition will not be without its problems (human rights issues, environmental concerns, etc.), but the long-term trend is still up.

Finally, with regard to China, our economy is not that exposed to the Chinese economy. Certainly Chinese demand has been the driver of commodity prices the past several years, but China's impact on our economy is fairly small. In 2014, the latest period for which data is available, U.S. exports to China hit a record of over $120 billion. That sounds like a lot, but when compared with our overall GDP of almost $18 trillion, it comes to just 0.67%.

Other Issues

There are certainly other issues, besides China, that are driving the volatility in the U.S. stock market. Uncertainty over the Fed continues

Fourth Quarter 2015 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indcies. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are the HFRI Fund Weighted Composite Index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

to weigh on the market, as do still relatively high valuations.

The Fed has already started to raise short-term interest rates, and has indicated it will continue to do so. While rising interest rates, at the margin, are not a good thing, they also aren't a disaster if handled properly. Historically, averaged over many Fed tightening cycles, the first two to three years of rising interest rates have been relatively benign with regard to the stock market. After that, the Fed has historically tightened monetary policy too much, and stocks have declined. This time around, the Fed has said it is proceeding cautiously and will only allow "gradual increases" in short-term interest rates. We'll see how that plays out, but there does not seem to be any imminent threat to the economy or the stock market from overly aggressive Fed policy.

Stock market valuations remain high relative to the historical averages. This is particularly true if you look at metrics such as the long-run price-to-earnings ratio, which divides the price by the average earnings over the past ten years. Even with the recent market decline, this ratio stands well above what some market pundits would like to see. However, there are some well-publicized flaws in using that metric to assess the market's level. Other metrics show more moderate valuations, but in any event, the overall U.S. stock market does appear at least fully valued.

That is not to say that bargains are hard to find. Value stocks offer very compelling, well, value currently. They trade at a current P/E ratio of only 12 times earnings. Small-cap value stocks trade around 13 times earnings. Developed market international stocks have a P/E of 16, and emerging market stocks look downright cheap with a P/E of 11.

Bargains Abroad

Speaking of international stocks, they suffered through another tough year. I've been making the case that international stock markets are currently looking like the U.S. market did back in 2009. There are still plenty of economic problems to worry about, but stocks look cheap, there is a lot of economic stimulus being pumped into the markets, and the inflation and interest rate environment is friendly to business. Since 2009, the U.S. stock market has appreciated nicely. Will the international markets do the same? I think so, but it may take longer. It may be small solace to those who want better returns now, but we expect international stocks to be the darlings of the next decade.

Emerging market stocks should lead the pack over the long term. While they are notoriously volatile, these economies are experiencing the most robust long-term growth, and the stock markets trade at levels not seen since the end of the global financial crisis in 2009. There certainly could be more pain before they experience any sort of rebound, but the long-term outlook appears favorable.

Bonds: Keep it Simple

Turning away from stocks, the bond market was similarly lackluster. Safer bonds, such as issues from the U.S. Treasury, government agencies (such as Fannie Mae and Freddie Mac), and high-quality corporate bonds, earned a positive return in 2015, but it was well below their historical average of 5.0% or more. With the Fed now raising interest rates, the outlook for bonds still isn't great.

That said, we've written many times before about the importance of bonds in most portfolios as a means of risk control. Even with their paltry expected returns, the case remains as strong as ever. Most of us can't stomach the volatility of a portfolio that is invested 100% in the stock market. Accordingly, a risk mitigating asset is required, and high quality bonds seem like the best candidate.

Many investors disagree with this thought process, and have been turning to riskier bonds in an effort to boost returns. It worked for a while, but has been unravelling lately. The Credit Suisse High Yield Bond Index declined almost 5.0% in 2015, while safer bonds provided a positive return. It is not unusual for these types of bonds to track volatility in the stock market, making their diversification benefits suspect. During the stock market downturn in 2008, high yield bonds declined more than 26%. The Barclays Aggregate Bond Index, a proxy for the returns of a diversified portfolio of higher-quality bonds earned a positive 5.5% that year.

The same is true for foreign bonds, which have been popular of late. The Barclays Global Aggregate bond market index declined by over 3.0% in 2015, as the U.S. dollar strengthened against most other currencies. We view bonds as an asset class that is supposed to provide safety and risk control. These more

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esoteric segments of the bond market don't seem to fit the bill.

Alternative Investments

While we stick with plain vanilla in our bond portfolios, we do espouse the more exotic in one part of our portfolios: alternative investments. Certainly hedge funds, private equity, commodities, and the like have earned well deserved reputations as risky investments that the average investor should steer well clear of. Yet, done properly, there can be a real advantage to incorporating non-traditional asset classes into a portfolio.

During 2015, the HFRI hedge fund index provided relatively flat returns. However, an average of the returns for the funds we use in our portfolios was a gain of 6.6%. This is not because we're good at picking hedge funds. We're not. It is because we build our alternative investment portfolios to have attractive statistical characteristics. We start by focusing on risk control. We're not trying to find the next hot manager. We merely want to find ways to reduce the odds of big downturns. Accordingly, we look for funds that employ strategies that are truly complementary to stocks and bonds. Most hedge funds have a lot of exposure to the stock and bond markets, so they don't adequately protect you when these markets decline. The funds we prefer strip out market exposure either through quantitative methods, diversification across many complementary asset classes, or by investing in assets that are completely distinct from traditional stocks and bonds (e.g., catastrophe bonds). This approach has allowed our alternative investment portfolio to zig when the markets zag, and so far it has worked nicely.

We generally have smaller allocations to alternative investments, as they do have some warts. They are neither low cost nor tax efficient, but in small doses these sins can be overlooked. When added to a more traditional portfolio, they have proven effective at boosting risk-adjusted returns.

Conclusion

While 2015 wasn't such a great year to be an investor, it certainly could have been a lot worse. The stock market has effectively gone straight up for six years, so flat returns in the seventh year is hard to complain about. Also, the types of corrections we're seeing now are not unusual. Historically they have occurred far more frequently than what we have become accustomed to.

We wrote earlier in 2015 that volatility would likely pick up, and we expect that will continue. However, we also expect that decent returns can be had from here. Diversification hasn't worked terribly well the past couple years, but with the valuation disparities that now exist, we expect our approach will provide solid return potential.

Things could certainly get worse before they get better, but we do not expect a 2008-like disaster. The domestic economy is too strong. Stock market volatility may cause some unpleasant periods as we go forward, but we would be surprised to see more than a 15% dip from the market's high. In the end, a recent Wall Street Journal editorial by Princeton finance professor Burton Malkiel offers the best advice, even in this market: "keep invested, don't try to time the market, and diversify broadly".

A Look Ahead

A New Year means lots of prognosticating about the year ahead. We generally don't make market forecasts, though you'll find a few wishy-washy ones interspersed throughout this newsletter. The reason we don't make many forecasts, or believe anyone should, is that the data shows us they are all but useless.

We have written before in this newsletter (you can find the archive at our web site) about studies of market pundits, and how they are wrong more than 50% of the time. Flipping a coin is thus more accurate in predicting market outcomes than the "experts" you'll see on CNBC each day.

You don't have to look far to find examples of this. A recent Wall Street Journal article pointed out that Wall Street strategists have collectively forecast 10% annual returns for the S&P 500 since the year 2000. The market has actually risen 4.1% annually over that period. Even more telling, the consensus has always predicted positive returns for the market since 2000, which obviously hasn't exactly worked out. For the record, the consensus of Wall Street strategists for 2016 is for roughly 8% market growth.

Interestingly, there is another approach to stock market forecasts that has been uncannily accurate, though not infallible. It was developed by our friend and hero, Jack Bogle, founder of The Vanguard Group.

At its core, Jack's approach takes today's dividend yield and adds in the rate of corporate earnings growth. That provides what he believes is the best estimate of the true economic return of the stock market. Jack does add another element, the speculative return, which is the change in the market's price-to-earnings ratio over time. However, that is harder to forecast, so it can be dropped from the analysis if you like.

This is a very simple model that lacks the complexity favored by most market strategists. Yet, it has been more effective. Jack's model has a long-term track record that is impressive. Of course, unlike the Wall Street strategists, Jack's model provides a forecast for the coming decade, not the coming year.

For those of us with short-term mindsets, and intent on immediate gratification, a forecast for the coming decade can be somewhat unsatisfying. However, it gives us the best guide of what we can expect over time, and is much more useful than erroneous year-to-year forecast.

Currently, Jack's model shows that returns for the coming decade should be below the historical averages. This is not surprising, given that the market has experienced a lot of growth since 2009. Taking the current S&P 500 dividend yield of 2.25% and adding in corporate earnings growth, which is 4.7% by Jacks' reckoning, gives us an expected return of just shy of 7.0% compounded over the next decade. The price-to-earnings multiple may expand or contract to give us a bit more or a bit less, but 7.0% would be a good expectation for long-run stock returns.

Jack also points out that a very good predictor of future, long-term bond returns is today's yield-to-maturity. This is another simple approach, but it has a lot of academic support, including some recent studies we've mentioned in past newsletters. The yield-to-maturity on the Barclays Aggregate Bond Index is currently around 2.50%.

Putting it all together, a typical 60% stock, 40% bond portfolio could expect to earn average returns of 5.2% over the coming decade. Reality may be a bit better or a bit worse. This is below the historic norm, and may be below what some investors are hoping for. There is potential upside to be had through portfolio construction. Value stocks are quite cheap currently, and therefore should provide stronger returns than the overall stock market in the coming decade. Also, Jack's model only considers domestic stocks. International stocks, as we've discussed, could outperform in the years to come.

Nevertheless, in a period of compressed return expectations, the classic tenets of investing will be more important than ever. Managing costs and taxes will allow investors to keep more of their returns, and smart portfolio construction could help squeeze out more return for the risk you are taking on. If you have concerns and would like to discuss this more specifically to your portfolio, feel free to give us a call.

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Amer, and I regularly attend the open ukulele jam at Bernunzio Uptown Music each month. Bernunzio's seems to be the epicenter of local ukulele activity, as they are home to the Rochester Ukulele Support Group and the open jam that we attend. The fact that this is just around the block from the renowned Eastman School of Music makes it all the more fun.

On a typical Saturday, roughly a dozen or more ukulelists (yes, that actually is a word) show up to play together with our trusty leader, Randy. Randy is a very patient, if somewhat eclectic individual. He's actually an amazing musician, but for some reason chose the ukulele as his weapon of choice. The group plays an assortment of songs, ranging from the very easy to the somewhat less easy, reflecting our collective musical ability.

One week we came to the song "Rocky Top", which Amer had been practicing throughout the summer. Actually, it was the only song he played all summer as a form of juvenile protest at being forced to practice an instrument. Fortunately, all his hard work was not in vain. When he indicated he knew this song, Randy invited him to play solo as a demonstration for the rest of us.

I envisioned an out-of-time mess of poorly-played chords, but was pleasantly surprised when Amer ripped through the song at a handy pace in fairly tight fashion. He even sang. The rest of the crew was equally impressed, and we had many inquiries after the class about our practice techniques. I was reluctant to admit that we really only played once per month, at these events, or the real reason behind Amer's proficiency on Rocky Top. It is always fun to play though, and we made some new friends that day.

In the end, Amer was thrilled to be the center of attention, and to earn his dad's visible pride. However, he still refuses to practice.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm's innovative "Passive Quant" investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, New York, ACM is employee owned, independent, and free of conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client's unique objectives.

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