CLIENT NEWSLETTER Q4 2015

AMM

AMERICAN MONEY MANAGEMENT, LLC

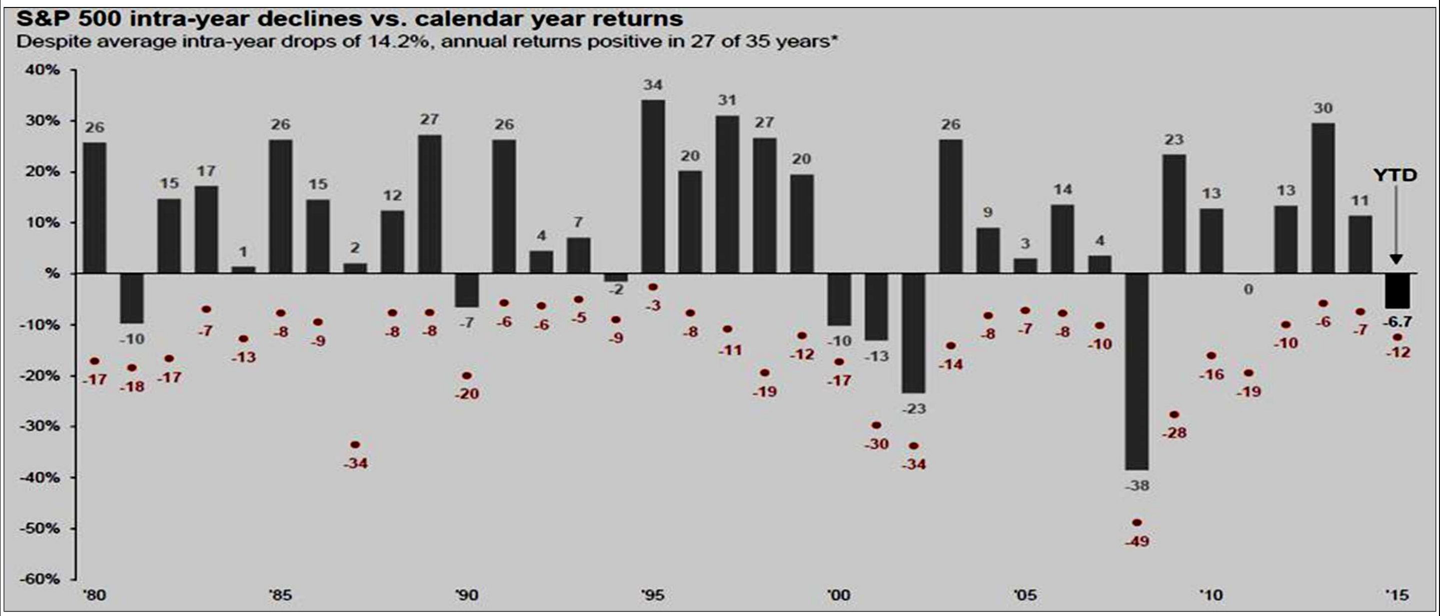
SEC Registered Investment Advisor

PO Box 675203, Rancho Santa Fe, CA 92067 | Tel 888-999-1395 | Fax 858-259-6906 | info@amminvest.com | www.amminvest.com

The Big Picture ~ Volatility is Not Risk

After more than three years without a pullback of more than 10%, the U.S. stock market (S&P 500) declined approximately -12.4% peak to trough during the 3rd quarter. The Dow Jones Industrial Average fared even worse with a ~15% peak to trough decline. While this kind of downside volatility can be fear inducing for investors, it is important to remember how normal these kinds of drawdowns are, and that they ultimately increase the opportunity set for investment. Exhibit A below shows the calendar year price return of the S&P 500 since 1980 (grey bar) along with the largest intra-year decline (red dot) for each year. This chart represents over 35 years of U.S. market history including the strong secular bull market of the 80s and 90s, the '87 crash, Asian contagion of '97, technology bubble, 9/11, the great recession, "lost decade" of the 00s, and countless other periods of market stress long forgotten.

Exhibit A



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management

Despite average intra-year drops of -14.2%, the S&P has an annualized total price return of 8% per year (not including dividends) over this time frame. One of the curious elements of investor psychology is that all investors want opportunity, but no one wants fear. However, fear (and, at the minimum, great uncertainty) generally accompanies opportunity in the stock market. The maxims of this in the investment lexicon run deep from Baron Rothschild's "Buy when there's blood in the streets, even if the blood is your own" to Warren Buffet's "You want to be greedy when others are fearful, and fearful when others are greedy".

An investor seeking to avoid volatility during periods of market stress (red dots above) would likely have generated a far lower rate of return over this time frame, while an opportunistic investor that added to their positions during these periods would have fared far better. Our point is not to dismiss market risk (which we discuss in more detail below) but rather to remind ourselves that volatility is normal; and, without the acceptance of volatility, investment returns are likely to be much lower over the long-run.

(OVER)

AMM's Principles of Risk Management

Investing is always about foregoing consumption today to have more in the future. Without perfect knowledge of how the future will unfold, risk is inserted into all investment decisions. The default risk management position for many investors is simply to sell when "there is blood in the streets". This is reactionary risk management and can be detrimental to long-term returns. As an alternative, we believe investors should set their portfolio risk policy in advance of a market storm by following the below steps.

1. <u>Know what you don't know</u>: The world is infinitely complex, and economies and investments are interconnected in ways that are not readily apparent to even the most astute observer. More often than not, the risks you think you understand are already well understood by other market participants and are already priced into the market. Investors should focus on what they can control (see items 2-6).

2. <u>Diversify</u>: While the correct level of diversification is dependent on your specific investment goals and tolerance for volatility, generally speaking, no investor should put all of their eggs in one basket.

3. <u>Have an appropriate time horizon</u>: All investments have a certain duration. Bonds with stated maturities have a straightforward time horizon (though call features can shorten the expected time horizon here). On the other hand, stocks are a "long duration asset" meaning an investor in stocks should have a long (multi-year) time horizon for their investment. As Warren Buffett said, "If you aren't willing to own a stock for 10 years, don't even think about owning for 10 minutes."

4. <u>Focus on valuation</u>: The price you pay for an investment determines your return. Just because an investment goes down in price does not make it a bad investment. Over the short-run it may be a bad trade; however, if you have purchased the investment at a reasonable or even value price, then time is on your side, and you should practice patience.

5. <u>Invest in quality</u>: Lots of investments go bankrupt or decline and never come back. We do not suggest that one simply buy and hold anything and it will go up over time. By focusing on quality (i.e. businesses with a history of dividend growth, strong returns on investor capital, and the ability to generate sizeable cash flow), you should increase your odds of success over time. For index or diversified fund investors, the broad basket of businesses owned should suffice to protect you from a disaster in a single stock.

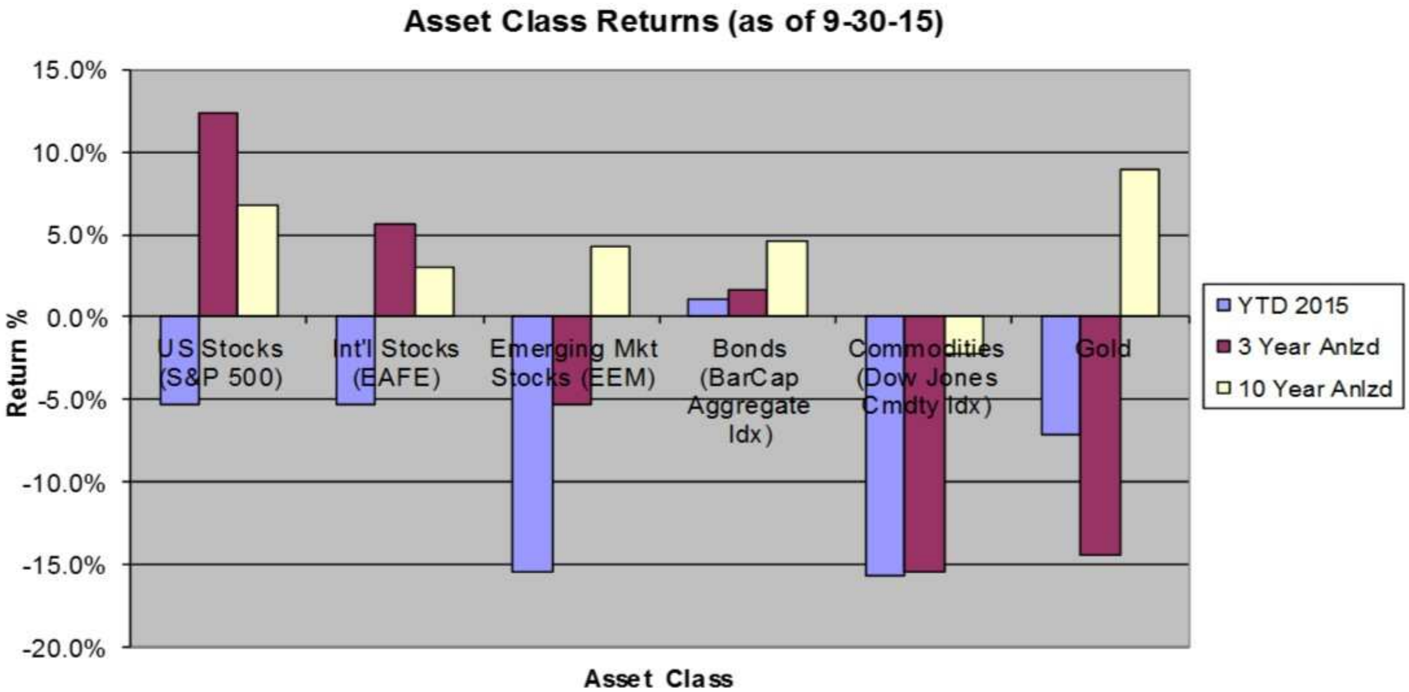
6. <u>Have an owner mindset</u>: Buying a stock is akin to becoming a fractional *owner* in the underlying business. All businesses go through up and down cycles. An owner of a small business does not immediately sell their company every time they go through a rough period or difficult economic environment; nor should the owner of common stocks.

YTD 2015 Review ~ Asset Class Outlook*

Through 9/30/15, domestic stocks (S&P 500) declined -5.3%, developed international stocks (EAFE) declined -5.3%, and emerging market stocks (EM) declined -15.5%. Bonds (Bar Cap Agg Idx) gained 1.1%, commodities (DJ Commodity Idx) were down -15.7%, and gold was down -7.1%. We have updated our asset class return chart (Exhibit B) to reflect YTD 2015 along with three and ten year annualized returns for the aforementioned asset classes.

(YTD 2015 Review...cont.)

Exhibit B



Fixed Income (Bonds): While investment grade bonds will generally fare better during periods of market turmoil, our longer term view on this asset class has not changed from previous letters. With interest rates at historically low levels, bond investors will have a hard time beating inflation and generating wealth in the years to come. Nevertheless, for more conservative investors or those seeking a more balanced and less volatile portfolio than a pure equity strategy, bonds remain an important part of their overall asset allocation.

For the fixed income portion of a client's asset allocation, we continue to focus on a 3 pronged strategy that includes: 1) Keeping maturities relatively short (<5 years), as shorter maturity bonds are exposed to less interest rate risk than long-term bonds; 2) Investing in alternative fixed income sectors including floating rate bank notes and absolute return bond funds. Both investments should do better than traditional bonds in a rising rate environment; and 3) Investment in Merger Arbitrage strategies that offer bond like returns without the associated interest rate risk.

Stocks: The recent downturn in the stock market has brought valuations to more reasonable levels. Stocks in the US on average are now trading modestly *below* their 25 year average Price to Earnings multiples vs. the beginning of Q3 when they were trading modestly above their long run average. In many ways, one could view the recent weakness in stocks positively. First, frothy, overvalued markets are not healthy and almost always lead to a painful ending. Recent market activity has corrected some of the valuation concerns that markets had gotten ahead of themselves. Second, markets exhibiting a degree of skepticism and fear *are* healthy. The 2008-09 financial crisis continues to loom large in the investor psyche. The first signs of uncertainty whether they be economic (China slowdown, interest rates, etc.), micro-economic (downward earnings revisions), or political (debt ceiling, government shutdown, etc.) are swiftly met with a shift towards bearishness on the part of investors. These are far from the kinds of conditions that mark the end of most bull markets, which generally die on irrational exuberance and an absence of fear.

The situation for international stocks is similar with valuations back to more reasonable levels. But, fear and uncertainty here has been amplified on concerns of a slowdown in China's economy. While we do not completely discount the concerns surrounding China, it is important to keep things in perspective. Only a small percentage of U.S. and Eurozone GDP is represented by exports to China, and the country's foreign exchange reserves total more than $3.6 *trillion (USD)* giving them significant room to support the economy. For diversified asset allocation portfolios seeking capital appreciation, we continue to see value in long-term investments in Non-U.S. stocks.

(OVER)

(YTD 2015 Review...cont.)

Diversifying Assets: Diversifying assets encompass all assets that do not fit into a traditional stock or bond category. These assets, by definition, do not have a strong correlation with stocks or bonds and, therefore, increase portfolio diversification. Over the last several years, both gold and commodities have performed poorly relative to traditional assets as persistently low inflation, moderate economic growth and a stronger dollar have reduced investor demand for these inflation hedges. For these reasons, our typical position size in both of these assets remains modest. Still, we view these positions as providing a hedge against the possibility of an inflation surprise in the years to come.

**Individual accounts will vary based on the client's stated objectives, risk tolerance, and time frame. We manage several different portfolio strategies, so not every client has exposure to the securities or asset classes listed above. In addition to growth and/or income oriented asset allocation strategies, we also manage more concentrated equity portfolios that generally carry a higher degree of risk and volatility. Please contact us if you want to discuss your portfolio strategy in greater detail.*

Should you have any questions regarding your investment account(s) or, if there have been any recent changes to your investment and/or retirement objectives, please do not hesitate to contact our office. We can also provide you with a current copy of our SEC Form ADV Part II, at your request.

As always, it is a great privilege to be entrusted with the stewardship of your retirement and investment assets.

Your Portfolio Management Team

Gabriel Wisdom *Managing Director*	Michael Moore *Chief Investment Officer*	Glenn Busch *Portfolio Manager*	Vicki Ohara *Operations Manager*	Jim Rhodes, CFA *Executive Director*
Mike Green *Portfolio Manager*	Adele Canetti *Portfolio Manager*	Robert Frazier *Investment Advisor*	John Nyaradi *Investment Advisor*	Bryan Case *Investment Advisor*

AMERICAN MONEY MANAGEMENT, LLC

14249 Rancho Santa Fe Farms Road, PO Box 675203

Rancho Santa Fe, CA 92067

Tel: (888) 999-1395 Fax: (858) 259-6906 E-mail: info@amminvest.com www.amminvest.com