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

Happy New Year ~ Embrace The Volatility!

After a fairly boring 2015 for US stocks, essentially closing the year where they began, the new year started off with a bang with the Dow Jones Average posting its worst first week ever. While volatility in the stock market is a normal part of investing, it is always challenging. Everyone wants a "correction"; yet, when the moment of truth comes and prices decline, it becomes very difficult to stick to a long-term strategy, much less take advantage of lower prices. The first instinct hardwired into our brains – professional and individual alike – is to rush for the safety of cash and risk free assets.

The modern 24/7 financial news cycle has actually exacerbated this problem as investors are alerted in real time on their smartphones to every gyration in markets often telegraphing a sense of urgency to Take Action! The reality is that a well thought out asset allocation strategy ahead of time means that wholesale portfolio overhauls should not occur very often, if ever. Rather than making major strategy changes under the duress of difficult markets – which generally is accompanied by selling low – most portfolio trading should occur incrementally and be based on things like age, retirement, a change in household income, etc.

In our view, the silver lining in the most recent correction is that it helps to temper enthusiasm and brings global markets more in line with economic reality. Markets work best when there is a healthy degree of skepticism about the future. The worst outcome for markets is a bubble environment where stocks inflate beyond any rational view of their worth, and expectations are for stocks to only go up. These environments always end badly. While some sub-sectors of the broad market had overheated prior to the most recent sell-off, we do not think that broad market valuations suggested bubble conditions.

For our part, we will continue to follow our firm's core investment principles in good and bad markets. While we repeat these often in our quarterly communications, they are the beacon for our portfolio decision making process. For clients, we believe a basic fundamental understanding of our approach is critical, especially during tough market environments.

AMM's Investment Principles

<u>Core Principle #1</u> **– Asset Allocation is the Most Important Decision**. Asset allocation involves deciding the appropriate weight of stocks, bonds and other assets in your portfolio. No single decision is more important in determining the risk and ultimate return of your portfolio. For example, a 1-7 year treasury bond ladder has never had a losing year (low risk), but returns are very modest. Current 1-7 year ladders return something less than 2%. On the other end of the spectrum, stocks post losing years roughly a quarter of the time (S&P 500 since 1928); but, this risk of loss has come with commensurate gains as stocks have annualized returns of more than 10% since 1928. In addition to traditional stocks and bonds, the asset allocation decision can be extended to include international stocks, real-estate, gold and a number of other sub-categories.

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(AMM's Investment Principles cont.)

For most investors, stocks remain a critical engine for generating portfolio returns. This is perhaps true now more than ever as the returns available from competing assets like bonds are at historically low levels. Because of this, it is important for investors to have an appropriate time horizon for the portion of their account invested in stocks. Exhibit A shows return data for stocks going back to 1871. Since this time, there has never been a losing 15, 20 or 30 year stretch in stocks; and, there have only been 4 negative 10 year periods (i.e. 2.9% of the time). This data suggests that an investor with a 10+ year time horizon should be reasonably comfortable with a sizeable weighting in stocks, as the potential rewards from this asset class appear to outweigh the shorter-term risk of decline.

The Stock Market's Positive Returns: 1871-2014

Through holding periods of 15 years or greater, the stock market's total returns, including reinvested dividends, have always been positive. For five- and 10-year intervals, there have been periods of loss, but these have been infrequent.

	5-year	10-year	15-Year	20-year	30-year
Stocks	15.8%	8.5%	5.2%	10.2%	11.3%
Updated Equity Data	**5-year**	**10-year**	**15-year**	**20-year**	**30-year**
Best	27.0%	19.0%	17.8%	16.9%	13.8%
25th Percentile	14.9	13.2	12.0	11.6	10.8
Median	9.5	8.6	8.4	8.2	9.6
75th Percentile	3.3	5.4	6.1	6.7	6.9
Worst	-15.6	-2.1	0.2	2.8	4.1
	5-year	**10-year**	**15-Year**	**20-year**	**30-year**
Number of times negative	16	4	0	0	0
Number of times total	139	134	129	124	114

Note: Data as of 12/31/14. The 25th, Median, and 75th numbers are break points for the returns and not specific years.
Source: WisdomTree Asset Management

If you have a shorter time horizon, then a more balanced blend of stocks, bonds and other assets is likely more appropriate. However, even here, investors need to separate the stock component of the portfolio from the rest of their strategy and be comfortable with near-term volatility. Of course, these are general rules of thumb and everyone's situation is unique – some older investors are very risk tolerant and have sufficient outside income to withstand more portfolio volatility, and some younger investors have an aversion to risk that makes a 100% stock portfolio inappropriate.

Please contact us if you want to review your overall asset allocation strategy. We have recently incorporated a new quantitative software program to use in conjunction with our qualitative assessment to help us determine the appropriate allocation for client portfolios. If you are feeling uncertain about your specific strategy, a quantitative and qualitative review may assist in determining whether a change is in order or if you should stay the course .

<u>Core Principle #2</u> – Volatility is not risk. As we have mentioned in previous quarterly letters, the average intra-year decline in US Stocks (S&P 500) has been ~14% since 1980. While this kind of volatility can be stomach churning when it happens, it should be welcomed by investors as 1) it allows funds to be invested at lower prices, and 2) the risks associated with market volatility are what provide the *opportunity* for higher returns. Attempts to dramatically reduce or eliminate portfolio volatility (whether by hedging, buying insurance or simply panicking and outright selling) invariably lead to lower long-term returns.

<u>Core Principle #3</u> – The price you pay determines your return. In investing, it is really as simple as that. Pay too high a price for *any* investment, and you will earn a sub-par return. As noted by famed investor Howard Marks of Oaktree Capital, "there are no bad investments, just bad prices". Even the bonds of a nearly bankrupt company may be a great investment at pennies on the dollar. Of course, as clients of AMM know, we do not seek to invest in near bankruptcy candidates but rather focus on quality stocks for dividend growth and/or capital appreciation. By focusing on quality *and* valuation, we seek to reduce real risk (i.e. permanent capital impairment) and, in the case of dividends, build a long-term income stream.

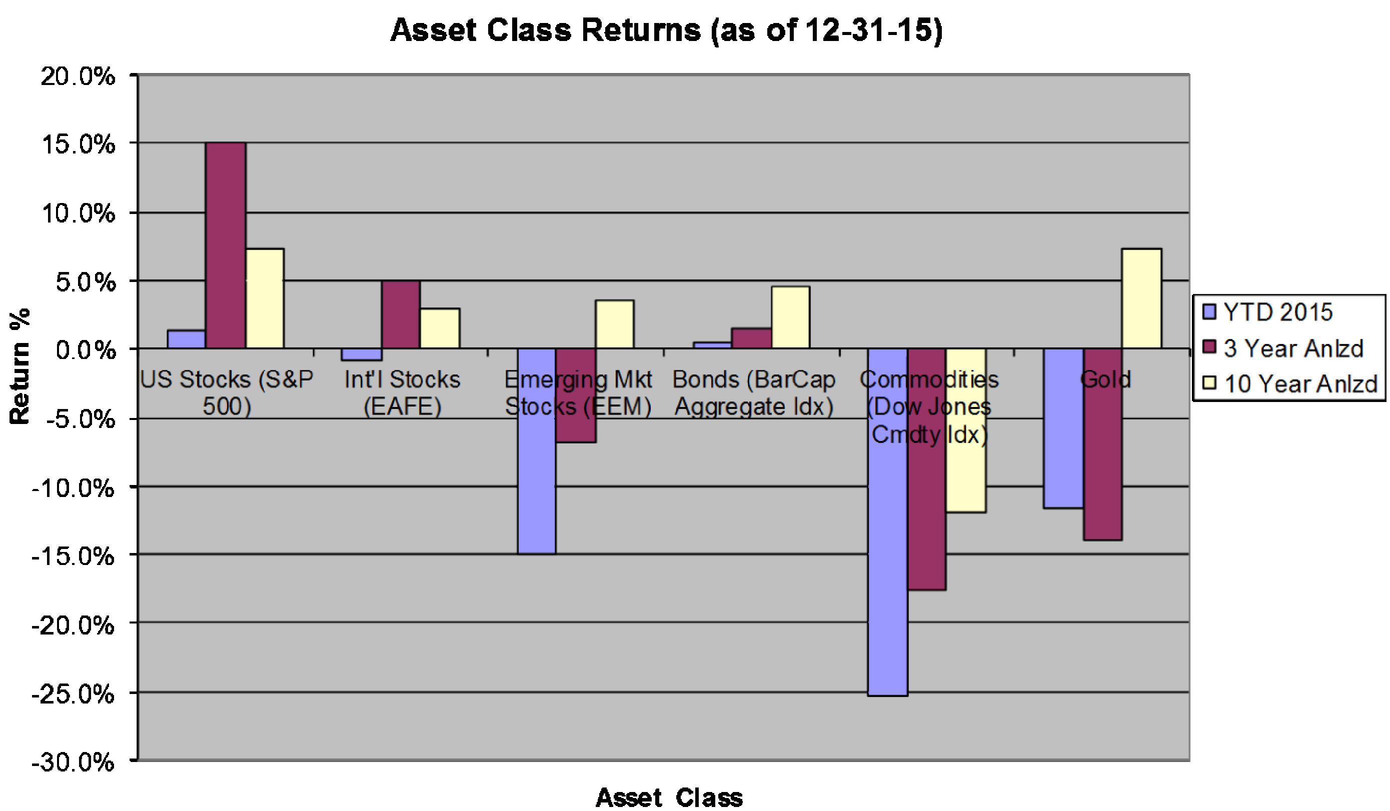
<u>Core Principle #4</u> – Time is your ally, but returns are not linear. Since 1928, stocks have annualized returns of 11.4% versus bonds which have returned 5.2%. In more stark terms, $100 invested in stocks in 1928 would now be worth $294,060 versus $7,061 if the same amount were invested in bonds. Over the long-run, stocks have trounced the returns of more conservative bonds; but, to achieve this, investors generally need to be patient and accept shorter stretches of time with lower/negative returns.

(AMM's Investment Principles cont.)

<u>Core Principle #5</u> – You can't predict the future. If only we could, we would simply exit "risky" markets and then reinvest when the "coast is clear". However, when investors attempt this in practice, it generally results in selling low and buying high – a disastrous approach to investing. The decision to "go to cash" is almost always a 50/50 proposition. Even worse, however, is that once in cash, the next decision about when to reinvest is also a coin toss. In statistics, getting two 50/50 propositions correctly puts your odds of being right at 25%. This says nothing about the frictional costs the portfolio undergoes with all of the buying and selling (more fees for the broker = a guarantee of less money in your account). In our view, the better approach for almost every investor is to take the significantly greater odds that over time markets will reward their risk taking (since 1928 – markets have risen approximately 72% of the time). By following principles 1-4, we seek to follow a disciplined approach to intelligent risk taking and improve our clients odds of long-term investment success.

2015 Review

Through 12/31/15, domestic stocks (S&P 500) increased 1.4%, developed market international stocks (EAFE) declined –0.8%, and emerging markets (EM) declined -14.9%. Bonds (Bar Cap Agg Idx) were up 0.6%, commodities were down -25.3%, and gold was down -11.6%. We have updated our asset class return chart to reflect Calendar Year 2015 along with three and ten year annualized returns for the aforementioned asset classes.



The returns above show that, over the last several years, more diversification has actually worked against portfolio returns as international and emerging market stocks have lagged significantly behind their US counterparts, while inflation diversifiers like gold and commodities have significantly underperformed other assets.

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(2015 Review cont.)

Depending on your specific allocation strategy, you may have exposure to assets beyond just US stocks and bonds. When comparing traditional measures of value across major stock markets, the underperforming stock markets are exhibiting much better risk/reward opportunities relative to the US. That stands to reason since prices have not kept up with US stocks, yet earnings are expected to grow in line with economic growth globally. Where appropriate, we continue to view exposure to international and emerging market stocks through a long-term lens and expect more favorable valuations in these markets to be followed by better returns in the future.

The bond environment remains tricky. The long expected increase in interest rates should be a headwind for bonds; however, high quality bonds tend to be the best "flight to safety" asset when the stock market is under pressure. For balanced and conservative income oriented accounts, we are investing a healthy weighting in fixed income ladders and/or intermediate term bond funds. The ladders should help mitigate poor price performance when rates rise, while at the same time helping to preserve capital during difficult environments.

We still believe gold and commodities can serve a role in a broadly diversified portfolio; however, their contribution will not likely be seen until we begin seeing stronger inflationary pressures later in the economic cycle.

Enclosed is a copy of our Privacy Notice. We can also provide you with a current copy of our SEC Form ADV Part II, at your request. 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.

As always, we thank you for entrusting AMM to help you achieve your investment and retirement objectives.

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*	Bree Carlson *Administration*

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