July 31, 2015

Dear Friends and Family,

As stocks enter the seventh year of a bull market, various broad market indicators are sending mixed signals about the value of equities. On the one hand, equities remain reasonably valued relative to fixed income alternatives and are supported by an improving US economy. In addition, investors also continue to remain wary about stocks, which historically has served as a positive, contrarian indicator over the intermediate term.

That said, investors should prepare themselves for the eventual return of market volatility and understand that there are increasing signs of speculative behavior among market participants.

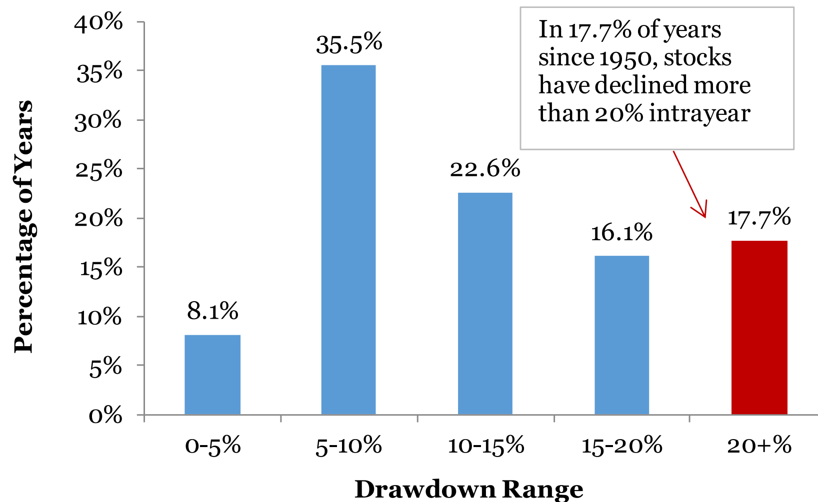
In this environment, your Advisor believes it is important to temper expectations. Nevertheless, we caution investors against market-timing strategies with their core portfolios.

FASTEN YOUR SEATBELTS

"Fasten your seatbelts. It's going to be a bumpy night."
- Bette Davis, from the movie "All About Eve"

A market correction is defined as a decrease of 10% or more within one calendar year. Using data from 1950-2011 (Chart 1), over half of the years in this period (56.4%) experienced a correction of more than 10%. Notably, in 17.7% of all years in this study, the market as measured by the S&P 500 declined by more than 20%.

Chart 1: Frequency & Magnitude of Stock Market Corrections



Sources: Bloomberg & Marquette Associates

Over the past four years, U.S. stocks have exhibited very little downside volatility. Since 2012, the largest intra-year decline has been a relatively mild 10% (Table 1).

Table 1: S&P 500 Intra-Year Declines vs. Calendar Year Returns

Legend	
Red	**Intra-year decline greater than 10%**
Green	**Intra-year decline less than 10%**

	Largest Intra-year Decline	Calendar Year Price Return
2008	-49%	-38%
2009	-28%	23%
2010	-16%	13%
2011	-19%	0%
2012	-10%	13%
2013	-6%	30%
2014	-7%	11%
2015 YTD	-4%	0%

Source: JPMorgan

Volatility will return at some point. This often works to our advantage, as your Advisor uses temporary pullbacks to selectively purchase businesses at bargain prices.

Despite this, we know how declining prices and negative headlines can impact even the most rational of investors. We welcome the opportunity to stress test your financial plan, as we want all of our clients to understand the implications of, and to prepare for, the possibility of a short-term market decline of over 20%.

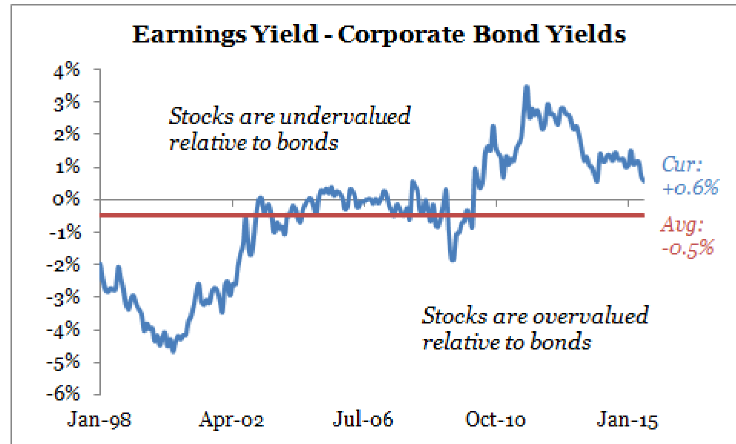
TAKE THE GOOD...

Various economic and valuation indicators that we track continue to send mixed signals.

On the positive front, the U.S. economy continues to grow despite international headwinds. The unemployment rate recently fell to 5.3% which is close to the formal definition of full employment. The household debt service ratio has also dropped to the lowest level in 25 years, with Americans spending less than 10% of their income on debt-related expenses. Declining energy costs have also assisted the consumer in spending and saving. A robust economy provides a solid foundation for continued growth in corporate profits and business worth.

Furthermore, the so-called Fed Model (Chart 2), a relative valuation indicator that compares the earnings yield of stocks to those of fixed income assets, shows that stocks continue to be valued more attractively than bonds.

Chart 2: The Fed Model



Source: Bloomberg

In addition, sentiment indicators give equity investors reason to be constructive. Over time, measures of investor sentiment have been shown to be contrarian indicators. When people are negative, it's time to buy.

Recent investor sentiment polls conducted by the American Association of Individual Investors (AAII) demonstrate that optimism among investors is at a historically low level, and neutral sentiment is at an unusually high level (Table 2). Both such occurrences have typically been followed by better-than-average intermediate-term returns for stocks.

Table 2: AAII Investor Sentiment Survey

	Historical Average Since 1987	**Current Reading**
Bullish Sentiment	38.8%	21.1%
Neutral Sentiment	30.5%	38.2%

Source: Bloomberg

...AND THE BAD

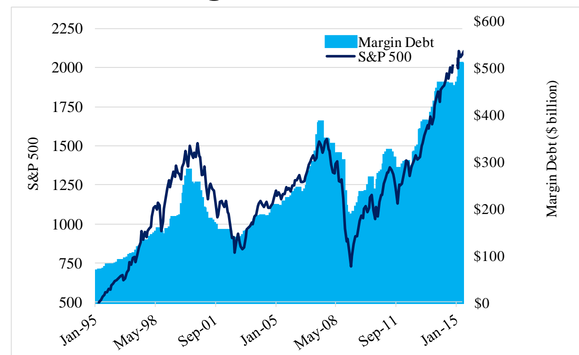
"Success breeds a disregard for the possibility of failure" - Hyman Minsky, Economist

We all want to believe that we're rational most of the time. However, who hasn't miscalculated a decision in the heat of the moment only to have buyer's remorse once calm prevailed? Market participants vacillate between being overconfident in bull markets and overly cautious in bear markets.

Most recently, one area of concern is the rising levels of margin debt, or the money that is borrowed by investors against the stocks that they own.

Margin debt has recently reached record levels, with US investors borrowing over $500 billion from their investment portfolios. Accordingly, the last two major market declines began as margin debt levels peaked, as demonstrated in Chart 3.

Chart 3: Margin Debt and Stock Prices

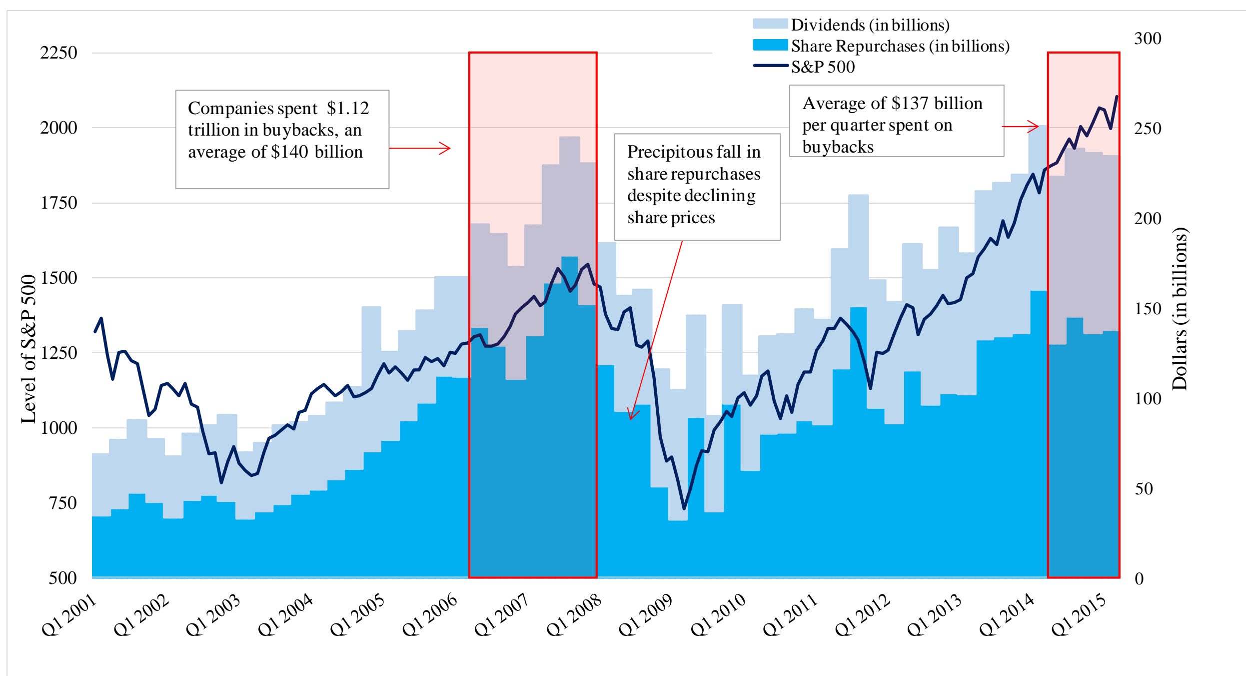


Source: Bloomberg

Corporate buybacks also provide a reason to temper expectations. When a company repurchases stock, it uses its cash to buy its own outstanding shares, a strategy that makes financial sense when the stock is undervalued.

Yet, in many cases, management has demonstrated a propensity to buy high with these repurchase programs. Chart 4 shows how stock buybacks accelerated close to the top of the market in 2007 and then fell when markets were at their lows in 2009.

Chart 4: Share Repurchases and Dividends vs. S&P 500: 2001-2015



During the previous buyback wave from 2006 through 2008, the members of the current Standard & Poor's 500 repurchased more than $1.12 trillion worth of their own shares, which represents $140 billion per quarter. In 2009, a year during which almost all stocks traded at low valuations, buybacks declined 63%.

In recent months, buybacks have surged back to record levels, averaging $137 billion per quarter. Many companies have taken advantage of low interest rates to borrow money in order

to buy back shares. In addition, in many instances, C-suite executives are incentivized to initiate buyback programs, as their short-term compensation rises when share repurchases increase.

History suggests that with increased levels of margin debt and corporate buybacks, investors should proceed with a high degree of caution.

THE DIFFICULTY OF MARKET TIMING

In this environment, we want to find an appropriate balance and stay disciplined. There is a temptation to time the markets, but we strongly counsel against trying to pick entry and exit points with a core portfolio.

The evidence against market timing is very strong. Some investors feel like they can “get out” of the market when it looks bad, and “get in” when things look better. Let’s take a look at the success of such an approach.

Let’s take an investor in the midst of the dot-com euphoria of 1998 who starts with $10,000 in the S&P 500 Index. He comes up with a timing strategy. If the market falls 5%, this person sells everything. He then get back into stocks when the market goes up 5% and the world looks better. Chart 5 demonstrates that the market timer would have severely underperformed a simple buy-and-hold strategy through 2011 (Not to mention, he would have a higher tax bill because of all the selling!). In the appendix, we provide a couple other timing strategies to consider.

Chart 5: Growth of $10,000: Market Timing Strategy

Pull out of the market when the market is down 5%, and re-enter when the market is up 5%

Source: Vanguard

If you’re still not convinced that market timing strategies do not work over time, consider how past market upticks have played out. Market returns are not achieved through smooth increases over time, but through large, sudden jumps.

A portfolio that was fully invested from 1990 to 2014 would have achieved annualized returns of about 9.6% (Table 3). However, if the 50 best days in the market over this period of time were missed, the returns would have been negative. For some perspective, 50 days over this period is equal to about 0.56% of all days.

Table 3: Missing the Best Days in the Market from 1990 to 2014

	S&P 500 Index Annualized Returns	% of all Days
Fully Invested	9.6%	
Miss best 20 days	4.5%	0.22%
Miss best 50 days	-0.3%	0.56%

CONCLUSION

When your Advisor first began managing money in the early 1990's, sophisticated investors would use a Quotron to look up stock prices. Most people, however, learned about the previous day's stock market while reading the newspaper.

Information is now widely accessible and investors are more aware of short-term volatility.

Despite this, better technology has not fundamentally changed the way we allocate capital. Our focus on investing with a margin of safety has helped us to successfully navigate various markets. Although we have written this letter to temper expectations for the intermediate term, we look forward to working with you to achieve your family's financial goals.

One important, near-term objective is to ensure our clients are well-protected against digital threats. Lately, there have been many headlines about hackers gaining access to sensitive information. If you would like a personalized security review, please contact George Andresen. George has worked with many of our clients, and has dealt with security breaches from stolen credit cards to hacked e-mail accounts. You can call our office and ask for him, or e-mail him directly at george@roundviewcapital.com.

We appreciate your trust and partnership each and every day and look forward to speaking with you soon.

Very Truly Yours,

Howard Alter   Stephen Shueh   Andrew Lieu   Matthew Wallack

APPENDIX

Growth of $10,000: Market Timing Strategy
Pull out of the market when the market is down 15%, and re-enter when the market is up 5%

S&P 500 -- Timing Strategy --

Growth of $10,000: Market Timing Strategy
Pull out of the market when the market is down 5%, and re-enter when the market is up 15%

S&P 500 -- Timing Strategy --