Third Quarter 2014 Investment Letter

"Uncertainty actually is the friend of the buyer of long-term values." - Warren Buffett

Welcome to Sheppard Wealth Management! Please enjoy the first ever copy of our newsletter.

It appears today that the stock market rally is now sputtering. I have been hearing a lot of talk, as I am sure you have, about a "big correction," which many people believe is long overdue (after all we are 68 months/5.5 years into this bull market).

And maybe that's what the markets are telling us today with the return of volatility. Or maybe Jeremy Grantham is correct about the markets having another 10%-15% of bullishness left in the tank. Or it could be that we are in the middle of a longer term market rally. What I do know is nobody can predict the short-term direction of the stock or bond market.

Warning: Bull markets are easy to endure. Bear markets are not, and will require all your discipline. One thing that my 17 years of working in this field, and around some of the brightest minds does tell me is that no one knows how this is going to turn out. I do know this, investing should never be about a moment in time, it should be a process *over* time.

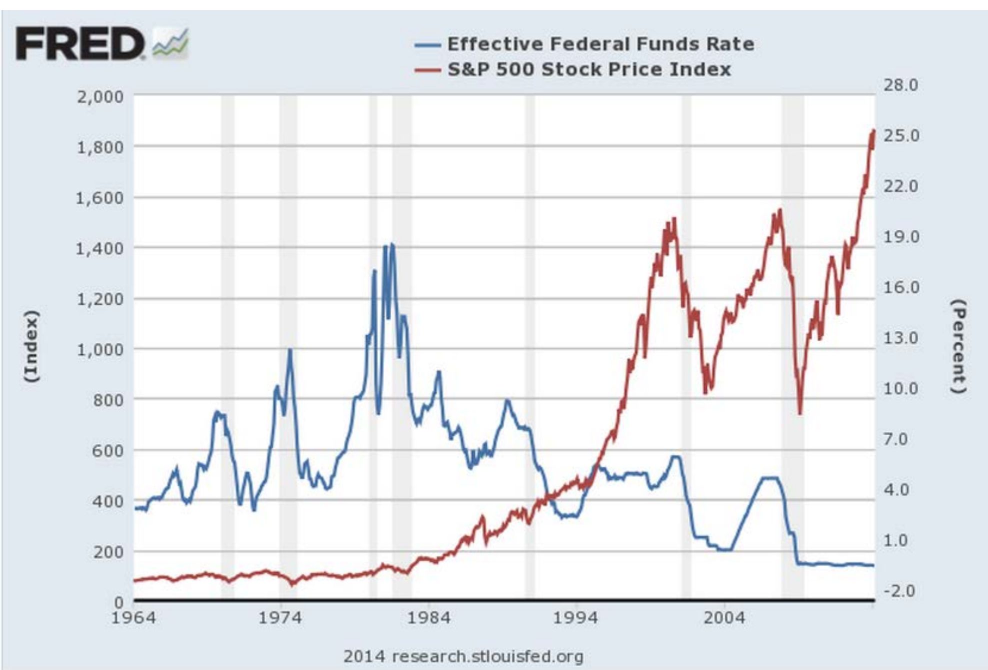
You can look online right now and find just as many Bears as Bulls claiming which way this market is headed. Historically this bull market marks as the fifth-longest run since 1928 (defined by a market gaining more than 20% without an opposing correction of 20%) and has lasted 5 months beyond the average term of similar bull markets. What makes this bull market a bit different is the amount of government stimulus pumped into the economy affectively reducing borrowing costs and raising corporate valuations. This low interest rate environment (stimulus) is having a big impact on *valuations* which is resulting in higher stock prices. With these higher prices, finding value is exceedingly more difficult.

Searching for Value:

The "stock market," as most people refer to the act of investing, is really a market of individual stocks. While these stocks may be pulled along momentarily by a strong bull market, ultimately it is the individual stocks that determine the market, not vice versa. All too many investors focus on the market trend or economic outlook. But individual stocks can rise in a bear market and fall in a bull market. Sheppard Wealth does not buy into trends or economic outlooks, rather search for value. This discipline is being tested currently as we view the global markets through the lens of present risks: violence in the Middle East, Russian sanctions, weak Chinese growth, Europe's struggles, Ebola outbreak, and lots of uncertainty around Federal policy.

For the last five years, the Federal Reserve (the Fed) has been pumping more and more money into the "system." But now the Fed is starting to evaluate the next course of action. Specifically, it is beginning to reduce its support. With the end of QE (Quantitative Easing) upon us, Fed President, Janet Yellen, appears determined to continue this record low interest rate environment, and do whatever it takes to bolster the economy. I do not agree with the current majority of higher interest rates on the near horizon. This idea of the Fed on the cusp of raising rates has been a consistent theme for the past 3 ½ years with very little change. I believe we are in for more of the same if not the possibility of additional Fed support over the next 6-12 months. So why is the media so focused on rising rates? Let's take a look. In the past, major changes in direction of Fed money-pumping have often been followed by changes in direction of stock prices. Not immediately. And not always. But often. The current story out of Wall Street goes something like this… "When the Feds begin raising rates (squeezing the supply of money) then the stock market is sure to fall." Most commentators would agree that this tightening is just around the corner, and therefore the Bear Market is upon us.

Here's a look at a few time periods. The blue line is the Fed Funds rate (a proxy for the level of Fed money-pumping.) The red line is the S&P 500. Note that Fed policy goes through "tightening" and "easing" phases, just as stocks go through bull and bear markets. And *sometimes* these phases are correlated, however the graph below clearly reflects markets move in random.



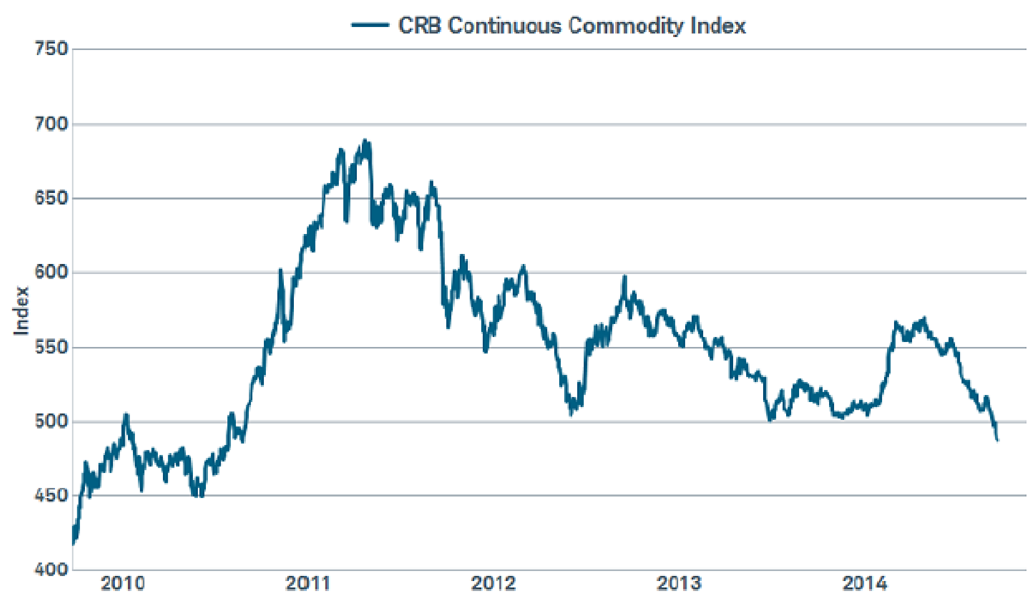
One of the oldest sayings on Wall Street is "Don't fight the Fed." This saying has meaning in two directions, both when the Fed is easing and when it is tightening. A glance at these charts shows why.

On the positive side, the Fed's tightening phases have often lasted a year or two before stock prices peaked and began to drop. So even if you're convinced that sustained Fed tightening now will likely lead to a sharp stock-price pullback at some point, the bull market might still have a ways to run.

Changes in the Portfolios…

I believe we are in a position to act proactively, and use periods of volatility to bolster long-term returns making several adjustments to the portfolio's overall allocation in order to reflect the current and forward-looking risk environment. First, we decreased our fixed-income exposure with the liquidation of Pimco Total Return fund. Bill Gross, a.k.a. the Bond King, departed, or was highly encouraged to leave, from Pimco earlier this month. I believe the downside psychological risk is greater than the upside potential with new management. A few days after we liquidated the position, Charles Schwab, and many other portfolio managers, validated these concerns by announcing they would be removing the fund from their managed accounts as well. Second, I have been adding a few new positions to the portfolio, two of which pay a sizable yield and will benefit the portfolios as volatility picks up. The hunt for value is challenging, but increased volatility does pave the way for more favorable risk-return dynamics.

From my perspective the potential for global events to derail continued growth is real, but arguably to sell news and get viewers to click on their stories. Economic and company fundamentals in the U.S. look positive, although high, I don't believe we are in "bubble" territory. The Fed appears adamant to keep rates low, and commodity prices (filling our cars up with gas) have been steadily falling the past two months. Both of which, at the end of the day, put more dollars in the pockets of the consumer and stimulates activity (see chart below):



Source: FactSet, Commodity Research Bureau. As of Sep. 22, 2014.

As contrarians, we see value in a few energy sectors that have been punished by declining commodity prices (see the chart below):

As you can see above, the S&P 500 (blue line) has given back almost all of its year-to-date performance in the last month, and the energy index (orange line) is down (as a group) over 6% from its peak back in June.

Additionally, with an increase in "fear" we are close to being buyers of gold as spot prices are down over 11% year-to-date. Here is the price on gold year-to-date:

New/Familiar Face…

I am excited to announce a new, but familiar face to the Sheppard Wealth team. Andrea Crump has joined me as an Associate, and will be assisting with client servicing and day to day operations. Many of you will remember Andrea, as I had the pleasure of working with her for five years at a previous company. Andrea graduated from Oregon State University in 2003 with a bachelor's degree in finance. She worked in the financial sector from 2003-2009. From 2009-2014 she ran her own childcare business along with raising her children. She and her husband have resided in Bend, Oregon for the past 10 years. She enjoys spending time with her family and friends, and camping throughout the year.

Andrea can be reached at: andrea@sheppardwealth.com or 541-241-8659. Welcome Andrea!

In Conclusion…

As always, my personal capital is fully and closely invested alongside that of my clients, and I remain disciplined in my effort to construct portfolios in areas where I see value. I recommend that you turn off the TV, stay away from Crammer, and read a good book written by Warren Buffett, Sir John Templeton or Guy Spier which will help you to gain a long term investment perspective, and stay away from present moment- by-moment hyped philosophy. Ambiguity really can be an ally in this market!

Sincerely,

John Swanson
Sheppard Wealth
October 2014

Introduction to Sheppard Wealth…

If you have a friend, family member, or colleague that may benefit from our expertise, please consider making an introduction. Thank you for your continued trust and confidence.