First Quarter 2016 Client Letter

"Skepticism is the chastity of the intellect, and it is shameful to surrender it too soon or to the first comer: there is nobility in preserving it coolly and proudly through long youth, until at last, in the ripeness of instinct and discretion, it can be safely exchanged for fidelity and happiness."
- George Santayana

The first quarter of 2016 continued with the familiar 2015 volatility. It started with a BANG correcting to the down side by over 10%. However, Q1 had one of the greatest comebacks in stock market history. According to Ryan Detrick of LPL Financial, this was the first time since the fourth quarter of 1933 that the stock market slumped more than 10% in a quarter, yet finished in positive territory. The S&P500 sank to a loss of 11.3% by mid-February, but ended the quarter with a gain of 0.7%.

Slowing growth in China and other emerging markets, continued weakness in oil, and turmoil in the Middle East generated fears amongst investors. According to Morningstar Direct, U.S. Asset Flows show a continued outflow from U.S. equities with international equities gaining inflows. Given the aforementioned, the current presidential election, and the uncertainty with the Fed's direction, the markets have a lot to digest. Rob Lovelace, Portfolio Manager at American Funds, hit the nail on the head as we look out into 2016, "From a macroeconomic standpoint, this is not a very exciting world. Then you go to the industry and company level and there are a lot of things to be excited about. Even then you have to dig deep to understand which drug companies will get their therapies approved, which components will be needed in the next generation of technology and which companies are in the markets where the next wave of growth will come."

This Doesn't End Well

Do you remember playing the game musical chairs? To refresh your memory, Wikipedia provides the following definition of the game: *Musical chairs is a game where a number of chairs, one fewer than the number of players, are arranged facing outward with the players standing in a circle just outside the chairs. Usually music is played while the players in the circle walk in unison around the chairs. When the music stops each player attempts to sit down in one of the chairs. The player who is left without a chair is eliminated from the game. One chair is then removed to ensure that there will always be one fewer chair than there are players. The music resumes and the cycle repeats until there is only one player left in the game, who is the winner.*

This definition sounds a little too close the current global economy. Recent sovereign defaults and debt restructuring include Greece (2012), Argentina (2014) and Brazil (any day now – last time it was

1990.) Most are aware of the major debt issues here in America. The politicians and media speak with such casual disregard for the massive amount of debt we are building it's easy to say, "Wow, those are big numbers, but it doesn't really affect me." I thought it would be of value to dig into the numbers and see if I can make any sense of what these huge numbers mean. After all, debt-fueled expansions have ended in financial ruin for hundreds of years.

So let's have a look at our current debt in real numbers (not the ones thrown around by the politicians). The numbers I have provided below are available here www.Treasurydirect.com:

Debt to the Penny:

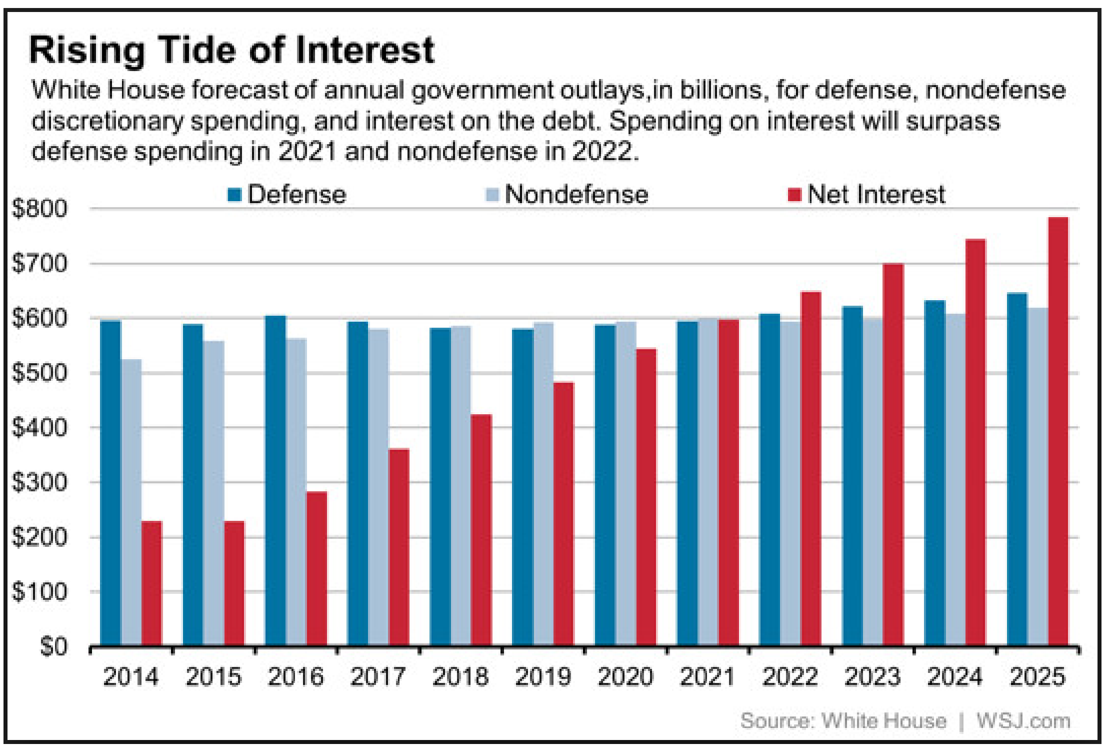
4/10/2016 – Debt Outstanding: $19,226,226,489,207

09/30/1999 – Debt Outstanding $5,656,270,901,615

9/29/1989 – Debt Outstanding: $2,857,430,960,187

9/30/1975(approximately when I was born) Debt Outstanding: $533,190,000,000. Compare this number to the cost to service our debt for 2015 of $402,435,356,075 and you can quickly see how far we have come in just 40 years. (That number seems bigger when I write it in this letter☺

The chart below shows that in 2021 shows the inflection point where our debt interest costs will surpass all other spending here in America. The debt cost is a real issue and it looks to get worse if we don't start taking actions to curb it. My guess is we could see continued monetary action through another round of quantitative easing (QE4), A.K.A negative interest rates as seen in Japan.



Carmen Reinhart, Professor of Economics and Director of the Center for International Economics at the University of Maryland, notes in her book, *This Time Is Different*, "The common theme is that excessive debt accumulation by government, banks, corporations, or consumers often brings great risk. It makes government look like it is providing greater growth than it is, inflates housing and stock prices beyond sustainable levels, and makes banks seem more stable and profitable than they really are. Large-scale debt buildups make an economy vulnerable to crises of confidence - especially when the debt is short-term and needs to be refinanced (the usual case)."

We should remember however, that other countries have spent decades far above the 100% debt/GDP ratio (Japan) with little consequence. A more relevant figure to look at is the amount of revenue the government is receiving – its tax receipts. This figure shows some improvement as our debt costs were lower in 2015 than the two previous years 2014 and 2013, as well as 2011, 2010, 2008, 2007 and 2006. While the situation is dire, I like what Howard Marks of Oaktree Capital said about all this, "Most of the time, the end of the world doesn't happen."

Mr. Market

We buy individual stocks in our clients as well as our personal accounts. The most often asked question I am asked is, "What's the market doing?" Let's first define what "the market" is. As Howard Marks wrote in his most recent memo, "First it's important to understand for this purpose that there really isn't such a thing as 'the market.' There's just a bunch of people who participate in a market. The market isn't more than the sum of the participants, and it doesn't 'know' any more than their collective knowledge."

With this definition in mind I encourage you to view "the market" as a barometer of human emotions. Behavioral psychology is fascinating to me and I recently reread James Montier's book *The Little Book of Behavioral Investing.* In the book, Montier quotes Seth Klarman, the head of Baupost and value investor, "So if the entire country became securities analysts, memorized Benjamin Graham's *Intelligent Investor* and regularly attended Warren Buffett's annual shareholder meeting, most people would, nevertheless, find themselves irresistibly drawn to hot initial public offerings, momentum strategies and investment fads. People would still find it tempting to day-trade and perform technical analysis of stock charts. In short, even the best-trained investors would make the same mistakes that investors have been making forever, and for the same immutable reason - that they cannot help it."

So how can we minimize the mistakes? Having a plan and committing to a strategy!

Fiduciary Rule

The Labor Department is undergoing a rule change surrounding retirement accounts. The Fiduciary Rule imposes tougher fiduciary standards on all brokers and advisory's overseeing retirement assets. The spirit of the rule is to increase transparency around fees, and to raise the ethical standards to which financial advisers are held. This is great news for the industry and we are glad to see stronger oversight. A big reason for starting our own wealth management firm was because we wanted to move away from any conflicts of interest (i.e. getting paid to sell products) and we wanted full transparency on how we are compensated for our management. Please reach out to me if you would like to discuss this rule change and how it is going to impact the industry.

Sheppard Wealth Improvements

We have just made it through the 2016 tax season (aside from the numerous extensions) and we now are focused on upgrading our client facing menus. We are currently in the process of improving our quarterly reports (what you are receiving with this letter) and our client portal experience. Our goal is to provide a more enjoyable online experience with much more transparency within your personal accounts. Along with these changes will be our wealth planning software. Our goal and hope is for these improvements to have very little disruption on your ability to view your accounts. These conversions will be implemented in the next couple of months as well as a few other exciting items. We will be touching base soon in an effort to review your accounts, as well as learn how to better serve you.

As always, we are humbled and grateful for the trust you have placed is Sheppard Wealth. Thank you!

Warmly,

John Swanson, AAMS