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Dec. 22, 2016

OBSERVATIONS ON THE MARKET

No. 306

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What a year, and what a great year to look back on and examine some key turning points. Some are obvious, and some receive virtually no attention. However, they all provide some great lessons.

First on the list is the bond market. In July, it appeared that the economy was permanently stuck in the doldrums, so bond investors were confident that any bond that paid interest, no matter how little, was a good bond. In July, the U.S. 10-year Treasury reached a low yield of 1.36%. An even more amazing feat was that France sold some 50-year bonds at a yield of 1.75%. Since we now have the benefit of hindsight, we can now say with complete certainty that anyone who bought these bonds in July currently doesn't look so smart. Since the yield on the 10-year Treasury has now advanced to 2.55%, that bond has declined by 9% in value. It will only take you four years to earn enough interest to break even, it is true that they will mature in 10 years, and your net worth will increase by 1.36% per year if you continue to hold the bonds. However, most of us look at our statements once a month, and it is not fun to watch something go down in value, especially when you know that that interest rate is a fixed contract with you, it will never get any better. In July, they were perceived as a low risk investment because they are guaranteed. With the benefit of hindsight does it look low risk now?

The story regarding the 50-year French bonds is even scarier. Yields on the 50-year French bond are now up to 2%. At first glance .25% appears to fall into the "so what" category. Even though interest rates only increased by .25%, it has resulted in a 12% loss for the bonds. Bonds that have longer maturities are more sensitive to interest rate moves. These investors will only have to wait six years to get their money back. A 1% increase in interest rates will be devastating to these bond holders. It will result in a decline of more than 30%. One should ask why these investors took that kind of risk back in July? First, it was because as interest rates declined investors were seeing the positive side of owning 50-year bonds. They made a lot of money. Second, when everything seems to be working, it is hard to step back and see the downside. It will take a long time for the cash flow from these bonds to cover current short-term losses.

Another interesting phenomenon this year was the discovery of "minimum volatility" funds. These were funds that owned the big dividend paying stocks which tend to be more stable than the stock market. One of these funds was an index from iShares with the symbol of USMV. In the first half of 2016, USMV had gained about 12%, as compared to the S&P 500 which was up about 6.5%. What happens when an investment is touted as less risky but makes more money? The money comes pouring in. The fund has attracted $4.7 billion this year, almost doubling its size. That was then, this is now. Since July, USMV is down 4%, while the S&P 500 is up 3.7%. Investors apparently decided there was no longer a free lunch because they have since pulled out $680 million.

This leads us to today. The *Wall Street Journal* had an article on November 11th entitled: "Do You Really Have the Stamina to Be Wealthy." One of the statements in the article was that: "It seems to be a law of finance that investors who try to sprint their way to wealth never make it to the finish; somehow, the last in are always the first out." Patience and stamina are needed as much during market advances as they are during market declines. The key is to be calm during both periods. As the above examples suggest, 1.75% interest rates didn't make sense from a long-term perspective. In today's market stock prices reflect a somewhat optimistic near-term outlook. It may happen, but if you find yourself paying too much for the cash a company generates, you find yourself like the bond investor who waits four years to get their money back. Not to say that the market is overvalued, but patience is the best gift you can give yourself this Christmas.