

## *Observe by Watching*

*By Bill Koehler, CFA*

Late last month, America lost one of its national treasures and cultural icons. Lawrence Peter Berra, better known as Yogi, passed away at age 90. Although he was a fantastic baseball player, he was better known by many Americans for his good-natured humility, everyman demeanor and malapropisms, phrases that would leave listeners both shaking their heads and seconds later nodding their heads because the words contained much wisdom. He uttered so many of these memorable, unwittingly witty remarks, that they became known as Yogi-isms. His best-known quote is quite likely, "It ain't over till it's over," followed closely by "It's déjà vu all over again" when describing how events tend to repeat themselves.

After 15 consecutive seasons as an All-Star player and a 10-time World Series champion with the New York Yankees, he became a coach and manager, leading both the Yankees and the New York Mets to the World Series. He was once asked

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about his strategy as a manager. He responded simply, "You can observe a lot just by watching."

What does Yogi's managerial strategy have to do with our investment approach? We also value the power of

observing a lot just by watching. We firmly believe good, old-fashioned vigilant observation has served our clients well since 1966. As we prepare to celebrate our 50th year of serving clients, we anticipate these powers of observation will continue to be an important part of recognizing, anticipating and acting upon the actions, trends and events that we, to paraphrase Yogi, observe by watching.

### **Current Observations**

What are we observing in today's market landscape?

All developed market stock indexes are currently in correction territory, and emerging markets in bear market territory. As of October 2, the S&P 500 is off 10% from its May 21 all-time high of 2,134. Commodity prices have tumbled, hitting energy and basic materials stocks particularly hard. The Bloomberg Commodity Index is below levels seen in the early 1990s. The energy sector is off 23% year-to-date, and deflation fears persist in many quarters. Concerns of weakening global economic growth, primarily led by China's slowing, are weighing on investors' collective psyches.

While we characterize investor psychology as fragile, one could reasonably argue it has been fragile since the financial crisis began in the fall of 2008. At the same time, U.S. corporations are awash in cash with \$1.32 trillion, a near record. Merger and acquisition activity is running at a record pace. Cash dividends paid by S&P 500 companies in the third quarter of 2015 are at record levels. Even with yields dropping from 2.40% to 2.05% in the third quarter, U.S. 10-year Treasury yields remain above comparable 10-year bonds in Italy and Spain.

### **Stunted Earnings Growth**

Has the 2009-to-2015 stock market been an artificial bull market driven only by an extremely accommodative Federal Reserve Bank? We don't think the Fed has been the primary driver. Stocks prices are driven by earnings growth, and stock price growth has tightly tracked corporate earnings growth over the past six years. However, in 2015, overall corporate earnings growth has stalled. The weakness in energy prices and the strength of the dollar has, in effect, served to negate any corporate earnings growth this year. Therefore, in a year where overall earnings growth is scarce, a stall in stock price growth is not unexpected. It's also important to consider that perhaps we were due for something other than a linearly rising stock

market, such as most of the past six years. The relevant numbers to remember in evaluating investment results so far in 2015 are 16%, 32% and 13%. The numbers approximate the positive returns from the S&P 500 in 2012, 2013, and 2014, respectively.

### Observing Volatility

I know of another adviser who received a call from a client in August asking, "How can I invest in the VIX (the volatility index) in my 401(k)?" That is a true indication of an up and down month. Volatility and emotions can make it tough to follow through on any strategy. In addition, research substantiates that volatility is increasing.

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From 1950 to 2000, there were 354 daily moves in the S&P 500 greater than plus or minus 2%. From 2000 through September 2015, we have now had 357.

We believe better technology, better access to data/information and shorter time horizons (and shorter attention spans on the part of some investors) explain this increase. We believe this development can create opportunities for investors employing a longer-term orientation, such as we utilize, to exploit short-term mispricing in individual securities that can result from this volatility.

The volatility we are seeing may seem extreme, but there is precedent for this type of market action. Four short years ago, in August 2011, over four consecutive days, the S&P 500 returned -6.7%, +5.2%, -4.8% and +4.6%. So, this is not unusual. Having an intelligent plan that balances stocks and bonds and allows you to tune out the noise is the best remedy for weathering the inevitable volatility.

### Looking Ahead

What will we be hoping to "observe by watching" in the fourth quarter? A more stable dollar, more stimulus measures from China, more job growth in the United States and a decision by the Federal Reserve Bank to begin to normalize interest rates. More

geopolitical stability in the Middle East would be welcome too. In our opinion, these developments would serve to mitigate the volatile environment in which all investors have been operating.

We are closely monitoring the pace of overall global growth, particularly China's outlook and actions. That said, we believe the gradually improving "plow horse" growth of the developed economies will offset the weakness of the emerging market economies. There is no question that economic growth in the United States, and now across the globe, is slow by historical standards. However, we do not see a high risk of recession in the United States. The lower relative level of economic growth increases the probability of a longer-lived recovery. Therefore, we are cautiously optimistic on equities, particularly developed market equities. With regard to fixed income, we see no catalyst for a material upward move in rates over the near term, and we continue to search for multiple sources of income across the spectrum of income-producing securities, including preferred stocks.

### Upward Sloping, Not Linear

I don't think Yogi would say his life was linear. Likewise, stock markets are not linear. However, they are upward sloping over the long term. In many ways, his long life paralleled markets and offers a lesson on them. Despite the ensuing inevitable volatility, \$1,000 invested in the stock market in 1925, the year of Yogi's birth, would be worth \$5 million today. We counsel investors to take the long view of markets, heed Yogi's sound advice in observing the markets with a watchful eye, and remain alert for opportunities to deploy capital into profitable ideas and situations.

This publication is intended for use by clients of FCI Advisors and investment professionals.

## CURRENT DISCLOSURES

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