RCN WEALTH ADVISORS

Semiannual Market Update & Outlook
July, 2015

The Debt Collector Cometh

- How I assess stock market "risk" and where we stand today
- Why volatility across asset markets is likely to increase moving forward
- How I've been repositioning your portfolio this year to protect against and benefit from potential risks

Dear Clients,

I hope this letter finds you enjoying your summer!

Despite a very tepid first half of 2015 for US stocks and bonds, with the S&P 500 Index up a little over 1% and the US Aggregate Bond Index down approximately (0.15%)[1] through June 30th, I've been relatively happy with our start to the year. This is largely due to the takeover of a few of our individual stock holdings. When a company is bought-out, the deal usually occurs at a very nice premium to where the stock had been trading. It also frees up the cash to invest in something else but allows me to be patient in terms of making that next investment because the buyout essentially accelerated a year or two worth of gains into one day. This is just one of the many benefits and reasons why we invest in individual stocks instead of the broad market as a whole via a fund.

With some early gains and a stock market that seems to be slowing its pace, my focus this spring largely turned toward minimizing potential drawdowns. I've been reworking many of our stock holdings on both the Growth and Income sides of portfolios, as well as using options to hedge the risk of a drop in stocks. I would like to provide a little background on our approach to assessing overall stock valuations and how we go about protecting your portfolio against potential drops, and then will touch on some recent portfolio updates of individual holdings.

I generally view the stock market as being in one of three phases. Phase 1 is when the overall market is undervalued/fairly-valued and generally begins after a bear market ends and a new bull market begins. As the bull market matures, we enter Phase 2 which says that stocks are expensive but the market is still trending higher. Lastly, I consider Phase 3 to begin once the uptrend breaks, which often leads to the next bear market.

Below is a chart of the S&P 500 over the last 20 years, showing when we transitioned between each of the three phases and where we stand today. I currently consider the market to be in Phase 2. I should note though that *past performance is not indicative of future results*. Just because the past two occurrences of Phase 3 led to sizable drops, doesn't mean that the next one will. Only time will tell…

[1] Source: Morningstar, YTD Returns of SPY and AGG through June 30, 2015

3161 SOLOMONS ISLAND ROAD, SUITE 1 | EDGEWATER, MD 21037
PHONE: 410-956-6003 | FAX: 410-956-6004

These three phases can be thought of as how “risky” I view stocks, with risk meaning the probability of low or negative returns moving forward. I use this view to determine how aggressive or conservative we should be with our exposure to stocks and whether or not we should be hedging this risk with stock options. To determine when we transition from Phase 1 to Phase 2, I use a fundamental assessment of valuations for the stock market as a whole. I then flip to a purely technical (mathematical) assessment to determine when we’ve transitioned into Phase 3. Some of my preferred measures to assess fundamental valuations include metrics like:

- Average Household Equity Ownership - The percentage that households are allocating to stocks within their portfolio. High equity ownership means everyone already owns stocks and there are relatively few buyers left to drive prices even higher (stock valuations are largely driven by perception and willingness to take risks)
- Stock Market Capitalization-to-GDP – This has long been one of Warren Buffett’s favorite indicators. It measures the total value of the stock market relative to the size of the economy. High readings indicate that stocks have grown much quicker than the overall economy, and thus are likely overvalued.
- Outstanding Margin Debt – Many traders/investors will borrow money on margin when they’re optimistic about a rising stock market. That optimism tends to grow as the market continues to rise until it reaches a crescendo and needs to be unwound by a lot of selling.

Historically, all of these measures have held a high negative correlation to future stock returns on a 3, 5 and 10 year outlook. Simply put, this means they offer us an idea of what average annual returns will be over the next 5 to 10 years. When valuations are high, as they are today, it predicts future returns will be much lower than the long-term historical average, and when valuations are low, it predicts high returns. Most fundamental valuation measures I follow began to suggest stocks as a whole are expensive last fall. The long-term historical average return for US Large Cap stocks has generally been approxiamtely 10% per year (dividends included). However, most fundamental valuation measures are currently predicting that US Large Cap stocks should average anywhere from 1% to 4% annually over the next 10 years. Obviously this is significantly less than the long-term average but this makes sense considering the run the market has had over the past few years. I think everyone understands that stocks cannot continue at this pace forever and we’ll inevitably see another downturn. This is simply the cyclical nature of markets which follows the cyclical nature of economies. My job, of course, is to assess when that drop might occur and to do what I can to minimize the effect.

3161 Solomons Island Road, Suite 1 | Edgewater, MD 21037
Phone: 410-956-6003 | Fax: 410-956-6004

Some people prefer to look strictly at the fundamental valuations, only buying when stocks look cheap and selling when stocks look expensive. This isn't necessarily a bad approach but just because a market might be overvalued, doesn't mean it will immediately fall back to fair value. On the contrary, since markets are the compilation of all participants, and we human beings are very emotional creatures often driven by fear and greed, they typically overshoot on the upside and downside quite a bit! This means that even though stocks may be overvalued (in what I would call "Phase 2"), they can certainly continue climbing for quite some time, even years, as they did in the late 1990's and 2005-2007. These potential gains are something we'd like to capture if possible.

Additionally, just because the stock market as a whole might be expensive, it doesn't mean there aren't individual stocks still trading at attractive valuations. Obviously these are the companies we try to find and want to own. There will almost always be a nice group of high quality companies worth owning so it would be silly to think that we would ever have no money in stocks. As mentioned above, I use these market phases to determine how aggressive/conservative we should be, what type of companies we should own, and whether or not we should hedge using options - not as a question of whether we should be "in" or "out" of the market.

After the fundamental valuation metrics start to warn of trouble ahead, I begin to conservatively hedge stock risk by selling options that still allow for future gains. I'm then on alert for trigger #2 by using a purely technical (mathematical) approach on the charts to assess the market's trend. As long as the uptrend holds, we'll continue to ride the wave. However, once certain technical indicators begin to break down, I begin to manage stock risk fairly aggressively by actually purchasing put options to protect against the downside.

Our approach can be summarized with the following table:

Phase	Valuations	Need to Hedge Risk?
Phase 1	Stock valuations are NOT expensive	No need to hedge risk
Phase 2	Fundamental valuations begin to show that stocks look "expensive"	Conservative hedging of risk with stock options
Phase 3	The stock market's uptrend ends	Aggressive hedging of risk with stock options

We're currently in phase 2 – conservative hedging. I do this by selling call option spreads approximately 5% to 7% above the market's current price which expire every two months or so (I typically use the S&P 500 as our gauge of "the market"). This means that if the S&P 500 Index does not rise by approximately 6% or more in the next two months, the option contracts will expire and we keep the premium collected as profit. I'm essentially saying that I think the pace of the rally is slowing and that there is a strong chance the market does not climb by more than 6% in the next two months. Now, if the market does rise by more than 6%, let's say 10%, well that's great because we still own a portfolio of stocks. We might lose a little bit of money on the options, but the portfolio of stocks we own have most likely climbed with the market, meaning that we're making money overall. I'm willing to sell these option spreads because I'm not concerned about missing a huge move higher since we've already seen the bulk of the bull market. I'm now concerned about minimizing the downside.

It's possible for Phase 2 to last for a couple years and while the pace of the rally has slowed this year, there are no signs of entering Phase 3 yet.

Economic Outlook

There's too much debt in the world. A lot of longtime investors that are much smarter than me, like Ray Dalio and Bill Gross, call the environment we're in the end of a debt SuperCycle. After decades of fiscal mismanagement and the piling up of debt by governments, many Western nations now face very poor demographic structures (not enough workers per retiree). The issues plaguing Greece, Puerto Rico, Detroit, Illinois and many other cities, states and national governments are all the same. We've hit the tipping point where the amount of debt held by governments becomes restrictive to economic growth and further debt accumulation only exacerbates the deflationary forces. As the cost of servicing the debt (interest payments and rolling

over of maturing debt) continues to grow and stresses budgets, governments simultaneously raise taxes and cut spending on services. This leads businesses and younger workers to leave the area in search of better opportunities, which further reduces economic activity and tax revenue, until it all ends in an eventual default/bankruptcy/restructuring of the debt. We haven't had a true "spring cleaning" of the system since the Great Depression because governments continue to bail out institutions, allowing excesses to accumulate.

For the past 20 years, politicians' preferred means of not properly dealing with this debt issue has been to use their country's Central Bank to effectively bail them out by lowering and suppressing interest rates. But Central Banks are now stuck between a rock and a hard place. Not only have these policies suppressed interest rates but also volatility, and unfortunately you can only manipulate a market for so long before the market being manipulated shoots out with great force. A perfect example was earlier this year when the Swiss National Bank (the SNB) ended its currency peg against the Euro and the Swiss franc jumped by 20% overnight! I've mentioned on my blog over the past few months that **moving forward, the only thing I'm certain of is that we'll see greater volatility in almost all asset prices**. Over the last year we've seen rising volatility in currencies and commodities, it's starting to trickle into the bond market, and there's a strong chance it will eventually hit stocks. The interesting thing is that this may not end badly for stocks, as one would typically think. Higher volatility doesn't necessarily mean stocks will fall precipitously. It just means that we'll see wider than normal ranges. Sharp drops could also be followed by sharp increases. I've mentioned in past letters that the problems ahead will be in the government bond markets and when money realizes the game is over, it could flood into stocks for the relative safety of companies with strong balance sheets. Volatility is only a problem for investors that aren't prepared for it or are betting against it. I promise you that is not the case in your portfolio as we stand ready to capture the benefits that rising volatility might bring (more on this in the next section).

Another large ramification of these low interest rate policies are the misallocation of capital, which I'm concerned that we've seen occur within the energy sector. Cheap and easy money tends to distort prices (think about the housing market just a few years ago…) which eventually get resolved in a major reset. Our exposure to energy has largely been on the Income side of portfolios, focusing on the pipeline and storage companies. These business models are far less exposed to fluctuations in the price of oil/gas, and thus I believe them to be a "safer" way to invest in energy. Fortunately, they have fared much better than the production-oriented companies after the massive drop in oil prices last fall. Oil has bounced back a decent amount this spring, but I think we'll be seeing lower prices (below $60/barrel) for quite some time. I wouldn't be surprised to see yet another new low below $40/barrel. I fear this will eventually play out in many bankruptcies and bond defaults within the energy sector so my view is that it's still far too early to go bottom fishing for deals.

Portfolio Updates

I mentioned earlier that I've been reworking the stock holdings within both the Growth and Income sides of portfolios. Given current valuations and where we are in the business cycle, it's simply time to make sure we're only holding the strongest companies with the most financial flexibility. I'm becoming increasingly concerned about companies with too much debt, especially if the next crisis in the markets is a government *debt* crisis. If credit markets tighten up (as they eventually always do) just when a company has debt maturing and needs to issue new bonds, they will find it very difficult to do so. Debt (leverage) can be a beautiful thing when it works for you, but it can be very nasty when working against you. I've sold most of our highly indebted companies and I'm largely focusing on companies with very solid balance sheets that are holding plenty of cash and generating solid free cash flow.

Here are some updates over the last 6 months: I completely sold out of Dunkin' Brands (DNKN), Dow Chemical (DOW), Flowserve (FLS), Chevron (CVX), Spectra Energy (SE), Dupont (DD), Waste Management (WM), and Agrium (AGU) either because they were not executing, had too much debt, or not enough free cash flow to support future dividend increases.

I trimmed Hain Celestial (HAIN), Under Armour (UA), Starbucks (SBUX) and Stericycle (SRCL) based on valuations. Each of these four companies have been or are currently owned on the Growth side of portfolios. They are all great companies but the stocks are trading at pretty expensive valuations. I will gladly add back to these positions on a downturn that brings the stock back to more appropriate valuations though.

3161 Solomons Island Road, Suite 1 | Edgewater, MD 21037
Phone: 410-956-6003 | Fax: 410-956-6004

We've also seen some changes from companies we've owned that have been acquired by another company. Allergan (AGN) was acquired by Actavis (ACT) for cash and stock. The deal took about 9 months to close but your position in Allergan flipped into Actavis, and then the company changed the corporate name back to Allergan so now the stock trades as Allergan (AGN) again. Catamaran (CTRX) was purchased by United Health for cash at a solid premium of over 20%. PartnerRe (PRE) is in talks to merge with another insurance company while another suitor has been making takeover offers. I sold the stock after it jumped almost 20% on the news. Lastly, Williams Brothers (WMB) has turned down a takeover offer as they say the price undervalues the company but the suitor is still in pursuit. Williams saw a very nice pop on the news as well which allowed me to lock-in some gains.

As for new additions, on the Growth side of portfolios, I've started positions in:

- Flextronics (FLEX) - a Singapore based manufacturer
- Chicago Board Options Exchange (CBOE) - the exchange that options and volatility futures contracts are traded on (New York Stock Exchange is to stocks as CBOE is to options)

On the Income side of portfolios, which are stocks we primarily own for the dividend and consider any price appreciation as a bonus, we've purchased:

- Walmart (WMT)
- Parker Hannifan (PH) – a maker of motion and control technologies for the mobile, industrial and aerospace industries
- Oracle (ORCL) – one of the largest software service companies
- Travelers Insurance (TRV) – a property & casualty insurer

Finally, with the emergence in popularity of dividends, the final companies aren't quite pure "Growth" or "Income" so I pretty much classify them as "Hybrids" that I split half Growth/half Income. These include:

- Lincoln Electric (LECO) - a maker of welding and automation equipment
- General Dynamics (GD) – a global defense contractor
- Amgen (AMGN) – a biotech/drug company that I've been adding to

I've also added a very small allocation to an India stock fund (an ETF). This is just the beginning of a region that will eventually make up a very large allocation of your portfolio within a few years. India is going to be the center of the world's growth for many years to come and everyone around them is going to benefit. Pull up a map and look at the Indian Ocean. Every country that touches it, going from East Africa up to the southern part of the Middle East, over to India and down through Southeast Asia is in a very, very nice position. The economic and demographic fundamentals of these countries are ripe for years of strong growth. I'm currently still wary of Emerging Markets given my view that the US dollar is going to continue rising in the near term, but this should eventually lead to a wonderful buying opportunity in many of these countries. I'll be discussing this theme much more in the future.

Lastly, a note on some of your stalwarts - like the old mafia movies (think Goodfellas), you own a couple of stocks which I consider to be "made stocks." As long as current management is at the reins, these stocks can't be touched (only bought on dips). The simple reason is that management just "gets it" when it comes to creating long-term value for shareholders. They have an ideal business model and know exactly what to do with excess cash flow each year (known as free cash flow) in order to maximize shareholder returns. You can think of these companies as the pillars of your portfolio. They include:

- Ross Stores (ROST) – a discount clothing retailer
- O'Reilly Automotive (ORLY) – an auto parts retailer
- CF Industries (CF) – the lowest cost producer of nitrogen-based fertilizers
- Church & Dwight (CHD) – maker of household products like Arm & Hammer, OxyClean and Orajel

3161 Solomons Island Road, Suite 1 | Edgewater, MD 21037
Phone: 410-956-6003 | Fax: 410-956-6004

We have a few new holdings this year that are quickly moving up the ranks and have great potential to become "made stocks," but that will take a little more time of management proving they can continue to execute as expected. Three new hopefuls include the Chicago Board Options Exchange (CBOE), Travelers Insurance (TRV) and General Dynamics (GD).

I'd like to discuss the reason for purchasing CBOE and GD in more detail. When it comes to portfolio construction, you want to own assets that are not highly correlated, or better, are inversely correlated. When combined, these assets should smooth out returns and lower the volatility of the portfolio as a whole. It's also very important to understand macro-themes and to assess the potential risks that could adversely impact each part of your portfolio. For example, above I mentioned that I believe all asset classes will experience higher volatility moving forward. When it comes to the stock market, this means we're likely to see some wild swings, including periods where stocks take a fairly nasty dip. The way to diversify this risk is to also own assets that will *benefit* from rising volatility.

This is where CBOE comes into play. CBOE is the exchange where many futures and options contracts are traded, including the Volatility Index (VIX) itself. These are products that investors and traders use to manage risk within portfolios – just like we're doing with options. Typically, the higher the volatility being experienced in markets, the more traders will use these products and the more money CBOE makes. This means that CBOE tends to perform well when the stock market falls. Despite being *a stock* within your portfolio, it's a diversifier to the stock component of your portfolio against the risk of rising volatility.

Another macro-theme is the risk of war. Do I want a major war to break out somewhere in the world? Of course not! But if one does, it will almost certainly shake the investment markets. So it's always a good idea to own an asset that would *benefit* from rising geopolitical tensions, like General Dynamics (GD). General Dynamics is a defense contractor that makes various land, air and sea combat vehicles, systems and technologies. Similar companies you've probably heard of include Lockheed Martin, Northrop Grumman and Raytheon. General Dynamics just happens to be the one that I feel is the best stock in which to invest. We've also seen the US cut back on defense spending as we're no longer trying to police the world, which has forced many other nations to *increase* defense spending now that they must protect themselves. This has been a net positive for most of the defense contractors.

As for other macro-themes, you own companies that will benefit if crazy weather (i.e. a drought or flooding) causes food prices to spike. Conversely, you own assets that will benefit if a deflationary shock hits the global economy and commodity prices fall. You own companies that will benefit if the price of oil spikes higher due to geopolitical tensions in the Middle East. Conversely, you own companies that will benefit if energy prices remain low. Other macro themes in which we've been invested (and earning nice returns!) include the rising demand for healthcare, biotech advancements, automation and robotics, a multi-year boom in the aerospace markets, and the continually changing world from advancements in technology.

Hopefully you can see that our focus isn't what "the market" does during any given period of time. We're building a portfolio that can handle any potential situation (risk) thrown at it, and not only survive but thrive in the long-run. We do this by investing in the best run companies when valuations are attractive, allow those gains to compound over time, and to utilize various means to diversify and hedge specific risks when the odds are stacked against us. There will always be big risks out there; smart investing involves not only an understanding of how to avoid them but also how to flip them around to create an opportunity.

All the best to you in the rest of 2015,

Nicholas R Lumpp

3161 Solomons Island Road, Suite 1 | Edgewater, MD 21037
Phone: 410-956-6003 | Fax: 410-956-6004

**Please note that there may be a company or two mentioned that you didn't or don't currently own. I try to keep everyone's portfolios equivalent, meaning if I find a company that I think is a good investment for the Growth side of portfolios, I want to buy the appropriate amount for everyone's portfolio based on their overall allocation. However, sometimes there are specific tax or cash flow reasons that prevent me making a purchase in your portfolio and you instead own a more tax-efficient company that I feel is a strong equivalent (i.e. I feel that Exxon Mobil and Chevron are pretty comparable equivalents so you might own one or the other).

This material contains the current opinions of the author and such opinions are subject to change without notice. This content is provided as general information only and is not intended to provide investment or other advice. This material is not to be construed as a recommendation or solicitation to buy or sell any security, financial product, or instrument, or to participate in any particular trading strategy. ***Past performance is not a guarantee or a reliable indicator of future results. All investments contain risk and may lose value.*** *RCN Wealth Advisors, Inc. provides investment advice solely to those clients which have engaged in an Investment Advisory contract.*

3161 SOLOMONS ISLAND ROAD, SUITE 1 | EDGEWATER, MD 21037

PHONE: 410-956-6003 | FAX: 410-956-6004