To say the first quarter of 2016 was a bit wild for the markets is an understatement. What a roller coaster!

After watching many of the major indexes move lower around the world by quarter’s end, including the S&P 500 losing approximately 11%, we now see that many of the markets have rebounded substantially from their lows in February. Each quarter during the last two-plus years, I have been warning investors to expect market conditions similar to what we’ve been experiencing — increased volatility and very small to zero growth in the overall markets, portfolios and economy.

The market conditions and its associated volatility witnessed during this first quarter of 2016 is an excellent example of what we often tell clients about investing; “It is time in the markets (or more importantly, time owning the businesses we own) and not timing the markets that provides the greatest opportunity for success.”

As evidenced by data published by various financial and news organizations, many investors once again sold equities during the first quarter and moved to cash or other perceived “safe” investments during the volatility. The result of this perceived flight to safety is that they are now looking at markets and portfolios rebounding to levels that are close to the beginning of the year while they are on the sidelines. That’s what we often say: “Be an investor in great businesses over time.”

cont. next page
Additionally, because we look at most of our investments as long-term investments in great businesses, we believe that volatility is our friend.

It’s the volatility that we experienced this past quarter that creates the opportunity to take advantage of buying new businesses that have gone on sale, or adding to existing positions in companies at lower prices. After all, who doesn’t love a great sale!

With the wild start of the year, it seems we have seen a lot of headlines about a stock market correction or a stock market crash being on the way. Frankly, when I see so much negativity, I generally think that is the best time to consider the contrarian position and be both positive and a buyer.

I want to continue to remind you that you should always be prepared for a sizable correction or stock market crash.

As the past shows us, corrections and crashes come and go. What is important to remember about crashes and corrections is that they do create opportunities to take advantage of both increasing the quality of your portfolio and better positioning your portfolio for the next stage of growth.

I will further discuss what businesses we added in our portfolio during this volatile period, as well as other portfolio allocation management information, in the “Portfolio Structure & Outlook” section of this Update.

Are we going to see the elusive 20% market correction?

I am sure that many of our clients have seen the chart below, as we add this chart every quarter to our Updates. This chart is a great reminder to our clients of the historical frequency of stock market corrections. Of course, as we have reminded our clients over and over again, we have yet to see a 20% correction since the financial crisis… almost 8 years ago.

When will we see a correction of the 20% magnitude? Who knows. But, it is important for us to remember corrections do happen and will continue to happen in the future.

If the volatility associated with your portfolio bothers you, please consult with your advisor on what may be the appropriate allocation for your particular situation and portfolio.
The “New Normal”

According to Investing Daily, a new phrase that has been floating around the investment world is the term, “The New Normal.”

It’s said the phrase was initially used by PIMCO Analysis, Mohamed El-Erian in 2009 to describe the economic landscape consisting of stagflation, high unemployment, and slow growth for the next 3 to 5 years.

In a public letter that attracted global attention, El-Erian used the phrase “The New Normal” as a headline stating among other things, they expected a world of muted growth. As I thought about this “New Normal”, one of the things that came to mind was the idea that investors and their investment expectations were also entering a “New Normal”.

Historically, financial advisors and investors have used “historical average” returns in their financial planning and baseline for investment expectations. However, as we have entered a new world of different monetary and government policy, it is extremely important for investors to be adjusting their expectations as it pertains to expected rate of return on their investment portfolios.

To give you some perspective; when you think historically, and depending on the investment timeframe, many charts and marketing materials have shown the S&P 500 having historical returns averaging between 9% and 10% and U.S. Government bond returns in the 6% range. The important thing investors must consider regarding those returns is that those averages take into consideration money market and government bond interest rates at much higher levels than in the past.

For example, if you consider the money market rates at an average of 4% (which should be close to historical performance based on the numbers today’s investors have seen), the S&P 500 did an average of more like 10%, giving you an estimated difference of 6%. Now take into consideration that money market rates sit around .50%. Using the same delta, you could argue that if the S&P 500 averaged 6.5%, that could be considered equal to the performance of the 10% return and 4% money market rates. Of course, different investment objectives have different “historical” performance relative to the interest rate/investment return spread.

Bottom Line: Investors must consider reducing their expected average returns on a yearly basis for their portfolios based on the idea that interest rates and return on invested capital at those rates are now much lower, and may remain low for an extended period of time.

From our perspective, we believe long-term average rates of returns on portfolios will be muted because of this “New Normal” of lower interest rates and monetary policy. Of course, my hope is that I am wrong and average portfolio returns begin to move to higher levels in the near future. However, when it comes to financial planning and attempting to accomplish your retirement or other financial planning goals, it is always better to be more conservative and exceed your expectations and goals, than to be short of those goals.
Despite the continued chatter in the media about a forthcoming correction and or crash, we prefer our clients focus on the Bottom Line vs. the Headline.

We are not in the business of trying to guess when the next big correction or crash is going to happen. We prefer to monitor the valuations of the companies we own and their competitive position in the marketplace. Of course, even great companies go through good times and bad times – this is why we are always monitoring the companies we own and the companies we are looking to own in the future, if appropriate.

In light of the very poor start for the year, it only seems logical that the media and experts looking for a crash or correction would come out of the wood work, as they did. However, we don’t see any big correction or crash in the short term. We actually continue to believe that assuming “business as usual”, we believe 2016 could end up being a decent year for investments.

Obviously, we have a big election looming and that could certainly play a role in the short-term performance of the markets and businesses owned. However, our indicators show a very low probability of a recession at this point. That could change at any time. If it does, we will address portfolios accordingly.

Listed below are several factors as to why we believe the Bottom Line is far more important than the Headline and a crash or recession is a low probability for now:

1. The Institute for Supply Management reported that its March index of manufacturing activity signaled expansion for the first time in 6 months. The index jumped to 51.8 from its February reading of 49.5, with 50 the dividing line between contraction and expansion.

2. Nonfarm payroll employment in March rose by a reasonably solid 215,000 jobs, putting average monthly gains for the first quarter at 209,000 up from 190,000 for the first quarter of 2015.

3. Average hourly earnings rose by 0.3% despite calendar quirks that might have kept them muted. This kept the year-over-year increase in average hourly earnings at 2.3%.

*Bottom Line:* Although, we don’t know how long the current correction and stock market sentiment will last, one thing we do know: regardless of a correction or crash, quality, well-run businesses will continue to do well over time as they adjust during periods of volatility or contraction in the economy. As always, we will continue to monitor and look for opportunities to buy more of the great companies on sale.
As discussed earlier, volatility was dramatic in the first quarter of 2016. While many sectors were involved in the increased volatility, biotech, banks, oil and commodity stocks seem to have been the areas of the most volatility. This volatility had a more than usual short-term, adverse impact on our portfolios; largely due to the fact that at the start of 2016, two of our three largest holdings were Bank of America and Citi Corp.

Although there were market factors impacting the share price of Bank of America and Citigroup, they were also hit over fears of oil companies having to file bankruptcy or not being able to pay their debt obligations. From our perspective, while this could be true, we feel the correction in the stocks were overblown and these banks still trade at a 25%-35% discount to their tangible book value.

Considering the out-performance we have seen in the last several years in portfolios, I am quite pleased with how our portfolios are holding up in light of the current allocation and news. This is the first quarter in over four years where the performance of the portfolios lagged our internal metrics.

Of course, we don’t manage portfolios for the short-term. However, when we see potential headwinds in companies or sectors we are invested in, it is prudent to monitor the situation and make adjustments if or as needed.

Although we continue to be very bullish on our bank holdings, we have made some adjustments in light of several factors to the percentages held in our bank stocks. The reason for the reduction was to free up cash to take advantage of several other companies we added to portfolios. I will discuss portfolio additions in the “Portfolio Update” section.

Lastly, and maybe most importantly, our Investment Philosophy & Strategy calls for portfolio diversification, not over-diversification (arguably, an inefficient form of investing). However, as Fiduciaries of our client’s assets, we must adhere to appropriate portfolio diversification.

**Bottom Line:** We continue to be extremely proud of our long-term performance of client portfolios. Portfolio theory mandates appropriate diversification, which means allocating assets in international businesses and emerging markets businesses, as well as with owning U.S. businesses. Government policy continues to limit economic growth. Portfolio returns will continue to come in the form of inconsistent, short-term performance. A long-term view will continue to be the best approach to successful investing.
Although I addressed the current status regarding the markets earlier, below are additional points you should consider regarding the current investment climate. While the year has only just started, and trends for 2016 are too difficult to gather at this time, we see that several investment themes continue to be present and continue to keep things exciting! Some of these themes include:

1. Investors continue to pay for “growth”. However, the biotech and healthcare sectors have continued to be very weak. This of course has provided great buying opportunities for a few of the companies we do own.

2. Many of the oil and commodity stocks appear to have bottomed, at least in the short-term. This past quarter finally saw a noticeable rally in the energy and commodity space. Of course, the logical question many are asking is: have we seen a bottom in that sector? Who knows, but, generally speaking, I am not a fan of making long-term investments when there is not a lot of clarity around the sector at the current time. We will continue to monitor the oil sector and invest accordingly.

3. For many years now, investors have paid very expensive prices for investing in “Growth” stocks. Stocks whose valuations, many would argue, are that of the pre-bubble in 1999. This is pretty typical when you have an environment of very low interest rates. Investors look for new and different ways to generate returns and do so by paying up for “growth”. However, this too shall end. At this point, we may finally begin to see “value” outperform “growth” in terms of asset class. However, we own both perceived growth and value stocks in our portfolios and will continue to monitor the businesses and associated valuations.

4. The big surprise for the first quarter of 2016 for many is the rebound that we have finally seen in the Emerging Markets. Both widely followed Emerging Markets ETFs, the VWO and EEM were both up over 6%, far outperforming U.S. and European indexes.

5. As often happens with corrections, investors have a tendency to flock to what is perceived “safer” investments, including utilities, gold and U.S. Government bonds. This was the case with the last quarter, as well as investors continuing to invest emotionally as opposed to fundamentally.

6. The conversation from the experts relating to negative interest rates continues to heat up. This is a situation we as an investment committee are watching very closely. Negative interest rates would not be good for the overall strength of the economy. That said, we will not see any major movement one way or the other until after the election in November. But, it is definitely something we are watching very closely.

7. We believe that the U.S. economy will continue to plug along while Europe and the EM will begin to improve. This should provide for continued growth in the values of the businesses we own over the next several years.

We continue to be in the midst of a very volatile correction that started last summer. While we are still in the midst of that correction, the reality is, it has been quite mild by many standards on a relative basis.
Listed above are portfolio returns of many of the popular ETFs in the market which track indexes as of March 31, 2016.

The purpose of providing this chart each quarter is to give clients a snapshot of what is happening around the world. Please understand that although we provide this document for informational purposes, as a firm, we do not put any emphasis on these indexes. Why? Because they provide NO Clarity in helping investors understand what businesses are owned and the associated risks long-term of owning such businesses!

Despite the extremely poor start to the year, many indexes began rebounding in March.
TAKE A LOOK IN THE MIRROR

- From the Desk of the Vice President of Global Research

With the release of the latest 2016 Dalbar; the 22nd Annual Quantitative Analysis of Investor Behavior (QAIB) we can’t help but think of summarizing this year’s report with the famous anonymous quote; “If you are searching for that one person that will change your life forever, take a look in the mirror.”

As we will explain later, the study is once again an indictment on investor behavior and their subsequent poor results. In this article, we take the Dalbar Study one step further in describing how we believe that not only do investors exhibit poor decision-making, they blame others for it. The quote to the right capsulizes what we would like to say to today’s investor.

Dr. Sigmund Freud in his landmark study of the human mind referred to this highly destructive and addictive behavior of not owning-up to one’s mistakes and blaming them on others as Psychological Projection. Although present in all facets of life, it is pervasive in the lives of investors. And in our estimation, as we believe the data will prove, that instead of a healthy self-examination of their own feckless behavior, investors end up blaming everyone under the sun except for themselves. The host of fall-guys includes, portfolio managers, the Fed, government policy, Wall Street, hedge fund managers and financial advisors. As in any endeavor, there is the good and the bad, the competent and the incompetent and the wise and the foolish – no doubt. Our conviction however, is that the evidence shows investors really are their own worst enemies and are most to blame for poor results and not the aforementioned third party entities.

“If you are searching for that one person that will change your life forever, take a look in the mirror.”

cont. next page
TAKE A LOOK IN THE MIRROR

So how can we make such a claim you may ask?

As we stated before, this year’s QAIB does an excellent job in honing in on not only the problem but the solution to the ongoing investor dilemma. Like most illnesses, the disease is simple to diagnose, while the remedy is harder to implement. The disease or the problem is the acute usage of emotion with which to base investment decisions. The average investor simply gets caught in the moment and buys when prices peak and sells when prices bottom. Although a chronic persistency of this exists, it was very much pronounced in 2015 as Dalbar reports that the S&P exhibited a calendar year total return of +1.38% while the average equity mutual fund investor earned -2.28% a disparity of 366 basis points. Even more than the wide disparity was the manner in which it occurred as the chart below on the right shows.

This chart shows a pattern that reflects the mirror image of one another. A mirror image can best be described as one that is identical in form to another, but with the structure reversed, as in a mirror.

Last year the average investor bought at peaks and sold at troughs.

Above is a link to an animation from http://psych-your-mind.blogspot.com/2012/02/freudian-defense-mechanisms-good-bad.html best describes, in our estimation, the disposition of the current investor.
At the end of the day, it all simply comes down to the four keys to successful investing and whether the investor is seeking clarity that will determine an emotional-based method vs. one that is rational and logical. The Dalbar Study continues to lay a damning indictment on the retail investor who can’t find their way. Our goal as always is to help change that and in a most decisive manner!

- From the Desk of the Vice President of Global Research
PORTFOLIO STRUCTURE AND OUTLOOK

Listed below are changes that took place, in a general manner, in our portfolios during the first quarter, as well as the reasons why those changes were made.

1. We continue to be very happy with the companies we own in client portfolios. However, during periods of volatility, there are usually opportunities to potentially improve portfolios by selling weaker companies in favor of stronger companies. This last quarter was no different.

2. We continued to take profits in companies we want to continue to own as we balance the percentage owned in the businesses to raise cash for new opportunities or income needs.

3. Because we are quite pleased with the companies in the portfolio, it has been very difficult to raise cash for new opportunities during this correction because we really haven’t wanted to sell any of the companies. Therefore, the majority of cash that was raised for new opportunities was done so by lowering the percentage owned in other positions in the portfolio (like BAC and C).

Companies added to portfolios included: AA, LMT, EXPE, PII, NSRGY and VTR. The amount of new positions added this quarter was quite a bit higher than we would normally see. This has to do several factors including, the companies being on sale from the correction and increasing the diversification in terms of sector holdings (Healthcare, REIT, Commodity and Consumer Brands).

Only one position was sold last quarter, BIP. BIP is an outstanding company and one we really did not want to sell. However, we needed cash for new opportunities to remain flexible and address a world where there are thousands of businesses to choose from. We made a corporate decision to sell BIP in an effort to also make the management of assets easier for the clients.

BIP is a Master Limited Partnership. Each tax year MLPs provide a K-1 to investors. We have decided that in light of the difficulty in managing investors’ taxes and having to have K-1s, it’s easier for clients if we did not own MLPs. Therefore, investors will receive a K-1 in 2017 for 2016 taxes, although we will no longer be adding MLPs to portfolios because of the confusion and extra work it involves for investors.

4. In light of the overall valuations of publically traded companies, we continue to be very selective and patient with opportunities we see in the marketplace. Because many companies currently sell for higher valuations than they have in the past, we are happy to be patient and picky.

5. On a relative and absolute basis, the valuations of client portfolios as a whole, do trade at a discount to the overall markets and are well positioned for future growth as we continue to move further away from the financial crisis in 2009.
As many of our clients know, we are very active in the management of client portfolios. This active management includes the continual buying and selling of a small amount of shares in one’s portfolio – we call this “Strategic Cost Averaging” (SCA).

Our SCA process is something we believe is very unique and important to our portfolio management strategy. It allows complete flexibility in the management of your portfolio. This flexibility is extremely important to the long-term success of investing. SCA provides us the ability to be continually investing in great businesses over time while simultaneously providing us flexibility to sell a portion of a business under our “Sell Discipline” (listed below). In fact, we have written a blog piece called, “A Penny For Your Thoughts” to give investors a deeper look at the strategy in this process.

That said, there were several factors in the last quarter that accentuated our SCA. These factors included the extreme market volatility, the number of new companies we wanted to add to portfolios, the fact that we did not want to sell out of our current holdings and that the portfolios are structured using models to provide the percentages we want owned in any given position.

Because of these factors, we did a lot more adjusting of the target percentages for each position in the portfolios. With the addition of six new positions (which is considerably more than we usually see in a quarter) it had us adjusting percentages quite often.

It is extremely important to remember two things: one, our clients pay no trading costs, providing us with complete flexibility in managing the portfolios. Two, as we remind our clients, there is no one position in the portfolio that should make or break the long-term performance. The portfolio’s overall allocation is far more important.

Although there was a lot of adjusting in the past quarter, the bottom line is, it had very little if no impact on the overall performance of the portfolios, yet, it allowed us to add quite a few new positions we wanted our clients to own.

Remember, we have four sell disciplines that we adhere to in our investment process:

1. **Selling a company when the long-term fundamentals are in jeopardy or have changed.**
2. **Selling a part of a position to lock in profits to raise cash for other opportunities or cash needs.**
3. **Selling a weaker company in favor of a stronger, less expensive company.**
4. **Selling positions to take a loss to offset future gains (Tax-Loss Harvesting).**

As we continually say, a portfolio has a lot of moving parts. Due to the way our portfolios are structured, there is not any one position that will make or break a portfolio and its long-term performance. Every position in our portfolios is owned for a specific reason. As we continue to watch the markets and valuations, we continue to look at our current companies and new opportunities that are available.
As I have stated for several years, investing in fixed income investments will not provide the types of returns they have historically. In light of the Federal Reserve finally making a move to normalize interest rates, more than likely we are in the beginning stages of a long-term trend to higher interest rates.

Of course, like any type of investment, higher interest rates will not happen overnight. It will take time. However, like any good investment, we like to look at what we call, “Risk Adjusted Return”. What is Risk Adjusted Return? It is level of risk taken for the associated investment’s return on the investment. Bonds do not warrant the associated risk for the potential associated return.

However, we continue to believe that the only way to own bonds is to have shorter duration bonds (1-5 years at most), and that they should be viewed as investments to help reduce portfolio volatility and not to provide much of any assistance in overall portfolio return. As for our target allocations, particularly in the more “conservative” portfolios, we continue to be extremely selective and patient on what bonds we want to own for our clients.

Therefore, we continue to favor solid dividend producing companies with long standing businesses to continue to provide income opportunities for our clients and continue to hold cash as we look for opportunities that have an appropriate risk vs. the potential reward.

Some exciting news at Neipsis Capital Management

As many of you may know by now, after years of consideration and encouragement, I have started a new radio show, “Investing For Success”. There are many reasons why I finally decided to start the show, including having a platform where our clients could hear thoughts, ideas and other information from their Portfolio Manager in an easy format. Additionally, I continue to be extremely passionate about the ideal of “Investing With Clarity” and the fact that many investors end up not Investing For Success because of the lack of Clarity in their portfolios and strategy. My goal is to have not just our clients, but, investors as a whole, “Invest For Success”!

If you would like to listen to the show or download the podcasts, head to investmentsuccessforyou.com. Also, the show airs 4:00-5:00 pm Monday-Friday on iHeart Radio or you can tune in by looking up 1440 KYCR Minneapolis or you can livestream the show at twincitiesbusinessradio.com. Please be assured that the markets are closed during the show therefore, doing the live show does not inhibit in ANY way our ability to manage our client’s portfolios!

Although the show has only been on for about seven weeks, we are already experiencing great success and are preparing to take the show into more markets nationally! Hope you can catch a show soon.

As Neipsis Capital continues to grow, we appreciate your continued confidence and support. We believe successful investing requires Investing With Clarity™ in your portfolio. We look forward to continually providing you with the Clarity needed to be a successful long-term investor.

Respectfully,

Mark Pearson
President, Founder & CIO
Neipsis Capital Management, Inc.