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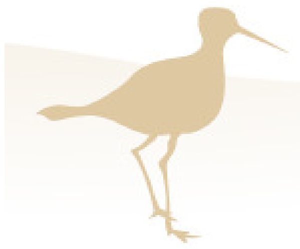
Volume 8, Issue 1

Sandpiper Capital

Gleanings



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Safety First

Given our shrinking allocation to stocks over the last few years, I thought it would be good to review Sandpiper's philosophy regarding risk and its implications to the structure of our client portfolios.

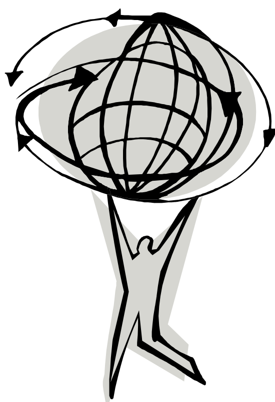
Market Returns Annually and Ten Years Ending 12/31/2015

Index	2013	2014	2015	10 Yrs
S&P 500	32.4	13.7	1.4	**7.3%**
ML 1-5 yr Gov't/Corp	.3	1.5	1.1	**3.3%**
EAFE (Dev Fgn Mkts)	22.8	-4.9	-.8	**3.0%**
Emerging Markets	-2.5	-2.1	-14.8	**3.9%**

We have three reasons why we are averse to risk. The first is the math. It takes an up 50% year to get back to even after you've had a 33% drop. (1.5 x's .666 = 100). Your money can grow faster with a a series of smaller average returns without having to recover from big down years.

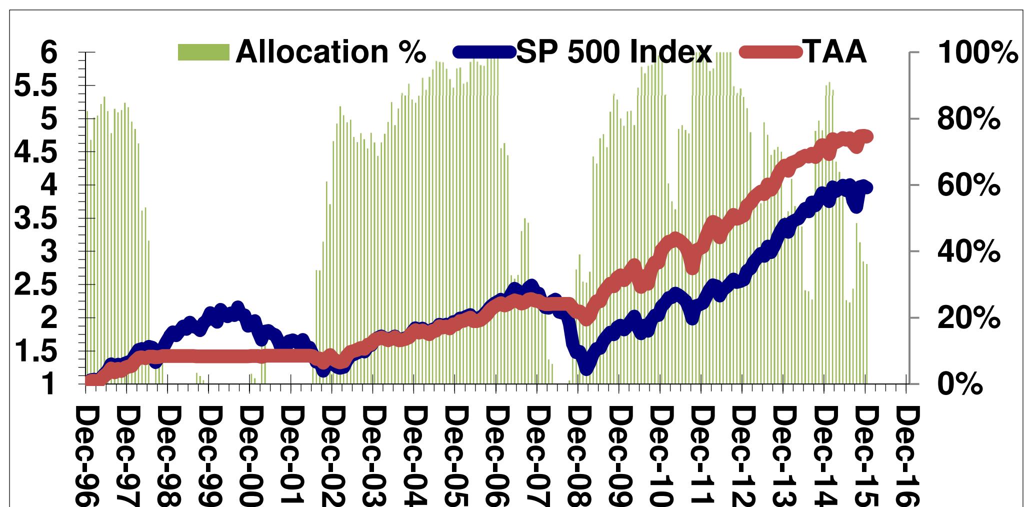
The second reason is our client base. Over the last three decades, (it'll be 35 years in May) our aggressive clients have left and our conservative clients (and their friends whom you have so kindly referred to us) have stayed. You don't want to lose money. You need it for your livelihood. While we would like to harvest some big returns once in a while, we know that rule one is to not lose money.

Finally, I have to admit, I am always a bit worried. About a lot of things. So many things can and do go wrong in the financial markets and I am concerned about them all. Most of my time is spent looking for clues of what risks might be on the horizon and documenting whether they are growing or abating. In our own variation of the Hippocratic Oath, we first want always to do no harm to our clients' portfolios. Our belief is that if you avoid losing money, making it takes care of itself.



"Most of my time is spent looking for clues of what risks might be on the horizon and documenting whether they are growing or abating."

One good example of how that works is shown below in the graph of the history of our allocation model. The green bars drop to as low as 0% stocks in those months when we see too much risk. The red line is that percent in stocks times the S&P's return each month. It goes flat when we are out of the market. Using only published information regarding earnings, inflation and the economy, we seek to avoid the big down years when the measured risk has grown too far. On the reverse, you'll see a chart of the annual results. While often out of the market too early, we believe that clients benefit from missing the big downdrafts that are a consistent feature of financial markets.



Tactical Allocation Model vs. S&P 500

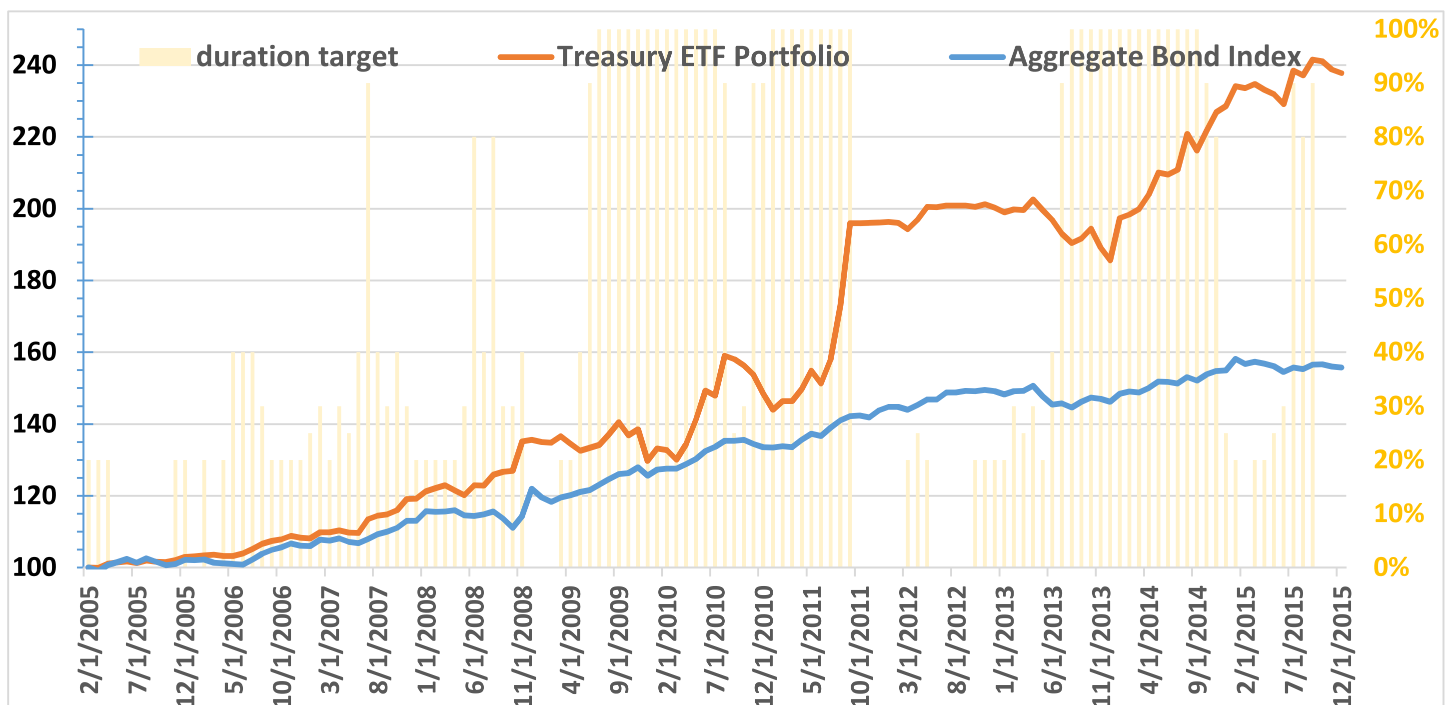
The model allocation results illustrated drive our decision making process for client portfolios. Those non-taxable accounts with mostly exchange traded funds see the biggest shifts as we move to Treasury bonds out of stocks as the circumstances dictate. Fully taxable accounts with individual stocks have less dramatic shifts as we seek to minimize taxes but we will emphasize dividend stocks or avoid reinvesting sales proceeds when risk is high. The performance of the model since we put it in use in 1997 does suggest that taking advantage of the flexibility and low cost of exchange traded funds and applying model allocations in all portfolios does make sense.

	TAA	S&P		TAA	S&P
1997	26%	33%	2006	15%	16%
1998	12%	29%	2007	3%	5%
1999	0%	21%	2008	-7%	-37%
2000	0%	-9%	2009	26%	26%
2001	1%	-12%	2010	14%	15%
2002	-4%	-22%	2012	2%	2%
2003	21%	29%	2013	15%	16%
2004	9%	11%	2014	7%	14%
2005	5%	5%	2015	3%	2%
			Total	8.5%	7.5%

With interest rates on money market accounts so low, we have been working on a solution of the problem of what to do with idle cash. We alluded to the benefits of Treasuries as a complement to stock portfolios last quarter and I wanted to share our progress on that front with you here.

Just as we know that there is an objective and quantifiable fair value for stocks that we can use to judge when they are cheap and when they are expensive, we can apply that same logic to interest rates. Confining ourselves to the Treasury market (because it is such a good complement to stocks), we apply a model that buys long term Treasuries when those rates are above calculated fair value and sells them when they slip below. Bond money not in long Treasuries is in short Treasuries, again using exchange traded funds. We have implemented this model in client portfolios only recently, but we illustrate ten year model performance for a monthly rebalancing below.

Obviously, the returns shown for our stock allocation model (which assumes money not in stocks is held as cash) would be enhanced by a complementary strategy that puts those balances to work. I think Treasury bond funds, if properly managed, would further enhance our tactical allocation model's returns.



Tom Lukic