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QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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A CHALLENGING INVESTMENT BACKDROP

The "FANG" Trade

"My favorite FANG stock for 2016 is Google" was the first sentence in a recent Morgan Stanley Research publication entitled the 2016 Playbook. Most non-Wall Street types would ask the question, "What in the world is a FANG stock?" Well, it was the ubiquitous buzz phrase for 2015 as Facebook, Amazon, Netflix and Google were a small subset of the handful of large growth oriented technology and consumer discretionary stocks that heavily influenced the results of the market weighted S&P 500 Index. What do these four stocks have in common? For starters, fundamentals such as no dividend yield and high price earnings (P/E) ratios, in some cases, astronomically high P/E ratios. Amazon.com, the internet retailer and cloud computing giant has an earnings multiple based upon the prior twelve month earnings of nearly 980 times earnings. A company who had earned 69 cents per share was being valued in excess of $300 billion dollars! After five years of average annualized rates of return of 30% per year, you can understand why it has a cult following on Wall Street. Consensus earnings expectations for 2016 for the company is to earn $5.49 per share, a nearly eight times increase from the recent trailing 12 month results. I must admit I am a frequent user of Amazon, but the four Eveready 6 volt batteries I recently purchased probably did not move the needle too much to meet their inflated 2016 earnings target.

Company	2015% Change	Market Cap (In $ Blns)
Facebook, Inc.	34.15%	$ 296.00
Amazon.com, Inc.	117.78%	$ 317.00
Netflix, Inc.	134.38%	$ 49.00
Alphabet, Inc. (Google, Inc.)	44.56%	$ 521.00

Source: Factset

Market Breadth

On a total rate of return basis, the S&P 500 Index was up 1.38% for the year, but was heavily influenced by the FANG trade and other large capitalization growth stocks that dominated market results. If you made the same calculation applying equal weight to all 504 stocks in the S&P 500, this calculation resulted in a 4.68% loss for the year.[2] What is this telling you? One, on average more stocks were down than up and two, there was great disparity between the performance of the winners and the losers. Practically speaking, absent being a large cap growth manager who fishes in a pond of high growth, high beta (risk) stocks, the common stock market was generally not a very productive environment in 2015.

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1 Source: Morningstar. Large Cap Value – Russell 1000 Value Index, Real Estate Investment Trusts – MSCI US REIT GR Index, US Intermediate Fixed Income – Barclays US Aggregate Bond Index, International Stocks – MSCI EAFE NR USD Index, Small Cap Growth Stocks – Russell 2000 Growth TR Index, Large Cap Value Stocks – Russell 1000 Value TR Index, Small Cap Value Stocks – Russell 2000 Value TR Index, Gold Prices – GSCI Gold Spot, Emerging Market Stocks – MSCI EM NR USD Index, Commodity Index – S&P GSCI TR USD Index

2 Source: Morgan Stanley Wealth Management. Unweighted – Geometric Linked Calculation

Will Williams
President

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Dividend Paying Stocks vs Non-Dividend Payers

According to Factset, in April 2013 a trend began that has grown in its intensity. Dividend paying stocks as a group have significantly underperformed non-dividend payers on a total return basis. *(S&P 500 Index constituents as of 12.31.15 = 422 Dividend Payers, 82 Non Dividend Payers)*

In fact, the negative return spread is the widest it has been since August of 1999. As you might recall, the technology bubble burst in the spring of 2000. Understandably, a significant contributor to this underperformance in 2015 was attributable to the 21% decline in the energy sector, which has been traditionally dominated by dividend paying stocks.

Volatility Trends

If you sense the U.S. equity market has become more volatile since August of this year, your perception is reality. As a gauge of market volatility, you can look at the percentage of intraday price swings from high to low greater than two percent. Through the end of July of this year, only 3.31% of the 151 trading days experienced this level of volatility. Fast forward to year end 2015 and in the months of August through December, that statistic had increased to 19.40% or a 6 fold increase. Research performed by the firm Alliance Bernstein had indicated that 18% is the long-term average dating back to the late 1990s. So despite the fact that we feel that markets have become unusually disruptive, from a historical perspective we have really just stepped back into a normal trading environment.

And despite the fact that DJIA intraday market swings of a couple hundred points are becoming more common, the unusual aspect of 2015 was that 80% of the time this activity was contained in a historically narrow trading range from high to low of roughly 8%.

Experience Matters

As evidenced by the 2015 asset class performance review, gaining positive traction in the financial markets over the past 12 months was challenging. Simply avoiding nasty surprises in some ways defined success as much as anything else. Despite somewhat benign results on the surface, there was no question that as the year progressed a growing anxiety crept into the markets. Headwinds such as the slowing Chinese economy, the strong U.S. dollar, weakening energy prices, growing geopolitical risks and the continued bear market in commodity prices dominated the headlines. And then of course we had the Federal Reserve Board and the ongoing guessing game as to when and by how much they would boost short-term interest rates. All of this rolled up into a market that increasingly became more volatile and contributed to investor uncertainty and lack of conviction. With this as the backdrop, it was an enigma to me that investors viewed as more desirable investments high P/E ratio, no dividend paying stocks that by their nature exhibit higher risk characteristics. Is this simply poor decision making or has the risk paradigm changed? In our view, the sources of risk change, but how one manages it remains constant. We will once again be tested in our convictions.

KEY FIGURES FOR 2016

Limits remain largely unchanged from 2015 as briefly recapped below, however some tax extender provisions passed at year end are certainly worth noting.

Section 112: Permanently extends the ability of individuals at least 70 ½ to exclude from gross income qualified charitable distributions from IRA accounts (not to exceed $100,000 in any tax year).

Section 302: Expands the definition of qualified higher education expenses from 529 accounts to include computer equipment and technology.

Defined Contribution Plans: Limits are all unchanged. The maximum allowable employee contribution remains at $18,000, catch up contributions remain at $6,000 and the annual limit for combined employee and employer contributions remains at $53,000.

IRA Contribution Limits: Contribution limits for 2016 remain at the same level: under age 50 can contribute up to $5,500 (Roth and traditional) and individuals over age 50 can contribute $6,500.

The only change from 2015 to 2016 is that an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between $184,000 and $194,000 (up from $183,000 and $193,000).

The AGI phase out range for taxpayers making contributions to ROTH IRA is $184,000 to $194,000 for married couples filing jointly (up from $183,000 and $193,000). For singles and head of household, the income phase out range is $117,000 to $132,000 (up from $116,000 and $131,000).

Contributions to Health Spending Accounts (HSA): The maximum has increased by $100 for families but remains the same for individuals: $6,750 for family coverage and $3,350 for single coverage. The catch up for age 55+ remains $1,000.

Estate and Gift Tax: The federal estate tax exemption for estates of those who die in 2016 increases to $5.45 million and the gift tax exemption remains at $14,000.

Brian Christensen, CFA
Senior Vice President

AN ENERGY SECTOR UP IN FLAMES

2015 was a tough year, and no place was the pain more evident than in the Energy sector. West Texas Intermediate (WTI) Crude Oil peaked at $106.90 per barrel in June 2014 and closed 2015 at $37.04. The Energy sector of the S&P 500 lost more than 21% in 2015 as investors ran for the exits and speculators piled on with record short positions. On November 27, 2014 the members of the Organization of the Petroleum Exporting Countries (OPEC) elected to maintain their 30 million barrel per day production quota which was originally set in 2011. This decision marked the start of a global price war in the oil markets. OPEC believed that the market was oversupplied, largely blaming non-OPEC countries for the build-up in inventories. OPEC's intent has been to drive oil prices lower and force what they believed to be higher cost producers (U.S. shale oil) out of business. Historically, OPEC, and more specifically Saudi Arabia, has been the world's "swing producer" – that is the producer who is able to quickly ramp up or slow down production to address undesirable prices or supply/demand imbalances. With the announcement to maintain its production quota at 30 million barrels per day, OPEC clearly implied they would no longer be the swing producer for the oil markets forcing the U.S. to take on that role. The successful development of the U.S. shale oil resource drove a 47% increase in U.S. oil production from 2004 to 2014 and OPEC finally responded.

Beyond the obvious increase in the supply of oil, much has been written about the slowing of demand from major industrial nations. Specifically, China has been cast as the primary cause of lower global oil demand but the facts suggest otherwise. From January to November 2015, China's crude oil imports averaged 6.6 million barrels per day, which is 8.6% more than the imports during the same period in 2014, according to data from the Chinese General Administration of Customs. Rising imports indicate that China is working to meet demand from its refineries and build its new strategic petroleum reserve. Demand for gasoline in China, as estimated by Platts China Oil Analytics, is up almost 22% as the Chinese are becoming more active automobile users. Refiners are actively re-stocking oil supplies to meet this growing demand for gasoline. Further, China has been aggressively adding to its strategic petroleum reserve seeking to build a 100-day supply by 2020. As of mid-2015, China held about 29 days of supply in their strategic reserves. A recent Bloomberg survey estimates Chinese oil imports in 2016 will grow by 8% or 7.2 million barrels per day. Virendra Chauhan, an analyst at Consultant Energy Aspects, gave the highest growth estimate in the survey saying Chinese imports should rise by at least 1 million barrels a day in 2016, or about 15%, given that the refiners have to meet their quotas or risk losing their licenses.

Any slowdown in Chinese oil demand will be offset to some degree by India. 2015 will likely be the year India surpasses Japan as the third largest consumer of oil in the world. Like China, gasoline consumption is growing as more automobiles arrive in India. Through the first half of 2015, India had imported 488,000 metric tons of gasoline, compared with just 61,000 metric tons for the same period in 2014. Indian Oil Minister Dharmendra Pradhan has asked the three state-owned refineries to begin planning for capacity additions. The International Energy Agency (IEA) forecasts India's oil demand to double by 2040. Yes, that's a long ways away but the pace of economic growth, industrial expansion and demands of a growing middle class in India and other developing countries will certainly drive increases in near-term demand. Global demand for energy is not going away nor is it slowing.

The *OPEC World Oil Outlook* published in December forecasts world oil demand to grow by 1.25 million barrels per day in 2016 with an average annual increase of 1 million barrels per day to 2020. Road transportation, aviation and petrochemicals account for two-thirds of the demand growth out to 2040. The table below shows OPEC's projections for medium-term and long-term supply and demand under their Reference Case which assumes world GDP grows at a 3.5% annual average in the period 2014–2040.

The OPEC outlook assumes any shortages will be covered by increased production within OPEC countries – presuming they have legitimate excess capacity. The U.S. Energy Information Administration (EIA) estimates OPEC spare capacity will average 2 million barrels per day in 2016. The chart on page 4 provides a historical look at OPEC surplus levels during the past decade.

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2015 OPEC OIL OUTLOOK - GLOBAL SUPPLY & DEMAND FORCASTS

(Millions of Barrels per Day)

SUPPLY - REFERENCE CASE	2015	2020	2025	2030	2035	2040
Non - OPEC	57.4	60.2	61.4	61.3	60.6	59.8
OPEC	31.0	30.6	32.1	34.7	37.9	40.7
Global Supply	88.4	90.8	93.5	96.0	98.5	100.5
DEMAND - REFERENCE CASE						
Global Demand	92.8	97.4	100.9	104.3	107.2	109.7
Surplus/Shortage	- 4.4	- 6.6	- 7.4	- 8.3	- 8.7	- 9.2

Data source: OPEC World Oil Outlook 2015

CONTINUED FROM PAGE 3 : AN ENERGY SECTOR UP IN FLAMES

The long-term supply and demand picture leaves me continuing to believe $40 per barrel oil is a short-lived event. With OPEC forecasting supply deficits averaging 7 million barrels per day by 2025 and their historical average surplus capacity of approximately 2 million barrels per day, the world economy can't allow prices to remain at levels where new investment in exploration and production are unattractive.

Big oil continues to cut its capital expenditure budgets to protect balance sheets and dividend streams. Global oil and gas investments are expected to fall to their lowest levels in six years to $522 billion on the tail of a 22% decline in 2015. This will be the first time since the 1986 oil market downturn that we see two consecutive years of investment reductions. Drilling rig counts are now at levels not seen since September 1999. Companies are improving efficiencies, reducing costs and placing emphasis on their most profitable projects. If past cycles are any indication, the recovery can be sharp and powerful as the market reverses from over-supply to shortage.

An issue that may be more near-term impactful than supply and demand imbalances or the dramatic reductions in exploration budgets, is the fiscal crushing OPEC countries are experiencing. The International Monetary Fund (IMF) warned in October that if oil remains around $50 per barrel, most countries in the Middle East will run out of cash in five years or less. Saudi Arabia, Kuwait, United Arab Emirates, Qatar, Oman and Bahrain amassed a surplus of more than $600 billion when oil prices were going up. However, the IMF projects deficits of $700 billion will develop over the next five years for the same countries if oil prices remain low. Below are the break-even levels required for OPEC countries to operate under balanced budgets.

Oil Price Needed to Balance Budgets

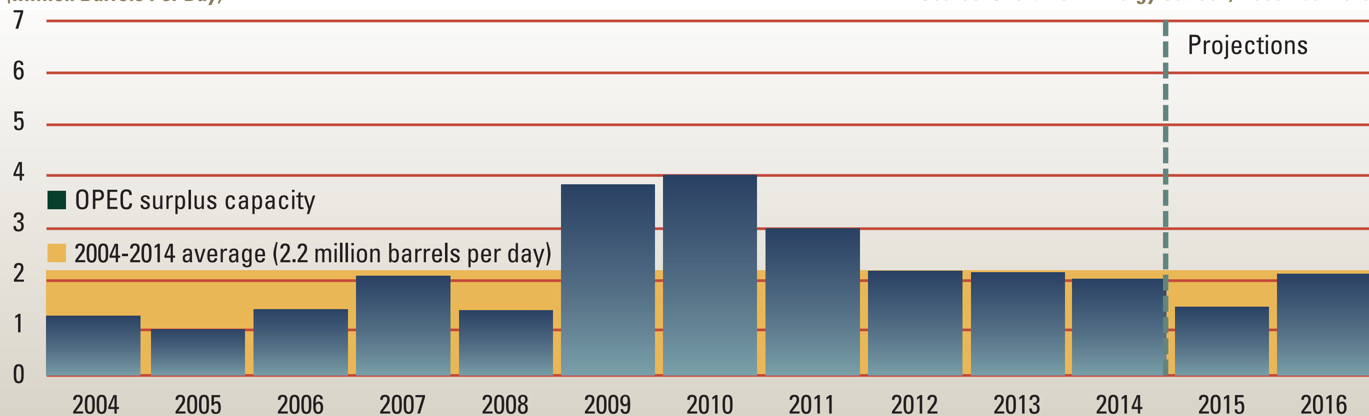
Country	Fiscal Break-Even
Algeria	$ 96.10
Angola	$ 110.00
Bahrain	$ 107.00
Ecuador	$ 120.00
Iran	$ 87.20
Iraq	$ 81.00
Kuwait	$ 49.10
Libya	$ 269.00
Nigeria	$ 122.70
Qatar	$ 55.50
Saudi Arabia	$ 105.60
United Arab Emirates	$ 72.60
Venezuela	$ 117.50

Source: IMF

Strain in Saudi Arabia is already becoming evident as the country posted a record deficit in 2015 of $98 billion. The kingdom's 2016 budget forecast is for a deficit of $87 billion. In efforts to support spending, Saudi Arabia floated a rare bond issuance borrowing over $5 billion in 2015 and expects to borrow an additional $32 billion from capital markets in 2016. Withdrawals in 2015 from its sovereign wealth fund are estimated at $70 billion. Finally, and maybe the most telling, was the country's announcement that it was raising fuel prices to the public by 50%. At home, Alaska is talking about instituting an income tax on residents as oil royalties and energy taxes have dwindled to levels unable to support the state's budget. Who will blink first?

Let's review. Global demand for energy is growing – significantly in developing economies. Global supply of energy is growing but at what appears to be a slower pace than forecasted demand. Current output has been slashed dramatically. Industry investment has collapsed. OPEC countries are getting squeezed fiscally and face growing socio-economic and geo-political problems. It feels like we are nearing the point of maximum pessimism, that point at which Sir John Templeton would follow his contrarian views into the wreckage looking for bargains. Companies holding the best assets with the best technologies that are the best funded should rise from the ashes and thrive.

OPEC SURPLUS CRUDE OIL PRODUCTION CAPACITY



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