WOLF GROUP CAPITAL ADVISORS
GLOBAL WEALTH MANAGEMENT

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"A myth is an image in terms of which we try to make sense of the world." Alan Watts (English Philosopher 1915-1973)

The word "myth" connotes a myriad of meanings. Some consider the term synonymous with fairy tales or something clearly false. Others think myths are based on true historical facts, and as such are worthy of careful consideration and discussion. Yet others regard them as useful allegories – stories that illuminate an important lesson about the human condition or a specific people or culture. Whatever one's view on myths might be, we would note that many myths have even penetrated the complex world of investing. More on that after the review…

Second Quarter Review

Returns were mixed for the quarter. All of the gains for the year in the major stock indices disappeared in the last few trading days of June, leaving many of them flat to only slightly up for the year. Once again, Greece dominated the macro news. Although the actual economic impact of Greece defaulting or leaving the Euro Zone is measurable, many investors acting with an abundance of caution sold shares late in the month, leading to these mixed results. In the quarter, we also witnessed the long-expected correction in the bond market. Investors apparently have concluded that the U.S. economy is sufficiently strong to warrant an increase in the Fed Funds rate sometime this year. Experts continue to debate how fast, how much and for how long interest rates might rise. Interestingly, the indices which did poorly in 2014 (small-cap, emerging markets, international markets, commodities, etc.) have all rebounded nicely so far in 2015. Seeing last year's leaders struggling this year re-enforces the dangers of chasing performance by wanting to own the asset class that shows the best recent performance. The best performing index last year (the S&P 500) is near the bottom of returns so far this year.

Here is what the second quarter looked like by the numbers:

Index	2nd Qtr 2015	Year to Date	Trailing 12 Months
Dow Jones Industrial Average	-0.3%	0.0%	7.2%
S&P 500	0.3%	1.2%	7.4%
NASDAQ	1.8%	5.3%	13.1%
Russell 2000	0.4%	4.8%	6.5%
MSCI EAFE	0.6%	5.5%	-4.2%
MSCI EAFE Small Cap	4.5%	10.4%	-0.5%
MSCI Emerging Markets	-0.2%	1.7%	-7.5%
Barclays Aggregate Bond	-1.7%	-0.1%	1.9%
Barclays Municipal Bond	-0.9%	0.1%	3.0%
Dow Jones Commodities	4.8%	-1.5%	-23.6%

Mythology

Mythology – a set of stories, traditions, or beliefs associated with a particular group or the history of an event, arising naturally or deliberately fostered (Source: Dictionary.com). One theory suggests that myths arise from actual events. Through repeated telling and elaboration of over the years, historical accounts can turn into myths. Myths serve many functions. One is to establish models for behavior. Many ancient peoples performed certain rituals to please or appease the gods who otherwise would inflict various calamities on the people. They also used myths to explain or simplify observation of natural phenomenon – the changing seasons, the phases of the moon, the light of the sun, the weather in all its diversity, and so forth. Myths also validated and maintained certain sets of rights and wrongs within a society. Myths could also explain, in a simple form, complex phenomena that otherwise would be mysteries. Correct or incorrect, myths have over the years helped (and sometimes hurt) people trying to make sense out of the confusing world in which we live.

Myth Busters

For years, the Discovery Channel has broadcasted a science entertainment program called "MythBusters," which features two special effects gurus (Adam Savage and Jamie Hyneman) who use science, technology and their own special skill sets to debunk (or confirm in some cases) a wide range of urban legends. By using a version of the scientific method, they try to "replicate the circumstances, then duplicate the results" often using traditional measuring devices to quantify and analyze the data.

"Analyze the data" may be the best takeaway from the show. Much of what we hear and see in the media represents opinions and interpretations of the data presented in a format to influence our opinions. Often we will hear an "expert" on some matter present a very compelling argument with tons of data in colorful graphics "proving" his or her point of view. Opinions are artfully presented as facts. In the age of the Internet, one can easily find the original data for nearly everything, and can with a little work debunk, confirm or at least provide additional color to the perspectives presented in the media.

A simple example will illustrate this point. On July 2nd of this year, the U.S. Department of Labor released its monthly employment report. Of all the data in this report, most commentators focus on the number of jobs created and the unemployment rate. In the latest report 223k jobs were created, in line with both expectations and the recent trend in employment growth. No controversy here.

On the other hand, the unemployment rate fell more than expected to 5.3%, the lowest level in years. Taken at face value, this looks like unequivocally good news. It would be easy and reasonable for a commentator to use this data point to support the opinion that the U.S. employment situation is in great shape. Yet, looking down further at the details of this report, we see that the labor participation rate (the number of able-bodied workers with jobs or looking for jobs) also fell 20 basis points to 62.3%. One could use this number to point out that the unemployment rate fell in part due to some people ceasing to look for work, which then removes them from the denominator used to calculate the unemployment rate. The point here is not which view is "correct" but rather how looking at the fundamental data helps one formulate an opinion independent of the sometimes biased experts.

Investing Myths Worth Busting

Like the myths created by other cultures in former times, the myths of Wall Street contain some kernels of truth. They are not wildly bold fabrications spun from whole cloth, yet believing in them, or more importantly, acting on them may lead to inferior returns. What follows is our attempt to bust some of these widely believed myths.

1) **The market is a "zero-sum game."** This myth arises from the notion that every time someone sells a stock, someone else (presumably as smart as the seller) buys it. Someone must be wrong, right? However, because a stock is a share of ownership in a company, shareholders make money as that company grows in value over time. Although some investors try to make money by just trading stocks, the best investors grow their wealth by owning shares of companies that become more valuable because of growth in earnings. Over time, stocks have always provided positive returns for investors.
2) **The U.S. economy drives the U.S. stock market**. As intuitive as this may seem, it is wrong. First, about half of S&P 500 earnings come from outside the U.S. Second, the correlation between the market and GDP is not high. Granted, being able to predict recessions might help one to trade stocks better, but predicting or reacting to year-to-year or quarter-to-quarter GDP trends is mostly useless. Many studies have shown that perfect knowledge of future GDP figures (if that were possible) six months to three years in advance would yield no benefit to a stock investor. One study concluded that GDP explains no more than 1/5 of the movement in stock prices.
3) **The Federal Reserve controls the markets.** The statutory goals of the Fed are

"maximum employment, stable prices and moderate long-term interest rates." "Prices" here refers to inflation, not the prices of stocks. True, interest rates can affect the valuation of stocks, but here too the impact is less than this myth purports. Many studies show that the main driver of the current bull market is actually earnings growth and not simply the Fed's easy money policy. Creating bubbles in the stock market is not one of the Fed's policy goals, and those who suggest such are probably trying to market gold as an investment.

4) **Risk is bad.** What is risk? To most people risk is the fear of losing money. Yet, risking loss is the only way an investor can realize a gain (recall the risk/return dynamic learned back in Econ 101). In a recent essay, Howard Marks identifies 24 different types of risks to investing. "Risk of permanent loss" seems to be the one most people really care about, but that only happens when one sells a losing position. The paper losses incurred during the Great Recession in 2008 and 2009 were recouped in subsequent years by investors who did not sell. Those who sold realized their worst fears and suffered permanent loss. If one wants to invest, one must accept the risk inherent in the exercise in order to reap its benefits. Contrary to the myth, risk is good. It is actually very, very good and ultimately generates all investment returns.
5) **There is a "secret formula" for making money on Wall Street.** Every year someone comes along with a new approach to investing that is, according to its promoters, foolproof and/or superior to all other approaches. Lately, technology seems to be the key driver of such ideas – new "algorithms" emerge that can "guarantee" superior returns. The sad truth is that no gimmick, no black box or easy approach can always work. Many of these formulas show success in back testing and may work for a while, but ultimately always fade into obscurity. Arbitrage theory suggests that any method of investing that is widely known and repeatable will eventually erase all monopolist gains earned by this method. In our view, the secret to investing is to find an approach that works for you and stick to it. This will lead to better long-term results than constantly trying to find something new and improved.

If Not Myths, What?

Wouldn't it be great if the capital markets were simple enough to respond to the factors incorporated in these myths? That all we need to do to earn attractive returns in the markets is follow the Fed, predict GDP growth, find that one mystic algorithm or trade the TED spread.

No, the art and science of investing actually takes a lot of hard work to do well. Complex systems confuse people. We want that "one key factor" to measure, understand and use. We want simple answers. The simple answer, in our view, is that there is no simple answer. We have concluded that only a handful of factors account for most of the markets movement – earnings, interest rates, sentiment and changes in these three factors. Growth in earnings helps stock prices rise. Interest rates help determine the market's valuation – lower rates allow stocks to trade at higher multiples. Sentiment is largely a contra-indictor. Extremes in sentiment often signal market inflection points – euphoria a market peak and despair the market's nadir. Right now, we see earnings growing, interest rates potentially rising a bit and sentiment mixed. Absent a recession, that is a recipe for continued higher stock prices.

The Outlook

As of this writing, investors seem most concerned about Greece and any domino effects a Greek default or exit from the Euro might have on the global economy and its markets. The good news is that Greece's main creditors are the European Central Bank and the International Monetary Fund, which really are lenders of last resort for the nation. Whether these concerns cause a correction in global stock markets is yet to be seen, but most experts believe that the true economic impact is likely to be small, and thus any stock market weakness due to these worries, could be a buying opportunity.

Apart from Greece, the Eurozone is doing much better than it did last year. After a weak first quarter, the U.S. economy is also showing more strength. China's economy is once again looking to slow, but the volatility in its stock market is capturing the big headlines. Here too, the long-term impact on the U.S. markets is likely to be minimal. Chatter that the U.S. stock market is overvalued or in a bubble represents potential good news. We think that the time to worry is when investors think there is no bubble and that historically high valuations are reasonable, not when there are concerns about these things. By the way, the forward P/E ratio for the S&P 500 now is around 16x – which is the average over the last 25 years.

One key event for the balance of the year could be the Federal Reserve's move to raise the Fed Funds rate. Consensus expectations call for the Federal Reserve to begin raising interest rates as soon as September. We think that the Fed's decision will be driven by the data and not the calendar. Moving to a less accommodative (but still "easy" by any measure) policy should signal that the U.S. economy has strengthened – a good thing for stock prices. Before the worries about Greece hit the markets, bonds were beginning to price in a Fed Funds increase. Bonds continue to be an investor's best friend in time of worry and crisis. We continue to think that holding bonds for some investors makes good sense in that they can lower overall portfolio volatility. We continue to think that cash (beyond some reasonable "rainy day" reserve) is the worst asset for investors to hold.

Sincerely,

Wolf Group Capital Advisors