January, 2016

2015 – Year in Review

It was a flat year for many of the major equity indices in 2015. That fact belies a volatile period, where many asset classes fared poorly. Several factors contributed to this struggle.

In China, the movement towards a consumer based economy led to unexpected outcomes. The past decade of infrastructure investment has resulted in massive overcapacity in many industries. With slowing internal demand for this production, Chinese companies looked to the export markets to absorb the excess. As a result, prices for many industrial commodities fell precipitously, including copper (30%), iron ore (40%), and nickel (45%). In addition to hurting producers of commodities, this shift also impacted multinational industrial companies who had counted on China to provide growth. Suddenly, this growth market was no longer expanding. Since late summer the Chinese manufacturing PMI has been below 50, suggesting the manufacturing sector is contracting.

The Federal Reserve's continued discussion/action on interest rates was another source of volatility. Several times the market seemed sure rates would rise, only to have the timing pushed out due to geopolitical or global economic concerns. The belief the Fed would eventually raise rates (they finally did so in December), led to a strengthening US dollar. This helped consumers as their dollars were able to purchase more goods, but hurt multinational firms as falling international sales translated into lower profits.

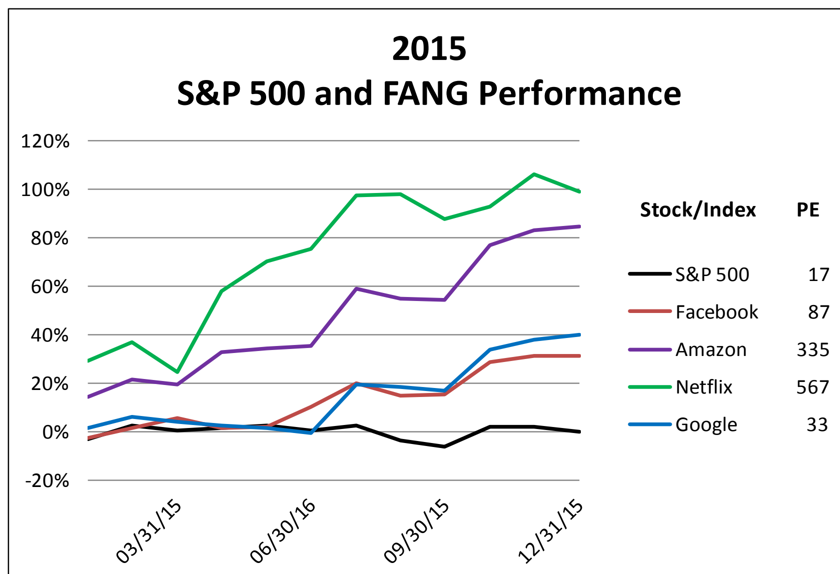
The combination of a weaker China and a strengthening US dollar served as an incremental headwind to other commodities, such as oil. Crude was already under pressure as a result of Saudi Arabia's commitment to maintain market share, regardless of price. Both oil and natural gas prices declined around 45% in 2015, on the backs of large declines in 2014. This significantly impacted energy producers and caused pain for many industrial companies that supply the oil patch.

Though the fears around China and uncertainty over the Fed increasing rates remain present, there are economic bright spots. The US continues to grow, albeit at a +/-2% rate, we have an improving labor market, and a few of the concerns, at least as it relates to energy prices and a strong dollar, actually aid the consumer. Longer term, we also remain optimistic about China and the emerging economies.

All of the above led to a roller coaster year for US equities. The impact can be seen in the dispersion in performance among various indices and investment styles. The S&P 500 was nearly flat for the year, the Russell 2000 Value Index was down 7.5% and the Nasdaq, home to this year's "fab four", was up 7.11%.

While much of the equity market struggled, a small (and shrinking) group of very expensive stocks helped mask broader weakness. Consider this excerpt from a note authored by Liz Ann Sonders, Chief Market Strategist at Charles Schwab, "**FANG stocks ruled.** The "fab four" stocks nicknamed FANG—for Facebook, Amazon, Netflix and Google (now called Alphabet)—

were up over 60% on a cap-weighted basis. Excluding those four stocks, the S&P 500 was down 4.8% last year." The NASDAQ was also helped enormously from FANG. Without their gains, the average NASDAQ stock had a negative 4% return. Value investors, by definition, DO NOT participate in the type of feeding frenzy that leads to the hyperbolic PE valuations illustrated below.



A reason for optimism is derived from our 'out of favor' investment style. Value investing has underperformed growth for the past five plus years; this was magnified in 2014 and 2015. We have seen this in the past and know that the cycle will change. Valuations will again matter and our style will return to favor. Over long periods of time KLCM's value investing has bested growth (and the markets). We cannot predict the timing of the turn, but do know it is on the horizon. There will be twists and turns along the way, and there is the potential for a market correction/bear market. Irrespective of that, the cycle will change, and our prudence and perseverance will be rewarded.

We understand the current playing field; a sluggish (albeit growing) US economy, China and many other parts of the world struggling, and momentum driven markets that reward whatever is working and pay limited heed to valuation. We also see and feel the increased market volatility across many asset classes, especially the commodity complex. As long term investors, we have patiently bided our time, accumulated cash and are ready to pursue opportunities as the market evolves. We are confident that we will get the chance to deploy capital at attractive levels, and achieve superior returns.

Thank you for your confidence and we wish all a Happy New Year!