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Resolute Connections

Greetings from the Resolute Financial team, we hope your 2017 is off to a great start. In this newsletter we review the past year from a market perspective in *A Look Back at 2016* courtesy of our guest writer Weston Wellington of Dimension Fund Advisors. Who would have thought we would end the year up 12%, as measured by the S&P500, when at this time last year the market was down 8% and prognosticators were predicting a more dire market plummet? Mr. Weston takes a critical look at what the market pundits were saying early in the year and how those predictions turned out, it is not a pretty picture from a pundit perspective.

Investments to Avoid reviews MorningStar's list of the worst new investment ideas to come out of Wall Street in 2016. It is amusing and sad at the same time to consider what is foisted on the public by some investment managers. *No Leverage = Higher Costs* discusses the high cost of prescription drugs in the US while *The Disruptors and the Disrupted* touches on the types of industries open to being turned upside down by online platforms.

If you have any questions about anything we have covered in the articles below, or a specific situation please feel free to give us a call, or visit our website, www.ResoluteFinancial.com.

A Look Back at 2016

Weston Wellington, Vice President - Dimensional Fund Advisors

Every year brings its share of surprises. But how many of us could have imagined that 2016 would see the Chicago Cubs win the World Series, Bob Dylan receive the Nobel Prize in Literature, Donald Trump elected president,

and the Dow Jones Industrial Average close out the year a whisker away from 20,000? The answer is very few—a lesson that investors would be wise to remember.

At year-end 2015, financial optimists seemed in short supply. Not one of the nine investment strategists participating in the January 2016 Barron's Roundtable expected an above-average year for stocks. Six expected US market returns to be flat or negative, while the remaining three predicted returns in single digits at best. Prospects for global markets appeared no better, according to this group, and two panelists were sufficiently gloomy to recommend shorting exchange-traded emerging markets index funds.[1] Results in early January 2016 appeared to confirm the pessimists' viewpoint as markets fell sharply around the world; the S&P 500 Index fell 8% over the first 10 trading sessions alone. The 8.25% loss for the Dow Jones Industrial Average over this period was the biggest such drop throughout the 120-year history of that index.[2] For fans of the so-called January Indicator, the outlook was grim.

Then things seemingly got worse. Oil prices fell sharply. Worries about an economic debacle in China re-entered the news cycle. Stock markets in France, Japan, and the UK registered losses of more than 20% from their previous peaks, one customary measure of a bear market.[3] Plunging share prices for leading banks had many observers worried that another financial crisis was brewing. As US stock prices fell for a fifth consecutive day on February 11, shares of the five largest US banks slumped nearly 5%, down 23% for 2016.

The Wall Street Journal reported the following day that "bank stocks led an intensifying rout in financial markets."[4] A USA Today journalist observed that "The persistent pounding global stock markets are taking seems to be taking on a more sinister tone and more dangerous phase, with emotions and fear taking on a bigger role in the rout, investors questioning the ability of the world's central bankers to calm the market's frayed nerves, and a volatile environment in which selling begets more selling."[5]

February 11 marked the low for the year for the US stock market. While prices eventually recovered, as late as June 28 the S&P 500 was still showing a loss for the year. Meanwhile, a number of well-regarded professional investors argued that the next downturn was fast approaching. One prominent activist in May predicted a "day of reckoning" for the US stock market, while another reportedly urged his fellow hedge fund managers at a conference to "get out of the stock market." A third disclosed in August a doubling of his bearish bet on the S&P 500.[6]

Throughout the year, some observers fretted over the pace of the economic recovery. The New York Times reported in July that "Weighed down by anemic business spending, overstocked factories and warehouses, and a surprisingly weak housing sector, the American economy barely improved this spring after its usual winter doldrums."[7]

Despite all of this noise, the S&P 500 returned 11.9% for the year and international stocks[8] returned 4.4% for US dollar investors (6.9% in local currency[9]), helping to illustrate just how difficult it is to outguess market prices. Once again, a simple strategy of embracing sensible asset allocation and broad diversification was likely less frustrating than fretting over portfolio changes in response to news events.

Investments to Avoid

Every year, the Morningstar mutual fund tracking organization releases a list of the worst new ETF investments—and generally, these tend to be trendy new offerings that are designed to catch the eye of investors who are responding to yesterday's headlines rather than their long-term economic future.

This year's top nomination is something called the VelocityShares Leveraged Crude Oil ETN, closely followed by the VelocityShares 3x Inverse Crude Oil Fund.

What do you get when you invest in these shares? Every day, the VelocityShares products give you three times the daily movements of the price of oil on the global markets. The first fund gives you three times the amount that the price changes in the same direction, while the second gives you three times the movement in the opposite direction.

Set aside the fact that there is no conceivable reason why you would want daily exposure to an investment as volatile as crude oil. For the moment, ignore the fact that the typical portfolio already has plenty of oil exposure, since energy companies are among the largest of the large caps, and just about every U.S. and global organization uses energy as one of its major expense items.

The bigger problem with these shares is that the more volatile an investment is, the lower its long-term performance will tend to be in dollar terms. When a stock or ETF goes down 50% and then back up 50%--and this could happen in a week with these shares—the round trip delivers you a 25% loss. Lather, rinse and repeat, and you're looking at an underperforming asset—at three times the normal velocity.

What else did Morningstar single out? You might also consider avoiding the Whisky & Spirits ETF. Not only is this portfolio concentrated on a small component of a much larger business sector, it is even highly-concentrated within the small realm of alcoholic beverages. A single stock accounts for 23% of the portfolio, and its top 10 holdings comprise 79% of the total dollars invested. And for this absurd lack of diversification, you pay 75 basis points a year—as much as you might pay for a diversified international fund. Why not just buy your own distillery instead?[10]

No Leverage = Higher Costs

We hear all the time that medical costs are too high in the U.S., and that Medicare is going to go bankrupt in the future. The President-Elect recently told us in a press conference that drug companies are "getting away with

murder." So how high are drug prices, and are those prices contributing at all to the high medical costs in the U.S.?

A Public Citizen research report looked at the prices that older citizens pay for their medications under the Medicare Part D plan, the largest federal drug program, which now covers more than 39 million people. You might be surprised to know that when the plan was passed by Congress under the Bush Administration, Medicare was specifically not allowed to "interfere" with the negotiations between drug manufacturers and pharmacies. The program was prohibited from leveraging its purchasing power to create economies of scale. And that would have been plenty of scale; currently, Medicare recipients account for 28% of all medical drug purchases in the U.S. marketplace.

But surely the marketplace itself would have resulted in reasonable drug costs. Right? The researchers compared the total expenditure per capita on pharmaceuticals across 33 large nations around the world, and found that not only did the U.S. spend the most—just over $1,000 a year per U.S. consumer, but the U.S. was a huge outlier over the rest of the world. Canada, whose socialized medical system is widely derided in political debates, came in second, at $750 per capita, and Belgium, Japan, Germany, Ireland, France and Greece are all near or above $600. At the other end of the scale, countries like Chile ($200), Israel ($300) and Denmark ($300) have managed to control drug costs without sabotaging the quality of their citizens' health care.

A separate analysis in the same paper found that Americans pay much higher prices for patented drugs than any country in the world—by a nearly 2:1 ratio. In fact, Medicare Part D pays nearly twice as much for the same medications as the Veterans Health Administration (VHA), due to the VHA's ability to negotiate prices with its own purchasing power.

The Disruptors and the Disrupted

You know that online technologies are turning whole industries upside down. Think Uber vs. the taxi industry, or Airbnb vs. hotels. But has anybody

assembled a comprehensive look at the new platforms and what are threatened by platform technologies?

A recent article in the Harvard Business Review concludes that the companies susceptible to disruption by online platforms are not manufacturing enterprises like General Motors or Coca Cola. They tend to be matchmaker businesses that connect different groups of customers.

The article lists online platforms that are threatening traditional businesses. Oddly enough, the list doesn't mention how Apple's iTunes platform has basically eliminated the music/CD industry, but it does say that Alphabet (Google), Yahoo! and Facebook, with their ad-supported search capabilities, are disrupting advertising supported media like magazines. Amazon, meanwhile, is disrupting shopping malls and department stores. Uber threatens the taxi and limousine companies, while Snapchat threatens traditional communications.

The conclusion? Any business whose value comes from serving as an intermediary between manufacturers or service providers and customers has a target on its back.

Sources

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2. www.djaverages.com, accessed January 6, 2017.
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6. Dan McCrum and Nicole Bullock, "Growling Bears Provide Soundtrack for Investors," Financial Times, May 21, 2016.
7. Nelson D. Schwartz, "US Economy Stays Stuck in Low Gear," New York Times, July 29, 2016.
8. Source: MSCI. International stocks represented by the MSCI All Country World ex US IMI (net div.).
9. Local currency return calculation represents the price appreciation or depreciation of index constituents and does not account for the performance of currencies relative to a base currency such as the US Dollar. Local currency return is theoretical and cannot be replicated in the real world.
10. Bob Veres Inside Information.

For more information on these topics or for a free consultation, contact Resolute Financial, LLC at (978) 463-8771 ext. 1003.

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