INVESTMENT COMMENTARY: Q3 2015

October | 2015

Third Quarter Returns

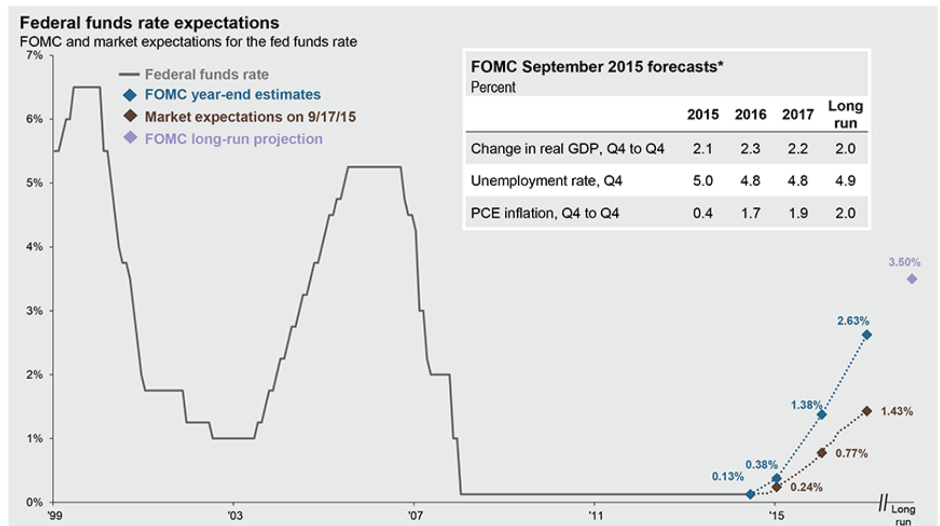
US stocks dropped approximately -7% in the third quarter of 2015. The drop in US equities was quite large, but paled in comparison to the -17% decline in emerging markets, including a -27% plunge in China. Volatility rose dramatically during the quarter and during one week in August, all semblance of a liquid and fair market were forgotten in the equity markets.

Credit default swaps rose dramatically as worries over certain bond issuances intensified. Commodity-based securities and economies were among the biggest losers as news out of China suggested that the world's largest consumer of commodities was slowing.

Headwinds for Global Growth

When the Fed (and other central banks) added liquidity to the system, publicly and privately taking action to support and stabilize asset prices, investors were content to simply buy growth assets, often using leverage to own more and more equities. Volatility became historically low as stock price movements became extremely narrow, grinding higher with central bank activity as a tailwind.

As 2015 has unfolded, the probability of an interest rate hike has risen. By many accounts the US economy should be able to withstand small rate hikes that begin a move back toward "normal" conditions. Interest rates have been held far below normal levels for years. These low rates have spurred borrowing, reduced interest costs and provided cheap money to nearly every market participant.



	2015	2016	2017	Long run
Change in real GDP, Q4 to Q4	2.1	2.3	2.2	2.0
Unemployment rate, Q4	5.0	4.8	4.8	4.9
PCE inflation, Q4 to Q4	0.4	1.7	1.9	2.0

Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the September 2015 FOMC meeting. *Forecasts of 17 Federal Open Market Committee (FOMC) participants, midpoints of central tendency except for federal funds rate, which is a median estimate.
Guide to the Markets – U.S. Data are as of September 30, 2015.

In the third quarter, concerns rose that the combination of a Federal Reserve rate hike in the US and an economic slowdown in China could cause a broader global slowdown. Equity investments around the world declined on the news. At times the declines were violent, and investors were reminded that equities can be extremely volatile.

Leveraged businesses and commodity sensitive ventures began to show signs of stress. And while the US economy appears to be chugging away, a concern over a strong US dollar has added to interest rate concerns. Rising interest rates and a strong currency combine to create downward pressure on earnings and price multiples. More than half of the aggregate sales of large US-based companies occur overseas. A strong dollar translates into lower revenues. Rising interest rates have historically coincided with lower price-to-earnings (P/E) multiples and higher borrowing costs. Naturally, lower revenues and higher costs lead to lower earnings. Apply a lower P/E multiple and a stock or index can suddenly appear quite expensive.

For example, let's assume that analyst earnings predictions for S&P 500 at the beginning of the year was $120 and that low rates could justify a P/E multiple of 18. The stock market which started the year around 2100 could be viewed as "fairly valued." However, following a significant rally in the US dollar, a slowdown in China and worries about rising interest rates, the same analysts reduce expected earnings to $108 and apply a more moderate multiple of 15, which would equate to a price level of 1620 and a stock market decline of more than 20%.

That may sound like an extreme swing, but the stock market has had one of the longest uninterrupted rallies in history. Elevated market multiple levels are logical during a time when the central bank actively supported markets, reducing rates and borrowing costs and expanding their balance sheet.

One methodology, the cyclically-adjusted P/E (CAPE), seeks to reduce the noise caused by short term swings of both price and earnings (in this case, abnormally low interest rate policy). It seeks to find the sustainable and long term growth trend of the US economy and applies the average long term P/E multiple of the asset class. By the CAPE measurement, the "median" fair value of the S&P 500 is around 1550, or roughly 20% below the closing level on September 30.

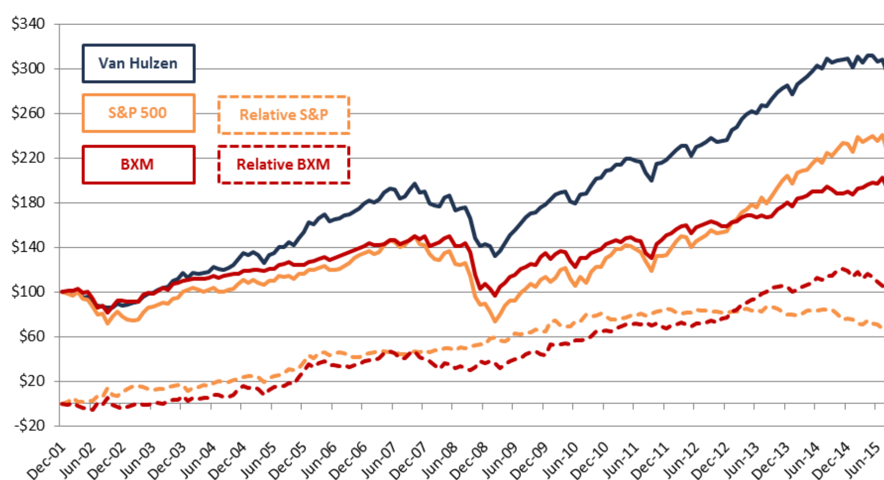
This is not to say that we are predicting a precipitous decline from current levels. We do, however, recognize that the recent market weakness is justified given the headwinds facing the global economy and that a business cycle has both growth and contraction periods. We expect that businesses will adjust to the new economic climate and work to increase shareholder value over time.

Covered Call Strategy in Review and Outlook

The defensive nature of covered calls became very visible in Q3. The S&P 500 index went down 6.4% for the quarter while the strategy was down 3.2% (gross). The BXM was down 2.4%. Volatility, as measured by the VIX Index, spiked as the market corrected in mid-August. It reached as high as over 50 a level last seen in 2011. We took this opportunity to roll to higher implied volatility calls on our holdings.

The above mentioned are realities as we enter the fourth quarter. The market is not necessarily cheap (Shiller's adjusted S&P P/E (CAPE) is at 25 or at the 3rd highest level in history), China is slowing, and US earnings are likely to come under pressure from the strong US dollar and possibly from rising rates. We may see further selling from leveraged speculators. But in the end we believe, an investor with a long range plan and a diversified portfolio of quality assets can, with the help of good advice, stay the course, ignore the actions of others and ultimately succeed in achieving investment goals.

Covered Call Strategy Performance (gross as of 09/30/2015)



Returns (annualized)*	Sep 2015	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	0.3%	-3.2%	-2.8%	-3.9%	-3.0%	7.6%	8.7%	8.7%	7.4%	8.2%
Van Hulzen (Net)	0.3%	-3.6%	-3.4%	-4.8%	-4.2%	6.2%	7.3%	7.3%	6.3%	7.1%
BXM	-0.2%	-2.4%	-0.5%	1.2%	0.4%	5.7%	7.3%	5.1%	4.2%	4.9%
Difference (VAM-BXM)	0.5%	-0.9%	-2.3%	-5.1%	-3.3%	2.0%	1.4%	3.6%	3.2%	3.4%
S&P 500	-2.5%	-6.4%	-6.2%	-5.3%	-0.6%	12.4%	13.3%	9.8%	6.8%	5.9%

Our covered call approach is to find believed undervalued high quality stocks and sell call options to get a good total return on the position. We believe that equity markets will continue to be more volatile than over the past few years. As covered call investors we welcome back this higher volatility since it makes the total return performance less dependent on price appreciation only due to the higher income received on the options.

It is not easy to buy low, or to sell high. Emotions can get in the way. But if we have the proper allocations and right level of cash and liquidity, as covered call investors we can use market volatility to our advantage.

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