What we do in the Shadows

Pine Haven Investment Counsel, Inc. – Commentary –1st Quarter 2016
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This was the title of a New Zealand mockumentary released in the US last year and our inspiration for this quarter's commentary. The movie is about centuries old vampires who are living in modern times. They befriend Stu, a mortal computer programmer, and respect his expertise and mortality and work to keep him safe from other vampires and werewolves. In the end, Stu becomes a werewolf but is able to broker a peace between the warring factions of vampires and werewolves. The absurdity of our election season and the illogical vacillating market has reminded us of this silly movie. Even through this we maintain our optimism for resolution and reason.

You've heard plenty from us over the years that markets do not like uncertainty. With our predictable election cycle, usually the disruption is minimal, but this year feels different. The current political season has been contributing to the market volatility and with unusual claims, polling numbers and promises, the wackiness and disruption looks like it will be with us through November.

Other areas of uncertainty and volatility are continuing with many of the same culprits as last quarter: the health of the global economy, in particular, China; the effect of rising or falling oil prices; and the effectiveness and/or implementation of monetary policy and intervention around the world. In our fast-paced media driven world, information can skew, inflame or dampen depending upon the source and veracity.

Because of the intensity and volatility of the market, especially this past quarter, we've been searching in the shadows for explanations beyond inflamed emotions and fear. Much like vampires, some elements of our work at Pine Haven is not readily visible. One is researching our investments and macro trends. The past few months have found us reading more, attending seminars and conferences and hearing from various fund representatives. We wanted to be sure we weren't missing anything beyond ghost stories.

Recently, we've seen an increased fear over defaults. Since the financial crisis, many institutions pulled back on lending to increase capital reserves and repair the quality of their loan portfolios. Collectively, there is a "healthy" distrust in our financial institutions and their toxicity. Throughout the crisis, though, and continuing through today, default rates remain below historical norms. Corporate balance sheets still appear healthy with significant cash reserves – much greater than when we entered the 2008 crisis.

A major sector of concern is in the US oil industry, which contributes only about 2.5% to our gross domestic product (GDP). With the higher oil prices of a couple of years ago, oil companies had grown quickly and much of their financials were based on oil prices higher than where they currently sit. The drop in the price of oil is causing financial strain in oil producing parts of our country yet the industry sector alone doesn't contribute significantly to our gross domestic product (GDP). Some of the bond funds we invest on your behalf had significant allocations to high yield debt and the market punished these funds during the end of 2015 with the assumption there would be many oil related defaults. We have seen a bounce back as reason, information and perspective returned. Fundamentals are far stronger than the market fear indicates and nothing seems to be lurking in the shadows.

Another area often unseen in our business is keeping abreast of regulatory changes – changes largely made in an effort to protect consumers. We attended several seminars or conferences this past quarter that also help us manage our business or inform our compliance to the numerous regulatory rulings.

Effective April 8th, The Department of Labor (DOL) put into effect the fiduciary rule governing advice to retirement accounts and plans. A fiduciary standard requires that advisers place clients' interest over their own. We have always been held to that standard – and more – as our personal ethics dictate it.

While seminars on new Securities Exchange Commission (SEC) regulations can leave a person baying at the moon, we do get a glimpse into the market and best practices. Exchange traded funds (ETF's) are a current area of focus. The number and types of these vehicles have proliferated greatly and are often touted as wise investments due to tracking a market index while charging minimal fees. The simpler funds can add proper diversification with minimal tax liability. Now, however, there are funds that have leverage, sophisticated options strategies or black box active trading. No longer are they all "passive" or simply following an index. In order for an individual to trade options, they must document an understanding of the risks involved. This is not the case with exchange-traded funds. This leverage may be one of the contributing factors lurking in the shadows fueling volatility and potentially destabilizing the financial markets depending upon structure and oversight. It may also be a danger to those unsuspecting investors looking for a "cost effective" investment solution.

As advisers we are always doing our best to see where the "dark shadows" are and use that to guide us into the uncertain future. We have our garlic necklaces ready as we ride the wave of Primary Election fright and springtime quarterly results, knowing that, in the long-term, the global economy will continue to prosper and we will benefit.

"Who knows what evil lurks in the hearts of men? The Shadow knows."
– The Shadow, radio drama circa 1930