Q4 NEWSLETTER

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PILOT WEALTH MANAGEMENT

We Already Wrote this Commentary

By Nick Fisher, Portfolio Manager & Principal

The middle of 2015 might very well mark a temporary high in stock markets worldwide. Commodities and transports led the way down signaling a slowing of Chinese economic growth (a clear benefactor of low worldwide interest rates). Stock markets managed to survive almost 6 months from the time US Federal Reserve ceased their unprecedented monetary policy of quantitative easing. Without this blatant market manipulation, most asset classes peaked by the late spring and have been having difficulty gaining any upward momentum since.

As of this writing at the end of January 2016, the markets have been quite volatile. We have had a few conversations over the last couple years with clients wondering why we were so conservative. A few actually pointed to other investors who were earning a more substantial return, while their returns were more subdued. It is amazing how quickly the narrative in the market has changed from momentum-based risk taking to capital preservation.

To recap, from our past newsletters where we have come from:

As a result of the grand experiment of unprecedented monetary policy enacted by the US Federal Reserve, investors who were unwilling to accept the paltry returns available in safe haven assets began taking more risk. We demonstrated this by looking at the change in the capital markets line from a normal environment to the present environment. Clearly valuations in many asset classes were becoming at the least, fully valued and at most extremely over valued. As we know, above average valuations are followed by periods of low return. This type of environment does not adequately compensate an investor for taking risks. We said that this behavior of reaching for return, while only regarding the recent volatility as a guidepost for risk, would "…end with mal-investment and the loss of capital for less disciplined investors."

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Past newsletters can be found at www.pilotwm.com

An unconventional portfolio, with a slightly higher emphasis on liquidity and a tolerance for greater volatility will be necessary to earn higher returns. Furthermore "…we are not forced to swing at every pitch and there are no called strikes, therefore it is prudent to "wait for our pitch." A skew towards lower risk, safer assets will be necessary to avoid the siren song of short-termism.

While we are not very good at predicting when a correction will happen, we can be certain that it will. We must be prepared, as the lower prices will create plenty of opportunity. Our emphasis is not on how much less we have lost relative to the markets, rather the opportunities that we are looking at presently.

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Let's look at what some of the most intelligent people in finance have to say about the Federal Reserve's QE, stock market valuations, demographics and inflation:

> I believe we engineered a version of the "Wimpy philosophy": We gave stock-market investors two hamburgers today in exchange for one or none tomorrow. We pulled forward the price-reaction function of markets. If that is a correct assessment, then there may well be a payback period of lesser movement in stock prices to follow. 2015 might have been the beginning of that balancing out...It would not be unreasonable to expect subdued returns this year given that stocks are still richly priced by historic standards.
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> Now we will see who the truly smart investors are and who merely looked smart by having ridden the rising tide engineered by the Fed. As Warren Buffet has often said: "you only learn who has been swimming naked when the tide goes out."
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> – Richard Fisher, 2005-2015 President of Federal Reserve Bank of Dallas

> "Of course, I'm so old I remember coffee at five cents, and all-you-can-eat cafeterias at 25 cents, and brand new automobiles for $600. Over a span of many decades you can count on democracy to cause the money to deteriorate… Somebody my age has lived through the best and easiest period that ever happened in the history of the world…the biggest increases per annum that most people's standard of living ever got…If you're unhappy with what you've had over the last 50 years, you have an unfortunate misappraisal of life. It's as good as it gets, and it's very likely to get worse. It's always wise to be prepared for it…It's the unfavorable surprises that cause the trouble. You can almost count on the fact that you'll have way more trouble in the next 50 years than we had in the last…We should all be prepared to adjust to a world that is harder.
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> - Charlie Munger, Vice Chairman of Berkshire Hathaway

> Well it is true that if much of the developing world is younger demographically (think India), then developed nations could and should transfer an increasing percentage of their financial assets to emerging markets to help foot the demographic bills back home. It's also commonsensical that if higher Millennial wages are the probable result of a shortage of healthcare workers relative to Boomer requirements, then an investor should go long inflation and short fixed coupons…Other (developed) countries have similar burdens. Boomers have in part been responsible for asset appreciation during the heyday of their productive years and that now, drip by drip, year by year, they will need to sell those assets to someone or some country in order to pay their own bills. Asset returns will therefore be lower than historical norms, especially because interest rates are close to 0% in developed countries.
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> - Bill Gross, "Bond King" Portfolio Manager for Janus Capital

The bottom line: if the smartest finance minds in the world think it is important to be cautious, we should probably listen. Rest assured there will be a time to be more aggressive, but these things will take some time to play out. Furthermore, the latest correction may be shallow and lead to much higher prices, only to have another epic crash. We just don't know, therefore we will be prepared for either outcome.

For those with a plan, the lower prices are welcome. Nine months ago (1st quarter 2015) our newsletter provided a guidepost for preparing ourselves for the inevitable rollercoaster ride of the markets. It's worth reading again.

When Brand Promise Matters to the Business Model

By Rick Thomas, Business Advisor & Principal

Wal-Mart's recent announcement that they would be closing 154 stores across the country caught my attention. Especially so given that 125 of those stores were Express and Neighborhood Stores, Wal-Mart's attempts to go "small box". I had a consumer's perspective on this not long ago as I had visited a Neighborhood Store in search of some anti-freeze. Being familiar with the big box SuperCenter store that had opened in my neighborhood awhile back, I had grown to expect the offering from Wal-Mart for the variety of merchandise and competitive pricing. This is the essence of their brand promise, great selection and low prices. I do not, on the other hand, go to Wal-Mart expecting to receive exceptional customer service, be greeted by name or see a familiar face. Because whether intended or not, that too is part of their brand promise.

All this to say when I visited the Wal-Mart Neighborhood store looking for anti-freeze, I was soon disappointed. Turns out they did not carry automotive supplies at the Neighborhood Stores. They also didn't carry sporting goods or household hardware items and I found the store nothing short of confusing, as if it were having a corporate identity crisis. Located in a building that used to be a Whole Foods location, it had a smaller layout typical of a boutique grocery store but with none of the premium features such as fresh espresso, handcrafted cheeses or Italian meats. Yet it also lacked the merchandise selection I had come to expect from Wal-Mart, hence when they announced the store closings I was none too surprised. By my experience alone, what Wal-Mart had failed to recognize at the outset was their foray into "small box" concepts were inconsistent with their brand promise.

A brand promise is not only the slug-line under a corporate logo, but also what the customer actually experiences. Wal-Mart's official tag line is "Save money. Live better." A bit grandiose but I do save money at Wal-Mart on certain items which is why I shop there and my experience is consistent with how they position themselves. Except for the small store market they decided to go after which created the disconnect between what I have come to expect, and the shopping experience I had at the Neighborhood Store. All of which has lead me to the question that screams to be asked: How is it that arguably the worlds most successful retailer missed on a fundamental

concept of business in always ensuring the customer experience is consistent with the brand promise?
Surprisingly, it happens more often than one might think, and with some of the largest and most recognizable brands. In the 1990's, under pressure from attempts to clone their OS, Apple licensed their software to a third party PC manufacturer and for a short period of time, you could buy a non-Apple PC running the Mac OS. It was a dismal failure and a far retreat from the brand experience die-hard Apple fans had come to expect. The Apple CEO, Gil Amelio, soon lost his job and hearkened the eventual return of Steve Jobs.

In another example, Howard Schultz, CEO of Starbucks famously penned an email to his senior leadership team just before his return to the chairmanship, lamenting that the growth of the business both in the US and internationally had lead to a significant dilution of the brand promise, namely the stores no longer smelled of coffee. In Starbucks zeal to drive further revenue growth, they had switched from the classic La Marzocca machines to a more efficient automatic machine that spit out venti lattes at a much faster pace. All of which lead to an atmosphere in the coffee shops that was a far cry from where they started as a small roaster in Seattle's Pike Place Market.

What Schultz recognized was that by overlooking the brand promise, Starbucks had lost their soul and to his credit when he returned to the helm in early 2008, lead a significant brand overhaul. Schultz led this overhaul during the depths of the financial crisis when many argued it was not the time to take on the cost of a brand overhaul. His determination and eventual success, however, to reinvest in the brand in spite of the recession is further illustration of the importance of brand promise to the long-term health of the business.

And the list goes on of major brands that have lost sight of their brand promise, some who were lucky enough to recover, and many whom have not. The lesson is for all the talk around business models vis a vis product differentiation, segmentation, margin analysis, velocity of turnover and an abundance of other measures; the understanding of what is core to the customer experience and the essence of the brand promise is as fundamental as understanding profit. When a business loses sight of this, the impacts are often significant, if not a threat to its very existence.

If you have identified the brand promise for your business, kudos to you and you will be well served to keep it close by. Whether contemplating new strategy or optimizing your current one, filtering all of these considerations through the brand promise will ensure that the essence of the business is preserved. As Jim Collins famously penned in Good to Great, the precarious balance to be maintained in growing your business lies in preserving the core, while stimulating progress. Adherence to the brand promise is as essential as anything in preserving the core.

If, on the other hand, you have not identified the brand promise, then as is also famously penned, "The best time to dig a well was twenty years ago. The second best time is today." In other words, get on it! A healthy discussion amongst the senior team at a minimum is a start (a simple internet search will produce plenty of resources), while some prefer professional facilitation. Regardless, however you get there…get there. Uphold the brand promise as much as you drive for return on your invested capital. Your business model depends on it.

Pilot Wealth Management
601 SW 2nd Ave., Suite 2350
Portland, OR 97204

503-847-9723
www.pilotwm.com