Math Does Not Add Up!

"I would highlight that equity-market (stocks) valuations at this point generally are quite high," Federal Reserve Chairperson Janet Yellen weighed in on the debate on the stock market, suggesting the year-long stock rally may have driven prices too high. This was in response to a question posed by Christine Lagarde, International Monetary Fund Managing Director at IMF Headquarters in Washington D.C.

If you are planning for retirement or for other financial endeavors, the solution to this dilemma of high valuations must begin with realistic measures such as increasing your savings rate, rather than hoping for continued strong returns. High valuations reduce the chance of a positive outlook for returns in the future. Unfortunately, there is no math that allows investors to achieve the typical 10% return that has been accomplished in the past. In fact, over the last 15 years, investors have achieved an average return of less than 5% from the S&P 500.

If investors expect to obtain such returns, they must realize they have assembled a plan that is not capable of working. There is no math that can be done to allow earnings of 10% per year plus inflation over the long haul.

Where do returns come from? Despite what people may think, there is some rationale to the returns. Although the short-term, which can be as much as five years, is driven primarily by emotions, the long-term stretch of seven years and beyond is dictated by three things: valuations, dividends and earnings growth.

Valuations

Let's start with valuations, better known as price-to-earnings expansion or contraction. By Chairperson Yellen's admonition, investors are currently paying more than usual for a dollar's worth of future earnings. This will be a headwind to future returns. Let's just assume that the long-term future return from valuation of investments will be zero. It could very well be negative, but we will be generous.

Dividends

The second area of returns is dividends. Historically, the average for dividends is about 4.3% per year. Currently, the

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dividend rate is below 2% for the Dow Jones Industrial Index.

Earnings Expansion

The last area for growth comes from earnings expansion. The actual return before inflation is about 4%.

When you add these three areas together, the high end of expectations equals out to be about 6% in returns.

This is all based on historical calculations, but unless we are missing something huge about the years to come, there is no reason to think or assume that the future will be a total break from the past. From 1900-2014, the S&P index of stocks (500 large company stocks in an unmanaged index) returned about 6.5% after inflation. About two thirds of that return came from dividends and the reinvestment of all dividends.

Despite this, investors are expecting greater returns than what is likely to occur based on historical standards. The annual survey of global investors by Natixis Global Asset Management indicated that investors need an annual return of 9.7% per year **above inflation** to meet their long-term goals. As we have previously mentioned, investors' chance of long-term success is ……..approaching zero. This return is just not attainable.

Lest we end on a down note, let us look at the areas where we do see opportunity. Emerging markets, owner financed notes, peer-to-peer lending, timber, innovation and new technology are bright spots, along with good old American ingenuity.

Emerging markets have not had the fuel of quantitative easing to spur them on. Additionally some countries have fallen ill to slow economic growth. GuruFocus has run similar projected returns (as above) for other markets and indicates that Singapore, Australia, Russia, China, India, and Brazil serve as good market opportunities, albeit not without some risk.

Investments in other asset classes may include timber, owner financed notes, and peer-to-peer lending. While not your typical investments, these specific areas may have return potential that exceeds what is expected for the S&P 500, with returns that may match the inherent risk.

Last, the need for energy is constantly growing. With each new birth, the need for more energy expands. Consequently, developing new technologies to harvest energy is an exceptional opportunity for economic growth.

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This is all to say that opportunities exist.

Portfolio Notes

The foregoing comments represent the general investment analysis and economic views of the Advisor, and are provided solely for the purpose of information, instruction and discourse. Only comments in the Portfolio Notes section relate specifically to the Capstone Portfolios and the investment positions.

ETF PORTFOLIOS (Aggressive, Growth, Moderate, Conservative and Income)

The ETF portfolios gained some ground against the S&P 500 (a broad market index holding 500 of the largest companies). All of this was the result of iShares Nasdaq Biotechnology (IBB) and SPDR S&P Pharmaceuticals (XPH) which experienced a decline in profits based on returns last month, but eventually gained back those losses. As we indicated last month "it makes sense to remain holding biotechnology and pharmaceuticals." After a freight last month, bonds have stabilized.

The Aggressive, Growth, Moderate, Conservative and Income portfolio returned 8.3%, 5.5%, 5.6%, 5.6% and 2.3% over the past 12 months, respectively, after fees. This compares to the S&P 500 up 12.0% and the DOW (an index of 30 companies) ahead by 7.8%. We have not made changes to this portfolio in the last two months.

Analyst Upgrades increased 4.5% net of fees versus the S&P 500 with a rise of 12.0% in the last 12 month period. Overall, the performance was muted and remains just as volatile as the S&P 500. Strength came from Dow Chemical (DOW) which was sold for a gain of 7%, and State Street Corp (STT) with a boost of 6%. We sold a couple of losing stocks, including L-3 communications (LLL) for a loss of 9%, and Tyco (TYC) with a 9% drop as well.

Analyst Momentum gained 23.3% net of fees versus the S&P 500 with an increase of 12.0% in the last 12 months. Drags to the portfolio included Bloomin Brands (BLMN) for a loss of 6%, and Casey General Stores (CASY) with a decline of 6%. On a positive note, Alon US Energy (ALJ) was sold for a gain of 26%, and Boyd Gaming (BYD) earned 9%.

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Focused Strength gave up some gains, and has remained more volatile than the S&P 500, with a slight gain of 0.9% over the past 12 months. The volatility is extreme as the rotation in strength between asset classes is high. After gains experienced earlier in the year, iShares Barclays 20+ Treasury Bond (TLT) fell by 1%. In addition, the Guggenheim S&P 500 Equal Weight (RSP) was sold for a loss of 1%. The current holdings are Guggenheim S&P 500 Equal Weight (RSP) and Vanguard Europe Developed Markets (VEA).

MaxBalanced maintained its consistency by reducing volatility and is positioned well with a mix of asset classes. To date, the portfolio is up 1.8% versus the Dow Jones Global Moderate portfolio with a gain of 3.2%. The MaxBalanced portfolio is structured like a university endowment; investing in more than 12 asset classes. The idea behind this investment is that we cannot predict the market, nor can we accurately forecast how assets are measuring up at any given point.

iShares Mexico Index Fund (EWW) is among the stocks currently suffering from heavy losses, with a fall of 14.4%. Guggenheim Multi-Asset Income (CVY) also weakened and is now down by 11.8%. Wisdom Tree Japan (DXJ), once down significantly, is up 19.7%. The second best performing returns are from SPDR KBW Regional Banking (KRE) and iShares Russell Mid cap index with an advance of 8%.

Bond ETF gained 0.8% in the last 12 months, compared to the Barclays Aggregate Bond Index, which was up 2.7%. Most of the gains are coming from iShares Barclays 20+ Treasury Bond (TLT), but these gains have declined recently for an estimated gain of 6.2% currently. Overall, Emerging Market Bonds have bounced back with a handful of gains off the loss of 5.2% earlier this year.

Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.

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Our next monthly conference call will occur Thursday, June 18th at 11:00 a.m. Mountain Time (1 p.m. EST).

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