Quarterly Newsletter

HFG
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"We have this investment discipline of waiting for a fat pitch." - Charlie Munger

Update

My first quarter of the year has been quite active with travel. In February, I attended the CFA Society of Seattle's annual event. My primary reason to attend was to listen to Howard Marks. Howard is the Warren Buffett of distressed debt. You'll hear more about Howard later in our Market Summary in the coming weeks. In March, I traveled to California to attend the 10th anniversary of the LIDO Family Conference Symposium. The primary purpose of the conference was to understand what additional services we should be exploring for our clients. In our recent HFG Connect letter, we talked about how HFG is evaluating the creation of a trust company. I attended the LIDO event to discuss with others what they are doing to assist clients that need trust services. The event was both informative and entertaining. Our speakers were outstanding. The speakers presented topics from investing to economics. One of my favorites was Dorothy Collins Weaver, a former Chairman of the Federal Reserve Bank of Atlanta. (Her brother in law is Richard Fischer of the Dallas Federal Reserve). We were also entertained by Jay Leno and Walter O'Brien. I expect you know who Jay is, but Walter is the inspiration for the TV series Scorpion, which is based on his life experiences. He has an IQ of over 190. The odds of this is 1 in 1.5 billion. Our closing speaker was retired General Keith Alexander, who was the most recent director of NSA. Without divulging government information Gen. Alexander had everyone's attention as it related to cyber safety and shared tales that would make all of us proud to be an American. While in California, I also had a partial day performing a due diligence meeting with a large investment firm. We are excited to see how the relationship will evolve. This coming Friday, May 1st, Will and I fly out to attend the 50th annual Berkshire Annual Meeting in Omaha, NE. I attended last year and found it very interesting to listen to Warren and Charlie's 5 hour Q & A session. With the Berkshire annual meeting on my mind I thought I'd share with you some of my favorite Charlie Munger quotes through the balance of this letter. If you don't know who Charlie is I encourage you to Google him. Charlie is Warren Buffett's partner at Berkshire Hathaway. At 93, he is still sharp as a tack.

First Quarter

The first quarter has been in the books for almost a month and it was a modest period for large US stocks. The S&P 500 returned less than 1% with international, US small and mid-cap indices up 4-5%. The US equity markets have had a steady run since the bottom of 2009 and haven't had a 10% correction since 2011. On top of this our Federal Reserve has engineered a paltry interest rate environment that provides income investors with no yield for safe investments. The European Union has now set forth on its own brand of Quantitative Easing to reduce interest rates in Europe. As of 4/27/15 the 10 Year Germany Bond yields .16% and the Swiss 10 year yield is -.16%. Yes, that is correct and not a typo. The Swiss bond has a negative yield, which means investors are paying the Swiss government to hold onto their capital. This has prompted the legendary Bill Gross (Bond manager) to state that the current environment (low yields) is so inhospitable that he is reduced to trading more than owning bonds. Good luck with that Bill!

Our Thoughts

So, what is HFG doing in response to these unusual times?

"Necessity never made a good bargain" - Charlie Munger

First, we remain patient. We search where reasonable returns can be generated with a thorough understanding of risk. We save the anecdotal commentary for the talking heads and instead focus on the math. We continue to believe that the price we pay for an investment today will likely be the determinant of its future return. As we have stated for the last several years, there is currently very little in the area of investing that rings of "easy opportunity". Whether I talk with other portfolio managers, executive directors of some high net worth family offices or those that are in agriculture, it seems there is plenty of money chasing all assets. Everything is priced at fair value at best, and in most cases in excess of fair value. If there is any good anecdotal news it is that I don't see the frothy speculation yet as we saw in 2000 and in the 2005-07 real estate markets. With that said we are making incremental changes from US equities to international markets. Table I illustrates the valuations as measured by the Shiller PE ratio of the most followed world markets. You will see that the US market has the highest PE ratio. You will also notice that Russia and Greece have the cheapest PE ratios. We want to clarify that price isn't the only determinant in our analysis. A country's health and rule of law contributes to the mix as well. As a group foreign markets are selling at lower valuations, and thus we are positioning our portfolios to reflect our perception of the advantage this could bring over the next 5-10 years. What else are we doing?

Market	**Current Shiller PE**	10-Yr Avg. Expected Return %	Volatility %
Russia	**4.87**	16.80	37.5
Brazil	**8.89**	12.20	35.5
Poland	**10.55**	8.90	33.5
Turkey	**10.86**	8.50	42.2
Italy	**10.90**	6.00	25.6
South Korea	**12.37**	4.90	27.4
UK	**12.65**	5.60	17.5
Spain	**12.69**	7.20	26.9
China	**14.60**	6.80	25.8
France	**16.21**	4.50	22.5
Australia	**17.16**	5.50	23.2
Thailand	**17.53**	6.00	26.7
Hong Kong	**18.00**	4.00	20.7
Malaysia	**18.53**	6.00	17.0
Canada	**19.45**	3.80	20.5
Germany	**19.64**	3.40	25.0
Taiwan	**20.46**	3.40	23.0
India	**20.51**	6.40	30.1
Indonesia	**21.49**	6.70	32.6
Mexico	**21.50**	4.20	24.1
South Africa	**21.80**	6.20	25.9
Sweden	**22.50**	3.50	25.6
Switzerland	**23.35**	1.10	16.6
Japan	**26.76**	3.10	15.8
US (Large)	**26.95**	0.70	14.6

"There are worse situations than drowning in cash and sitting, sitting, sitting. I remember when I wasn't awash in cash – and I don't want to go back" - Charlie Munger

Secondly, we have positioned the portfolio for opportunity. We don't know when the US stock market will decline by more than 10%, but we believe it is long overdue and our short term bond holdings are positioned to take advantage of the opportunity when it presents itself.

Reporting Changes

Changing subjects from the market to reporting, please take a minute to review the HFG Benchmark Disclosure. It is included in your packet every quarter. We've reduced the equity allocation to the HFG Model 2-5 benchmarks to reflect our reduced exposure to equities in client portfolios. Although we have been steadily reducing portfolio equity allocations for some time, this is the first benchmark adjustment in 3 years. The discrepancy was most noticeable for Models 4 & 5. What do changes in the benchmark have to do with your personal portfolio? Nothing directly. We have created a benchmark for each HFG Model to give clients a point of reference. Clients don't own a benchmark, but it acts as a sort of 'fog line'. Our benchmarks are meant to be similar to your portfolio risk and return. We would expect over a market cycle that your portfolio and the benchmark will have similar returns and volatility. We would also expect small variations year to year because the benchmark does not include all types of investments we are willing to own for clients. Also important to note: benchmarks have returns unimpeded by expenses, unlike investment portfolios. Finally, you will also see we've added a second benchmark that uses the MSCI World index in lieu of the S&P 500. The MSCI will give investors a better view of global market performance. Benchmarks are now more consistent with the portfolios and will provide a more accurate gauge of expected performance.

I also direct you to your allocation or pie chart. You will notice that if you own international equities there is a category for this now. If you didn't own international equities on March 31st, you won't notice this addition until next quarter. In the past, International was lumped into "Equities-Stocks". Another change to the pie chart is the "Alternatives" category. In the past we had Real Estate, Commodities and Hedged Strategies that were each separate asset classes. We've chosen to consolidate these items into one asset class to simplify the view.

This is a good spot to discuss the purpose, risk, and return of each asset class. The first two asset classes are cash and fixed income. Cash is generally temporary funds that are on their way to another asset class. Our selection of fixed income investments are meant to have predictable results. You will hear us call this "Dry Powder" at times. We do not expect any surprises from our fixed income. If you are retired we like to keep 8 or more years of your cash flow in this asset class. The next group is called "Alternatives". We've placed real estate, hedging strategies, short term high yield bonds and merger arbitrage in this category. If some of these sound Greek to you, don't be alarmed. Feel free to ask us what they mean during your next review. We would expect long-term returns for this group to be more than fixed income (bonds) and less than equities (stocks). We would also expect these asset classes to hold up better in a down market as well. We tend to add to this bucket when we forecast equity returns to be lower than normal and we feel there is more downside risk. The final two categories are US equities and International equities. We invest in these asset classes for long-term capital appreciation and dividends. Year to year this asset class will surprise, some good and some not so good. I hope this helps in understanding our view of the different asset classes.

In closing, we look forward to seeing all of you at our first ever Stakeholders Event this May 28th at the Three Rivers Convention Center in Kennewick. We have a wonderful duo of speakers lined up for the evening. We have the author of *The Little Book of Sideways Markets* Vitaliy Katsenelson, as a guest speaker. I've come to know Vitaliy over the last couple of years and hope that you find him interesting and deep in thought. Vitaliy was born and raised in Russia. He immigrated to the US as a teen and lives in Denver as a portfolio manager. Your other speaker is yours truly. I can only hope to live up to everyone's expectation, but generally find my own is sufficient to make me squirm. If you haven't seen your invitation or if you've lost it please contact our office to get a new one. We'd appreciate an RSVP so we know how much food and beverage to provide.

Here's to wishing Charlie a Happy 94th,

Ty Haberling, CFP®