HFG | HABERLING FINANCIAL GROUP

3RD QUARTER 2015

MARKET SUMMARY

EXPECT THE UNEXPECTED

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"The individual investor should act consistently as an investor and not as a speculator." –Ben Graham

THIRD QUARTER 2015

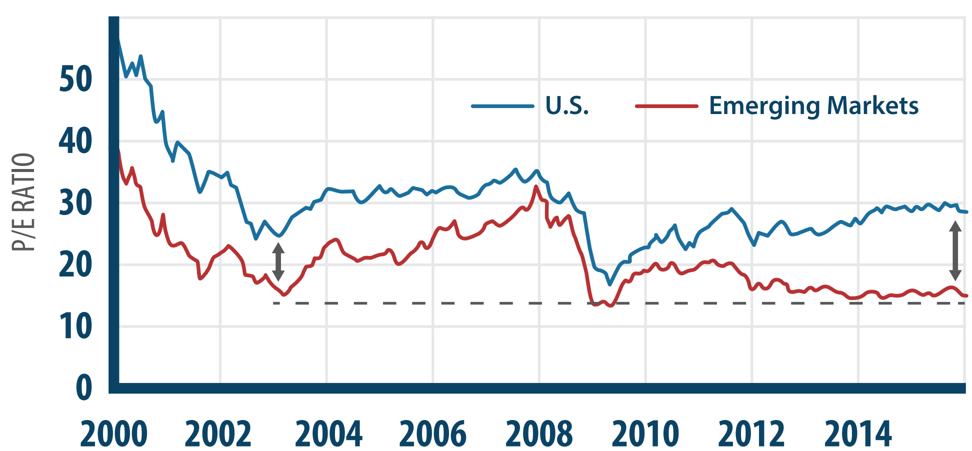
The third quarter provided us with lots of conversation. We witnessed some of the most volatile days since 2008. The S&P 500 declined 10% in 10 days in mid-August. For the third quarter the S&P 500 was down 6.44% while the Dow Jones Industrial Average and EAFE index were down 6.98% and 10.19% respectively. The emerging markets were down the most, 17.90% as measured by the MSCI Emerging Markets index. Investment grade and government bonds held their own by producing small but helpful returns of 1.23% and .32%, as measured by BC US Aggregate and the BC 1-3 Year Government Index. With interest rates so low today, bond market returns were not as robust as we have seen in prior stock market declines because rates had no room to fall unless they were to go negative. As of 10/21/15 US equity markets have rebounded and recovered their declines of the third quarter. Emerging markets have only recaptured about ½ of their third quarter decline.

OUR THOUGHTS

Many of you have asked if we were active during the decline. Active yes, but not as much as you would think. The Dow shed as much as 2,000 points from top to bottom, while the S&P 500 shed 25 points. The Dow decline seems huge only because it is a larger number. The size of the decline in numerical terms is not what is important, what is important is the percentage decline. Both indices shed about 10% from top to bottom. Normally, 10% declines provide long-term buying opportunities. However, a 10% decline is minor when the markets are 30-50% overvalued. In order for the S&P 500 to be priced at historical valuations it would need to decline to 1,280, the bottom in September was in the mid-1800s. For the Dow Jones it would need to fall to 12,000 from today's value of 17,700. One area of the global equity markets that has created interest from our perspective is Emerging Markets. Why? Valuations of course! The chart below is provided to us by an institutional money manager named GMO. The chart illustrates that Emerging Market PE ratios are hovering above 10 while US Valuations are in the mid 20's.

Exhibit 1

Stock Market Valuations



This chart illustrates cyclically adjusted P/E ratio, excluding financials. Source: GMO

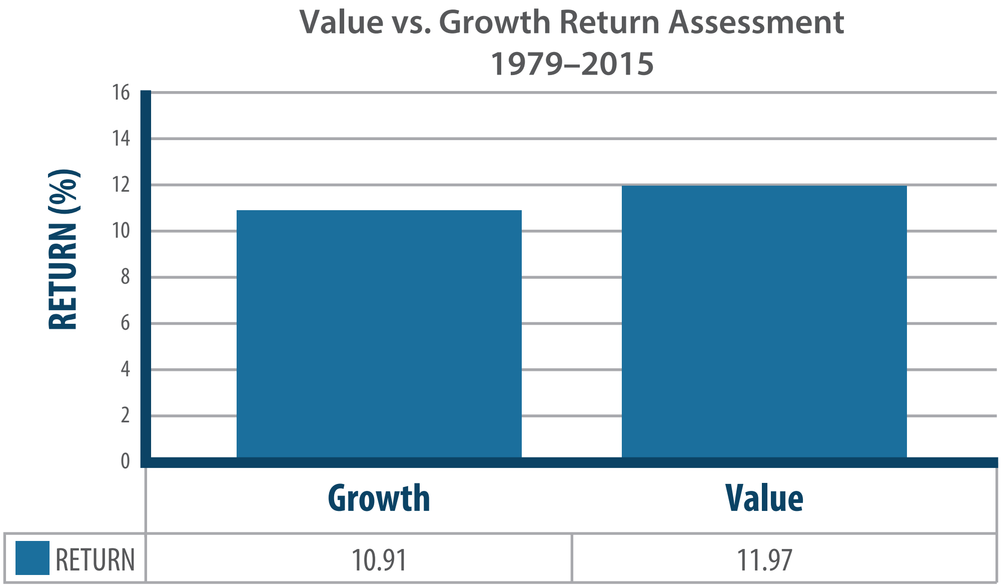
EDUCATION SECTION

I thought I'd write on the subject of Value vs. Growth investing. The terms Value and Growth reference a style or philosophy. Both styles share the same objective, which is return. Growth style investing focuses on purchasing companies that have an expectation of higher than average revenue and profit growth in the future. Value investing puts more emphasis on a company's existing profitability. The 5 top holdings for the Russell 1000 Growth index are Apple, Microsoft, Amazon, Facebook, and Google. The 5 largest holdings in the Russell 1000 Value index are Exxon, GE, Wells Fargo, Berkshire, and Johnson and Johnson. Growth companies tend to be newer enterprises while Value companies tend to more established. This statement is not an absolute.

To illustrate how companies change classification over time, let's examine McDonalds. Ten to twenty years ago McDonalds (MCD) was a growth stock. The company paid very little in dividends and chose to plow their profits into building more stores. The goal was to "grow" the business aggressively. The market priced MCD with a high PE ratio with the expectation of strong growth. Today, McDonalds, has saturated the market with stores and is distributing more of its earnings in the form of dividends. McDonalds today is more likely to be classified as a Value stock than a Growth stock because of its valuation (lower PE ratio) and increased dividend distribution. Companies that sponsor index data such as Russell and Standard and Poor build Value and Growth indices by dividing their core index into smaller subsets. For example, to form a Value index each of the sponsors select companies that have lower Price to Earnings and Price to Book ratios and higher dividend yields. This new subset is now called the Russell 1000 Value or S&P 500 Value index. The remaining companies in the larger core index are the ones with higher Price to Earnings and Price to Book ratios and lower dividend yields. These are called Growth style stocks. Growth style investing doesn't mean growth stocks will grow faster. ***It simply means the market has priced these companies in such a way that in order to justify their price they will need to grow earnings faster than the market.*** I hope you are now asking the question, "What performs better?" To come to some reasonable conclusion let's look at the historical information of Value vs. Growth style investing in Exhibit II. I've chosen to use the Russell index information for our assessment because it provides the longest sample period. Russell publicly provides historical data that starts in 1979.

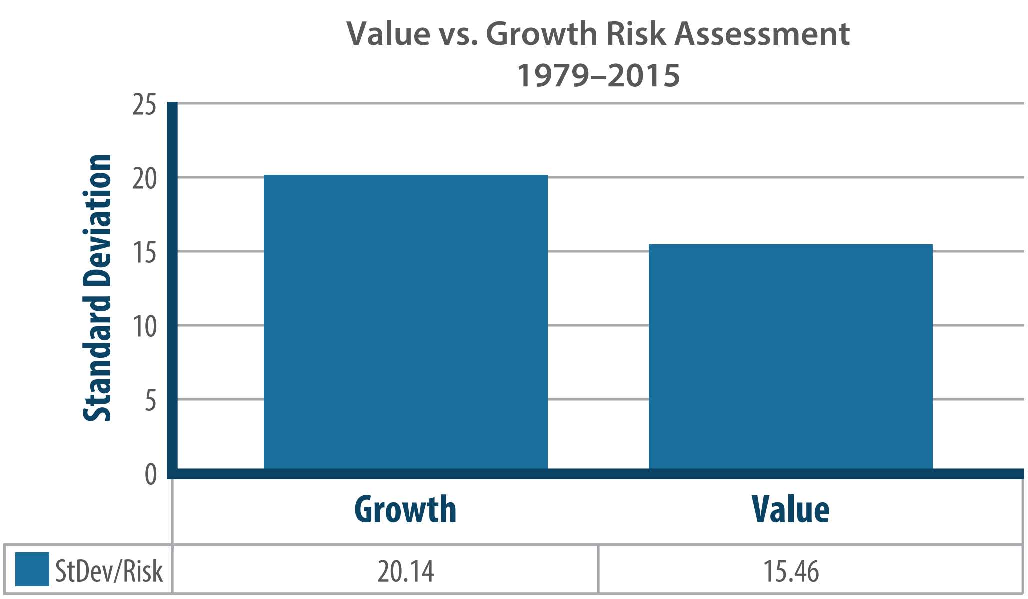
Since inception of 12/31/1978 to 9/30/2015, the Value Index has achieved a return of 11.97% per year while the Growth Index has returned 10.91%. There are many academic studies that support Exhibit II's conclusion. Even though we at HFG are more aligned with Value investing, the return difference is not statistically significant enough for us to wave the Value flag too aggressively, if return was the only factor to consider. Another reason I am cautious in stating emphatically that Value investing produces better returns is because a major factor of this research was dependent on when we start and stop the holding periods. There have been holding periods where Growth has returned more than Value. Thus, it is not a definitive answer when it comes to which has higher return because results can be dependent on starting and ending dates.

Exhibit 2



This is what we are comfortable stating: ***the assessment of risk and volatility is one area that is often overlooked when investors discuss return.*** Much like our philosophy on price, it is difficult to compare two assets when all you have is the absolute price. In order to accurately compare price, you need an earnings factor. Therefore, in order to fairly compare return, one must consider the path that paved the way for that return, in other words, volatility. In finance, the most commonly used measurement of volatility is standard deviation. In Exhibit III, you can see that Value investing over this time period has had significantly less volatility at 15.46 compared to Growth's 20.14.

Exhibit 3



According to this measurement, Value investing does seem to have had a slightly smoother ride while providing similar if not higher returns. Should you assume that Value investing will prevail over Growth every year? The answer is NO. No investment has had that type of predictability or superior result. The next chart illustrates the annual differences in return between the two styles over the last five years. Notice, over this time period there is little difference.

Exhibit 4

Year End	Growth	Value	Variance
2010	16.71	15.51	-1.20
2011	2.64	0.39	-2.25
2012	15.26	17.51	2.25
2013	33.48	32.53	-0.95
2014	13.05	13.45	0.40

However, as you dive further you will notice there can be extreme differences as illustrated in Exhibit V. Look at the Variance column and look for the orange color. This highlights the years where Value outperformed Growth significantly. The shaded blue is where Growth had significantly larger returns. For example, in the first year of the tech crash, Growth stocks declined 22.42% while Value stocks actually increased 7%. In 1998 and 1999 tech stocks helped Growth outperform Value by 23%-25%. ***Since 1979, the average variation year to year of Growth vs. Value has been about 9%.***

Exhibit 5

Years with Significant Performance Variation

Year	Growth	Value	Variance	
2000	-22.42	7.01	29.43	Value Outperformed Growth
1993	2.87	18.07	15.20	
2001	-20.42	-5.59	14.83	
2006	9.07	22.25	13.18	
1981	-11.31	1.26	12.57	
2002	-27.88	-15.52	12.36	
1983	15.98	28.29	12.31	
1988	11.27	23.16	11.89	
1984	-0.95	10.10	11.05	
2004	6.30	16.49	10.19	
1989	35.92	25.19	-10.73	Growth Outperformed Value
2007	11.81	-0.17	-11.98	
1980	39.57	24.41	-15.16	
1991	41.27	24.55	-16.72	
2009	37.21	19.69	-17.52	
1998	38.71	15.63	-23.08	
1999	33.16	7.35	-25.81	

So, what is the take away? First, style can explain performance year to year. Good Value managers can look like they are asleep at the switch in a Growth Style market and vice versa. Second, in our opinion all things being equal, we favor using Value managers because we believe Price Determines Return over the long run and Value has provided lower volatility. Thus, we hope to get the best of both worlds. Third, investors should expect material differences year-to-year between Growth and Value. Our view is to stick with a disciplined approach and resist the temptation to chase current results. Fourth, we believe growth investing is speculative by nature because you are ***anticipating*** that growth in the coming years will justify the current higher price. For 2015, style has influenced stock market returns as Growth has declined only 1.54% while Value stocks have declined 8.95%. This comes to over a 7% variance in favor of Growth. For the first time in five years there is a material difference in returns based upon style. Only time will tell how long Growth will maintain its advantage before the pendulum swings the other way. All investment strategies (Growth or Value) attempt to get to the same destination. However, we believe our approach is a more prudent path.