QUARTERLY NEWSLETTER

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HFG | TRUST

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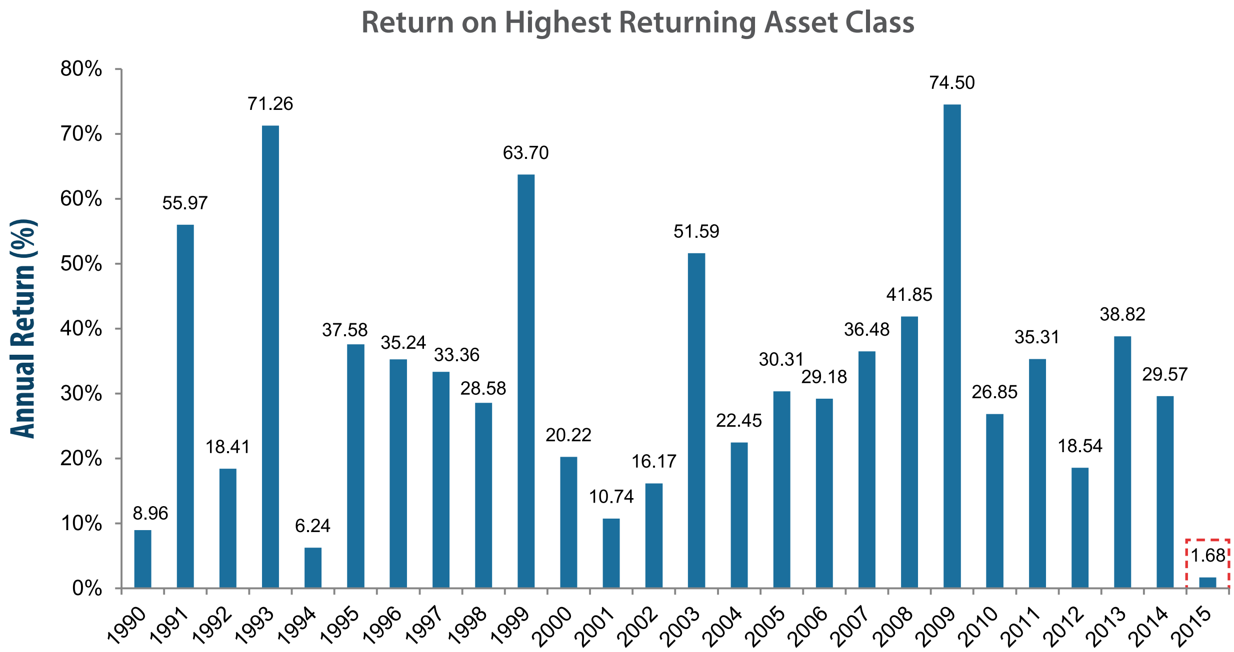
"When everything seems to be going against you, remember that the airplane takes off against the wind, not with it" *—Henry Ford*

Turbulence is Part of the Journey

2015 provided no sanctuary for investors. FPA, a mutual fund manager we use, shared this observation in their recent 4th Quarter report. The chart below illustrates the best return among the major asset classes from 1990 to 2015. The best return among the major asset classes last year came from Developing World (non-US) bonds, the return was only 1.68%. Since 1990 there has generally been at least one asset class that generated significant returns. Even in 2008, when global stocks had -40% returns, 30 year US Govt bonds provided a return of 41.85%. This isn't the only interesting oddity in 2015. While the Federal Reserve increased the federal funds rate by 1/4 of a percent, other major central banks in the world like Japan, Europe and China continued to lower rates. In fact, this week the Bank of Japan reduced their short-term rates below 0%. It is hard to fathom a world where savers are not compensated for deferring consumption. It is equally puzzling that companies have not been enticed to borrow at these low rates to expand their business. Rather, we've seen Wall Street borrow at low rates to buy back stock. The media has coined this "financial engineering". This form of financing creates no investment or jobs, with the exception of Wall Street bankers. Global central banks have promoted easy money and low rates since 2008. Yet, the results have not produced satisfactory or intended economic growth. The US has failed to hit 3% growth in any year since the start of QE and zero interest rates. Europe is struggling to find 1% growth with rates lower than the US. What the Federal Reserve has created with their policies is inflation within the stock and real estate markets. Our concern is the Fed could be creating another bubble in liquid assets.

Exhibit 1



Source: Bianco Research. The chart compares returns of the following assets classes and plots the highest return each year: large cap U.S. equities (S&P 500), small cap U.S. equities (Russell 2000), 30-year U.S. Treasury, 10-year U.S. Treasury, Barclays Aggregate Bond Index, 3 month Treasury bill, U.S. high yield, U.S. investment grade corporate debt, emerging market equities

The next chart illustrates 2015 and the five-year annualized returns for the core asset classes we primarily follow. What probably stands out to you is the poor results for Emerging Markets last year and over the last five years. This is precisely the asset class that intrigues us. We like to find asset classes that have underperformed over a 3–7 year period. We've found this is generally an indicator of opportunity. This asset class leads us to a discussion of our investment results and thoughts for the 2015 year.

Exhibit 2

Asset Class Returns

Index Name	Asset Class	Style	2015	5 Year
Barclays 1-3 Year Government Index	Fixed Income	Short Term	0.57	0.73
Barclays Long Term Treas Bd Index	Fixed Income	Long Term	(1.21)	7.74
Barclays TIPS Index	Fixed Income	Inflation	(1.44)	2.55
Barclays US Corp High Yld Index	Fixed Income	Low Credit	(4.47)	5.04
Russell 2000 Index	Equity	Small Cap	(4.41)	9.19
Russell Midcap Index	Equity	Mid Cap	(2.44)	11.44
S&P 500 Composite Total Return Index	Equity	Large Cap	1.38	12.57
MSCI EAFE Index	International	Developed	(0.39)	4.07
MSCI EM Index	International	Emerging	(14.60)	(4.47)
FTSE NAREIT REIT: Equity Index	Real Estate	—	2.83	11.91

HFG PORTFOLIO STRATEGY LAST YEAR AND GOING FORWARD

Since 2012, US and Global stocks have been overvalued on an earnings, sales and GDP metric. Our research forecasts that the S&P 500 and Russell 2000 are likely to generate returns of 1-3% over the next decade because of these high valuations. (see exhibit 3 for current valuation metric) John Bogle, the legendary founder of Vanguard Funds, stated in November of 2015 that he thought stocks would provide 4% returns over the next decade. The math behind our forecasts is rather simple. In our firm, we call it affectionately the "PIG" formula. By taking the components of investment returns and analyzing them individually we can make an intelligent forecast. **"P"** stands for **Price Change**. Today, Shiller PE ratios are 23-24. We need to make an assumption of what investors will be willing to pay for stocks at the end of the next decade. Our educated assumption is they will revert to the mean of approximately 16 or slightly above. If we purchase something at 24 and sell at 16 we lose on Price to the tune of about 4% per year over the decade. **"I"** stands for **Income**. We use the current dividend yield on the S&P 500 today, which is 2%. **"G"** stands for **Growth**. Prior to 2008 the economy and S&P 500 earnings increased 5-6% per year on average. I don't think many analysts are projecting 5-6% earnings growth in their assumptions today. Thus, we will use a much more tame projection of 4%. By adding the -4% (Price Change) + 2% for Income and 4% for Growth we get a total return of 2%. Mr. Bogle is using the same formula, but his assumptions on P or G are likely slightly different than ours.

Exhibit 3

HFG Market Valuation Table

As of February 6, 2016

Valuation Metrics	Current	Average	Decline to the Mean
P/E Year Trailing Earnings	20.74	14.57	-30%
Shiller P/E Ratio (CAPE)	23.80	16.58	-30%
Price to Sales Ratio	1.69	0.96	-43%
Market Cap to GDP	1.15	0.70	-39%
Q-Ratio	0.94	0.68	-28%
Wilshire 5000 to GDP	1.17	0.72	-38%

It is understandable valuations are extended when interest rates are pegged close to zero. However, in our opinion the only logic to over allocating to US stocks at these valuations is the premise interest rates will continue to be at or near zero for the next 5-10 years. We believe rates will gradually rise over this time period and as they do, investors will be enticed to own lower risk based assets (bonds). This will put downward pressure on P (Price or PE Ratios). The timing of all of this is unknown. Our belief is that markets revert to the mean or average valuations over 7-10 years. Since we have not seen acceptable valuations since the beginning of 2009 and if we are accurate that markets mean revert over 7-10 years, we would expect a market correction between now and 2019. We've reacted to this information by under-weighting our client's allocations to global stocks. For example, in a normal valuation climate balanced portfolios would be allocated 50-60% in global stocks. (When we say stocks think of stock mutual funds) We believe this to be too high of an allocation today and we have reduced our client's equity allocation to 25-30%. In 2012, we also removed International stocks (funds) from our client portfolios. So far, this has been effective as from 12/31/11 to 12/31/14 US stocks as measured by the S&P 500 had a cumulative return of 75% while International stocks as measured by MSCI EAFE index had a cumulative return of 38%. Thus, favoring US stocks proved to be accurate for the time being.

At the end of the first quarter of 2015, we reassessed International valuations and determined it was time to re-enter. We did this based upon the comparison of US valuations to International valuations.

Exhibit 4

Valuation Comparison

Index	S&P 500	MSCI EAFE	MSCI EM	
Asset Class	US Equity	International Equity	International Equity	
Style	Developed	Developed	Emerging	
Price/Earnings (Shiller)	26.00	14.00	12.00	Apr-15
Price/Book	2.71	1.73	1.52	
Price/Earnings (Shiller)	24.00	13.00	10.00	Feb-16
Price/Book	2.50	1.44	1.28	

**Shiller PE Data provided by Research Affiliates and Price to Book values were courtesies of JP Morgan Market Recap*

We started buying Emerging Markets early to Mid-April and Developed International Markets in early May. This proved to be too early, as Developed International markets declined 10% and Emerging Markets declined 20% through year-end. Fortunately, our emerging market selection declined only 1/2 as much and our Developed Market selection tracked the index. This illustrates that even though an asset class has a low valuation, it doesn't mean it will produce superior results overnight. I can't quantify my next statement, but I can tell you over my 32 years of managing money, I along with many other value managers tend to re-enter early. Rarely, do we ever buy at the bottom. **However, our goal isn't to find the illusive perfection, rather we attempt to buy at a price that provides a reasonable or excellent return over the 7-10 year holding period.** This early move to International cost you, our clients, 0.25% - 0.50% returns on your portfolio for 2015. We expect to make up this difference and more over the next 3-7 years as we continue to believe this asset class offers a better longer-term risk reward prospect.

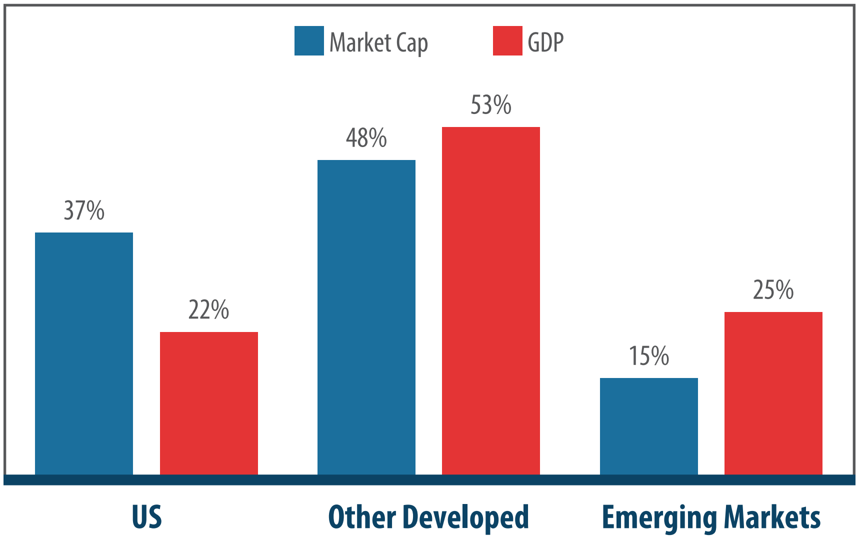
WHY DO WE LIKE EMERGING MARKETS?

Emerging Markets (EM) is an unloved asset class. This is one reason we like it. However, our reasons go beyond anecdotes and verbal affection. Our primary focus is on valuations and growth. Let's examine why we think EM is unloved today. First, let's examine it through the lens of Growth. EM economies tend to be commodities driven. Commodity prices globally, from oil, metals and food declined on average 25-33% last year as measured by the Dow Jones Commodity index and the S&P GSCI Commodity Index. When you visit the pump to fill your car, you can feel the impact. Your gain is the other guys loss. Secondly, the US dollar has strengthened against most currencies in the world over the last couple of years. Many EM countries borrowed money in US dollars. This means the debt they owe must be paid back in US currency. A rising dollar makes the re-payment more expensive. So far, I've only provided a negative scenario. Let's look at how this could turn positive. The good news in regard to the debt EM countries borrowed is found in the fact that most EM countries have less debt as a percentage to GDP than the US and Europe. EM economies have younger populations too, which generally means more productivity and less social cost. They have the potential to provide higher growth for consumption as they spend more to raise a family. The previous mentioned negatives can turn positive as devalued currency makes EM goods and services cheaper for consumers in the US. This provides the EM economies a potential price advantage as they compete globally, which creates economic growth for EM countries. Next, commodity prices are historically very volatile. As prices crash, production of the commodity ceases. This allows the excess supply, which caused the price decline, to be absorbed in the global economy. As the supply goes from surplus to a shortage, prices again appreciate. It's the free market and enterprise system working to correct excess. In summary, we are buying oil at 70% below its peak and metals, such as copper at 80% below its peak. We expect this to be the strategy of buying low.

Now let's look at it from the lens of Valuations. Valuations confirm prices are low. One macro view of examining valuations is comparing EM GDP to World GDP and then comparing EM Stock Market Valuations to World Stock Market Valuations. What we find is that EM Stock Market valuations are underrepresented on the exchange based upon what they produce. For example, the USA generates about 22% of World GDP, yet it's stock market presence is 37% of the world stock market. EM countries are 25% of world GDP but only represent 15% of the world's stock valuations.

Exhibit 5

World Market Cap vs. World GDP comparison



If we were to compare Price to Earnings ratios (See Exhibit 4), we would find we can purchase foreign grocery stores, consumer goods and commodity producers at 10-15 times their earnings or US companies in the same field at 25, which makes economic sense? We believe the former merit an allocation.

SUMMARY

I hope our message doesn't come across as apologetic or defensive. We would prefer to be precise in our asset selection and timing every year. Unfortunately, that isn't possible. Managers of all disciplines will look like they've lost a step in some years and look like a genius in another. **What matters most in my opinion is the process and discipline a manager uses.** What we want to avoid is chasing the latest and best performers and have the patience like an orchardist as they watch their newly planted trees grow to produce fruit in the future. Our slight underperformance in a slack year isn't due to a change in strategy or poor results from our fund managers. Rather, it is strictly a timing of re-entering an attractive asset class. Our strategy is valuation based and will continue to be so. **We believe the ultimate determinant of future returns is the price you pay for an investment today.** Since 2012, stock market valuations and zero interest rates has made it challenging to find investments that meet the test of durability. However, we think International and Emerging Markets meet this test and we have selected experienced and proven managers to implement our strategy. While we wait to see our future results we have continued a conservative posture with the balance of your assets in capital preservation ideas that will provide us "dry powder" to re-enter other asset classes if and when we get a market correction.

CLOSING

It is official, Haberling Financial Group is now HFG Trust. We are only one of a very few Registered Investment Advisory firms in the country that have made the successful conversion to a trust charter. The trust charter will allow us to serve you in many more ways than what is currently in our wheelhouse. For some of you, it may mean no change in service because trust and custodian services are not needed at this time. For others, you may find a need for professional and audited trust services. Either way, our Nordstrom service and Fiduciary relationship of placing your interest above our own will remain the foundation of our commitment to you.

HFG Trust is a financial services corporation specializing in investment management and financial planning. HFG has been providing quality wealth management services since 1983, and currently manages over $325 million in assets for 600 families and retirement plans.

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