Second Quarter Outlook 2015

I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

"We can't solve problems by using the same kind of thinking we used when we created them."

Albert Einstein

First Quarter Update

Our client portfolios benefited from the diversification we built into our models because a wide range of asset classes had positive returns for the quarter. Notably, international stocks led U.S. stocks, even with currency movements eating into foreign returns for U.S. dollar-based investors. The bond market was also up because Treasury yields declined over the quarter.

The U.S. economy appears to be in decent shape overall which has prompted the Federal Reserve to hint at the possibility it could begin interest rate hikes later this year. The employment picture has also improved since the recession, and economic growth has been modestly positive. However, the strong dollar has hurt U.S. export growth, and consumer spending hasn't shown material improvement amidst persistently slow wage growth. Inflation is still very low, and the decline in oil prices has added additional downward pressure, at least temporarily. On the international front, the European Central Bank launched quantitative easing (bond buying) during the quarter in an effort to boost Europe's sluggish economy. With the Bank of Japan and the People's Bank of China also undertaking stimulus efforts, there is no shortage of central bank support for global financial markets. Central bank stimulus is usually supportive of risk assets like equities, especially as bond yields become less and less attractive.

Portfolio Commentary

Durability and resilience are two important characteristics we take very seriously when it comes to portfolio construction. At its simplest level, these qualities entail building diversified portfolios that have multiple paths to positive returns and that protect against multiple risks. Over time, this approach enables us to generate strong risk-adjusted returns, as has been the case over our history.

We are always mindful of multiple risk factors when we build the equity portion of our strategies. We believe that U.S. stocks are now a bit expensive. In addition, the Fed support, which has been critical to the post-financial-crisis stock market rally, is slowly being scaled back. However, we still have a prolonged low-interest-rate backdrop that is constructive for equities. Looking forward, in our view the most likely scenario is lower U.S. equity returns compared to what we have witnessed over the last few years. Despite this outlook, we recognize that stocks remain attractive relative to some other asset classes and could continue to perform well for an extended period.

Moving to developed international stocks, and Europe in particular; our top down asset class view is very different from the United States. In the United States we see above-trend profit margins, earnings growth and higher valuation multiples but in Europe we see earnings below trend and lower attractive valuations. Most international stocks, including Europe have not enjoyed the same gains as U.S. stocks in recent years and therefore are more attractively priced today with stronger return potential over the near term. The fact that European stocks have lagged hasn't been surprising given the poor economic health of the region and the ongoing questions about the durability of the Eurozone. What matters when investing is that with lower prices the economic picture doesn't have to be rosey. Investors are buying the asset class more cheaply and therefore with presumably more upside potential. In this instance, we believe many developed international markets are priced like this and have the potential to generate attractive returns if we look five years into the future and assume a return to more normal economic and earnings growth; a scenario we think is reasonable.

We still like the emerging markets growth story, valuations look attractive and earnings appear to be depressed relative to our long-term expectations. Of course, emerging markets face some unique risks as well. We've previously written about some of these concerns, like China's slowing growth rate and the potential for a sharper downturn as the Chinese government seeks to get the economy on a more sustainable path. With China's growth rate slowing over the past few years, many of these risks have already been priced into the market. The other main head wind for emerging markets is a strong U.S. dollar (more on this later). So, we think it is prudent to factor in a healthy margin of safety to account for these unique risks. Considering both the potential rewards and risks in emerging markets, we have exposure to this asset class at increasing levels based on overall portfolio risk objectives.

News Notes

Our 2015 annual client appreciation event will be a luncheon held at Inverness Hotel and Conference Center on **Wednesday, September 30th**.

Look for more details soon!

The U.S. dollar has appreciated 23% over the past 12 months. There are several cross currents from the rise in the dollar in terms of its impact on both the real economy and financial markets. On the positive side for the U.S. economy, a strengthening dollar reduces the cost of imported goods (dollar buys more than it used to) and is also associated with falling oil and commodity prices that are priced in dollars on the global market. This will tend to depress domestic inflation. Dollar strength has a negative impact on U.S. exports (more expensive), U.S. manufacturing, and U.S. multinational company profits. Another notable negative is dollar-denominated debt issued by emerging market companies and governments. The appreciating dollar makes this debt more expensive to pay back in local currency terms.

When we structure the fixed income portion of our clients portfolios, we know that the movement of interest rates is a predominant factor in determining future bond returns. Since we do not have the ability to predict when or if rates will rise, we consider a range of differing assumptions over a five-year time horizon as part of our disciplined analysis that is a key element to our portfolio construction process. Today, all of our scenarios yield the same conclusion about core bond returns over the next five years. They are likely to be low regardless of whether rates decline from 1.95% (where they ended the quarter) or rise. As a result, we own less core bond funds and have moved into a number of income strategies (Hybrid asset class) with broader mandates that should enable them to achieve better relative performance through a variety of interest -rate climates. The fundamentals for floating rate loans continue to look attractive to us and should protect against rising short-term rates. With this as our current investment environment, we reiterate that the primary role of core bonds in our client portfolios is to reduce risk and provide “ballast” to lower overall portfolio volatility.

We know that not all risks we manage through our strategies will play out, and in many cases there could be a small price to pay for the “insurance” we build into our models. We also know it may take time for our investment strategies to be rewarded and there may be periods when few opportunities seem overly compelling. But we are confident that our focus on risk and our return considerations should result in sound, well-performing portfolios that help our clients meet their financial goals.

We will continue to stay focused and disciplined in our stewardship of your assets. And as always, we appreciate your confidence and welcome any questions you may have.

ISG Team News

We are very sad to announce Advisor Linda Ruh will be retiring and relocating to Arizona (and Mexico). We will miss Linda’s capabilities, contributions and fun loving nature. We know her decision is the right one for her family. We admire her courage and willingness to leave a job and team she loves for family.

At the same time, we are very pleased and excited to announce the hiring of Barbara Krause. As Linda plans her new adventure, we are confident we have found a professional with a similar background and dedication to our clients, company and industry.

Barbara is a Certified Financial Planner as well as a CPA. She has a Bachelor of Business Administration Degree in Accounting as well as a Master of Science Degree in Management Information Systems. She also is a Certified Wealth Strategist (CWS) and has worked the past five years in the Schwab Private Client area as a Senior Portfolio Consultant.

We are excited for you to meet and work with Barbara.

Fund Fact

American Century Investments is a high quality investment manager, committed to providing clients with solid investment results as its sole focus. We own their Equity Income fund in some of our investment models.

A little known fact; more than 40% of American Century Investments’ corporate profits support the Stowers Institute for Medical Research-a world class biomedical research organization dedicated to researching and uncovering causes, treatment and prevention of gene-based diseases (cancer, diabetes, dementia, etc.). The Stowers Institute was established in 1994 through the extraordinary generosity of cancer survivor James E Stowers Jr., the founder of American Century, and his wife Virginia, who dedicated their personal fortune to improving human health. Contributions to date exceed $1 billion.