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Celestial Wealth Management

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I. Instability and Risk Taking

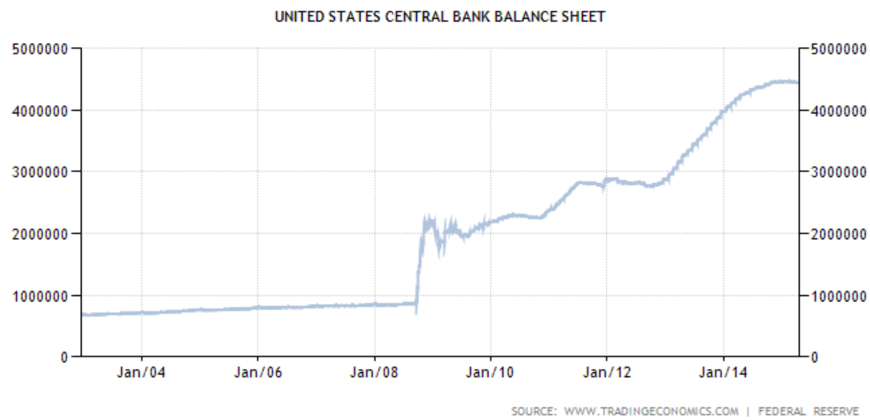
Prior to having my two wonderful children, my wife and I enjoyed skiing all over the country. Whether the mountains in Vermont, Colorado or Utah, we enjoyed the sport, the beautiful scenery, great comaradarie and the adrenaline rush at the drop in.

Sorry to say that having young children has definitely curtailed not only our ski vacations but also our risk taking. But, I will never forget waking up in the morning, looking out the window at the blue sky and the fresh powder covering the mountainside. If you have been in the mountains skiing you know that each morning the ski patrol fires shots from artillary guns into the mountains to check for unstable snow and potential avalanche conditions. It is a precaution to help ensure the safety of those on the mountain. At the time I didn't fully appreciate the lengths the ski patrol went to keep people safe. But, the news from Mount Everest brought that risk home.

If you haven't heard, dozens of people were climbing Mount Everest in April when a deadly earthquake in Nepal triggered an avalanche. At least 18 people died and dozens more were injured. While this horrific tragedy couldn't have been prevented, the risk management team at the mountain was able to prepare climbers for the potential of an avalanche prior to it happening. Because of that preparation and training, one could assume that the loss of life was minimized. Climbing a mountain of that size is obviously very risky, but the legwork by the mountain patrol and the climbers beforehand help prepare them for the potential of unforseen circumstances.

Avalanches don't occur because of the artillery guns shooting into the mountains or the earthquake in Nepal. **Avalanches occur because of the unstable snow conditions on the mountain.** You never know what can cause the avalanche to start, any number of catalysts can start one, but they only occur in areas where the snow fell in a certain way. On any mountain slope, the snow piles up over time and is supported by what is called the snow-pack. This pack keeps the snow from tumbling down the mountain. Conditions become unstable when the snow-pack starts to weaken. Then because of overloading, temperature or vibration the avalanche begins.

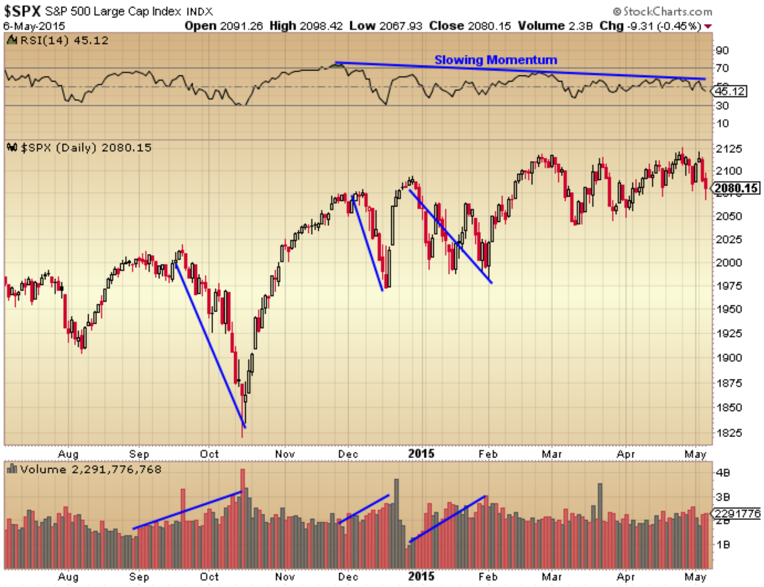
I think this is a perfect segway into current market conditions. We are now a full 6 years since the depths of the worst financial crisis since the Great Depression. According to an Economist Magazine report from March, the Federal Reserve



has increased the size of the assets it holds from less than $1 trillion in 2007 to more than $4 trillion today. Its quantitative easing program created currency units in an effort to stimulate economic activity and revitalize borrowing. But, some worry that the flood of easy money has encouraged reckless financial behavior by companies, invesetors, house flippers, and central bankers. Others are concerned that when the central banks begin to sell their assets into the market, interest rates will soar, bringing this economic recovery to an end. Personally, my belief is that quantitative easing has done little to improve the economy but has helped restore confidence, which is the key to any recovery. Asset prices have been pushed higher as the 0% interest rate policy of the past six years has encouraged investors to speculate in more risky securities in search of higher returns**. In my opinion, the reach for yield beyond what one is normally used to creates the unstable conditions needed for the next turn in the economic cycle.**

To be fair, this stock market rally has continued further and longer than I ever thought….and there is no reason why it can't keep going higher and higher as long as investors are willing to speculate. However, the current U.S. stock market profile joins high valuations with a plethora of evidence that a subtle shift towards risk aversion is occuring. It seems that the liquidity pumped into the financial markets by the Federal Reserve has been waning. As you can see from the above chart, over the past six months, the Fed's balance sheet has stopped growing. That is liquidty being pulled from the market….slowly.

A few astute investors believe that liquidity is what drives market higher and lower around the fundamentals of economic growth and valuations. Liquidity, or demand, can be added pushing markets higher or taken away driving prices lower. The current market features a combination of high valuations with the apparent beginnings of risk aversion. Now, this overvaluation has been present since 2012 so that has not been a good timing indicator in the shorter term. But, the recent reduction in risk taking combined with a reduction in liquidity from the Federal Reserve **may** be the cocktail that marks the end of this bull market. Over the past year or so, momentum investors riding the updward trend and reluctant investors who feel as if they have no choice but to play have been driving the market. Any realistic view of corporate reveneues, earnings and economic growth show that stocks are at least slightly overvalued if not significantly overvalued at current levels. If a meaningful amount of speculators get spooked and try to sell stock and reduce risk, there may not be much natural demand at these prices because value conscious investors don't have a desire to accumulate shares of overvalued stocks until they reach far lower prices. Just as in 2000-2003 and 2007-2009, someone has to own the stock during the



downward completion of this cycle when it occurs. I would prefer a reduced exposure at this point in the cycle. The term I use is cautious participaction.

In the stock market, when looking at price action versus volume, what we see is that there have been a few bursts of high volume selling followed by a low volume advance. This is the exact opposite of what you would want to see in a healthy bull market. In a healthy bull market you would see higher volumes on advances and lower volumes on pullbacks. We are seeing the exact opposite as momentum slows.

All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

II. Memories…

When I first started in the business, it was May of 2000….right as the NASDAQ technology bubble was bursting. Last week, after I have been in the business now for 15 years, the NASDAQ finally clawed its way back to even. In March of 2000 the NASDAQ reached its intra-day high of 5,132.52 and then subsequently fell 78% to 795.25 by October 2002.

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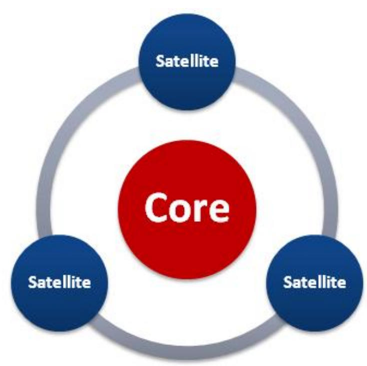
It really is amazing that if you could invest directly in the index of technology stocks 15 years ago, it would have produced a return of exactly 0%…<u>if one didn't panic or get frustrated and sell.</u> That is how important valuations are to long term investment returns. Valuations mean almost nothing in the short term but when looked at over 7 years or longer, valuations can be a powerful predicter of future returns. Back then, investors were extrapolating the good times of the late 1990s out many years in the future, rather than looking at valuations realisticly. Those who did, saved themselves from large losses and many headaches. However, it probably meant looking foolish for many months as markets continued to advance even in the face of the highest valuations in history. I distinctly remember, analsysts and market pundits on Wall Street coming up with all kinds of reasons why this time was different and valuations don't matter. Funny thing, I also remember pundits doing that as the housing bubble was bursting in 2007. Not coincidentally, I see the same thing happening today.

III. Tennis Anyone?

Being a former college athlete I often use sports analogies to explain the investment world. There are a lot of parallels between sports and finance. Tennis is an amazing sport. It can be played by 5 year olds or 75 year olds. It can be played by those in shape or out of shape. It really is incredible because the pace of play can be adjusted to the players. When you are young, your goal is just to get the ball over the net and in bounds. As you get older, the goal becomes to have a rally in which each player hits it back and forth in order to get entertainment and exercise from the sport. Then as competitiveness works in, the goal often becomes to beat your opponent.

I have often heard that for the vast majority of tennis players taking the tact of wining by not losing makes the most sense. Don't double fault, keep the ball in bounds and wait for your opponent to make a mistake. By following this advice, I have heard that 80-90% of players can be beaten. It is only the top 5-10% of players, in which making mistakes is rare that players actually have to attempt to making winning shots and beat their opponents by winning.

I compare this to investing in the following way. Most investors believe that they need to invest aggressively to achieve the returns needed in retirement. In actuality, often you can win at investing by not losing. Risk management is extremely important. In my opinion, not enough advisors place enough value on reducing the chance of large lossess. **Consistent compounding of positive returns while reducing large losses is boring. But, in my opinion is what wins in the game of life.** Most people invest for a goal, retirement planning, education planning or philanthropy drive the need for investment. Rarely is the goal of investing "to make as much money as possible". Amazingly, striving to compound positive returns and attempting to reduce large losses CAN lead to larger actual returns with many less headaches.



I often advise that clients take a core-satellite approach to building an investment portfolio. The core portfolio is designed to compound slowly over time with lower volatility than the overall markets. Then the satellites are instituted to strive to take advantage of themes that may be emerging over the coming 3-5 years.

IV. Investment Ideas

- **Rather than trying to "beat the market", focus on beating the rate on cash. Plan for lower volatility and liquidity while seeking positive returns.**
- Equity valuations are very rich but masked due to the distortion of the Treasury curve. I believe volatility will return to the markets and think long/short managers are best positioned to capture this volatility by owning companies with strong businesses, barriers to entry, and good valuations and selling short weaker companies with high debt loads that have risen sharply with the broad market rally. I think this strategy of <u>hedged equity may have the potential to produce attractive risk-adjusted returns</u> if and when investors begin to question the valuations of companies. Stock investing involves risk including loss of principal. No strategy ensures success or protects against a loss. Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.

- In 2013, the Affordable Care Act began implementation. There will be many winners and losers in the healthcare industry as a result of the biggest change in the healthcare industry's history. With the largest portion of the U.S. population entering their golden years, healthcare needs will become even more important. Long/short Healthcare seems to be a very attractive way to invest in a sector with lots of potential and lots of potential pitfalls. Investing in a specific sector involves additional risk and will be subject to greater volatility than investing more broadly.

- While there isn't a current shortage of energy on the planet, it is taking more and more energy to discover, drill, transport and refine it. Long term demand should continue to grow globally, particularly in China, India, and other developing countries.

- Potential food shortages due to inclement weather and higher demand from the emerging Asian middle class could result in a boon to agricultural land and potash fertilizer companies. International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

- Tight supply and a depressed single family home market are combining to keep apartment buildings full while driving rents higher. The number of potential renters continues to expand as a large cohort or echo boomers enters the workforce. Rents have been increasing as the desire to remain mobile and inability to secure home financing keeps renting attractive. In addition, low supply of new rental units should allow this space to flourish. Apartment REITS typically offer dividends and potential appreciation opportunities. Investing in Real Estate Investment Trusts (REITs) involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time.

- Precious metals mining companies have been extremely beaten down over the past two years. Mining is an industry that spans hundreds of years. These companies have been through good times and bad. Companies that mine for commodities are often highly cyclical, meaning they have sustained moves both up and down. When investing in the mining space it is important to be a contrarian. Ideally, I believe you would want to accumulate miners when sentiment is poor around them and sell them when sentiment is positive. Historically this has been a good strategy.

No strategy ensures success or protects against a loss.

MAY 7, 2015

Regards,

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