NOTTINGHILL INVESTMENT ADVISERS, Ltd.

**Vol. XVIII No. 3** **August 2015**

# An Update

**SCORECARD**

| | 2015 QI-QII | One Year | Three Years | Five Years | 10 Years |
|---|---|---|---|---|---|
| **S&P 500 Index** | 1.23% | 7.42% | 17.31% | 17.34% | 7.89% |
| **10-Year Treasury Note** | -0.24 | 3.84 | 1.17 | 4.71 | 5.29 |
| **Gold** | -2.17 | -10.84 | -9.85 | -1.20 | 10.35 |

All multi-year returns are annualized, and all returns are associated with time periods ending June 30, 2015

## 2015 QII - At Long Last

At long last, are we just about there? At long last, is the Federal Reserve Board about to raise the fed funds target from essentially 0%? The official response is that such decisions will be "data-dependent." But, all eyes are on September. And, if September turns out to be the month of the official Fed pivot, that will mark the end of a seven-year, 0% interest rate policy. The time probably is right. Granted, a weakening China and Greece remain question marks; but, U.S. economic data have been generally good, if not awe-inspiring, and the dark days of 2008-2009 now are a distant speck in the rearview mirror. The time probably is right.

Turning to the markets, U.S. equities ended flat-to-slightly down in the second quarter as the drama in Greece captured everyone's attention in June's final week. Nevertheless, the broadly based S&P 500 Index provided a total investment return of 0.28%, with the Growth side generally outperforming the Value side that we prefer. Growth or Value, though, large caps as an equity class did manage to outperform small-company stocks. Bonds? As the macro data improved and the Fed's intentions become clearer, bonds reversed course, and had a somewhat difficult second quarter. Our proxy is a Treasury note maturing in 10 years, and that note's second quarter rate of return was –2.79%. And finally, gold (Engelhard industrial bullion) came in at -1.29%, which reflects a continued strong-dollar environment and follows a similar decline in the first quarter.

So, how do things look now? Large-scale asset shifts are not part of our investment process, but we do like to take a peak at something called the "outlook." Here are three numbers that we find useful.

- **The Price/Earnings Ratio of the S&P 500 Index**
  On March 31, the Index was priced at 19.52x the earnings of its underlying companies. On June 30, that ratio was 20.17x, which means that valuations in general continue to tick up. We are nowhere near the high valuation levels of 1999-2000, but neither are we near the rock-bottom valuations of 2009.
- **The Current Yield of the 10-Stock Yield Group**
  One characteristic of a stock market peak is premium valuation. Another characteristic is a dearth of bargains, of the type to be found in our Yield Group. On March 31, the average current yield within the Group was 3.66%, and then stood at 3.75% on June 30. The Group was a slightly better value in other words, and both yields are well within the normal range.
- **The Yield of a 10-Year Treasury Note**
  In our last Update, we asked the question: "How competitive is the stock market's main competitor?" Since the 10-year Treasury was yielding 1.93% at the time, the correct response: "Not very," and, even at June 30's 2.32%, that continues to be the case. The interest rate path of least resistance may be up, but still, advantage equities by a fairly high margin.

Our outlook for U.S. equities, therefore, is generally positive, with large-company stocks typically more attractive then small-company stocks. And, if we cast a wider net, the overseas emerging markets appear to be more attractive still. All three equity classes, however, belong in a well-diversified portfolio.

Bonds? They too belong because, even though the interest rate path of least resistance is up, bonds should continue to be a risk-mitigating shock absorber in case some exogenous factor weighs on the equity markets.

The number of moving parts out there appears to be growing, but our advice is the same: Stay diversified, and stay the course.

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Once again, the balanced strategies are front-and-center.

### *About the Firm*

Nottinghill Investment Advisers, Ltd., is a registered investment adviser founded in May 1996.

Nottinghill is owned by the seasoned professionals serving its clients, and effectively managing the assets of those clients, taxable as well as tax-exempt, is the Firm's only business. The twin results are commitment and focus.

Total Portfolio Management, or TPM, is Nottinghill's largely indexed, balanced approach to the management of a client's overall portfolio, and Indexed Total Portfolio Management, or ITPM, is the fully indexed variation. In both cases, portfolios contain three sectors: Equities, either indexed or governed by the Firm's Value Plus Equity Strategy; U.S. Fixed Income, either indexed or governed by the Firm's Select Four Bond Strategy; and the fully indexed Alternatives Group. TPM and ITPM are two complete, widely diversified answers to any client's investment needs.

Seasoned investment professionals. Commitment and focus. Two complete, widely diversified answers. Nottinghill is your ideal partner.

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# Total Portfolio Management

Total Portfolio Management, or TPM, is our largely indexed, balanced approach to the management of a taxable individual's or tax-exempt institution's overall portfolio. The objectives are inflation- and benchmark-beating investment returns, as well as the investment return stability that comes with a balanced portfolio structure.

## Investment Process - The Complete, Largely Indexed Answer

TPM portfolios consist of three sectors: Equities, U.S. Fixed Income, and the Alternatives Group. The Firm's Value Plus Equity Strategy, an active strategy, governs the U.S. large capitalization component of the Equities sector, which also includes three other, indexed Exchange-Traded Fund (ETF) components. The U.S. Fixed Income sector is governed by the Firm's Select Four Bond Strategy, a combination of three actively managed bond mutual funds and intermediate Treasuries. And finally, positions in three alternative asset classes (three ETF positions) constitute an Alternatives Group that adds yet another layer of diversification. The complete, largely indexed answer. One destination for all of the taxable individual's or tax-exempt institution's investment needs.

## 2015 QII - Convergence

REITs were an outlier, but, aside from this asset class, the overall convergence of asset class/portfolio component performance in the second quarter was noteworthy. Longer-term, such convergence is not necessarily what we like to see, i.e., proper diversification is an important objective, and proper diversification actually equates to dissimilar performance patterns. Still, valid generalizations are hard to come by over short time periods and in flat, largely trendless markets. The indicated course is to defer to the grand economic and market forces that produced this convergence.

## Performance — Value-Added Stability

| | 2015 QI-QII | One Year | Three Years | Five Years | 10 Years | Life of the Strategy* |
|---|---|---|---|---|---|---|
| TPM Baseline** | -0.09% | -1.30% | 9.62% | 9.57% | 7.58% | 8.32% |

** Strategy inception for discussion purposes is January 1, 2002*
*** 65% equities*

*Nottinghill Investment Advisers, Ltd., is an independent, registered investment adviser utilizing a number of large capitalization equity and widely diversified balanced investment strategies. The Total Portfolio Management performance data, which are provided net-of-the management fee, are a combination of the actual investment returns associated with Nottinghill's Value Plus Equity Strategy, three equity and fixed income mutual funds/ETFs, a Treasury ladder, gold bullion/an ETF tracking the price of gold, and, after January 1, 2014, two alternatives indexes/ETFs. The investment returns are actual; however, the combination is simulated, and such simulated data have certain inherent limitations. First, unlike an actual performance record, simulated results do not reflect actual trading. Second, since trades have not actually been executed, results may contain an under- or over-compensation for the impact, if any, of certain market factors. All multi-year returns have been annualized, and all returns are associated with time periods ending June 30, 2015. To receive details regarding the calculation and the presentation of any Nottinghill performance data series and/or a complete description of all Nottinghill performance composites, please contact Nottinghill Investment Advisers, Ltd. Whether simulated or actual, past performance is no guarantee of future results.*

Now, let's continue the focus on balanced portfolio investing, and talk about ITPM in 2015. Details on the next page.

# Indexed Total Portfolio Management

Indexed Total Portfolio Management, or ITPM, is our fully indexed, balanced approach to the management of a taxable or tax-exempt investor's overall portfolio. Once again, the objective is inflation-beating investment returns; but this time, they are expected to be in line with the passive indexes, and expenses are expected to be ultra-low.

## Investment Process - The Complete, Fully Indexed Answer

ITPM portfolios also consist of an Equities, a U.S. Fixed Income, and an Alternatives Group sector. A total of nine components, and all nine consist of Exchange-Traded Fund (ETF) positions performing in line with an associated equity market index, bond market index, or commodity price. The result: the traditional performance advantages of indexing, along with ultra-low transaction costs and management fees. The complete, fully indexed answer. As with TPM, one destination for all of the individual or tax-exempt investor's investment needs.

## 2015 QII - Convergence

Micro-capitalization equities joined the REITs as outliers in ITPM portfolios, but again, the overall degree of convergence was noteworthy. The essence of proper diversification is dissimilar performance patterns among the nine asset classes, and, to a large extent, that did not happen. Once again, however, the equity market in particular was flat and trendless, so generalizations tend to be less valid than usual.

## Performance — Indexed Stability

| | 2015 QI-QII | One Year | Three Years | Five Years | 10 Years | Life of the Strategy* |
|---|---|---|---|---|---|---|
| **ITPM Baseline**** | **0.62%** | **1.79%** | **8.66%** | **9.78%** | **6.52%** | **7.36%** |

**Strategy inception for discussion purposes is January 1, 2002*
***65% equities*

*Nottinghill Investment Advisers, Ltd., is an independent, registered investment adviser utilizing a number of large capitalization equity and widely diversified balanced investment strategies. The Indexed Total Portfolio Management performance data, which are provided net-of-the management fee, are a combination of the actual investment returns associated with certain indexed mutual funds/ETFs or the indexes upon which those indexed mutual funds/ETFs are based and the actual investment returns associated with gold bullion or an ETF tracking the price of gold. The investment results are actual; however, the combination is simulated, and such simulated data have certain inherent limitations. First, unlike an actual performance record, simulated results do not reflect actual trading. Second, since trades have not actually been executed, results may contain an under- or over-compensation for the impact, if any, of certain market factors. All multi-year returns have been annualized, and all returns are associated with time periods ending June 30, 2015. To receive details regarding the calculation and the presentation of any Nottinghill performance data series and/or a complete list and description of all Nottinghill performance composites, please contact Nottinghill Investment Advisers, Ltd. Whether simulated or actual, past performance is no guarantee of future results.*

Texas Tea? Check out the back page.

# Texas Tea

Then one day, he was shooting for some food,
And up from the ground come a-bubblin' crude.
(Oil, that is...black gold, Texas tea.)

-- "The Ballad of Jed Clampett,"
Lester Flatt and Earl Scruggs (1962)

Everyone has a group of favorite writers, most of whom write about subjects that the reader finds fascinating. One such subject in our case is investing, and two favorite writers about all things financial are Jim Grant of Grant's Interest Rate Observer and Nick Colas of Convergex. Both routinely turn out commentaries that are well-written, full of sharp analysis, cleverly witty, and refreshingly contrarian. For example, take the recent Colas missive: "Gold, Stocks, Oil...Choose One." The focus here will be on oil, and we'll get to Colas' oil thoughts in a moment.

Ah, oil. Every time we pull up to the pump, those numbers in the little windows make us smile. Not for long, though, because plunging oil prices to an equity investor with any kind of oil-stock exposure clearly are a two-edged sword. Let's review some history.

It's real late, sometime in the summer of 1964. After a night of riding around, "The House of the Rising Sun" is blaring from the radio in the (all-metal) dashboard for about the 10th time. Great tune; but, everybody is tired, and wants to go home. Problem is, the needle is on E. After a pooling of resources, the tally is...50¢! (Come on, you've been there.) So, you pull into Johnny's Sunoco. Johnny ambles out, mutters something about no windshield washing or roadmaps this time, and pumps the gas. But, mission accomplished. On 50¢ worth, you're able to drop everybody off and get yourself home because a barrel of West Texas Intermediate crude sold for $3, and Johnny was selling a gallon of Sunoco's refined product for about 30¢. Those were the days, but the times they were a-changin' in so many respects.

Fast forward to late-1973. (The dashboard now is padded, and maybe you've graduated to Led Zeppelin.) In response to yet another Arab-Israeli war, the Saudis and the rest of OPEC have declared an oil embargo on the U.S. and its allies. Oil prices then proceeded to quadruple in 1974 (WTI crude sold for about $11 per barrel at year-end), and we were off to the oil supply manipulation races. Actually, that's a poor choice of words because we all had to learn how to "race" at 55 M.P.H. and how to live without all those gas station amenities from earlier times. More important, we had to learn how to live without Johnny. But, we managed to survive during the next few years. The Saudis and the rest of OPEC? They learned all about real power.

The Second Oil Shock occurred in 1979-1980, and was the direct result of the Shah's fall in Iran. A lot of supply suddenly was taken off the market; a barrel of WTI crude went from $15 to $37 over this two-year period. Also at about this time, the world in general and the U.S. in particular, it was thought, were running out of oil. The unalterable conclusion: Cheap oil never again would be seen in our lifetime. A whole host of luminaries told us so.

So much for that. The high oil prices of the early-80s brought forth (what else?) supply, and all those small, ugly cars and other attempts to conserve reduced (what else?) demand. From December 1980 until December 1986, the price of WTI crude went from $37/barrel to $16/barrel. From there, prices firmed a bit, and then the Persian Gulf War produced a sharp, but short-lived spike (1990). However, oil for the most part turned into a somewhat expensive, but steady and reliable factor of production and fact of life.

Then came the 00s and...shale. Suddenly, there was an abundance of homegrown supply. The Saudis in particular were slow to perceive the threat, but, when they did, they acted (2014). The spigots were thrown open, and a lot of excess supply flooded the market. Why? Clearly, the objective of Saudi Arabia, the world's major at-the-margin producer, was and is to lower oil prices and drive out as many of the marginal shale and other producers as possible. Sure, it's a 180-degree switch, i.e., too much supply on the market this time versus no or reduced supply in the 70s, but the fact remains, the same lessons learned in 1973 now are being applied in 2014-15. Those lessons: The importance of being the marginal producer cannot be overstated; supply can be manipulated to achieve the desired price outcome; ultimately, Saudi Arabia still has the power, at least for now. From a 2014 high of $106/barrel, WTI crude has declined 59% to a recent $43/barrel. So, where does that leave us? Enter Nick Colas.

In his recent article, "Gold, Stocks, Oil...Choose One," Nick Colas of Convergex presents some interesting metrics. For example, you have $2,100 in your pocket and two options: one share of the S&P 500 Index, or at this point anyway, 48.8 barrels of WTI crude. Advantage oil since the 30-year average is one S&P 500 Index share per only 28.6 barrels of crude. Given a constant S&P 500 Index in other words, crude would have to rise from the current $43/barrel to $73/barrel if the 30-year equilibrium is achieved. New ball game, you say? Maybe, but the 10-year average, i.e., one share of the S&P 500 Index per 17.7 barrels, suggests that the price of crude would have to rise all the way to $120/barrel if this particular "equilibrium" is achieved.

Are either of these outcomes possible? Probably not over the near-term, but value will out as Ben Graham often said. WTI crude is cheap by any historical measure in the modern era. What about the equities of Big Oil? As most friends of the Firm know, we regard dividend yield as a very important — maybe the most important — indicator of investment value. As someone once said, a company's earnings and book value are subject to some degree of interpretation, but dividends are real dollars, not abstractions. Those ConocoPhillips dividends were real and generous when we bought the shares, as were the Chevron dividends when those shares were bought. Then came the Saudi Surprise and the 60% fall in crude prices. Now, the ConocoPhillips complex (COP itself and the now-spun off Phillips 66 shares) yields 4.9%, Chevron yields 5.1%, and ExxonMobil with its AAA-rated balance sheet yields about 4%. All seem attractive relative to the NIL (yield) provided by a money market fund, the 2.2% provided by a Treasury maturing in 10 years, and the 2% provided by the S&P 500 Index. Attractive. Patience probably required, but attractive. Colas' conclusion:

"The upshot of these two case studies (oil and gold) is pretty clear: Oil is cheap relative to stocks, and the savvy investor should look to the beaten up energy sector for value plays. Oil doesn't stay cheap forever — never has anyway."

We agree. Again, our "Texas tea" may require a couple of cubes of patience, but patience is what value investing is all about.