The most misused saying in the financial industry is "this time it’s different," implying that historic market fundamentals no longer apply. It is most often used to justify some existing market phenomenon like high price-to-earnings ratios. Not infrequently, it’s heard just prior to the bursting of a bubble. Anyone espousing changes is often mocked.

In truth, the most consistent feature of the markets is change itself, an unending, rolling parade of ever-evolving, constantly fluctuating movement of new trends, companies, industries, and interrelationships. The markets are both never the same from decade to decade and simultaneously always reverting to a pattern, a mean seen before and repeated.

The phonographic record is replaced by the cassette tape, then the CD, then the digital playlist. The demand for music never changes, just the companies and technologies. RCA fades as iTunes is invented. Creative destruction at work. Companies, industries, and sectors prosper and then collapse. Print media, which once dominated, is slowly becoming redundant.

According to a 2013 study at Oxford Martin, it’s likely that as many as half of the jobs in the U.S. will vanish within a few decades. Many will be replaced by new, wholly different jobs with different skills and requirements. The percentage of workers available to work remains at very low levels, last seen in the 1970s, as boomers retire, worker skills don’t match available jobs, and government support enables extended idleness.

Information, once the prized domain of a few, is now available to anyone armed with a smartphone. The tsunami of data is allowing retailers to predict what you’ll buy next. New companies are being created to provide, process, and profit from the processing of data, identifying trends and solutions at the fastest pace in history. Cyber platforms make enormous profits from connecting those with the need for a service, such as a car ride or a place to sleep, with those who can provide the service.
The information technology revolution has changed the manner and structure of companies and industries. The largest global retailer is Amazon, which has no conventional stores. The largest transportation company is Uber, which owns no vehicles. The largest hotel company is Airbnb, which owns no properties. The fundamental nature of business is changing.

Automated robots are assembling cars, and artificial intelligence will soon design them according to data sampling of population needs and preferred aesthetics. There is even an initiative to abandon hierarchical decision making in corporate management; employees, rather than reporting to superiors, would form committees to determine priorities and deliverables.

These are transformative times for capitalism. Henry Ford created definable value when he institutionalized the assembly line, dramatically increasing the productivity of individual workers. Information technology is so inexpensive it increases every company’s profit margins and productivity. Value calculations become ephemeral. How much is a platform worth if it’s infinitely expandable, instantly reproducible, and quickly outdated?

We come to every market development with an inherent skepticism. We try to formulate an opinion whether it’s a near-term trend or a long-term opportunity. Thus, we currently challenge the view that China’s problems are overwhelming and that its stock and real estate markets are bursting bubbles. China’s markets are undergoing a near term correction, but we don’t think it will enter a prolonged stagnation like Japan. China’s role in the global economy is enormous and getting bigger. China will eventually have the largest economy in the world. Its current GDP per capita is under $10,000/year while the U.S. (currently the largest economy in the world) has a GDP per capita of $53,000/year. Although China’s growth has slowed recently, it is still growing nearly three times faster than the U.S. and about six times faster than the Eurozone. China’s national debt is 25% of GDP while the U.S.’s debt is 100% of GDP, giving China more flexibility to pursue expansionary policies.

Indeed, China’s hasty and seemingly imprudent solutions to its stock market sell-off are disconcerting (e.g. buying stocks directly and ordering state-run companies to do the same). Despite the turbulence in the market, Chinese stock market valuations,
as determined by price-to-earnings ratios, are at 18x according to Bloomberg. Since history tells us that stock prices eventually track corporate earnings growth over time, there is reason to expect Chinese stocks to sustain earnings multiples slightly higher than those prevalent in the U.S. or Europe. Of course, with higher expected growth rates there will be higher interim volatility and uncertainty. In the end, China’s economic growth rate is likely to support future stock market gains.

It is always hard to recognize change as it is happening. Our task as investment managers is to remain alert to developments and avoid “confirmation bias,” the behavioral tendency to seek out data that confirms a preconceived conclusion and ignore data that undermines our viewpoints. Our Investment Committee operates on a principle of open debate where everyone is expected to express his or her point of view and challenge one another. We reject taking umbrage at disagreements and welcome letting the best ideas surface by consensus based on persuasive data objectively examined.

“IN TRUTH, THE MOST CONSISTENT FEATURE IN THE MARKETS IS CHANGE ITSELF.”
John Bogle, the legendary and outspoken founder of Vanguard, is known for being blunt and direct, especially when it comes to investing matters. Here are some of my favorite quotes of his:

- “Don’t do something, just stand there!”
- “Don’t look for the needle in the haystack. Just buy the haystack!”

Both quotes refer to the so-called “passive” investment strategy which doesn’t try to pick stocks, rather only invests in the market as a whole. That means that when you invest in the index fund that represents the U.S. large cap stock market - the S&P 500, for example - you’re buying the companies that make up the index at the time.

Investors have followed Mr. Bogle’s advice in a big way over the last several years. Assets in passive equity mutual fund strategies, including those managed by Vanguard, increased by $150 billion for the 12 months ended June 30, 2015, while $156 billion flowed out of active equity funds during the same period [Source: Morningstar U.S. Asset Flows Update, July 16, 2015]. Along the way, Vanguard has become the largest asset manager in the world, with over $3 trillion in assets under management.

There are several reasons for the trend - index funds provide low-cost, tax efficient exposure to an asset class, and investors don’t take the risk that the manager will make a stock selection mistake. On the other hand, passive strategies allocate capital into the stocks that have performed the best and have appreciated to become the largest components of the index. As of June 30, Apple was the largest stock in the index, making up about 4% of the index, followed by Microsoft and Exxon Mobil. The way Apple got to be the largest component of the index was a result of its fantastic recent performance: +37% in the 12 months ending June 30, 2015, and 128% over the 2 years through June 30, 2015 [Source: Bloomberg].

The best example of performance-chasing in passive strategies comes from the internet bubble 15 years ago. At its peak in 2000, the technology sector accounted for 36% of the entire U.S. stock market, triple its weight from three years prior, and at valuations that were never seen before or since! [Source: Bespoke Investment Group]

A similar situation exists now within the index of U.S. small cap growth stocks, where biotech stocks make up 13.5% of the index (double its weight from only 18 months ago) and the not-so-appealing combination of money-losing plus barely profitable companies make up over 36% of the index. [Source: FactSet, Kalmar Investments] It’s difficult to justify allocating client capital that way even if that is what’s performing well now. And when we evaluate our managers’ performance relative to benchmarks, we take these factors into account.

Indices that track stocks in the emerging markets also concern us. Chinese stocks are currently the largest component of the FTSE emerging market index (as constructed by Russell Investments) at 29%. The Chinese market, as represented by the Shanghai exchange, has experienced tremendous volatility in the last eighteen months, dropping 30% in the last six weeks after increasing by 140% in the prior 12 months. Because China is in the process of allowing greater foreign access to their markets, Russell expects to increase China’s weighting over time to as much as 50% of the total index. [Source: ETF Daily News, June 5, 2015] Is that a good idea? We’re not sure, but because Vanguard’s $50 billion emerging markets fund tracks this index,
50 cents of every dollar invested will go into China. We would rather allocate to good companies in the emerging markets as opposed to whatever happens to be the largest weightings in the index.

At times, we at MCM use passive strategies and believe that they have some advantages over active managers. But we don’t use them blindly and without understanding their composition and weighting methodology.

We also understand that our active managers won’t always conform to an index - nor should they. Should a manager that only invests in high-quality small cap companies have a 20% weighting in speculative biotech stocks because that’s what their relevant index is?

To summarize, there is no question that passive strategies can have a place in portfolios; however, it’s important to understand what you’re buying and how that fits into your portfolio.
As fiduciaries, we at Manchester Capital take very seriously our responsibility to protect clients’ assets and their confidential information. Our dedication to this responsibility can be seen in our approach to three current threats to clients—wire fraud, custodial malfeasance, and cybercrime.

• Wire fraud is on the rise, and the sophistication and complexity of these fraudulent attempts to steal assets increases every day. MCM is not immune from such attempts, and occasionally we receive wire requests from fraudsters. In most instances, requests come from a client’s known email address after it has been hacked. According to Fidelity, the majority of fraudulent wire attempts resulting from the compromise of a client’s email address involve those with AOL addresses.

MCM has an internal policy of calling clients to verify first-time wires to third parties. If you make such a request, expect a call from your Wealth Manager seeking verbal confirmation that the request is actually coming from you. In one fraudulent request we received, we were asked to wire $50,000 to an account that had been created by a fraudster in the client’s name at a well-known bank. Even though the receiving account was in the client’s name, MCM made a call to the client to confirm the validity of the transfer to a bank where the client had never sent money before and learned from the client that the request was an attempted theft.

• Custody issues have been a major SEC regulatory focus since Bernie Madoff’s Ponzi scheme was uncovered in 2008. Because Madoff both custodied client assets AND produced client statements, he was able to falsify portfolio balances. All MCM client assets are held by well-known qualified custodians—almost exclusively with Charles Schwab and Fidelity Investments, which provide independent verification of portfolio balances. However, MCM is “deemed to have custody” in situations where a client has authorized us to direct payments from his or her account to a third party. A “standing letter of authorization” is required to be signed by the client and on file with his or her custodian specifying the parties that MCM is authorized to pay on the client’s behalf.

• Under the Investment Advisers Act of 1940, and subsequent regulations, having “custody” requires investment advisers to take specific measures to ensure the safekeeping of client assets. One of these requirements is an annual “surprise custody audit” from an independent public accounting firm. This accounting firm must then file a report with the SEC attesting to its audit of the investment adviser.

This year, MCM’s surprise custody audit by Grant Thornton utilized data since its previous audit through April 30, 2015. Clients selected by Grant Thornton were sent a letter requesting verification of the value of their assets, a list of all approved payees, and a list of transactions for the period audited, including payments directed by MCM on their behalf. As we were certain would be the case, Grant Thornton reported that our records continue to be in order.

• Cybersecurity is a focus in many industries, the financial industry included. At MCM, our Information Technology department strives to maintain the most secure system possible, with constant monitoring and updating as new viruses and other threats develop. As part of our best-practice program, we periodically engage a third party to perform “penetration tests” to evaluate the security of our systems and firewalls.
Periodically, MCM also hires third-party regulatory consultants to perform risk assessments as well as regulatory compliance services in the form of a mock SEC audit. In April 2015, MCM underwent such a mock SEC audit performed by National Regulatory Services. The company’s examination provided valuable feedback for us to help ensure we are ready in the event the SEC selects MCM for examination.

MCM’s compliance team consists of Bart Kraft, Chief Compliance Officer; Bliss Bernal, Operations and Compliance Associate (who is also an Investment Adviser Certified Compliance Professional); and Brian McGunnigle, Director of Operations. We are committed to having a strong compliance program, and strive to stay ahead of regulatory changes and industry trends through continuing education and by working with consultants to ensure that our systems and processes represent best practices for our industry.

If you have any questions about MCM’s compliance program, please do not hesitate to contact us.
Recent Firm Highlights

We’re proud to announce Ted Cronin has again been selected as one of the “Top 100 Independent Investment Advisors” in the country. Barron’s began publishing this list in 2007, and Ted has been named to this list each year since its inception.

Barron’s Top 100 Independent Financial Advisors rankings rank individual independent investment advisors based on data provided by individual advisors and their firms. Advisor data is confirmed by Barron’s via regulatory databases, cross-checks with securities firms and conversations with individual advisors. While the formula Barron’s uses to rank advisors is proprietary, it has three major components: assets managed, revenue produced and quality of practice. Investment returns are not a component of the ranking because Barron’s bases an advisor’s returns on being distanced largely by the risk tolerance of clients. The quality-of-practice component includes an evaluation of each advisor’s regulatory record. The process of being ranked in Barron’s starts with filling out a detailed online survey. Accordingly, advisors who do not complete a survey are not considered. Advisor data is confirmed via regulatory databases, cross-checks with securities firms, and conversations with individual advisors. For more information, visit http://online.barrons.com/rank-best-financial-advisors. Such rankings may not be representative of any one client’s experience and are not rankings of Manchester Capital Management or a firm-wide basis. Such rankings are not indicative of future performance.

Welcome to the Team

We are excited to announce that Jordan Rubin joined Manchester Capital earlier this summer. Jordan is based in our Virginia office, where he supports Drew Beresford, Ben Cullop, and the rest of our investment team. Jordan’s primary responsibilities include monitoring portfolios, analyzing portfolio positions, researching investment ideas, and working on client-related projects.

Jordan graduated from the University of Virginia in May 2015, where he received a B.S. in Commerce. Jordan grew up in Scarsdale, New York, and still has plenty of family living in the area.

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