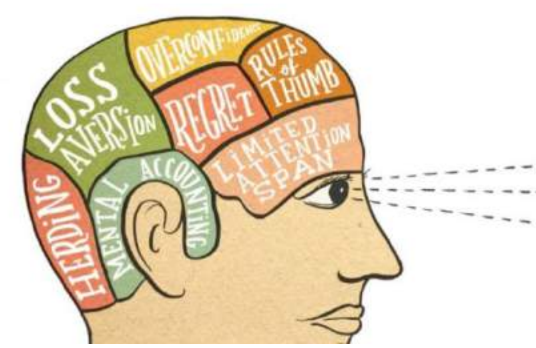
April 15, 2017

Dear Clients and Friends,

As I have written from time to time in my newsletters, I believe that being a student of history is a prerequisite for being a good investor. It doesn't mean that the world doesn't change. In fact, it is changing rapidly. But human nature is fairly constant. When investors are making buy, hold, or sell decisions regarding their financial assets, it behooves us to remember that investors are humans. Despite all the algorithms, big data, and quantitative models employed in the quest for profit, human emotion rules supreme in the pricing of assets.

Humans make mistakes and good investing is about not making too many avoidable mistakes. That brings us back to history, where we can study human behavior through time & place and perhaps recognize behavioral impulses that could be detrimental to our investment success.

Some of my friends and colleagues cringe at the thought that finance is a social science at heart. By nature, I am also more drawn to the quantitative aspects of finance, but with time have come to believe that investing is a very human endeavor. However, we should be thankful that investing is a social science. If markets were truly rational, there would never be an opportunity to buy at the point of maximum pessimism or sell at the height of exuberance. Risk premiums – the amount of return you earn in excess of low risk assets – would be low because rational behavior would in turn reduce risk for everyone and thus return. That would be a drab, colorless, world indeed!



So what annals of history have I been looking at lately? Those of March 9th, 2009, which was the day that US stock markets found a bottom during the Great Financial Crisis (GFC). Why am I looking at that? Rest assured it is not because I predict a repeat of the GFC. It is because I believe that reimagining that time of crisis, will go a long way towards avoiding behavioral mistakes the next time financial markets turn sour and fearful.

Below are a couple news clippings from that day:

CNN – *"Stocks tumbled Monday, with the Dow and S&P 500 ending at fresh 12-year lows, as Merck's $41 billion purchase of Schering-Plough failed to distract investors from worries about the economy. Since closing at its all-time high of 14,164.53 on Oct. 9, 2007, the Dow has lost nearly 54%. The S&P 500, which also hit its high of 1565.15 on Oct. 9 has lost around 57%. "Valuations are reasonably attractive outside of financials, but most investors are in defensive mode," said [CNN contributor], "They've seen too many losses and are sitting on the sidelines."*

Wall Street Journal – *"Dow 5000? There's a Case for It. Despite Friday's small gain, the Dow Jones Industrial Average marked its fourth consecutive week of losses as it tumbled through the 7000-point mark and spiraled to new 12-year lows. The Standard & Poor's 500-stock index is trading below 700 for* *the first time since 1996. As earnings estimates are ratcheted down and hopes for a quick economic fix fade, the once-inconceivable notion of returning to Dow 5000 or S&P 500 at 500 looks a little less far-fetched."*

That was a gloomy day indeed. It would have also been the best day in my investment career to buy stocks. Hindsight is 20/20, and one could not have known on that day that a turnaround was imminent. But perhaps when fear makes a comeback and investors hit the panic button, we will be reminded of March 9, 2009, see the silver lining, and think "opportunity."

It is Not About Stock Picking

I don't like to write those words, because researching and selecting stocks is fun. But evidence overwhelmingly suggests that it is near impossible to pick stocks that *in the aggregate* do better than the market, especially if you factor in trading costs and taxes. According to a Wall Street Journal article of April 12th, 2017, over 93% of actively managed US small-cap funds, 95% of US mid-cap funds, and 92% of US large-cap mutual funds underperformed their respective indices over a 15-year time period. Stock pickers might do well for a while, but invariable the math catches up with most of them and their luck runs dry.

According to David Swensen, who manages the Yale Endowment and arguably has the best record of any institutional investor around, asset allocation drives over 90% of return. This is true because no *prudent* investor, especially not one managing other people's money, would bet the farm on a very small number of individual stocks, nor would she day-trade the entire portfolio. As a result, prudently managed portfolios tend to have some level of diversification, which naturally leads to asset allocation becoming the primary driver of return.

Yet, much effort is expended by professional and individual investors alike, on stock picking and it comes at the expense of asset allocation (as time is limited). I try to be mindful of that and spend a good amount of time where I can have the greatest impact: making decisions about stocks vs bonds, small cap versus large cap, growth vs value, international vs domestic, emerging market exposure, alternative investment exposure, etc. Stock picking still gets mindshare, but not without first putting in place the proper foundation of a forward-looking, diversified portfolio.

Offshore Wind Energy in the US

The potential for offshore wind energy is enormous. According to the Global Wind Energy Council, it could meet Europe's energy demand 7 times over, and the US demand 4 times over. To date, over 90% of the offshore wind energy has been installed in Europe in the North Sea, Irish Sea, Baltic Sea, and English Channel.

One of the common objections against offshore wind is the fact that it is expensive and cannot exist without subsidies. Unsurprisingly, costs have been coming down as a result of scale and innovation. In early April, German and Danish utilities EnBW and Dong Energy caused quite a stir when they announced that they had won 2 project bids in the North Sea without asking for a subsidy. The projects are slated to go into production in the early 2020s, almost a decade before Ernest &

Young's prediction of when offshore wind would be competitive without subsidies. Mind you, fossil fuel energy still gets subsidies today.

Ok, that's in Europe. What about the US? The first commercial project entered operation in 2016. It was not Cape Wind in Nantucket Sound – maybe that one will never see the light of day – but Block Island off the coast of Rhode Island. The wind farm consists of 5 turbines with a total capacity of 30 megawatts. It's a start, but pales in comparison to 3,230 turbines and 11,034 megawatts of European offshore wind through 2015. What is holding us back? It certainly isn't the technology. It is a combination of lack of state government support as well as NIMBY issues. Perhaps with Block Island up-and-running and the knowledge that offshore wind will soon be cost competitive on an unsubsidized basis, state legislatures will become more supportive.

Investment wise, most of the opportunities are at the project level, which makes it hard to participate in for individual investors. Of course, the turbines and infrastructure come from a wide range of companies and some are investable, such as GE, Siemens, and ABB. The ultimate owners of wind projects will include investor-owned utilities, but offshore wind will represent only a small part of their portfolios for the foreseeable future. The market will gain scale though, and with that the investment opportunity set will expand as well.

Block Island, RI – These 5 Turbines Represent the Entire US Offshore Wind Capacity!

As I write this letter, I am looking out the window and see green hills. Northern California has been blessed this winter and spring with ample rainfall and snow in the Sierras. As the weather warms up and the days grow longer, travel plans are starting to take form. I look forwarding to seeing my clients on the East Coast and in the Pacific Northwest, the Rockies, and Southern California. Perhaps in New England I will get a chance to visit Block Island and muse about 2020 when hopefully there won't be 5 but 500 turbines gracing our coast line.

I welcome you to contact me with any questions or to learn more about our investment strategies and financial advisory services.

Wishing you a rejuvenating Spring time.

Kindly,

Jan Schalkwijk, CFA

JPS Global Investments