# Investment Playbook

# Better earnings but with a reduced margin of safety

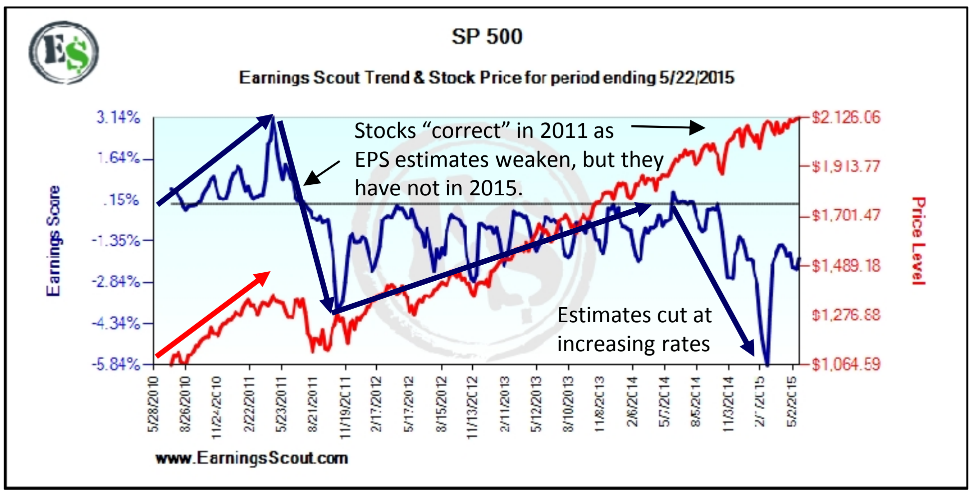
May 28, 2015

***Once again, low balled earnings expectations paved the way for positive surprises during 1Q 2015 earnings season. This provided investors some relief and has kept U.S. markets near record highs. However, top-line 1Q 2015 sales were very disappointing and make no mistake there is a slowdown in growth underway that has not been accounted for in stock prices. Therefore, we remain modestly bearish on stocks and recommend underweighting U.S. and Emerging Market stocks, while overweighting Developed International.***

As we approach the summer trading months, the good news for equites is that it is highly likely the worst of the negative earnings estimate revisions, in terms of magnitude downward, are over having occurred in February 2015. This would normally make us very bullish as we would then expect stock prices to rise along with the improving earnings estimate trends. However, because stock prices never corrected earlier this year to reflect the slowdown in 2015 growth, there is now a reduced margin of safety in the market. We are also not as optimistic as Janet Yellen and the Fed that the recent slowdown is based solely on “transitory” factors. Therefore, we prudently advise caution in the months ahead.

## Five year EPS estimate and price trend(s) for the S&P 500

- *The last time S&P 500 earnings estimates were being raised, on an absolute basis, was during the 1Q of 2011.*
- *During the summer of 2011, earnings estimate trends began to weaken sharply and this marked the last time there was a correction (>10% drop) in stock prices.*




- *From the Fall of 2011 to the end of 2014, EPS estimates were falling, but at lesser rates. The improving revision trend confirmed higher stock prices in 2012, 2013 and 2014.*
- *The improvement in earnings estimate trends stopped in late 2014 and prices never corrected. This reduces the margin of safety for stocks. Be careful.*

Nick Raich, CFA®
Chief Executive Officer
The Earnings Scout
312.391.6805
nick.raich@earningsscout.com
www.EarningsScout.com
@EarningsScout

## I. Tactical Asset Allocation – No change

| Asset Class | *Tactical Asset Allocation | 1 month Return | 3 month Return | **2015 YTD Return |
|---|---|---|---|---|
| Domestic U.S. | Underweight by 5% | 0.69% | 0.29% | 3.14% |
| Emerging Markets | Underweight by 10% | -4.45% | 3.39% | 7.05% |
| Developed International | Overweight by 10% | -1.43% | 2.39% | 9.73% |

*If your normal strategic allocation to U.S. stocks is 35%, we recommend a current tactical allocation of 31.5%.
*If your normal strategic allocation to Emerging Market stocks is 10%, we recommend a current tactical allocation of 8.5%.
*If your normal strategic allocation to Developed International stocks is 15%, we recommend a current tactical allocation of 16%.
**Through 5/27/2015

## II. Domestic Recommendations – No change

| Asset Class | *Tactical Asset Allocation | 1 month Return | 3 month Return | **2015 YTD Return |
|---|---|---|---|---|
| Large Caps | Overweight by additional 0% to 5% | 0.69% | 0.29% | 3.14% |
| Small Caps | Neutral | -1.40% | -0.75% | 2.11% |

*If your normal strategic allocation to U.S. large cap stocks is 35%, we recommend a current tactical allocation of 31.5% to 33.25%
*If your normal strategic allocation to U.S. small cap stocks is 10%, we recommend a current tactical allocation of 9%.
**Through 5/27/2015

## III. Sector Recommendations – No Change

| Sector | Recommendation | *Weight | 1 Month Return | 3 month Return | **2015 YTD Return |
|---|---|---|---|---|---|
| Consumer Staples | Overweight | +125 bps | 0.39% | -2.11% | 0.87% |
| Materials | Overweight | +100 bps | 0.04% | -2.03% | 4.24% |
| Financials | Neutral | +50 bps | 2.56% | 1.15% | 0.20% |
| Health Care | Neutral | +50 bps | 2.57% | 2.95% | 9.38% |
| Industrials | Neutral | +50 bps | 0.36% | -2.16% | -0.03% |
| Energy | Neutral | Even | -4.02% | 0.02% | -2.21% |
| Utilities | Neutral | Even | -0.97% | 0.12% | -6.52% |
| Telecom | Neutral | -75 bps | -0.01% | -0.47% | 3.80% |
| Consumer Discretionary | Underweight | -150 bps | -0.06% | 0.18% | 6.50% |
| Technology | Underweight | -150 bps | 0.98% | 0.73% | 5.45% |
| **S&P 500** | | | 0.69% | 0.29% | 3.14% |

*Recommended over/under to index benchmark weight

**Through 5/27/2015

## IV. Industry Recommendations: No Change

| Sector | Overweight / Go Long | Underweight / Avoid / Go Short |
|---|---|---|
| Consumer Discretionary | Apparel Retail<br>Auto Parts & Equipment<br>Hotels Resorts & Cruise Lines | Broadcasting<br>Distributors |
| Consumer Staples | Distillers & Vintners<br>Food Distributors<br>Food Retail | Drug Retail<br>Tobacco |
| Energy | Drilling<br>Equipment & Services<br>Exploration & Production | Integrated Oil & Gas<br>Refining & Marketing |
| Financials | Industrial REITs<br>Investment Banking & Brokerage<br>Residential REITs | Life & Health Insurance<br>Multi-Line Insurance<br>Regional Banks |
| Health Care | Health Care Technology<br>Health Care Services<br>Managed Healthcare | Health Care Distributors<br>Health Care Equipment<br>Health Care Facilities<br>Life Sciences Tools & Services |
| Industrials | Industrial Conglomerates<br>Railroads<br>Office Services & Supplies | Air Freight & Logistics<br>Construction & Engineering<br>Trading Companies & Distributors<br>Trucking |
| Materials | Industrial Gases<br>Paper Packaging<br>Paper Products | Commodity Chemicals<br>Metal & Glass Containers |
| Technology | Data Processing & Outsourced Services<br>Electronic Components<br>Electronic Equipment & Instruments | Systems Software<br>IT Consulting & Other Services |
| Telecommunication | Integrated Telecommunication Services | |
| Utilities | Electric Utilities | Independent Power Producers |