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Sound Investments Inc.

Thrd Quarter 2016

DJIA 18308 S&P 500 2168 NASDAQ 5312

Summary

Warren Buffet and wrote "In the short term the markets are a voting machine, but in the long run, it is a weighting machine." What it means is this; As emotional animals, we tend to get caught up in the frenzy of the financial markets, but as rational human beings we eventually figure out what things are really worth.

If interest rates rise, the market will demand a better return, forcing it to correct at a lower level. In my last client letter I wrote about the prediction of the well known Technical Analyst, (i.e.. Chart Reader), Louise Yamada. Ms. Yamada went back to the years 1946 to 1949, when interest rates last raised after going down since 1932. She thinks we are in a trading range that could last for some time.

Investors are choosing companies that have proven they can continue to increase profits in a slow growth economy.

This investment letter is mailed quarterly to our clients and friends.

A Solid Quarter

Stocks zigzagged in September amidst all the political and financial turmoil. As the media and analysts started to tout a stock market decline, it rebounded in July. The surge in July, followed by a flat August and September, allowed U.S. stocks to turn in their best quarter in a year. (So much for sell in May and Go Away). In this slow growth environment, most indexes are up about 6% year to date.

International and emerging markets are moving up in the ranks for the first time in almost 8 years and we are monitoring this development to ensure it has staying power.

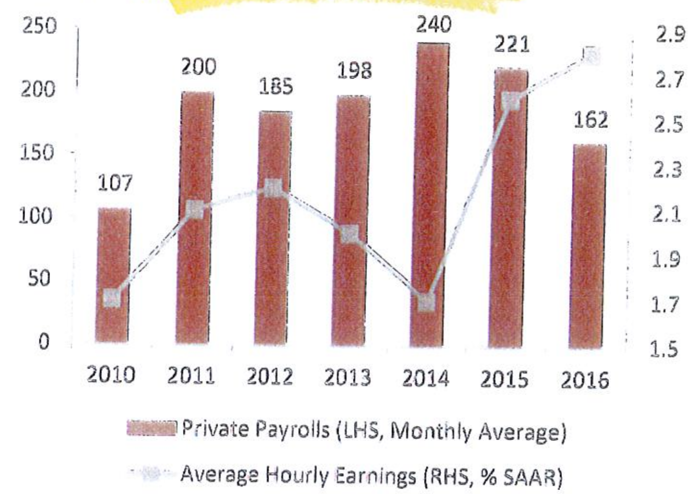
Our Current Economy

We have a largely consumer based economy and what provides the fuel for growth? It's primarily job growth and and employee cash flow that keeps this country going. On page 2, (see back of this page) a graph that shows private payrolls. Increases in the number of jobs created, has actually decreased from 221,000 in 2015 to 162,000 for 2016 (see red bar). What's interesting, is the grey line which shows stronger wage growth. Hence, we are seeing slower job growth but stronger wage growth. More importantly or in other words, the "Goldilocks Economy" --- a wage growth strong enough to support spending and yet not too strong so the Feds won't raise interest rates.

The number of people employed age 25 to 54, rose .2% to 81.5%, the highest level in 3 years. The middle chart on the back of this page shows the people outside the labor force or people not looking for work. This fell to the lowest level in 20 years. The bottom line is that there are less people available to work, hence wages are going up.

Housing market strength remains an important driver for the labor market as well. The bottom chart (see page 2) shows the gradual increase in wages for construction workers.

Slowing jobs growth, stronger wage growth

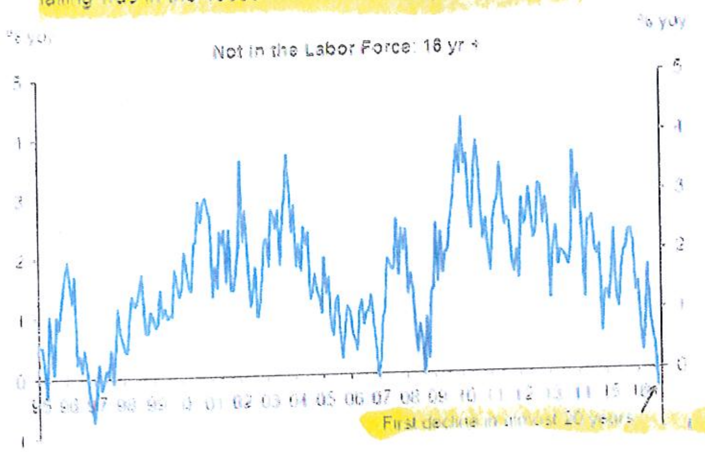


All three charts show an improving employment picture.

Red line shows number of jobs created.

Grey line shows increase in wages.

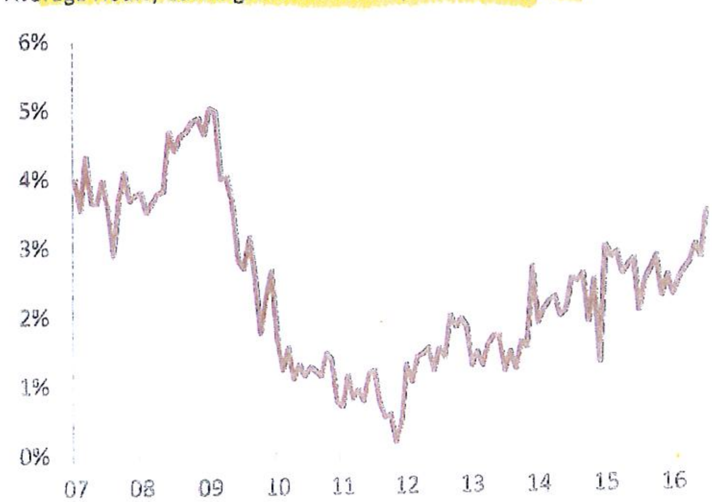
Last time the number of people outside the labor force was falling was in the 1990s when the economy was booming



Supports view that there are less workers.

Builders need workers

Average Hourly Earnings: Construction (YoY % Change)



Source: Haver Analytics, Renaissance Macro Research

Stronger demand for construction workers is forcing wages higher.

These factors indicated economic strength. Other factors such as lower unemployment claims, a normal yield curve and positive readings from leading economic indicators reflects this long term improvement. We are looking ahead to whether they will raise interest rates in December and at how Christmas sales come in.

The Weighing Machine Gets to Work

Warren Buffet and wrote "In the short term, the markets are a voting machine, but in the long run, it is a weighting machine." What it means is this; As emotional animals, we tend to get caught up in the frenzy of the financial markets, but as rational human beings we eventually figure out what things are really worth.

Since interest rates are so low and money is so cheap (due to low rates), it only makes sense that profits will fall as well and that's exactly what is happening. The earnings yield or how much profit a company earns per share, is falling. I hope this doesn't get too complicated but I placed a chart on the back of this page entitled, "Better Value than You Think". Not only has the earnings yield per share gone down but yield on 10 year treasurers has declined as well. This, of course, is old news but the chart shows that the difference between the earnings yield and the 10 year bond yield has remained almost unchanged over the past 6 years. If interest rates rise, the market will demand a better return, forcing it to correct at a lower level. In my last client letter I wrote about the prediction of the well known Technical Analyst, (i.e.. Chart Reader), Louise Yamada. Ms. Yamada went back to the years 1946 to 1949, when interest rates last raised after going down since 1932. She thinks we are in a trading range that could last for some time.

So, what else does the weighing machine tell us? Investors are choosing stocks based on talent rather than looks. The weighing machine is hard at work adding heft to companies that have proven they can continue to increase profits in a slow growth economy. As long as the U.S. economy can continue to grow, a crash like we had in 2002 and 2009 seems hard to justify but a correction of 10% is certainly not out of the question.

Asset Allocation

The lower chart at the back of this page, "Diversification and the Average Investor," is somewhat self explanatory. It is interesting to note that the 50/50 and 60/40 portfolios did almost as well as the S&P 500, yet they didn't go down nearly as far and recovery was significantly faster.

Conclusion

As outlined above, we think the economy has recovered and will continue to plug along. We believe a select group of mutual funds and stocks will continue to perform at an above average rate. As outlined in the 3rd paragraph of this page, if interest rates rise 1%, we could see a slight downward revaluation of equities.

We continue to watch and monitor the portfolios. Please call anytime.

Better Value Than You Think

The below-average spread between bond yields and the S&P 500's earnings yield* implies that stocks aren't overpriced.

Date	S&P 500 Earnings Yield	10-year Treasury Note	Spread
2010	6.36%	2.97%	339
2011	6.41	3.18	323
2012	6.43	1.67	476
2013	5.52	2.52	300
2014	5.27	2.53	274
2015	4.46	2.35	211
2016	4.11	1.49	262
		Average:	312

All values are for last trading day in June of each year. *Earnings yield is how much profit a company earns per share price.

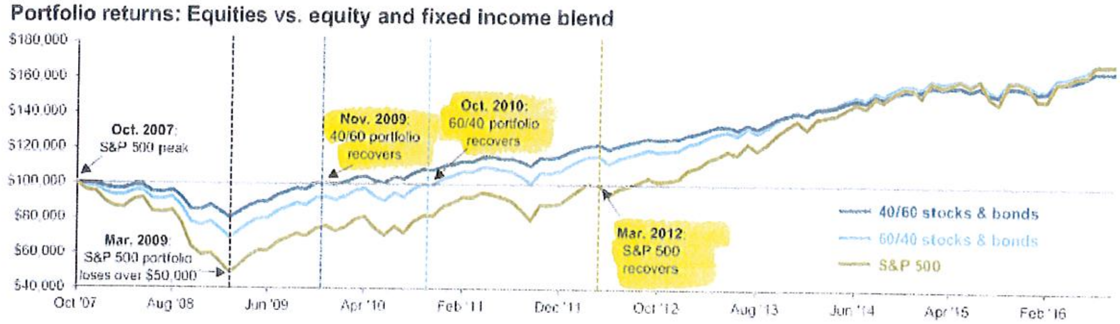
For the past 6 years, the spread between the earnings yield and the 10 year treasury remained relatively unchanged.

If interest rates were to go up, we can expect the stock market to demand a better yield, which may force it to correct.

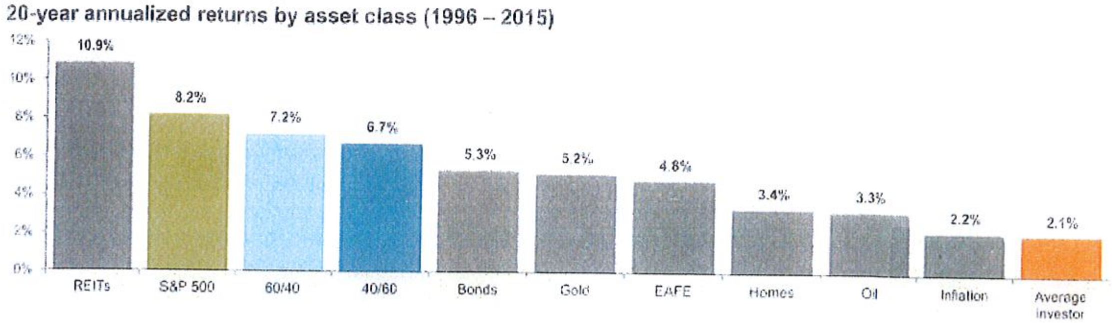
Asset Allocation

Diversification and the average investor

Portfolio returns: Equities vs. equity and fixed income blend



20-year annualized returns by asset class (1996 – 2015)



Investing principles

60% STOCK
40% BONDS

A 60/40 portfolio provides almost the same return with less volatility.