MEMO

To: Clients and Friends of Scott Strategic Investments

From: Bob Scott

Date: May 2016

Re: 1st Quarter Investment Memo
"Styles, Valuation and Risk

Summary

My goal in writing these memos was an attempt to codify my thinking on investing, share the insights I have gained over 30 years of investing, in various roles, and most importantly educate my clients. I think my background is fairly unique and as many of you have experienced our brand of investing sometimes takes a similarly unique approach.

In an effort to increase readership, I will continue in my efforts to be brief. No guarantees.

Summary

- All three domestic stock indices and the international EAFE index staged a March comeback.
- Value looking better than growth.
- Last year's loser is this year's winner, for the quarter.

	3/31/16 Close	12/31/15 Close	Change	Gain/Loss
DJIA	17,685.09	17,425.03	+260.06	+1.47%
NASDAQ	4,869.85	5,007.41	-137.56	-2.74%
S&P 500	2,059.74	2,043.94	+15.80	+0.77%
MSCI EAFE	1,660.68	1,716.28	-55.60	-3.24%

Performance reflects price returns as of market close on March 31, 2016.

As many of you know, I consider myself a "value" investor. Which generally means we are trying to buy things at a price below their intrinisic value. To "over generalize" the characterization, value investors care about the price and ignore the company's prospects; growth investors care about the prospects and ignore

the price. When there is less attention paid to what something is worth and more attention focused on future prospects – frequently well into the future, to justify price – I call that growth investing.

Both work over time, but I like the idea of value and most academic research has tended to show that over the long term value investors perform better than growth investors.

My point is simply that value and growth like hemlines and fashion go in and out of style. Value has been underperforming for sometime and some think that may be changing. The style boxes below indicate that may be true.

1 WEEK

	Value	Blend	Growth
Large Cap	(0.72)	(1.22)	(1.71)
Mid Cap	0.11	(0.57)	(1.27)
Small Cap	(0.32)	(1.37)	(2.44)

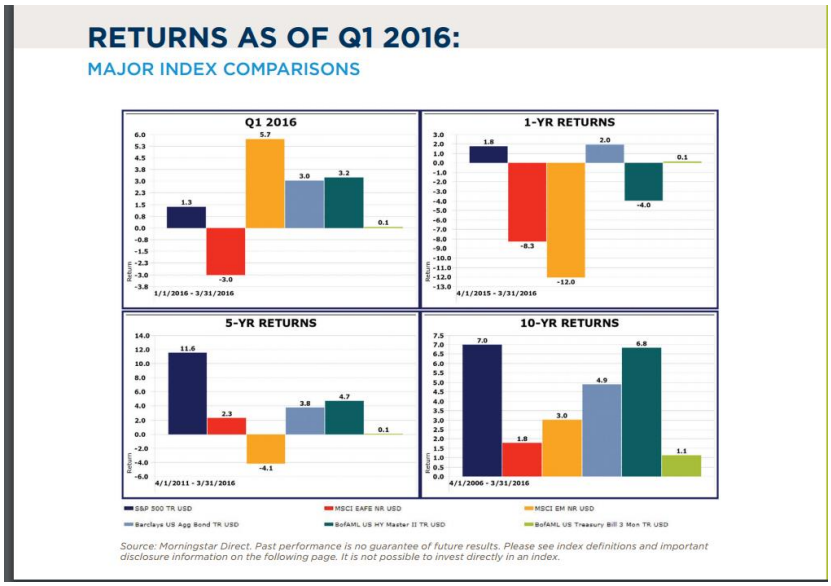
QTD

	Value	Blend	Growth
Large Cap	2.10	0.54	(0.91)
Mid Cap	2.15	1.06	(0.06)
Small Cap	2.12	1.57	1.00

YTD

	Value	Blend	Growth
Large Cap	3.77	1.72	(0.18)
Mid Cap	6.15	3.33	0.52
Small Cap	3.86	0.03	(3.73)

Source: Morningstar. This information is designed for educational purposes and should not be construed as a recommendation of any investment strategy. Past performance is not a guarantee of future results. All investments carry a certain degree of risk and no one particular investment style or manager is suitable for all types of investors. Indices are not available for direct investment. Any investor who may attempt to mimic the performance of an index would incur fees and expenses which would reduce returns.



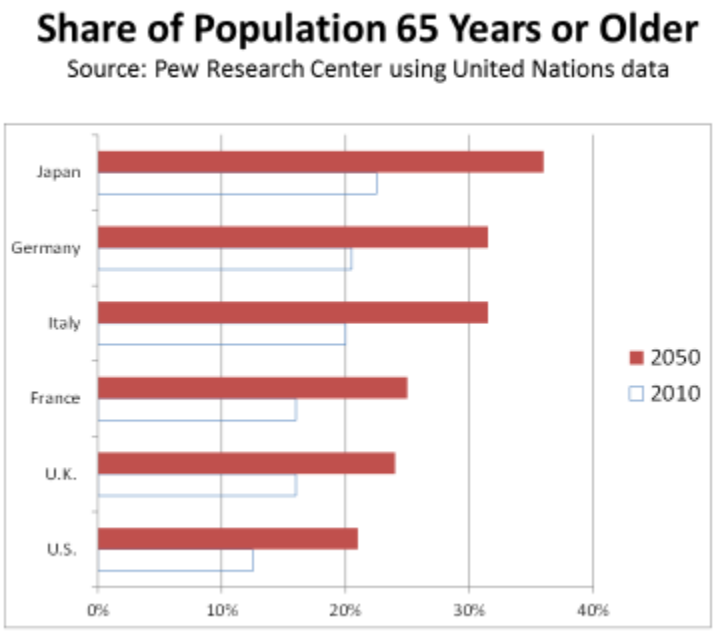
Just as value thus far seems to be overtaking growth, the asset class with the worst performance for the 1 year period had the best return for Q1 2016. I hope nobody switched? This is a long-term game.

Commentary

Two things I want to talk about, likelihood of low returns in the future and risk.

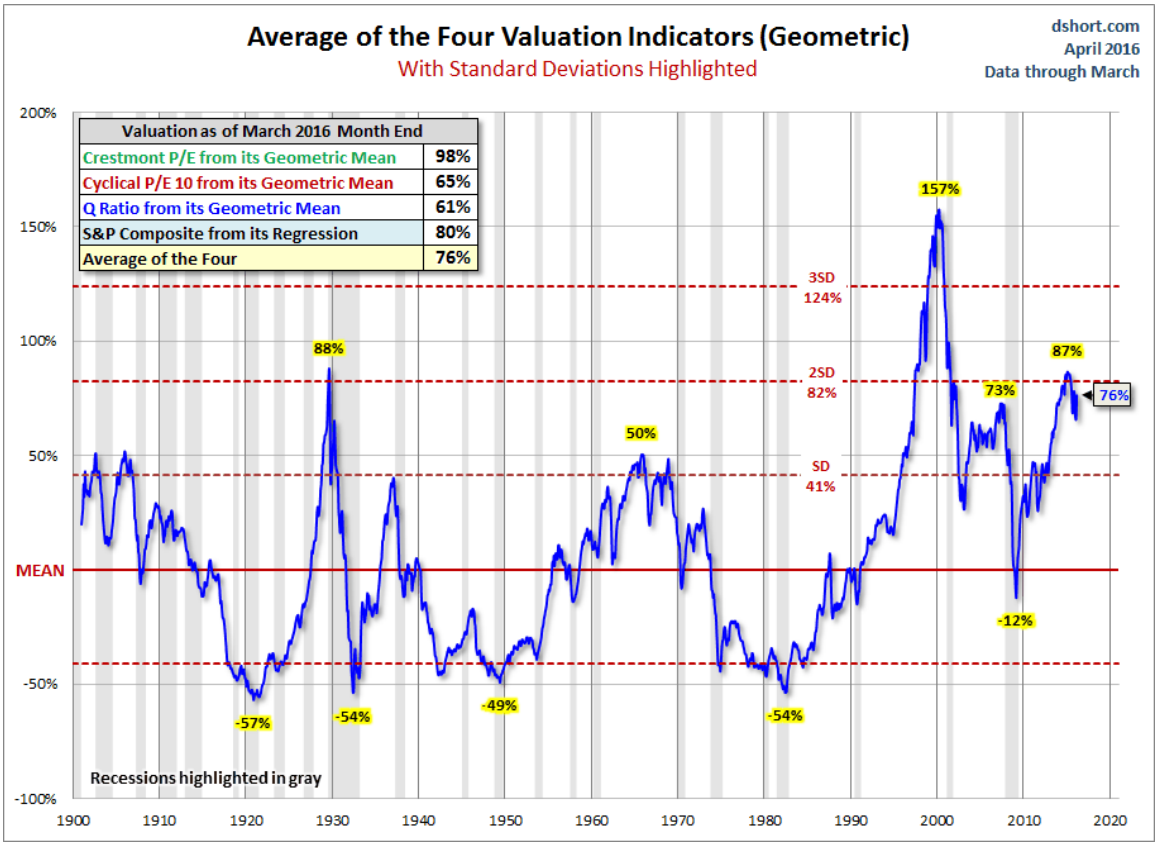
Lower Returns

The first is a theme I have been writing about for some time, the likelihood of below average returns and growth relative to history. Very simply there are some very smart commentators who believe this low growth future is largely due to demographics, the aging of developed societies and low birth rates. The problem is much of the developing world and China is turning Japanese, where adult diapers outsell diapers for babies.



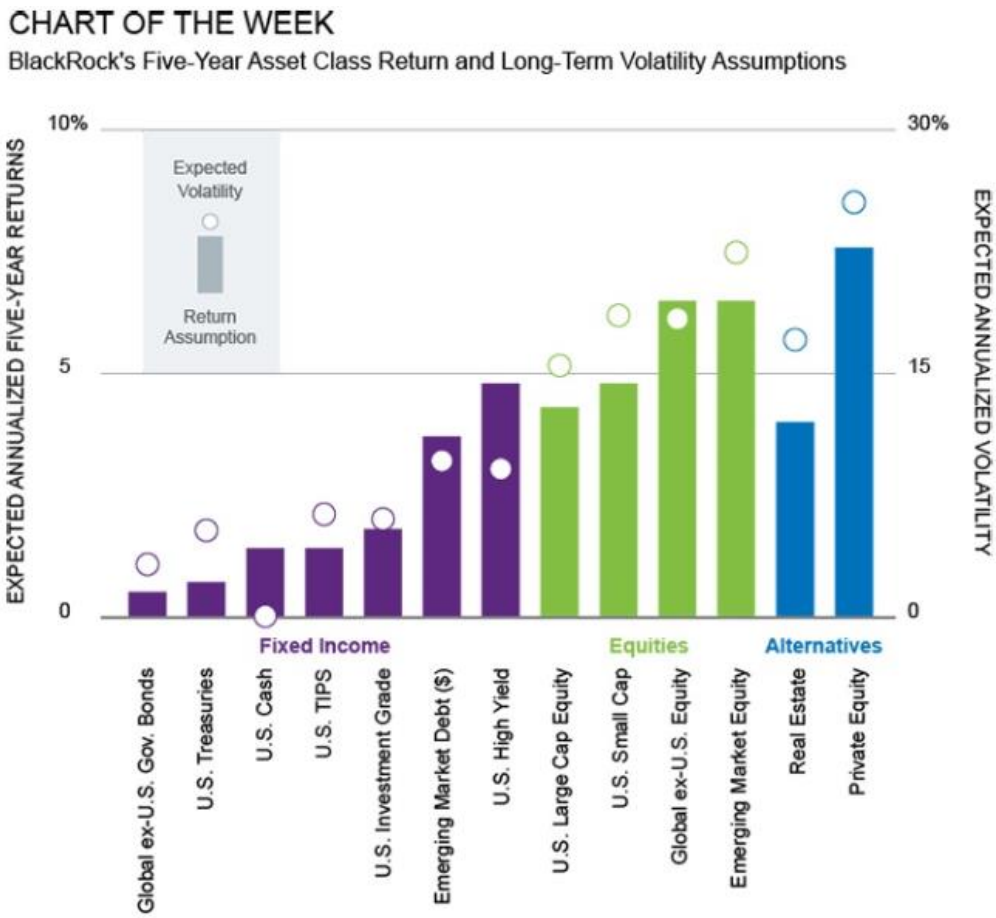
Because interest rates are so low around the world people have pushed up the prices of risk assets searching for income and return, which ultimately pushes expected returns down.

1. Valuations - Note the chart below with the four different measures of valuation. Choose your poison, and don't shoot the messenger, I am just pointing out the math. Basically, the chart shows an average of four common valuation measures, the average (index) is 76% above its historical average.



This is for illustrative purposes only. Past performance may not be indicative of future results.

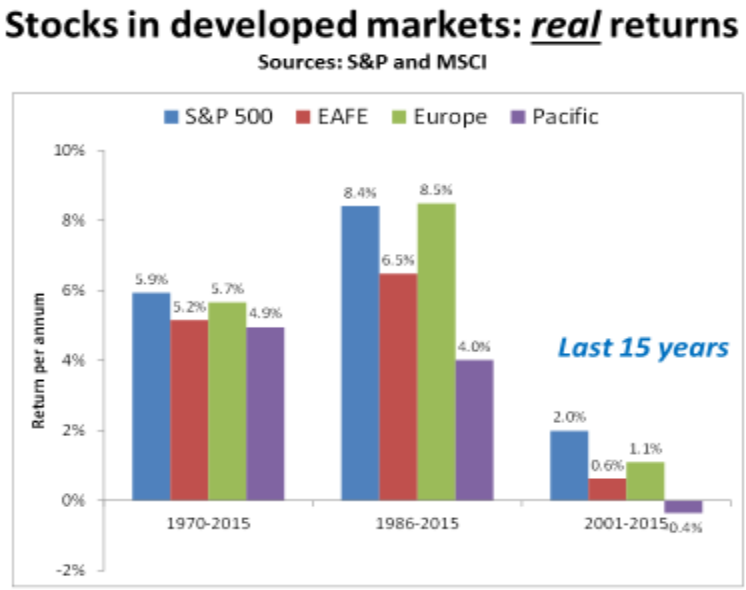
Yes, the price you pay does matter. As I have tirelessly explained, I believe valuations are high and investors should manage expectations and their understanding of risk accordingly. Below are BlackRock's ideas of future expected returns and volatility.



Sources: BlackRock Investment Institute and BlackRock Solutions, April 2016.
Notes: The bars show our annualized five-year nominal return assumptions from a U.S. dollar perspective. Representative indexes used are (left to right): BofA Merrill Lynch Global Government ex U.S. Index, Barclays U.S. Treasury Index, Citigroup 3-Month Treasury Bill Index, BofA ML U.S. Inflation-Linked Treasury Index, Barclays U.S. Credit Index, JP Morgan EMBI Global Diversified Index, Barclays U.S. High Yield Index, MSCI U.S. Index, MSCI U.S. Small Cap Index, MSCI World ex U.S. Index, MSCI Emerging Markets Index. Real estate and private equity are based on BlackRock proxies.

The bubble indicates expected volatility and the bars expected returns. Looks to me like US Large Cap is below 5%, and the greatest expected return and volatility are outside of the US. Not quite as pessimistic as some and remember nobody can predict the future. It is important to realize these are fundamental quantitative measures based on math. Investor psychology (fear and greed) could drive returns in either direction well past long term averages and fundamentals long before they mean revert.

So how does that compare to history? Baby boomers have enjoyed some of the best stock market returns ever.



Remember this, to grow an economy (or GDP) you need to have population growth or more productivity. Keep the following equation in your thoughts this election season when candidates and arm chair quarterbacks are talking about what needs to be done and when you are thinking of economic growth or lack thereof.

Change in GDP = Change in Population + Change In Productivity

So, more adult diapers than baby diapers means population decline. Productivity increase or decline – well the fact is as we age, from an economic standpoint we are less productive. So high valuations and the rise of retirees relative to workers, those are just some of the factors that will likely drive lower returns in the future.

Risk

For those of you interested in the key takeaways.

- Beware the "sirens of Wall Street"
- Per Warren Buffett "Risk is not knowing what you are doing."

I am a firm believer that through educating our clients they will appreciate our approach and our focus on their financial well-being. More importantly, however, my primary goal is for our clients to be more successful than the "average" investor. The Scott Strategic approach is not accidental nor is it based on following the current investing "fad" or "fashion" but rather a high conviction process driven approach. And similar to other notable value investors, our compass bearing is well west of Wall Street and Wall Street's constant siren song tempting main street investors away from a common sense, evidence based, value tilted proven approach to long term investing.

For those doubting the power of the sirens, quick little walk down memory lane.

- The crash of 87.
- The Dot Com Bubble.
- The Great Financial Crisis (GFC).

All of which were perfect examples of the sirens of Wall Street and their impact on many individual investors. But it takes two to tango. Wall Street was clearly an enabler but had plenty of willing investors

interested in taking their shot at a winning lottery ticket. Whether it was betting on a .com, buying a bond made up of subprime mortgages with an unrealistic credit rating or getting a NINJA mortgage (no job, no income and no assets) Wall Street called and investors answered.

Wall Street's propensity to assist in the creation of bubbles and stay too long at the party, much to everyone's eventual heartache, is epitomized by the comment of Chuck Prince, the CEO of Citigroup in July 2007 when he said "When the music stops in terms of liquidity things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing". That comment says a lot about the mindset of the big banks on Wall Street and their focus on making money at the expense of common sense and the principles of investing and wealth accumulation that they themselves know to be true; i.e., valuations matter. Interesting to note, in the same interview, Prince indicated he was bullish on Japan and the interview was just a month before the Lehman Brothers collapse. Unfortunately, Wall Street has another more powerful enabler this time, the Federal Reserve. We don't think you should "fight the fed", but are any of these people really doing anything to help the individual investor meet their long-term financial goals? I think not. Prima facie evidence, the Big Short.

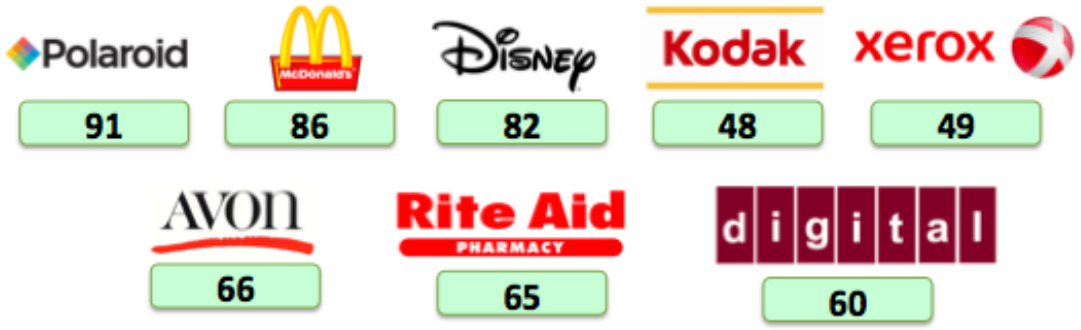
So, what is an investor to do – that is where we come in.

In investing there are many definitions of risk. I am partial to risk being defined as the "permanent impairment of capital", most of Wall Street likes the idea of "standard deviation" or volatility, which by the way didn't work very well for them in the GFC.

Lets keep it simple - Warren Buffett defines risk as "not knowing what you are doing". Unfortunately, many investors get pulled away from the fundamentals of investing by the "sirens" of Wall Street and the misguided belief that the "market" knows best. If you believe the market knows best, I can't help you.

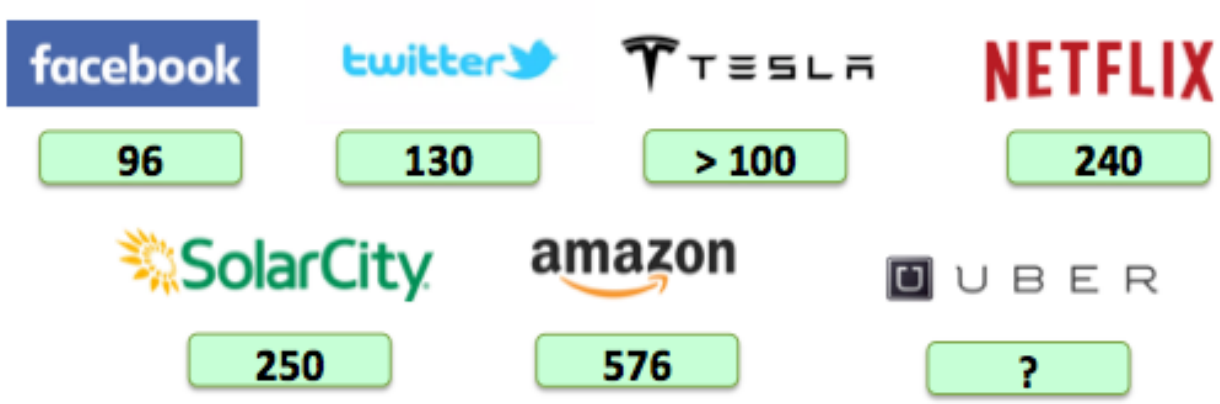
Recently I read an article in bitsbusiness.com from an individual that attended the famed Pabrai Funds annual meeting where famous value investor Monish Pabrai talked about the similarities of the "nifty fifty" of the early 70s to some of the Wall Street darlings of today. The "nifty fifty" were fifty growth stocks credited with propelling the bull market of the early 70s. They were touted as 50 stocks to buy at any price and hold for the long term. Monish makes the point that many of the highly valued growth stocks of today that narrowly propelled the market of 2015 are reminiscent of the fifty. In the boxes below the company names are the price earnings ratios of the companies per the 12/31/2015 Annual Meeting of the Pabrai Funds.

THE FOLLOWING IS NOT A RECOMMENATION OF ANY STOCK OR STRATEGY AND IS FOR ENTERTAINMENT AND EDUCATIONAL PURPOSEs ONLY.



During the bear market that got started in 1972 many of these highly valued stocks saw their p/e ratios decline significantly. Polaroid declined by 91%, Avon 86%, Disney 75% and Xerox 71%.

Some of today's popular names that also have high valuations to match their popularity are as follows.



There are some great businesses named above, but great at any price? History says price matters. If you are going to follow the herd and assume the "market knows best" you are likely exposing yourself to risk.

Finally, in the "risk is not knowing what you are doing category" Morningstar recently published a report entitled – "Buy the Best, Perform the Worst (Vice Versa)". The bottom line of the article is investors, typically invest in the best most recent performer and ultimately end up underperforming. The better-proven approach is to consider an investment that is currently underperforming but has a strong long-term track record. I believe the selection process is not quite that simple but generally agree that buying or holding short-term underperformers can absolutely be effective. Think the average investor is not that naive? According to the same article, "Across investor segments, there is a clear and incontrovertible pattern of buying high and selling low."

As I have shared with many of you, we have a well-defined process for evaluating investments and strategies. Although we have no idea what is going to happen in the short run we know our SSI Tenets of investing will prove successful over the long term and we like to think we know what we are doing.

SCOTT STRATEGIC INVESTMENTS TENETS OF INVESTING

1. I believe a value driven investment philosophy is the most effective way to build long term wealth.

2. Investor behavior can be more important than investment performance.

3. Price matters, risk and return are a function of price.

4. "This time is different are the four most dangerous words in investing."[i]

5. Managing risks is more important than higher returns.

6. Market timing and macroeconomic forecasting are not critical to investing nor do I believe they are possible.

7. Investing is not speculating or gambling there is a difference.

8. Managers should focus on absolute returns, not relative performance.

9. I believe in "eating your own cooking" and working with managers who also believe in this aligning concept.

10. Be diversified, but not too diversified.

For those of you interested in specific economic news I would highly recommend you visit my website www.scottstrategicinv.com and visit the Market View Tab where you can see various Raymond James commentary and video Point of View Updates.

Please do not hesitate to share our quarterly Investment Memo with friends and family. We greatly appreciate your confidence and trust and will continue to dedicate ourselves to earning it. If you have any questions, please don't hesitate to contact me.

Best regards,

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Financial Advisor

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Market Indexes Defined

MSCI EAFE U.S. Dollar: An unmanaged capitalization-weighted index of companies representing the stock markets of Europe, Australasia and the Far East.

MSCI EAFE Small-Cap Index: An unmanaged, market-weighted index of small companies in developed markets, excluding the U.S. and Canada.

MSCI Emerging Markets: Designed to measure equity market performance in 25 emerging market indexes. The three largest industries are materials, energy and banks.

BC High Yield: Covers the universe of fixed-rate, non-investment grade debt. Pay-in-kind (PIK) bonds, Eurobonds, and debt issues from countries designated as emerging markets (e.g., Argentina, Brazil, Venezuela, etc.) are excluded, but Canadian and global bonds (SEC-registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures and 144-As are also included.

Russell 2000: Measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index.

Barclays Capital Aggregate Index: Measures changes in the fixed-rate debt issues rated investment grade or higher by Moody's Investors Service, Standard & Poor's, or Fitch Investor's Service, in that order. The Aggregate Index is comprised of the Government/Corporate, the Mortgage-Backed Securities and the Asset-Backed Securities indices.

Standard & Poor's 500 (S&P 500): Measures changes in stock market conditions based on the average performance of 500 widely held common stocks. Represents approximately 68% of the investable U.S. equity market.

BC Global Aggregate ex-U.S. Dollar Bond Index: Tracks an international basket of bonds that currently contains 65% government, 14% corporate, 13% agency and 8% mortgage-related bonds.

The Dow Jones-UBS Commodity Indexes : Composed of exchange-traded commodity futures contracts rather than physical commodities.

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[i] Sir John Templeton quote.