CROWELL WEEDON ASSET MANAGEMENT
MONTECITO INVESTMENT PORTFOLIOS

January 1, 2016

Dear Fellow Investors,

We've outlined the major topics & takeaways of this year's letter in an easy to follow format. Those four sections are:

Main Message Highlights

- Another year of returns in the equity markets below the 50 year averages as we believe companies will come to realize they can't continue to buy Earnings Per Share growth but must instead invest for the future.
- After 6 solid years of stock market returns with only one 10% plus correction (in 2015) there is a lot of talk surrounding the valuation of the stock market. Various metrics are often cited to support market valuations but we believe psychological influences may be the most important to focus on, and these cannot be readily measured.
- One of the simplest metrics that shows business success (Sales Growth) may be of utmost importance in today's slower growth "new normal" economy.
- Where companies are in their business life cycle can be one of the most important principals to pay attention to when balancing risk and reward.
- It is easy to get sidetracked by the bad news – it is important to have the ability to see through the headlines and have a more balanced and longer term view.

Forecast Review for 2015 **-** As forecasting goes we did pretty well with credit for 7 out of 10 correct. We had a couple of forecasts that once again were spot on, a couple we got half right, and a couple that didn't come close but that's just the nature of predicting the future!

Thoughts & Forecasts for 2016 **–** Never learning our lesson we will forecast the future once again!

- ***US equity market sees continued volatility but ends 2016 up 5 – 9% on a total return basis***
- ***Short-term rates: 4 to 5 Fed hikes with 1% - 1.5% on the Fed Funds rate by year end***
- ***Long-term rates: flattening of the yield curve with long end not increasing as much as short***
- ***Oil prices: see $50 to $60 as equilibrium and prices reach this level by year end***
- ***Inflation: remains in check and below 3% for 2016***
- ***Sub investment grade bond defaults: higher default rate led by weakness in oil & gas sector. A few high profile bankruptcies in the energy sector could correspond with marking the bottom in oil price cycle.***
- ***Commercial real estate – rising interest rates will create a headwind. We want to own Health Care, Data Storage, & Residential (apartments & manufactured housing). Still a preferred alternative to a buy and hold of long term bonds, but underweight in an all equity portfolio.***

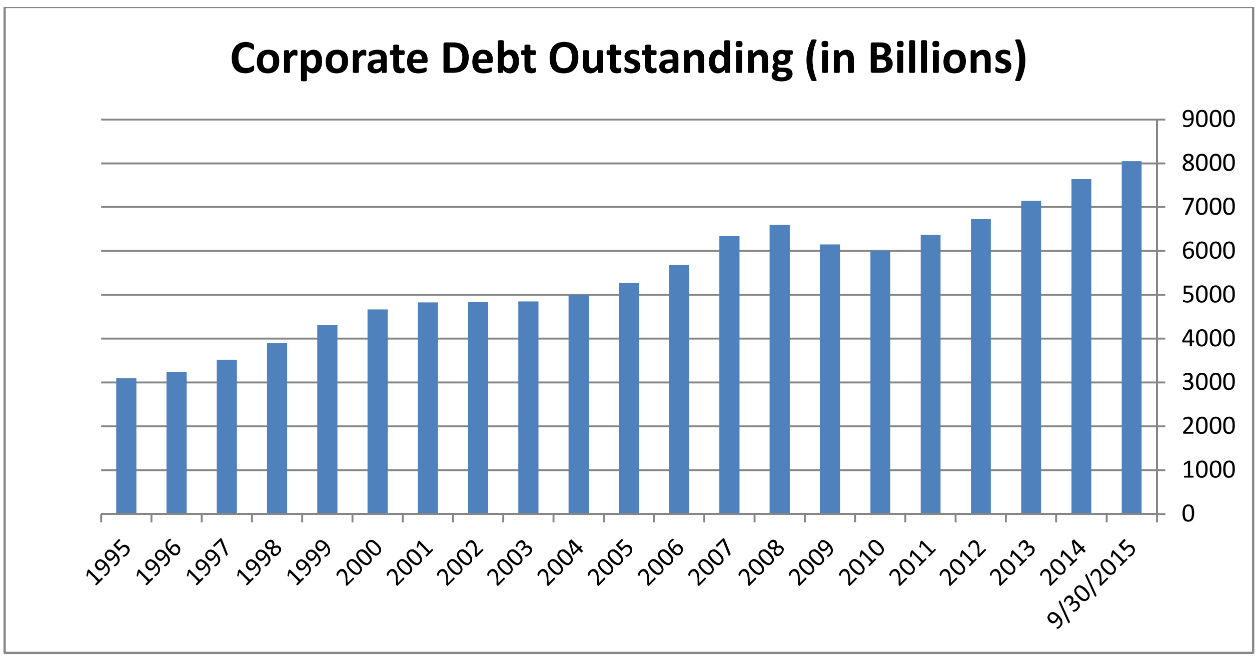
- ***Residential real estate – smaller homes still the spot to be and in states that are tax-friendly or retiree friendly***
- ***Three more forecasts that are not entirely investment related***

***Conclusion** – 2015 was a tough year in the markets but you weren't alone. Some of the brightest investing minds with impeccable track records saw declines in their portfolios as well. As a matter of fact, the average stock declined in 2015 as evidenced by the negative 6.42% return in the much broader NYSE Composite index. When compared to these "market gurus" and broad market indexes we are proud of the returns we delivered in 2015. Don't lose sight of the long-term goals and the long-term potential we remain extremely excited about for the US economy!*

Main Message

Buying Earnings Per Share Growth - the good & the bad of stock buybacks

As you can see from the chart that follows corporate debt outstanding has increased by nearly $2 Trillion dollars since 2010. We believe that this 33% increase in debt outstanding is corporations taking advantage of the record low interest rate environment we've been in since the deep recession of 2008-2009.



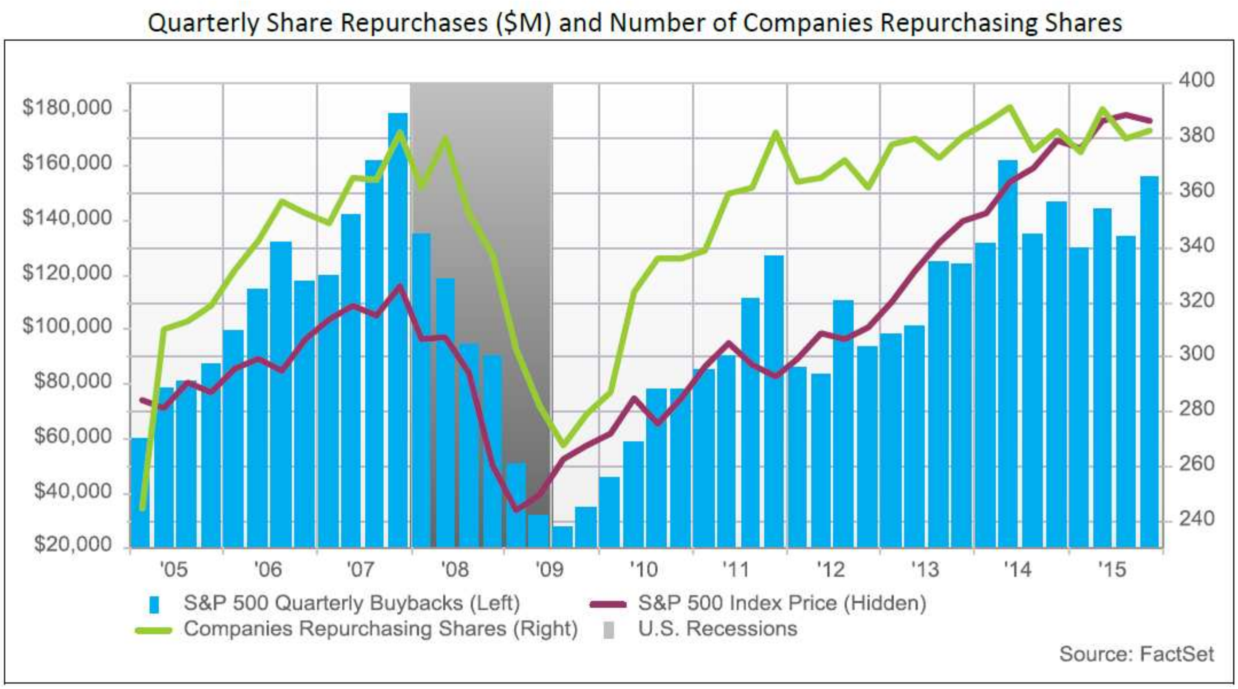
Source: FactSet, data from 1995 – 9/30/2015

At its core, a successful corporation is an entity than can take capital and grow that capital at a positive, acceptable rate of return. There are 2 sources of capital – giving up ownership (equity) or borrowing money (debt). There is a cost for each of these sources. The cheaper the cost, the greater potential return the corporation can earn on this capital. The cost of equity can be difficult to quantify as it is not an explicit number, it will depend on the future success of the company to determine. However, the cost of debt is easily identifiable by the interest rate at which the debt is originally put on the balance sheet. We believe many corporations are excellent stewards of financial responsibility – certainly better than our politicians. Corporations normally will borrow when rates are significantly lower than their return on capital – hence enhancing returns to their shareholders. This is why, for the most part, Corporate America is in solid shape today. We've seen many companies come to market with debt offerings locking in these record low interest rates and therefore locking in a cheap source of capital - all good things in our opinion provided they can continue to service the debt while maintaining Earnings Per Share. With this increased rate of debt issuance we believe this is a telling indication that corporations are trying to lock in these low rates before they rise and also a meaningful indicator signaling interest rates are ready to rise.

Our main concern is about what these corporations are doing with this cheap source of capital. Corporate explanations can be extremely vague when discussing the use of a debt issuance using words such as "general corporate use". Usually, the proceeds from a debt issuance are used for:

- Refinancing a higher cost debt – think of yourself when refinancing your home. If you can save money, why not do it?
- Investing in the business – this creates the potential for future company growth. If the expected long term return on the investment is greater than the cost of capital, it creates wealth for the corporation and its shareholders.
- Share repurchases – if a company shrinks the equity "pie" then shareholders are rewarded with a greater ownership stake – who doesn't want to own a greater slice of the pie without having to put up your own money?

The statistics for the same period that saw $2 Trillion dollars of additional debt taken on by corporations, show that a great deal of these debt proceeds have been making their way into share repurchases. And share repurchases may or may not be the best use of the funds.



As the above graph shows, share repurchases for S&P 500 companies have substantially increased since the depths of the Great Recession in 2009. During the trailing twelve months S&P 500 companies have repurchased $566 Billion of their own stock. This represents 64.6% of trailing twelve month Net Income for these companies. Further, 130 companies spent more on share repurchases than they generated in Net Income. Obviously a portion of these funds for these repurchases are coming via issuance of debt, and thereby leveraging the balance sheet of these corporations.

Are the stock buybacks a good thing? If a company truly believes its stock is undervalued and buying back shares delivers a higher long-term rate of return than investing in the company itself, then we do like the stock buybacks. However, in the past corporations have not been great investors in their own stock tending to buy more when the price is high and buy less when the price is down (just look at buyback activity in 2009 – the lowest point of the market in over 12 years!). Granted, there is extra cash flow in the good times when your stock price is most likely higher, but just because you have the cash or access to cheap financing, doesn't mean that is when you should buy back your shares.

Our biggest concern is many companies today are merely buying back stock to make their supposedly all-important quarterly financial estimates so dearly followed by Wall Street. Delivering higher earnings per share metrics allows senior management to earn additional income (much of which is share or option based). This short-sightedness is not good for the long-term growth of our economy. Instead, we would prefer to see companies investing for growth right now. Research and Development, plant expansion, synergistic mergers are just three areas the capital could be invested to generate long-term, sustainable earnings growth. We live in exciting times and companies not innovating will be left behind. At this point, we feel the majority of stocks are not undervalued. Our models indicate that Corporate America should suspend share count reduction until meaningful undervaluation is present, and instead focus on the future. At the same time we worry that recent PE expansion in the market as a whole has been aided in no insignificant part by these share repurchases. When interest rates rise and the cost of capital to fund these repurchases makes them less attractive, we see the risk of a potential market decline as investors realize one of the significant supporters of EPS growth may be going away. This is why we prefer to own companies that have not needed to "buy" EPS growth, but have instead been able to create it.

Which metrics matter?

We've been doing some research recently on the predictive power of various metrics we use to analyze the markets. In doing this research we've discovered something very interesting. That is, most identifiable metrics such as price to earnings multiple, price to book ratio, Schiller's CAPE ratio, Fed Model, Earnings Yield, etc. are generally poor predictors of future stock market returns with each metric having an extraordinary amount of variance associated with it. While we do indeed closely monitor these widely followed metrics they can, and do, go in and out of favor along with their rationale supporting movements in the marketplace. We use them in part to determine our confidence in various asset classes for weighting purposes and to determine what "the street" may be looking at that might influence that metric. However, the one metric that does have the best predictive power of future market returns is the one tied to something we can't even quantify. That is - investor's desired allocation to the stock market – or put another way, emotion.

Looking at the market today, there are many debating if we are "overvalued" or at "fair value". Ideally, investors want to buy something when it is undervalued and sell it when it becomes overvalued. (The average investor finds this difficult as their emotions get in the way – they get greedy at market tops and buy & then fearful at market bottoms and sell. Hence the use of investment disciplines to help break the cycle of bad emotional investing.) Valuation of the market can be debated for months or even years as market multiples gyrate along with future earnings estimates. We do believe the bigger question we need to ask ourselves about the market is what is the current psychology of the average investor? Are investor's cautious? Are they afraid? If that's the case, odds are the market will be trading at pretty reasonable levels and give us the opportunity for decent future returns. The average investor has their emotions dictated by the events that have just happened, not those that are going to happen. If investors are optimistic & euphoric chances are we've missed a great deal of the price movement and may be in store for lower future returns.

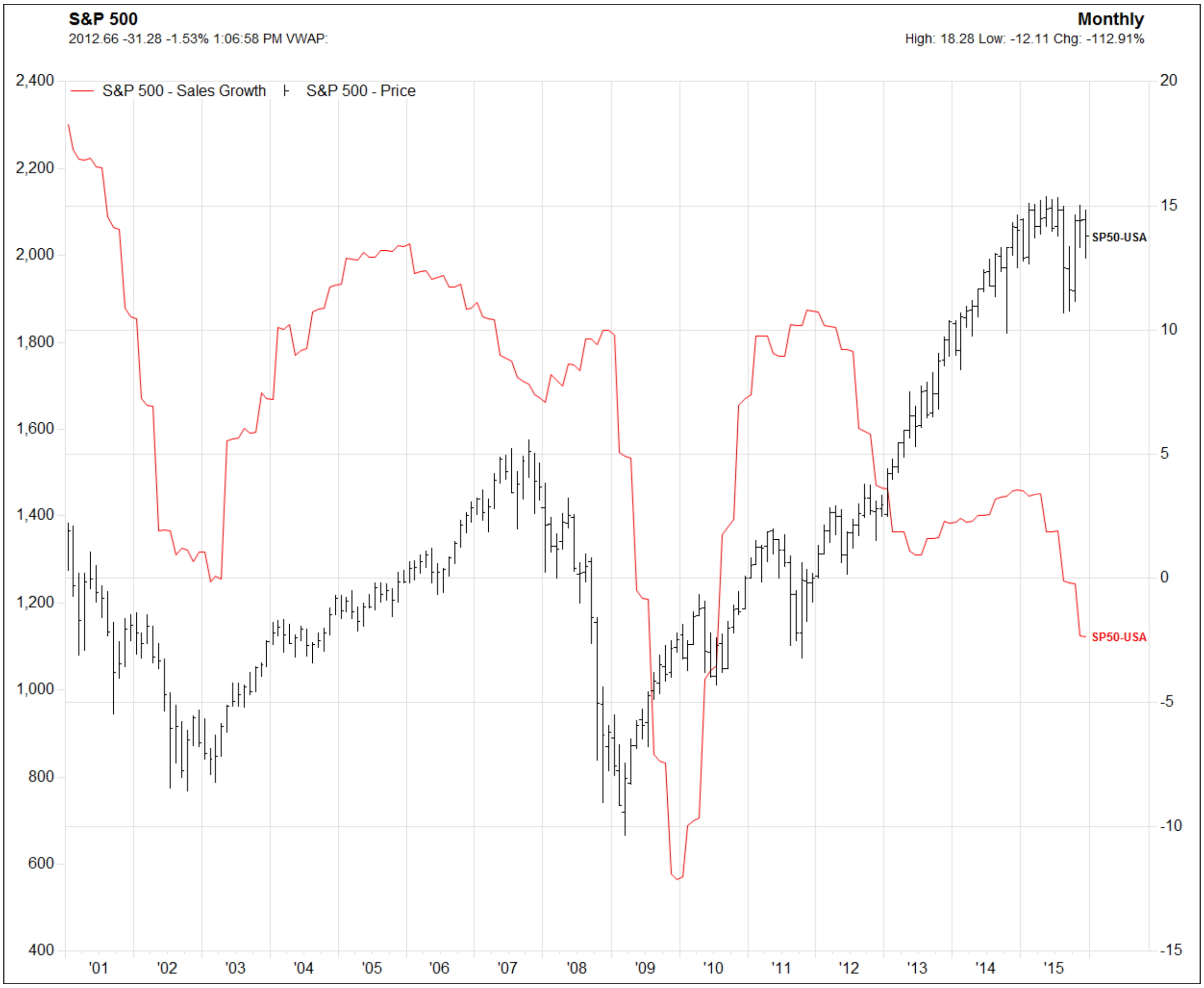
If we had to generalize today's investor we believe several emotions are out there including fear, anxiety, hope, & relief. However, we do believe we are still a tad early to generalize investor's as optimistic about the future – let alone euphoric about investing which marks significant tops in the markets. We believe the media & virtually every political candidate does a good job to ensure that we don't think things are good in this country and on the contrary want us to believe things are bad – the Pounding Pundits of Pessimism to borrow a phrase from First Trust's Brian Westbury. But is this true? Is life really so bad for us? We note that the quality of life has improved dramatically in the United States from a few generations ago. Here are but a few of countless statistics to just to give some perspective:

- US life expectancy was 49 years in 1900. Today the number is just around 80 years.
- Today the average American retires at age 62. In 1900 the number of people living beyond 62 – let alone retiring at age 62 - was much smaller given life expectancy was only 49. (In fairness we need to note that infant mortality and wars took many lives early to drive down the average)
- 2% of American homes had electricity in 1900. This also meant that virtually no homes had a refrigerator.
- During the 1950's median household income adjusted for inflation was around $25,000/year. It's nearly double this today. To put this in perspective in the world today, you need an annual income of $34,000/year to be in the richest 1% of the world according to World Bank economist Branko Milanovic's 2010 book "The Haves and the Have-Nots". Where would this same level of income put you in America? – close to the poverty level.
- The size of the median American home has increased by 34% just in the past 25 years.

We do believe 2 major market declines in the past 15 years has led to much of this pessimism related to the stock market. However, as we've pointed out in previous letters, we also believe we're witnessing amazing technological advancement in many industries that will eventually get the average investor in a more optimistic mood. A 62 year old today who retires should expect to be retired and alive for almost 2 decades. We maintain that there most likely will be at least one period of higher inflation in that twenty year period where the purchasing power of fixed income will be dramatically reduced. Equities have in the past over longer periods of time (5 to 10 years) done a better job of protecting purchasing power than fixed income – even through the volatile gyrations of the emotionally driven market cycles.

So, in a market that no longer offers the bargains of 2009 what do we focus on when recommending investments for the years ahead. Often times, we believe success can come from simplicity.

Focus on Revenue Growth

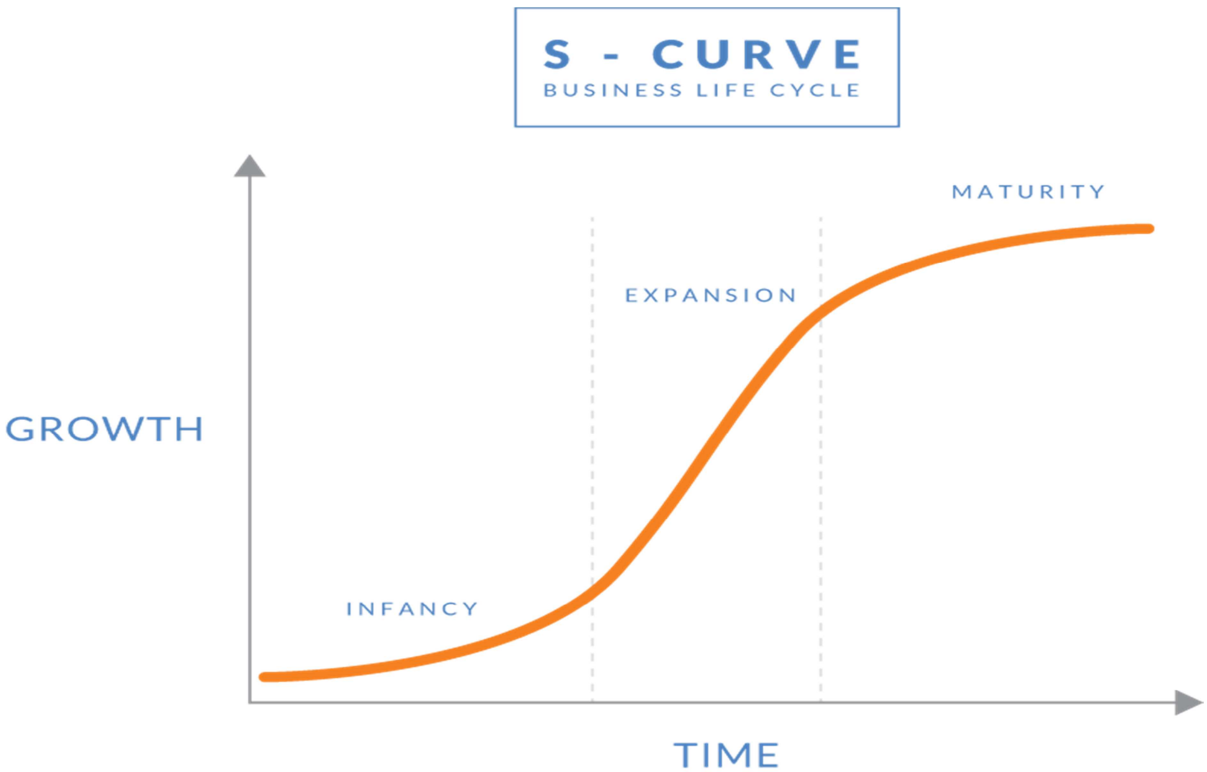


Source: FactSet, data from 2001 - 2015

As mentioned earlier, there are many metrics which we track related to the valuation of the market. There is one metric we tend to put quite a bit of weight & belief in and that is revenue growth. In our opinion, a successful business will generally see more demand for their product & service. More demand should equate to higher revenue. It doesn't matter if you're a business that sells cheap goods and looks to do huge volume (think Wal-Mart) or a business that sells very few items but at big prices (think Boeing). Excuse the pun, but the bottom line is that top line growth is what counts. From there, a lot of good happens. Higher sales can translate into higher margins, higher cash flows, higher earnings, & higher dividends. Of course, this is an over-simplification of how a business works. That said, seeing sales increase is a problem most CEO's would like to have and an indicator of management effectiveness we pay attention to.

When it comes down to it investing is about earning an acceptable return based on the amount of risk you are willing to take. It is generally accepted that investing in the stock market involves risk because it can be so emotional and therefore volatile. Stock Market investing is recommended for long-term investment capital. When we think long-term we generally think about growth. If we are going to commit capital for years or decades we want to see this money grow. When we think about growth it is hard to explain how an investment will be worth more in a decade if the underlying business is not able to see their sales growing. This is why growth in sales is such an important metric to us but one that is often overlooked because of its simplicity. Instead, many analysts & the media focus on the immediacy of this quarter or year's earnings.

The following chart shows the typical life cycle of a successful business with growth on one axis and time on the other. The typical successful business will go from Infancy which is when an idea is hatched, initial funding found to develop the idea, and success results in commercial launch of the idea. If a company can emerge from the infancy stage, we move into Expansion. During this time the greatest percentage of success happens. The company sees rapid growth & captures market share. Eventually as time progresses, Maturity happens. Growth slows, and the company matures growing along with the general industry or economic growth rates.



Source: md7.com

At Montecito Investment Portfolios we have disciplines that must be met in order for a company to be considered for investment. Our primary objective is to help clients achieve their Financial Independence (where their investments can generate the cash flow to support their life style), we believe a portfolio including high quality businesses delivering consistent results allows for some "peace of mind". Generally, this means we are investing in companies that have proven their worth in the marketplace and are therefore beyond the Infancy phase. They've also received commercial acceptance and been through much of the rapid growth part of their Expansion phase. The majority of the companies we invest in are in their mid to late Expansion phase. They have a solid footing in their respective industry, ample growth opportunities ahead, and not yet reached saturation or maturation in their markets. In this phase, you generally see solid returns on capital, ample cash flow generation, & dividend initiation & increases. All desired characteristics of investments we want to own for investors looking to replace themselves from having to work with ownership of a portfolio of companies that are going to work for them. The only drawback to investing in this phase of a company's life is that many times we've missed the true wealth creating stage of their existence.

True wealth creation, where stock prices can double, triple, quadruple, or more, is usually seen in the Infancy to early Expansion phase. This is the point when many companies have become public and therefore investable to the general public. It is also when commercial success happens or doesn't happen. There are many that fail to emerge from this stage and go out of business. When they do progress to the expansion stage, it can create true life-altering wealth for shareholders. The true wealth creators are usually company's creating something new, or a new way to deliver an existing product. We call this a disruptive technology. To illustrate this consider the following: Google has been testing a driverless car in Mountain View, CA for years now. They have logged over 1 million miles on the roads of Mountain View. The car has no pedals, no steering wheel. It drives itself by use of cameras and GPS systems. Now, how do you think this affects industry stalwarts such as Ford, GM, Chrysler, Toyota, Honda, etc? Will people in the near future not even need to buy a car, but instead pay for it like a service whenever they need a ride – or own a co-op car with others? They pull up an app on their phone, request a car and the nearest available car comes to them. Google seems to think so. Does Google partner with Uber to bring the cars to you? (By the way, Uber is another example of a disruptive technology based company that in a very short period of time has become part of the economic landscape.) Certainly a buy and hold strategy for the Big Three auto makers doesn't seem like as good strategy as it was in times past. Disruption can happen fast which means companies as well as investors must be aware of this or risk getting left behind.

We do believe that some investors that possess the capital can afford the risk of investing a small portion of their investable assets in a portfolio of companies in this stage of their lifecycle. Should you find this of interest, we do have a managed portfolio of such companies.

Should you pay attention to the news??

A few headlines from 2015 that would make you think investing in the market is a bad idea:

China's "Black Monday" sends markets reeling across the globe – The Guardian August 24, 2015

After historic 1,000-point plunge, Dow dives 588 points at close – money.cnn.com August 24, 2015

While it is true that China's stock market had a wild 2015 what most people don't realize is that their market will close out 2015 with a ***gain*** of approximately 12%! However, all we heard about during the month of August was how the Chinese government was intervening to save their market and how this Chinese meltdown would affect the rest of the world. This was a major contributing cause of the drop in the US markets that saw the Dow decline by 1,000 points intraday.

As it stands the Dow Jones Industrial Average finished the year a few percentage points below where it started the year. At the same time, the broader based NY Stock Exchange Composite Index finished the year the year off approximately 6.4%. While not very exciting to see a flat to slightly down year in the market it is hardly a reason to sell all of your stock investments and run for the hills.

Our advice to investors – tune out the media. They are in the business of selling ad time, ad space, web page views, etc. Media is a business. To get your attention the headline can't say something like:

DOW JONES FINISHES FLAT FOR 2015!!!!!!!

Try as we might to get readers attention, the fact is boring doesn't sell very well. We remind our investors of an old saying: it is easier to fall down than it is to get back up. When market declines happen they usually happen very rapidly. The fall down grabs your attention and can generate additional fear which further exacerbates the decline. However, the eventual rebound is rarely put in the headlines because it can take days, weeks, or even months to happen. This boring recovery is often missed by investors due to the lack of airtime or front page worthiness for the media companies. After all, they have moved on to the next exciting, and probably negative, headline to grab your attention.

FORECASTS

This is the section of the annual letter that most readers turn to first – that foolish section where we actually make forecasts for the future! We enjoy this process of using "What If" in our thought process as it allows us to think outside of the box and challenge our (and your) assumptions. Much like our health, checkups are single points in time and we may have to adjust things in the future if we get sick in between check-ups, these forecasts are our thoughts as of the writing of this annual letter.

We remind everyone our portfolios are managed substantially from the bottom up – meaning, we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2015's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2016.

First, let us check and see how we did last year.

2015 Forecasts

- ***US Economic recovery continues its moderate recovery with GDP for full year around the 3% range***
    - While full year figures are yet to be released and always hold the possibility for revisions, GDP results so far have been as we predicted with moderate growth slightly below this 3% level – ***Full Point***

- ***Fixed Income – the long-term bottom established in 2013 at sub 2% on the 10 year Treasury holds. We see the 10 year yield drifting to higher yields but do not expect it to end above 3.5%***
    - We did see the 10 year yield close just below 2% a couple of times in 2015. As we approach year end the 10 year yield will most likely wind up being slightly higher than where we started the year but certainly well below 3.5% - ***½ point*** as yields held above the 2013 low marks, but remained lower for longer than we thought.

- ***Federal Reserve Discount Rate will stay below 100 basis points and language will change in the Fed statements***
    - We were spot on here. Fed has started increasing rates and the language in the Fed statements has changed to being more optimistic about our economy than in recent years – ***Full Point***

- ***US Equity market will see the continuance of corporate balance sheet restructuring with buybacks funded by debt issuance at record low rates, US energy producers scaling back on development budgets which will lead to stability in energy prices, & allow the market to look beyond 2015 & trade on anticipated 2016 earnings figures of $142. We see 15 x this for a minimum S&P 500 year-end target of 2130 with the potential for upside to 2272 – 2414 by year end. We also see the long anticipated 10% or greater correction occurring during 2015 as***

we are long overdue. Bottom line is a positive year for the S&P 500 up greater than 5% on a price basis.

  - Dec. 31, 2014 = 2058.90. Dec. 31, 2015 = 2043.94. On a price basis the index was down less than 1%. If you add in the dividends paid it was up a bit over 1% for the year. Let's call it unchanged and below our forecast of up greater than 5%. 2015 did see one of the most memorable corrections in recent history with the Dow Jones Industrial Average declining by 1,000 points on an intraday basis on its way to the 10% correction many had been waiting for. Because of this, we will take ***½ point*** on this call.

- ***Commercial Real Estate – it would be easy to look at previous year's worst performing sectors and predict them to play catch up and outperform for 2015. However, we don't believe this will necessarily be the case and instead see economic fundamentals driving outperformance. Therefore, we see the downsizing of housing & retail space as a positive for Self Storage, Manufactured Housing and Apartments. Also, the continued demographic trend for Healthcare should lead to strength in that sector.***
  - We pretty much nailed this one with the leading sectors in the REIT space for 2015 being Self Storage, Manufactured Homes, & Apartments. Health Care was one of the weaker performers but we'll take a ***full point*** here with the 3 top performing sectors in Real Estate.

- ***Residential Real Estate – continue to see moderate price improvement in the lower end of the marketplace. Downsizing by baby boomers & first time purchases by millennials & echo boomers will create demand here. We see prices still below the peak of 2006 – 2007 but do see continued price improvement with the S&P Case-Shiller Index up by close to 5% again in 2015.***
  - There are 2 composites put out by S&P Case-Shiller, a 10 city composite and a 20 city composite. Both of these indexes saw an increase just above 5% over the past 12 months – ***full point.***

- ***Inflation – until interest rates start to inch higher, the pressure to raise prices will continue to be contained. While we see inflation higher in 2015 than 2014 we do not believe it will be above 3% for the year.***
  - Inflation has indeed remain muted for 2015 with the CPI slightly above year ago levels. Excluding Energy, the inflation rate has increased 1.8% from year ago levels, as forecast well below 3% – ***full point.***

- ***Oil Prices – we feel the US is now the producer on the margin that will bring supply & demand in the oil industry back into balance. We view $65/barrel as a fair price for oil with a potential spike above $70 during the second half of 2015.***
  - The "Lower for Longer" mantra has taken hold in the oil industry. While US producers have indeed slashed Capital Spending budgets ($154 Billion spent in 2014 vs. estimates of $98 Billion spent in 2015 – a reduction of 37%! – and 2016 budgets even lower) actual production has continued to climb. Supply concerns coupled with weak demand from slowing global economies has created the perfect storm for low energy prices in the futures trading pits. – ***No point.***

- ***Tax bill passed to repatriate overseas corporate cash***
  - While mentioned often in the headlines no actual bill was passed to allow the approximate $2 Trillion dollars in foreign profits held by US corporations to make its way back to the United States – we still believe this should be done, but tough to imagine it will happen in an election year. – ***No point.***

- ***African Infrastructure investing expands with significant investments being made***
  - We highlight a story from the African Development Bank Group that disclosed a $1 Billion investment to support power & infrastructure projects in Africa. The Private Sector Department experts describe this as "an unprecedented record level" of investment – ***Full Point.***

2016 Forecasts

- ***US Equity Market*** – The growth rate of Earnings Per Share has been significantly impacted by the losses seen in the Energy market – reminiscent of 2008 when 3 Financial companies losses wiped out a significant portion of the earnings for the entire S&P 500. Current forecasts call for EPS growth of 7.7% for 2016 & 12.5% for 2017 for the S&P 500. We do believe the way EPS calculations are done for the S&P 500 Index overstates the effect of losses as the EPS calculation is not done on a market weighted basis. To illustrate this let's consider a 2 stock index:

Company A		***Company B***	
Market Cap:	$150 Billion	Market Cap:	$10 Billion
Earnings:	$10 Billion	Earnings:	-$9 Billion
P/E:	15 x	P/E:	None due to losses
Weight in index:	94%	Weight in index:	6%

If we calculated EPS the way S&P does this for this simplified index we would sum the earnings of the 2 companies. In this case, this would be $1 Billion. With a combined market cap $160 Billion, the P/E ratio of our index would be 160! If you were to instead weight the earnings by the respective market cap of each company, this portfolio would have earnings of $8.813 Billion which would give you a P/E ratio of 18.2 – certainly a much different view of valuation than a P/E of 160! This leads to our conclusion that during times of severe losses for several of the index constituents the market should trade at a higher multiple because of the dramatic effect significant losses have on the index.

In an attempt to counter this negative bias we've witnessed, we looked at constituent earnings & earnings estimates on a market cap weighted basis. Doing so leads to EPS growth that would actually be closer to 12% for 2016 & 14% for 2017 – both rather respectable growth rates and certainly better able to justify an earnings multiple of 16 – 18 times. With this said, we do believe the market remains in "fair value" range. We do believe volatility will remain heightened from previous years and see a strong possibility for another intra-year significant correction (greater than 10%) during 2016. We believe the earnings yield of the market has been a good predictor of real future returns. With the market trading around a 17 multiple, this implies a return of 5.8%. Based on our forecast of muted inflation we would target a total return for the S&P 500 in the range of 5% - 9% for 2016 or 2,174 – 2,256 on the Index level. If anticipated earnings growth does not materialize this year we do believe there is the risk of multiple contraction with the market trading above its long-term average. In this scenario another volatile year with minimal return could materialize.

- ***Short term rates*** – We believe the Fed will continue their interest rate hike plan on a gentle glide path in 2016 with 4 – 5 hikes. We see 1% – 1.5% on the Fed Funds rate by year end. More hikes would surprise us but fewer would not due to presidential politics and the lack of international growth.

- ***Long term rates*** – We see long-term interest rates being slightly influenced by the Fed but more influenced by the US and global economies and depressed commodity prices. We see a potential tug-of-war with continued moderate growth from the US offset by sluggishness & slower growth from Europe, China, India, & other emerging economies. Because of this, we predict a flattening of the yield curve with the long-end of the curve rising less than the short-end.

- ***Oil prices*** – Oil above $100 is too expensive. Oil below $40 is too cheap. In our view, $60 oil is equilibrium where demand is largely at "normal" levels. At these prices one can justify the cost of developmental exploration but not speculative drilling, hence replacing the reserves but not expanding reserves. We feel prices will move higher because of the underlying facts about energy - worldwide demand continues to grow & worldwide depletion is a real factor. With US energy production run by for-profit companies and the US now a swing producer, it takes longer for these companies to adapt to the economics of prices. Therefore the recovery of oil we saw going to $60 plus last year didn't materialize. US companies could not shut down production fast enough to bring supply and demand back in line. With 2016 Capital Budget estimates now half of what they were in 2014 and the specter of some bankruptcies in the sector in 2016, we believe equilibrium will be found in the oil markets and see the price once again slowly trend to above $50 and as high as $60 or more by year end. And of course there is always the wildcard of political instability surrounding the balance of power in the Middle East that could disrupt supply and send prices higher.

- ***Inflation*** – remains in check for most of the year until energy prices begin to rebound. Otherwise, we see continued strength in the dollar which should keep inflation low as imports remain down in price in dollar terms. We see moderate economic growth along with moderate wage increases. In our opinion, another year of benign sub 3% inflation.

- ***Sub investment grade bond defaults –*** We see another difficult year for high yield corporate bonds led by a rise in defaults from overleveraged oil & gas companies with inadequate capital reserves. After a few bankruptcies, we believe this will most likely mark the bottom in oil. Likewise, we recommend investors steer clear of any banks or finance companies with heavy exposure to the oil & gas sector. We see too much potential risk in the sector if oil prices recover slower than expected.

- ***Commercial real estate –*** Will face a strong headwind in a rising interest rate environment. Because of this we recommend staying away from triple net lease properties unless they have inflation or automatic rental increase clauses – otherwise we feel they will respond very similar to 15 to 30 year bonds which will see weakness with rising interest rates. However, we still prefer to own select REITs instead of a 10 year bond as higher yields coupled with the possibility of an increasing dividend that make them more attractive and better able to insulate against a price decline due to rising rates. Because of this we recommend a slightly underweight exposure to REITs in general and see outperformance in the sector coming from Health Care, Data Storage, & Residential (both apartments & manufactured housing).

- ***Residential real estate*** – Will rising mortgage rates create a spike in demand as buyers look to get in before it's too late? We're not sure about this as we have a couple forces at play that may offset this. 10,000 baby boomers retiring every day and looking to either downsize or move to a senior living community could offset some of the spike along with millennials embracing the sharing economy and less likely to see the need to buy a house. In our view, the McMansions will have trouble selling. We still favor the small end of residential housing in states that are tax friendly or retiree friendly. Prices which start the year still below peak levels of 2006 – 2007 should continue to climb near 5% for 2016 and potentially those peak levels of 2006- 2007 should be realized again nationwide.

In the past we've tried our forecasting knowledge at everything from a World Series match-up to glaciers breaking apart. This year we have a couple more out of the box forecasts to add to the list – and as in years past it may just be the opportunity to bring a subject to light that may be otherwise below the radar:

- ***Climate change is real –*** While we will avoid the political debate surrounding climate change (whether it is man-made or merely a cyclical process the Earth goes through) we cannot ignore the fact that the planet is warming. We predict 2016 will end with the highest or second highest average temperature since being recorded!

- **Republican Convention** – With many qualified candidates still in the race and plenty of cash left in campaign war chests, we believe this year will be the first since 1976 where a Republican candidate does not enter the convention as the "Presumptive nominee" with enough delegates to win on the first ballot. 1948 was the last time time Republicans actually had more than one ballot and Dewey was selected on the third ballot. Absent some last minute, very high level compromises, we believe this convention may take a couple of ballots to determine who will represent the party.

- **Saudi Arabia begins to lose its grip on power in the Middle East**. – Western allies have had a strong tie to the House of Saud since it was invested with the Kingdom of Saudi Arabia in 1932. 150 years ago Muhammad bin Saud and Muhammad bin Adb al-Wahhab formed a pact that eventually led to Wahhabism becoming the official form of Sunni Islam in 21st century Saudi Arabia. While there are fewer than 5 million Wahhabis in the Persian Gulf region (compared to 28.5 million Sunnis and 89 million Shia) Wahhabism has been linked to inspiring the ideology of the Islamic Sate of Iraq and the Ilenat (ISIL) and labeling Muslims who disagree with the Wahhabi definition of monotheism as *takfir* – thus paving the way for their execution for apostasy. The petroleum dollars since the 1970's has allowed the House of Saud to support the ultra-conservative movements within Islam financially and behind the scenes without having it appear to impact their Kingdom.   We see the connection as becoming more transparent in 2016 and the international backlash against Saudi Arabia start to gather force.

<u>Conclusion</u> *– 2015 was a tough year but you weren't alone*

Although several of the major market indexes showed slight losses for 2015 we know there was more pain felt during the year. We want to reassure you that you were not alone. To illustrate, several "legendary" investors & quality asset managers found 2015 difficult as well:

Investment	***2015 Return***
• Berkshire Hathaway Class A	-12.5%
• T Rowe Price Equity Income Fund (PRFDX)	-6.7%
• Fidelity Value Fund (FDVLX)	-6.5%
• Vanguard Windsor Fund (VWNDX)	-3.3%
• PIMCO US Dividend Fund (PVDAX)	-14.7%

After the first year of decline in the major market averages since 2008, the Federal Reserve signaling the directional shift in the direction of interest rates, and the general emotional mood of market participants being cautious to negative, we continue to believe that long term investing in a disciplined, diversified manner will provide the most predictable path for investors to achieve their personal financial independence. ***We believe that as long as you are receiving sufficient income from your portfolios to meet your cash flow requirements, then you can weather the volatility created by emotions in the markets and be patient to receive the long-term wealth creation afforded by investing in America. Remember, it can be difficult to look through the real-time & constant bombardment of negativity put forth by the media. However, we believe if you do, your mental & financial health will be greatly rewarded.***

As always we want to thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility and will always endeavor to be responsive to your questions and concerns. We welcome and encourage your comments as well.

Montecito Investment Portfolio's Mission: To provide diversified, disciplined long-term investment solutions, service and guidance to help our clients achieve their "Financial Independence".

Sincerely,

Blake Todd, AIF®, CWS
Portfolio Manager

Jarrett Perez, CFA
Portfolio Manager

Disclaimers

This Annual letter expresses the personal views of the author and Montecito Investment Portfolios on the current and future economic and investment landscape, at this date. It is subject to change and is not necessarily the opinion of Crowell, Weedon & Co. a division of D.A. Davidson

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Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected b the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.