MARKET REPORT
FIRST QUARTER 2017

During the first quarter, U.S. stock and bond markets rose. It appears economies and corporate profits moved in the right direction, and consumer, business and investor sentiment remained high. While the Federal Reserve increased interest rates and is expected to do so again later this year, much investor focus seems to be on whether the new administration can execute on its pro-business agenda. It recently had a setback when its comprehensive healthcare bill did not pass through Congress. Significant challenges are likely ahead as it moves on to tax reform and other policies. Regardless of what the new administration is or is not able to accomplish, we believe markets in general are not cheap.

We avoid making aggressive assumptions about government policies, economic growth and persistent low interest rates that may help other investors justify many current asset valuations. If rosy scenarios play out, we believe we will participate in the resulting upside.

It has been our experience that many investors primarily focus on returns, whereas we try diligently to understand the return and risk potential. One way we work to reduce portfolio risk is to lessen the probability of a permanent loss of capital by consistently executing our value-oriented investment process. A key component of the process is making investments where a margin-of-safety exists. One concept of a margin-of-safety is simply the difference between the market price of a security and its intrinsic value. Intrinsic value is the estimated value or range of values that a knowledgeable buyer would pay for a security. Investing at a discount to the intrinsic value increases our odds for success, but clearly cannot eliminate all risk.

Total Return as of March 31, 2017						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	6.1%	6.1%	17.2%	10.4%	13.3%	7.5%
NASDAQ	10.1%	10.1%	22.9%	13.5%	15.4%	10.6%
Russell 3000						
Index	5.7%	5.7%	18.1%	9.8%	13.2%	7.5%
Value	3.0%	3.0%	20.0%	8.6%	13.1%	5.9%
Growth	8.6%	8.6%	16.3%	10.9%	13.2%	9.0%
Russell Mid Cap						
Index	5.2%	5.2%	17.0%	8.5%	13.1%	7.9%
Value	3.8%	3.8%	19.8%	8.9%	14.1%	7.5%
Growth	6.9%	6.9%	14.1%	7.9%	12.0%	8.1%
Russell 2000 (Small Cap)						
Index	2.5%	2.5%	26.2%	7.2%	12.4%	7.1%
Value	-0.1%	-0.1%	29.4%	7.6%	12.5%	6.1%
Growth	5.4%	5.4%	23.0%	6.7%	12.1%	8.1%

Attractive price-to-intrinsic value investment opportunities remain limited in the current environment, yet we are relentlessly searching for ideas where we believe the odds are stacked in our favor.

When things are going well, it is worth remembering that occasional bumps in the road are normal. To help you think about this topic, we touch on a few equity market statistics below. We also review the components of a mutual fund's total return. First, we summarize equity, fixed-income and commodity markets for the quarter.

Equities

The S&P 500 lifted 6.1% during the quarter (including dividends).

Technology was the best performing sector as many companies continued to grow and could benefit from potential government policies (e.g., deregulation, allowing companies to bring cash back from overseas at a low corporate tax rate). Energy declined the most as oil and natural gas prices pulled back (more on oil and natural gas below).

Growth stocks outperformed value stocks and large-caps led small-caps.

Fixed Income & Commodities

Corporate bonds, as measured by the BofA ML 1-10 year index, increased 1.3% for the quarter. U.S. Treasuries and Agencies, as measured by a similar index, increased 0.5% for the quarter. The 10-Year Treasury's yield decreased to 2.4% from 2.5% at the start of the year. As we mentioned in last quarter's letter, "interest rates are still quite low and we have continued to position portfolios with this in mind."

Commodities (as measured by the Bloomberg Commodity Index) decreased 2.3% during the quarter as energy prices weighed on the index. In particular, oil and natural gas prices slid as the active U.S. rig count increased. Additionally, many large oil producing countries had not reduced oil supply output as they collectively agreed to in the recent past (with the intention of restricting global oil supplies). Investors may be even more wary as to whether or not these countries have the will to make the full oil supply cuts they committed to and whether they will make similar deals in the future.

Framing Perception for Market Downturns

The current U.S. equity market expansion is one of the longest in history, and consumer, business, and investment sentiment are at high levels. Investors are increasingly viewing stocks through a glass that is half-full and stock valuations on average reflect their enthusiasm. As such, we thought now would be a good time to review a few statistics to help get you more comfortable with volatility (especially the valleys, most people can handle the peaks!) that inevitably comes with successful long-term stock investing.

To that end, we recently came across an article highlighting a few facts worth sharing. The author, investment manager Ben Carlson, looked at S&P data from 1928-2016 and found that, on average:

- Three times per year, stocks declined at least 5%
- Once per year, stocks declined at least 10%
- Once every two years, stocks declined at least 15%
- Once every three to four years, stocks declined at least 20%

In recent years, the U.S. stock market has been void of numerous and extended downturns of significance. As such, we believe the author sets expectations well based on history and we would encourage you to embrace his general view: "Average historical returns never tell the whole story because so few years or cycles ever follow the averages, but these numbers can be instructive. Stock market investors should expect to lose a little money quite often, see a correction occasionally, lose a decent amount every couple years and lose a lot of money on an Olympics-like schedule."

While downturns may not feel good in the short-term, historically they have provided us with attractive investment opportunities. This may sound odd, but we are actually hopeful that downside volatility increases so that we can put your money to work at lower prices for the long-term benefit of your investment portfolios.

Mutual Fund Returns

The total return (price change plus distributions) of mutual fund shares can be tricky to understand, especially bond mutual funds where the share price typically does not vary too much. Since a few investors have asked questions about this topic, we thought more may be interested and therefore decided to dedicate some ink to education. We hope you enjoy.

- **Price Change** – A mutual fund is required to calculate its Net Asset Value (NAV) after the close of business on any day the exchange on which it trades is open. The fund's NAV/share or net worth per share is derived by subtracting its liabilities (i.e., any expenses) from its assets (i.e., stocks, bonds, etc.) and then dividing by the mutual fund's shares outstanding. The NAV/share or share price changes on a daily basis based on this calculation.

- **Distributions** – Dividends and interest are typically distributed at regular intervals with an occasional true-up distribution. Realized capital gains are typically distributed each year, due to regulations. Importantly, distributions reduce a fund's NAV (i.e., NAV goes down and distributions go up).

- **Total Return –** Price change plus distributions (which may be used to purchase additional mutual fund shares).

Some financial news sources only show the change in NAV/share in charts, excluding distributions which can be notable. Looking at a fund's NAV/share over time is only a part of the picture and understates total return. Scenarios can occur where a fund's NAV decreases, yet investors experience good positive returns due to distributions (common in bond funds where the primary source of return is often interest). Lastly, it's common for fund distributions to be reinvested; increasing the number of shares owned (all things being equal). Owning more shares impacts an investor's aggregate market value in the fund and his/her average cost basis.

Summary

- Equity markets are off to a good start for the year. Expectations are high and valuations are not cheap. We are searching diligently for investments priced at attractive discounts to their intrinsic values.

- In recent years, there has not been much downside volatility in markets relative to history. We think it is wise to be mentally prepared for downturns to occur with more frequency and magnitude going forward. We believe we are well positioned to capitalize on opportunities as they arise, yet remain disciplined.

- When reviewing mutual fund returns, understand that NAV is just one part of the equation. Don't forget those distributions (and any shares purchased with distributions).

Past performance is not indicative of future results. Market and economic data has been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.