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ASSET MANAGEMENT

MARKET REPORT
FOURTH QUARTER 2016

In general, the fourth quarter was good for U.S. stocks and commodities but challenging for U.S. bonds. The many fears weighing on investor sentiment at the start of 2016 (e.g., China's slowing economy, potential recession) and later during the year (e.g., anxieties related to the "Brexit" vote – U.K. citizens voting to leave the European Union – and U.S. political elections) have seemingly been replaced by optimism.

Some market participants may have been pleased that the Federal Reserve raised short-term interest rates a small fraction in the fourth quarter and that increasing commodity prices should improve profitability for commodity-based companies. However, we believe the general improvement in investor sentiment was primarily related to the U.S. political elections. An emotional, divisive political battle resulted in one party taking control of both the executive and legislative branches of government. This outcome, surprising to most, has potential investment implications that we will discuss later in the letter (we are not keen on discussing politics and will opt to focus on likely economic and market impacts).

Thus far, U.S. stock markets appear pleased with potential pro-business government policies. Before we discuss this in more detail, we will touch on stocks, bonds and commodities.

Equities

The S&P 500 appreciated 3.8% during the quarter (including dividends), increasing returns for the year to 12.0%.

The financial sector was the best performer during the quarter as it was viewed as a beneficiary of potential policies from the incoming Republican-led executive and legislative branches (e.g., lower corporate tax rates, deregulation) and increasing interest rates.

The energy sector was the best performer during the year as oil prices rose, and ultimately a large group of oil suppliers completed an agreement to limit output (putting additional upside pressure on oil prices).

Several sectors (e.g., utilities, consumer staples, real estate, healthcare) containing stocks that investors may have purchased due to their large dividend yields (relative to other assets, including bonds) lagged other sectors during the quarter. As interest rates rose, dividend yields of these companies may have looked less attractive relative to bond yields. For the year, healthcare was the only sector with negative returns amid some disappointing company results, failed mergers, and political pressure related to high drug prices.

Total Return as of December 31, 2016						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	3.8%	12.0%	12.0%	9.0%	14.7%	7.0%
NASDAQ	1.7%	8.9%	8.9%	10.2%	17.2%	9.6%
Russell 3000						
Index	4.2%	12.7%	12.7%	8.6%	14.7%	7.1%
Value	7.2%	18.4%	18.4%	8.7%	14.8%	5.8%
Growth	1.2%	7.4%	7.4%	8.4%	14.4%	8.3%
Russell Mid Cap						
Index	3.2%	13.8%	13.8%	8.1%	14.7%	7.9%
Value	5.5%	20.0%	20.0%	9.6%	15.7%	7.6%
Growth	0.5%	7.3%	7.3%	6.4%	13.5%	7.8%
Russell 2000 (Small Cap)						
Index	8.8%	21.3%	21.3%	6.8%	14.5%	7.1%
Value	14.1%	31.7%	31.7%	8.4%	15.1%	6.3%
Growth	3.6%	11.3%	11.3%	5.2%	13.7%	7.8%

For the quarter and the year, value stocks significantly outperformed growth stocks, and small-caps bested large-caps.

Fixed Income

Corporate bonds, as measured by the BofA ML 1-10 year index, declined 1.9% for the quarter but increased 4.2% for the year. U.S. Treasuries and Agencies, as measured by a similar index, decreased 2.1% for the quarter but edged up 1.1% for the year. The 10-Year Treasury bond returned -6.8% for the quarter and -0.2% for the year.

While the one-two punch of higher interest rates and potential pro-growth government policies have negatively impacted the returns of many bonds, interest rates are still quite low and we have continued to position portfolios with this in mind.

Commodities

Commodities (as measured by the Bloomberg Commodity Index) increased 2.7% during the quarter and 11.8% for the year, breaking its streak of annual losses over the previous five years. Gains were broad-based (e.g., forecasted colder winter temperatures stoked demand for natural gas; less supply amid closed mines helped Zinc prices; optimism related to potential government policies perceived to improve economic growth have helped industrial metals, including copper; the potential for deregulation and energy-friendly policies helped energy prices). Wheat was one of the exceptions, down 13.2% for the year on the back of record global production.

The previously mentioned deal between many large oil producing countries to restrict global oil supply was viewed as bullish for oil prices (West Texas Intermediate oil prices finished up 45.0% for the year). These types of agreements have been difficult to adhere to in the past for a variety of reasons. With even more oil supplying countries now involved than in previous agreements, we think the ability to adhere to and enforce the agreement is more questionable. At the same time, exploration and production companies (including U.S. shale producers) continue to innovate and reduce the cost of extracting oil and gas from the ground. While we have no definitive view of where the price of oil will go, we think oil and gas suppliers and their innovations are likely to keep oil and gas prices from increasing more than they otherwise would.

The Impact of New Government Policies and Valuation

We try hard to avoid expressing any political views, as we have stakeholders (e.g., employees, clients, suppliers) on all parts of the political spectrum and understand how difficult it is for anyone to change his/her political orientation. During the latest U.S. election season, emotions and mudslinging seemed to be as high (or higher) than anytime we can recall. That was unfortunate.

We aim to make investments that we believe will produce good risk-adjusted returns, regardless of the ever changing political tide. That being said, the fourth quarter appeared to be dominated by the outcome of the U.S. elections, which markets seemed to perceive as favorable for U.S. businesses. Early indications suggest consumer and small business sentiment is on the rise. This can be good for the economy. From a business and investment perspective, we believe the incoming administration's economic proposals can be **beneficial**. We are encouraged on that front. However, the potential benefits must be balanced with the **potential costs** of any proposals and the **valuations** of investments.

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Some of the <u>benefits</u> to U.S. companies that can come from the Republican-dominated government include the following:

- Lower corporate tax rates, which can help increase after-tax earnings for companies.
- A lower tax rate for companies to bring their foreign earnings back to the U.S., which again can save companies on taxes and encourage capital investment in the U.S.
- A large increase in infrastructure spending, which can result in more profitable business for companies.
- Deregulation, which can improve efficiencies and earnings for businesses.
- Increasing the standard deduction for individuals and lowering individual tax rates, which can increase U.S. taxpayers' after-tax incomes that could be used to purchase additional goods and services from businesses.

The fact that one party controls the executive and legislative branches of government **increases the likelihood** these items on their wish list can become law.

Some of the <u>potential costs</u> of the proposals include the following:

- How will some or all of the benefits above be paid for? Examples include:
    - There are discussions of taxing imported goods, which may make domestic-produced goods more cost-competitive, but could result in making imported goods such as shoes and apparel more expensive for U.S. companies to provide to U.S. customers.
    - There is mention of limiting deductions for interest on debt, which could increase the after-tax cost of financing and hurt businesses and consumers.
    - If the U.S. government chooses to issue debt to pay for many of the potential benefits, with the intention of depending on growth to help pay back the cost of implementing these programs, will that increase the potential and magnitude of financial distress for the U.S. further in the future (many market participants already worry about U.S. deficits, the country's sizeable debt load, and the costs of future payments related to Medicare, Medicaid, and Social Security)?
- **When** could potential benefits go into effect? For example, an infrastructure plan or tax rate reductions going into effect in 2017 can be more important in calculating the current values of companies than if those benefits come in subsequent years.
- What are **the sizes** of the potential benefits? For example, the extent of the reduction in the top federal marginal corporate tax rate (currently 35%) could have a significant impact on how much companies earn on an after-tax basis. Furthermore, how much will companies benefit from a tax rate reduction if many loopholes are eliminated as part of any proposals to simplify the tax code and pay for the potential benefits?
- Will companies be able to **retain** these potential benefits? For example, any cost reduction a company received – such as a lower tax rate – might be passed along to its customers in the form of lower prices over time due to competition.

- If the new administration imposes penalties and tariffs on products from China and other countries to help U.S.-based labor and businesses, will those countries respond with policies that are not friendly to U.S. labor and businesses?
- If the investment community believes in the benefits of the proposals enough, the U.S. dollar could strengthen relative to other world currencies, thus making exports from the U.S. **more expensive** than they may otherwise be.

These are just a few of the potential benefits and drawbacks to consider when assessing the effects of the potential policies currently being viewed by many as pro-growth. Very complex! We do not believe the outcomes can be forecasted with any precision, but we do believe U.S. corporate earnings can benefit as a result of the policies. We do think the lack of details (knowing that not all Republicans and their constituents will agree) and potential drawbacks should temper enthusiasm.

An analysis of this topic for the purpose of making investment decisions would not be complete without looking at the valuation of stocks:

Stocks are still not cheap based on various valuation measures, and at least one concludes valuations are lofty: The Cyclically Adjusted Price-to-Earnings ratio (aka CAPE) is a calculation that divides the S&P 500 index by the average earnings generated by companies in the S&P 500 over the previous 10 years. This valuation measure has a good track record of forecasting future returns over time and says stocks are more expensive now than 96% percent of the time going back to 1871. Additionally, it may not feel this way but the U.S. stock market advance since March 2009 is one of the top three longest bull markets of all time. The other two did not end well.

Therefore, while we carry some enthusiasm for the way potential government policies can play out, we believe current valuations anticipate a rosy outcome as it relates to how these policies could help corporate earnings in the future. Through our lens, we are positioned to take advantage of situations and environments that misprice assets.

Summary

- U.S. stocks and commodities enjoyed good returns during the year and bonds were challenged by a rising interest rate environment.
- Government policies that may be enacted in the future can be beneficial, but those benefits are difficult to quantify and weigh against potential costs.
- We believe valuations are still not cheap and likely embed a good portion of the potential benefits that could result from future government policies.
- We are working diligently to uncover investments with attractive risk/reward profiles, yet remain disciplined and patient.