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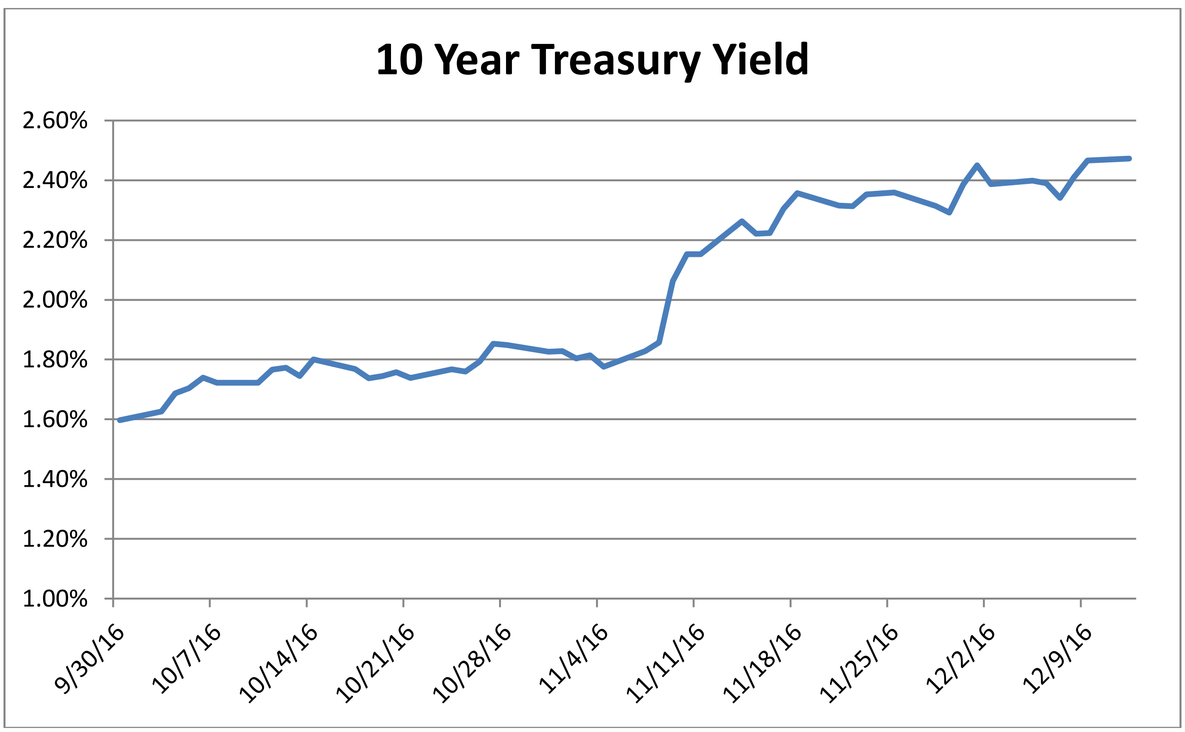
Investment Newsletter – December 2016

This newsletter starts with a discussion of market reaction to the election. Then we examine the likely impacts of potential policy changes next year when the Republicans take power and I'll interpret the market moves in the context of expected policies. We'll conclude with an update on the performance for the Quantitative Equity Investment strategy.

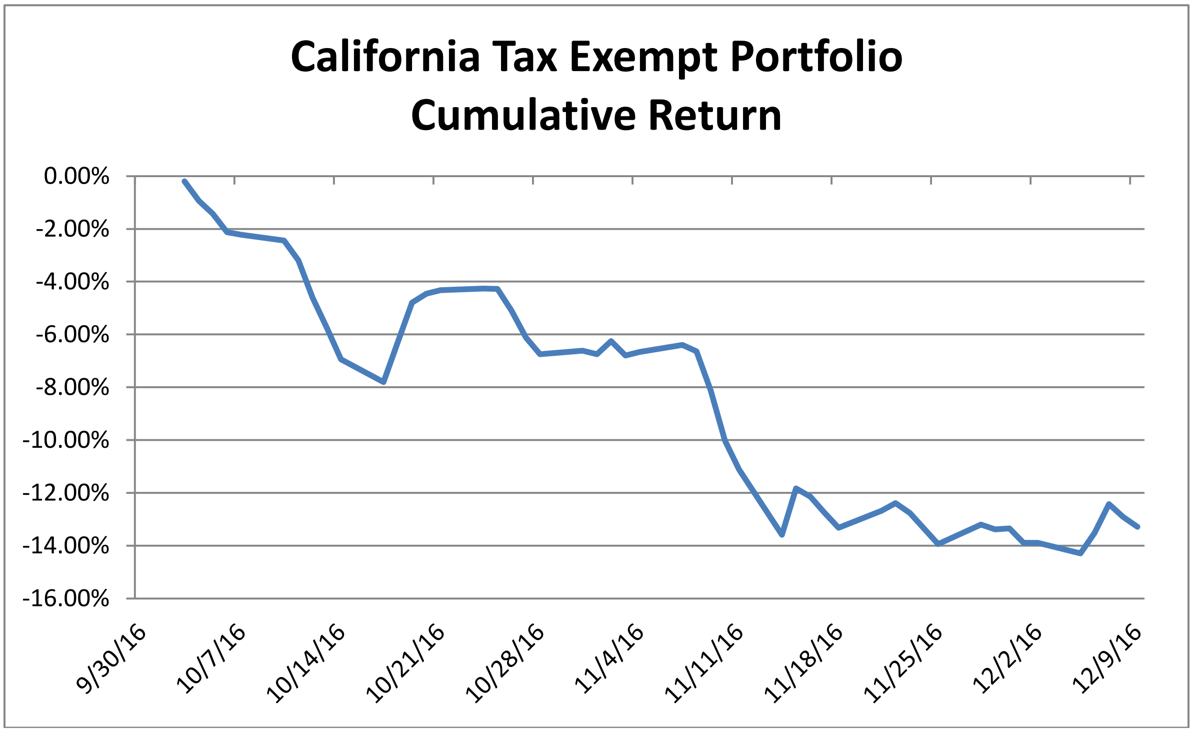
The Market Reaction to the Election and Expectations for the Economy

The surprise election of Donald Trump, along with Republican control of both houses of congress, triggered substantial market moves in various segments of the financial markets. First we'll discuss interest rates and corresponding sectors of the bond market, and then we'll review the effects on different sectors of the equity market.



As you can see in the chart on the previous page, the 10 year Treasury rate was already trending upward since the end of last quarter but then took a jump upward after the election. It went from 1.86% on November 8th, to 2.47% on December 9th. This .61% move in the 10 year Treasury rate is a very large move for the bond market.

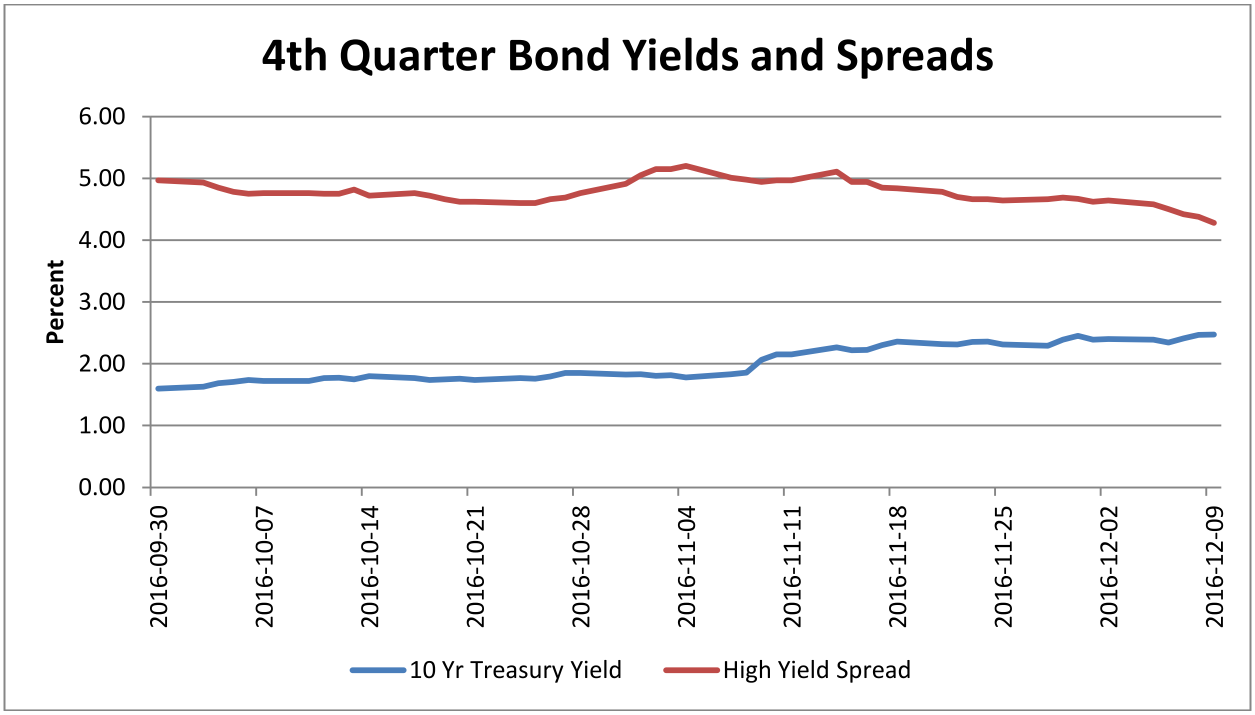
Rising interest rates correspond to falling bond prices. This was especially true in the tax exempt municipal bond market because these bonds are also sensitive to changes in tax rates for high income tax brackets.



The graph above shows the cumulative change in value of a portfolio of tax exempt closed end bond funds. As mentioned, the value tends to move inversely to the yield on the 10 year Treasury bond and we see it was already drifting down before the election. Then, in the four trading days after the election this portfolio dropped another 7%. The move on the fourth day was the largest one day move I've seen and this prompted me to buy in as the yield became very appealing. Since then the market has somewhat stabilized.

Overall the 10 year Treasury yield went up .87% since the end of the 3rd quarter; this accounts for roughly two thirds of the change in the tax exempt portfolio value. The rest came from increases in the closed end fund discounts relative to underlying bond values.

Low interest rates combined with high stock market valuations over the last few years have motivated a relatively large allocation to high yield bonds as a way to earn decent returns while remaining on defense against rising interest rates and an eventual change in market sentiment. In addition, a large part of this is in short term bonds which are less sensitive to interest rate changes. This strategy served as expected - as rates rose dramatically in investment grade bonds, the spreads on high yield bonds decreased – mitigating the impact on the bond values. This is a typical effect when rates are rising because of market expectations for faster economic growth because faster growth tends to increase corporate cash flows and reduce the likelihood of corporate bond defaults. Rising oil prices (in response to the announced cut in production by the Organization of Petroleum Exporting Countries) also contributed to the decreasing spreads. Here's a look at how the high yield spread index changed, with a comparison to the 10 Year Treasury Yield:



Thus we had a .59% reduction in high yield spreads, which offset most of the .87% increase in the risk free interest rate.

Meanwhile on the equity side, the large capitalization stocks, as represented by the S&P 500 rose 5.6% November 8th to December 9th. Small capitalization stocks, as represented by the Russell 2000, outperformed by rising 16.1% over the same period. Within the large capitalization stocks, the S&P 500 financial sector index was a star performer, rising 18.7%. Within the financial sector, Goldman Sachs was up 33%, Bank of America was up 36%, and even scandal plagued Wells Fargo was up 26% over this period.

Industrial, energy, and materials sectors all gained 9% or more between the election and December 9th. Caterpillar, which could benefit from increased construction activity, gained 12.8%. Meanwhile the information technology sector was a laggard, gaining just 2% over the same period.

The Change Agenda and Economic Impacts

These are very big moves considering no one really knows what the new administration can accomplish. The agenda is ambitious: the president elect and congressional leaders say that they plan to reduce taxes, reduce regulations, and Trump says he will increase tariffs on foreign made goods or negotiate better trade terms.

Corporate taxes are due for a major overhaul. Currently large corporations pay a 35% federal tax rate on worldwide income but don't pay taxes on foreign earnings until they are brought back into the U.S. This is one of the highest rates in the world and provides a large incentive not to bring earnings back to invest in the U.S. Trump has proposed lowering the tax rate to 15% and congress has proposed a rate of 20%. Assuming the tax rate goes below 20%, there will be a very significant reduction in taxes on profits earned in the U.S. thereby boosting net corporate earnings. Also, since this would bring our tax rates more in line with other countries and the foreign taxes paid on earnings are credited against U.S. tax, this would dramatically reduce the incentive to keep money overseas.

Because large multinational corporations earn substantial amounts outside the U.S. and keep the money offshore to avoid existing tax rates, they will benefit from reduced taxes much less than companies whose earnings are more concentrated in the U.S. Thus we should expect smaller companies to benefit more than large companies. Technology companies tend to have a larger share of income outside the U.S. and will benefit much less than other more domestically focused sectors. Banks, in particular, face rather high tax rates under current law and should therefore see large increases in after-tax income.

The reduction in corporate taxes, and the associated increase in net income, translates into a large after-tax increase in returns on investing in the U.S. When deciding where in the world to invest, this change in returns should shift significantly more investment dollars into U.S. projects. At the same time, the multinationals will have an opportunity to bring money home without large tax payments. This will tend to push up economic growth in the U.S. Increases in expected growth and returns on capital are driving interest rates higher.

Another factor in favor of higher growth is the proposed repeal or amendment of the Dodd-Frank financial regulations. While these may have reduced the risks of large bank failures they have done so at great cost to the economy. There are several economic effects. First smaller institutions face very high fixed costs to comply and thus the law effectively protects existing large banks from newer small entrants that could make the financial sector more dynamic and competitive. According to the Federal Reserve Board:

"The number of new bank charters in the United States has declined dramatically in recent years. From 1990 to 2008, over 2,000 new banks were formed, more than 100 per year. From 2009 to 2013 only 7 new banks were formed, fewer than 2 per year. "

In addition, higher capital requirements and restrictions on banks' activities has reduced lending to small businesses and reduced liquidity in bond markets which increases the cost of capital for borrowers and dampens certain investment activities. In short, the efficiency of banks in allocating capital within our economy has been degraded which must reduce growth - all else equal. Any changes which restore some of the lost efficiency will be positive for the economy (provided the changes don't lead to systematic risks of bank failures).

The prospect of higher interest rates, regulatory changes, and tax reductions has the potential to push banks' returns on capital back to more normal levels. This should allow their stock prices to rise back above book value on a sustained basis. This is why there has been a large rally in bank stocks.

The Obama administration set records for the growth of government regulations and control over the economy. It seems more than a coincidence that the recovery from the great recession was the weakest on record. Since a great deal of this rule making was not driven by new laws passed by congress, the new administration has promised to roll back a large part of the bureaucracy created in the last 8 years. While easing red tape may depress the billings of law firms, the overall impact is likely to be very positive for the economy. Changes to Obama care could also have a positive impact though it is impossible to assess without knowing the form that will take.

Lower personal income taxes are also on the table. Tax cuts are generally very positive for the economy as they shift spending towards more efficient parts of the economy. The proposed elimination of the Obama tax on investment income will be very particularly positive for investors – especially real estate investors as this tax tends to hit sellers of investment real estate. On the other hand lower taxes will reduce the advantages of tax exempt bonds.

Finally we come to trade policy. The president has wide discretion over trade and therefore can quickly impose tariffs without congressional approval. President elect Trump has threatened to impose 45% tariffs on imports from China and 35% tariffs on Mexico. In the short run such tariffs would likely be borne by consumers and lead to a significant reduction in imports or possibly a switching of sources to countries not subject to tariff increases. Longer term we could see some production returning to the U.S.

It seems unlikely that such high tariffs would actually be implemented. More likely, Trump will use this threat of cutting off access to the U.S. market to cut better deals – as he has said. In the case of China, simply getting them to live up to their prior commitments would be a big win.

As explained in the June 2016 newsletter, China's policy of directing the nation's income to government investment rather than consumers results in a huge imbalance of savings and investment relative to consumption. This follows directly from government control over their primitive financial system. This is not a market economy; the result is huge over-investment in export industries. These exports exert downward pressure on prices worldwide. This is slowly undermining the goods sector in the market economies like the U.S. At the same time China does not allow U.S. companies to compete freely in its market. They impose many non-tariff barriers that distort trade far more than tariffs would. Assuming Trump can counteract these market distorting policies from China, it should improve the economy over the long run. In particular it will help U.S. companies, though it is likely to be a negative for consumers in the near term. It will also be a negative for many technology companies because they have outsourced production to China. They will also feel the brunt of retaliatory trade barriers and suffer from restrictions on immigrant visas for technology workers.

Mexico is a different matter entirely. Although labor costs in Mexico are lower than in the U.S., we don't see the massive government interference that would constitute a threat to the U.S. economy. In contrast to China, Mexico actually has a trade deficit, not a surplus. The North America Free Trade Agreement (NAFTA) has led to a deepening integration of the economies of the U.S., Canada, and Mexico. Many of the factories in Mexico are owned by U.S.

companies (and therefore U.S. shareholders). It is hard to see what the U.S. can gain by renegotiating the agreement with Mexico.

Overall the policies put forth should tend to improve the economy and returns on capital given enough time. We can only hope that the transition back to a more normal financial and economic environment is smooth and that we can get back to the point where returns on capital are sufficient to fund the country's pensions and support the coming wave of baby boom generation retirees.

Quantitative Investment Strategy Test Results

Three years ago, we implemented a quantitative strategy on a test basis. The goal for this strategy is to outperform passive strategies across various market environments. This is not a risk managed strategy, so it would likely under-perform our existing Long Term Value strategy in a down market. Assuming we allocate some portion of equity exposure to this strategy, it could serve to reduce the variation in our returns relative to the market in up-markets.

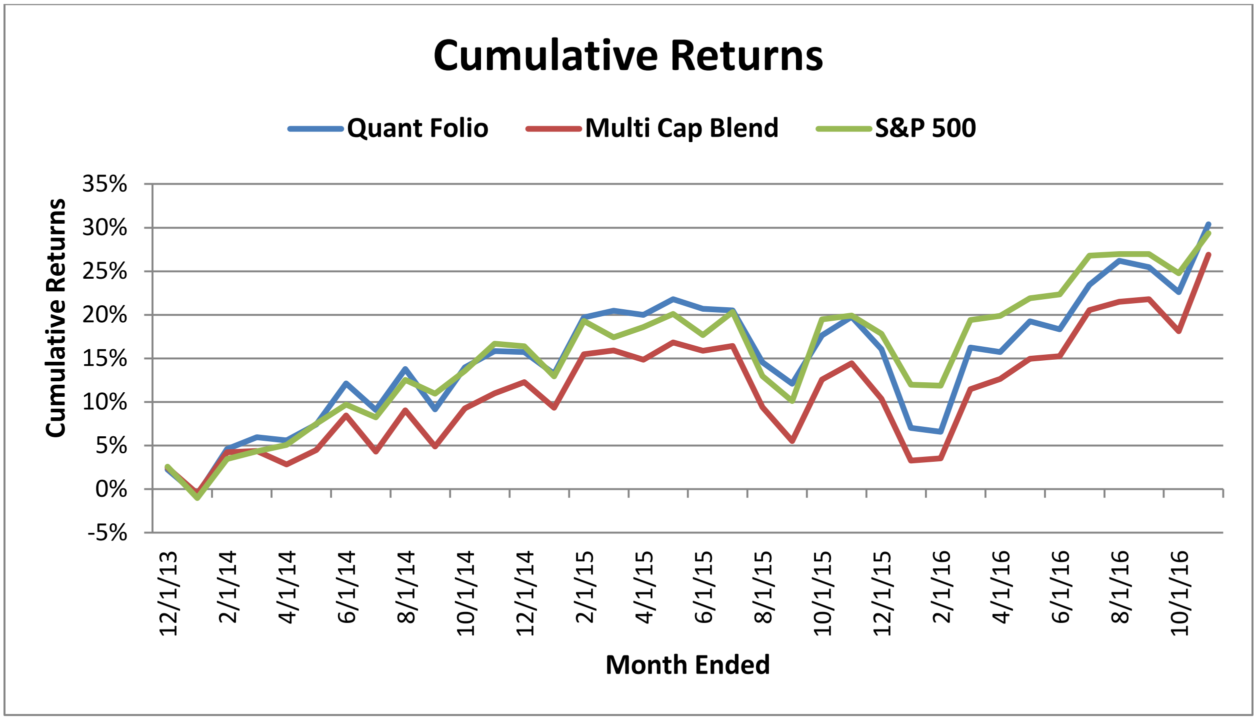
Because our goal with this strategy is to reduce volatility of our return variance versus the market, the portfolio is designed so that industry weightings are approximately in line with the overall market's industry weightings. We did not, however, put any constraint on the size of the companies chosen for the portfolio. Given that larger capitalization stocks are more efficiently priced in the market, we expected the portfolio to be weighted more towards small and mid-cap stocks. In fact the portfolio varied in composition widely from month to month, but on average it has been 38% large capitalization, 26% mid-cap, and 36% small capitalization.

Over the long run smaller capitalization companies tend to outperform larger companies in generating returns for investors. The last 3 years has been unusual in that this has been reversed: larger capitalization companies have done much better relative to smaller ones than we should expect going forward. Therefore, we would like to isolate this effect in evaluating the Quant Portfolio. This is important because we are really interested in how it would perform over the long run, not just in the late years of a bull market. If the strategy can outperform a blended benchmark with similar capitalization composition, that is likely to be a good indicator of long-run relative performance. The chart on the next page plots the cumulative returns of the Quantitative Investment Strategy compared to the S&P 500 and a "Multi-Cap Blend" benchmark. The Multi-Cap Blend is a weighted average of large, medium, and small capitalization market indices[1] where the weights are equal to the average capitalization weightings of the Quantitative strategy over the three years. The returns in this chart are from a "watch portfolio" rather than an actual account but they have been adjusted assuming a fee of 1.25% which would apply for accounts between $500,000 and $1 million.

The chart on the next page shows that the return (after fees) for the Quantitative Strategy outperformed the annual return on the S&P 500 by 0.29% and it outperformed the Multi-Cap Blend benchmark by .98% annually. Its total return over the first three years was 30.4%.This a very good result. The tracking error is within a small range and the strategy produced a nice spread over the

[1] Large was S&P 500, mid-cap was S&P Midcap 400, small was Russell 2000

comparable blended index return. This strategy is appropriate for retirement accounts - especially at the early and mid stages of a bull market. By allocating some portion of our portfolio to the current methodology we can reduce overall tracking error and increase returns in bull markets.



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