Sentiment (and the Market) is Rising

Quarterly Commentary – April 1, 2017

The U.S. stock market continued its upward march with all three major indexes hitting all-time highs during the quarter. At the end of the first quarter, the S&P 500, including dividends, had increased 6.07%, the Dow Jones Industrials increased by 5.19% and the technology-heavy NASDAQ Composite generated the strongest return, increasing by 10.13%. Bond returns were modest in comparison, as the yield on the 10-year US Treasury remained relatively flat, decreasing by 5 basis points to end the quarter at 2.40%. The Barclays Aggregate Bond index returned a positive 0.82% for the quarter.

The S&P 500 is now up over 11% since the November 8th U.S. presidential election on the market's expectations over the prospects and likelihood for passage of President Trump's pro-growth policies. "Trumponomics" is centered on the following three key themes; tax reform, deregulation and fiscal stimulus focused on infrastructure and defense spending. The intent of these policies is to accelerate economic growth which has been relatively anemic at 2.1% per annum during the recovery from the 2008-09 financial crisis.

While it is too early to see evidence of economic growth in the "hard data" such as GDP growth, the "soft data" focused on business confidence and sentiment is clearly indicating optimism about the economy. The March 2017 results of the Duke CFO Global Business Outlook Survey, which polls over 360 chief financial officers of both public and private companies in the U.S., shows that they are the most confident they have been about economic growth in more than a decade. The survey aggregates for expectations over the next twelve months for leading indicators such as earnings growth, capital spending, research and development spending, employment and revenue growth. As a funny aside, they also ask what advice they would give to President Trump to improve the business climate and 67% of respondents said to stop using Twitter. We wholeheartedly agree.

Along with businesses, the U.S. consumer is gaining in confidence as well. The March Consumer Confidence Index reached its highest level since December 2000. Much of this optimism is related to the fact that the unemployment rate is the lowest since 2007 and has fallen by more than 50% since the highs reached following the financial crisis. Additionally, we are beginning to see initial signs of wage inflation, which means more money in consumer's pockets. The result has been an increase in consumer confidence which should eventually lead to improved economic activity since nearly two-thirds of GDP activity is driven by consumer spending.

While the shift in sentiment may result in improved economic activity and a higher stock market, what ultimately drives returns in stocks is growth in corporate profits. Currently, expectations are for greater than 14% growth in corporate earnings in 2017, a return to growth following two years of flat to declining earnings. Two of the biggest headwinds to earnings growth over the past two years have been declining energy prices, and the relative strengthening of the U.S. dollar. Lower oil prices have hurt the profits of both the energy sector as well as the industrial sector that serves it, including businesses that we own such as Flowserve, W.W. Grainger and Colfax. The strong U.S. dollar has caused many U.S.

multinational businesses to compete at a price disadvantage as their products became relatively more expensive in the foreign markets in which they operate. The impact of both the decline in oil and relative strength of the dollar is now largely behind us and should no longer serve as a strong drag on corporate profits this year.

With the prospects for more robust economic growth, improved confidence from both businesses and consumers, and the likelihood of a resumption of higher corporate earnings this year, it does not surprise us that the market has continued its upward trajectory. Importantly, despite this post-election rally and new "highs" in the market, the valuation of the market still appears reasonable to us, although it is certainly no longer as "cheap" as it was several years ago. However, since much of the recent move in the market has been driven by the shift in expectations highlighted above, we have become increasingly cautious due to two primary risks; one being the prospect of Congress not being able to pass any major pro-growth legislation in a timely manner due to political dysfunction and two, that the current heightened confidence levels will not translate into an actual increase in economic activity. Because of these risks, we continue to focus on owning individual businesses as opposed to the "market" and our focus remains on owning superior businesses that are trading at attractive valuations relative to our estimate of intrinsic value. Stock selection will be the key to generating positive relative returns and ensuring that your portfolios allow you to achieve your financial goals and objectives. Simply "betting on the market" will be much more difficult going forward.

Q1 Portfolio Changes

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component[***].

During the quarter we eliminated United Technologies (UTX) and Diageo (DEO) from the portfolio and initiated positions in Medtronic (MDT) and Novartis (NVS). Explanations for these changes are provided in the following paragraphs.

Our decision to eliminate United Technologies was first and foremost predicated on that fact that the stock no longer represents a compelling value opportunity. In addition, follow-up research by our investment team in recent months disclosed that the probability and magnitude of commercial success for the Pratt & Whitney segment's newly-developed Geared Turbofan jet engine is perhaps lower than we originally estimated. Furthermore, while the market opportunity for elevator sales in China is substantial, the Otis segment's profitability in this country should continue to be depressed for many years as management recently made the strategic decision to permanently reduce elevator prices to win market share over the long-term. Together, these three factors compelled us to eliminate the position entirely in Q1.

We decided to sell Diageo during the quarter after a revisit of our valuation on the name indicated that Medtronic and Novartis represent superior risk-reward opportunities. The opportunity in the latter names is being provided by generally poor sentiment across the entire healthcare sector due to uncertainty over the potential repeal and replacement of the Affordable Care Act (ACA). While the situation on this front remains fluid and uncertain, our research indicates that Novartis and Medtronic should be largely unaffected by regulatory changes. Accordingly, after initiating positions in these securities we further augmented these positions with proceeds from the Diageo sale. More detailed explanations for why we originally invested in Medtronic and Novartis are below.

Medtronic

Medtronic is one of the largest medical device manufacturers in the world. With a focus on cardiology, diabetes, general surgery, renal care, chronic pain, and spine, Medtronic's solutions are used on a daily basis by physicians to alleviate pain, restore health, and extend life for patients worldwide. We believe Medtronic has strong competitive advantages derived by dominant, oligopolistic market positions across almost all product categories, abundant levels of patented technological innovation, scale advantages in manufacturing, and a highly-trained salesforce with intimate physician relationships and extensive technical expertise.

Our research indicates that Medtronic's profitability is set to benefit materially from an aging population, a promising product pipeline and, most importantly, by renewed efforts by management to improve overall company efficiency. Efficiency improvements should result from management's plan to implement lean manufacturing systems globally, improve raw materials sourcing, optimize its global supply chain, and integrate the company's technology systems. If management is successful in implementing these efficiency improvements we believe it will become clear to Wall Street that Medtronic's stock is considerably undervalued.

Novartis

Novartis is one of the largest pharmaceutical companies in the world with annual sales of $50 billion. The company is based in Switzerland and operates under three highly diversified business segments: Pharmaceuticals, Sandoz (generic and biosimilar drugs), and Alcon (eye care products).

The non-discretionary nature of the Novartis's products make sales and profits relatively immune to economic downturns and with only 30% of sales generated in the United States the company is more insulated than many of its peers from threats derived by healthcare reform.

Importantly, Novartis benefits from a wide economic moat. The company has dominant market positions in its major branded drug categories, especially in the rapidly-growing and massive oncology market; manufacturing and distribution advantages from its large scale in generic drugs; and unique know-how in the development and manufacturing of biosimilar drugs. In addition, the company's eye care business has strong brand loyalty and operates in a global market that is largely oligopolistic in nature.

Like Medtronic, Novartis is in the midst of an effort to improve efficiency across all business segments. The company intends to streamline its salesforce, realign its manufacturing footprint, and integrate its R&D efforts. We think all these actions will lead to a material improvement in earnings.

Colin Higgins – *President*