Q4 2017 Quarterly Commentary – January 1, 2018: Strengthening Economy and Tax Reform Draw Investors into Equity Markets

The fourth quarter capped a strong year in domestic stock markets. The S&P 500 produced a gain of +6.6%; the Dow Jones Industrials logged a return of +11.0%; the tech-heavy NASDAQ generated a gain of +6.6%. Results were driven by strength in the economy, with third-quarter GDP logging growth of +3.2%, corporate earnings growth, strong unemployment data and the completion of Republican tax overhaul. Global markets had mixed results, with the Eurozone's MSCI EMU index returning -0.5% in the fourth quarter, while the UK's FTSE All-Share Index logged gains of 5.0%. Asian and Emerging markets generally had strong performances.

U.S. Treasury bond yields rose over the quarter, the yield curve flattened, and corporate credit spreads narrowed, producing mixed results for bond investors, depending on the duration and risk-composition of their bond portfolios. The Barclay's Aggregate Index produced a return of +0.4% in the fourth quarter.

Value investors did less well than growth investors, and although the portfolio increased in value during the quarter, we along with many of our peers lagged the broad stock market indexes, but we feel good about the position of client financial assets vis-à-vis their long-term financial goals. We look forward to further discussions with you regarding your financial position, your short and long-term financial objectives, and your portfolio's allocations across equity and income-producing securities. Lives change and circumstances evolve, so it's important that we, as your financial advisor, make certain that we've fully understood your vision and have reflected it appropriately in your financial plan and the assets under our care.

<u>Corporate Taxes</u>

We have used these pages in recent quarters to discuss tax reform, which was the most important initiative (other than regulatory reform, perhaps) of the new administration to us, as investors, because of its potential positive impact on the intrinsic value of your holdings. Now that reform has been signed into law, we'll offer one more perspective, and hopefully provide you with a better sense on how we look at its impact on businesses that we hold and the ones we are considering for future investment. The principal changes were (1) the reduction in the Federal statutory corporate income tax rate from 35% to 21%, and (2) the adoption of a territorial tax system, whereby the U.S. will not impose a tax on earnings generated outside of its borders. This meets the primary goal of the people who drafted the law, which is to bring corporate tax rates down to a level competitive with the rest of the developed world, and provide incentives for U.S. corporations to direct more of their capital investment back to their home country. In general, U.S. corporations with predominantly domestic operations stand to benefit the most, but it requires some deeper investigation to determine the degree to which our companies truly benefit.

For example, Chipotle Mexican Grill is a very American company, notwithstanding its name, and consequently we believe it should receive a significant benefit from corporate tax reform due to the statutory rate reduction. In fact, as of September 30th, only 36 of the company's 2,366 restaurants were located outside the United States. Management estimates that its effective income tax rate will be 39.1% in the year just completed, payable to Federal, state and foreign tax authorities. We expect that Chipotle will get much of the benefit of the fourteen percentage-point reduction in the Federal statutory rate. There is wide disagreement among Wall Street analysts as to what Chipotle will earn in 2018 (a key reason for our interest in the stock), but if the company were to produce pre-tax profit of $418 million, which is the average of current Street estimates, then the tax benefit alone of the reduction in Federal taxes is roughly $58 million, or about $2.00 per Chipotle common share. We see this as a real value boost.

Owens Illinois, notwithstanding its name, is a global business that pays little in U.S. corporate income tax, and therefore we think likely stands to benefit less from Federal tax reform. The company operates across four reportable segments, defined by their geography: Europe (25% of sales; 27% of operating profit), North America (33% of sales; 34% of operating profit), Latin America (22% of sales; 31% of operating profit) and Asia Pacific (10% of sales; 9% of operating profit). Owens Illinois paid income taxes at an effective rate of approximately 24% (excluding the impact of taxes relating to non-operating items) in 2016, but it paid virtually none of this tax in the United States, as depreciation charges and interest deductions offset its domestic income. Therefore, when looking at the impact of the tax changes on Owens Illinois, we'd attribute negligible incremental value to the company or its stock, and perhaps a slight negative impact if some of its interest loses its deductibility.

Alphabet, Inc. (Google) is fairly typical of our technology holdings. The company shifted a substantial portion of its taxable income to Ireland through a sophisticated series of intercompany payments to reduce its effective tax rate to roughly 20%. With the U.S. statutory rate falling to 21%, there is less incentive for a global company like

Alphabet to divert income away from the U.S. in favor of foreign tax havens. We expect only a small benefit to the company in terms of its effective tax rate going forward, but we do expect Alphabet and other technology companies in a similar position to repatriate to the U.S. some of their accumulated overseas earnings, much of which sits on the company's balance sheet as idle cash. A recent survey of corporate treasurers conducted by Merrill Lynch revealed that the likely uses of repatriated cash included, in order of preference: (1) paying down debt; (2) share repurchases; (3) mergers & acquisitions; (4) capital expenditures; (5) dividends; and (6) pension contributions. We think all of these uses would benefit us as shareholders, and we particularly like the new provision in the tax code that allows companies to write off 100% of their capital equipment purchases for five years. This is a terrific inducement for companies to invest domestically and provide an economic boost to our economy. We are watching management teams closely as to their specific plans.

Bubble?

TD Ameritrade's Investor Movement Index, which measures the behavior of that firm's retail clientele, rose to historic highs in December. Morgan Stanley wrote in December that its institutional investor clients were increasing their risk, with "long/short net and gross leverage as high as we have ever seen it." Charles Schwab client cash balances reached their lowest level on record in late 2017. These are important signs of growing appetite for risk and of possible excess, but we continue to own equities. First, we remind ourselves that stock market direction is very hard to project, particularly during times when the economy is improving, as it is today. Former Federal Reserve Chairman Alan Greenspan made his remarks about "irrational exuberance" of stock markets in 1996, and he may have been quantitatively and qualitatively correct. But in the subsequent three years, the equity markets roughly doubled before heading into their dot-com tailspin. Our founder Michael Golub used to say that the best indicator that a market trend was nearing its end was that investors engaged in panic buying (at the top for fear of missing out on what they believe to be easy gains) or panic selling (at the bottom). We sense a steadily growing appetite for speculation and risk among retail investors, but we do not get a sense of panic buying. Second, valuations are stretched today, but look nothing like they did in 2000 before the market break. In December 2017, the median forward P/E multiple of the largest 50 companies in the S&P 500 was 19.7x. In March 2000, the same reading was 31.0x.

We think the best plan is to not try to predict the market's next move, but rather to maintain a discipline that we will only invest in assets that are priced appropriately. If we can put all of the money under our care to work, then terrific. If we can't, then some cash is a reasonable alternative. The price of this approach is that performance will deviate from underlying stock market benchmarks, as it has over the past several months, but the benefit is peace of mind that if markets become difficult, our exposure is limited to solid assets that are well priced.

Q4 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[i].

During the quarter we neither exited any existing positions, nor initiated any new positions. We did, on the other hand, change the weights of several holdings within portfolios as a normal part of our ongoing management. While the Investment Team is currently pleased with our current portfolio holdings we continue working diligently to find new ideas that meet our quality criteria for portfolio inclusion.