Q1 2016 Investment Review

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"In matters of principle, stand like a rock; in matters of taste, swim with the current."
- Thomas Jefferson

Right out of the gate, the first quarter of 2016 was dreadful for stock investors and there didn't seem to be a direct, easy connection between real time data and the markets' movement lower. The backdrop to the end of 2015 included concerns about the Federal Reserve's decision in December to increase short-term interest rates, Chinese economic growth, the potential for a US recession, and continued weakness in oil prices. The markets carried this sack of issues forward into January, so they were not new worries. It was as if the stock markets had made a false start in a running race, but were then allowed to continue on down the track. Many investors were understandably taken aback by both the magnitude of the decline in stock prices and the speed at which it was occurring. By January 11th - just six trading days into the new year - the S&P 500 had fallen more than 10%, while US Treasury bonds and gold (traditionally considered defensive investments) were rallying handsomely. Because all stock markets from time to time exhibit an ability to move solely on emotion or momentum, we counseled for patience and taking the longer-term perspective. Sure enough, global markets recovered before the end of March and the net quarterly result was rather benign - but only when viewed from the endpoint. We believe that swimming with the flow of daily (and variable) trading patterns often proves to be counterproductive, as was the case so far this year.

At quarter's end, the S&P 500 had gained +1.4%, the MSCI All Country World Index rose +0.4%, and the MSCI Emerging Markets Index had staged a +5.7% advance. The Barclays US Aggregate Bond index increased by +3.0% and long-term US Treasuries gained +8.2% (lowering the yield on the 30 year Treasury bond to 2.6%). Gold increased by 16.4%, WTI crude oil rose +3.5%, and the US Dollar Index reversed some of last year's gains by falling -4.1%.

As we survey economic and market fundamentals we see an American consumer still chugging along, encouraged by a combination of upwardly trending housing statistics, positive employment and wage growth rates, and gasoline prices that have stayed near decade lows. Short-term interest rates are minuscule (good for borrowers, less helpful for savers), so in many regards the scene is set for a potentially positive stock market. At least partially offsetting these positives, however, are the worries already mentioned - as well as the perception that most broad stock indices currently are priced at levels considered high in relation to historical valuation measures.

One reason to be especially mindful of the global interest rate environment is that somewhere imbedded in these market-based rates is a discounting rate that is used to estimate the *intrinsic value* of companies, and when extended, the markets themselves. Essentially, we believe the calculation of value for a company is defined as the sum of the future cash flows reasonably expected to be collected by owners (the numerator) discounted into present dollars using an appropriately conservative interest rate (the denominator). In mathematics, this is called a present value calculation. If the discount rate is very low, the equation's product will simply be a very large number, approaching infinity in the case of a zero denominator. So, a sensible argument is that as we muddle along with these very low market-based interest rates, the calculated present value of future earnings from a company is necessarily higher than in other periods of time when rates were much higher. Our approach is to make very conservative assumptions about what the future may bring both in regards to earnings growth and interest rates. Thus, we think our estimates for *intrinsic value* are typically understated when compared to the more enthusiastic prognosticators from the financial press and brokerage firm sales teams.

Negative interest rates are a phenomenon that we highlighted in the Q1 2015 letter, when some Swiss corporate bonds had traded with negative yields. Now in 2016, it has truly become a worldwide issue as Japan's central bank moved decisively on January 29th to begin charging interest on reserves kept at the Bank of Japan (BOJ) instead of paying interest. Last year we highlighted several reasons why negative rates may make sense to bond investors, with the most worrisome being the specter of deflation. Japan has been struggling with deflationary forces for twenty years and in its January policy announcement the BOJ referenced weakness in emerging economies (including China) coinciding with broad-based commodity price declines. What the longer-term future will bring from these negative rates is unknown to investors and policy makers, but it is clear that much of the global economic system is currently struggling to produce meaningful, positive inflation. For the near-term, this suggests that a damper remains on expectations for higher interest rates for discounting purposes, or otherwise.

As fundamental investors, we focus our analysis on several elements of a firm's balance sheet. Shareholder's equity, or book value, is one of them. We regularly evaluate the return on shareholders' equity (ROE), for companies and the market as a whole because it is a comparable measure of profitability over time. If the ratio is high, say above 20%, it may be one indication that a company enjoys competitive advantages and its owners may be on the path toward the joys of compounding returns. The numerator of the ROE ratio is net income, or earnings. The denominator of ROE is book value. The size and growth of book value is influenced by many corporate activities, principally the retaining of quarterly earnings. Whatever amount of earnings are retained come after the paying of dividends and the repurchase of shares, among many other things. Ideally, an investor would like to have durable earnings growth that is in excess of corporate needs. Dividend payout ratios have been rising in recent years and historically large stock repurchases have been the topic of many recent articles in the financial press. From a very basic perspective, if a company's management cannot find enough high-valued projects to fund for the future, they may chose to reward the owners (shareholders) with the return of their capital in the form of dividends and stock repurchases.

Over the past 25 years, the S&P 500's ROE has averaged just over 13% (using calendar-year reported earnings supplied by Bloomberg). More recently, since the Great Recession, the average has nudged up over 14%. On the face of it, this is one encouraging sign within the US stock market and one that correlates with the moderately improving health of our economy in relation to those aboard. Earnings have been growing over those same 25 years at a compound annual growth rate of about +8.4% and book value has compounded at +6.0%. Looking more closely to these past five years, however, those rates have decreased to +4.3% and +4.6%, respectively. So, the level of stock market profitability as measured by reported ROE seems to be solid enough to support the somewhat elevated valuation placed on it by investors (a Price-to-Earnings ratio of 18.5 times using 2015 calendar earnings), but further investigation is warranted. The trends of factors within ROE point toward less favorable conclusions and we are monitoring these with interest.

Corporate profit margins appear to be flattening and the per share earnings of the S&P 500 have been declining since the fourth quarter of 2014. Where the path leads for earnings over the next year will be influenced by global economic growth, the value of the US dollar, and energy prices to name a just a few. Since stock buybacks can work to lower reported shareholders equity, as do certain translation costs for reporting foreign currency operations, the ratio of ROE can grow without earnings strength being the root cause - lowering the denominator urges the ratio higher. Adding more leverage through debt will also tend to increase ROE. We applaud managements that engage in value-enhancing buyback activities, but not all buybacks are equal in their value to long-term shareholders. This is why the analysis of corporate fundamentals requires patient, thorough work as opposed to the casual screening of headline statistics. We suspect that the market's overall ROE is likely to move closer to the lower long-term averages in the years ahead, but that would not spell doom for investors. More likely, we think modest earnings growth combined with less leverage and fewer buybacks, market-wide, may do the job. If this is the case, a focus on quality, enduring profitability, and reasonable valuations should be important for investors. In our minds, the very high P/E stocks which have skewed the market averages for some time would be the most vulnerable.

We were recently alerted to an academic study about stock market trading in the US that suggests that as much as 70% of the trades made on any given day are connected to High Frequency Traders (HFT), which use price as the determinant for trades, not company fundamentals. This means that on most days momentum-driven, trend following strategies dominate activity in the stock market. All of this can be significantly divorced from the operational excellence and profitable trajectory of a company's core business, a sobering thought about the evolution of the US stock market.

We have seen within the past six months two episodes when the stock market has dropped over 10%, only to recover within a month or two. Based on our read of the overall market, we think that stocks are not dramatically overvalued, nor are they undervalued. The average stock seems to be traveling within a reasonable zone of fair value. This is why last August, and again in January, we viewed the market's gyrations as being less about impairments to the *intrinsic value* of corporate America and more about short-term trading phenomena. To paraphrase Benjamin Graham, the father of value investing; "over the short-term the market acts like a voting machine, where prices rise and fall on opinions and emotions. Over longer periods, however, the market mechanism resembles a weighing machine, accurately measuring the heft of corporate earnings and the advancement of earnings." With this observation as our compass, we believe our task of allocating assets toward the stock markets (foreign and domestic) will be most effective if we are driven primarily by the evaluation of earnings, especially with respect to their durability. We spend much less time assessing the fashion that drives traders at any given moment.

Pessimism and anxiety about the stock market staged a jailbreak in January. The number of days when the market rose or fell more than 1%, and even 2%, so far this year is similar to 2008/2009. Additionally, mutual fund company data has reported that the largest outflows from mutual funds have so far come from US equity products, while the largest inflows have been to money market funds. We suppose that in a world more and more influenced by computer-driven trading and the short-term focus on price - as opposed to intrinsic value - bouts of volatility are to be expected, though their occurrence cannot be anticipated with precision. We feel that reacting to the downward movements in price, when fundamental value has not been eroded, is not a sensible strategy for long-term investment success. Though Thomas Jefferson may have had it broadly correct, within the context of investing we do not choose to go with the flow of short-term trends and "tastes." We are resolute in our focus on only those principles that we believe will drive prudent investment decisions to protect and grow wealth over the long-term.