Q2 2016 Investment Review

David W. Lemons, CFA
Senior Managing Director, Portfolio Manager

"Ulysses, glorious Greek, arriving here! O stay thy ship, that thou mayst hear our voice! For none hath ever sail'd past this our isle, ere the sweet voice form forth our mouths he heard…and all things on the fertile earth we know." So spake their charming voice, and then my heart desired to hear.

***The Odyssey of Homer*, George William Edginton**

What Brexit? The timing of the vote by the Brits to leave the European Union (June 23rd), the result (leave!), the immediate financial market reaction (sell!), and the bountiful political, social, and economic commentary that continues unabated made it the dominating event in the minds of many investors during the second quarter. In the two trading days following the verdict, the S&P 500 fell -5.3%, the MSCI All Country World was cut by -6.9%, and the MSCI EAFE dropped -9.8%. Bond yields slumped (prices rose), and gold prices firmed. Yet the last three days of the quarter saw the S&P 500 essentially recoup all that had been lost. World stock indices, especially those with heavy European weightings, recovered only modestly. The S&P 500 finished the quarter up +2.5%, the MSCI ACWI rose +1.0%, and the MSCI EAFE fell -1.5%. Stock markets in the southern (peripheral) nations of the EU performed comparably worse; Spain was down -7.4% and Italy fell -9.7%, while Switzerland managed a +2.5% gain. The Barclays Aggregate bond index rose +2.2%, the US dollar index gained +1.4%, gold increased by +6.8% an ounce, and West Texas Intermediate crude oil recovered a surprising +26.1%.

We do not doubt that the implications of Britain actually leaving the EU will be significant in social, political and economic terms. Multidisciplinary thinkers are being served up a smorgasbord of facts, near facts, and postulations that will propel analysis and commentary for the foreseeable future. We consider ourselves to be such thinkers, but we are also experienced in the art of separating the noise from the signals, as it pertains to investment management. We do not take our direction from the daily movements of the financial markets, but we acknowledge that this momentous Brexit has not produced - to date - a serious setback in the broad US stock market.

As we noted in our market commentary on June 24th, a serious potential financial market outcome from Brexit may well end up being an unraveling within the European banking sector. It has been well researched and communicated that many large, national banks in the EU still have not adequately addressed their non-performing loans and other operational issues. These concerns have come to the forefront many times in the last seven years since the 2008/2009 financial crisis, including during the Greek debt crisis this time last year. Currently, the focus of concern is on Germany and Italy, and to a lesser degree some UK institutions, but others are sure to be in the mix of operational turmoil.

Ulysses learned from the goddess Circe that the song of the Sirens contained all of the knowledge of the world. Ulysses longed to have this knowledge but also knew the song drove men to madness and ultimate destruction. To pass the island of the Sirens, to hear the song, and to emerge unscathed, Ulysses planned to fill his shipmates' ears with wax and to have himself bound to the ship's mast; ears unblocked. So arranged, his crew rowed with the explicit instructions not to deviate course and not to untie their captain, no matter how strenuously he pleaded. The plan was a success. Ulysses was able to hear the song, was driven temporarily mad, but the ship was steered carefully past the island and disaster was averted.

All of the knowledge of the world is seemingly upon us. The ubiquity of the internet, the power of computing, and the constant flow of data into electronic channels means that the noise of so-called "information" is overwhelming. Worse, the speed of today's communications technology implies that decisions, more specifically competent decisions, can be made on newly presented data in real time. In our opinion, this is simply not the case. Drowning in data, many investors seemed to have been steering too close to the rocks and initial reactions to news about their incorrectly formed conclusions from all that data led to panic and improvisation. Implied in the story of Ulysses is that lasting, negative consequences from poor decision making can be avoided with proper structure and discipline designed to protect against emphasizing the momentary, noisy data.

Theorizing how events may play out in the banking, and other, sectors of the world economy is part of the process of connecting dots from the past, through the present, and into the future. We see our job largely as a process of connecting dots. The inherent difficulty is that most of the dots are fuzzy, or may simply represent data that is unknowable. We believe our efforts are best concentrated on determining the quality of the dots we *can* see, opening ourselves to receive more of the best quality dots, then connecting them in the most logical way - without the burden of excess complication. In this way, we attempt to eliminate our ability to respond to the temptations of noise. While we are not currently expecting a "Lehman moment" for the European banking system, we are not tempted to speculate in investments within the sector in our individual equity holdings. Caveat emptor.

Economic reports suggest that employment levels in the US are high, but that inflationary pressures are subdued. History tells us that understanding trends in the level of employment are very important to properly formed views on future inflation rates. Expectations for more inflation lead to generally higher interest rates. So far, however, that basic mechanism is not working as directly as it has in the past. The general level of interest rates in the US has been falling. The riddle to be unwound by investors in bonds continues. Other factors are at work that are increasing demand for US bonds, thus pushing up prices and keeping yields low. These factors include demand coming from central banks worldwide, the demographic tide of retirees seeking safety, and from various other investors abroad, where local bond yields may be negative, or political and economic expectations are substantially worse on a relative basis. Though we do not actually tie ourselves to a mast of dogma or decision-making dictum, we are principled in our analysis of factors likely to provide insight into the appropriate value of investments. We are, above all, patient.

An eye-opening 72% of Brits participated in a judgment about their continued involvement in and commitment to the European Union. That participation rate is an unqualified success for a democratic society. The verdict rendered was shocking to many, though, including those in the financial markets. The effects of the vote will continue to ripple throughout the markets for some time to come and will require analysis. We have discussed previously that one very important variable in the pricing mechanism for all financial investments is the discounting rate used to estimate future worth. The state of the world, today, suggests to us that the very low money market rates we see in the US and the low rates used for discounting purposes worldwide are likely to persist. Hence, we remain confident in our assessment that high quality stocks and bonds, appropriately combined, should continue to be the best investment for balanced portfolios. In addition, our overall full commitment to stocks is a reflection of the value that we believe exists in our investments. This view has not been diminished by what is, otherwise, a very noisy environment.

We thank you for your support and hope that you and your families are enjoying a fantastic summer!
