EAST COAST
ASSET MANAGEMENT

Q1 2017 Investment Review

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"A man who tells lies, like me, merely hides the truth. But a man who tells half-lies, has forgotten where he's put it."

Mr. Dryden - played by Claude Raines - in *Lawrence of Arabia* (1962)

In large part, the first few months of this year have been a continuance of the post-election rally last year. Global stock markets have generally been positive performers, as seen in the exhibit below. The bulk of these returns, however, occurred in January and February (+5.9% for the S&P 500 and +5.7% for the MSCI All Country World Index), with relatively little progress in March. The momentum that had built up in most U.S. stock indices, and many abroad, fizzled as March unfolded. Among the possible reasons for the leveling off were: the Federal Reserve's decision to increase short-term interest rates, Congressional Republicans' inability to substantially move forward the President's reform agenda, and revisions to Q4 2016 GDP that indicated subdued business capital investment. Persistent geopolitical tensions, worries about European banking institutions, the UK Brexit process, and sporadic acts of terrorism were also part of the global backdrop during March.

Benchmark Index Returns

	S&P 500	MSCI All Country World	MSCI Emerging Markets	MSCI EAFE	Bloomberg-Barclays Aggregate Bond	Gold $/Troy Oz.	Crude Oil $/bbl.
Q1 2017	6.1%	7.0%	11.5%	7.4%	0.8%	8.4%	-5.8%
Q4 2016	3.8%	1.3%	-4.1%	-0.6%	-3.0%	-12.4%	11.4%

Also notable within the capital markets were the decline in longer-term interest rates (and corresponding rise in the price of several bond indices), a pullback in the price of Brent Crude oil to $53 per barrel, and the decline in the U.S. Dollar Index. The dollar's weakness meant that returns for U.S.-based investors in foreign assets generally outperformed those in the home country.

Regarding interest rates, the last 35 years have been a period of decreasing bond yields in the U.S. Levels for the 10 year U.S. Treasury note peaked at 14.5% in January 1982 and hit a low of 1.7% last June. This trend has translated, by and large, into stable bond prices and has contributed significantly to higher stock prices. Lower rates, like a diminishing gravitational force, act as a levitating factor for stock prices. But the reverse is also true. Hence, we study the history of financial markets for context and to gain insights about how today's factors may impact the investment strategy we deploy on your

behalf. We believe it is very likely that we have seen the lows of this interest rate cycle and the future trajectory of discounting rates will be higher in the years to come.

Because we view short-term movements in financial markets as inherently unpredictable, we take great care not to be persuaded by the 'noise' that characterizes many of the half-truths peddled as market-oriented "analysis." Of the key areas for our investment deliberations today, four at the top of our list are:

1. The current level of interest rates used to calculate today's value of future dollars
2. Expectations for future, per share earnings growth for stocks
3. The valuations investors are broadly assigning to stocks (they are elevated, but still within the zone of fairly valued) and
4. The range and attractiveness of investments available to investors, other than stocks

Historical data can be parsed in so many ways that just about any conclusion about future investments can be justified if the numbers are tortured enough. So, the half-truths peddled as justification for products and strategies warrant deep consideration.

The investment compass that we strive to follow points to a methodology that places long-term, sustainable, *compounded* returns above other strategies. Specifically, we attempt to find those investments that we judge are able to take gains from one period and integrate them into their internal growth mechanism to produce more gains in the next period. If this process repeats, over and over, the ultimate return is likely to be much greater than simply stringing together a succession of discrete, short-term advances in a rather haphazard way. We hear quite a bit of debate in the financial world about strategies that advocate index products versus actively managed portfolios. We believe that this dialogue has set up a false tension that need not exist. Rather than being two polar opposite forces, we see them as being parts of a whole; two arcs of a circle, not end points on a straight line. For us, the key is to focus on the compounding potential at the portfolio-level, which has everything to do with understanding valuations, growth probabilities, and the forces likely to help or hurt these factors. As we apply this reasoning to the commentary that advocates index strategies as "the best," we find ourselves viewing the situation, dispassionately from above, with the attitude; "well, not always."

> - **It is very likely that we have seen the lows of this interest rate cycle**
> - **Stock valuations are elevated, but still within the zone of fairly valued**

Take as a historical case study the post war years of the 1950s and early 1960s. This period was characterized by the baby boom, infrastructure development, and emerging technological advances.

These were good times for U.S. GDP growth, corporate earnings, stock prices, and low interest rates. In the 1950s, the S&P 500 grew at a compound annual rate of 13.5%. This happy result was helped by a particularly good two-year stretch between 1954 and 1956 that annualized at 35.8%! The Price to Earnings ratio (P/E) of that index averaged about 12.5 and the average yield on the 10 year U.S. Treasury note was just over 3%. But the next twenty years culminating in 1979 were a different story. Bond rates began to climb, averaging 6.6% for the period but ending 1979 at just over 10%. The S&P's P/E ratio began 1960 at 17.1, averaged 15.1 for the two decades and bottomed at 7.0 in November of 1979, so valuations were tumbling as bond yields rose. For that twenty year period, the S&P 500 produced a compound annualized rate of return of only 3.2%; a sobering data point.

S&P 500 Historical Data

Time Period	P/E Ratio (Initial)	P/E Ratio (Avg.)	10 Yr. Note Yield (Initial)	10 Yr. Note Yield (Avg.)	Compound Annualized Return
1950s	7.2 x	12.5 x	2.3%	3.1%	13.5%
1960 to 1979	17.1 x	15.1 x	4.7%	6.6%	3.2%

Our view is that the specific context surrounding financial data matters, yet the context doesn't stand still. A critical part of the historical analysis of market returns hinges on the valuations (P/E's) and discounting rates (bond yields) at the beginning of the period in question. Starting at elevated stock valuations and facing a rising interest rate environment set the stage for the poor annualized index returns in the 60s and 70s. Likewise, starting at low valuations and enjoying low average rates helped propel great results in the 1950s. But, even this analysis is a partial one. Cultural changes, war, inflationary shocks, political upheaval - there are so many additional factors to consider when evaluating specific eras. Context matters, and our work leaves us deeply skeptical about the ability for the stock market "averages" to achieve compound annual growth rates in the years ahead that resemble the fantastic outcome since the lows of 2009.

Ultimately, satisfaction from a portfolio is a feeling, not an abstract set of numbers. Investing isn't based on natural, observable laws, like Newtonian physics. Newton's work provided the foundation of classical mechanics in physics and that legacy has deeply influenced our Western, ancient Greek-inspired thought process - which is inherently linear. From these laws, we can explain the cause, sequence, and timing of events around us, which is comforting. Human behavior, however, is anything but linear and people drive investment markets. People are prone to making poor decisions, either by incorrectly processing correct information or correctly processing incorrect information. People also carry biases and often act irrationally, so calculating exactly how markets will behave in the future is not a hard science. Investors tend to march into the future along squiggly lines, rather than straight ones.

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In their 2009 book entitled *Animal Spirits*, economists George Akerlof and Robert Shiller highlighted the power that psychological forces have in driving economic activity and investment returns. Central to the behavioral forces is the element of confidence. Confidence, they suggest, emerges from stories. The emotional state of investors can be positively influenced by stories that describe spectacular, joyous successes, or negatively influenced by tragic failures. Higher levels of confidence tend to come with inspirational stories and the rising confidence itself further inspires. This is the nature of virtuous cycles. Though "consumer confidence" and other survey-based statistics exist in the economists' toolbox, most of what is passed along as economic analysis focuses on those issues more easily measured, not stories. We are observing that stories of confidence and excitement within the business community seem to be increasing in frequency, perhaps due to the potential for lower tax rates or reductions in specific regulations. Whatever the reason, the emergent signs of animal spirits is a helpful sign for the future.

We at East Coast do not subscribe to a particular investment dogma when it comes to the prudent management of your financial assets. Statistics are an integral part of our financial system, but we guard against being ruled by them. Instead, as fiduciaries, we seek to be informed by the truth, however represented. Investing in indices may have advantages at times but we disagree that they are always superior to a thoughtfully constructed, actively managed portfolio, whether in stocks or bonds.

As with any significant purchase, we know that the deal you strike when buying an asset largely determines the satisfaction you will ultimately receive. Price, terms, and situational conditions all fit together to rule the exercise. Today, we observe that the popular stock market averages, like the S&P 500, face headwinds that may diminish future expected profits when compared to the last eight years. Specifically, stock prices are generally elevated and the discounting rates are low - and likely to rise in the years ahead. We continue to believe that common stocks are one of the best investment classes for the long-term, but selectively concentrating on investments that we consider to be higher quality than average remains our preferred strategy. Our daily objective is to earn your confidence through a combination of hard work and the results it produces.

We very much appreciate your trust and hope you enjoy the spring months ahead.

Past performance does not guarantee future results. To the extent that this piece includes forward looking statements, such statements are based on reasonable professional judgment and such events may or may not come to pass. For information on how any statements in this piece and the information within it may affect you, please consult with your advisor. Investments in equity and fixed income instruments may increase or lose value. For complete disclosures, please see our Form ADV Part 2A.