Market Commentary - May 2017

Corporate earnings announcements for the first quarter have been a resounding success for investors. Expectations were high coming in at 9% growth year over year. (After all, earnings growth averaged only 3% per year over the last six years.) The actual reported number thus far for companies in the S&P 500 is 10%. Technology companies have reported an astounding 14% growth! And growth is expected to continue to accelerate later this year and into 2018. According to Bank of America Merrill Lynch, earnings growth is forecast at a robust 12% in 2018 (which assumes a 20% corporate tax rate, currently 5% higher than President Trump's proposal).

Clearly, some companies will benefit more than others from a lower corporate tax rate. For example, Warren Buffet's Berkshire Hathaway will see book value rise by 11% this year with a 15% corporate rate, and earnings will rise an expected 23% in 2017 if the corporate tax plan becomes effective this year (according to the *Wall Street Journal*). This is quite a bump for Berkshire and many other companies may have similar results.

Accelerating earnings growth due to tax reform (and other company specific factors) could give the bull market extended life. Higher earnings should help stock prices remain elevated. However, we remain concerned about valuation levels among other factors. Diligent risk management is vital at this point in the market cycle (see next section).

Managing Portfolios in a Higher Risk Environment

Risk management is central to all of our decisions. We believe a responsible investment manager must provide not only solid long-term returns but also a portfolio that will better withstand the twists and turns typical of today's stock market. While risk can never be eliminated from a stock portfolio, we believe it can be tempered. For investors who have grown overly confident due to the stock market rally of the past eight years, risk reduction strategies may now seem less important or even unnecessary. Given this complacency, we think it is especially important in this higher risk market (high valuations combined with substantial geopolitical risk) to have a disciplined risk management strategy to manage both volatility and risk. Below is a summary of our strategy that has proven successful over 35 years:

1. Adequate Diversification: In Core equity portfolios we purchase 35-40 individual stocks, in our Dividend Growth strategy 25-30 individual stocks. This is done to provide adequate diversification and to limit overall portfolio losses if one name suffers a setback. Our purchases cover a variety of industries and economic sectors.

We purchase both growth stocks and value stocks to support more consistent returns regardless of the style cycle. Typically when one style is out of favor the other is growing in popularity. Growth stocks are usually bought in anticipation of rapid sales or earnings growth whereas value stocks are purchased based on attractive valuation ratios.

(more diversification) and pricing power even in a low inflation environment.

While we may be attracted to the investment potential of certain industries, we will not eliminate the less popular or less exciting industries. Managers who greatly overweight the “hot stocks” risk getting caught in the next bubble, much like the tech bubble of the late 1990s. Reasonably priced opportunities usually exist in most industries and we strive to take advantage of them. **Industry diversification is crucial for reducing risk.**

2. Reasonable Valuations: We avoid unproven companies (including IPOs), ‘hot stocks’, and those that have become popular due to price momentum. We use fundamental analysis to determine if a stock’s price is an attractive value. Fundamental analysis is the study of how a company’s stock price compares to its business performance.

The exact metrics or financial ratios vary by industry but typically we buy stocks with relatively low Price/Earnings ratios (P/E). Faster growing companies deserve higher valuations. Whether a company is a fast grower or not, its stock must be at or below the P/E ratio we have determined to be reasonable for its industry.

We also consider other valuation ratios when analyzing stocks depending on the industry. For example, we look at Price/Sales (P/S), Price/Book (P/B), and Price/Cash Flow (P/CF) when appropriate. Analyzing the value of a company’s underlying assets along with relative debt levels is also considered in certain cases.

It is important to note that we will not relax our valuation metrics for new stock purchases because the market itself is trading at a high valuation level.

3. Monitoring and Rebalancing: We monitor equity positions closely and rebalance as necessary in order to avoid dangerously overweighting any one stock. Over-weighted individual stock positions are trimmed if they appreciate to more than 8% of the equity portfolio, and we invest no more than 30% of the equity portfolio in any one economic sector (while maintaining industry diversification within that sector).

4. Strict Sell Discipline: Knowing when to sell a stock is much more challenging than the buy decision because emotions can get in the way, especially with a big winner. Here are some of the disciplined reasons we sell a stock:

- The forward P/E ratio is excessive given the three year estimated growth rate in earnings per share.
- The forward P/E ratio is excessive compared to the forward P/E ratio for the S&P 500 stock index.
- The fundamental business story has deteriorated.
- Our sector strategy has changed.

5. Market Timing: We do not engage in market timing. History has proven that big market returns often occur in short, unpredictable bursts (for example, 2013). The bigger risk for long term investors is being out of the market. In a recent study of the stock market from 1992-2012 (source: Schwab Center for Financial Research), investors earned an annual rate of return of 8.2% in the S&P 500 stock index. If, however, investors missed the 20 best days in that 20 year period, their annual return was almost cut in half to 4.5%. **Clearly time invested in the market is more important than trying to time the market.**

Some Final Thoughts

While we cannot eliminate the risks and market swings associated with equity investing, we believe our careful criteria and disciplined strategy can manage those risks while still allowing our investors to benefit from the market’s long term potential.

Our goal is to meet each client’s individual objectives while allowing them to sleep at night. If the stock market’s volatility proves to be too stressful, we suggest a reduced exposure to stocks. We believe, however, that most of our clients have come to terms with increased volatility and now understand that being out of the market is fundamentally more risky to their long term (inflation adjusted) wealth than being in a carefully selected stock portfolio. Our investors agree that risk cannot be eliminated but can be controlled through careful risk management.

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