

Fourth Quarter 2015 Client Letter

4th Quarter gains in the US stock market partly offset 3rd Quarter losses. However, stock and bond markets both produced sub-par returns for the year. While negative at the index level, the S&P 500 index ended 1.38% higher after dividends. The index for international stocks, the MSCI EAFE, ended up 0.95%. Bonds also struggled in 2015, with the Barclay's US Aggregate Bond index producing only 0.55%. Underneath it all, a growing dispersion in performance for both economic sectors and individual companies continued to unfold. Evidence of this was notable at the sector level (like energy, materials, industrials down -23.6%, -10.4% and -4.7% respectively, versus consumer discretionary, staples and technology up +8.4%, +3.8% and +4.3% respectively). However, dispersion of returns were even felt within winning sectors, with companies such as Walt Disney (DIS), Gilead Sciences (GILD), Amazon (AMZN), Nike (NKE), Apple (AAPL), Netflix (NFLX), Facebook (FB) and Google (GOOGL, now Alphabet) accounting for nearly ALL gains in the S&P 500 and Nasdaq indices.

Bond markets were similarly divergent. US government bonds were largely unchanged through the year as investors anticipated an upward change in interest rates, but with declining inflation and growth expectations. Corporate bonds were weak, and high yield securities were at the center of the commodities price collapse that stressed many companies operating in those sectors – driving bond prices lower across the board

Market environments like this are not uncommon. New and rapidly growing companies that are thought to be transformative or disruptive are always emerging, and optimistic investors often become willing to buy into growth stories at too high a price, where future earnings power may or may not crystalize. While simultaneously, companies not considered to be part of the growth stories are often looked at with too much pessimism.

Unfortunately, good quality companies are often caught up in a “shoot first, ask questions later” mentality that pervades uncertain times and this can lead to underperformance for fundamental investors. One way to look at this is to compare the long term performance of an index of company stocks that is biased toward solid, quality companies with an index of stocks biased toward the companies poised for growth – including the “Fabulous Five” currently favored in the market. We used the Russell 1000 Value index to represent quality stocks and the Russell 1000 Growth index for stocks of growing companies. Through history, there were several years for which the Value index underperformed the Growth index notably (for example Value underperformed Growth by 9.5% in 2015). But more importantly, over the 46 years that the indices have been tracked, the Value companies have outperformed the Growth companies for well over half the time (60.9% of the years), and compounded at just over 12% annually compared to 8.5% for the growth index. To realize this kind of relative performance advantage, it is critical to stick to the strategy.

We made significant adjustments to many client portfolios late in 2014 to further focus portfolios on quality companies and securities. We also decide to raise “opportunistic cash”, between 10% and 20% in most client portfolios as we sensed that the balance of risks is tilted toward a volatile market ahead. In our view, holding cash was preferred to insulate client portfolios from volatility while preserving optionality for future investment at lower prices. This remains our view and lagging short term portfolio performance is not sufficient cause to abandon that strategy.

As we discussed for some time, fundamental investors missed out on some of the return from the “high flyers” of 2015. The emerging trend of benign revenue growth and a “profits recession” is beginning to erode post-crisis gains in some names. In our view, this situation must be resolved before stock markets resume a fundamentally-driven growth trajectory and bond markets normalize. In the meantime, we gain confidence from the skill of the fund managers, the quality of the portfolio holdings and the reserve of “dry powder” from portfolio cash holdings.