The theme of our last quarterly paper was concerned but optimistic. We drew attention to a disconcerting pattern that we felt sure would eventually reverse. Over the first six months of 2016 our clients' portfolios had lagged popular benchmarks, despite the better than average business results of the companies in which we had invested. We scratched our heads at the strong stock performance of other companies with at best fair to middling fundamental prospects and historically high valuations. We promised to stay the course in investments whose virtues had yet to be recognized by others, not to follow the crowd into yesterday's winners.

In the intervening three months, the market has started to move in our direction. Sharp rebounds in technology, banks and insurance stocks have led to a marked improvement in absolute returns. The "safe" sectors such as Utilities, Telecoms and certain Consumer Staples suffered from over-popularity in the first-half of the year. Steering clear of them helped us avoid absolute losses and outperform peers and benchmarks.

The Financial sector was a source of great frustration to us during the first-half of the year. We felt certain that by focusing primarily on the impact of continued low interest rates, market participants were turning a blind eye to the investment opportunity created by substantially below-normal valuations. A mere four days before the mid-point of 2016, Brexit seemed to rule out any possibility of rising rates, creating even more downward pressure on bank stocks.

In a pleasant surprise, investors returned from the long Fourth of July break with a strong sense that the fortunes of U.S. companies could be independent of the social, political and economic tribulations of Great Britain. While this led to a broad improvement in the U.S. stock market, the Financial sector was one of the biggest beneficiaries. With only one exception, the banks and insurance companies in our client portfolios have posted solid returns since mid-year.

Despite the stronger recent returns, we still believe that the financial companies in which we are invested potentially offer extremely attractive future returns. Today, investors continue to be fixated with the interplay between interest rates and profitability for financial companies. While higher rates would likely lead to improved profitability, especially for banks, such an environment is not the sole prerequisite to above-average stock appreciation. As we pointed out in our last quarterly writing, a bank or insurance company whose shares trade at a steep discount to tangible book value holds the possibility of above-average returns even at current levels of profitability. We admire deep analysis, but not over-complication. We believe the simplest answer is the best one in this case. Financial companies are still too cheap.

Technology stocks also returned to favor in the quarter, especially the large, well-established companies that we prefer like Google, Microsoft and Apple. Each advanced between 10% and 20%, converting negative performance in the first six months into nicely positive returns for the year so far. Only Oracle lagged in the quarter. However, even having given back a portion

SPEARS ABACUS

147 EAST 48TH STREET, NEW YORK, NY, 10017 SPEARSABACUS.COM
T 212-230-9855 F 212-230-9861

of its strong first-half performance, the provider of massively scaled enterprise software has contributed an above-average return for all of 2016.

Healthcare stocks also struggled in the first-half of the year. In our view, the sector has been a victim of the harsh light of an election year, intensified by the misdeeds of a few particularly bad actors. In the third quarter, our holdings had mixed but improving returns; all but one had positive results, though none as high as 10%. At some point political rhetoric will fade; hopefully regulators will accomplish the much tougher task of singling out and punishing profiteers. We believe that investors will reward companies, like those in our portfolio, that can advance the quality and efficacy of care and potentially reduce its long-run cost.

The presidential election is casting a shadow over more than just Healthcare stocks. We have little to add to the bulging library of political reporting, editorializing and prognosticating. We can, however, make two observations. At this writing (shortly after the first Presidential debate), we believe that markets are anticipating a Clinton victory. Trump coming out on top would be a surprise that could lead to market volatility in the short run. Brexit has taught us that markets are not very adept at forecasting voter preferences and that surprises can be emphatically unwelcome. Given the fluid and unorthodox nature of this campaign season, we feel that markets are likely to be volatile at least until the outcome is known.

After the votes have been counted, global investors will likely return their focus to speculating about the next action of the U.S. Federal Reserve. All eyes will be glued to the results of its December meeting. There will be many guesses, some more educated than others, about whether the Fed will announce an increase in short-term interest rates. Like the Presidential election, there are only two possible outcomes. Either the Fed Funds target range will be raised, or it will not.

Between now and then, market participants will be searching for hints that might help to predict whether the inevitable rise occurs or is postponed. Every release of economic data will be searched for clues as to whether the U.S. economy is growing strongly enough to allow for a rate hike. Government and private statistics alike that fall outside of predicted ranges will cause unanticipated market activity. Asset prices will reset to incorporate new information. Some price movements could be extreme, but more will be risked than gained by trying to predict either their direction or magnitude.

For the remainder of 2016, even more than they usually do, investors will look for guidance on the front pages of newspapers rather than the footnotes of corporate financial statements. Focus will be on the big questions:

- Who will be the next President of the United States?
- What will that mean for healthcare, trade, taxes, etc.?
- When will the Fed raise interest rates?
- Will Deutsche Bank be another Lehman Brothers?

SPEARS ABACUS

147 EAST 48TH STREET, NEW YORK, NY, 10017 SPEARSABACUS.COM
T 212-230-9855 F 212-230-9861

By definition, this is the study of generalities. Are stocks cheap or expensive? What sectors will be helped or harmed? Are bonds safe? In such an environment, we think there is more lucrative opportunity in analyzing specifics. By far the most important variables will be, as they always are, the fundamental prospects of the businesses in which we invest, and the specific valuations at which their stocks trade. When we look at our portfolio today, we are encouraged by the prospects, especially when comparing the companies we hold to the market as a whole. Politics and macroeconomics may well cause unpredictable volatility over the rest of the year. We think investing in solid businesses at reasonable prices is the best defense.

SPEARS ABACUS

147 EAST 48TH STREET, NEW YORK, NY, 10017 SPEARSABACUS.COM
T 212-230-9855 F 212-230-9861