A Look Back

It is useful to view 2016 in two parts, each with distinctly different market environments. To do so, it is easy to point to a single date that served as the inflection point, and provided a change of leadership. The dividing date was not, however, November 8, but February 11.

Over the first five and a half weeks of the year, the S&P 500 index declined nearly 11%. A sharp decline in the corporate bond market accompanied by a near liquidity crisis in junk bonds made it feel worse. Only the utility sector eked out a positive return; the consumer staple sector was the runner-up with a negative 2% return.

Even without the benefit of a precipitating event, stock and bond markets turned on a dime on February 11. The S&P 500 advanced more than 25% from that date to year-end, accompanied by a clear change in market leadership. The former leaders faded and were replaced by financials and energy, which showed substantial appreciation (50% and 45% respectively) for the duration of the year. The next best performers during the period were industrials and materials, both advancing by more than 33%.

Out of these dry facts, a clear pattern emerges. While safety was of paramount concern at the beginning of the year, by mid-winter, investors began to move decisively toward those industries that benefit most from a stronger economy (energy, materials and industrials) and higher interest rates (financials).

Our Portfolios

Our client portfolios have benefitted from this rotation and have kept pace with the strong market rise since February. That pattern of results held true for the fourth quarter. Having been a significant drag on returns in January and February, portfolio companies in the financial sector have since been meaningfully positive contributors. This was especially true over the last three months. As forcefully as we could, we argued that the group was simply too cheap during the first half of the year. Extremely attractive valuations gave us the patience to maintain significant exposure to high quality banks and insurance companies. Our patience was rewarded.

Unfortunately, the same cannot yet be said for our healthcare investments. As a whole, healthcare has been the most challenging of the broad economic sectors, being the only one to exhibit a negative return for the year. Rising healthcare costs are a concern to all and became an oft-mentioned feature of the campaign trail. As we have written before, a number of bad actors cast an unflattering light on the entire sector. Understandably, investors shied away.

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The underperformance was exacerbated over the last few weeks of the year, as investors scrambled to realize whatever tax losses might be available. Just as we did with financial stocks earlier, we firmly believe that our healthcare investments have potential for meaningful future appreciation. The companies we hold are not bad actors. Their earnings should grow at an attractive rate. Valuations are well below normal. We believe that the laggards of 2016 will become leaders of the future.

Looking Forward

Price is always a good indicator of what investors think, or hope, will happen next. The market as a whole is trading at its highest valuation (as measured by a multiple of anticipated earnings) since the 2008 crisis. Economically sensitive sectors are likewise at high valuations. Defensive sectors (utilities, consumer staples and healthcare) are not. Investors are banking on stronger economic growth leading to an above average increase in earnings.

In order for this to occur, investors seem to be assuming that the U.S. economy will receive assistance from the new administration. Growth-friendly policies might include lower individual and corporate taxes (including some form of incentive for corporations to repatriate at least a portion of the $2.6 trillion they hold abroad) and higher government spending. To a certain extent, the assumption of lower corporate taxes is already reflected in stock prices. Since the election, those companies that would benefit most have outperformed those with already low tax rates.

We think there is a potential wild-card that may contribute to stronger economic growth. We have come to the conclusion that ultra-low interest rates have had the unintended consequence of dampening consumer confidence, thereby keeping a lid on spending.

The theory of aggressive monetary stimulus is that lower interest rates will induce consumers and corporations alike to borrow cheap money and spend more aggressively. In fact, U.S. consumers did just the opposite, paying down mortgage and credit-card debt, while spending (as a percentage of GDP) stagnated even in the face of the massive windfall of lower energy prices. We think the most logical explanation for this phenomenon is that consumers (especially baby-boomers) recognized that they had to spend less and save more because their capital was earning an inadequate rate of return to fund retirement.

Corporations did in fact take advantage of cheap money by increasing their debt. However, faced with few opportunities to grow revenues, the proceeds of their borrowings went to stock buybacks rather than expanding operations and hiring workers.

Starting in mid-summer, interest rates began to rise around the world. We think that a more normal environment may increase confidence and lead to stronger consumer spending. Personal consumption is roughly two-thirds of total GDP, so the impact could be meaningful. The most recent robust reading of the Michigan Consumer Sentiment survey, and early reports of increased holiday sales, seem to support this theory, but it is too soon to know for sure.

Given high valuations, it appears that optimism is built into markets. Unfortunately, the environment is not without risk. A new administration always introduces an element of forecasting uncertainty; this one seems less predictable than normal. We do not think that investors have adequately accounted for foreign-policy risks, particularly those arising from trade.

Though unlikely, we believe that trade policies that live up to campaign rhetoric could cause a very negative shift in investor sentiment. While we think outright trade wars are improbable, even isolated skirmishes can have unforeseeably negative outcomes. Likewise, greater economic instability in the Eurozone or expanding hostilities in the Middle East could send investors to the sidelines.

Finally, there is always the risk that the most firmly held beliefs will turn out to be unexpectedly wrong. Today there seems to an absolute consensus that U.S. interest rates will continue to rise as the Federal Reserve follows through on its stated intention to increase the overnight borrowing rate. Tied to this is the uniformly held expectation that the U.S. dollar will continue to strengthen indefinitely. We can point to no specific evidence to suggest the imminent reversal of either of those trends; however, unvarying opinion is generally a good cause for healthy skepticism.

Looking forward, we will continue to focus on individual companies and try to take advantage of idiosyncratic opportunities. We will stick to our bedrock belief that successful investing is the product of careful study of the specific rather than the general. The healthcare sector overall is undervalued, but some companies are well positioned to prosper; others will face significant challenges, just as banks and insurance companies outperformed other constituents of the financial sector.

We will not ignore the broader market environment, especially considering the unusually high level of unpredictability surrounding the new administration. As one does, we have drawn a line down the middle of a legal pad and stacked the reasons for optimism on the left and caution on the right. As a backdrop to the overall investment climate, the two columns are fairly well-balanced. Higher than average current valuations, however, argue for somewhat greater than usual caution. Consequently, we have maintained larger than average cash reserves. In part this should serve as a cushion in case of a broad market sell-off. More likely, the cash will allow us to take advantage of bargains should surprises create opportunities.

All of us at Spears Abacus wish you and your family a healthy, happy and prosperous New Year!

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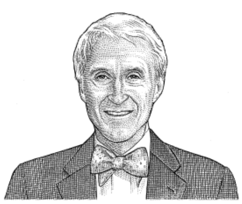

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