JANUARY 9, 2018

Overview

For better or worse, this is the time of year to reflect on decisions made (or not made), opinions held, positions taken, and events unforeseen. Before embarking on a self-critique, we should point out that 2017 was a good time to be invested in stocks and bonds. Portfolios advanced, wealth accumulated, and the spending power of our client accounts increased at a rate significantly greater than inflation.

While we would love to take credit for predicting such beneficial markets, we cannot. One year ago, we wrote "higher than average current valuations…argue for somewhat greater than usual caution." We echoed that view in our "Investment Perspectives" throughout the year. We would have had better results had we jumped on the bandwagon of optimism.

In the short run, momentum can be a far more accurate indicator than valuation, and it ruled the roost in 2017. Investors exhibited a distinct preference for stocks that had already outperformed. This can be starkly illustrated by the return disparity between the USA Momentum Factor Fund, which "targets stocks with strong recent performance,"[1] and the Russell 1000 Value Index, which is comprised of those stocks that are cheaper than average.

	2017 Return
USA Momentum Factor Fund	37.47%
Russell 1000 Value	11.86%

This performance anomaly is often a symptom of speculation. There is some of that in the marketplace, to be sure. But it is also the result of changing investor preferences that give this trend a thick veneer of rational behavior. Since the financial crisis, nearly $1.5 trillion has been invested in funds that mimic stock indexes.[2] By definition, more money has flowed to stocks that have outperformed, regardless of valuation. This cannot last indefinitely. When sentiment sours, as it ultimately must, high-priced stocks will not be able to sustain their valuations. Those that have been rewarded the most will have the farthest to fall.

[1] Morningstar
[2] Investment Company Institute

Looking Forward

Since the market bottom at the depths of the financial crisis, stocks have advanced smartly despite tenuous global economic conditions. With the notable exception of China, GDP growth around the world has been anemic and inflation below levels considered healthy. Investors anticipated more robust growth and patiently awaited its arrival. That time finally seems to have come.

Growth in the U.S. seems to be accelerating. Corporate decision makers are upbeat about lessening regulation and the new tax code (to some extent). Some consumers are anticipating more in their weekly paychecks (they will have to wait until February or March to find out for sure). Europe is finally exhibiting an upward trajectory. Even Japan seems to be emerging from its decades long slump. Ironically, this may create more challenges than benefits for equity investors. Market participants may become concerned that historically low unemployment will lead to inflationary wage growth. Stronger economic statistics will give central bankers the political cover necessary to curtail expansionary monetary policies. Interest rates, at least on short instruments, could continue to rise.

As we have remarked frequently over the last year or so, low interest rates and cheap and readily available credit have enabled significant demand for stocks in the forms of corporate buybacks, mergers and acquisitions and leveraged buyouts. Each of these activities was slightly less frequent in 2017 than the previous year. But the numbers are still large. U.S. mergers were 11% lower, year over year, but still a massive $1.44 trillion. Stock buybacks are down for the second year in a row, but still totaled about $500 billion.[3] Private equity firms like Carlyle, Apollo, BlackRock and KKR have raised enormous funds.

If stocks were cheap, we would say that the backdrop was more than attractive. But with valuations at their highest since the fiscal crisis and at the high-end of historical ranges, we are not inclined to chase the momentum trend. We like what we own. Our holdings in the technology sector may have slightly greater short term risk, but we think each has terrific long term prospects so we are not currently tempted to take profits. We will continue to focus on individual opportunities, and feel that we are appropriately positioned for a potentially more difficult market environment.

All of us at Spears Abacus wish you and your family a happy, healthy and prosperous New Year. We look forward to speaking with you soon.

[3] Wall Street Journal Market Data

Important Note About SA Investor Commentaries

This letter should not be relied upon as investment advice. Any mention of particular stocks or companies does not constitute and should not be considered an investment recommendation by SA. Any forward-looking statement is inherently uncertain. If you would like to learn more about SA and its investment program, please contact us at www.spearsabacus.com.

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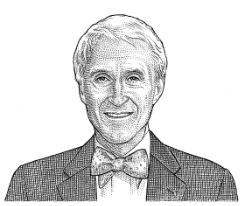

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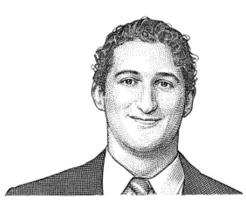

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