Portfolio Managers Commentary – Q4 2016

"A stock dividend is something tangible - it's not an earnings projection; it's something solid, in hand. A stock dividend is a true return on the investment. Everything else is hope and speculation." – Richard Russell

2016: The Year in Review

Every January, it's customary to take a look back at the year that was. What were the highlights? What were the "lowlights"? What got us to where we are today? What were the events we'll always remember? Most importantly, what did we learn?

To answer that, let's briefly recap some of the most notable events of 2016. Some have to do with politics and some with the markets. I'll even throw a little "sports talk" in. Then see if you can spot a common theme.

Current Observations

The year 2016 began with what have been termed the worst first six weeks in equity market history—the S&P 500 declined more than eleven percent from its 2015 close through February 11. In June, the market went down nearly six percent in a (trading) day and a half following the Brexit vote. And there was a moment, somewhere around 2:00 a.m. eastern time after the presidential election, when I saw the futures on the Dow Jones Industrial Average down 800 points! (Thank heaven this didn't happen during the regular trading day.) Yet despite all that unnerving market volatility, the S&P 500 closed out the year at 2238. With dividends of about two percent, the market's total return this volatile year was 12.25% percent. In a sense, then, the equity market put on a tutorial in 2016, highlighting the wisdom of tuning out shocking current events and the attendant volatility. During such episodes, it seems to me that the best investment advice I can offer is always, *"Turn off the television."*

There can be little doubt that the major market imponderable in the last third of the year was the U.S. presidential election. Indeed, the pall of uncertainty was so heavy in the run-up to the voting that the S&P 500 managed to close lower on nine straight trading days—a feat it had not accomplished since 1980. Thus, the most important aspect of the election from the market's perspective may simply be that it's over. We know the outcome, and that's no small thing. Because in my experience, what the equity market hates most is uncertainty. It can deal with anything, as long as it knows what it's dealing with.

It is not at all a political or partisan observation but a simple statement of fact that the incoming presidential administration, enjoying solid majorities in both houses of Congress, is likely to pursue more pro-business, pro-capital, pro-growth policies than the other candidate might have. Everything else being equal—which it almost never is—I believe these policies should tend to be favorable to the long-term equity investor.

It is to me one of the enduring mysteries of financial journalism that it always manages to see the equity market as "overvalued." I beg to differ, not at all in the sense of predicting what the market will do in 2017—heaven forbid—but in the hope of gaining a sense of where we are. According to the statistical research service FactSet, the current consensus earnings estimate for the S&P 500 in 2017 is $132.87. At its 2016 close of 2,238, then, the forward 12-month price/earnings (P/E) multiple of the Index is 16.8. The 25-year average forward P/E ratio is 15.9. Accepting the consensus earnings estimate, it is difficult to see the market's current valuation as much greater than average. I would add only that valuation has never been a reliable market timing tool. *(The 25-year average is taken from J. P. Morgan Asset Management's current "Guide to the Markets.")*

Sports

Let's shift gears for a moment.

While it didn't get much coverage over here, sporting history was made in May when Leicester City, a relatively small soccer club in England, won the Premier League championship for the first time in their 132-year history. It was a stunning accomplishment—and one nobody could have predicted.

In the U.S., history was also made a month later when the Cleveland Cavaliers defied expectations by winning the NBA championship. It was the team's first ever title, and the first major trophy won by a Cleveland-based team since 1964. The Cavs were also the first team to come back from a 3-1 deficit.

As exciting as that series was, it pales in comparison to what the Chicago Cubs did a few months later. Not only did they come back from their own 3-1 deficit in the MLB World Series, they also won their first championship in over a century.

So what can we learn from all this?

Have you spotted the common theme yet? If not, here it is: all of these events went contrary to most expectations. *In 2016, the unexpected kept coming true.*

Many analysts thought 2016 would be a bad year for the markets. We saw the opposite. Many analysts thought Brexit would never happen. It did. Many analysts thought Donald Trump would lose. He won. Even in sports, most predicted Golden State to win the NBA finals. Most figured the Cubs would fail to overcome a 3-1 deficit.

The reason I point all this out isn't to criticize the various pollsters, pundits, and prognosticators who got these events wrong. In most cases, they had good reasons for thinking the way they did. They used history, statistics, and demographics to shape their expectations. They gave educated, well-researched opinions.

And yet, they were still wrong.

So what can we learn from this? Expect the unexpected. Don't assume that what seems most likely to happen is guaranteed to happen.

General Principles

It will be worth reiterating, in the context of this annual letter, the nature of our philosophy of advice. Generally speaking, my experience has been that successful investing is goal-focused and planning-driven, while most of the failed investing I've observed was market-focused and performance-driven.

Another way of making the same point is to tell you that the really successful investors I've known were acting continuously on a plan—tuning out the fads and fears of the moment—while the failing investors I've encountered were continually (and randomly) reacting to economic and market "news."

Market Commentary

Most of my clients are working on multi-decade and even multigenerational plans, for such great goals as education, retirement and legacy. Current events in the economy and the markets are in that sense distractions of one sort or another. For this reason, I make no attempt to infer an investment policy from today's or tomorrow's headlines, but rather align clients' portfolios with their most cherished long-term goals.

I don't forecast the economy; I make no attempt to time markets; and I cannot—nor, I'm convinced, can anyone else—consistently project future relative performance of specific investments based on past performance. In a nutshell, I'm a portfolio manager and a planner rather than a prognosticator. I believe my highest-value services are planning and behavioral coaching—helping clients avoid overreacting to market events both negative and positive.

My essential principles of portfolio management in pursuit of my clients' most important goals are fourfold. (1) The performance of a portfolio relative to a benchmark is largely irrelevant to financial success. (2) The only benchmark we should care about is the one that indicates whether you are on track to accomplish your financial goals. (3) Risk should be measured as the probability that you won't achieve your financial goals. And (4) investing should have the exclusive objective of *minimizing that risk* to the greatest extent practicable.

Once a client family and I have put a long-term plan in place—and funded it with the investments that seem historically best suited to its achievement—I very rarely recommend changing the portfolio beyond its regular annual rebalancing. In brief, my principle is: if your goals haven't changed, don't change the portfolio. My unscientific sense is that the more often people change their portfolios, the worse their results become. I agree with the Nobel Prize-winning behavioral economist Daniel Kahneman, when he said, ***"All of us would be better investors if we just made fewer decisions."***

Going back to 1980, the average annual intra-year decline in the S&P 500 has exceeded fourteen percent. Yet even without counting dividends, annual returns have been positive in 28 of these 37 years, or 76% of the time, and the Index has gone from **106** at the beginning of 1980 to **2238** at year-end 2016. I believe the great lessons to be drawn from these data are that—historically, at least—**temporary market declines** have been very different from **permanent loss of capital**, and that the most effective antidote to volatility has simply been the passage of time. I can't predict that it will always work out this way. I can only fall back on the wisdom of the great investor and philanthropist John Templeton, who said that among the four most dangerous words in investing, is ***its different this time***.

The nature of successful investing, as I see it, is the practice of ***rationality under uncertainty***. We'll never have all the information we want, in terms of what's about to happen, because we invest in and for an essentially unknowable future. Therefore we practice the principles of long-term investing that have most reliably yielded favorable long-term results over time: planning; a rational optimism based on experience; patience and discipline. These will continue to be the fundamental building blocks of my investment advice in 2017 and beyond.

Of course, if your personal or financial situation has changed, please reach out to me or one of the members of my team, and we can discuss any changes in your circumstances and how that might affect your current plan.

I hope you've found this review to be educational and helpful. If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

Thank you very much for the trust and confidence you've placed in my team and my firm.

Sincerely,

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P.S. - I don't often ask for referrals, but during these unsettling times you might have a friend, relative, or co-worker who is in need of level-headed counsel on investing. Give me a call if you think I can help.