GROWTH EQUITY REVIEW

First Quarter 2016

THE WIND AT OUR BACKS

PERFORMANCE COMMENTARY

Since the onset of the bull market in March of 2009, there have been periodic setbacks as wary investors continually reassessed the environment. Still emotionally scarred by the near death experience of 2008-9, they have been vigilant of potential risks, real or perceived. And there has been ample fodder fueling their frustrations. The stop-go, subpar US economic growth, dysfunctional political system, threat of Greek insolvency toppling the EU, unconventional monetary policies by the four leading central banks, and rise in global geopolitical tensions, to name a few, have kept investors in a constant state of anxiety. The technologically "advanced" structure of the financial markets, with algorithmic, high frequency trading strategies, transformed investors' concerns into inexplicable fits and starts of heightened market volatility. It is hard to believe that one of the historically great bull markets could be so frustrating and unappreciated.

The first quarter of 2016 has been no different. Investors' emotional fluctuations between concern and complacency over a US recession, a hard economic landing in China, economic and financial dislocations from the rapid decline in oil prices, the timing of Federal Reserve "tightening," and bizarre domestic politics were manifested with the stock market declining -4.96% in January, off -0.13% in February, and rising +6.78% in March. The summation of all these crosscurrents was a modest +1.35% gain in the S&P 500 Total Return for the quarter. Mixed returns were also registered by the Dow Jones Industrials +1.49% and Nasdaq -2.75%.

These rather mundane overall returns were also evident in investment styles with defensive stocks up +2% and cyclicals +1%. Value stocks rose +2%, with growth +1%. Again risk aversion was evident as large cap rose 1% versus a decline of 2% in small cap. These, however, masked some wide industry dispersions. The concerns over a global recession and the fragility of the financial system impacted the banks -13%. Fears of a Clinton victory, with possible price controls in healthcare, brought the pharmaceuticals down -8%. Seeking safety, investors buoyed utilities +16% and telecommunications +17%.

PORTFOLIO COMMENTARY

During the first quarter, the passage of the federal highway bill and continued strong cement prices lifted **Martin Marietta Materials (MLM)** +16.8%. After poor operating results during Christmas of 2014, **United Parcel Services (UPS)** excelled during the 2015 holidays and the stock rose +9.7%. Favorable trial results for biotechnology company **Mesoblast (MESO)** were well received with a +51.3% gain. **Corning (GLW)** rose +11.7% as business stabilized and the outlook for its fiber optic cable business improved. Also benefiting was **Dycom (DY)** +15.2%, the leading US installer of telecommunication transmission equipment.

On the negative side, computer service company **Unisys (UIS)** dropped sharply, -26.9%, as corporate restructuring and large debt financing were announced. **Dish Network (DISH)** fell -19.1% over concerns of a possibly lackluster upcoming FCC spectrum auction. An investigation into its accounting practices weighed on **Boeing (BA)**, -12.2%. The rolling stock market correction caught up with the market leaders and **Amazon (AMZN)** finally had a pullback -12.2%. Also caught up in the leadership correction were the biotech stocks with **Morphosys (MPSYF)** falling -23.7%.

PORTFOLIO ACTIVITY

The quarter was very active as transactions were made to increase exposure to areas of well above average growth. In technology, new additions emphasizing "the cloud" included **Redhat (RHT)** and **Microsoft (MSFT).** In social media **Facebook (FB)** was purchased. The exposure to cyber was increased with additions to **Unisys (UIS)**. In telecommunication technology, positions in **Dycom (DY)** and **Infinera (INFN)** were initiated. In health care, companies with potentially breakthrough new therapies were added; **Incite (INCY), Opthotech (OPHT)** and **Regeneron (REGN).** In the infrastructure area, a new position was taken in **Summit Materials (SUM).** To fund these **United Parcel Service (UPS)** was reduced and **Morphosys (MPSYF)**, **America Movil (AMX)** and **Cree (CREE)** were eliminated.

MARKET COMMENTARY

Does this rear view mirror of the past seven years give us any insight into the future of the US economy and stock market? Will the environment be as frustrating, yet as conducive to positive investment returns? As an investor, saddled with these irresolvable macro issues, how does one find an effective investment strategy?

From a macro point of view, the global economy has been in a state of gradual improvement. The Western world, although still tethered to the teats of central banks, has settled into a moderated rate of expansion; Europe at roughly 1% and the US at 2½%. Japan's three arrow stimulus program is very slowly taking hold and China's initiative to attain a more balanced economy is working with consumption up over 10%. In **relative**

terms, the world has moved from teetering on the brink of depression to a subpar, but sustainable rate of growth.

In the US specifically, the economy is currently coming out of a moderate inventory correction and embarking on a period of 2-3% quarterly growth led by government fiscal deficits, consumer spending and housing. Since the output gap (gap between productive capacity and current output) is wide, the economy has sufficient financial liquidity, untapped labor, and productive plant and equipment to maintain the current expansion for a number of years.

Another perceived risk to the market is valuation. Entering its eighth year, naysayers feel the market is long in the tooth and overvalued. However, absolute measures of duration and valuation can be misleading. A better gauge is the sentiment of investors. Is there euphoria and speculation with broad based participation? In today's market, just the opposite exists. Although years have passed since the bear market, a high level of risk aversion still persists. Pension fund equity allocations are conservative, hedge funds cautious, and the public absent. Until there is a more spirited participation, valuation is not a risk factor.

Given a subpar, but long lasting, economic growth and few valuation excesses, what is the appropriate investment strategy? Persistent slow growth means most industries and companies find it very hard to show above average revenue and profit growth. Accordingly, corporations have responded with increased merger activity, higher dividend payouts and aggressive share buybacks. All of these are prevalent today, a sign of diminished opportunities. In this environment companies with above average revenue growth should present the best investment opportunities.

Our long held investment philosophy has always been to invest with the economic wind at our backs and limit the breadth of our holdings. We are firm believers in Warren Buffet's admonishments against over diversification. Thus, we focus the bulk of our investments in areas that will show, over the next three to five years, potential for growth well in excess of the general economy. We emphasize innovation and scientific advancement and major demographic changes. Moreover, within these growth industries, we select specific companies with the greatest risk adjusted growth potential. Today, these areas include Health Care, Technology, Telecommunications, Advanced Industrial Technologies, and Infrastructure.

As the economy regains its footing and the bull market resumes, investor anxieties, however, will not quickly dissipate. The next few years will most likely resemble the past six. The direction continuing up, the disbelief holding firm. In this environment, our selective, growth oriented philosophy should prove to be timely.

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