CORE EQUITY REVIEW

Second Quarter 2016

LIGHT AT THE END OF THE CHUNNEL

PERFORMANCE COMMENTARY

After a very volatile first quarter with monthly changes in the S&P 500 ranging from +6.8% to -5.0%, the first eleven weeks of the second quarter were distinctive in their ennui. The market began the quarter at 2060 and until June 23rd traded in a narrow range of 2119 (+3%) to 2040 (-1%). During the quarter, complacency on the economy set in with the peak of the inventory correction behind and prospects for better second half growth ahead. Rather than repulsed, investors seemed to be oddly entertained by the antics on the domestic political scene. Global and domestic terrorism continued unabated, but the financial markets were inured to its brutality. That was until June 23.

With the vote by the UK to leave the EU, chaos reigned. British political leaders were ousted with no apparent succession, economic pundits cast dire forecasts on the outlook for the UK, EU, and US, and around the world interest rates, currencies and stock markets were epileptic. The initial two-day downdraft in the US stock market was -5.4%, providing market historians with ample fodder for dire forecasts. As cooler heads prevailed, the optimists, armed with predictions of new and necessary monetary easing in Europe/UK and potential delays in rate hikes in the US, overcame the pessimists and by quarter end the market had regained almost all of its earlier losses. By June 30, the rally brought the S&P 500 Total Return up 2.5% for the quarter, 3.8% year-to-date and within a few percentage points of its all-time high.

The rather unimpressive gains for the overall market disguised some rather significant internal dispersions and a strong risk-averse bias. For the quarter, defensive stocks rose 5%, while cyclicals were up 2%. For the six months, the gap was even wider at +7% versus +1%. For the six months, value outpaced growth by +6% to +2% and the market favored large-cap (+4%) to small-cap (+2%). Individual industry returns were even wider. For the second quarter, telecommunication and utilities were up 8% and energy +11%. The only negative area was information technology at -2%. Year-to-date, leadership was the same with telecommunications +24%, utilities +22%, and energy +14%. At 0%, technology was the sole industry showing no gain.

	Periods Ending June 30, 2016						
	QTD	**YTD**	**1 Yr**	**3 Yrs**	**5 Yrs**	**7 Yrs**	**10 Yrs**
Core Equity Wrap Composite – GROSS*	**2.2**	**6.2**	**5.5**	**9.8**	**11.4**	**14.9**	**9.8**
*Core Equity Wrap Composite – NET***	1.6	5.0	3.1	7.3	8.9	12.3	7.4
S&P 500 Total Return Index	2.5	3.8	4.0	11.7	12.1	14.9	7.4
Russell 1000 Total Return Index	2.5	3.7	2.9	11.5	11.9	15.0	7.5

*Gross performance is presented as supplemental information to the full GIPS compliant presentation which is available upon request.

**Net Returns reflect the highest fee any advisor charges – most advisory clients are not charged the highest fee.

Performance figures for periods one year and longer are annualized.

PORTFOLIO COMMENTARY

One of the laggards in the first quarter, **Bristol Myers Squibb (BMY)**, recovered from concerns of a drug-pricing scare from a potential Clinton presidency and a generalized selloff in health care. The stock was up 16% during the quarter, and is now up over 7% year-to-date. Concerns over economic growth induced investors to look for companies with yield and enduring recurring revenue streams. **Crown Castle (CCI),** a cell tower REIT, certainly offers both and was up 18%. **Martin Marietta Materials (MLM)**, after being a leading performer in the first quarter, continued its run and was up 21%. Year-to-date the stock is up 41%. MLM, as a provider of aggregate, is a beneficiary of the recognition that we are at last starting to rebuild our infrastructure. **Pfizer (PFE)**, another beneficiary of the abatement of concerns over drug pricing, was up 20% and **American Tower (AMT),** our second cell tower REIT holding, was up 12%.

The two leading laggards were airline stocks. **United Continental Holdings (UAL)** and **American Airlines (AAL)** both sold off as the quarter progressed on the rise in energy prices. Fuel is a significant component of cost. The nail in the coffin was the Brexit vote. Investors sold off what were arguably cheap stocks on fundamentals over fears that Brexit would curtail international flights, and the North Atlantic routes are a very profitable aspect for the airline industry. They were down -36% and -31% respectively. We believe they are exceedingly cheap on a longer term basis from a fundamental standpoint. **America Movil (AMX)**, which we sold during the quarter, continued to sag and was off -28%. Although the stock may be cheap, we believe it will be a long time before the impact of increased competition and the Latin American economy is vibrant enough to support a price recovery. **Apple (AAPL)** and **Microsoft (MSFT)** were off -12% and -7% in the quarter. We believe this to be a temporary condition as Apple has a new phone out in the fall which we expect to be a driver of revenues and Microsoft's position in offering data storage for the cloud is starting to drive their revenue and earnings.

PORTFOLIO ACTIVITY

During the quarter, we opportunistically readjusted the weightings within the portfolio, slightly trimming our exposure to **Canadian Pacific (CP)**, **Corning Glass (GLW)** and **United Parcel Service (UPS)** and adding to existing positions in **Crown Castle (CCI)**, **Novo Nordisk (NVO)**, **Pfizer (PFE)**, **Cisco (CSCO)**, and **Intel (INTC)**. We also sold our positions in **America Movil (AMX)** and **United Airlines (UAL)**. Essentially, we gave up on the prospects of a rapid recovery of AMX. We see the continual pressure of government policies to reduce the monopolistic hold AMX has on the delivery of voice and data in Mexico, continued weakness in Brazil, and a soft Latin American economy as retarding prospects for growth. We may well revisit the company when prospects improve. We also reduced our exposure to the airline industry, selling our position in United Airlines. We continue to hold American Airlines. At the quarter end we added **Monolithic Power Systems (MPWR)** to the portfolio, believing that they are well positioned to benefit from the increased use of portable devices. We have been waiting for an appropriate entry point and the Brexit vote provided it. MPWR is a specialty semiconductor manufacturer focused on converting, regulating and applying electrical current as it powers mobile devices, displays, and computing.

MARKET COMMENTARY

The Brexit vote and the success of the two non-traditional candidates (Trump and Sanders) in the US can be seen as a statement by a meaningful portion of the electorates that the current political and economic policies are not working, that new and maybe even some refurbished old ideas need to be explored.

In the aftermath of the Brexit vote, there have been few if any observers who have felt anything but deep concern; concern over the health of the already fragile global economic and political systems, especially those of Europe. No forecaster has raised the possibility of better future economic growth or pondered a more stable political environment in the Western developed world.

The titles of two recent reports from the macroeconomic research firm Strategas cleverly address some of the underlying issues. “Revenge ON The Nerds" by Daniel Clifton proposed that the middle class, after years of frustration over the profoundly ineffectual policies of the elite intellectual ruling class (both left and right), is rebelling. In "Angry Is The New Hope”, Jason Trennert addresses the frustration and indignation of the populace in their elected officials. President Obama ran using the slogan of “Hope”, and after eight years voters sense little progress has been made. Anger has replaced hope and many are looking for a new type of leadership to restore economic growth.

However, if one steps back from the current anxiety and looks a bit longer term, there may be some very positive repercussions from today's and tomorrow’s likely dislocations.

In high school social studies, students get their first taste of economics, "The Economic Triangle," which, because of its simplicity, does not bear the name of a noted Nobel economist. It depicts an economy consisting of three participants: Government, Business, and Labor. The three are supposed to cooperate with “constructive" tension providing for growth. It has been the cornerstone for the unrivaled success of the American economy: the Government’s building of the railroads, highway system and electrical grid, while implementing social security, Medicare and Medicaid; Business with scientific discoveries, manufacturing innovations and capital investments; Labor with a strong work ethic and mobility. All three worked to dramatically improve the US's standard of living over the past decades. So, what has gone wrong with the "Triangle" in recent years? Why are Europe and the US stuck with subpar growth and seemingly having only "unconventional" monetary policies as their elixirs?

In the natural and social sciences, constituents have defined life cycles. In economics, they are often depicted by an S Curve, with rapid growth at the embryonic stage, slowing over time to eventual death. Might it be that the "Economic Triangle" is in the later stages of its life? That the current efforts to stimulate growth will only get unsatisfactory, diminished returns? That the "Triangle's" constructive tension has turned destructive? That the three participants need to reset their priorities and egocentric behaviors?

Does Government need to be smaller and/or more efficient, be more responsive to the needs of the middle class majority, and become less intrusive? Does Labor need to be more responsible for its own education, to rekindle its work ethic, to become more mobile? Does Business need to stop hiding behind the four worst words in capitalism (maximization of shareholder wealth), become more sensitive to income inequality, have greater respect for the environment, and rethink its tax responsibilities?

The pessimists contend that the rising populist desire for change/inclusion will undermine the current somewhat fragile political/economic stability. This heightened uncertainty is, in their eyes, unacceptable and the status quo is preferable. The voters are expressing a different opinion.

The question is where, over time, will the beginnings of this populace movement lead? The system is at an important fork in the road. If Government and Business selfishly turn a blind eye to change, then social unrest and ugly nationalism could follow. If, however, priorities are reset and the constructive tension is restored, then future economic activity can return to its prior rates of growth. If the reformation begins under the tutelage of responsible leaders, it will be positively received by investors and expressed by a higher stock market.

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