SECTOR SELECT – CONCENTRATED 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**
Sector Select – Concentrated Equity – GROSS	**3.5**	**6.2**	**3.8**
Sector Select – Concentrated Equity – NET	3.3	6.0	2.6
S&P 500 Total Return Index	2.5	3.8	4.0
Russell 1000 Growth Total Return Index	0.6	1.4	3.0

Performance figures for periods one year and longer are annualized.

PORTFOLIO COMMENTARY

Dycom Industries (DY) is a leader in engineering, building out, and managing network broadband infrastructure. They were a leading performer last quarter and were up another 39% this quarter. **FEI Company (FEIC)** was acquired on an all cash bid by Thermo Fisher Scientific. While the takeover was for only a 10% premium, the stock was up 33% overall in the quarter. **Amazon (AMZN)** was up 21% in the quarter and continues to execute brilliantly on its plan of dominating retail and cloud services. The necessity to build or rebuild our infrastructure is one of our significant investment themes. **Martin Marietta Materials (MLM),** as a provider of aggregate, is a beneficiary of the recognition that we are at last starting to rebuild our infrastructure. MLM, also a leading performer in the first quarter, continued its run and was up 21%. Year-to-date the stock is up 41%. 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 17% during the quarter, and is now up over 7% year-to-date.

Infinera (INFN) was down 34% in the quarter, as they missed earnings estimates for the first quarter and indicated a soft second quarter. We expect demand to build in the second half and next year. The demand driver of need for increased speed at which to transmit data is only growing. The need to update optical networks as data transmission speeds go from 40g to 110g is significant. INFN is exceptionally well positioned to be a primary beneficiary. **United Continental Holdings (UAL)** sold off as the quarter progressed on the rise in energy prices and was down 32%. 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. **IPG Photonics (IPGP)** stock valuation (off 17%) suffered twice during the quarter. The stock had performed well in the first quarter but sold off in April as they issued softer guidance and it took another hit at the end of the quarter on the Brexit vote. Part of their operations are in Germany and they have considerable exposure to Europe as well. **Apple (AAPL)** was off -12% 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. **Regeneron Pharmaceuticals (REGN)** was off 9% and continues to be subject to general weakness in the biotech sector.

PORTFOLIO ACTIVITY

We sold FEI Company (as it was acquired for cash by Thermo Fisher Scientific) and trimmed holdings in Bristol Myers Squibb. With the proceeds we tactically added to positions in **IPG Photonics**, **Infinera**, **Regeneron**, **Summit Materials** and **Unisys** and added one new position in **Alphabet (GOOGL)**. GOOGL continues its dominance in internet search and is expanding the pace at which it is generating mobile ad revenues.

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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