SECTOR SELECT – CONCENTRATED EQUITY REVIEW

Fourth Quarter 2016

LET THE GAME BEGIN

PERFORMANCE COMMENTARY

The eighth year of the bull market was very rewarding for sage and steadfast investors.

However, it proved to be humbling for stock market sages, economic forecasters and political pundits. Few prognosticators predicted the inter year volatility or rapid swings in market leadership, much less a double digit return for the year. Misreading a normal inventory cycle correction earlier in the year, many economists were startled by a 3+% GDP in 3Q. And the political gurus, most notably the press (liberal and conservative), lost both credibility and respect for their uneven and biased election reporting.

The year ended on a strong note with a 4Q advance in the S&P 500 Total Return average of 3.8%. This brought the full year gain to 12%. The optimism centered on the hope that President-elect Trump's proposed fiscal stimulants would accelerate economic growth. As a result, the leadership in the quarter focused on the banking industry, energy, materials and industrial stocks. Telecommunication and financials also outperformed on the hope of a reduction in regulatory burdens. Underperformance occurred in the more defensive and interest sensitive sectors: consumer staples, health care and real estate. As we look into 2017, we expect the positive tone to continue. Moderate economic growth, rising corporate profits and contained interest rates will be supportive towards equity price appreciation. While the US will have more than its share of political anxieties, the most likely scenario is for the market to continue to climb the wall of worry and the bull market advance to remain intact.

	Periods Ending December 31, 2016		
	QTR	**1 Yr**	5/27/15 to 12/31/16
Sector Select - Concentrated Equity - GROSS	3.5	13.6	5.7
Sector Select - Concentrated Equity - NET	3.2	12.8	4.6
S&P 500 Total Return Index	3.8	12.0	5.6
Russell 1000 Growth Total Return Index	1.0	7.1	3.7

Performance figures for periods one year and longer are annualized.

PORTFOLIO COMMENTARY

Unisys (UIS), whose stock price has frequently had significant ups and downs on a quarterly basis, was up over 50% this quarter. It appears to investors that the old-line database processor's new management team has finally righted the ship and they are on course for a recovery. We own it solely for its novel approach to protecting data. Although currently a small part of their overall business, we see its differentiated approach to protecting data as a potential game changer, not just for the company but believe it has the capability to transform the manner in which the entire cyber industry operates. We are seeing progress but it is grudging progress. We are patient investors. The airlines rallied significantly in the quarter on the belief that economic growth was going to improve significantly under the new administration. Accordingly, **United Continental Holdings (UAL)** soared 39% in the quarter after a very weak second quarter. **Martin Marietta Materials (MLM),** a leading performer the first two quarters, more than recouped it loss in the prior quarter and rallied 24% this quarter. They will be a significant beneficiary of the pending infrastructure rebuild as proposed by the new administration. **Summit Materials (SUM)**, akin to previously mentioned MML, is a producer of aggregate (crushed stone, cement, and concrete) and should also be a direct beneficiary of the pending efforts to rebuild our nation's infrastructure. Accordingly, the stock rose 28%.

We see value in investing for clients in scientific discovery, as it gives us a forward view into an ever changing world and provides the potential for enhanced returns (when you get it right). One of our scientifically driven health care investments, **Opthotech (OPHT)**, didn't get it right and collapsed on the results of its Phase III trial. Their efforts to obtain approval for a drug to treat macular degeneration had demonstrated significant increased efficacy in all prior trials and it was our expectation that with a equally positive Phase III the company had very bright prospects ahead of it. Investors were stunned by the lack of enhanced efficacy and the stock collapsed. It was off 91%. There is not much to say other than we have moved on, albeit licking our wounds. The price of **Vertex (VRTX)** has been drifting along awaiting positive news from its efforts to develop and expand treatment for cystic fibrosis. The stock was caught in the backlash of ill will generated by headline concerns against pharma stocks and was off 16% in the quarter. **Amazon (AMZN)**, which we believe even at current prices is an outstanding investment opportunity, consolidated its run after rising 17% in Q3 and retreated 10% as investor sentiment focused away from technology. In December, **Redhat (RHT)** suffered two losses – an earnings season miss and the resignation of their CFO. These were not related, as is sometimes the case. The CFO resigned to become the CEO of another software company that is slated to go public this year. In terms of earning, the company's federal contracts revenues slipped and we expect this to be temporary. The company was down 14% for the quarter. However, there is increased competition building from other providers of open source software and we are considering the degree of these threats to the company's prospects.

PORTFOLIO ACTIVITY

We made a mistake in buying **Opthotech (OPHT)** in October. We thought they would exit Phase III trial with flying colors and be close to offering a treatment for macular degeneration. While they did exit the trial in December, the drug didn't offer any increased efficacy of treatment. We sold the stock and took a capital loss to offset some significant gains. We also sold our position in **Union Pacific (UNP)** into strength and at this juncture are looking for more true growth than cyclical growth.

MARKET COMMENTARY

Up until the 2016 Presidential cycle, the word trump had two different connotations: the designation of a suit in a card game or a real estate tycoon. It is now most thought of in terms of the President-elect.

There are four suits in a deck of playing cards: hearts, diamonds, clubs and spades. Over time these have taken on meanings of specific human characteristics: Hearts – love, emotion, sharing; Diamonds – energy, success, imagination; Clubs – work, growth, luck; Spades – negativity, challenges, problems. Among the face cards are two males, the King and the Knave (Jack). The King has come to represent love and leadership engendering trust and respect. Conversely, the Knave is charismatic and resourceful, but challenged by integrity and honesty.

In the game of bridge, a spirited bidding process determines which of the four suits will be most powerful and dominate the action of the game. The suit winning the bid is designated as trump. Soon, in the game of government, the election winner will bridge to new leadership. It is uncertain what this Trump will be. Like a Heart, Diamond, Club or Spade? A King or a Knave?

Despite the difficulty in analysis and ascertaining how, and more importantly to what extent, European politics and pending elections in France and Germany, Middle east strife, expectations for increased acts of terrorism, US/Russian/Chinese relationships and the unprecedented domestic political uncertainty will impact an already fragile global growth, the general outlook for the US economy is sound and improving.

The US enters the New Year on a firm footing. Despite continued subpar underlying growth - hovering around 2% - consumers are in good spirits while the financial system has been significantly repaired. The stabilization of oil prices bodes well for capital spending, and fiscal deficit spending, as projected in the pending highway bill, should be stimulative. Monetary policy should also remain accommodative.

However, as we go through the eighth year of the recovery, the economy should begin to show its age. Major sectors are maturing, potentially adding little to future growth. Auto production and commercial construction are the two most immediate examples. Based upon the current economic trajectory, the US economy would be growing at merely a +1% rate by 2018.

Fortunately, with the election of Trump, new fiscal stimuli are being proposed that would offset the upcoming slowdown. With his promises/platform he vowed to "Make America Great Again", and consumer and investor confidences have surged. Optimistic economists have ratcheted up their forecasts to 3-4% growth. We are in a period when unbridled optimism can flourish and rosy assumptions cannot be disproven. How long can this honeymoon last?

There are four main proposals that contribute to the estimates for an improved outlook.

- Repatriation of offshore profits will stimulate domestic capital spending. Issue: Presently, the US financial system and corporations are awash with low cost capital. It has been the paucity of good projects that has inhibited capital investment.

- Tax cuts/reform will provide business/consumer stimulus. Issue: This is a political hot potato with powerful interest groups mounting their defenses. In the zero sum game of moving money from the high income tax payer (investment) to the mid-to-low income class (consumption), how are the pressing needs for capital and infrastructure investment satisfied?

- Reversal of onerous regulations will increase US productivity. Issue: The excessive use of executive orders by either party will have, over the long run, a dampening effect on business confidence. What Obama put in and Trump takes out, the next President can put back in. Long term capital investment is problematic with fickle government policies. However, over the short term, regulatory relief will be moderately helpful, especially in energy and banking.

- Fiscal stimulus (deficits) will be additive, especially in defense and infrastructure. Issue: In the long run, these are positive, but the planning cycle is long and projects multi year. The impotence of the TARP spending program gives one pause.

While the direction of these initiatives is positive, the timing and magnitude are questionable. Remember, the Tea Party, paring knives in hand, is waiting in the wings to whittle away on these proposals. It is possible that the upcoming State of the Union address may be the peak of optimism and the end of the one-sided debate, marking the end of our honeymoon period.

The most likely economic outcome may be a continuation of the 2+% growth with shifting leadership within the maturing economy. Overall corporate profits should improve as energy and financials recover. For the financial markets, interest rates will remain unpredictable after the recent rise, with movement in either direction possible. For equities, the next few years should look like the past eight: up in direction with the magnitude of move and the extent of volatility the unknown.

While this is the most likely scenario, much will depend on how this game of cards is played. In the game of bridge, success is determined by the player's possession of three attributes:

- Deductive Reasoning: The ability to size up a situation on inferences available
- Empathy: The ability to view a situation from another person's (friend or foe) perspective
- Foresight: The ability to visualize problems before they arrive

Are these the same attributes needed to be an effective President? If so, only time will tell how this game of government will end. It started in the Republican primaries with a bid of one no Trump. Will it end with the final card being played the King of Hearts or Knave of Spades? Despite the uncertainty, we believe America is well positioned to hold the winning hand. Let the game begin.

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