



October 5, 2017

### **Third Quarter Update and Outlook**

The general stock market charged ahead in the third quarter, as it has for much of the time since 2009. We dare say investors are getting used to this. Yet political noise is louder than it has been in years. The U.S. Federal Reserve has signaled it will reverse its easy monetary policy (we think they mean it this time); threats from North Korea (nuclear) and threats of trade wars seem more than offset by optimism over the possibility of tax reform and other pro-business initiatives announced by the current U.S. presidential administration.

It has occurred to us that some of the market's strength doesn't deserve fundamental explanation; rather it may have more to do with money flows. Central banks have encouraged asset investing as a consequence of their low interest rate policies. Increasingly, central banks have also become big investors in stocks, a rare phenomenon a decade ago. Investment flows into passive funds have benefitted U.S. stock market indexes and are reflected in their near record high valuations (S&P 500 sells for 19.0 times 2017 estimated earnings). While many investors are focused on further gains, there is a sense of caution on our part as reflected in the above average cash reserves we hold in the Opportunistic Value Equity Strategy investment portfolio.

For some time, growth stocks have been outperforming value stocks and large companies have outperformed small company stocks. The third quarter market index returns do not reflect a rotation that is probably long overdue, but we sense it is now happening. Out of favor sectors such as industrials, energy and other economically sensitive industries have shown signs of life over the past month while the popular large company growth stocks stopped leading the stock market during the third quarter. In addition, international markets showed strength, ahead of their U.S. peers.

We recently purchased Embraer SA, the well regarded Brazilian-based maker of regional jets. Embraer stock had fallen in price due to investor frustration over a declining backlog for older model jets and declining earnings as it transitions to its new model E2 jets. We expect Embraer's improved prospects in 2018 to reignite investor enthusiasm for the stock.

We purchased Petroleo Brasileiro (Petrobras) ADR, the Brazilian multinational petroleum producer. Petrobras controls significant oil reserves off the coast of Brazil. After a tumultuous period marked by overspending and politically-related scandal, the company has made significant progress at enhancing its corporate governance, reducing expenses,

and reducing its debt. We believe that Petrobras' progress will reward patient shareholders in coming years. The Brazilian government remains its largest shareholder.

During the quarter, we added to our position in Abercrombie & Fitch, the U.S.-based fashion retailer. The fashion retail sector has been out of favor due to recent poor financial results and related concern over the ability of brick and mortar shops to survive the transition to the Internet economy. Abercrombie & Fitch has a well thought out multichannel sales platform which includes robust Internet sales and a physical store presence. A&F chose not to follow through with a recent buyout opportunity likely because the price offered was below what the company's board believes it can attain on its own. We sold Alder Biopharmaceuticals, the developer of the drug Eptinezumab for the prevention of migraines. While phase 3 results recently announced were positive, the results appear no better than competing drugs also currently being developed by other companies. We fear that it may be difficult for Alder to earn a fair return on its large investment in the drug.

Soon enough we will know if proposed tax reform happens (very unlikely in its current form), if in fact, the Federal Reserve Board has started the process of monetary tightening resulting in higher short-term interest rates and if U.S. corporate earnings hold up in this third longest economic expansion in U.S. history.

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