Our process and philosophy:

Our investment style is built off of over 20 years of experience at Goldman Sachs Asset Management and Fortress Investments. We continuously monitor the global markets and stay abreast of current events. However, you will never hear us claim that we are economists. We will leave the market forecasts and guestimates to others, as we simply do not have any material insights on predicting macro events. Our passion is to conduct bottom's up, fundamental research and to build world class portfolios. We seek to achieve long-term investment returns by identifying superior, growing businesses. One of our key tenants is that the equity markets offers premium return potential that can be captured through proprietary, in-depth research and security selection.

We seek to take advantage of disparities between a stock's current share price and its underlying intrinsic value. When a company's share price fully reflects the prospects for its business, offering us a fairly low return for the commensurate risk, we look to sell our position. It can be difficult to immediately re-invest this capital, so we may hold cash until another opportunity arises. This process requires patience and a willingness to wait for our opportune time. We realize that holding cash may be a slight drag on performance, but we absolutely do not want to over pay for a business for the sake of putting money to work.

At its most basic level, we are business buyers and investors, not short-term traders. We focus on strong, durable franchise businesses with identifiable growth prospects and excellent management teams. Our process seeks to identify growth businesses with certain key attributes. These characteristics are high barriers to entry, market share leadership, pricing power or flexibility, recurring revenues and predictable free cash flow. We have found that investing in companies, with these durable competitive advantages, leads to outperformance.

Portfolio construction:

We are quite aware of business and stock correlations and consider these in our construction process. We avoid rigid, arbitrary rules on maximum position sizes - based on third party classifications. Instead of these inconsistent outside party determinations, we apply our own experience and judgment. Our unique set of qualitative criteria helps us identify superior businesses that we expect to outperform over time. Once we determine which businesses to purchase, additional analysis determines the corresponding weight. This is a function of our perceived risk / return ratio for each individual investment. This research is constantly being performed and we update the portfolios and position sizes to reflect price changes, news and circumstance.

The year in review:

The S&P 500 had some wild swings in 2015, but ended essentially back where it started. While the 1st half of the year had solid gains, this positive momentum was impacted by geopolitical uncertainty. Heightened unrest in the Middle East, European immigration concerns and Russian military aggression were just a few of the global worries the market began to wrestle with. By August, a Chinese slowdown hit commodities, which proceeded to impact emerging markets. Oil prices ended lower for a 2nd consecutive year and this plunge in energy prices impacted both the equity and debt markets. In December, high yield debt (especially from the energy sector) became a concern. The high profile collapse of the Third Avenue Credit Fund rattled the debt markets at the end of the year. A cautious US consumer and uncertainty around the timing of interest rate hikes led to a fairly skittish tape.

2015 marked the busiest year ever for mergers and acquisitions with over $5 trillion of deals. Some acquisitions make economic sense and are quite rational. Some are for financial maneuvering and tax avoidance. Others can be signals that management teams are using their inflated currency (ie: their stock price) to their advantage. Lastly, some deals are simply a function of the historically low cost of capital. We expect the market to remain fairly receptive to additional transactions, as most of these "catalysts" still exist.

The United States:

The US is growing, but only at a low single digit pace. We just concluded the 10th straight year of economic growth under 3%. Excluding the financial crisis, economic growth has averaged only 2% over the last decade. This should not be a total surprise, as economic growth has only been 3.3% over the last 4 decades. The vast majority of our productivity gains have already been captured and the estimates of the labor force are not expected to exceed 1% for the foreseeable future.

While this is not an ideal level of growth, it still is the envy of the world. Unemployment is running at roughly 5%, which is the best it has been since April of 2008. Energy prices continue to fall and overall inflation remains contained under 2%. The Federal Reserve (The Fed) is focused on these two key tenants for setting its benchmark interest rate policy. In December, The Fed took the opportunity to raise interest rates for the first time in a decade. Historically, the average length of rate tightening runs two years. This would imply that the cycle could last well into 2017.

One could also expect rising rates to eventually lead to a recession. However, history leads us to believe this typically does not occur for an average of 41 months. This would put us well into 2018 or 2019. The Fed's easy monetary policies of rock bottom interest rates and massive bond purchases have somewhat postponed a normal market adjustment. This market-based adjustment is still needed, if we are to have a fully functioning and rational economy. We see some of The Fed's actions, while perfectly understandable based on the circumstances of dealing with a financial crisis, as delaying an inevitable day of reckoning.

Looking forward:

The market did not experience its normal year-end rally and the first few trading days of January have started in the red - down well over 5%. Our expectation is for gradual rate increases in 2016, but possibly not as many as the market is currently forecasting. Futures are looking for three to four interest rate hikes this year and we believe this could be aggressive. While The Fed needed to raise rates from its zero bound, we do not see economic growth justifying that aggressive of a tightening. We expect The Fed to utilize its "data dependency clause" to hold off on some potential increases.

Investor sentiment seems quite concerned that the Fed might tighten too quickly and choke off any US growth. Despite this, the US economic environment continues to chug along. Lower oil prices benefit consumer spending and we do not envision a dramatic lift in commodity prices anytime soon. Last year, the average price of gasoline was $2.40 per gallon which saved Americans $540 per household (per AAA). Considering that the median US household is $53,700, this is a de-facto tax cut. With a national average forecast expected to stay steady or even drop this year, this should continue to benefit discretionary spending.

We are optimistic on the resiliency of the US economy and equities in particular. Some market pundits seem overly pessimistic based on current trends. Maybe this is due to 6 years of equity gains? Maybe there is a reversion to the mean expectation? With the S&P 500 up 250% from its crisis lows in early 2009, this certainly is understandable.

Valuation:

When there are macro concerns, we always find some solace in taking a fundamental valuation snapshot. As of now (early January), the S&P 500 is trading at 17x 2016 estimates, which assumes 5% earnings growth. While we do not advocate this is outright cheap, we do not believe this valuation to be unjustified. If we back into some implied market thoughts, let us assume a P/E at 20x. This valuation corresponds to a 5% earnings yield and a 5% forward looking real return on equities. Assuming that P/E ratios remain constant and stable, one could construct earnings per share growth coming solely from buybacks and dividends. Buybacks have been running at roughly 3% per year, while dividends can be estimated at 2%. With the 10-year TIPS bond at 0.60%, that would give equities the advantage over bonds (by over 4%). A 5% real equity return is not awful and it assumes that there is essentially no organic growth in earnings per share.

Quite simply, if the market were to maintain its current valuation, one could expect to see a rise in the equity markets in line with earnings growth. If one assumes that commodity prices stabilize and/or consumer spending surprises to the upside, earnings could grow even faster than expected. If we are able identify superior growth companies, the market should reward these stocks for their dominance with an even higher multiple.

Following the financial crisis, The Fed needed to respond with historic measures. Now that we are 5 years removed from these "life support" efforts, the economy has stabilized. Other markets are easing, as they look to spur economic growth. As China releases a new 5-year plan and digests its decelerating growth, the global markets will be volatile. Global markets are truly intertwined and correlations are higher today than ever before.

China:

Over the last 6 months, the world has learned that a bump in China's economy cannot be ignored. The bigger question is whether or not the world feels this as a tidal wave or as a ripple. China s the 2nd most important economy in the world and The International Monetary Fund (The IMF) expects China to account for 18% of world economic activity this year. Any analysis of China must begin with the understanding that the data we receive is somewhat flawed. The government releases information that it wants to see and market experts tend to view the data as biased. That being said, any headline coming from China can be viewed to match your own market thesis. If you are bearish, China is growing at its slowest rate in 25 years. If you are bullish, China remains one of the world's fastest growing economies.

Let's begin with the growth rate, as there is no denying that it is slowing. With lower growth, the impact goes global. Those countries, that are highly dependent on China for spurring demand, are obviously negatively impacted. With a truly integrated global economy, these actions impact other nations. The low price of oil and commodities has pushed Russia and Brazil into a deep recession and caused a financial crisis in several Gulf states. What used to be an isolated action in a foreign country now has our market's reacting quite significantly.

The People's Bank of China will step up to tackle this slowdown, just like our Fed did during the financial crisis. The Chinese government is attempting to spur demand and re-ignite its growth. Not everything they are doing is proving successful (ex: circuit breakers, trading restrictions, outlawing short selling, leverage restraints, currency purchases, etc), but they will eventually figure this out. An economy that large will not change overnight, but the government has already accomplished significant change. The real fruits of their labor may take quarters to see, but China will rebound.

Asset classes:

Overall, we prefer equities to bonds. We prefer US markets versus other emerging markets. We will explain some of our thinking below, but this overriding preference will help guide some of our portfolio positioning.

Commodities:

Commodities have struggled, but we believe this might continue. We are hesitant to invest directly in commodities based upon their significant volatility. In addition, many emerging and developing countries are struggling to deliver growth, which should act as a cap on commodity prices. Without the incremental Chinese buyer, some commodities are going to find it difficult to get pricing. Some of specific thoughts on energy are captured below.

Fixed Income:

We are struggling with making blanket statements on all types of fixed income. In general, some fixed income investors have become lulled into a false sense of security because performance has been so strong for so long. We simply believe that fixed income allocations are too high and there is risk that might surprise some participants this year. We recommend staying fairly short in duration, where the returns might be small, but the inherent risk to higher rates is limited.

As rates continue to rise here in the US, we find it hard to believe Fixed Income will generate superior returns. We believe there are two main reasons for this expected pressure. First is macro. Oil continues to weaken, US manufacturing is not robust, the strong US dollar will hurt and international growth is fairly tepid. The second reason is much more fundamental. There was an explosion in high yield bond issuance over the last few years. Issuance boomed during the zero interest rate policy era. Retail investors flooded this market in a desperate search for yield. This has come to a screeching halt.

High Yield Debt:

We expect additional volatility in high yield debt. Why? One needs to look deeply into what has transpired in this segment of the market. In the past, large capital expenditures were financed through the banking channel. Following the financial crisis, many banks hesitated to bring these loans onto their balance sheet. In addition, financial regulation prohibited some banks from doing this lending. Specifically, energy companies bypassed using banks to finance their capital expenditures and instead began to utilize the high yield debt market. This was fine, as long as the price of oil remained high. With a collapse in commodity prices, energy companies are beginning to default on these loans. We anticipate additional trouble for those energy companies especially those without a strong balance sheet.

One could argue that normal supply and demand trends should correct for this downdraft in energy prices. For example, producers in theory should decrease searching and drilling for oil now that the price is uneconomical. This would reduce supply and ultimately lift prices. That would be economical and reflect a well functioning marketplace.

However, there are unusual forces impacting supply. First of all, US producers need to continue to drill (despite the lower price) to pay off their debt burden. Some governments need to continue to pump oil, to support inflated spending initiatives (ie: Russia and Saudi Arabia). In addition, the US has begun to lift sanctions against Iran. After years of being excluded from the global oil markets, Iran plans on dramatically increasing their production. Chinese demand, which buoyed prices for years, has evaporated as well. Couple this with OPEC statements that it plans on abandoning its traditional role as a price stabilizer. OPEC seems content on continuing to pump oil despite these fairly low prices. Saudi Arabia is playing a multi faceted chess game where it seeks to crush US production and financially impact its Middle Eastern rivals (primarily Iran). All of this leads us to believe that the price of oil will likely be in a lower band for quite some time. The days of $100 barrels of oil seem like a far away proposition. As we write this today (early January), WTI and Brent broke under $30 per barrel for the 1st time since early 2004.

This energy thesis has an impact on the fixed income market, especially high yield debt. We are hesitant to gain significant exposure to this segment. We prefer lower credit risk and prefer US muni's. We would advise investors to stay very short in terms of duration. While being short duration does not insulate fixed income investors from losses, it hopefully avoids the ugliest parts of the market.

Sovereign Debt:

The definition of an investment is the action or process of investing money *for profit*. Specifically, we are very concerned with European sovereign debt trading at negative yields. While some believe this is a temporary trend, we will choose to bypass this as a solid "investment". The concept of putting money to work in a financial instrument that would essentially guarantee a loss of principal is not for us. Negative yields, on debt instruments denominated in a currency that their central bank is actively tying to depreciate, is not a sound investment philosophy for us.

Economists have debated negative interest rates for years, but many considered it purely a monetary phenomenon and not a real life issue. How bizarre are negative interest rates? We recently got a real life example from Switzerland. On Swiss region – the Zug Tax Authority - has just asked its community to not make early tax payments. Since cash receipts will cost the authority money, it is asking to receive its money as late as possible. We view this as just one example of how the concept of negative interest rates can have a distorting real world effect on the economy.

Real Estate:

Another asset class impacted by higher rates will be real estate. We anticipate that higher rates will eventually ripple through to long dated mortgage rates. With fixed, 30 year mortgages still only costing ~ 4.1%, we do not expect a material drop off in home prices. We would however expect the growth and pace of real estate's accent to somewhat slowdown.

Alternative Investments:

Many Alternatives, especially hedge funds, struggled last year to deliver excess returns and to justify their high fee structures. The average hedge fund was down 3% last year and this marks the 4th consecutive year this asset class failed to beat the broader market. Some select hedge funds should begin to generate better returns with heightened volatility, but this remains a segment of the market that requires intense manager scrutiny. We tend to favor long / short products that utilize fundamental research for security selection. Macro funds and market timing vehicles are less attractive - in our opinion.

Based on all of these factors, we favor US equities for outperformance this year. We are building a bullish scenario for stocks in 2016, even though the beginning of the year is off to a tough start.

Conclusion:

Recessions - and bubbles - come from excess. We believe that the US is in recovery mode, not even yet in its expansion phase. Zero interest rates were a function of the financial crisis and are no longer warranted. The US economy does not need to be on "life support" and is steadily improving. This led to the first - of hopefully several - rate increases. These increases would indicate that the US economy is growing and continuing to improve. Modest global growth, without worries of inflation, should create an ideal opportunity to invest in superior growth companies. This is an environment where stock selection is critical and where we believe active management may begin to outperform.

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