

April 1, 2016

Greetings,

In my last investment letter, I wrote that I expected more volatility this year. I was correct on that end as the market experienced its second 10% correction in seven months. This after the market did not experience a correction in a near record four years. A 10% correction every year and a half is a normal part of a healthy bull market. Two corrections in seven months is abnormal. What essentially happened was “a growth scare”. Basically, almost like a tidal wave, some market participants thought that there was a real possibility of a recession in this country. As frustrated as I am that the prices of many of our companies literally collapsed, I wasn’t all that concerned because I didn’t see any evidence, based on economic data that there was any kind of realistic possibility of a recession. Also, just as important, when our holdings reported earnings, very few reduced their earnings guidance. When people are emotional, they don’t think clearly. They just react. A client called me around when the market indices were near their lows and wanted to know why the market was going down. I wasn’t trying to be cute when I answered “because it is going down”. That is what happens in the very short term when people lose their heads. They forget why they own the companies they have and then sell them because they are fearful that for a short period of time, the prices of their positions will be temporarily lower than what it is at the present time. What is even crazier is that there were some great buying opportunities in January and early to mid-February. Regrettably, many people were selling good companies at cheap prices instead of buying them.

Speaking of crazy, the leading sector so far this year is the overpriced utility sector. We have no exposure to this sector nor will we. We also have zero exposure to the worst performing sector which is the financial sector, nor will we. Both professional, individual and large institutional investors continue to have the herd mentality as they chase the high dividend payers. The high yield fixed income market is risky because many of the companies that have issued the bonds are not fundamentally sound, otherwise the yields wouldn’t be so high. So; now you have individuals, large financial institutions and professional investors all chasing the same handful of companies in search of some income in a zero interest rate environment. The fact that these are equities (that carry the risk of equities) and not bonds are irrelevant. Someone on CNBC said recently that these kind of equities are behaving like bonds, even though they are not. Someone on CNBC just now said something very funny. He stated “that these people chasing the high dividend payers are like someone buying a cat thinking they own a small dog”. He then stated (and he is a pretty smart man) that so many of these people just don’t know what they really own and the risks associated with them. The fact that these are equities and not bonds are irrelevant to the people chasing them. The fact that these equities are overpriced based on any intelligent valuation method is also not relevant to

the herd/pack. What is relevant to the herd is that for the time being (and I acknowledge because of the Fed's current policy, this could last longer than I expected) and for the past several years, the herd is earning a safe, relatively (in this environment for now) strong income. In addition, the stocks have been doing well because (similar to the tech bubble in the late 1990's) when a significant amount of money chases a relatively small number of stocks, then they go up in price. While I also favor stocks that have nice dividend yields (more important to me is that the companies consistently raise the dividend payouts) and many of ours do, my primary focus is on owning companies that grow their earnings that are also reasonably priced. A picture is worth a thousand words. When companies such as General Mills, Con Ed and Altria Group (the U.S. version of Phillip Morris) have price to earnings ratios that are nearly twice that of Apple, then in my view, something is seriously wrong. Several years ago, before the chase began, most of these companies actually had higher yields than they do now. What happened was that once their prices continued to go up and since most of these companies don't increase their dividends by that much, their dividend yields went down. The problem is that now most of these companies have dividend yields that are only in the 3-4% range while Apple has a 2% yield. I won't go into all that goes along with Apple. I save that for the mid quarter update. Suffice it to say that when all of this capital is chasing these companies, guess what? That capital is not buying our holdings, at least not for the past nine months. Hence, our subpar performance.

The Federal Reserve is doing a great job of playing musical chairs. Let's just say that whoever positioned themselves to be invested as if the Fed were going to raise short term rates multiple times this year must feel like the person who didn't have a chair after the music stopped. The Fed made it clear late last year that this would be the year that they would begin the process of normalizing short term rates. After recently back tracking not once but twice, I would say the Fed may have lost some credibility. Personally, knowing what I know of Janet Yellen and what I see in the economy (both global and domestic), I didn't believe the Fed would raise rates more than once this year. The reason I say "may" have lost credibility instead of "did lose credibility" is because I give the Fed some credit for being flexible. In the past, when the Fed started raising rates it did so at each and every meeting. That is not the case now. I think it would have been smarter for the Fed not to signal to the markets that it was looking to raise rates 4 times this year. It certainly contributed to the stock market volatility. My view is that just a few months ago, the Fed had a poor grasp on how weak the economy is, both global and domestic. Part of the problem that the Fed didn't grasp (these people are supposed to be smart) were the effects of raising short term rates while Europe has negative rates and quantitative easing while Japan has negative rates. In addition, the strong dollar would have become the stronger dollar on steroids had the Fed continued to raise short term rates. In my view, one of the reasons the domestic economy is so mediocre at best, is because of weak exports. Exports (and corporate profits) are weak because of the strong dollar. Kind of like a vicious cycle.