Investment Commentary

June 30, 2017

Over the past quarter we added to overall stock and bond investments as corporate earnings improved and inflation declined.

In Washington, Republicans have made little progress implementing their agenda. Latest reports are of disagreements among Republicans themselves on healthcare and taxes. Expectations vary, including our own, on whether there will ultimately be substantive change on either front. Time is running out before another election year arrives, and legislation or compromise become even harder to accomplish.[1]

We maintain that the kinds of tax cuts proposed would raise the intrinsic value of assets materially, especially those of cash generating businesses paying the full federal tax rate of 35%. With all the disagreement and disorganization within the GOP and the president's behavior, it's hard to see the market being certain about lower taxes. If this is the case, then markets would likely jump if a tax cut is ultimately passed.

While politics have ruled headlines, a pleasant surprise has come in the form of strong corporate earnings over the first half of 2017. Corporate earnings had been negative for the six quarters prior to 2017. Forward earnings estimates from Wall Street may be too high, however, and there is a good chance earnings growth will slow going forward, requiring fiscal policy (i.e. tax cuts) to take the baton to justify higher prices.

International Stocks

In the first quarter we allocated some capital into international stocks through an ETF with broad exposure into "emerging markets." We followed up with an investment in "developed" European equities, again through an ETF.

For a long while we had avoided broad allocations in foreign-based stocks. The reasons were generally fundamental in nature: we believed the U.S. had superior economic prospects, governance, growth, and shareholder focus—with prices similar (and often times, less) to foreign stocks. We argued investors got higher quality and growth without paying up for it. And we were happy to point out that roughly 40% of S&P 500 earnings actually come from abroad anyway. One is a global investor with a basket of great, large, American companies.

Over time, this orientation has worked out. U.S. stock returns have handily outperformed broad international indexes over three, five, 10 and 20 year periods. For the additional risks one takes with foreign-based investments—less developed capital markets and additional currency risk, to name two—it seems there hasn't been much reward.

[1] It should be noted one area the Trump Administration has been effective, to the general delight of business, is in regulatory rollback. The number of pages in the Federal Register hit a record of 96,994 in 2016. Bianco Research estimates that the Trump Administration is on pace to eliminate tens of thousands of pages by the end of 2017.

So why invest in broad foreign equity markets now? To be clear, we still believe American companies are the most competitive, profitable, and valuable companies on Earth—and will be for quite some time. American investors should have the largest portion of their equity holdings in the American stocks.

And yet we have seen reasons to diversify some into foreign markets. The degree of outperformance of U.S. stocks and the dollar alone raises the case for increased regional diversification. Nothing lasts forever, and too often the best time to lean into an asset class and diversify is after years of its underperformance.

There is perhaps a value reason as well. Strong U.S. returns have resulted in a material premium for U.S. stocks. Using the S&P 500 index as a proxy, U.S. stocks sell for almost 19 times (bullish) 2017 earnings estimates. Developed markets (using the MSCI EAFE Index as a proxy—think Japan, Britain, France, Germany, Australia, etc.) sell for approximately 15 times 2017 earnings estimates. Emerging markets (through the MSCI Emerging Markets Index—think China, Korea, Taiwan, India, Brazil, Mexico, etc.) sell for 12.6 times 2017 earnings estimates.[2] Now one should not put too much in relative P/E ratios. An asset with a 13 P/E isn't necessarily cheaper than another asset with a 19 P/E. But there is something pleasant about diversifying in a way that lowers overall P/E and gains more income. (Developed and Emerging stock indexes carry dividend yields 3.0% and 2.4%, respectively, versus the U.S.'s 1.9%.)[3]

Perhaps the most important reason is a rising sense that *anything can happen* when it comes to U.S. politics and the Trump Administration. While we focus on pro-growth legislation and tax cuts as catalysts, we have to be vigilant of outcomes that raise risk. A trade war or geopolitical conflict are just two examples. It may not take much for investors globally to pull money out of the U.S. and the dollar, which may favor more exposure abroad.

Our position outside the U.S. is still modest, as is our conviction level. We will keep you apprised as our views and strategy develop.

Notable Trades

The following summarizes major buys and sells placed during the quarter in our Core strategies (conservative, asset allocation-driven and absolute return-focused portfolios representing a majority of our clientele). Note that not all clients or portfolios participate in every trade idea due to clients' circumstances, account size or other factors. Some portfolios are managed primarily, or exclusively, with exchange traded funds.

New Buys:

The Charles Schwab Corporation (Ticker: SCHW)

Charles Schwab is the largest retail discount broker with $3.0 trillion in assets under custody. Schwab makes money through net interest margin and fees from proprietary investment products and investment advice. Schwab has operational leverage to a rising stock market and higher interest rates. Schwab is also a bank, though it has not really pushed banking and related financial services; we expect the company to increasingly monetize its millions of customer relationships. Schwab has almost always

[2] Source: Bloomberg.
[3] Ibid.

traded at a good premium to the market. Though shares are not cheap at 24 times earnings, we believe Schwab's premium was at a multi-year low, and earnings growth should justify prices paid. Dividend yield: 0.8%.

iShares Core MSCI Europe ETF (Ticker: IEUR)

We expanded our allocation into foreign-domiciled equities with this ETF offering exposure to a broad range of European equities. The troubles of Europe have been well-documented, and we have a hard time seeing Europe do as well economically or returns-wise as the U.S. over longer periods of time. But those sentiments, shared by the market, along with years of European under-performance, often signal a good opportunity to diversify. Investors meanwhile pay a lower multiple for earnings and get more in terms of dividend yield. A weaker dollar should favor this investment as well. Dividend yield: 2.5%

Facebook, Inc. (Ticker: FB)

We picked up a small holding in the world's largest social media company. Facebook has some 2 billion active monthly users, with some two-thirds of them daily users. Facebook has morphed to a sticky service with large network effects for users and powerful, cost-effective advertising solutions for business customers. Owners today pay about 28 times earnings for a company growing 25% or more annually. Owners also get potential free "options" in the form of a focused research and development effort. Facebook is spending billions on potentially breakthrough platforms including artificial intelligence and augmented reality. Management has proven to be world class. The boy-wonder writing code in his college dorm room has shown a rare ability to learn and develop into an exemplary CEO. Dividend yield: none.

SPDR S&P 500 ETF Trust (Ticker: SPY)

After reducing equity exposure in the first quarter, we increased in the second quarter, a good amount of which was done in one trade with this S&P 500 ETF.

Two-year Treasury Notes

Annual yield to maturity at purchase was approximately 1.35%.

Sells:

The Walt Disney Company (Ticker: DIS)

We have observed Disney closely since we purchased shares in the fourth quarter last year. The movie business is hitting on all cylinders as it continues to monetize its animation, Marvel, and Star Wars content and release blockbuster after blockbuster. However, the studio's success only covers for the troubles at its cable business (especially its ESPN channels) which remains a large contributor to Disney's overall profits. ESPN's problems are multiple in nature and will take a good amount of time to fix (including overpaying for long term sports contracts); some problems may be secular and long term. Disney is still a great company; however, we believed we had better uses for the capital.

W.W. Grainger Inc. (Ticker: GWW)

We sold Grainger at a loss. The distributor of products used to maintain, repair and operate facilities has been well-managed over time; however, competition and the internet have become increasingly impactful to the company. The result has been poorer pricing power and lower volume growth. That even a distributor as good as Grainger could be hurt—it was early and effective in online sales and has maintained high customer satisfaction—has made us re-think the competitive position of distributors as a whole.

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