Profitable Risks/Unprofitable Risks

Loss avoidance is a key to long term investment success. We deem certain risks profitable, to be exploited with sound research, while other risks are inherently unprofitable and should be avoided.

Our Risk Management Tenets

- We believe in extensive asset class diversification
- We actively manage tactical asset allocation policy
- Our stock selection process emphasizes intrinsic value, innovation, and durable competitive advantages
- We believe excess returns are achievable due to market inefficiencies that persist over time
- We seek to build diversified portfolios of stocks with attractive valuations, quality balance sheets and above-average earnings growth
- We closely monitor valuation measures to limit downside risk
- We carefully control portfolio average capitalization and beta

EQUITY MARKET OUTLOOK

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The Trump Rally – Hope and Change

Since our last Equity Market Outlook, much has changed. Last November’s US Presidential election result that was surprising to most observers has brought about much speculation as to the future direction of not only the U.S. but also, given other populist surges in other locales, the world overall. The question is – how much have things really changed? After a two-term presidential administration which was originally brought into office on a mantra of hope and change, obviously, the answer is a lot. The next most important question is – how will this change manifest itself for investors over the foreseeable future?

- US Equity markets rallied on the election news, and even right before it, reversing a slide as investor optimism about changes in economic policy takes hold.
- Risk continues to be high despite the fact that certain measures of short-term volatility have been trending downwards.
- Corporate fundamentals are finally turning around and showing some signs of emerging growth.
- Quantitative Easing is still a major consideration effecting both asset prices and underlying fundamentals around the world.
- European Central Bank (ECB) buying of non-financial corporate bonds (announced in March 2016) stimulated yield-seeking behavior, accelerating the flow of funds into low-quality assets.

In this quarter’s Equity Market Outlook, we review the major possible effects from the presidential election and new administration as well as the emergence of growth opportunities around the world.

The Era of Big Government is… changed

Over the last decade and a half, the direction of public policy in the US has been a more robust federal government engaging in more energetic fashion with all participants in the economy. From massive expenditures on a variety of public well-being initiatives, to massive expenditures on foreign entanglements and interventions, from massive amounts of new regulations to massive interference in markets (e.g., mandates), and from massive spending increases to massive tax increases, the burden placed on private sector production in the US has grown steadily, and massively. Perhaps the clearest and most distinct change brought about by the election of Donald Trump as President (coupled with the ability to work with Republican majorities in both houses of Congress)
is the immediate cessation of this steady build-up of burdens, at least as far as regulations, mandates, and current taxes are concerned.

All by itself, this change appears to have resulted in an immediate mark-up in expectations for near-term fundamental (revenue and profit) growth. Expectations were already improving from the flat growth in revenues and declines in earnings evident over most of the last year and a half and the Trump presidency has stimulated that optimism.

The initial post-election run-up in stock prices through the Christmas holidays repriced the upside potential in economic and earnings growth. Since that time, domestic equity markets have ebbed and flowed within a narrow range and have not advanced significantly. It appears the stock market has adopted a more “show me” approach toward both the probability of all the hoped for reforms actually materializing as well as the ultimate impact of the new policies.

Low Quality Rally Continued After Election
As we reviewed in this space last November, investors have an elevated appetite for risk at present. This is evident when looking into the underlying characteristics of the types of stocks that have performed best in the last year. In general terms, lower quality stocks have been outperforming higher quality ones. Our assessment is that this is largely driven by the massive amounts of liquidity still being pumped into global markets by central banks, primarily the European Central Bank, the Bank of Japan and the Bank of England. Partly, this is a function of the old definition of inflation: “too much money chasing too few stocks.” This preference for lower quality persisted in the post-election run-up in stock prices however there are at least preliminary signs of a shift back to quality in the first month of 2017.

The best performing sectors since the election have been the lowest quality sectors, in terms of trends in expectations about future growth of underlying fundamentals. Excluding the Energy sector (with its substantial retrenchment in earnings over the last two years and expected huge bounce back in earnings growth this year), on average the sectors outperforming the S&P500 since the election have seen their 2017 EPS estimates reduced by 8% so far this year; while the sectors which have underperformed the S&P500 since the election have seen their 2017 EPS estimates cut by only 4%. Furthermore, trends in fundamental growth in the 3rd and 4th quarters of 2016 were running inverse to stock performance. In general, companies with weaker fundamental growth in those quarters saw better performance in their stocks than the rest.

However, the differences among the growth characteristics of the best and worst performing sectors is narrowing compared to the middle part of 2016. Especially as the market has progressed through the latter part of January, an investor preference for quality (i.e., companies with more attractive earnings growth and less leveraged balance sheets) is showing signs of emergence.

The pattern of equity investors preferring lower quality companies’ stocks has been mirrored in the credit markets lately with significantly higher performance coming from the lower quality segments of the bond markets, driving yield spreads on junk bonds to levels which normally signal overvaluation. Junk bond credit spreads in the aggregate have reached levels near the bottom of very long-term ranges (with the exception of crisis periods). As of 1/31/17, junk bond risk premiums, as measured by the Barclay’s High Yield Corporate Bond OAS (option adjusted spread, referring to call options) on average were 3.88% higher than 10-year U.S. Treasury Bond yields. For reference, at the beginning of 2016, that spread was 6.74%; and at the depths of the Financial Crisis / Great Recession, when default risk was at its highest, the High Yield OAS peaked at 19.71%.

A Return to Quality Accompanying a Return to Growth
That a return to quality seems to be emerging in early 2017 is a good sign for active investment management, which generally suffered in 2016 as indiscriminant buyers ignored fundamental growth distinctions. The core philosophy underlying COAM’s equity portfolio management process is that fundamentals ultimately drive stock prices. When a market environment persists in which the companies with the worst trends in underlying fundamental growth are rewarded with investor dollars and superior stock returns, that philoso-
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Unless otherwise noted, all performance and return data sourced from Bloomberg, LP, February 15, 2017.

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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