Stock Wars

Late last year the much anticipated release of the latest installment in the Star Wars series opened to critical acclaim and huge crowds. First released in 1977, the original Star Wars created an instant phenomenon with fans waiting in line for hours to get tickets. Of course, this was before you could order tickets online and download them to your phone. The original movie was followed by two successful sequels, and then by a "prequel" trilogy that garnered a much more subdued reception from critics and fans. This latest movie, however, seemed to capture the buzz of the original.

The financial markets are in the midst of their own prequel, as well, following a number of strong years fueled by historically low interest rates and massive amounts of Fed liquidity. The stock market was a major beneficiary as companies used an ample labor pool and easy money to drive down costs and boost operating results. Corporations applied this improving cash flow, and a willingness to leverage their balance sheets, to expand stock buyback programs and magnify the impact of reported earnings per share. It was a great story as long as the Fed liquidity continued and rates remained low.

As 2015 unfolded some of these factors started to unwind and we began to get the feeling that we had seen this before. The Fed had already started to reduce the flow of liquidity as it opted not to extend their quantitative easing programs. While the reduced liquidity flow seemed to go smoothly, the move created upward pressure on the dollar relative to other currencies which hurt the earnings of multinational corporations. As the Fed began to broadcast their intention to raise interest rates over the course of the year the resulting increase in financing costs raised concerns about economic growth and the continued improvement in operating results.

The economy was buffeted by a number of adverse developments as 2015 progressed. The dramatic decline in the price of oil crushed the burgeoning shale exploration industry leading to widespread layoffs, a collapse in energy sector capital spending, and concerns about the financial viability of this highly leveraged industry. The lack of any perceived income growth among middle income wage earners contributed to weak retail sales and increased competition among retailers fighting for market share despite razor thin operating margins. Political pressure to raise the minimum wage and higher health care costs led to store closings and layoffs at several well known retail names.

As global growth slowed China began to feel the pressure of years of overinvestment in infrastructure projects and reliance on an export based economy. A spike in the Chinese stock market followed by a sharp decline was met by a ham-handed intervention by Chinese policymakers making a difficult situation worse for the markets. Growth slowed as grandiose real estate projects stood near empty and industrial accidents increased due to mismanagement. These policy mistakes illustrate the difficulties of central planners managing change in a command economy.

Under the circumstances it comes as no surprise that revenue growth has become increasingly scarce, and earnings misses all too common. The Fed finally found the courage to raise the Fed Funds rate by 25 basis points, after backing off earlier in the year, while making

sure that investors knew that the path of further rate increases remained highly uncertain. Equity markets held up reasonably well as a strong rebound in October regained the ground lost during the summer selloff. Absent the August decline and October rebound, the stock market traded in a tight range, with narrow leadership among a few high-profile stocks. Dubbed the FANG stocks, Facebook, Amazon, Netflix, and Google, these few names accounted for a significant portion of stock market return for the year. The extreme valuation multiples for Amazon, Facebook, and Netflix in particular did not seem to matter as investors loaded up on the names, reminiscent final stages of 2000 when the market was driven by AOL, Worldcom and several other names at similar valuations, many of whom are no longer with us.

While it is tempting to go back to those prequel days and jump on board those momentum stocks, we remember that those episodes didn't have happy endings. We believe that successful investing starts with strong companies whose stocks represent reasonable valuations based on earnings expectations and financial strength. Despite the allure of these great story stocks, we remain true to an investment process that has the demonstrated ability to identify companies with reasonable growth opportunities, strong balance sheets, and free cash flow. We will invest in companies with attractive valuations based on these factors and where management has a clear focus on execution. We believe that a consistent application of these time-proven measures will enable us to prevail over the course of a full market cycle.

Sincerely,
Daniel A. Morris