Market Update
November 2016
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In this November letter, we cover a lighter topic on why the market may be so hard to beat on a regular basis, and then some comments on a much more serious event that took place with last night's vote in Italy on constitutional reforms.

IS IT REALLY A LOSER'S GAME?

Peter Bernstein was a well known financial historian, economist, and educator who made significant contributions to investment research, often questioning and challenging in his writings the workings of the money management industry. I came across some of his papers recently—he passed away in 2009—and it reminded me of a baseball analogy piece he wrote back in the 90's based on an interview he did for the book, Investment Titans, and how relevant it is in today's investment environment. The interview is over 20 years old but still very relevant and I thought I would resurrect it for this month's commentary, especially since it has application to our view on market benchmarks and how important the income component is to investment returns.

Bernstein said that in baseball, a .400 batting average was an amazing achievement, since most batters were lucky to bat .300 in any season, with the average for all players at the time being around .260 since record keeping began in 1870.

The frequency of .400 hitters seemed to decline over time. Bernstein noted that in the 30 seasons between 1901 and 1930, at least one batter reached .400 in nine of those 30 seasons. So on average every 3 to 4 years we would have a .400 hitter. Ted Williams of the Red Sox had a .406 average in 1941, and since then no player has managed to hit that mark. So Bernstein asked the question: Where have the .400 hitters gone? His first inclination was that batting skills had declined, but what he found was that fielding averages had actually increased over this time period. The players had gotten better.

He then looked at the investment world and asked a similar question. Where have all the .400 hitters gone in the investment world. Where are all of the money managers who claim to have the ability to beat the market averages year in and year out? Are today's managers less talented, or has the market become so much more efficient with the immediate and mass dissemination of information that is literally at our fingertips. Peter Bernstein came to a similar conclusion. Like baseball, the players-professionals-in the investment world became more skilled in analyzing companies and disseminating information. "Competition is too tough for somebody to hit .400. The market is full of smart, eager, highly motivated people. It's hard to be a winner by enough to matter, or to stay a winner by enough to matter."

A telling statistic—Retail investors, with little information at their fingertips, comprised approximately 70% of investor assets in the 1970's. That number has since flipped to today, where over 70% of market assets are in the hands of institutional investors who direct teams of analysts to dissect balance sheets and income statements, evaluate macro and micro trends and, as Merton Miller once said, to—aggregate, evaluate, and incorporate information into price targets.

With all of this information flow available, it is hard to argue that the players in the investment industry have gotten better and that it is difficult at best, and costly to attempt to consistently beat the averages. This brings us back to the importance of focusing on the things we can control, and not on what is out of our control. One of those things is the importance of dividends to equity returns.

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WHY DIVIDENDS AND DIVIDEND GROWTH MATTERS.

We are hearing a lot from the media about how higher yielding dividend stocks are falling out of favor as interest rates rise and alternative income sources to dividend paying stocks appear. Yet the facts bear out that since the great depression, dividends have accounted for a remarkable 60% of the S&P 500 Index return! So yes, there will no doubt be cyclical episodes of investor rotation in and out of various style equities—dividend payers included. But in the long run, we believe that a strategy of buying well managed companies that share with investors will not just provide market-like returns, but will also minimize volatility for those clients who are drawing from their portfolios to meet spending goals. Our approach of building cash flow backwards recognizes the income component of equity returns and the impact this has on volatility over time.

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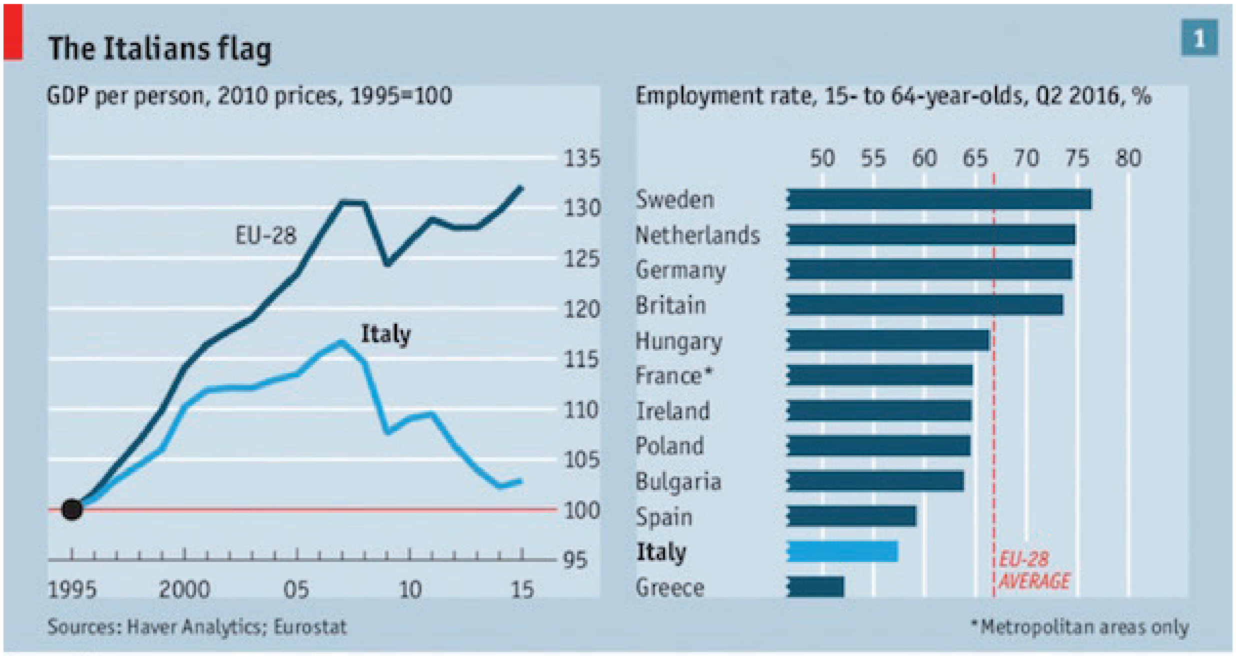
It appears we have finally exited the earnings recession, with earnings growth for the third quarter actually increasing by about 3%. As we look ahead to the fourth quarter of 2016, estimates are for earnings growth of 3.3%. This number has decreased from prior expectations of 5.3% fourth quarter growth. From a valuation perspective, the forward P/E ratio for the S&P 500 is 16.7. This is above the 5 –year and 10-year averages but not at lofty levels considering low interest rates and increasing corporate earnings. We have mentioned in the past that we were somewhere between the skepticism and optimism stage of market sentiment, and nowhere near the euphoric backdrop that ushers in bear markets. Optimism now appears to be taking over, as investors welcome the possibilities that deregulation, more fiscal spending, and lower taxation bring to economic growth. So as we move further out on the sentiment continuum to a more positive tone, attention will turn more to corporate earnings and exactly how and if the proposed policy changes translate into real corporate profits.

The Italian Vote—Italy moves closer to crisis

One of the concerns we mentioned as a new block in our wall of worry in our September letter was the referendum vote that just took place last night in Italy. Matteo Renzi played a hand similar to Britain's David Cameron and lost on a no vote against constitutional reforms that would allow Renzi's government to operate more effectively. Having lost the vote, Renzi will now have to step down, paving the way for another government—Italy's 63rd since World War II.

Matteo Renzi wanted to work within the Eurozone structure, and believed the changes he proposed would move his country forward and strengthen Italy's position in the Union. Italy now faces the prospect of an election that ushers in a far right nationalist candidate. The possibility of Italy leaving the Eurozone has just increased, and the stakes are much bigger than Britain's vote to leave the European Union. In addition to Italy's banking crisis, the country has issued a mountain of sovereign debt. Any move to leave the Eurozone would kick-start a event that would dwarf the Greek debt crisis in terms of market impact—Italy is the 8th largest economy in the world.

Sure. A return of the Lira might allow a country like Italy to become more competitive in global markets, but that is a longer term outcome that would come after much pain in the form of a major banking crisis. As the economist John Mauldin recently noted "the banking mess turns the political mess into an economic mess."



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But the pain felt of a major devaluation in the Lira against a mountain of Euro and dollar denominated sovereign debt would crush Italy and it's banks. And not to be forgotten, the European Central Bank(ECB), has purchased a huge amount of that sovereign debt with the objective of breathing life back into the weak banking system. Exiting the Eurozone and forcing the ECB to pull that plug would have very serious market consequences across the globe. For these reasons, we do not think an exit is the odds bet.

As we write this letter the morning after the vote, the markets remain relatively calm and perhaps are still assimilating what this might mean. For now we are watching the situation closely as we enter what we believe will be a period of heightened volatility in the first quarter of 2017.

For now, we would like to wish all of our clients a very happy and safe holiday season.

We are always here for any of your financial needs, and we welcome an opportunity to meet with you to review your accounts and help you in any way we can.

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