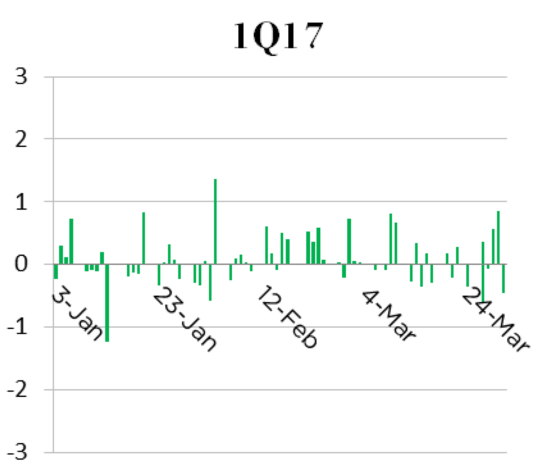
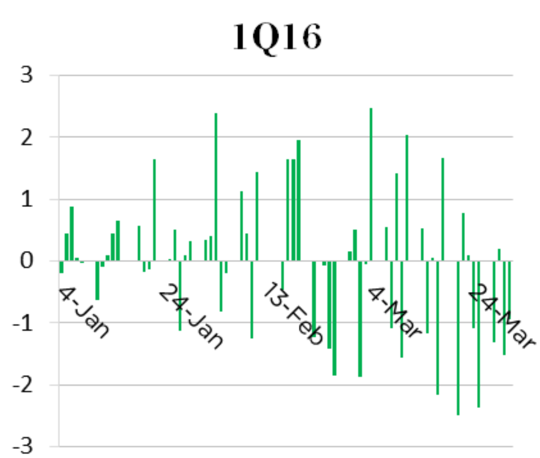
Overview

The first quarter of 2017 was kind to investors, and our portfolios advanced across the board. With the exception of Japan and Norway, virtually every equity market around the world reported positive returns in its home currency. Even politically beleaguered Brazil and trade-threatened Mexico boasted strongly positive stock markets. At home, large companies out-performed small, but all broadly observed benchmarks were in the black. Despite the well-advertised rise in the Fed Funds rate, even bond investors made money. Some news outlets have christened this the "Trump Rally," but we are not so sure. We are having trouble reconciling the static coming out of Washington with the eerie serenity of first-quarter stock price movements.

Though our nation's capital has been an unusually eventful place recently, U.S. stock markets have responded with record calm. On only two days in the first quarter did the S&P 500 change more than 1% in either direction (left hand chart), the lowest level of daily stock price volatility in any quarter since 1965. In comparison, one year ago (right hand chart) there were 26 days in which stocks moved more than 1% and six greater than 2% over the first three months.





Investors, ourselves included, are inclined to be highly wary of uncertainty. Our elected officials are providing very little visibility into the likely outcomes of major policy initiatives (healthcare, taxes, trade, foreign policy and regulations to name a few). We think it is likely that the orderly advance of stock prices indicates that investors are focusing more on monetary policy makers than politicians. Fed Chair Yellen and her colleagues have done a good job of telegraphing their intentions and then following the script. The interest-rate hikes in December and March surprised no one. It is likely that most market participants are

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confident that future interest-rate policy will be orchestrated in an orderly and well-communicated fashion.

This is no trivial matter. The "zero interest rate policy" (ZIRP) had been in place since 2008. It was likely a necessary response to the deep economic wounds caused by the financial crisis. However, as time went by investors began to question whether the policy could or would ever come to an end. Mounting concern that global economies had become hooked on ever increasing mountains of cheap credit seems to have given way to rising confidence that central banks will be able to return to more normal policies. We feel that this may be an important inflection point. We have been in a declining interest-rate environment since 1981. A transition to a sustained period of rising rates, if it occurs, will likely require investors, businesses and policy makers to adjust their frameworks for calculating potential risk and reward.

Our Portfolios

In our last commentary, we stated that, though the healthcare sector was a detractor from performance in 2016, we still felt confident that our portfolio companies would prove to be profitable holdings. We were pleased to see our patience begin to be rewarded in the first quarter. Though we had one loser (Gilead), the rest of our healthcare holdings outperformed the market as a whole, some significantly. Where they had grown too large, we trimmed positions in Thermo Fisher. Proposed deep cuts in the budget of the National Institute of Health could have adverse near-term effects on both earnings and valuation. We still believe the company represents good long-term value, however, and fully intend for it to remain a core holding.

Holdings in the technology sector all provided solid returns, with each outperforming the S&P 500. Apple continued on the upward trajectory that began in the spring of last year. Oracle finally seems to have convinced investors that it will stand up to new competition in a world of cloud computing and successfully transition its business. We have been patient and confident holders, which has not been easy.

Financial companies, which had been so strong over the last six months of 2016, largely took a breather in the quarter. Investors became less optimistic about the promise of an easier regulatory environment. As we did with Thermo Fisher, we trimmed positions that had grown too large. However, we are still optimistic about the companies we hold.

Looking Forward

In our end-of-year commentary, we struck a note of caution, pointing to high valuations and political uncertainty. On the political front, old-fashioned gridlock seems to be taking the sting out of some threats, like the potential for unhealthy protectionism. But, the overall uncertainty level remains higher than average. As the market has advanced, valuation continues to be a worry. We enter earnings season with very few negative pre-announcements or "early warnings" of disappointing results. That tells us that most companies likely did pretty well in the first quarter. Investors will be listening to what managements have to say about future prospects. Companies that project a lack of confidence will likely see declining stock prices, especially expensive stocks with high price-to-earnings multiples.

In the short run, the transition from ZIRP to normal could very well be benign. We continue to believe that higher interest rates may lead to greater consumer confidence, at least in the near term. Positive signs might include a pick up in housing starts or an increase in retail sales (especially for struggling general merchandise and grocery stores). Economic growth in the U.S. as well as Europe could be stronger than expected. Any of these factors could justify current investor optimism, likely leading to higher stock prices. As always, risks stem from unknown or unforeseeable events. Investors would not welcome an unexpected arrival of inflation (improbable but not impossible) as a result of a trade war or an oil shock precipitated by conflict in the Middle East. Another defection from the Eurozone might also cause market dislocation.

We could go on, but we will not. As we have said countless times, we focus more on the specific than the general. We invest in companies that have distinct advantages in their industries, that generate cash and use it wisely. That the overall stock market may rise and fall, unpredictably, is obvious and beyond our control. We firmly believe that the best approach is to invest in companies that are equipped to manage challenging periods and as a result, emerge as ever-stronger competitors.

Important Note About SA Investor Commentaries

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