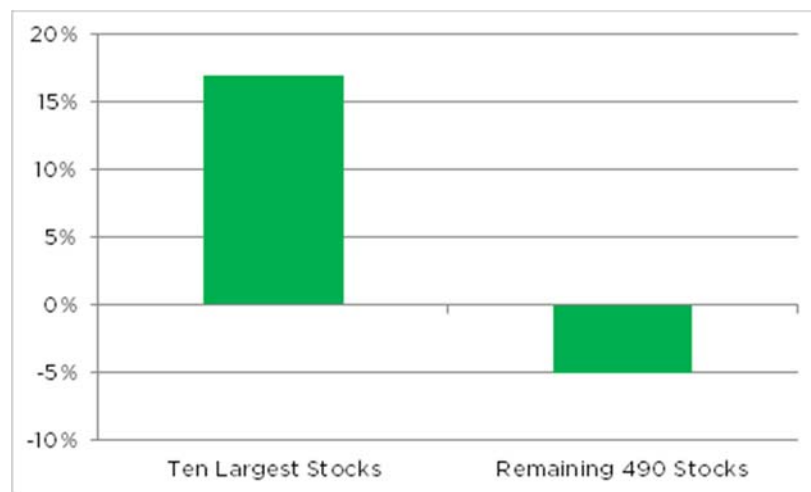


*Rip now resumed his old walks and habits; he soon found many of his former cronies, though all rather the worse for the wear and tear of time; and preferred making friends among the rising generation, with whom he soon grew into great favor. – “Rip Van Winkle” Washington Irving*

Market observers spent much of 2015 wondering when, or even if, the governors of the Federal Reserve Board would attempt to abandon the zero interest rate policy that had governed the monetary environment since the financial crisis. By mid-December, when Fed Chair Janet Yellen revealed the decision to raise the Fed Funds target range to 0.25 to 0.50%, the widely anticipated announcement had all the suspense of the Rockefeller Center Christmas Tree Lighting. The outcome was no longer in doubt. The hours and days that followed did feel the rustling leaves of moderate market volatility, but there was no seismic activity recorded. Had a modern day Rip Van Winkle awakened at year-end after a brief 12 month nap, he would have hardly noticed a difference.

To close the year, the ten year US Treasury note yielded 2.27%; virtually the same as a year earlier. The S&P 500 finished the year within 100 points of its starting level, though the stability of beginning to end belied turbulence in between. Much like Dr. Seuss’s “Cat in the Hat” tales, there was a period of chaos followed by a rapid, almost miraculous cleanup. The S&P, which was down 6.44% in the third quarter, rebounded 8.44% in October alone. However, the recent volatility was not the most important stock market story of 2015.

The S&P 500, generally considered the best proxy for U.S. stock market performance, is a **capitalization weighted** average. This means that the biggest companies have far more influence on the calculation than the smallest do. Rarely has the weighting effect had more impact than it did in 2015. The 10 largest companies in the S&P 500 had an average return of 17%, while the other 490 actually lost money on average (down 5%) *See chart below.*



Source: Strategas Research Partners

As it happens, we favor four of the ten largest companies: Apple, Microsoft, Alphabet (Google) and GE. These, along with positions in the healthcare sector, were meaningful contributors to performance. But it is an old investor's maxim that one never owns enough of the good ones, and 2015 was an uphill battle for investors who did not have relatively big positions in the largest companies.

The steepest hill was found in the energy patch, the old "cronies, rather the worse for the wear and tear of time". The sector once commanded more than 30% of the total market capitalization of the S&P 500. Today it is less than 7%, about the same as the combined market value of Alphabet and Apple (the "rising generation").

The energy sector finished the year down nearly 25%. To put it bluntly, we did not escape the carnage. We did make some good decisions with our energy holdings. We reduced risk in February and August by selling positions in exploration and production companies that are highly exposed to the price of crude oil and natural gas. These proved to be prescient decisions; our former holdings finished the year at approximately half the price for which we sold them.

We thought we were taking shelter on higher ground by focusing on companies in the energy pipeline business. Pipelines are known as the "mid-stream" because they simply transport oil and gas from well to refinery or other end-user. We calculated that mid-stream companies would provide a greater degree of safety for two reasons: 1) their revenues should be steady because they are tied to the volume of oil or gas that passes through their pipes not the declining price of the commodity itself. 2) The stocks had relatively high dividend yields that we expected would provide cushions in a turbulent market. We were right about revenue, but dead wrong about the yield. Investors began to question the sustainability of the dividends and the companies' ability to raise the capital needed to grow. These stocks declined meaningfully in the fourth quarter.

Our losses in mid-stream companies painfully highlight the vulnerability of a business that requires frequent access to capital markets to fund growth. We were not blind to this risk, but failed to appreciate how quickly the negative feedback loop of lower equity prices and higher debt costs would progress in the absence of meaningful deterioration in the underlying business. Once this spiral took hold, traditional valuation methods were rendered obsolete.

Many have expressed concern that Fed actions to raise interest rates will prove to be a negative for stocks in general. We do not believe that is currently a significant risk. In fact, we feel there is a very strong case to be made that only short term rates will rise and that longer term rates may stay level or even fall slightly. This is known as a "flattening of the yield curve". (see Appendix - "Bond Jargon"). The laws of supply and demand should keep longer term rates in check. There is nothing new on the demand side of the equation. Traditional investors, like insurance companies and pension funds, buy the longest dated securities in order to match their liabilities. Foreign buyers continue to have an incentive to buy long-term U.S. bonds because our currency has been strong and our rates, as low as they are, are among the highest in the developed markets (see table below).

Country	10 Government Bond Yield (%)
United States	2.31
United Kingdom	1.99
France	0.99
Germany	0.63
Japan	0.26

Source: FactSet

While demand for treasury securities should remain robust, net new supply will remain relatively constant year-over-year, however the mix of new issuance will be weighted with shorter maturing liabilities (treasury bills). The Fed also plans to reinvest the proceeds of approximately \$200 billion of maturing securities that it owns through its Quantitative Easing strategy (quantitative easing (QE) is a monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective). The result is that the global markets will likely have fewer, longer U.S. Treasury Securities available to them compared to last year, at a time when global demand for those securities appears to be higher. There simply will not be enough longer notes and bonds to go around which should cause interest rates on those securities to remain stable. If this is the case, the interest rate environment itself should not be an impediment to the stock market.

We are keeping an eye on a couple of conditions that are sometimes early warning signals of a potential stock market decline. Within the bond market, there is observable stress. Junk bond “spreads have been widening” (see “Bond Jargon”). In short, despite the fact that rates on US Treasury securities have stayed flat, low quality borrowers have had to offer higher interest on their bonds to attract lenders. This is usually a sign that investors are losing confidence in junk bond issuers. An alternative, no less worrisome, explanation is that bond investors are already anticipating an environment in which credit is generally less available and lower quality issuers will have to pay higher rates to meet their borrowing needs. Tight money and deteriorating credit conditions are not a good backdrop for a strong stock market.

The other condition that worries us is known as market “breadth”, to which we alluded earlier by pointing out the lopsided strength of a small number of the largest companies. A “narrow” market, when only a handful of stocks advance, usually means that the average investor is not fully participating in market gains.

Given the robust market environment since 2009, wide bond spreads and narrow stock market breadth could be signs that investors are starting to worry that the party might be over. Confidence is a fragile commodity; nervousness in one asset class can spread to others. However, it is important to note that the fundamental backdrop is nowhere near as risky as it was before the financial crisis. Excess leverage simply does not exist to the extent it once did. The U.S. economy continues to grow; we do not believe it will be derailed by slightly higher short-term interest rates. Europe still seems to be improving. China is struggling, but its woes alone are not sufficient to create a dangerous global bear market.

We believe our portfolios are well positioned to withstand market volatility. If other investors make poorly calculated decisions based on fear, we stand ready to capitalize on their mistakes. We are not predicting a downdraft, but should one occur we believe it will create more opportunity than risk.

## Appendix

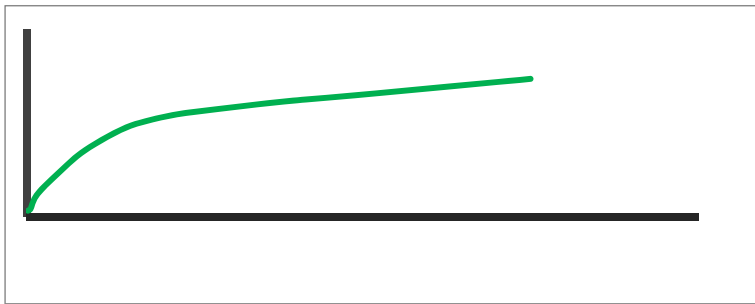
### Bond Jargon

It seems that bond market participants use more than their fair share of jargon. Fixed-income investing is a very quantitative process; somehow math just lends itself to idiomatic expressions. The phenomenon is so common that it is easy to forget that many terms mean absolutely nothing outside the confines of the financial industry. Below are the definitions of a couple of terms used in this commentary.

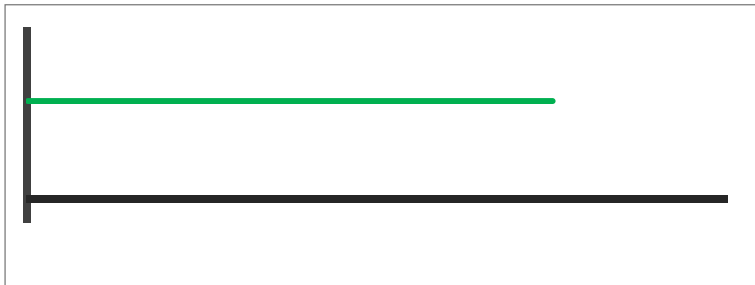
### Yield Curve

Broadly speaking, interest rates on bonds will vary for two reasons: credit quality and length of time to maturity. Both of these variables are indicators of risk. Investors demand higher rates of interest to induce them to take more risk. The yield curve isolates maturity as the only factor determining different rates of interest. Using our old friends, the X and Y axes, the yield curve plots the interest rates of bonds having equal credit quality but different maturity dates. The most common yield curve compares the interest rates of US Treasury securities from three months to 30 years. The curve is considered “normal” when short rates are lower than long rates, “flat” when rates are roughly equal for all maturities, and “inverted” when long rates are lower than short rates.

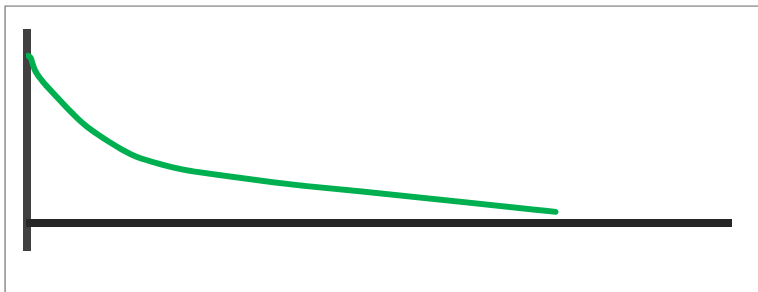
### Normal



### Flat



## Inverted



## Spread

“Spread” is also a tool to identify risk among different bonds. While the yield curve isolates maturity risk, the spread is a measure of credit risk. The spread is simply the difference in interest rates of two bonds (or classifications of bonds) with the same maturity. In the vast majority of cases, the spread is measured between US Treasury securities and something else. US Treasuries have the lowest credit risk of all debt instruments, so they serve as the reference in most discussions about spread. A small, or “narrow”, spread indicates that investors are confident that a bond has little risk of default. A large, or “wide”, spread indicates a greater degree of caution or outright fear. “Tightening” or “widening” spreads reflect changing attitudes about risk in fixed income markets.