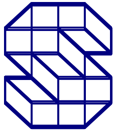
Steinberg Asset Management, LLC

# Second Quarter 2015 Commentary and Outlook

Major stock averages ended the quarter largely unchanged while continuing to hover near historic high levels. This persistence is impressive given the uncertain international background: slowing global growth, a meltdown in Chinese stocks, rising terrorism and the Greek debt crisis with the existential threat it poses to the European Union all contributed to a worrisome environment for equities. Domestically, investors were also focused on the timing of the Federal Reserve's move away from an ultra-easy monetary policy and the potential for that move to impact economic growth and corporate profits.

The resilience of U.S. equity markets reflects several factors, among them, the generous liquidity provided by the Fed, rising corporate profits, and the attractiveness of U.S. assets to foreign investors. In a troubled world, the United States has served as a magnet for capital from around the globe.

## A Historically Long Business Cycle

Equity valuations are stretched and if global growth slows, U.S. corporate earnings could fall short of expectations. Also, the consumer has adopted a more cautious spending posture of late. Still, any market-related correction would likely be modest and short lived; extended valuations are not the same as a bubble.

After the deep recession of 2008-2009, we have experienced an unusually slow recovery. This means the business cycle has not matured as much in this recovery as is normal. For example, as a percentage of GDP, the cyclical sectors of the U.S. economy (e.g. housing and non-residential construction) are still close to their lowest levels since the cycle reached bottom in 2009. Generally recessions begin only after these sectors have heated up. In addition, it is worth noting that historically recessions have started, on average, roughly five years after a course reversal for a series of select signal indicators, including monetary policy, a peak in corporate margins and profits, and accelerating wages and inflation. To date these signals have not begun to flash signs that a recession is in sight.

The economic expansion has significantly exceeded the post-war average in length without showing signs of significant excess, presenting the Fed with a policy conundrum: Since the start of the year, reported growth and productivity gains for the economy have both again disappointed. For the Fed, this subdued level of growth demands that the central bank exercise considerable caution in raising rates. On the other hand, low productivity suggests that increasing capacity utilization, despite low economic growth, puts upward pressure on inflation. Coupled with indications that the U.S. is drawing closer to full employment, this may argue against any delay in beginning to move away from the easy monetary policy. Of course, divining the correct policy rate is difficult in even the best circumstances.

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Should the Fed choose the wrong course, the consequences of that policy error would be magnified at a time when the global economy is mired in secular stagnation. Emerging market growth, this accounts for around half of incremental global output and is dominated by China, remains fragile. As long as the Fed's monetary policy fully reflects this contextual reality by moving early but gradually, then the risks associated with a serious error in monetary policy are likely to be avoided. Fortunately, this appears to be the most likely policy scenario. If properly executed, a gradual long-term increase in interest rates, as signaled by Fed Chair Janet Yellen, may provide the Fed with the flexibility it needs to more effectively manage the next recession.

**Positioning The Portfolio**

Post-crisis equity market returns have risen above historic averages despite the tepid recovery. This is largely due to the Fed's infusions of liquidity into the economy. As we have noted in previous letters, under these conditions, our opportunistic and highly differentiated approach may not distinguish itself on a relative basis, despite achieving our absolute-return objectives. As 2014 drew to a close, we remarked that we expected market returns to moderate as the rate of liquidity infusions decelerated and corporate profit growth and stock-price multiple expansion slowed. Under these conditions all boats do not rise equally. Stock returns begin to diverge as investors differentiate between individual securities. This shift directly benefits managers with demonstrated skill in stock selection. We expect our highly differentiated investment approach, with its focus on company fundamentals and stock selection, to be favored in the equity market environment we see developing, leading to superior returns over the long-term.

We also noted in a recent letter that historically, after periods of meaningful relative underperformance, our portfolios have tended to exhibit extended periods of outperformance. We believe strongly that this characteristic may be magnified in the developing market environment.

**Exceptional Investment Opportunities Still in Evidence**

Given the extended run in equity prices and current elevated stock valuations it is worth sharing our assessment of current investment opportunities. As our clients of long standing know well, we hold concentrated portfolios, with an investment horizon of three to five years. Therefore, each year we need to find only a few new investments. This allows us to be discriminating in stock selection, maintaining our investment discipline and replenishing the portfolio with investments that meet our demanding criteria. In the recent period our focus has largely been on identifying businesses that generate the bulk of their earnings domestically, thereby reducing exposure to the financial and geopolitical risks abroad. In addition, we have been successful in identifying attractive businesses subject to high domestic tax rates. This creates a free-call should Congress address tax reform in a way that leads to lower corporate taxes. It's worth noting that we believe such a legislative direction is likely in coming years but we certainly would not pay for it or invest solely on that basis. As dispersion among stock returns becomes more evident we are finding discrete opportunities across the market cap spectrum. Such opportunities have not been concentrated in a particular sector but rather run the gamut.

**High Active Share Managers / Stock Pickers in a Preferred Position**

Looking ahead, the prospects of an extended period of slow economic growth, reduced liquidity, a generally rising trend in the dollar and a reduction of systemic risks point to an environment where high active share managers / stock pickers will be in a preferred position to deliver superior long-term returns.

Consistent with our high active share approach, the portfolio has been constructed from the bottom-up around investments that display asymmetric risk/reward profiles. For the portfolio, expected returns are tied largely to the development of discrete, stock-specific events. We believe the portfolio is particularly well positioned to thrive in the environment that we believe will characterize the coming years. Independent of the market environment, we will continue to pursue our strategy of identifying and investing in those businesses that we judge to exhibit extraordinary risk/reward profiles in order to position the portfolio to generate attractive long-term returns.

As always, if you have any questions please don't hesitate to reach out to us.

Sincerely,

Michael A. Steinberg
Managing Partner

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