



## Third Quarter 2016 Commentary and Outlook

Stocks ended the quarter on a high note with major indices recording their best quarterly performance of the year. This occurred despite the sputtering of corporate earnings as asset-friendly central bank policies continued to support equity markets.

Looking immediately ahead, equity markets face greater uncertainties as investors anticipate the effects of the U. S. general election along with the possibility of the world's central banks backing away from their easy-money policies faster than anticipated or warranted.

### A Return to Fundamentals

Equity valuations appear stretched just as the Federal Reserve Board seems poised to begin gradually normalizing interest rates. That means moving forward corporations' earnings fundamentals, rather than expansion of their stock multiples (i.e. higher P/E ratios), will hold greater importance in determining the outcome of returns.

Once the presidential election is behind us there are several factors that could help produce an acceleration in economic growth and corporate profits. These include:

- **The easing of political uncertainty.** The unusual level of rancor in this presidential election has fueled uncertainty and created a headwind to economic growth. For example, it is estimated that 40% of firms with 50 or fewer workers are delaying expansion plans because of uncertainties surrounding the election.
- **The potential for a more expansive fiscal policy.** After the election investors are likely to begin to focus on the future benefits to be derived from a more active federal fiscal policy. For example, on the spending side of the equation, as we discussed in last quarter's letter, a meaningful infrastructure spending program could be put in place, regardless of who is elected.
- **The prospect of a reduction in the federal corporate tax rate.** A negotiated compromise on the balance between individual and corporate rates is likely. Because Congress has recently demonstrated little willingness to take on substantive legislation, most investors do not believe anything meaningful will develop along fiscal policy lines and therefore it has not been discounted by the market. We believe this would be well received by equity markets.
- **Increases in U.S. real inventory accumulation.** If history is a guide, then U.S inventories are set to lift GDP, perhaps meaningfully. Over the past year U.S. real inventory accumulation declined significantly. The past five times this has occurred, going back to 1980, GDP growth has accelerated over the subsequent year by more than 1%. This would provide an unexpected boost to earnings.

## **Monetary Policy: Critical Decisions Ahead**

In the first quarter of 2016, global financial markets corrected because investors feared the impact of potentially tighter U.S. monetary policy. Since then U.S. equity markets have risen on the back of the aggressive, coordinated policy response by the world's leading central banks to protect and promote global growth.

As a result of this accommodative monetary policy, bond yields have trended lower, stock earnings' multiples and share prices have pushed higher and the rise in the U.S. dollar has been capped. The dovish shift in monetary policy was also followed by improvement in leading economic indicators. More recently, however, global GDP growth estimates have been revised lower, even as markets continued to rally and expectations for continuing monetary policy support declined. The posted odds for a Fed rate hike in December of 2017 have increased to over 65% from less than 15% early this year.

If a less-accommodative monetary policy unfolds it would likely help fuel a rising dollar, creating turmoil in global currency markets at a time when growth is fragile. As a result, corporate profits would likely suffer, falling below expectations with markets adjusting accordingly.

## **Electoral Uncertainty**

The atypical U.S. presidential election we are currently experiencing exposes America's economy to an unusually high level of political uncertainty.

Until now financial markets have essentially disregarded the current presidential election. In large part this reflects the consensus view that a Hillary Clinton win would largely maintain the market's status quo. However, markets have not assumed any possibility that Clinton's coattails could turn both houses of congress Democratic. If that were to occur, it could roil financial markets because it might be perceived as support for a more populist, anti-business, anti-growth agenda.

A Donald Trump win would bring a host of uncertain outcomes as he has proposed a number of economic causes and initiatives, including: attacks on the Federal Reserve, a proposal to default on Treasury debt (since walked back), sweeping tax reform and plans to raise trade tariffs. Since investors hate uncertainty, the market would be more volatile if a Trump victory is judged to be likely or if it in fact occurs.

## **Shifting Dynamics Will Favor Stock Selection Disciplines**

As our economy normalizes over the next five years, active managers (stock pickers) should be prime beneficiaries. Since the current seven-year bull market got under way, value oriented active managers have generally been in a less-preferred position than passive managers who structure portfolios to mimic a benchmark or index. This extended period of challenging performance has recently led to a massive shift of assets into passive investments from active strategies, a shift that in and of itself has reinforced the performance of indexes compared to active managers.

The primary forces that have favored passive investing over actively managed strategies show signs of dissipating; as they unwind more fully in the coming years, we believe skilled active managers will once again be recognized for providing superior long-term results. The factors we are referencing include:

- **Broader market leadership.** Active managers fare best when stock rallies are more evenly distributed rather than when a handful of the biggest stocks are driving the market's gains. For example in 2015 just four stocks (Facebook, Amazon, Netflix and Google) accounted for a significant portion of the returns for the major indices. So far in 2016 the equal-weighted S&P 500 is topping the market-capitalization weighted index, meaning that the market advance is broadening and becoming less dominated by the largest companies.
- **A shift in market dynamics due to macroeconomic factors.** Growth stocks tend to outperform value stocks when interest rates are low or declining and when economic growth is challenged. These conditions have largely been intact since the financial crisis. However, as the economy recovers more fully from the great recession, economic characteristics are likely to change. Some economists posit that after a financial crisis GDP growth is roughly 1% below normal for a decade, on average. With the last financial crisis dated to 2007/2008, this suggests the pace of economic growth may pick up in the next several years. Such an advance would most likely be marked by: an increase in the labor force participation rate (which we have already begun to see), higher capital spending, and productivity improvements. Also, the housing industry could be expected to benefit from a meaningful rise in household formations. These elements of the economic equation have been unduly depressed since the onset of the financial crisis. Barring policy errors it seems reasonable to expect each of these elements to recover in the years ahead. As they do the pace of economic activity should quicken and inflation should pick up along with an interest rate rise. In this environment value should reassert its dominance over growth and active management should once again shine.

## Portfolio Developments

We continue to be pleased with how the businesses that comprise the portfolio are developing and expect these securities to produce excellent long term returns. A senior living facility operator is a helpful illustration of a business that is developing along the lines of our expectations, but whose value has not yet been reflected in the share price. Instances like these create opportunities for us, provided we are patient and diligent in regularly reviewing the business' operational progress. This company is an owner and operator of facilities in secondary markets where competition is less prevalent. The Chairman and CEO owns a significant amount of the shares outstanding. The company generated strong cash flow from operations (CFFO) in 2015 and it should steadily increase further. This increase comes from three areas: first, the company is converting units from independent living to assisted living/memory care which have much higher rents; second, the company has undertaken meaningful acquisitions each of the last three years and this is expected to continue; third, a modest increase in occupancy is likely over the next two years.

We believe that no new meaningful supply is coming on in their markets because it is uneconomic to build new facilities, which is why the company buys existing facilities. We also believe that demand is accelerating due to very favorable demographic trends, with the 82 to 86 year old cohort growing rapidly between 2016 and 2021.

All of the drivers outlined above appear to be developing in a manner which would support our projection of increasing CFFO in 2018. We expect this to become visible in the back-half of 2017. The visibility into higher free cash flow from operations will coincide with a large decline in capex as the unit conversions are completed. For these reasons, we believe that even in our conservative view, the stock should trade at higher multiple of FCF than the current share price reflects. Further, this multiple could be meaningfully higher if investors get excited by the inflection in favorable demographics and absence of new supply.

## Firm Developments

In our fourth quarter letter of 2015 we shared with you that this year, 2016, would, “present an opportunity to position [the firm] for the next many years both in the portfolios we manage for you and as an organization.” We have done this in a number of ways big and small. One of the most significant developments to date was achieved this quarter when we formed and had the inaugural meeting of the Steinberg Asset Management Advisory Board. We created the Board to provide an outside perspective on best practices in the industry, to ask tough questions and offer candid feedback, and to provide guidance as we continue our efforts to build a world-class investment firm. We are very fortunate to have attracted exceptional advisory board members who bring a depth of industry knowledge and experience to Steinberg. The advisory board currently has three members:

**Joseph Boateng:** Joseph is the Chief Investment Officer at Casey Family Programs, a highly regarded institution in the foundation and endowment community. Before joining Casey, Joseph was a member of the Johnson & Johnson Investment Committee, responsible for managing over \$17 billion in employee benefit assets worldwide. Joseph also spent 13 years at the Xerox Corporation (where Michael first met him), where he was a key member of the Trust Investment Team that managed \$10 billion in assets. In addition to his role at Casey, Joseph is Chair of the Investment Advisory Committee for the Seattle City Employees' Retirement System and a member of The Seattle Foundation's Investment Committee. He also serves on the Advisory Council for the African Private Equity and Venture Capital Association, the pan-African industry body which promotes and enables private investment in Africa.

**Bruce Lueck:** Bruce was President and Chief Investment Officer at Okabena Financial Services, Inc., a leading Minneapolis based family office where he served for eighteen years. At Okabena Bruce directed asset allocation, internal portfolio management, and global manager selection. Prior to Okabena, Bruce was president of IDS Advisory, Inc., as well as a member of the IDS/American Express internal board of directors. Currently, Bruce is on the board of the Sit Mutual Fund Group in Minneapolis and the University of Minnesota Foundation Investment Advisors.

**Sumeet Narang:** Sumeet is the founder and Managing Director of Samara Capital, an India-focused private equity fund based in Mumbai, India. Samara is recognized as one of the premier boutique private equity investment firms in India and counts among its clients some of the world's most respected investment groups, family offices and institutions. Prior to founding Samara in 2006 Sumeet worked at Goldman Sachs and Citigroup India.

We are honored to have such high quality individuals join us in this advisory capacity. They have already made meaningful contributions and we have no doubt that our firm and our clients will benefit from their counsel and guidance as we go forward.

Sincerely,



Michael A. Steinberg  
Managing Partner

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