Fourth Quarter 2014 Commentary and Outlook

Reflecting a potent combination of easy money, low interest rates and rising profits, the bull market advanced into its sixth year in 2014. A brief equity market swoon early in the fourth quarter reflected investor concerns for prospects of slower global growth and higher interest rates. Federal Reserve Board Chair Janet Yellen assuaged those fears and bolstered confidence by pledging patience on interest rates. Markets resumed their advances with most major indices ending the year at historic highs.

Earnings Key to 2015 Equity Returns

For the past several years stock price valuations have been driven largely by the expansion of the multiples applied to corporate earnings. Earnings multiple expansion accounted for about 76% and 58% of the total return for the S&P 500 in 2012 and 2013, respectively. In 2014, multiple expansion is estimated to have contributed around 23% of the index's total return. Looking ahead to 2015, we would expect the contribution from multiple expansion to continue to dissipate. Multiples have now risen to the high end of historic norms and the macro factors that generally contribute to high earnings multiples, including low long-term interest rates, improving consumer confidence, subdued volatility, job growth and increasing corporate profits, are likely largely reflected.

In this environment, earnings growth will be essential to extending the stock market's positive performance, and improvements in corporate profitability will be highly dependent on healthy economic growth. While the recent precipitous decline in oil prices should buoy consumer spending, perhaps by as much as a full percentage point on an annual basis, there is little else to suggest economic activity will support a strong acceleration of earnings growth. To the contrary, there are clear indications of headwinds: China, Europe, emerging markets and Japan all appear to be on slower economic growth trajectories than the U.S. which is troubling because approximately 46% of the S&P 500's revenues are generated abroad. Central banks around the world are likely to aggressively pursue monetary policies designed to stimulate growth. However, based on recent results, it is not clear how effective these policies will be. In addition, the strength of the dollar will be a drag on exports, which account for close to 15% of U.S. GDP. Also, the positive wealth effect from rising home values and equity prices is likely to moderate. It would be constructive for the economy if improvements in the labor market translate into healthy wage gains. However, for industrial companies, rising wages would serve to offset the beneficial effects on operating margins of lower input costs for energy and commodities. For service-sector companies, there are no meaningful benefits to margins from lower input costs, and higher wages would likely cut into profit growth. On balance, the path to healthy advances in the pace of economic activity and corporate profits is less clear now than in recent years.

Global Turbulence Possible

There are an unusually large number of situations brewing in the geopolitical and global financial arenas that could adversely and quickly affect the outlook for 2015 earnings:

- **Continued Strength of the Dollar –** The dollar rose more than 10% in 2014 against a basket of currencies of major trading partners. Dollar-denominated debt of non-U.S. corporations and sovereign entities is up nearly fourfold since 2008 to more than $6 trillion outstanding. This level of debt, combined with the dollar's rise, makes issuers and holders vulnerable to panic from a possible credit event. This problem may become self reinforcing if investors shift from currencies, stocks and bonds in non-dollar-denominated markets into dollars. At a minimum, emerging markets growth will suffer, and the earnings of U.S. exporters and multinationals will be restrained. In a demand-deficient world, no country desires an appreciated currency. Therefore, there is the potential for competitive devaluations and trade wars that would threaten global growth. In the short term, we would not be surprised to see the world's central banks collaborate in a campaign to cap the dollar's rise, however, over the longer term, the trend toward dollar strength is unlikely to be reversed. So long as any further advance is gradual, it need not be destabilizing.

- **Energy Uncertainty –** Investors have been quick to recognize the immediate benefit to economic growth tied to the decline in the price of oil. However, it is still too early to discern all of the secondary effects that might occur, including whether companies and even countries, including Iran, Russia and Venezuela, will suddenly lack the cash flow to service their debt. This means we do not know who may be exposed to potential defaults (from U.S. banks with large shale exposure to Russia's German bank creditors), and if this might be a brake on lending that slows economic growth. Other reverberations could include oil-producing countries pulling liquidity from the market rather than adding it through investment.

- **Euro Zone Discord –** There are worries that Greek political upheaval could reignite the long-simmering Euro zone debt crisis. The leftist Syriza Party, currently the nation's main opposition party, has promised to roll back austerity measures if it wins a majority in January's national elections. While outright victory appears unlikely, results could embolden populist factions in other countries seeking to challenge the austerity provisions that tamed the debt crisis.

  Further, as we write this letter the tragic terrorist attacks in France have only recently concluded. Recent events and the growing anti-immigration mood, may lead northern European states to question the benefits of open borders, and have already led to increased prominence of nationalist politicians and political parties which can only make a shared political and economic union more strained.

Longer Term Outlook

Slower long-term economic growth and extended stock price multiples point to generally lower equity returns in the years immediately ahead. We expect the broad market return from equities over the next ten years to be meaningfully lower than the 11% annualized return from 1983-2014, and certainly below the 16% of the last five years. This view is based primarily on two factors:

- **Economic growth will be slower.** Rapid debt growth played an important role in supporting demand growth over the last decades. If, as we believe, the debt super cycle has been broken, then future economic growth will be at a slower pace than that experienced since World War II. This will translate into a slower rate of growth for corporate profits, particularly since margins already stand near historic highs.

- **Equity valuations are high and bond yields are low.** The early 1980s presented an ideal starting point for assets to deliver extraordinarily large returns over a multi-decade period. As that decade began, bond yields were very high and stock multiples were low. Today those conditions have been reversed, which portends for modest long-term market returns.

Investment Implications

Under these conditions, high active share managers, those whose focused stock selection leads to portfolios with a high degree of variance vs. the benchmark, occupy a preferred position. Highly differentiated portfolios, built around securities with asymmetric risk/reward profiles should deliver meaningfully superior long-term returns. Our team manages a concentrated and differentiated portfolio for you based on individual security selection. Our investments are selected with the goal to underwrite a long-term return in the area of 18%-24% per annum. Adjusted for the inevitable underperformers, this should translate into long-term returns in the area of 12%-15%. While our returns in recent years have generally been consistent with those expectations, they have trailed an overachieving market. In the past, periods of meaningful underperformance for our investment style have been followed by long-term outperformance, which is exactly what we expect to occur for the reasons outlined above. In short, we expect to continue to do what we have done over our more than three decade history while the market is unlikely to repeat its historically unique performance.

The highly differentiated nature of the strategy underlying our portfolio means that while long-term returns are expected to be superior to the market there will be periods where a disconnect may occur between the return streams of our portfolio and those of the market. Such a divergence occurred in the fourth quarter when our relatively large exposure to energy-related investments weighed heavily on results. We materially reduced the portfolio's exposure to energy and to related equities relatively early in the period of declining crude oil prices. We did not, however, reduce positions in two of our larger energy shipping holdings because the fundamentals of these businesses, in our view, should not be altered in any material way as a result of recent developments in energy. In fact, we used the recent sentiment-driven weakness in the prices of these investments to add to our holdings in these securities. Based on our fundamental analysis, we believe that the long-term return profiles of these equities may be unmatched. While these investments have hurt short-term performance, we believe they hold potential for very large long-term returns. For example, based on our conservative analytic case, we estimate one of these energy shipping companies can compound its share price 40%-50% per annum over the next three to five years. If the business develops along the lines we anticipate, then the long-term returns from this investment can be well above that base case.

Other securities in our portfolio also present asymmetric risk/reward profiles. These companies hold the potential to deliver long-term returns at levels well above average. We do not presume to know or predict how your portfolio will perform in the short-term. However, based on our bottom-up analysis, we remain confident in your portfolio's potential to deliver meaningfully superior returns in the years ahead.

Firm Update

Recently we strengthened our investment team with the addition of Analyst Kavitha Venkatraman. Prior to joining Steinberg Asset Management, Kavitha worked as an equity analyst at Blackrock where she employed a fundamental bottom up approach. Kavitha received her MBA from Wharton. In addition to being a passionate investor, Kavitha is an avid runner, which we trust will provide her with the endurance to persevere in any market condition. We remain opportunistic in our search for talented high-quality individuals who fit well in our firm's collegial culture, are committed to our investment philosophy and have the desire and ability to do the fundamental work required to successfully execute our investment strategy.

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

Sincerely,

Michael

Michael A. Steinberg
Managing Partner

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