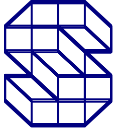
Steinberg Asset Management, LLC

Fourth Quarter 2015 Commentary and Outlook

Major stock indices bounced back in the quarter, regaining ground from their first quarterly decline in four years to end the year little changed from where they began. Investor concerns over disappointing earnings and the likely trajectory of interest rates contributed to market weakness in the quarter's closing weeks and dampened a 2015 advance that had been fueled largely by just four stocks: Facebook, Amazon, Netflix and Google. Broader market measures like the Value Line Index, down about 11% for the year, offer a more substantive reading of the health of American businesses, which have been hampered by a lackluster economy, the rising dollar and falling prices for commodities, particularly energy.

Decisions of Policy Makers Likely to be Unusually Important in 2016

The economy in 2015 was characterized by a continuation of the previous year’s trends of subdued growth, low inflation and easy monetary policy. In 2016 these underlying trends are likely to persist. However, significant uncertainty surrounds the path of monetary policy and interest rates. Because of this, the decisions of policymakers will likely be of paramount importance.

Barring exogenous influences it is likely the US economy will continue to grow in the same 2%+ range that it has averaged throughout much of the current recovery. The outlook for the consumer sector, which accounts for around 70% of GDP, is reasonably positive. Employment is in a steady uptrend, wage growth is advancing, and housing should continue to improve as the recovery in household formations continues. These favorable factors should be sufficient to more than offset headwinds from subdued business investment, a flattening in the growth rate of auto sales, and the strong US dollar, that will likely lead to a decline in net trade for the first time since 2009.

In this environment - with margins at high levels and pricing power limited - corporations will struggle to improve their profits, especially if economic growth falls short of expectations. The Fed’s recent 25 basis point increase in the fed funds rate target is not going to have a large or lasting impact on the economy or the financial markets. The important issue is what path the Fed follows going forward.

The Fed expresses a more optimistic view of economic and wage growth than is expressed by the market. If the Fed is correct in its view and pushes forward with increases to rates that are currently well above market expectations, it will most likely cause an undesirable rise in the already-strong dollar. This would hurt exports, corporate profits and GDP, and create unwanted downward pressure on inflation. It could also create considerable turmoil in emerging and developing economies, which are feeling the effects of slowing global growth and falling commodity prices. On the other hand, if market expectations are correct and a more gradual increase in rates turns out to be the proper course, then unless the Fed adjusts its stated policy it will have made an error that will exacerbate the situation, risking recession and excessive market volatility, until it is reversed.

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Volatility Influences Stock Price Multiples

Shifts in stock market volatility can drive changes in the prices (earnings multiples) that investors are willing to pay for stocks. In the current slow-growth environment, with low inflation, short-term interest rates near zero and valuations stretched, it is unlikely investors would be willing to pay a higher price for a given level of expected corporate profits. If market volatility were to increase, downward pressure on earnings multiples could develop, creating attractive opportunities. In the current environment some of the potential drivers of volatility, beyond interest rates, include:

- **China:** China's manufacturing sector, which accounts for close to 40% of that country's GDP, shrank for the fifth straight month in December. As a result of this decline, the world's second largest economy is poised to generate its slowest growth in 25 years. At the same time, the country has been depleting its currency reserves at a rate some observers consider unhealthy. If China is to avoid a hard landing and further undesirable capital outflows, then the country's policymakers must successfully pursue the more "proactive" and flexible fiscal and monetary policies they have promised.

- **Sovereign wealth funds:** Sovereign wealth funds hold around $7 trillion in assets, about twice that of the world's hedge funds and private equity funds combined. Nearly 60% of these financial assets are in funds that are dependent on energy exports. With these funds now shrinking or being tapped by governments as their oil revenues fall, some funds are borrowing money or selling investments, developments that hold potential to further pressure global markets.

- **Emerging markets:** Most emerging markets are facing financial pressures created by capital flows and lower commodity prices. This makes them vulnerable to crisis.

- **Terrorism:** While the horrific human impact of terrorism cannot be overstated, over the long term, the effects of terrorism on soft targets are greatly diminished as social attitudes adjust to the higher probability of harm. However, in the immediate future if social attitudes have not been adjusted these events can depress economic activity.

- **EU:** A UK referendum on the country's membership in the European Union could threaten the British economy, and would raise questions about the possibility of an EU unraveling. This is an issue big enough to matter for the global economy, particularly at a time when terrorism and migration issues have created a combustible political climate that threatens the tenets of open borders and the free flow of capital, which are essential to a unified Europe.

- **Tensions in the Gulf:** Revived tensions between Iran and Saudi Arabia threaten to stoke the flames of sectarian conflict across the Middle East. The risk of conflict may grow swiftly in the region with increasingly volatile oil prices as a consequence.

Recent Performance

We are disappointed with the performance of your portfolio for the quarter and the full year. Several stocks in your portfolio were punished severely, primarily for temporary, non-recurring setbacks or merely for guilt by association. These investments represent a meaningful portion of the assets you have invested with us. Knowing that it is not always easy to recognize and acknowledge when an investment thesis has gone bad, we undertook a rigorous examination of each of the positions that weighed most heavily on performance. Our conclusion is that, in each

case, the investment thesis remains fully intact and, by virtue of the decline in price, the return potential of these holdings is greater today than when the initial investment was made. For our clients of longstanding this type of poor result is unusual because over the years of our investment history it has generally been uncommon to have a period where such a meaningful proportion of the portfolio's assets were exposed to adverse non-recurring short term events.

Portfolio Update

For those who follow our portfolio holdings and our energy exposure, you are aware that a substantial portion of recent results can be attributed to the relentless decline in the price of oil. We feel that while our core energy-related holding is being impacted, the business has made progress towards realizing its long-term potential, which remains large. In fact, the fundamentals of the business are developing ahead of our expectations, in part because the decline in the price of oil has created a monopoly-like position for this pioneering, low-cost-tolling provider of liquefied natural gas (LNG). We expect the pipeline of new projects to develop more rapidly and to be considerably larger than what existed in recent years when energy prices were high. This should occur because the economic attraction of stranded and associated gas is more compelling in a lower-priced energy world and can now be monetized. There is currently a highly valuable financial incentive for owners of natural gas reserves to capture potential windfalls and for sovereign entities to encourage and support development of these projects to capture the related tax and economic benefits.

It is true that the return profile for these long lead time projects will be influenced by the price of energy. However, even under what we believe are conservative assumptions based on the number of projects, tolling fees and valuation metrics, this investment should produce outstanding returns in the years ahead. As we move forward we expect that the visibility of a growing portfolio of projects with an attractive return profile will begin to be reflected in the market price of this equity, and will more than compensate for the meaningful loss of performance by the stock.

The declines from peak to recent troughs in two other large holdings the healthcare and consumer discretionary spaces, were driven by what we believe are non-recurring shortfalls in their near-term results. While this is disappointing, it has not altered our view of the favorable prospects for these businesses over the long term. Therefore, as is the case with our energy-related holding, we have been or expect to be adding to these positions. Each of these companies is run by a senior management team that has meaningful personal capital invested in the business and has a demonstrated record of sound capital allocation that has translated into large, long-term value creation for shareholders in these or other endeavors.

We believe our holding in a diagnostic health information provider was impacted by short term delays in a small number of international orders, which have already reversed themselves, but which caused a shortfall in the most recent quarter's results. This was coupled with a mild flu season, which will necessarily result in weaker sales for the company's flu diagnostic products. Both issues are, clearly, temporary and going forward we expect the company to register rapid earnings growth driven largely by new products.

Our holding in an international retailer saw its stock price suffer when unseasonably warm winter weather hurt retail sales and the Paris terrorist attack adversely impacted sales in its European space. Further, negative sentiment gripped department store retail companies as investors worried that e-commerce would impair the earnings of brick and mortar competitors. Importantly, our investment thesis is not predicated on a reversal of the well established trend of the growth of e-commerce. Rather we seek to capitalize on the company's unique value

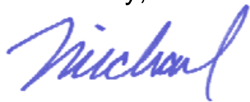
proposition related to its exceptional real estate holdings, the transformation of under-earning stores (e.g. the flagship store which is undergoing a significant renovation), an increase in its digital penetration which lags peers, and the successful growth of its "off -price" stores which is in the very early stages. The shares are down around 40% from their recent high. We estimate that at this level they are selling at around a 50% discount to the value of their high quality real estate assets with negative value ascribed to the company's attractive retail holdings.

Firm Update

There were no new developments to report at Steinberg Asset Management in the fourth quarter of 2015. As we enter 2016 we would like to extend our wishes for a happy, healthy and prosperous new year. We are committed to constant improvement and this year will be no exception. The coming year, our 34th investing with and for our clients, presents an opportunity to position ourselves for the next many years both in the portfolios we manage for you and as an organization. We look forward to keeping you apprised of our progress in both regards.

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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