Steinberg Asset Management, LLC

Third Quarter 2014 Commentary and Outlook

Capital markets turned in a mixed performance in the third quarter. Equities traced a rocky path through the period, ending with modest gains for the largest capitalization companies and declines for smaller companies. Commodity prices weakened and bond prices advanced as investors' actions expressed an outlook for limited economic and corporate profit growth.

This deterioration of investor sentiment contrasted with the prevailing market environment of the last three years when equity markets advanced without noticeable interruption. That steady rise in stock prices defied a raft of mounting concerns for investors, including softening economic growth in Europe and Asia; the winding down of the third round of quantitative easing in the US; a strong dollar, which serves to restrain economic growth and reduce the reported earnings of multinational corporations; unsettling geopolitical developments in the forms of provocations by China and Russia, unrest in Syria, Israel, Iran and insecurity in any country in the shadow of influence of the Islamic State, or ISIS. Most recently, the list of investors' worries has been expanded to include heightened threats to consumer confidence from data security concerns and fear of the spread of Ebola.

Weaker Commodities and Lower Rates Signal a Softening

The three-year bull run for stocks left equity markets priced for a perfect mix of steady economic growth coupled with healthy gains in corporate earnings. More recently, however, sharp declines in commodity prices and falling yields on US government bonds has brought into question the basic fundamental assumptions which have underpinned markets through the rally.

With oil prices dropping about 20% from the recent peak and yields on the 10-year Treasury falling from 3% to nearly 2% this year, market forces have presented an unmistakable sign that the rate of economic growth holds little hope of accelerating and the weakest economic recovery in history may be poised to decelerate after a five-year run. With this sudden realization, financial markets quickly began adjusting expectations and incorporating new uncertainties, which for some included a growing threat of deflation.

For nearly 70 years, central bankers and investors have focused on the threat to society from inflation. A new and different challenge would be posed if deflation, which would be reflected in declining consumer spending, falling corporate profits and a rising burden from debt, was to gain traction. Obviously, policy makers would do everything to avoid such an undesirable economic outcome; however, barring a policy error, the most likely path for the economy appears to be an extended period of sub-optimum growth.

New Fiscal Policy Imperative

With interest rates near historic lows, monetary policy alone holds little potential to power the economy. We expect fiscal policy will play an increasingly important role in the future and the unsettled geopolitical background may provide the ideal catalyst for increases in government spending. Following the mid-term elections, the Republicans may begin to advance a platform to boost long-term defense spending. Expect Democrats to counter with requests to bolster their preferred programs with the end result a desirable fiscal increase that could also address needed rebuilding of public infrastructure. Such a fiscal program could produce extremely positive long-term results for the US and global economy. None of this is likely to occur swiftly, however, and the overhang of unenthusiastic investor sentiment will likely continue to weigh on financial markets.

Long-Term Slow Growth

The long-term economic environment will most likely be characterized by continued subdued growth, low inflation and low interest rates. The lackluster economy can be expected to support only anemic corporate profit growth and, as a result, equity indices will likely produce returns at levels below historic averages. While low inflation and low interest rates would normally translate into an increase in the price investors are willing to pay for earnings (the price/earnings ratio), in the current environment price multiples already reflect those factors but may not yet incorporate the prospect of long-term slow growth. Therefore, the longer-term return from equities, as measured by the major indices, is likely to closely mirror sluggish economic growth.

For many years, the rising market served to buoy stock prices somewhat indiscriminately. In coming years, companies that actively enhance shareholder value are more likely to be rewarded. This serves our investment approach, which favors companies whose stocks offer an asymmetric risk/reward profile. Because returns from individual stocks are often tied to discrete events and your portfolio's holdings are relatively concentrated, the stream of returns will likely be lumpy but also most rewarding for patient investors.

Positioning the Portfolio

We recently added an international architecture, engineering and design management company to appropriate portfolios. Unlike most companies in this sector, the company generates high quality free cash flow because it has effectively no fixed-price business. The company is well positioned to capitalize on the build-out of the world's developing and emerging markets as well as any cyclical recovery in the construction markets in developed economies. In addition, if government infrastructure spending is employed as a tool to stimulate economic growth, the company should be a prime beneficiary. Company management has demonstrated a record of sound capital allocation and in recent years has repurchased a significant amount of outstanding shares. Given the high quality of company earnings and free cash flow, the prospect of large earnings gains in the years ahead and the able management team, we believe our investment in this company holds the potential for outsized returns in the years ahead.

We continue to build our position in a leading North American retailing company. This investment typifies the fundamental characteristics we are attracted to and that we strive to construct your portfolio around: an asymmetric risk/reward profile with a free call* attached. This company owns prime, largely unencumbered real estate assets that we believe are worth substantially more than the current market value of the equity. We expect the company's talented management team, which has made a substantial personal investment in the company and has a demonstrated record of creating large shareholder wealth, will accrete the value of these real estate assets in both the short and long term. At the same time, as a free call, we believe in the potential of the company's new retail management to realize the value inherent in two of the company's well positioned but under-earning retail properties. This management team has a stellar operating history, which contributes to the opportunity to realize an outsized rate of return over the next several years with limited fundamental risk due to the large underlying asset values.

Firm Update

As is the case in the corporate world, mergers at Steinberg Asset Management are occurring at a record pace. We are very happy to be able to share with you news that SAM's family continues to grow. Eric Muhlfeld, an associate in our Marketing Department was married this September. Not to be outdone Justin Steinberg, a partner and senior member of our investment team got married, which made one managing partner particularly proud and happy. We want to congratulate them and wish them all the best.

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

Sincerely,

Michael A. Steinberg
Managing Partner

**When used by SAM in describing its investment philosophy "free call" refers to a future event or transaction that may or may not occur, the value of which is not reflected in a company's share price. For example, it could be the potential appreciation of intellectual property or increased demand for a product. This event or transaction when realized serves as a long-term catalyst for the share price and will, in SAM's estimation, add value to the company that will be reflected in a higher share price as the market recognizes this. SAM is not implying that an investor receives securities or options in securities for no cost by use of the term "free call".*

The opinions, forecasts, assumptions, estimates, and commentary contained in this report are based on Information provided to Steinberg on both a formal and informal basis which Steinberg believes to be reliable. However, Steinberg cannot represent or warrant their accuracy. The impact on Steinberg's opinions, forecasts, assumptions, estimates, and commentary due to inaccurate information, incomplete information or information taken out of context may be substantial. Further, all opinions, forecasts, assumptions, estimates, and commentary in this report are made only as of the date indicated and are subject to change at any time without prior notice.

Discussions and calculations regarding potential future events and their potential impact are based solely on historic information and Steinberg's estimates and/or opinions, and are provided for illustrative purposes only. No guarantee can be made of the occurrence of such events or the actual impact such events would have on the performance of the companies described in this report.

There can be no assurance that Steinberg will continue to hold the same position, or any position, in the companies described in this letter in the future. Positions reflected in this letter do not represent all the positions held, purchased, or sold, and in the aggregate, the information may represent a small percentage of activity or holdings in client portfolios. The information presented is intended to provide insight into Steinberg's investment process and certain noteworthy events, in the sole opinion of Steinberg, affecting client portfolios.