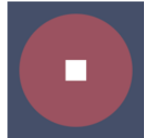

2016 Fourth Quarter Review and Outlook

Despite a less than auspicious start, 2016 turned out to be a good year for investors. US stock markets opened with their worst January ever, prompted by fears of Fed tightening and waning global growth. By early February, the MSCI All-Country World Index (ACWI) had fallen 11% and the Shanghai Stock Exchange was 45% below its 2015 high, stoking fears of an economic meltdown in Asia. Earnings of S&P 500 companies continued a slide that had begun the year before, pulled down by the energy sector and oil prices below $30 per barrel. Uncertainty about the Brexit vote and US elections only increased anxiety.

As is so often true, conventional wisdom—in this case about the “disastrous” consequences of Brexit, the fragility of China and the ageing US economy—proved wrong. A recovery in oil and commodity prices lifted emerging markets, while the European economy strengthened and the US continued to benefit from falling unemployment, solid manufacturing and rising home prices. From the February lows, the ACWI rebounded strongly to end the year up almost 8%. US companies did even better, gaining almost 13% for the year.

Bonds experienced a similar roller-coaster, rallying strongly in the early part of the year as economic pessimism grew and the Fed stepped back from its promises of tightening, only to reverse course in the second half as increasing confidence allowed the Fed to raise rates by 0.25% and to signal the likelihood of several more increases in the year to come. By year-end, bond investors saw half their gains evaporate, with US Aggregate Bond Index finishing up less than 3%.

LongView’s portfolios benefitted from an overweight to smaller companies and from our defensive positioning relative to rising rates. Firm-wide, our equities outperformed global stocks while our bond and absolute return funds outpaced the bond market by a wide margin.

The primary contributors to our equity performance were US stocks, especially smaller companies, and emerging markets. Our gradual shift into Dimensional (DFA) funds has also been helpful since the smaller, cheaper stocks that DFA emphasizes performed well this year. Outperformance in fixed income was due primarily to our overweight in sectors such as high yield bonds and floating rate loans that are less sensitive to changes in interest rates. Absolute return funds performed in accordance with their mandate, offering shelter from rising rates and generating returns well in excess of cash.

We are pleased to report that the transition we’ve discussed in recent letters and meetings—building “core” equity positions in DFA funds while consolidating our remaining “satellite” positions—is well underway and has been a positive contributor to performance. As mentioned before, this transition will reduce portfolio expenses, increase tax efficiency and make us nimbler in our management process.

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Outlook
Positive economic fundamentals including the trend toward stronger US growth, higher wages, the ongoing manufacturing recovery in Europe, moderate energy prices and better corporate earnings, should be supportive of global equities.

Market sentiment expresses a widespread confidence that the policies of the President-elect and Republican-led Congress will lead to stronger economic growth and a jump in corporate earnings. This optimism appears to ignore the fact that the slow pace of recovery since 2009 has been in no small part due to structural constraints including demographics, stagnant growth in the workforce and lower productivity resulting from a decades-long decline in capital expenditures. Simply put, we are getting older as a nation and technology is not increasing output quickly enough to offset this trend. This is not something any administration can easily "fix" (except perhaps by encouraging immigration on a massive scale.) A modest pick-up in growth—to say 2.5% in 2017—looks likely, but we are mindful that the current economic expansion is in its ninth year, the fourth longest period of sustained growth in well over a century.

Higher spending, rising deficits and more protectionist trade policies from a Trump administration risk accelerating inflation. Coming off such low levels, even small increases in interest rates can negatively impact bond markets (as we saw in 2016). US equity investors, meanwhile, will be contending with elevated stock valuations (stock prices have moved higher while corporate earnings fell during 2015 and the first half of 2016.) Notwithstanding the current ebullience of 'animal spirits', it would seem prudent for investors to take little for granted going forward.

After four years of underperformance, overseas markets may offer better opportunities. Compared to the US, which is at or close to peak levels in employment and corporate earnings, the developed international economies have more room for recovery and market valuations are lower. Manufacturing growth in the Eurozone is picking up strongly and this improvement is not yet reflected in stock prices. The US dollar is at fourteen year highs—too high in the estimation of many economists—and any decline in the currency would be a boon for US investors with foreign holdings. Despite the recent trend of US leadership, we feel there are good reasons for maintaining a globally diversified portfolio.

Final Thoughts
Market performance in 2016 was generally strong despite investors' well-deserved concerns about growth, earnings, geopolitical instability and political dysfunction. All major asset classes generated positive returns. This year seems likely to usher in a new era, with the aggressive intervention of central banks finally drawing to a close and a strongly pro-business government in control of Washington DC. While we have no crystal ball for the coming year, we are confident a well-diversified portfolio that is prudently managed, with close attention to costs, will help steer you through.

Looking ahead, we want to mention one other issue. As investors and as citizens, the most consequential long term challenge we foresee is climate change. Allowed to continue unchecked, global warming, habitat destruction, and mass extinction will affect every aspect of life from food security, public health and migration, to economic growth and geopolitical stability. We have watched with dismay the incoming administration's pledges to roll back progress on domestic and global environmental protections. We believe strongly that socially responsible investing can help tip the balance in the transition to a sustainable world economy. Moreover, financial research and our

own experience have shown that one need not sacrifice long-term performance in order to invest sustainably. If anything, the application of environmental, social, and governance (ESG) investment criteria can help mitigate business risk (e.g. 'stranded' fossil fuel assets) and access significant opportunities in sustainable technologies. LongView offers a wide range of sustainable investment choices in both equities and fixed income and we are always available to discuss these alternatives with you. If you are interested to learn more, please contact us and, as ever, please don't hesitate to call us with any other questions or concerns.

With our warm regards and best wishes for a wonderful 2017!

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