ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
July 2, 2015

Dear Clients:

The end of the second quarter 2015 will be remembered, perhaps for only a short time, for all of the impending deadlines of seeming consequence. There is the Iran Nuclear Agreement deadline, the Greek Government Debt deadline, the Puerto Rico debt deadline, and the much-anticipated session-ending decisions of the US Supreme Court. Combine these events with the on-going fixation on the Federal Reserve Board's map for future interest rates, the impact of a feared meltdown in the China economy, and the spectacle of a melee known as a US presidential election cycle, an investor might well head for the hills to ride out this prospect for doom and gloom. We say these things will come to pass as well and are reminded of William Shakespeare's Macbeth – "Life's but a walking shadow, a poor player, that struts and frets his hour upon the stage, and then is heard no more. It is a tale told by an idiot, full of sound and fury, signifying nothing".

Investment Market Returns as of June 30, 2015

Returns on marketable securities around the world were mixed with equity returns being slightly positive and bond returns being materially negative for the most recent quarter. US equity returns were essentially breakeven with the total return of the S&P 500 Index up only 0.28%. Similarly, the MSCI-EAFE Index (non-US stocks) for developed countries was up 0.62% in USD terms, but down -1.82% in local currency terms. In both cases, the average prices of stocks declined during the period, perhaps signaling the beginning of a long-awaited correction.

Returns on bonds also signaled a change in direction as higher interest rates and worsening credit conditions led to negative total returns for both US and foreign bond indices. The Barclays US Aggregate Bond Index (taxable bonds) was down -1.68% for the quarter, while the Barclays Municipal Bond Index declined by -0.89%. Price declines due primarily to higher interest rates more than offset the approximate quarterly coupon return of 0.50% plus.

We believe the major signals imbedded in market returns are increasing odds of a rise in interest rates sooner rather than later and markedly slower growth in corporate earnings. The outlook for rising interest rates is confirmed by weakness in the share prices of US utility stocks and US REIT stocks which were down about -5% and -10%, respectively for the quarter. The Bloomberg Commodity Index also showed a hint of inflation with a 4.7% rise in Q2 2015.

Our expectation for a slowdown in corporate earnings growth is based on our reading of the sales and earnings data for the S&P 500 constituent companies provided by Howard Silverblatt at Standard & Poors Corporation. That data provides the following signals:

1. Profit margins peaked at record highs in the third quarter 2014 and are now down nearly -3% from the high but still 8-10% above historical norms.
2. Sales in the first quarter 2015 were down versus the fourth quarter of 2014 for seven of the ten economic sectors. The comparison of Q1 2015 versus Q1 2014 sales showed strength in only two sectors – healthcare and information technology; the other eight sectors had either weak single digit or negative sales growth year over year.

3. EPS growth has been tepid through Q1 2015 with "operating" eps up only 3% year over year, while "net" eps was actually down -1%. The bottom up estimates from the always optimistic investment industry analysts is a modest 2-3% for the year ended December 31, 2015. But as if on cue, the bottom up crowd is "hyping" 2016 full year estimates of 15+% eps growth. Reduced shares outstanding continue to provide an eps tailwind; whether share repurchases should continue at today's elevated share prices is another story.
4. Investors should also not ignore the on going gap between "operating" eps and net eps, which is a typical 12% for the twelve month eps as of March 31, 2015. Corporate managements and their co-dependent industry financial analysts prefer to talk in terms of operating earnings, conveniently ignoring the cost of discontinued (aka failed) operations and write-downs of excess acquisition prices and other "non-recurring" charges . To further cloud the quality of reported earnings, the investor relations people are increasingly spinning the notion of "proforma non-GAAP" earnings in support of today's lofty price earnings multiples.

Our Look Forward

Given the recent backdrop described above, we believe long term investors should remain focused on the principal components of the expected future returns from stocks and bonds. For stocks, we believe the market is roughly using a 9% cost of capital hurdle rate combined with an optimistic growth assumption for earnings. In contrast, our view of history suggests a hurdle rate closer to 12% and a sustainable earnings growth rate of around 6%. A rapid reversion to these factors would produce a material decline in stock prices. A change in expected inflation from zero to around 3% is the most likely catalyst for such a move, but a generalized acceptance of slower growth in future profits would also put downward pressure on stock prices.

Bond return components dealing with duration and credit seem conservatively set at the moment. The outlier is the inflation component. Currently, bond yields reflect the near zero return on money market funds (the same as an expectation for zero inflation). This situation exists in contrast to current pricing of US TIPS bonds that suggests an imbedded inflation factor of nearly 2%. At some point, the return on money market funds will revert to expected annual inflation which is the only way the purchasing power of our currency is maintained. Today, the actual CPI seems somewhere around 2% and on the way to the long term average of 3%.

We remain comfortable with a strategy that underweights exposure to long-duration stocks and bonds and maintains dry powder to take advantage of material downward price adjustments in both broad asset classes. This strategy allows investors to ignore the sound and fury of cable news/entertainment's moment by moment pronouncements signifying mostly nothing.

In Closing

We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meeting your expectations.

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