ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
January 3, 2018

Dear Clients:

“The Matrix is the world that has been pulled over your eyes to blind you from the truth.” – Morpheus from the movie The Matrix.

As we survey the world’s investment markets and economies, we wonder whether what we see and hear is real or some “virtual reality” concocted by mysterious players in the ether world. Bitcoin has become the rage of the financial and general news media and apparent source of new found wealth for the relatively few players with the personal aptitude to accept “ownership” of an unregulated, algorithmically-derived instrument accessible only through a password-protected, dark market exchange. We admit our inability to understand Bitcoin either as a crypto currency (one measured in US dollars?) or as an investment with no income-producing or tangible asset-based attributes. We may yet need to consult Morpheus to understand the value in Bitcoin. One plausible explanation for an alternative currency is the impending collapse of the developed world’s paper (aka faith) based currencies resulting from the quantitative easing experiments by central bankers. We doubt this explanation is sufficient to justify Bitcoin in its current form, but none of us should be surprised by increased volatility in the world’s currency markets.

Similarly, we find the current fascination with “Robo Advisors”, FinTech, the VIX, and the unquestioned faith in indexed investing as evidence of the approaching death of “old fashioned” fundamental investment analysis. While advances in technology are clearly changing, and in many ways improving, the way we all conduct business and personal activities, we remain unconvinced that rational asset pricing decisions can be reduced to algorithms designed by PhD mathematicians and solved on super-fast computers. This trend is consistent with what we see as the increasing use of societal “short cuts.” In news media, think Twitter and purported reporting with a strong opinion angle versus in-depth, non-biased investigative reporting. We wonder whether old fashioned investigative reporting based on “dot-connecting, mosaic piecing” has been replaced by the micro burst of 140 characters over the internet being taken as gospel truth without any verification. We characterize these trends as a preference for tech versus sweat, youth versus experience, and instant versus delayed gratification. We hope what we see are normal and ultimately productive evolutionary movements toward a more prosperous and bountiful future; however, none of us should forget the advice of Sir John Templeton that the four most expensive words in the English language are “this time it’s different.”

While we await the proof of the bounty, we will continue to manage your money with assets that generate a reasonable expectation for future income valued in present dollar terms using a reasonable return hurdle. This approach reflects Warren Buffett’s admonition that successful investing is simple but not easy. The difficult part of successful investing is dealing with the unknowns of future factors, including the level and growth of corporate earnings, price inflation, interest rates, and return premiums for risk. As anyone who keeps up with the financial/economic/political press knows, there is a very wide spectrum of opinions on these factors. You can count on us to lean to the more conservative choices for each of these factors given our belief that this time is not so different.

Investment Market Returns as of December 31, 2017

Stock market returns, including dividends, were again strong for the year as evidenced by a total return from the S&P500 Index of 21.8% and from the MSCI-EAFE Index (developed country, non-US stocks) of 25.0%. In the US, the price to earnings multiple increased by over 10%, contributing at least half of the total return for the year. Non-US stocks benefited from an even larger increase in the price to earnings multiple. Strong price growth for a relatively small number of technology and “growth-story” stocks were significant drivers of the multiple expansion. In contrast, stock returns for mid to small size US stocks were generally less than 15% for the year, reflecting less “enthusiasm” for smaller, more traditional business models. Emerging market stocks, as measured by the MSCI-Emerging Stocks Index, had a total return of 37.3% for the year, driven by both margin expansion and the expectation for robust earnings growth. Since 2008, total returns for US stocks have had above average returns in seven of the nine years, while total returns for non-US stocks have lagged for most of that time span, due in large part to lower price multiples and a strong US dollar. In 2017, the currency effect reversed with a falling US dollar contributing almost 40% of the gain in non-US stocks for the year.

Bond returns for the year were a mixed bag. The yield on the benchmark 10 year US Treasury Note was essentially unchanged at around 2.5%, while falling yields on investment grade corporate issues resulted in a total return of 5.5% with a current coupon of about 3.4%. Bond investors appear to be quite satisfied with historically low coupons and unconcerned about future inflation. Our primary index for foreign bonds reflected a total return for the year of 8.8%, as near zero yields on sovereign government bonds issued by Germany, Switzerland, and Japan and a weak US dollar provided out-sized price support.

Returns on defensively oriented Alternative Investments out performed bonds but remained far behind stock returns. Nonetheless, price strength was evident in the hedged equity and certain commodity segments, possibly foretelling a period of rising asset price volatility.

Returns on cash averaged about 0.9% for the year, following nearly eight consecutive years at or slightly above 0%. At year end 2017, the 1 year US T-Bill yielded 1.9%, possibly indicating rising inflationary pressures.

Our Look Forward

As this commentary goes to press, market prices for tradeable securities are suggesting a continuation of low cash yields and a reversion to mid-single-digit annual total returns. With stock price to earnings multiples at historically high levels, annual earnings growth well above 6% is being factored into price quotes. We believe current fiscal policy in the US is supportive of higher economic growth rates, and reports from global markets suggest growth rates are improving across the world. Of course the risks to a “benign” outlook derive primarily from the occurrence of the unexpected. Over the last several years, we have expected stock price multiples, bond yields, and inflation to revert back toward historical averages; none of that happened unless one considers the bull market for stocks a new inflation barometer and very low yields on government bonds a hedge against systemic disorder.

The truth is no one knows for sure what the future investment returns will be over the next couple of years. Our belief is that investors should closely monitor the trends in inflation (higher prices for goods and services and wages), the term structure of interest rates as indicated by the shape of the yield curve from short to long maturities, and earnings health of business. We feel the trend in the first two elements suggest higher future interest rates which drives higher return hurdle rates and lower price multiples. Expectations for future earnings can be sufficiently strong to offset a rise in the hurdle rate, but investors should be mindful of the fragility of “expectations.” We remain cautious in this environment and continue to employ a strategy of broad diversification of assets to manage our clients’ capital.

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 meet your expectations.

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