ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
April 8, 2014

Dear Clients:

During the first quarter of 2014, investment market actions clearly signaled increased focus on the strength and sustainability of the US economic recovery and greater scrutiny of the US role in world politics. In the US, the upward trajectory of market multiples for equity securities weakened, while the bond market signaled its concerns by pushing yields down and prices up for longer-dated assets. In the currency markets, the US dollar lost a little ground versus the cap-weighted basket of foreign developed country currencies, perhaps the result of an assessment of declining US geo-political influence and a lessening of confidence in US monetary policy. Much attention is being paid to the 2014 mid-term elections and the possible change in political balance in Congress. Whether a change in control will occur and whether a change will make a difference in the performance of the economy remains to be seen. For sure, the trend in corporate profitability will ultimately determine the performance of stocks fixed income securities. Keeping close tabs on unit demand, pricing power, and cost factors will provide the best clues for the future direction of the markets.

Investment Market Returns as of March 31, 2014

Equity market returns were mixed in world markets. The S&P 500 Index produced a 1.8% total return for the quarter and 21.9% for the twelve months ended March 31, 2014, while the Russell 2000 Index generated comparable returns of 1.1% and 24.9%, respectively. Conversely, the MSCI-EAFE index posted a 0.7% USD return for the first quarter and a 17.6% USD return for the trailing twelve months. The MSCI-Emerging Markets Index continued its weak trend with losses of (0.4%) and (1.4%), respectively, for the quarter and trailing one year. Returns on developed market stocks were helped by a weaker US dollar, while weaker currencies in emerging countries had the opposite affect. Stock returns for the quarter included estimated dividend yields of 0.5% for the US broad market and 0.7% for the broad foreign market.

Returns on fixed income assets were strong for the quarter. The Barclay's Capital US Aggregate Bond Index had total returns of 1.8% and (0.1%) for the quarter and twelve month periods, despite having a current annual yield of about 2.3%. The longer-dated US municipal bond market index was even stronger with comparable returns of 3.3% and 0.4%, respectively, while the current annual yield was only 2.7% for a portfolio with a duration of 7.7 years. Returns on foreign bonds were quite similar to those for the US municipal market. Price increases of this magnitude normally signal a weaker economy and constrained inflation pressures.

An interesting contrast is observed in the price behavior of commodities and gold during the first quarter. Indices for both the DJ-UBS Commodity Index and gold were up around 7% for the recent quarter, reflecting a reversal of trend over the last twelve months. We interpret such movements as leading inflation indicators or, specifically in the case of gold, a leading indicator of future instability.

Capital Allocation – Earnings, Dividends, and Share Counts

Investors know that dividends can be an important component of the return on equity securities. However, without earnings, there can be no sustainable dividends. Without retained earnings, the growth potential of a company is limited unless financed with potentially dilutive equity issuance or increased use of debt which may increase risk. Senior management of profitable companies must make the critical allocation decision between reinvesting earnings into the company and paying a portion of earnings out to shareholders through dividends or share re-purchases. For financially healthy firms that pay no dividends, our expectation is for that company to generate an attractive return on invested capital (ROIC) above an investor's reasonable expected equity return. Think Berkshire Hathaway Inc., a company that has never paid a dividend and only sparingly used equity issuance as a source of growth capital. Of companies that pay a regular dividend, there are two broad categories: an attractive group that earns a sufficient ROIC such that the retained earnings exceed the incremental equity needed to fund growth and a less attractive group that earns a weak ROIC such that the retained earnings are either insufficient to finance future growth or unnecessary due to the absence of attractive future growth opportunities. The common denominator with respect to capturing optimal equity returns is the consistent generation of ROIC in excess of the cost of capital which, combined with favorable growth prospects, creates an attractive equity investment.

Share re-purchases are a special form of shareholder distribution, while share issuances are a source of financing. Both activities are routinely misused by company management. History shows that share re-purchases occur more frequently when share prices are high, often above a rational estimate of the company's intrinsic value. When this happens, normally when the company's share price reflects a high earnings multiple, company managements are essentially making sub-par investments that will not earn the desired ROIC. Shareholders would prefer management to re-purchase shares when prices are low, ideally below a reasonable estimate of intrinsic value and thus accretive to existing shareholders, or simply return the excess via dividends. Not surprising, share issuance operates in the opposite fashion and is most frequently done when the company is distressed or to finance an acquisition that generates sub-par or even negative ROIC. Often times the new shareholders or the acquired shareholders benefit disproportionately over the existing shareholders. Share issuance benefits existing shareholders when the shares are issued at a price far in excess of the estimated intrinsic value of the company. Perhaps the recent acquisitions by giant social media companies may prove to be examples of value-creating share issuance; Berkshire Hathaway's acquisition of Burlington Northern Santa Fe is an example of a value-creating acquisition using equity issuance.

Our View Looking Forward

We continue to view average stock and bond prices as being above a reasonable estimate of intrinsic value. Our inclination is to remain under-weighted in our exposures to equities and longer-duration bonds. This posture is designed to lessen the impact of downward price adjustments while maintaining a meaningful participation in the broad markets. We will endeavor to add equity investments that have the favorable characteristics described above with full awareness of the difficulty of doing so in a market priced at a high multiple of above trend earnings.

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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