

April 19, 2017

"Only when the tide goes out do you know who's been swimming naked." – Warren Buffett

Dear Clients and Friends,

It is the time of the year again when our firm is required to send out several disclosure documents for your review. Please know that these documents are for your benefit and we are required to make them available to you each year.

Accordingly, please find the following items enclosed in this reporting package:

1. Your quarterly portfolio report as of March 31, 2017
2. Annual Offer Letter of our Form ADV
3. Our Privacy Policy
4. State of New Jersey Disclosure Document

Taking a brief look back at the First Quarter of 2017, we saw a healthy continuation of post-election positive results. The Barclays Global Aggregate Bond Index appreciated 1.76% while the S&P 500 returned 6.07% and the MSCI World Index appreciated 6.91%. Economic news flow during the quarter was generally positive, as solid gains in job growth, new home construction, retail sales and consumer confidence moved the economy forward. The Federal Reserve saw enough strength in the economy to raise interest rates for only the third time in the last decade. However, the rally began to lose steam in March after the new administration failed to repeal the Affordable Care Act and investors grew skeptical of the speed at which other initiatives may be enacted. Terrorism in London along with continued concerns in Syria and North Korea also dominated the news towards the end of the quarter.

Generally speaking, our boutique managers saw solid performance for the quarter but trailed the broad benchmarks. This has been a common refrain not only for our firm, but for most active managers. We wrote to you back in January and in July 2015 about this very topic concerning passive investment strategies outperforming active strategies over the past decade. We promise to not rehash the entire topic now, but we will mention some aspects that we believe merit a conversation today.

Passive investments, such as an S&P 500 Index Fund, have had an outstanding run over the last 10 years, returning an average of 7.50% per year. Although several of our boutique managers have equaled or bettered these returns, few have consistently done so over the last few years. But why has the S&P 500 performed so well during this time period? Certainly abnormally low interest rates have contributed, but might not explain the outperformance over most active managers. The chart below might prove somewhat enlightening:

S&P 500 Sector Weightings (%): Selected Year Ends Since 1990													
Sector	1990	1995	1999	2000	2002	2004	2006	2008	3/9/09	2011	2013	2015	2017
Technology	6.34	9.39	29.18	21.23	14.63	16.05	15.14	15.40	17.84	19.02	18.58	20.69	21.74
Financials	7.39	13.14	13.02	17.34	20.46	20.64	22.27	12.97	8.58	13.43	16.17	16.47	17.70
Health Care	10.28	10.82	9.31	14.36	14.77	12.68	12.03	14.92	16.11	11.85	13.01	15.16	14.17
Cons. Discret.	13.00	12.97	12.70	10.28	13.26	11.90	10.62	8.39	8.31	10.67	12.54	12.89	12.10
Industrials	13.70	12.63	9.91	10.57	11.50	11.79	10.84	11.06	9.46	10.69	10.93	10.05	10.11
Cons. Staples	13.86	12.80	7.17	8.10	9.48	10.48	9.25	13.06	13.90	11.54	9.79	10.06	9.38
Energy	13.32	9.14	5.55	6.57	5.99	7.16	9.82	13.14	14.05	12.27	10.24	6.50	6.48
Utilities	6.19	4.53	2.21	3.79	2.84	2.94	3.55	4.20	4.43	3.87	2.93	2.99	3.10
Materials	7.20	6.05	3.00	2.30	2.82	3.09	2.96	2.97	3.18	3.50	3.50	2.76	2.81
Telecom	8.72	8.53	7.94	5.46	4.25	3.27	3.51	3.88	4.14	3.17	2.31	2.43	2.41

<https://seekingalpha.com/article/4054803-s-and-p-500-sector-weights-lot-changed-8-years>

Please note that in 1990, the Technology and Financial Sectors accounted for approximately 14% of the total value of the S&P 500. Today, Technology and Financials represent approximately 40% of the S&P 500. Since the S&P 500 is "Market Cap Weighted", the larger the size of the company, the larger the impact its stock price movement affects the overall performance of the Index. Since they are extremely large companies, the top 10 (out of 500) stocks in the Index today represent approximately 19% of the total value.

So why might this explain the outperformance of passive investments versus active and why does this matter to an investor? Most passive investors own an S&P 500 Index fund and, therefore, have 40% of their portfolio invested in technology and financials, with 10 stocks representing almost 19% of this portfolio. These sectors and these 10 stocks in particular have had exceptional performance over this time period, with much of it coming after the recovery from the 2008 financial crisis. According to an article in the Wall Street Journal on April 18, 2017, the top 10 stocks of the S&P 500 have accounted for 53% of the year-to-date return of 4.7% with Facebook, Amazon and Apple alone accounting for 33% of this return.

In addition to the 10 stocks referenced above, all investors of the Index also own the other 490 companies. The only real common trait of these businesses is that they are all large companies. Some are great businesses, some are not. Some are highly profitable with very little debt and others are woefully unprofitable and have large amounts of debt. In short, you own the good, the bad and the ugly when you own the Index.

Referencing the great Warren Buffett quote at the beginning of this letter, most investors tend to only analyze their actual holdings when their returns are poor. No one cares about sector weightings or top 10 positions when returns are piling in year after year. However, when the markets decline, or "the tide goes out", you might suddenly realize that your swim trunks are not as well-constructed as you thought when you made the purchase.

Owning large baskets of stocks in an index fund or exchange traded fund (ETF) works magnificently in rising markets. However, you also really cannot beat the market since you essentially own the market. Again, no worries here in good markets. Even though it may seem like it now, good markets do not last forever. The longer we experience these rising markets, the closer we move towards more challenging markets. Although we never know when market dynamics may change, attempting to guess right and time the markets has proven to be a long-term losing strategy.

As you know, we choose to allocate capital to active investment strategies implemented by boutique managers who are experts in their own niches of the market. They do not turn around and purchase the largest 500 (or more) companies in the world and then let the chips fall where they may. Instead, they spend months analyzing the merits of a handful of high quality companies that are well managed and trading at reasonable values in the market. They analyze the financial metrics of these businesses. They meet the management team and ask them challenging questions. They use their knowledge and abilities to determine if these great businesses will turn out to be great investments for your portfolios. They then purchase these stocks and watch over them like a mother hen. Based on their expectations and the performance of these businesses, they will then buy or sell these holdings when appropriate.

Although this rigorous process may not have kept up with some index funds over the last few years, we believe it is a superior way to manage capital for the long run. Not that we welcome difficult markets, but we are secure in our beliefs that when the tides do inevitably go out next, we will be appropriately attired to withstand the choppy waters.

As always, we thank you for your continued support and confidence and we look forward to writing to you next in the summer. Meanwhile, please feel free to contact us anytime with questions or comments.

Best regards,

Bob

Robert W. Joel,
Chief Investment Officer

Chuck

Charles T. Woolston, CPA
Chief Executive Officer

