

## Letter to the Clients

January 27, 2017



Dear Clients,

Now that the elections are mercifully behind us, the markets should be able to focus on fundamentals, which are, as of this writing, neither terribly positive nor terribly negative. Over the next 12 months, we would expect, so long as U.S. growth continues, that interest rates will rise gradually at first, but then, possibly, more rapidly, in response to greater levels of inflation than what we have witnessed for the past several years. This will provide something of a headwind to stock valuations, particularly growth-oriented names that depend, in part, upon expanding price-earnings ratios. So long as economic growth continues, or accelerates modestly, we would expect traditional value names, which have long underperformed the growth sector until just recently, to do better. The key to stock price performance going forward will be economic growth. The Trump administration is likely to be far more growth-oriented and business-friendly than was the case in the Obama era. So, we expect this to provide a tailwind for the markets. The upside to the tepid growth of the past nine years is that few excesses have been built up in the economy. Indeed, the one identifiable excess, and the one obvious bubble, is

sovereign debt. This situation has persisted for some time, but there is reason to believe that the day of reckoning may be here sooner than the markets seem to think. This is a very obvious headwind. Very moderate commercial-loan demand and quiescent inflation statistics have kept bond rates at unprecedented lows, even negative, levels. It is simply wishful thinking to suppose that this can continue for very much longer. (And, indeed, since the Trump election, rates have begun moving up.) Higher rates and higher deficits, without very robust economic growth, is a recipe for fiscal disaster. So it seems obvious to us that the Trump administration will have no choice but to pursue an aggressive growth agenda. How successful they will be is another question, but at least until budgets get completely out of control, we would expect an expansionary bias to government policy that should have a salutary impact on the global economy. Our portfolios are generally positioned to participate in this environment, should it come to pass; but, as we are bottom-up stock pickers, rather than top-down managers, our stock selection is not dependent upon this scenario unfolding. Rather, we focus on companies of good quality that are selling below what we believe to be their intrinsic value. We will look at companies in any sector or industry. Value investors need to search for value wherever it can be found, not necessarily where we would like it to be. The past several years have been difficult ones for active managers, and beating the benchmarks has been a formidable challenge that very few managers have achieved. For any number of reasons, we believe that active management will have a recovery over the course of the next several years and we look forward to participating in that revival.

Sincerely,  
Robert W. Kleinschmidt  
President, CEO and Chief Investment Officer