Note: This material is provided to non-clients as a sample of quarterly client informational letters. Actual clients receive additional commentary specific to their account, account performance, and risk profile.

January 25, 2016

Dear Investor,

Investor accounts ended 2015 down an average of one percent, two percent below the S&P 500 (up 1%).

The result reflects a few factors. While the S&P index rose slightly for the year, the majority of the stocks in the index fell in value, and the majority of small company stocks, which are not included in the index, fell in value. In addition, some of our preferred stocks, real estate investment trusts, and bonds, which we hold for income, lost value. I discuss these in more detail in the preferred stock section below.

Several of our common stock holdings were hurt by the continued decline in commodity prices, particularly energy, metal, and grain prices. I sold most of these holdings early in the year but their losses prior to sale impacted our full year result. Also, a few of our holdings in sectors unrelated to commodities had disappointing performance. Trinity Biotech, a medical testing company, was one such holding. I discuss Trinity in the 'notes on holdings' section below.

A number of our holdings performed well over the year, including Quality Distribution and Liberator Medical. Both companies were acquired at premiums by larger companies. Also benefiting from merger activity, our small bank investments rose substantially, with Cape Bank of New Jersey announcing a sale to a competitor at a premium price in January 2016. Microsoft and Google also had a good year, and are currently trading close to their all-time highs.

Notes on the year ahead

As of mid-January, the stock market has had its worst start to the year on record, with the S&P 500 down more than 7%. We have fared slightly better than the market so far this year. The selling has been set off by indications of slowing growth in China at a time when the rest of the world economy is close to recession.

China's comparatively fast growth has supported global economic growth in recent years. If China's economy meaningfully declines, there is an increased risk of global recession. This development comes amid a retraction of monetary stimulus by the US Federal Reserve, which raised rates slightly in December for the first time since 2006. Several more rate increases are planned for 2016, although any action may be delayed by the current turbulence in global financial markets. Further, US inflation remains below the Fed's 2% target.

At the current time, most observers still expect slow, but positive, economic growth for the US economy this year. This is more or less the outcome that is still discounted by the market. To put some numbers on it, the companies which comprise the S&P 500 are expected to earn roughly $118 for the year ahead, representing about ten percent earnings growth. A reasonable multiple for investors to pay on those earnings, given current interest rates, would be something in the mid-teens. At the recent price of 1880 for the S&P 500, the market trades at sixteen times expected earnings – more or less fair value.

Should current earnings estimates prove to be accurate, I think the market could recover its early year losses as the year progresses. However if global economic growth weakens further, earnings estimates will fall. And sometimes, as earnings fall, the market multiple falls with it, magnifying losses. It is certainly possible that a six percent fall in earnings estimates and a six percent fall in the market multiple could trigger a double digit market decline from current levels.

In general, our stock holdings trade at lower multiples than the broader market. Further, many of our holdings, including Comcast and several of our health care investments, are not especially leveraged to global growth rates. As a result, I believe a further pullback of ten percent or more in the value of our stock holdings would likely be temporary, and would represent a buying opportunity.

<u>Preferred stock and exchanged traded bonds</u>

While I view our stock holdings as reasonably valued, I expect stock returns to be lower over the next few years then they have been for the prior six years. Given that more muted outlook for stocks I am gradually increasing our holdings of preferred stock and exchange traded bonds, both of which offer fairly predictable returns. Some of these income securities fell in value last year. Those losses, which I think will be temporary, were largely due to market expectations of rising rates and concerns about the health of the economy. Currently these securities yield between 6% and 8%, returns which look attractive in the current environment.

It's critical when investing in these securities to monitor the issuers' ability to service interest and dividend obligations. In most cases the underlying creditworthiness of our bond and preferred stock issuers is the same or in some cases better than one year ago. So, while the market sold down these securities last year, thereby giving them higher yields, I remain confident we will continue to receive our interest and dividend payments. In addition, these holdings are less likely to lose value in the event of a modest economic slowdown in the US economy. That makes them well suited for the current environment.

In general, the value of fixed payment securities falls when interest rates rise, and rises when interest rates fall. In theory that would make these holdings risky for a period where interest rates are expected to rise. However, I believe prices of these securities already reflect the expectation of higher interest rates, limiting the risk of losses due to interest rate changes.

That said, given market volatility, there is a possibility these securities will temporarily fall in value, in some cases simply because investors want to raise cash levels, so I am making any additions gradually. I hope to have increased accounts' exposure to these holdings by 10% from current levels by the end of this year.

Notes on specific holdings

One of our worst performing holdings this year was Trinity Biotech. Trinity manufacturers tests for a range of diseases including HIV, Lyme disease, and Diabetes. These are mostly 'point of care' tests, which a physician can administer and review in one appointment. The stock has been hurt by weakening demand for some of these tests, as well as slower than expected progress developing new tests. After some delays last year, Trinity submitted a potentially important test for heart attacks to the FDA for review. If approved, that test should substantially improve the company's earnings, and lead to a recovery in its stock. Given that potential, and what I see as limited downside from the current share price, I've continued to hold shares in Trinity.

Among our best performing holdings last year were community banks like Cape Bank of New Jersey and Ocean Shore Holding. I am continuing to look for other community banks that have reasonable valuations, some earnings growth, and the potential to be sold to larger banks at a premium. Assuming I can find other bank holdings that meet these criteria, I would expect our holdings of small banks to increase modestly over the next year.

As always, please contact me with questions.

Best wishes for the New Year,

Doug

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