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 17, 2017

Dear Investor,

On average, client accounts rose slightly above 11% for the 2016 calendar year. For comparison the S&P 500 rose 12% and the Barclays Aggregate bond index was flat over the 2016 calendar year. On average client accounts were two thirds stocks and one third cash and fixed income securities. If you apply these weights to the S&P and Barclays bond indices you would have a full year return of 8%, 300 basis points below our average return.

After a weak start to 2016, we did well in the final months of the year, largely on strength in our bank and insurance holdings. Strong moves in those sectors offset continued weakness in our health care holdings and a late year sell-off in our income holdings. Bank and insurance stocks rallied on expectations of lower US corporate tax rates, reduced regulation, and higher earnings on loans as a result of rising interest rates. I think cautious optimism about bank earnings remains warranted. However after the strong end of year rally some of our bank holdings appear fully valued, and I have begun to reduce our exposure to the sector.

Health care, which was the worst performing sector in the S&P 500 in 2016, hurt our full year performance. Two of our smaller health care holdings, Trinity Biotech and Infusystems Holdings, had notably bad years. I believe Infusystems will recover from recent setbacks and have added shares on price weakness. I am more doubtful about Trinity Biotech after recent developments and have exited the holding at a loss. I discuss both names in more detail in the company notes section.

Our investments in larger health care companies, specifically Abbott, CVS, Allergan and Gilead were also down for the year. For a number of years these businesses benefitted from price indifference among consumers, as rising drug costs were largely covered by private insurance and Medicare. This dynamic began to change last year, as insurance plans increased “co-pays”, requiring consumers to pay a larger portion of drug costs at the time of purchase. In consequence consumers have become more aware of drug price increases. At the same time, there was increasing political focus on the issue as part of the 2016 presidential campaign.

In this environment future profit growth for many health care businesses will be more subdued than in years past. However, a good deal of pessimism is already incorporated in the prices of health care stocks. They are now cheaper than they have been for several years, relative to their earnings potential. As a result I continue to hold health care names that I view as among the best able to withstand price competition.

Our largest health care holding is Abbott, which I view to be among the least sensitive to price pressure. This is due to its large presence in developing markets, combined with a leading position in over-thecounter nutritional supplements. Abbott is also likely to close on the acquisition of medical device manufacturer St. Jude, and that merger could provide cost cutting opportunities for several years.

Market Notes

The market has steadily rallied since the Trump election. I suspect the single largest factor contributing to investor optimism is the prospect of reduced corporate tax rates, which would give an immediate boost to US corporate profitability. As an example, a business that currently pays a tax of 30% on its US profits would get a seven percent profit lift from a reduction in the corporate tax rate to 25%.

A second factor in the market move is the anticipation of increased fiscal stimulus, both from higher infrastructure spending and reduced personal income tax rates.

However, investors seem to be ignoring a number of risks for corporate earnings and stocks. Among these:

1) Stocks are expensive relative to historical averages. Currently the S&P trades at eighteen times estimates for 2017 corporate earnings, more than 20% above historical averages. If corporate tax rates are cut, the index would trade at a still high seventeen times forward earnings.
2) Corporate earnings and profit margins are at record highs, and could be hurt by a tighter employment market and rising hourly wages.
3) Interest rates have begun to rise, increasing the relative attractiveness of bonds and the returns investors will require to hold stocks.
4) Strength in the US dollar will pressure earnings for multi-national corporations when they translate their foreign earnings into dollars.
5) Trade restrictions, should they be enacted as described by the president-elect, would likely depress economic growth and the earnings of multinational companies.
6) Global political uncertainty remains high, with risks including capital flight from China and political instability in the European Union.

Despite these risks, the market and its participants seem to be very much in a 'glass half-full' frame of mind. This has made it more difficult to find inexpensive stocks. It has also led me to reduce the position sizes for holdings whose market price appears overvalued.

Turning to our fixed-income investments, concerns over the potential for higher inflation and higher interest rates have led to a modest sell-off in bonds, preferred stocks, real estate investment trusts, and other income focused stocks. This means that we once again can add high quality securities to the income portion of our portfolio with yields of between six and seven percent. Just a few months back, these securities were yielding closer to five percent. These securities appear to be a reasonable place to invest additional funds, as their six to seven percent yields may compare favorably over time with stock market returns. However, should interest rates rise substantially from current levels, the prices of these securities will fall and the securities will offer even higher yields. As a result, I am only adding gradually to our income holdings. I would become more aggressive with purchases if yields should rise further later in the year.

Company Notes

One of our smaller health sector holdings, Trinity Biotech, saw its shares fall sharply in early October after the company failed to receive FDA approval for an important new product. As background, Trinity manufactures medical tests which can be used by doctors at the point of care. The company developed a device that would have allowed emergency rooms to test for heart attacks quickly and more accurately than competing products. All available information suggested a high probability of approval. Unfortunately for Trinity, in its product review the FDA applied a much higher performance standard than it had used in the past and denied approval. Without this product, Trinity's prospects become far less interesting. As a result, I sold the holding.

Trinity is one of the few stocks I have purchased where so much depended on a single event. To the extent possible, I intend to avoid similar situations in the future. Towards that end, I sold two other holdings which I viewed to have high single-event risks, the pharmaceutical manufacturers Flamel and Biogen.

Infusystems Holdings, a longtime holding that provides doctors' offices with infusion pumps, suffered two setbacks in 2016. The first occurred during the summer, when Medicare changed the way it reimburses for pumps, leading to a reduction in the revenue Infusystems receives. After that development I reduced our holdings moderately, as I did not think investors appreciated the negative long term implications of the change. Then last November, the company announced an accounting error, causing it to retroactively reduce reported earnings. Investors are highly sensitive to errors of this kind, as they can be a red flag for still larger accounting problems. However, after several conversations with the company, I believe that the accounting problem was an isolated event. As a result, I took the opportunity to repurchase some Infusystems shares at levels substantially below our last sale.

We continue to hold substantial exposure to the cable television sector, through our investments in Comcast, Cable One, Charter Communications, and Liberty Global. Investors have been wary of cable stocks as audiences have been shifting their viewing from traditional cable television to streaming services like Netflix. But lost among these concerns is cable companies' second and far more profitable business, the provision of high speed internet access. In many markets, the cable companies face limited competition in this business even while the service they provide is increasingly indispensable. It is one of the few growing businesses in which providers have substantial pricing power, and will provide support for earnings growth in coming years.

As always, please contact me with any questions.

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