

This letter is dated January 2017

***I would not give a fig for the simplicity this side
of complexity, but I would give my life for the
simplicity on the other side of complexity.***

- Oliver Wendell Holmes Sr.

Over the past 25 years I have come to know many of our clients' personal stories. In my experience, knowing where someone is coming from can improve communication and deepen understanding. In this letter, I will share experiences from my career that have served to form my approach to investing and life. I realize that a long personal letter may seem a bit much, especially in today's world of television sound bites and 140-character tweets. Some may prefer to jump to the last section which focuses on 2016 portfolio activity, the investment environment and the thinking behind our current portfolio positioning.

If I am going to do this right, I have to start with my first job—cutting grass for neighbors. My favorite customer was a widow I will call Mrs. V. I started working for her in 1979; I was twelve and she was seventy-two. Mrs. V made a lasting impression on me. She was always moving but never seemed to be in a hurry. She took great care in everything she did. She wore a dress at all times, even while doing yard work. I can picture her like it was yesterday. She was tiny but had big brown eyes that reflected a keen interest in whatever she was looking at—a flower, a bee, even a weed. When Mrs. V looked at things you had the sense she was studying them, working to understand them better. Everything she owned—her car, clothes, glassware, gardening tools, *everything*—was old, high-quality and in impeccable condition. Her yard and garden looked like a feature in *Home and Garden* magazine.

Each time I finished cutting Mrs. V's yard she would invite me to sit with her and enjoy a glass of lemonade on her screened-in porch. She served ice-cold lemonade, handmade from fresh lemons, in a Louisville Stoneware pitcher that was probably more than fifty years old. As I drank my

lemonade (still the best I have ever had) Mrs. V and I would chat a bit. Mrs. V had a sense for quality and a wonderful way of working *with* people, things and circumstances that I admired at the time and grew to appreciate even more over the years. Our conversations always had a certain rhythm to them. In the spring if I said something like “we sure have had a lot of rain,” she would reply “oh yes, it has been wonderful for pulling weeds, they come up so easily when the ground is nice and wet.” In late summer, when I complained about the heat and the drought, she would say something about being thankful that her grandson helped water her garden. She might also mention how pleased she was with her old sprinkler. I was convinced she owned the first sprinkler ever made. It hung in a special place in her spotless and perfectly organized garage. Somehow with that lone old sprinkler, in like-new condition of course, she was able to keep her entire yard thriving through even the longest dry spells. As we chatted, we both enjoyed the view of her backyard and garden. When I finished my lemonade Mrs. V would go inside to get the money to pay me. She would count out loud, softly and intentionally, as she carefully placed each dollar in my hand.

I used a *Snapper* mower in those early days of my grass cutting business and I was convinced it was superior to other brands. The *Snapper* was heavy, making it harder to push, but its design resulted in a beautiful cut. While most mowers shot the clippings into a bag situated at the side of the mower, the *Snapper's* bag hung directly behind the mower, inside the push handle. This allowed for the housing and wheels to be uniform on each side, making for sharp, clean lines. Extra horsepower and heavier deck housing, with nothing escaping out the side, combined to create powerful suction that left a yard looking like a freshly vacuumed carpet. Most of the other boys in the neighborhood used *Lawn-Boy* mowers. The *Lawn-Boy* was noticeably lighter, the housing was made of a thinner metal along with some plastic, and it had a grass chute on the right side. The wheels on the chute side were staggered, causing the wheel impressions left on freshly cut lawns to appear blurred. Some days my number one competitor, Bobby, a *Lawn-Boy* man, would happen to be cutting the yard across the street at the same time I was cutting Mrs. V's yard. The lightness of the *Lawn-Boy* made it easier to push and Bobby would invariably finish well before me, never looking back as he hurried on to the next job. The word on the street was that Bobby made more than \$200 a week.

Please forgive me, but I am going to toot my own horn for a minute here. I am pretty sure that I was the first in my neighborhood to cut a yard diagonally. I was thirteen years old when I first saw a yard cut this way. I was riding in the back of my mom's station wagon on our way to take my older sister somewhere and there it was: a diagonally cut yard. Oh, what an impressive sight! It was an "aha" moment for me. Cutting grass long ways over and over had always bothered me, as I worried that I might be wearing tracks in my customers' yards. I had tried alternating between "long ways" and "short ways" but "short ways" just did not look right to me. I never felt good leaving a yard after I cut it "short ways". Cutting diagonally offered a breakthrough solution that to me looked even better than the traditional "long ways" method. One week I'd go diagonal upper right to lower left and the next upper left to lower right. It makes me happy just thinking about it. It not only eased the track wear on the grass but also looked sharp and provided a nice contrast to the neighbors' yards on each side. Sure, it took a little extra time— there was a lot more back and forth given the shortness of the corner rows— but to me it was worth it. In those first few years I would stop just a bit down the road to admire Mrs. V's beautiful yard and compare it to the neighbors' yards on both sides and across the street. Hers was always the best and it gave me a wonderful sense of satisfaction.

I wish that I could say that I maintained that level of quality work throughout my grass cutting years but the truth is my focus shifted from quality to quantity and I eventually switched to using a riding mower. It was wider and faster, enabling me to finish jobs in about half the time as I did with the *Snapper*. I was sixteen years old and in a hurry to make more money. I became more like Bobby. I do not remember drinking lemonade with Mrs. V that summer. I do not remember stopping to admire my work either. I do remember cutting grass for a 54-unit apartment complex. It was a perfectly miserable job, dealing with trash and dog poop while cutting yards that were mostly clover and crab grass. I got hired for the job because I agreed to work cheaper than the big lawn care companies; I took the job because I wanted to make more money. It paid \$90 a cut.

My grass cutting career ended when I went off to college. I was interested in making money so I decided to study economics. A friend and I started researching stocks in our spare time. I use the word "research" in the loosest sense of the word. We were antsy to make money; in-depth

research was too time-consuming for us. One day, we read about an exciting new company that manufactured, of all things, hovercrafts. The company had just gone public. My friend and I were eager to get in on the ground floor of what we imagined would be a revolutionary new company, taking breakthrough technology to the mass market. We anxiously called the number of the Miami-based underwriter, fearing we might be too late and that the share price might take off before we had a chance to get in. We were connected with a broker who claimed to be one of the world's foremost experts on hovercrafts. He shared that the company was about to sign a contract with the US military. My friend and I scrambled to fill out the paperwork and send in a check.

You can guess what happened next. The company's share price started falling almost immediately after we bought shares. The price continued to sink in the weeks that followed. We started asking questions about the company's financials and the responses were disturbingly vague. The broker quit taking our calls. We sold after losing half our money in just a few weeks. The stock ended up going to zero. The whole episode made me nauseous.

The amount I lost roughly equaled the cumulative amount that Mrs. V had paid me to cut her grass over five summers. I was not thinking about how hard it was to make the money when I bought the shares. I was in too much of a hurry to make more.

That was the first and last time I tried to make a fast buck in the stock market. I stashed what little money I had left in a savings account and hit the books, determined not to get burned again. During my junior year, in the fall of 1987, I interned for Butcher and Singer, an old-line Philadelphia investment firm. About two months after I started, on Monday, October 19th, the Dow Jones Industrial Average fell more than 20% in a single day. For days afterward, the media featured financial experts offering explanations for the crash with impressive clarity and confidence. It was the first time I noticed that experts are much better at explaining the past than they are at predicting the future.

I worked in the department that took companies public. Up until the crash we were frantically busy floating new shares on the market. The day after the crash the department head called a meeting to inform us that all deals were being put on hold. I spent the rest of my internship reading research

reports and asking questions of brokers, analysts and bankers, most of whom had plenty of time on their hands when they were not working on their resumes.

Lessons learned during the fall of 1987 have stayed with me. The first was that demand for stocks can change suddenly and without warning. As a student of economics, the supply and demand dynamics of publicly traded securities fascinated to me. Higher prices attracted increasing supply, just as the law of supply and demand would predict. Falling prices, however, triggered fear which destroyed demand. That is not what the law of supply and demand would predict. Stocks were unique in this respect; demand for virtually all other goods that I could think of increased as prices fell. Not stocks, at least not in the short run.

The second lesson the crash revealed to me was that the financial markets and the economy were not one and the same. The fact that the market was falling apart did not necessarily mean the economy was falling apart. Similarly, shares of stock in a company and the company itself were not the same thing. Stock prices can rise or fall for all sorts of reasons, sometimes unrelated to company performance. The 1987 crash, as it turns out, was primarily caused by the widespread use of “portfolio insurance” which, in essence, was a hedging strategy that involved selling stock index futures as prices fell. Widespread selling of stock index futures pushed down prices of the underlying stocks further and further, creating a negative feedback loop. Falling prices also generated margin calls, forcing more selling and triggering rampant fear that fueled yet even more selling. In short, the crash was a market event rather than an economic event.

Perhaps the most important lesson I learned from the crash was that falling prices create disasters for some investors and opportunities for others. Those who were over-invested in 1987 suffered devastating losses as they retreated from stocks selling for pennies on the dollar, either because they were stretched financially or not emotionally able to handle such extreme volatility. At the other end of the spectrum, investors who were in a strong financial position, kept their cool and did their homework were able to build up portfolios at bargain prices, setting up what turned out to be great performance in the years that followed.

When I graduated from college I took a job in management consulting in Detroit. I chose management consulting because it appealed to my ego as

it was the new “hot” career path, replacing investment banking in the post-crash world. I picked Detroit because the position paid \$3,500 per year more than the consulting offer I had in Chicago. When ego, money or both are at the top of the list of decision drivers the outcome is probably not going to be very good. I quickly learned management consulting was not for me. Fairly or not, I was skeptical of the value added by consulting and knew I needed to move on to doing something I truly believed in. I was reading everything I could find on investing, seeking to build on the lessons learned from my hovercraft speculation and the crash of 1987. Warren Buffett’s Berkshire Hathaway shareholder letters and Peter Lynch’s *One Up on Wall Street* spoke to me. I wanted to be an investor. I was convinced that investing well could make a great difference in a person’s life. At the same time my wife, Marie, decided she wanted to move to Louisville to be closer to family. Management consulting was not for me and Detroit was not for her.

One day after work in Detroit I drove through the night to make an 8:00 a.m. interview with an investment firm in Louisville. I told the interviewer about my vision of helping people make good long term investments and he immediately put up his hand, signaling that I should stop talking. He said he was sorry, but they did not hire people my age and I should come back in few years after I had gained more experience. His words hit me like a punch in the face. My first thought was that he could have told me about the age requirement over the phone and saved me twelve hours of round trip driving. I was upset and my mind was swirling. As a cocky college kid, I had been certain that I was destined to achieve fame and fortune as a big-time investment banker on Wall Street. Now I was getting rejected for an investment broker position at a little firm in Kentucky. I was lower than low. I sat confused, looking across the desk at my interviewer. He went back to reviewing papers on his desk; the interview was over. I sat there with no idea what I was going to do next. It was the only interview that I was able to get. None of the big firms would return my phone calls. Eventually, my interviewer looked up from his papers. I could tell that he was surprised to see me still sitting there. Luckily for me, he assumed I had not left because I was the kind of guy that did not take “no” for an answer. He did not realize that I was actually so discouraged that I needed time to collect myself before I could stand up. He woke me from my stupor with a question: “Are you related to Phil McCauley, the banker from

Madison?” I straightened up and said: “Yes, he is my grandfather.” The interviewer’s eyes lit up and his energy changed. He broke into a smile as he stood up and walked around the desk to shake my hand. The next thing I knew I had a job offer and was taking a tour of the office, getting introduced around as the grandson of Phil McCauley from Madison.

My grandfather was my first client. He was essentially my only client for what felt like a long time. He loved competing. Let me rephrase that: My grandpa loved winning. He competed at everything— golfing, cards, fishing, checkers, bowling, ham slicing, you name it. I remember playing the card game *hearts* with him when I was maybe twelve or thirteen. I was his partner and I played a card that I should not have. He could not hide his frustration. “Why did you throw that?” he snapped at me. I replied that while I knew the odds were against it, I had a lucky feeling so I took a shot. He said nothing and he didn’t need to because the expression on his face said it all. He looked like he had just sucked on a lemon.

He was such a competitor and a perfectionist that he made fishing stressful. You had to fish according to his precise instructions—hooking the minnow in a certain way, casting in an exact motion each and every time. There was constant pressure to catch more fish than the other boats in our group. One time out, with the encouragement of my cousin, I snuck an extra weight onto my line so that I could outdistance our grandpa’s casts. It worked. Each time my cast flew beyond his he would shift around agitatedly on his seat. He was visibly annoyed and all the while my cousin and I exchanged knowing glances as we tried not to laugh. I was having the time of my life, besting the most competitive person I knew and impressing my older cousin. Then I got greedy and casted beyond him into a tree limb near the shore. I froze with fear, knowing my cheating was about to be discovered. As my grandpa untangled my line out of the tree his eyes locked on to the extra weight. I was scared stiff. He freed the line from the tree limb and held it up, the offending extra sinker dangling between his face and mine. Staring at the sinker, he said in a stern voice: “Hmm, I can see now why you’re not catching any fish; you know I’ve caught three already.” As he turned away I swear I saw the hint of a smile cross his face. I am not sure if he was pleased to know how I was out casting him or he liked the competitive spirit my little trick revealed. He never said another word about it and I was tremendously relieved.

My grandfather began his career in banking during the Great Depression and started investing in the 1940's, just after World War II. He invested through market booms and busts, periods of low interest rates and high interest rates, economic expansions and contractions, peace and war. He had invested in real estate as well as in private and public businesses for decades. Even so, fueled by the cockiness of youth and an inflated sense of the value of my financial expertise, I thought I knew more about investing than he did. I had a degree in economics, had worked for a big firm in a big city, knew all sorts of complex methods of financial analysis, read the financial press, studied Wall Street research and used computer databases. My grandfather, on the other hand, had little interest in any of that. I loved him as a grandfather but thought he was naïve as an investor. It took a long time for me to realize that I was the naïve one.

I enjoyed visiting my grandfather whenever I got the chance. It was not often, however, since I was ambitious and almost always in a hurry. When I stopped by his old Victorian home in Madison we would talk stocks at his breakfast table. On one visit, he invited me up to his office on the second floor. Everything in his office was in perfect order, just as I would have expected. He had three stacks of donation requests neatly arranged on his desk. He explained that the first stack included requests he had not finished evaluating, the second comprised requests from charities he was going to contribute to and the third stack was where he put requests he was rejecting. Incredibly, he was writing short notes to those he was rejecting, explaining why he was not making a gift. He took the time, he explained, because he thought they might find the information useful. He subscribed to a publication that rated charities by efficiency and other metrics. He shared his approach with me. First, he would consider the cause. How vital was it? There were so many wonderful causes, he explained, that he had to prioritize. He could not give to all of them. Did he think they could make a difference? How many lives might be improved? How much might they be improved? Next, he would go to his charity rating guide and read up on the organization and how efficiently it was managed. He hated waste. I looked at the height of the stack he was giving to and my eyes widened. He noticed and laughed saying, "Don't worry, I've been doing this for years and I have more money now than I did when I started. The more I give the more I have." I thought that might be the most naïve thing I had ever heard.

He showed me awards he had received as well as pictures with politicians and celebrities. One was of him and Ann Landers laughing together (or it might have been Dear Abby, I'm not certain). I was surprised at how good they both looked. When you are young you think of old people as always being old. At some point, if you are paying attention, you realize they are just a little further down the path than you are.

My grandfather asked if I had time to sit down for a minute. "Sure grandpa, what's on your mind?"

I want to tell you about an investment mistake that almost did me in. It was back in the early sixties. I had had a lot of success up to that point. I was moving up at the bank and I had made good money in real estate. Success can be dangerous; it can make you forget how tough it is to make money.

The big shoe manufacturer in town, Longini, had gone bankrupt and Madison was losing a major employer. A friend, a prominent attorney and a good fellow, asked me to invest in a new shoe company with the idea that we could save jobs that families depended on. We were so focused on all the jobs we hoped to save that we did not give the risk as much thought as we should have.

I wrote a check, making an equity investment that I could afford to lose. That was not the mistake. The mistake was that I signed personally on a line of credit for the new shoe company. To make a long and painful story short, the company racked up debt funding losses and plant investments in a failed effort to compete with foreign manufacturers who had much lower labor costs. We dug a deep hole trying like hell to make it work.

The bottom line is that it took everything I had to pay my personal obligation on the company's debt. I lost 50 times my equity investment—everything that I'd built up from over twenty years of saving and investing. I was 53 years old and had a net worth of zero. The experience almost killed me. I worried myself to the point where I became physically sick. I told your grandmother that I would not blame her if she divorced me, for I'd been a fool and lost all our money.

He studied my face, assessing whether I understood the gravity of what he was telling me. I did. I could see the pain on his face as he recalled that dark period of his life. I was shocked and could not think of anything to say. He locked eyes with me and went on:

Never do anything that could leave you broke. When you are broke, you see, money becomes the most important thing in your life. Never risk letting money problems dominate you. You miss too many more important things when you are worrying about money.

I think he could tell that his story shook me up. He decided to lighten things up a bit. With a smile, he said “I’m sure you’ve heard that old quote, ‘I’ve been poor and I’ve been rich. Rich is better.’ Well it’s true.” We laughed together. Then he got serious again and continued:

Now in terms of the business of investing I got a world class education from that experience. There is nothing like losing everything you have to teach you a lesson. The first thing is to do your own homework. I looked at some projections that were prepared by people who wanted us to start the new company. They were not worth the paper they were printed on, complete pie in the sky. A little homework would have saved me a lot of money and grief. The quality of the foreign shoes was clearly on the rise and they were selling them well below our plant’s production cost. All I had to do was go to a shoe store to figure that out. The second is to stick with businesses that don’t need a lot of capital. In banking, we use the customers’ money, a much better business model (he laughed). And last, but not least, study the downside. If you can’t afford the downside you can’t afford the investment. It’s that simple. There you go, I just gave you an education that cost me dearly and you got it for free (smiling). You got a much better deal but only if the lessons stick. Better to learn from the mistakes of others than make your own. Now, let’s go downstairs and get some more coffee.

Over coffee he explained that he rebuilt his financial position by sticking to those three simple rules. It took a long time but it worked. He added that he found that most investment opportunities he ran across were “over his head”. He would do a little homework and see that he could not hope to understand them. They were too complicated or in a business he had no experience with. He would just pass on those. “You have to stick with

what you know,” he said. Then he shared that in addition to his three rules there was one overriding principle that I should always keep foremost in mind:

In any endeavor, business or otherwise, people are the most important thing. An investment opportunity that meets all three rules but involves people I do not have confidence in is a “no-go,” plain and simple. My attorney friend was a good fellow, but he did not know the shoe business and he was prone to wishful thinking. Do not partner with optimists. They are vulnerable to taking on too much risk. Do not partner with pessimists; they never get anywhere. Partner with realists who have spent years solving problems in the business you are investing in.

My grandfather passed away in 1998 at the age of 88. An article in the local newspaper said that of all the people that lived in Madison in the twentieth century, he made the greatest contribution to the quality of life there. He would have loved reading that—he won first place.

I often think about what I learned from Mrs. V and my grandfather. We live in a noisy, hurried world and they serve as beacons in my mind as I make decisions. I try to quiet the financial “expert” in my head, and focus on what will matter most long term. It is not always easy.

I had lunch with a friend who is a client of ours a few months back. While we were eating at her club, she noted that the room we were in had been, until recently, for men only. She mentioned that a friend of hers said that every once in a while she catches a man giving her what she thinks is a dirty look, presumably disapproving of her presence in the room. My friend broke into a smile and said: “It kind of makes me enjoy the room more.” As we laughed together a man at a nearby table cleared his throat. When we looked toward him we both noticed he was giving us a disapproving look, which made us laugh more. Wanting to be good neighbors we quieted down, smiling at each other as we tried not to laugh.

We talked about her recent trip to Cuba, an African safari she went on with her grandkids, and the Chicago Cubs. I shared how much I admired the decisions I had seen her make in personal and financial matters. In my eyes, she had built a wonderful life and I asked her if she had a secret she could share.

No, I do not have a secret, but I can tell you I think most people worry too much. They get twisted up and stressed out about all sorts of things— most of which is either unimportant in the grand scheme of things or (laughing) something they can't do anything about anyway, so what's the point of making a fuss? Life does not have to be so complicated and stressful. I believe in keeping the few things that are really important in mind as I make decisions. I also believe in good wine.

She shared a story about something the Cubs' manager did that she thought was smart. At a low point during the season, when the team was mired in a losing streak and the players were really pressing, the manager gave each player a pair of onesie pajamas, complete with feet, to wear on their redeye flight back from the West Coast. She liked that story and so did I. Like the Cubs' manager she knew how to lighten things up.

It was hard to believe but I realized we were out of time. We said our goodbyes and I rushed out and jumped in the back seat of my cab. I was off to the station and I could not afford to miss my train into the city; the next one was nearly 50 minutes later. Worrying about traffic, I started to pull my phone out to check the market and my email. Wait a second, I thought, and quieted my mind for a moment. I tucked my phone back in my pocket without looking at it, leaned my head back, closed my eyes and went over my friend's words in my mind:

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Everything slowed down. I reflected on what was most important to me. A sense of gratefulness came over me as I thought about the many people who have made a great difference in my life. It dawned on me that my friend and I started working together nearly twenty years ago. The time has gone by so quickly it was hard to believe it had been that long. No, I did not have enough time to be in a hurry. My cab was stuck in traffic, but my mind took me to Mrs. V.'s screened-in porch. I could see us enjoying lemonade together as we admired her yard and garden. In my imagination, she turned and looked at me and somehow her eyes seemed to smile and say: "Yes, that's right, keep moving, there is always something good to do. And remember not to hurry; you do not want to risk missing it."

Investment Commentary

In short, 2016 turned out to be a better year for equities than we expected. Stock prices wobbled a few times, most notably in the first six weeks of the year when the prospect of higher interest rates alarmed investors and again in June when the Brexit vote caught Wall Street by surprise. While both declines were significant, they turned out to be short lived as investor confidence rebounded quickly. We put some money to work during each episode, but were not aggressive buyers. In both instances, we were surprised the market snapped back as quickly as it did. It has been our experience that market declines happen quickly but recoveries typically take more time. As a result, we tend to make incremental additions after market declines rather than rushing in to make big buys. It is of utmost important to us that our clients are able to weather tough times and continue moving forward even through extended downturns. Our philosophy is to participate in good times and prepare for bad times. Over time you are sure to see both.

During the course of the year we initiated two new positions—an organic grocery store chain and a mutual fund management company— both of which we have followed for several years and know very well. While clearly in very different industries, they share our three core equity investment requirements: 1) we understand the business; 2) we have confidence in management; and 3) we believe the entry price offers attractive upside for reasonable risk. While each company is dealing with competitive challenges currently, both are financially strong and earn high marks for brand loyalty and customer satisfaction, putting them in a good position, in our view, to grow longer term.

We also added to our positions in several other companies— leaders in used car auctions, health insurance, medical devices, pharmaceutical distribution, paper products and telecom equipment. With the exception of the auction company, which we first invested in during 2015, we have had investments in these businesses for many years. In general, we find that the longer we own a company the more we understand it and thus are better able to recognize opportunities presented by short term problems or market disruptions.

We sold out of three companies during the year. We sold our position in a consumer leather goods company due to concerns over increased competition and rising vulnerability to fast-changing fashion trends. We are also concerned that the economic cycle may be getting long in the tooth for consumer discretionary companies. We sold a second consumer goods maker due primarily to what we viewed as excessive executive compensation—a highly dilutive stock option plan—that made the shares more expensive than indicated by traditional accounting measures. We exited the third company when we observed that customers were switching to a new competitor that had a strong distribution advantage.

Since the presidential election, promises of lower taxes, less regulation and new fiscal stimulus have created a sense of optimism among investors who have responded by bidding up share prices. It is important to keep in mind, however, that policy changes will still need to run the political gauntlet and face the risk of being significantly watered down in the process. Furthermore, any economic impact is likely still at least a year away. Wall Street's enthusiasm, notoriously fickle, could fade well before then. In the interim, there are several headwinds building for the stock market which also warrant our attention:

- 1) Rising interest rates
- 2) Rising value of the U.S. dollar against major trading partners
- 3) Elevated U.S. equity prices
- 4) Risk of cyclical slowdown in the economy
- 5) Escalating geopolitical risks

I'll touch on each a bit. First, with respect to interest rates, I think it would be hard to overestimate the role of monetary stimulus in driving economic growth and higher stock prices since the Great Recession. The Federal Reserve kept its benchmark Fed Funds rate near zero from 2008 to late 2016, while also injecting billions of new dollars into the financial markets through quantitative easing. Today, given the significant recent increase in market interest rates and the Federal Reserve's stated intention to steadily raise the Fed Funds rate in 2017, the extended period of easy money appears to be coming to a close. There is an old saying on Wall Street: "Don't fight the Fed." Like most old sayings there is some wisdom in it, as interest rates impact the economy and markets on many levels. A sharp rise in interest rates means that big ticket items such as houses and automobiles are suddenly more expensive for the majority of consumers.

Higher interest rates increase corporate borrowing costs and can also hurt valuation multiples for stocks. Finally, given the amount of debt racked up by the federal government, it is not hard to imagine higher rates leading to larger budget deficits, ultimately calling into question the increase in fiscal stimulus and decrease in taxes that many market participants have already begun to factor into expectations.

Second, record strength in the U.S. dollar damages the competitiveness of U.S.-based companies as exports become more expensive abroad and cheaper imports pose a threat to margins and market share domestically. We are already seeing U.S. multinationals lowering revenue and profit expectations for 2017, citing the strong dollar as the primary culprit.

Third, we are eight years into an expansion that has seen U.S. equity indices advance to record highs. Record highs in and of themselves are not necessarily worrisome. "Records are made to be broken," as they say and in a world of long term growth and progress rising equity prices make sense to me. Still, a prolonged period of rising equity prices and low interest rates has led to increasingly risky investor behavior. Rising prices tend to breed confidence, justifiably or not, and the amount of money borrowed to buy stocks is near an all-time high. Additionally, valuations appear stretched based on a number of measures. One compelling bullish rationale for higher valuations has been the exceptionally low interest rate environment. That argument weakens as rates rise. The bottom line here is that higher equity prices have made it increasingly difficult for us to find stocks priced to offer what we think is attractive upside relative to the risk involved.

Fourth, the longer this expansion runs, the more we need to be aware of the risk of a normal cyclical slowdown, or even a recession. Over the past eight years the economy has expanded steadily, with unemployment falling below 5%, record car sales, and a strong rebound in housing. Economic expansions do not last forever. Economies have moved in cycles throughout history, and at this point it seems reasonable to be on the lookout for the end of this one. While it is true that tax cuts and fiscal spending could help to extend the current expansion, it is also possible that normal cyclical headwinds prove too much to overcome.

Finally, it appears that political risk and uncertainty is on the rise around the world. Election results in major countries, including the United Kingdom,

Italy and right here in the United States, suggest increasing nationalism, with potential negative implications for geopolitics and international trade. It is not hard to imagine an international event of some kind triggering a meaningful negative market reaction.

I share these “big picture” observations and concerns to give clients a sense of our view on the market and the economy. While our focus is on finding opportunities that meet our investment criteria, not on making economic or market forecasts, we do believe that it is important to consider where we are in both the market cycle and the economic cycle as we evaluate investments. In today’s environment, we are finding fewer investment opportunities as more optimistic investors have bid up prices above what we are willing to pay. We strive to be realistic and avoid wishful thinking that might lead us to overpay for investments. Over the past year, we conducted due diligence on over 100 companies. Of those companies, about 80% did not meet our quality criteria either because of the business itself or because of management. We have found that percentage to be relatively consistent over time. However, of the companies that did pass our quality criteria, 90% looked expensive based on our valuation analysis. That percentage is higher than usual. In early 2009, in the depths of the financial crisis, 90% of the companies that met our quality criteria were priced below our valuation target. It turned out to be a great time to be a buyer.

Difficulty in finding quality opportunities at attractive prices has led to higher cash levels in portfolios than we would like. For us cash is temporary, representing funds yet to be invested. We do not like holding cash long term as we believe its purchasing power is likely to decline over time. That said, we also believe that we can add long-term value to portfolios by sticking to our quality standards and price discipline. While many fear market declines, we welcome them as they tend to expand the number of quality stocks that meet our price criteria.

Our focus is in building portfolios of assets that generate growing streams of income over the long haul. While we are not in a hurry to put cash to work today, we are committed to keep moving forward. We are actively looking for opportunities to add to positions at attractive prices as well as to invest in new companies that meet our investment criteria. We fundamentally believe that we live in a world of growth and progress and are committed to doing all we can to preserve and grow client capital over

the long term. We recognize that, like Mrs. V, you are paying us to do a job and we are grateful for the opportunity to make a difference.

Phil McCauley III
January 2017

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