LEAR
INVESTMENT MANAGEMENT

2016 Year-end Review & 2017 Investment Outlook

As we close the books on 2016 and enter the late innings of this decade, we would like to share our thoughts on the memorable events of 2016, the current market environment and our investment thesis for 2017.

As we have discussed for the past year, the *World* is *In Transition (WIT)*. This theme was front and center in 2016. Transitions are the precursor for growth, but as it is with most change, there is an uncomfortable metamorphosis phase.

> *"You can't stop the waves, but you can learn to surf."*
>
> -Jon Kabat-Zinn

The Research team's 2016 investment thesis (WIT) had us well-positioned when the markets suffered the worst January in history (S&P 500 down 11%) and the following political events:

- Chinese Yuan devaluation
- Brexit vote
- Indian demonetization
- The US Presidential election

In a year with so many political distractions and unexpected events, the importance of research, conviction and portfolio process was critical to achieving our goals.

Just the Facts Please

The Lear Investment Management Global Vigilance Composite* returned 7.2% (net of all fees) for the year. We are very proud of this return in any year, but especially 2016. The amount of risk taken was lower than that of the equity market as an average account held approximately 45% in cash and fixed income.

In the fixed income world, we were able to achieve strong returns by leveraging our informational advantage. The favorable return stands in contrast to many investors which held traditional fixed income, like muni bonds and US treasuries, and experienced negative real returns in 2016. Many investors had been able to hide in long and intermediate duration bonds for the past several years, but the lack of ability to identify transition-friendly investments led to trouble within their "safe" assets in 2016.

Our performance in 2016 was a result of the firm's number one focus – to *Deliver Returns for a Controlled Amount of Risk.*

2016 Themes

We predicted that increased auto and home sales in 2016 would fuel economic growth. This held true in the face of Wall Street calling for the end of the cycle. 2016 was another record year for US and Chinese auto sales with a very strong recovery in Europe. Also, homebuilders enjoyed a strong year with the supply of homes still trailing the demand for affordable housing.

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Our research also suggested mature technology stocks would continue to have strong earnings. We took advantage of temporary price dislocations in several technology stocks to add to our position sizes when the stocks reached our target valuation metrics.

We did not follow the herd into value stocks (like utilities and consumer staples) in the first half of the year, and although we missed that flight to safety, we outperformed those industries in the second half of the year.

Oil was characterized by the lower for longer theme in 2016. While some energy stocks were able to recover a portion of their losses from 2015, many remain significantly below their 2015 highs. We remain skeptical of long term price appreciation in the underlying commodity as US shale producers can continue to pump at record levels.

We are not comfortable basing our energy investment thesis on the reliability of OPEC and non-OPEC countries to cooperate and fulfill promises to each other. We do not foresee a return to the 2016 lows but feel the price/barrel will continue to remain range-bound in $40-60/barrel level. We favor investments that benefit from the lower oil prices and are not subject to wild price swings based on commodity speculation or political winds that blow through the Middle East.

On the international side, the Brexit vote came as a shock to markets. While the equity markets bounced back, the currencies experienced enormous swings. The Euro moved from 1.15/US$ to 1.03/US$ since May with the British pound falling from 1.47/US$ to 1.22/US$ in that same period. We were cognizant of the risks in the region and were invested in currency-hedged positions which vastly outperformed. While we see great possibilities in this region, our attention to detail regarding risk in the portfolio was a boon to our clients' returns on the Continent and should serve us well in 2017.

Asia was a mixed bag in 2016 with the Chinese currency devaluation and Indian demonetization getting most of the headlines. We focused on the continuing longer-term growth in the region and pro-business policies that are being implemented. There will always be growing pains as emerging markets become established markets, but the fundamental principles of growth, demographics and future outperformance make investing there a core tenant of any diversified manager.

In the end, 2016 can be best characterized by WIT. Perhaps the greatest transition we witnessed was from the severe pessimism that permeated January to a greater level of optimism as the favorable economic conditions bore fruit and a pro-business administration was voted into office. The events of 2016 were certainly novel, and despite unforeseen twists, we navigated the markets with aplomb.

2017- The Transition Continues

Entering 2017, we believe the World In Transition will reach its most important stage.

The sovereign stimulus trade that has defined the past 8 years is coming to an end in the US. The economic training wheels will give way to fundamental growth and a pro-business administration.

The Federal Reserve has indicated a 75-basis-point hike through 2017, and this less accommodative stance is emblematic of a stronger domestic economy and a return to a more normalized fiscal policy. While the US GDP remains subdued, it is solidly expansive, and most economic indicators are supportive of a very low chance of recession in the next 12-24 months.

Mr. Trump goes to Washington: As the Central Bank slowly begins to raise interest rates, the baton is being passed to the Executive Branch and Congress. The newly elected administration has strongly championed a pro-business legislative and spending agenda, and it is useful to weigh the impacts of these policies. These branches can affect the economy in four major areas:

1) **Taxes (personal and corporate)**
2) **Regulation**
3) **Spending**
4) **Foreign Policy**

Passing legislation is a challenging process full of compromises and sacrifices. So, while we cannot pinpoint the effects of the new administration, several generalities can be gleaned.

- It is highly probable that new tax policy will be favorable for US businesses albeit less so for individuals. Much of the individual income tax legislation is revenue-neutral – allowing for lower rates but eliminating certain deductions.
- The corporate tax proposals will benefit many entities, but careful attention must be paid to domicile, net tax rates and international exposure.
- Many US companies have delayed or canceled capital programs due to increased regulation which has made investment in the US less desirable or riskier than in foreign locales. In concert with lower corporate tax rates, decreased regulation should result in increased capital expenditures which benefit long term growth and productivity and has a stimulative effect on the economy.

Thus far, the markets have focused on the positives of the new administration and less on the potential negative impacts of this transition. These pro-business policies will coexist with increased volatility in global markets due to a more aggressive tack on trade. Our ability to understand valuation and the key drivers of corporate earnings will be vital as we take advantage of new policies that are rolled out.

The negative impacts are most visible with the itchy trigger twitter finger of the President-elect. Late night tweets about foreign policy and unpredictable mud-slinging toward corporate entities are unsettling for allies and trade partners alike while putting corporations on the defensive. While the financial news channels might appreciate this volatility, the markets do not, and this big unknown can create price dislocations based on the uncertainty.

Home Alone: A secondary theme for 2017 will be the transition from internationalism to nationalism. Discontentment of the middle class has led to a call for change from the policies of the past decade and for the country to focus inward. The rise of terrorism has added to this sentiment to close borders, restrict immigration and increase national security.

The recent emphasis on increasing global trade has been replaced by a call for more protectionist policies, and the transition to nationalism is taking place in the US and Europe. Global trade will make a transition to a new set of rules, and we will remain focused on the effect this has on exchange rates, trade agreements and political upheaval. We will look to leverage our research advantages to avoid these pitfalls and to take advantage of quality assets when they become mispriced.

Revenge of the Nerds: The US Stock Market – The bull market which began in 2009 is fast approaching the longest bull market in history. The consensus estimates are for 10% earnings growth of the S&P 500 as moderate increases in rates, commodities and growth are buoyed by this business-friendly administration. While we can see some of this potential, we also remain cognizant of some short- to medium-term risks to avoid.

The last legs of the bull market will be reserved for the fittest of investments, and security selection should vastly outperform the broader indices. This late-stage market combined with the post-election appreciation in equities and a disincentive to sell securities in the 2016 tax year has us hypervigilant for short-term fluctuations.

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We start the year with 35% in short duration fixed income and cash. Our current holdings reflect our slant toward safety and our belief that short-term interest rates will continue to rise. We believe that the risk/reward paradigm is pointing to investment in safer, income-producing assets and is well-positioned to take on increased equity exposure when a pullback occurs.

A core focus remains on mature US technology stocks. We are bullish on the ability of large US technology companies to grow earnings and will continue to buy on dips, as long as valuations remain at the current levels.

We are also finding great opportunity in US homebuilders and foresee a strong 2017 for the industry. The lowering of corporate taxes, decreased regulation and a growing economy can greatly benefit their bottom lines, and there is significant upside based on current valuations. In our lower for longer thesis, slightly rising mortgage rates are a temperate headwind but should not offset the strong metrics that support homebuilders in the medium term. There is a housing shortage in the US for affordable housing, and demand from entry-level homebuyers is ripe to drive more growth.

On the fixed income side of the ledger, we are even more dedicated to short duration, shorter maturity high yield with a sector focus. The high yield market returned outsized gains in 2016, but much of those gains were in the riskiest portions of the fixed income universe. Metals, Mining and Energy Fixed Income is now trading at the same interest rates as the rest of the high yield universe, while comprising a full 80% of the defaults in the space. We will remain averse to these industries and happily enjoy our shorter-term investments that match with our forward view of the economy for the next 2 years.

We have had great success in senior-secured floating rate instruments, and they remain a part of our fixed income portfolio as we enter 2017. In a year where several rate hikes appear likely and where the benchmark for these instruments to ‘float’ has been met, we should enjoy a corresponding increase in interest for each move in short-term rates. As early investors in this space, we may look to diversify out of the senior-secured loan space due to the great appreciation of this asset class and dislocations in other parts of fixed income.

The Next Frontier: The mobile phone and social media revolution is entering the mature phase, and it is now time to focus on areas of artificial intelligence, machine learning and the cloud for the next phase of rapid growth. There are now more than 6 billion cell phones in the hands of consumers who are demanding more storage, more content and more accessibility. The Amazon Echo is the tip of the iceberg of this new trend as lives become automated through products like Nest, Sonos and Google Home while being driven forward in your self-driving car from GM, Ford, Google, Uber and others.

Beyond Borders: The other 6.7 billion people in the world - It is important to understand that the US economy is the largest in the world by production, but that the population is 320 million compared to the 7 billion of the world. We now turn our focus to the rest of the world.

Europe is an opportunity to catch the wave of a stock market at an earlier stage of the growth cycle. The political struggles in Europe have resulted in equity valuations at a historic discount to the US. At a time when our federal reserve is raising rates, the EU remains incredibly accommodative, and open market bond purchases have shown effectiveness. The Brexit shock of the past summer has been absorbed and it appears that there are strong areas of value available. Despite the dramatic devaluations of both the Euro and the Pound, we are likely to remain hedged in our investments in 2017.

India embarked on a surprise and revolutionary move in 2016 by taking 80% of their currency out of circulation. This move will pave the way for the first and largest economy in the world without physical currency. This is a bold and prophetic move by the Modi administration and should serve them well into fiscal 2018 (India is on a March fiscal year). India is growing up in the new world and is not having to transition like the US, Japan, China and Europe. We are continuing to keep an allocation in India and expect to be richly rewarded in 2017 as the fastest growing economy in the world breaks out of its teen angst and takes a more active seat at the adult’s table.

In Conclusion

On a macro basis, it is clear the world has changed – Fueled by globalization, technology, years of stimulative central bank policies, sovereign growth, a Brexit and significant currency devaluations – we look very different than we did 8 short years ago.

Domestically, our new reality of lower taxes, rising rates, government spending and a call for nationalism portend a new economic paradigm. As we see this new reality take form, we expect the transition will breed uncertainty, and uncertainty will cause dislocations in asset prices. In 2016 we were able to identify opportunities created by transitions and to profit. We believe 2017 will provide the same opportunity.

We believe the bull market will continue to run (or more appropriately, walk), and the difference between good investors and bad investors will become even more apparent as the easy money from the past few years is gone.

As in every year, we will not get all investment calls correct, but we have a proven research and portfolio management process for identifying the trends in the world and finding undervalued assets to express our thesis.

The goal today is the same as two years ago when the firm was launched – to help our clients get returns for a controlled amount of risk. Thank you for your trust and confidence.

The Global Vigilance Composite is a collection of separate accounts managed by Lear Investment Management. Currently the composite holds approximately 30% in cash and fixed income. The composite is tracked by Black Diamond (an Advent company). The composite ranges from $50 - $75 million dollars of total assets and is currently made up of 50 accounts. The composite reinvests dividends. Individual account performance will differ. Past performance is not a guarantee for future performance. These numbers reflect performance (net-of-fees). Mr. Lear made the investment decisions for these portfolios which are similar to portfolios currently under our management, and with similar investment objectives. This information is for analysis purposes only.

About Lear Investment Management

Lear Investment Management ("Lear") is focused on delivering superior investment returns with careful consideration to risk by identifying global trends. Our focus is on individuals, families and foundations. Lear also partners with Investment Advisors (as a sub advisor) to carefully construct portfolios to meet their client needs. Both individuals and advisors benefit from this holistic expertise in global portfolio management.