2ND QUARTER 2017 UPDATE

July 14, 2017

"American business—and consequently a basket of stocks—is virtually certain to be worth far more in the years ahead. Innovation, productivity gains, entrepreneurial spirit and an abundance of capital will see to that. Ever-present nay sayers may prosper by marketing their gloomy forecasts. But heaven help them if they act on the nonsense they peddle.."

Warren Buffett
2016 annual Letter to Shareholders

These are strong words from the Oracle of Omaha, and they help us deal with one of our central concerns here at Peak: what to do when the leadership of the stock market appears to have broken free of the normal constraints of reasonable valuation and entered an alternate reality with whose rules we are unfamiliar. Fortune magazine's Geoff Colvin recently wrote, "It's often observed with wonder…(that) Airbnb is the world's largest provider of accommodations but owns no real estate, and that Uber is the world's largest car service but owns no cars." And Tesla, an upstart 14 year-old car manufacturer that has never made a profit and in fact loses approximately $9,000 on every automobile it sells, has a market capitalization of around $50 billion, equal to that of General Motors, which sold 10 million cars in 2016 versus Tesla's 76,230, and whose net profit was $9.4 billion versus Tesla's loss of -$675 million. Tesla's stock price has soared 1,224% in the past ten years versus GM's meager increase of 12%. We look at these examples of entrepreneurial genius and inspired promotion with wonder, but we have no interest in investing in them, preferring to own companies that actually make money rather than depend on huge cash infusions from outside speculators and private equity gurus to maintain adequate capitalization.

The "FAAMG" stocks (Facebook, Apple, Amazon, Microsoft and Google) that are now the heavyweights of both Silicon Valley and Wall Street each have market cap valuations that dwarf both General Motors and Tesla combined. They also have accumulated large hoards of cash assets both at home and abroad. Their liquid balance sheets are the envy of managers of the more mundane and basic industrial, medical equipment or financial businesses that we have purchased for our own Model Portfolio*. We have an investment in two of these technology powerhouses, Apple and Microsoft, but before buying them we waited patiently for years until each had entered a valuation range where we were convinced it had become an investment in the classical Benjamin Graham sense rather than a speculation. Underlying this watchful waiting was the knowledge that the single most important determinant of the long-term success of any investment is the price that you pay for it. Unfortunately for us and our clients, this kind of discipline has so far prevented us from adding to our Model two of the other FAAMG powerhouses, Amazon and Google, both prime examples of the kind of innovation, productivity gains and entrepreneurial spirit that Warren Buffett so admires. Whether or not we will eventually acquire positions in either of these stellar companies is difficult to say at this point, but the general consensus among us at Peak is that it would take a large correction in the stock market for their prices to decline enough to tempt us.

The prospect of a stock market reversal and when it might occur is one of the great unknowns facing all of us in the investment business. For the past nine years central banks have remained accommodative and have driven interest rates so far down that the mantra of many stock investors has been TINA (There Is No Alternative). That easy money policy has recently begun to change, but the U.S. Federal Reserve is moving with caution and deliberation. Another undeniable fact is that the stock market has usually responded well during times of political impasse in Washington, and the current administration has taken gridlock and uncertainty to a new and historically unprecedented level. This may not change anytime soon, and so far in 2017 it has helped sustain a solid and steady climb in the S&P 500. A third factor in the rise of stocks has been the success of ETFs (exchange-traded funds) and the trend towards passive investing and away from active stock picking. Five years ago, 3.7% of Apple's shares were held by ETFs versus 5.4% today, and in the same period their 4% ownership in Microsoft has become 5.8%. This trend towards blindly buying into sectors of the markets rather than focusing on underlying fundamentals can contribute to making the entire market more expensive over time, until it turns into blind selling. There is nothing inherently harmful about the use of ETFs, and in fact we at Peak employ them extensively, especially in accounts for which individual stocks may not be appropriate. But while they are now magnifying an uptrend in the stock market, so also might they exacerbate a major downturn.

Given the increased amount of risk in a stock market that has regularly been setting new records over the past several years, a logical question is why we don't sell or dramatically reduce our stock holdings and wait with the cash (at least what cash is left to us and our clients after capital gains taxes have been paid out) until bargains once again become widely available, as they were in 2008-09 during the Great Recession. The best answer is that timing such moves is somewhere between difficult and impossible even for the most experienced and nimble managers. Another part of the answer was best addressed by Oakmark's Bill Nygren, who recently said, "I think it's dangerous to draw lines in the sand after which you'll just sit it out. Once you do, the temptation is to spend all your time trying to defend why now is not the time to be invested."

Like Nygren, we will continue to expend our energies in looking for the most attractively-priced stocks available and not try to divine the best times to exit or reenter the market. A key part of our investment strategy has always been to constantly readjust our and our clients' portfolios to reflect our perception of risk in the stock market at any given time, and in the bond markets as well. As I stated above, we are aware of the greater amount of risk inherent in an advanced stage of a bull market and are currently maintaining historically heavy amounts of cash and short term bonds. At the same time we are actively working on managing the target equity levels of our portfolios to minimize the effect of the shrinkage that will inevitably happen during such a downturn. When the stock market finally does correct, we will once again be happy that we have plenty of cash to put to work.

Best regards,

Noel F. Bennett

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results are available upon request.*