4TH QUARTER 2017 UPDATE

January 12, 2018

Animal spirits were alive and well in 2017, stimulated by the kind of good news that typically buoys stock markets: low interest rates, expanding economies both here and abroad and a domestic political climate that, at least in the short run, is welcoming to business. Since we at Peak are contrarian value investors, we view the past ten years of bull market with caution and wonder if history is about to repeat itself with the kind of dramatic downturn of 2000 and 2008. Predicting the future reveals more about the person doing the predicting than about what will actually happen, so it's best instead to base our actions on what we know and have observed over the years.

One of the economic indicators we look at consistently is the monthly Institute for Supply Manufacturing (ISM) report, and the most recent one shows an economy that is growing strongly in most sectors. That is consistent with the earnings reported by most, but not all, of the companies in our Model Portfolio*. For example, Stryker, a medical business that makes orthopedic implants and hospital equipment, has produced a steadily improving flow of "owner's earnings" to its shareholders over the last three years, enabling us to revalue its shares upwards by a corresponding amount. This is high on our list of favorite activities since it involves real growth and increased productivity in a business that we understand and admire. Stryker's rising share price reflects an actual improvement in its prospects rather than just riding the buoyant wave of a rising stock market, and as its intrinsic value rises it means we are less likely to have to sell it due to overvaluation.

With characteristic hubris, Donald Trump said, "The reason our stock market is so successful is because of me," but the reality is that the 21% gain in our Dow Jones Industrial Average for the year until mid-December was eclipsed by nearly every other main global market. Argentina led with a rise of 45% over the same period, followed by Austria with 43% and South Korea's 38%. While the Trump administration has helped create a hospitable climate for thriving companies, especially with the new reduction in corporate tax rates, the unusual phenomenon of a synchronized global expansion combined with a strong economy at home can rightfully take most of the credit. Years of highly stimulative central bank monetary policies and relatively low corporate tax rates have finally enabled foreign companies to gain traction, along with increased consumer spending and business investment. This led economist Anatole Kaletsky, writing in Barron's recently, to say that the upswing in corporate profits outside the U.S. has only gotten started and that "Europe, Japan and many emerging markets are entering the sweet spot." According to him, any resulting investor exuberance is entirely rational. He may be right, but such sentiments make one wonder if contrarian investors who worry about an eventual downturn are becoming an endangered species.

Those of us at Peak who were managing other people's money in the 1990s remember how stock market speculators at the height of the dotcom boom were basing their buy decisions not upon the earnings of internet companies but on how many page views a particular site received in a given month. They were betting on promise rather than business fundamentals, since in many cases there were no actual earnings. A decade and a half later we are regularly using and in some cases have become dependent on smart phones, cloud computing, artificial intelligence

and robots. The internet and the digital revolution have transformed our business and personal lives. Ironically, many of the same tech companies we avoided in the '90s but have invested in since then have benefitted handsomely, notably Apple, Microsoft, Cisco and Oracle.

Regarding our concerns about our Model Portfolio holdings becoming fully valued along with the overall stock market, we are acutely aware that the best time to buy equities is when we feel like we are the only ones in the world who are doing so, as we did in 2008-09. One money manager with a similar mindset to ours recently said he was "working on his worry," and another remarked that this stock market was the most hated bull market of his career. These are not people who are complacent and reveling in their and their clients' prosperity. They know that when the vast majority of investors have gone into a fearful defensive crouch and are clutching their purse strings, there are inevitably lots of good deals to be had. This is not one of those times.

It's undeniable that over the past few years our mission at Peak has gradually morphed from looking for bargains in the equity markets to managing risk and educating our clients and even ourselves about what can happen when above average returns regress to the mean. It bears repeating that our second quarter 2017 client letter said, "…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." Then we will again be able to put our hard-earned bargain hunting skills to work.

But if the present positive earnings trend persists, we will continue to revalue upward many of our current holdings based on their growth. And we are searching for potential buys among companies that have not benefitted, for whatever reason, while we scrutinize the prospects of our own holdings in the Model that also have not participated. There is a crucial difference between businesses that are experiencing temporary or cyclical difficulties but will recover in the next year or two and ones that are being relentlessly victimized by internet powerhouses such as Amazon. One need only look at the recent history of booksellers and big department stores to see examples of once-great companies that have failed to adapt. Our biggest challenge in the coming year may be to continue watching the predators and their prey, working on our ability to tell the difference, and making the correct investment decisions based on our judgements.

We appreciate the trust you place in us and we will continue to work hard to earn it. Please consider passing on our contact information to anyone you know who needs help in building and maintaining financial security. We are happy to share our perspective with them and to explore if there would be a good fit for working together.

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.*