January 15, 2016

America's position is unassailable. We are the imperial Rome of the 3rd Millenium. Our government is a CSX train on a track. People on one side (the left) yell at it, and people on the other side (the right) yell at it, but the train's only going to go down the track. Thank God for that. That's why I find American politics too boring to write about. Nixon is forced from office. Does a military junta rise up? Do the tanks roll? Give me a break.

Tom Wolfe (2000)

The founding father of value investing, Benjamin Graham, once wrote that "in the short term, the stock market is not a weighing machine but a voting machine," and with 2015 now in the rear view mirror this analogy has special relevance. At the same time that we were weighing which stocks were worth buying and which should be sold, American voters were weighing candidates for the next Presidency. With the upcoming election, the prospect of the Federal Reserve continuing to raise interest rates, and China coping with an economic slowdown, the coming year promises to be an interesting one.

A recent Wall Street Journal article stated that each of the past three financial booms in the U.S. was followed by an asset price bust: commercial real estate in the early 90's, tech stocks in 2001 and residential real estate in 2007. It is becoming apparent that the most recent boom and ensuing bust has been in the energy and minerals sectors. The unanswered question is what effect this dramatic downturn in an important segment of the economy will have on one of the longest expansions—now at 78 months—in the past 160 years in the U.S. With this in mind, in June 2015 we sold our position in Kinder Morgan, Inc., from the Model Portfolio* based partly on the knowledge that its long term debt load was starting to prove troublesome in the face of a weakening oil and gas sector. Kinder Morgan, a pipeline enterprise, was a more than decade-long holding for us, dating as far back as 2000, and was a good investment for our clients. Since we eliminated it from our Model its stock price has declined precipitously due primarily, we believe, to concerns about its debt and the fact that it cut its dividend by 75%.

There are a couple of realities looming large in the corporate world, from our perspective: First, companies that made aggressive acquisitions during the boom times in the commodities sector and used a large amount of debt to do so have paid a heavy price. Some of their executives made the mistaken assumption that the 15 year-long urbanization explosion in China would be the tide that lifts all boats for a long time to come. Many, if not most, of the people who made such decisions have been sent packing. Second, the use of debt to facilitate these deals has undermined the confidence of investors that these companies will be able to thrive in the long term, and in many cases their stock prices have sunk to lows that were unthinkable not long ago. Warren Buffett said, "Cash…is like oxygen. When you don't need it, you don't notice it. When you do need it, it's the only thing you need." In the same way, too much debt during a business contraction can feel like a boat anchor tied to your waist dragging you straight to the bottom. At such times cash and good options are in short supply.

Last fall we increased our Model Portfolio holdings in Emerson Electric and Oracle from half positions to full positions. Both companies are mainstays of their industries, have strong financial statements and relatively low debt loads, and are selling at reasonable price to earnings ratios. Then in the first week of the New Year we sold our entire position in Home Depot, another long term holding, first purchased back in 2006. We had bought it before the downturn in the housing market and watched with dismay as the income from its big box stores took a beating during the Great Recession. The nearly 700% rebound in its stock price from its 2008 low through late last year exceeded our expectations, but the company has done something that confounds us: It proceeded to buy back billions of dollars of its own stock each year at progressively higher prices, using cash and large amounts of long term debt. From 2012 to early this year Home Depot's debt to equity ratio ballooned from a comfortable and conservative 1:2 to an unwieldy 2:1. Knowing what Wall Street thinks of companies heavily laden with debt when their business cycles turn down, my conclusion was that Home Depot is playing with fire and may ultimately get burned.

Returning to the big picture of the U.S. economy, the Federal Reserve has committed to tightening the money supply slowly and carefully, aware that while unemployment is now down to its desired 5%, the manufacturing sector is starting to contract slightly and core inflation, which it would like to see at 2% is now just 1.3%. Per share profits of S&P 500 companies fell by an estimated 6% in 2015 and their profit margins, after rising during the recovery from 2009, are now narrowing. Undoubtedly in the mind of Fed Chair Janet Yellen must be the chilling cautionary tale of Japan, the world's third largest economy. Prime Minister Shinzo Abe's plan to jump-start the economy with a combination of stimulus and monetary easing has fallen flat; Japan's economy shrank in the third quarter of 2015 and the country sank into its fifth recession in seven years, according to Fortune magazine. Japan's demonstrated lack of success will almost certainly play a role in Yellen's gradualist approach toward raising interest rates in our own country.

Last but certainly not least in the big picture is the rogue's gallery of contestants in the 2016 U.S. Presidential race, which provides the media plenty of entertainment but not much substance. It is sobering to me to realize that one of these people is certain to be the next leader of the world's most powerful country. Even though they have aged 16 years, the words of the perceptive social critic Tom Wolfe quoted at the beginning of this letter provide some inspiration and encouragement in the New Year.

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.*