2015 Year End Letter

At SIM, we invest a lot of time reading. First and foremost, the purpose is to gather information as to how world and economic events affect our portfolios or to give us new ideas that we consider for investment. Secondarily, we read publications from around the world to gauge the overall sentiment of the investing public, which is a powerful force fueled by the media and driven by emotion. At present, there is a clear negative feedback loop in the news cycle creating a gloomy environment for already skittish investors. News out of Asia and the Middle East coupled with the familiar negative rhetoric of an election year here in the states is sending nervous investors into overdrive. All of this is adding to volatility, which has picked up recently as oil continues to search for a bottom and interest rates look for direction from the Fed.

In recent years, markets have shown a consistent pattern of short-term volatility. Changing dynamics of the modern day markets have created a new breed of global traders:

- Hedge Funds with $3 Trillion in Assets Under Management
- High Frequency Algorithmic Traders
- Program Traders with Computer Driven Models

Many of these traders do not care whether the market goes up or goes down, they trade on volatility. We continue to maintain our disciplined strategy of tactically and opportunistically rebalancing portfolios when volatility arises. This approach has served our clients well for many years.

Note: As we go to print on our 2015 letter, we would be remiss not to mention the market pullback of the first two weeks of January 2016. We would note that this is the third year in a row that the markets have had a rough start to the year; January 2014, the S&P was down 5.9% only to bounce back +8.2% in February. In January of 2015, the S&P was down 5%, but bounced back +6.8% in February.

2015 – U.S. Economy: Slow but Steady

The clear headwinds to 2015 corporate earnings in the aggregate were slumping commodity prices and a strong dollar. Overall, earnings for large U.S. companies are set to be flat for the year, but if you take a closer look, earnings adjusted for those headwinds were actually up around 7%, driven by strong gains in technology, healthcare, and consumer related stocks; a promising sign to us as we see those headwinds stabilizing this year. The U.S. economy is still in slow growth mode, but the employment picture has improved considerably, wages are beginning to pick up, new car sales just hit a record high, and real estate values remain strong. Lower oil prices continue to be a major benefit to most of the world economy. This type of environment has historically been good for stocks.

MLP's – Master Limited Partnerships: An Exceptional Opportunity

For those unfamiliar with MLP's, these are companies that store and transport commodities such as oil and gas and operate in a toll road business model. They do not own the commodities, they simply collect a fee (backed by long term contracts) for moving it from one place to another. Over short periods of time, MLP prices tend to be highly correlated with commodity prices, but over longer periods of time, there is a low correlation between the two.

We have avoided MLP's over the last several years, in line with our thesis that they were priced at a premium and would be vulnerable to any reversal in lofty commodity prices. MLP's reached a peak in August of 2014 and sharply reversed course from there; investors sold them indiscriminately to the tune of 45%, down more than the energy sector as a whole despite not having direct exposure to commodity prices. A disconnect of this magnitude piques our contrarian interest. We began establishing a position in MLP's this fall and continue to buy. Volatility persists in the asset class as investors have concerns about the viability of the distribution yields being paid out by MLP's, in the 10% to 12% range for ones that we own. Our focus is on midstream MLPs with the healthiest balance sheets, high coverage ratios, and contract visibility. We believe these MLP's have the highest probability of maintaining or increasing their distribution going forward.

China – The Dragon Changes its Tune

China certainly has had its fair share of attention this past year, with recent volatility in the Shanghai stock market causing unease globally. However, there are some important distinctions that need to be made. The Shanghai stock market, often referred to as the 'Chinese stock market', is not necessarily an accurate reflection of the Chinese economy.

First, the Shanghai exchange; new to the financial markets at only 25 years old is made up almost exclusively of Chinese individual investors, many of whom are uneducated and have a proclivity to gambling. This market rose 150% in the 12 months preceding the correction that began in the summer of 2015. The headlines that have dominated news outlets are focused on this mainland China exchange due to its wild swings as opposed to the more established and less volatile Hong Kong Exchange. The Hong Kong Exchange is the market where the majority of foreign capital, including us, invests for direct exposure to Chinese companies.

China's transition to a consumer based economy is fueling the growth of the middle class, which is projected to make up half of the overall Chinese population in the next ten years. This translates into a much healthier and sustainable domestic economy for China as well as a massive opportunity for foreign companies in developed countries to sell into this emerging middle class. This is what we are focused on in China and other parts of the emerging world, not on the day to day volatility of their markets.

Europe – Prime for Rebound

We remain positive on European equities for 2016 for much the same reasons we liked them going into 2015. An accommodative central bank stimulating growth in the region, a lower Euro benefiting exporters, most notably in Germany where their current account is the best it has ever been, and lower energy costs that remain a major benefit as Europe imports a majority of their energy. We view Europe as similar to where the US was a few years ago; at the beginning stages of a recovery that continues to be underappreciated by the market. Unemployment continues to improve, now at its lowest level in 4 years. Stocks in Europe are trading at a discount to those in the US and the percentage of 'buy' recommendations by European stock analysts are at the lowest level in years. In our opinion, the time to own European stocks is when sentiment is still negative and concerns are still there, rather than after the recovery is in full swing and stock prices reflect the optimism.

In conclusion, we remind our investors that market volatility is here to stay as global hedge funds, high frequency traders, and program traders dominate daily trading in stocks. In our opinion, there has never been a better time to be a global tactical manager. Volatility creates dislocations in the markets, which in turn creates opportunity for those positioned to capitalize on it.

The Sloan Investment Management Portfolio Management Team