January 2016

Economic Comment and Market Outlook

Concealing the volatility they displayed in the past twelve months, US stock market averages ended 2015 almost where they began the year. Including dividends, the S&P 500 delivered a 1.4% total rate of return. In light of the challenges posed by weak economic growth, foreign currency depreciation, dramatic commodity price declines, prospective interest rate increases, war in the Middle East, and terrorism, investors might consider this result a distinct positive. Fortunately, US companies remain highly profitable and have proven to be adept at navigating uncertain environments. However, these challenges have admittedly stalled profit growth for the S&P 500 and for a typical FS&Co. portfolio. In the short to intermediate term, the path of profits is likely to determine the path that the equity market takes, and there are both upside and downside possibilities. At this juncture, it is important for us to remind ourselves that we are investing for the long-term and not trying to time the market. Over a period of years, we believe that owning a portfolio of the world's best businesses offers the prospect and, more importantly, the likelihood of superior wealth creation. We remain confident in the companies in our portfolios—both in their future growth plans and in the stability and strength of their cash flows and balance sheets.

While the market averages displayed a fairly flat performance for the year, significant advances in a small number of stocks offset greater difficulty for a broader group of issues. Facing growing uncertainty in the overall environment, many investors deployed considerable sums in a small group of companies whose business and stock momentum appeared to make them less susceptible to a potential slowdown. CNBC viewers will recognize the acronym "FANG" used to describe four prominent examples of 2015's strong performers—Facebook, Amazon, Netflix, and Google. The FANG stocks, for example, appreciated between 34% and 134% in 2015. For reference, an equal-weighted set of these stocks trades at 223 times expected 2015 earnings and pays no dividend, which probably goes without saying. If you leave out the FANG stocks and the other top ten contributors to the S&P return in 2015, the remaining 490 stocks generated a total return of -2.0% for the index. Said another way, the average stock performed considerably worse than the market average as a whole. In addition, the markets punished a variety of income-producing securities during 2015. The highest yielding decile of stocks in the S&P 500 declined 14.6% while the lowest-yielding decile—all of which pay no dividend—appreciated 3.8%. Investors also beat a hasty retreat from two other income-focused sectors, high-yield bonds and master limited partnerships.

Even though the US equity market recorded only a slim return for investors, it proved to be superior to most investment alternatives in 2015. While some foreign equity markets, often supported by aggressive monetary stimulus programs, provided stronger returns in local currency, the rising value of the dollar resulted in outright declines when those returns were translated back into US currency. In local currency terms, the MSCI EAFE Index returned 5.8%

for the full year, but adjusted for currency movements, the Index fell 0.4% when the gains were translated back into dollars. Reflecting the ongoing challenges facing the emerging markets, the MSCI Emerging Markets Index fell 5.4% in local currency and 14.6% in dollars over the course of the year. To reuse a comment we wrote in this letter two years ago, "while most Americans are not satisfied with our economy, its performance—and that of our financial markets—has been leading the world." Outside of the equity markets, the fixed income indices also languished. The combination of low starting yields and gradually-rising long-term interest rates is a formula for low rates of return. The Barclay's Capital US Aggregate Index returned 0.55% for the full year as the yield on the benchmark 10-year US Treasury note rose 10 basis points and closed the year at 2.27%. Many hedge fund investors have been dissatisfied with the returns generated by that asset class in recent years. Those expecting a hedge fund rebound in a more challenging environment for equities were disappointed; the HFRX Global Hedge Fund Index declined 3.6% in 2015. Clearly, investment returns were difficult to achieve in 2015.

With 2015 finished, most investors were eager to begin anew in 2016, but January has started poorly, appearing very similar to the market downdraft we experienced in August and September of 2015. Now, the key question being asked is whether we are in the midst of a milder profit recession or beginning to experience a full-blown economic recession. There are certainly parts of the US economy that would qualify as being in recession, namely anything related to the energy sector and some export-oriented industries. However, the majority of the US economy is based on consumer and government spending. Those sectors account for approximately 86% of GDP, and we expect them to grow in 2016. Steady gains in employment and wages, along with lower energy prices, support consumer spending growth. In addition, consumer debt levels have declined measurably since the financial crisis, and combined with low interest rates, consumer debt service is at the lowest levels as a percentage of income in over a generation. Government deficits and debt levels rose significantly in the aftermath of the Great Recession, but more recently, spending restraint and improved tax collections have reduced the federal budget deficit to 2.8% of GDP. Projections for 2016 actually show a slight acceleration in government spending. So, while there are parts of the economy under pressure, the vast majority of the economy should be resilient. It is quite possible that economic growth may slow, but at the moment, an outright recession appears unlikely.

After seven years of setting short-term interest rates at zero, the Federal Reserve increased rates in December for the first time since 2006. At the same time, the Federal Reserve Open Market Committee released the members' projections for the future path of interest rates, showing a very gradual rise over the next few years. Our expectation is that the Fed's forecast is still too aggressive, like it has been consistently over the past few years. The slow growth of the domestic economy and the weak conditions in many foreign economies will likely cause further delays in normalizing interest rates. For similar reasons, long-term interest rates will also probably remain at very low levels for the foreseeable future. All other things being equal, the fact that US interest rates are likely to remain low will also work to arrest the appreciation of the dollar against foreign currencies, a development which began to occur during 2015. Although the European Central Bank and the Bank of Japan continue to engage in aggressive quantitative easing, the dollar remained approximately flat versus those currencies for the past twelve months. A slowdown or cessation in dollar appreciation would be a positive for US exports and also for the profits of US multinational companies, which have been weathering a severe dollar-induced headwind to profit growth.

With the profit headwinds from the dollar and commodity prices beginning to ameliorate over the course of 2016, our profit forecasts anticipate the S&P 500 and our portfolio companies regaining positive momentum through the year. As we discussed in our last letter, the drop in commodity prices and the rise in the value of the dollar represented major headwinds in 2015, causing the profits of the S&P 500 to stagnate around $118 per share. At that level, the S&P is currently trading at approximately 15.9 times earnings, which we believe is attractive given the low level of inflation and interest rates. The energy sector is currently operating close to breakeven compared to generating a profit of $112 billion in 2014. While the timing of a recovery is uncertain, we think current conditions are not sustainable and that energy profits will recover gradually over the next few years, suggesting that the current S&P profit levels are somewhat depressed. Excluding the energy sector, the remaining companies in the S&P 500 are trading at 15.0 times earnings. By the middle of 2016, investors will begin anticipating 2017 prospects for earnings, and we expect those forecasts to demonstrate better growth, with organic profit growth in most sectors and some recovery in commodity-related businesses. We also continue to expect our portfolios to generate stronger growth in earnings relative to the S&P 500.

A slow growth world presents many challenges and frustrations for businesses, governments, and individuals, but our portfolio companies have adjusted to that reality. Businesses have learned to "run tight," watching their expenses and their capital spending very carefully. If it is difficult to grow revenue, they have focused more on other mechanisms of creating shareholder return. One of those has been paying and growing dividends. As we tend to prefer dividend-paying stocks, 24 of the top 25 holdings in a typical Sarofim portfolio pay a dividend. In 2015 all 24 of those companies paid a larger dividend per share than they did in the previous year. The rate of dividend growth will probably slow in the current environment, but we expect most of our companies to continue to raise their payouts. Stock buybacks and merger and acquisition (M&A) activity have also played a prominent role as management teams sought ways to generate shareholder value in recent years. In fact, global M&A volume set an all-time record in 2015, surpassing $5 trillion, breaking the previous record of $4.6 trillion set in 2007. The healthcare and technology sectors were the most active, led by Pfizer's proposed $160 billion merger with Allergan and Dell's proposed $66 billion acquisition of EMC. Anheuser-Busch's proposed acquisition of SABMiller benefitted Sarofim portfolios, often in multiple ways given Altria's ownership of 27% of the target. With management teams looking to create shareholder value and many activist investors searching for undervalued businesses, we expect our portfolio companies to continue seeking a variety of ways to provide returns for shareholders.

There are many risks to monitor in the current environment, but fortunately, the characteristics of the companies in our portfolio protect against many of them. We are watching the impact of the commodity price declines on various sectors of the economy, the economic difficulties in many emerging markets, and the high levels of debt outstanding on a worldwide basis. Many investors also remain unsettled that the Fed has fewer degrees of freedom to combat another recession, should one occur while the world is still attempting to recover from the last financial crisis. In light of these concerns, it is comforting to remember that our investment portfolios emphasize companies with strong balance sheets, stable demand characteristics, high levels of profitability, and resilient dividend and capital allocation policies. With those characteristics our portfolio companies can often find ways of taking advantage of challenging times to improve their competitive positions, leading to stronger profits in the future. Of course, we remain optimistic that today's profit slowdown is only temporary, and growth should resume as a number of these headwinds begin to fade over the course of 2016.

In a volatile market environment, we remain committed to adhering to our time-tested investment philosophy and to delivering superior risk-adjusted returns over market cycles for our clients. As always, we welcome your questions and thank you for the trust that you have placed in our firm.