2016 Investment Playbook — December 22, 2015

It's that time of year again. Time to take stock of the year that was and time to try pondering what 2016 could look like.

Every now and then someone asks us how the stock market will do next year. Sometimes, they aren't asking for a range but an actual number, and I suspect an answer that isn't simply the 10% long term average we've experienced over time, but a number that takes into consideration the realities of what we call today.

While I would never promise anyone a specific investment return, I think we lose an opportunity to learn more about ourselves and the assumptions behind our investment thinking when we dismiss the question as a naïve one at best or a legal liability at its worst.

Each and every morning I take notes on the day's events. I guard this part of my day religiously from the demands of the outside world, believing that the primary purpose of my business is to serve those who are already clients. Whenever I make a change to the portfolio, I take the time to write an internal note explaining my reasoning not because I have to, but because I find the process of writing it down useful. Like batting practice, my hope is that in making the extra effort, I am developing valuable muscle memory at a faster pace and an intuition built on wisdom.

The ideas and predictions that we made in our 2015 Investment Playbook were generally above average for the second year in a row. Our investment performance has likewise been strong. While the goal of our Playbook is more about organizing and sharing the insights that might guide our investment decisions in the coming year, we won't lie to you, being right feels better than the alternative.

Enjoy!

Last Year's Playbook

Last year, we provided five predictions about 2015 and four additional observations about specific sectors and companies. These predictions and our assessment of the outcomes follow.

1. ***While the Fed will likely increase interest rates in 2015, the economy should be strong enough to absorb it.*** This prediction came true, but just in the nick of time. After seven years at zero, the Fed finally moved rates from the zero bound based on the improvement in the labor markets and an inflation rate that would likely meet its objectives in the intermediate term.

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9 Aurora Street, Suite 5
Hudson, Ohio 44236
Phone: 330-650-0921
www.broadleafpartners.com

2. ***Energy prices, like interest rates last year, may stay lower for longer, a net benefit for US consumers in an improving job market.*** Oil prices, as most know, not only stayed lower, but after a brief recovery in April, plunged from $60 per barrel to current levels in the mid 30's. While the consumer has received a net benefit from these lower prices, it isn't clear that they are spending it as quickly as they've done in past cycles. Some call this a "smarter" consumer.

3. ***A continued bid for the US dollar in a weaker global environment will tend to favor developed over developing markets once again, but also domestic operations over multinational ones because of these currency effects.*** Dollar strength did in fact continue throughout 2015, and while the absolute gains were uninspiring, domestic markets did outperform losses from most world markets.

4. ***Inflation should remain subdued thanks to trends in commodity prices, emerging market economies and the productivity of assets associated with the "sharing" economy. Non- inflationary driven growth tends to be a favorite type of growth for the stock market. Stocks should once again outperform bonds.*** There is no doubt that inflation trends remained subdued in 2015 from all the aforementioned factors. According to Morningstar, however, the aggregate domestic stock market and bond market returns are neck and neck with each other on a year to date basis at just under 1%. Fund flows, however, continue to be biased to the market's recent winners - international equities and bond funds. This is not unusual; typically the market clings to the glory areas of the recent past, especially when these once treasured areas come under significant fundamental and technical pressure. This process is known as distribution.

5. ***What could go wrong? Financial contagion related to the rapid decline in energy prices and weak overseas economies could affect the U.S. economy. Just as our domestic housing problems affected other areas of the world during the Great Recession, we can't rule out the potential for overseas problems to similarly affect us via financial contagion. While we believe our exposures are adequately contained and reserved against, it is a risk worth monitoring.*** Most of the risks throughout the year were global in nature, specific to China's slowdown as well as the rapid decline in commodity prices, particularly energy. While systemic risks associated with each haven't come to fruition, they've reared their heads several times during the year, including some year end stresses predominantly in the energy related credit sector. Stay tuned.

6. ***Heightened geopolitical concerns (Russia, Ukraine, ISIL) coupled with weak overseas economies may lead to increased defense budgets worldwide. While the aerospace sector has already made a big move in the past year and a half in spite of domestic budget cuts, perhaps this fact, in and of itself, says something.*** Based on recent statistics, it appears as though softer defense spending in the United States, by far the largest spender in the world, more than offset gains from the world's other militaries, including Russia and China.

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However, the world certainly feels more troubled than it did a year ago, as terrorism arrived on our shores for the first time since 2001. Aerospace as a sector has outperformed this year.

7. **Following the overwhelming success of Gilead's Solvaldi cure for Hepatitis C in 2014, other groundbreaking biotech discoveries could be in the offing. Are we riding a wave to future gains or setting ourselves up for another epic disappointment for the sector?** While we cut our biotech weighting in half during the year, the answer to this question was neither. In our opinion, there were no groundbreaking discoveries in biotech the magnitude of Gilead's Hep C and the sector, in spite of significant Hillary induced headwinds, has managed to outperform yet again in 2015.

8. **For the first time in history, television viewership may reach an inflection point and start to decline. This doesn't mean television "content" will disappear, only that it will increasingly be consumed elsewhere. Advertising budgets will follow the eyeballs as the democratization of broadcasting in social media and software apps takes share.** I guess this prediction was a bit sensational. After doing some additional research, I discovered that the trend was already evident when I wrote it last year. According to Nielson data, while TV remains the largest form of media, average monthly hours watched peaked in 2012 and continues to decline as more cut the cord. A recent NYTimes article also suggests that television advertising declined for the first time in a non-recessionary year in 2015, while the secular trend to digital spending on formats such as Google and Facebook grew 17.2% year over year.

9. **Investor enthusiasm for Facebook reaches Apple like proportions in the stock market. Google experiences an eighteen month period like Apple had in 2012-2013. Faced with huge cash balances that are deemed excessive and core advertising markets that are maturing in the face of new digital alternatives and a limited advertising pie, the company is pressured to consider a dividend and stock buybacks rather than investing solely in long term moonshots like self-driving cars and Google Glass. Perhaps an Icahn dinner with Brin and Page lies in the not too distant future?** While there may be no clear way of measuring investor enthusiasm for Facebook relative to Apple, on a year to date basis, Facebook has outperformed, up 36% compared to flat for Apple. On the Google front, our prediction was reasonable with regards to a new focus, as the company hired a new CFO who restructured the company, increasing transparency into their core businesses relative to their moonshot investments. While a call from Icahn wasn't necessary, Google clearly became more shareholder friendly as a result of these initiatives, and the shares are up 44% year to date.

Our 2016 Playbook

For the sake of time, we'll keep it to just three concise predictions and observations for the coming year.

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1. **Lower for Longer.** Everyone, including ourselves, wants to bottom tick the energy, materials and to a lesser extent, industrial sectors. Having fallen so much, we all wonder when it will be time to buy. While there will be trading opportunities in the sector throughout 2016, we frankly don't think the stocks have yet seen their bottom. China, oil, and commodity sectors all experienced bubbles of one type or another in recent years, and bubbles often take far longer to bottom and work out than most expect. Currency differentials will only worsen these trends. According to our work, the energy sector was down roughly 50% from its highs during the Great Recession; it is down about 40% from its highs right now, but the bankruptcy process has hardly started perhaps due to protective hedges in place for most of 2015. While it may not be comparable, past bubbles in housing and tech saw average peak to trough declines of 80%! While we have a great deal of respect for a few management teams in these beaten down sectors, Lower for Longer is a process that takes time, far more than a single year or even two.

2. **Fed induced jitters continue to affect the market, but company fundamentals start to matter more.** The Fed's historical involvement in the markets is finally turning. While I don't know if they will raise rates once, twice or three times in 2016, I do believe that the economy will be strong enough, particularly on the consumer side, to withstand such hikes. The market will have some fits and starts, but as the emphasis on the Fed recedes into the background, individual company earnings reports should get greater attention. Index investing will no longer shine in an environment where everyone doesn't get a trophy. Speaker of the House Paul Ryan will also continue to make great strides with Congressional fiscal policy, lightening the Fed's burden in a slow growth world.

3. **The stock market finishes 2016 on a surprisingly strong note.** While I won't give an exact figure, after a lackluster 2015, I tend to think the markets will do far better than most expect and perhaps in a manner that isn't necessarily to everyone's liking. For sure, the 2150 level on the S&P 500 has been very difficult to crack throughout 2015, but we suspect we will finally get through there and then some, in spite of the lack of participation in later stage sectors like materials, energy and industrials. Just as occurred following the 1994 Fed hikes, the stock market's gains are likely to become narrower in the months, quarters and perhaps even years ahead, with fewer companies and sectors driving the overall market's gains, especially given our Lower for Longer views. While we will have to be mindful about bubbles in the growth sectors of the market, continued strong results from these areas in a 2% type GDP economic environment will provide for another strong year. For 2016, at least, the discrepancy will likely continue.

Have a Blessed Christmas and Hannukah!

Doug
Doug MacKay
CEO & CIO
dmackay@broadleafpartners.com

Bill
Bill Hoover
President
bhoover@broadleafpartners.com

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