Annual Letter 2016

To Our Clients and Friends of Parthenon LLC

Well, 2016 is in the books and it was, at the least, interesting. We will discuss primarily matters financial but some politics will, by needs, be addressed. The year began with the worst first five days in market history, as the major indexes fell over 5%. After that, the market spent most of the year meandering up and down. By the Friday before the election, the S&P 500 index was up less than 4%. Then came the "Trump Exuberance" rally which propelled the index up to an above average 11.95% for the year. The economy continued to grow modestly and displayed some signs of acceleration as the year progressed. Bond yields remained near historic lows but rose in the final quarter. The 10-year Treasury bond began the year at 2.27%, and finished at 2.45%. In July, yields bottomed at 1.36%, the lowest level in history. We will dive a little deeper into bonds below.

The stock market's reactions to the twists and turns of the Presidential campaign and, most dramatically, the post-election rally, provided some of the more entertaining market theater in years. Investors have rarely seen a more illuminating and educational seminar on the market's short-term irrationality and unpredictability. In the months preceding the election, whenever Trump enjoyed a good day, the market usually had a bad one. A good political day for Clinton often precipitated a nice stock rally. It seemed abundantly and undeniably clear that investors and market traders preferred Clinton, and the market would undoubtedly tumble if she did not win. Indeed, as election results poured in and Trump appeared likely to win, market futures tumbled and pointed to a huge decline in the morning. We went to sleep expecting a rough day. You know the rest – the market rallied for the next week, and hit new highs almost daily for over a month. If you are looking for logic in the market's short-term behavior, you will be unlikely to find it. All things stock market may not be rational and, in the short-term, much is not.

We have invested through many elections and do not recall a more emphatic immediate response to the results. Investors raced to sell the "Obama/Clinton" stocks and, as fast and furious as possible, buy all the perceived "Trump" stocks. We are students of the great investors and have read and studied their philosophies and methods. Our reading, of course, includes much on the greatest investor, Warren Buffett. In all our reading, we have not seen that Mr. Buffett ever said the secret to his great success in the 1960s (as he was building his stunning record) included selling all his "Eisenhower" stocks while buying all the "Kennedy" stocks he could find. Maybe he is keeping that nugget of wisdom to himself.

We do not cavalierly dismiss all possible investment implications that may arise from the election. A change in political philosophy is clearly at hand. Our recommendation is to follow the advice of the great basketball coach John Wooden who admonished his players to "be quick, but don't hurry." Selling and/or buying stocks due solely to an election is likely to fall under "hurry." The structure and ultimate impact of any tax and regulatory changes is very uncertain. If, after careful analysis, one has strong reason to believe a new political environment will be more, or less, hospitable to an industry or a specific company, then that variable may be factored into an overall valuation analysis.

The irony in the market's excitement over the new administration is that stocks have enjoyed an extraordinarily strong run over the past 8 years. Since Inauguration Day January 20, 2009 until year end 2016, the S&P 500 has more than tripled, with an annualized total return of over 15%. If only the new President and his team knew the secret formula that the outgoing President used to get those great returns. Well, we do, and it will be hard to repeat. The recipe starts with very low valuations (the key ingredient), adds low (and declining) bond yields, plus an accommodating Federal Reserve. Finally, sprinkle in at least a dash of economic growth and corporate earnings growth and viola` – a tasty treat of well-above average market returns. Unfortunately, the next eight years will be missing at least one of those important ingredients and most likely others. Valuations are not, by any historic measures, low. Interest rates have little room to fall. The Federal Reserve has begun to tighten ever so slightly. Investors have responded positively to the expectation for corporate tax reform (with lower rates), less onerous business regulations, greater business confidence, higher capital investment, and stronger economic growth. That virtuous circle would then lead to faster corporate earnings growth. Will those potential economic positives be enough to overcome relatively high valuations and rising interest rates? We will see. Nevertheless, rational expectations and prudence compel us to expect much lower annual returns over the next eight years.

End of a 35-Year Era?
On September 30, 1981, the 10-year Treasury bond yield was 15.84% (let that sink in a moment). In 1990, the average yield for the year was 8.54%. In 2000, it was 6.02%. By 2010, the average was 3.20%. Then, this past July the yield bottomed at 1.36%. Around that time, we read that one renowned investment firm opined that the worldwide interest rate structure was the most extreme in "5000 years." We cannot verify that as our data on ancient Mesopotamian bond yields is imprecise. Nevertheless, rates reached historically low levels for the modern industrialized world, including negative rates on the bonds issued by several countries. Rates rallied at year end to the highest levels in over two years, perhaps signaling an end to an era of falling bond yields.

We currently remain positioned much as we have been over the past several years. Our average bond maturity is shorter than in previous years, and in some portfolios, where appropriate, we hold fewer bonds overall. Should rates continue to rise, we may become more cautiously opportunistic, adding more bonds and moving our portfolios out to longer maturities.

Of course, rates may not rise, and could even drop back to lower levels. Rates could "flatline" for many years (see Japan 1990-2016). They could move up gradually should the economy accelerate. It is not our practice to predict rates but instead, as we do with equities, search for relative value opportunities. Nevertheless, we believe it is wise to expect rates to move higher at some pace over the next decade and plan accordingly. The implications for equity valuations will depend on the pace of any rate increase and economic growth. The value of business earnings should be less in a higher rate environment, all other things being equal (though all other things rarely are). We suspect that if economic growth accelerates and pushes rates higher, we may witness a tug of war between higher earnings and diminishing valuations on those earnings.

The Prediction Follies (Continued)
As we discussed above, the stock market has experienced a long and strong rally from a very deep hole reached in the abyss of the 2008-09 financial crisis. Not everyone was on board for the ride. Just for fun, we compiled some titles/headlines from predictions that received much play over the past several

years as the market moved higher. Some are from some well-regarded market analysts and often quoted market savants (names excluded to protect the not so innocent): “Bear market to take hold in 2013: Expert.” “Dow could crash to 3,000 in 2013: Author.” And finally, “Stock Market crash of 2016: the countdown begins.” Such hyperbolic predictions and inflammatory rhetoric have always been around, but have proliferated over the past decade in an incredibly crowded media environment. If you are right, you gain the accolades, guest appearances on the hottest financial TV shows, and invitations to all the great parties. If you are wrong, all is ultimately forgotten and forgiven until the next prediction.

We are being more than a little facetious and perhaps picking on market forecasters a little too much (not for the first time). We could find just as many “correct” predictions from the past eight years out there as well. We are also acutely aware that our attitude toward the general market can come across a little like a golf-advice parody written by the author John Updike. The tips included, 1) don’t be tense, 2) don’t be “loose.” In a sense that does describe our stock market attitude. We think it is generally not a bad idea to be agnostic about the market’s short-term direction. If something is so unpredictable (even by “experts”) as to be no more reliable than a coin flip, it is best to not spend much time pondering it. Stoicism and indifference are not the worst temperament to have about the stock market’s constant gyrations. Holding a strong conviction/prediction about the market’s direction is not without risk. Believing one can predict the market can lead to decisions that are at odds to one’s long-term goals. An investor may do things out of exuberance or fear that creates long-term risk and missed opportunities. If you “know” the market is going higher, it might seem rational to ignore valuations and worry little about an appropriate asset blend. Conversely, if you “know” the market is going down, even a cheap stock should be avoided – after all, it is only going to get cheaper.

Being indifferent toward the market’s short-term moves does not mean being unaware of overall equity valuations, and the corresponding implications for long-term returns. It does mean accepting, and planning accordingly, for the uncertainty of the unpredictable.

A Continuous Process

We believe successful long-term investing requires a methodical and logical process. It is a continuum of rational decisions designed to achieve a long-term goal. It is not a series of reactions to discrete exogenous, unpredictable events. One should be positioned to withstand short-term challenges, and long-term goals should not be derailed or altered by occasional unpredictable events, however dramatic.

An investor should not be “whipsawed” from one event to the next, unmoored to any coherent goal or philosophy. Investing successfully should not be a reactionary process, trying to anticipate the next big score. We believe it is paramount to think of investing not as responses to a series of unrelated, unpredictable, dramatic events but instead as a continuum of many decisions made and positions taken or avoided.

Attempting to hit many singles and doubles may not be as exciting as swinging for the fences and hoping for that one big score that compensates for the many strikeouts. Not as exciting perhaps, but, we think, much more promising.

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January 2017

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