Investment Update

November 2015

Changing of the Guard

Sometimes a change in leadership makes all the difference. As a lifelong Miami Dolphins fan, I have followed the team through many different leadership regimes, from Coach Don Shula, to quarterback Dan Marino, up to now, with the hiring of Dan Campbell to replace Coach Joe Philbin. The recent firing of Philbin has caused a paradigm shift in the way the team plays, as Campbell has taken the same players and instilled in them a whole different attitude, resulting in a more consistent, and more dramatic team.

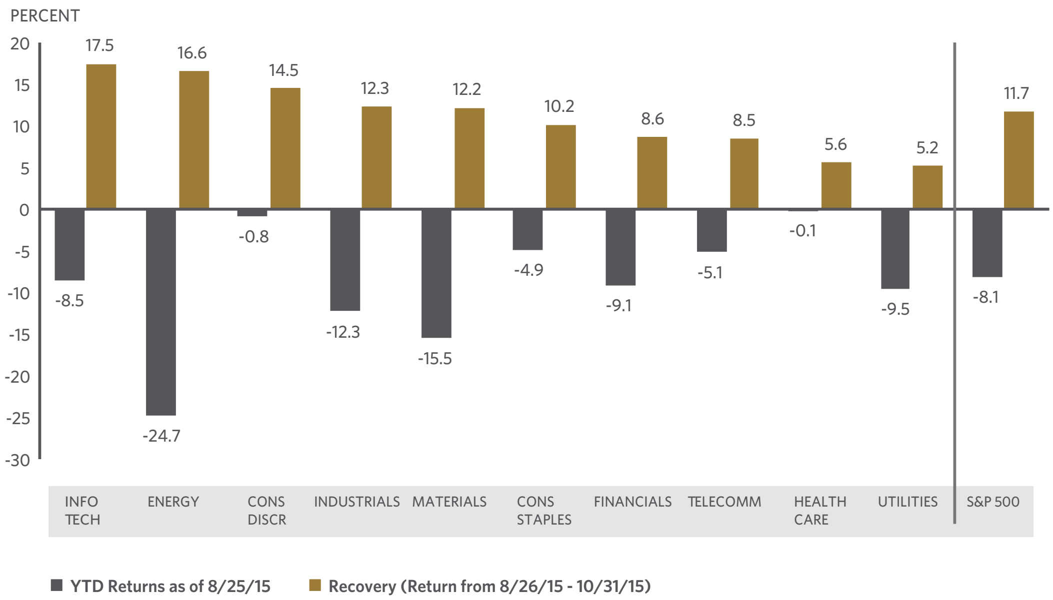
Another paradigm shift, albeit more subtle has also taken place in U.S. equity markets. To the naïve observer the recent rebound may look like the return of the old bull market, but deeper review reveals categorical differences beneath the surface. Let's discuss how this transition has manifested itself in three areas: sectors, initial public offerings and individual stocks.

The Last Shall be First

Although I am responsible for broad asset allocation and investment style recommendations for client portfolios (i.e., equity vs. bonds, large cap vs. small cap stocks and growth vs. value), I believe much can be learned about market shifts by digging into market internals, such as sector leadership. As can be seen in Figure 1, the energy sector was the worst performing S&P 500 sector from January 1, 2015 through the market low on August 25.

Figure 1—S&P 500 Year-to-Date Total Returns – Beneath the Surface

Sector Returns



Source: Morningstar Direct and FactSet

Since August 25 through October 31, it ranks second trailing only the technology sector. The materials sector followed a similar trend, lagging significantly year to date through August 25, but delivering very strong performance relative to most other sectors since the market's low. Even the technology sector is up to its old tricks: historically the strongest sector following late-cycle bull market corrections, technology is leading the pack with nearly a 17.5% return since August 25.

These changes in sector leadership illustrate many important facts. The first is that investors buying back into this market are now seeking stocks with different characteristics than those that led the market to new highs in May. Whereas before buyers prioritized growth and price momentum, after the market low they abandoned the healthcare sector, particularly red-hot biotech stocks. Investors instead flocked to battered energy stocks, now favoring combinations of both value and growth.

The second manner in which the market has changed its stripes since August 25 is through subtle, but telling, shifts in the IPO (initial public offering) market. For the past few years, private companies have been able to enter the IPO market with relative ease, garnering capital at favorable valuation levels. In particular, tech companies such as GoPro, Hubspot, and LinkedIn found a market that was extremely receptive to their ideas, allowing them to raise capital near the top of the valuation range, with the stocks then going on to soar higher post IPO.

All of that seemed to change on August 25 when markets hit their low and investors assessed whether or not valuations were reasonable. Since then companies that stayed on the path to become public have been met with much less receptivity from investors. In fact, many have priced either below their initial range or towards the lower end of it. Some companies, such as Albertson's, Neiman Marcus and Univision have decided to postpone their IPOs, waiting instead for a more favorable environment. On October 21, 2015 CNBC noted that of the fourteen IPOs that had come to market over the previous four weeks, only two priced within their expected range, with the average price 22% below the midpoint of the range. This change in tone among investor appetite for IPOs is one more indicator that the personality of the markets has shifted.

This impact is not just being felt in the IPO market, but is affecting private companies as well. Once red-hot technology companies, like Dropbox Inc., are now struggling to find investors amid cuts in valuation estimates. An article published on Business Insider on November 2, claims that Dropbox has raised over $1.1 billion in funding since 2007, "but there have been multiple press reports questioning the company's shaky business model in recent months, and investors reportedly cutting the value of its shares by 24%."

The third broad characteristic of the new market is a shift in individual stock leadership. Stocks that drove the market to new highs have lost their allure. Illustrated in Figure 2, the top ten performing stocks in the S&P 500 year to date through August 25 have since dropped dramatically in the ranks. With the exception of Amazon and Activision, the top ten have fallen deeply out of favor, with five ranking in the bottom half, two of which rank in the bottom quartile.

Figure 2—S&P 500 Member Ranking

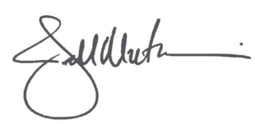
Name	12/31/2014 - 8/25/2015 Rank	Qtle	8/26/2015 - 10/31/2015 Rank	Qtle
Netflix Inc	1	1	320	3
Amazon.com Inc	2	1	9	1
Martin Marietta Materials	3	1	421	4
Electronic Arts Inc	4	1	178	2
Hasbro Inc	5	1	289	3
Gamestop Corp-Class A	6	1	344	3
Vulcan Materials Co	7	1	193	2
Activision Blizzard Inc	8	1	10	1
Reynolds American Inc	9	1	80	1
Cigna Corp	10	1	427	4
Sandisk Corp	500	4	1	1
Cameron International Corp	349	3	2	1
Newfield Exploration Co	158	2	3	1
KLA-Tencor Corp	469	4	4	1
Cablevision Systems-NY Grp-A	50	1	5	1
Freeport-McMoRan Inc	504	4	6	1
Nvidia Corp	123	1	7	1
Molson Coors Brewing Co-B	291	3	8	1
Amazon.com Inc	2	1	9	1
Activision Blizzard Inc	8	1	10	1

Source: Bloomberg

The opposite is also true, as the top performing S&P 500 stocks since August 25 were generally poor performers in the period leading up to that low. In fact, more than half of the stocks in the top 10 since the low were in the bottom half of S&P 500 stocks on a year-to-date basis through August 25, with three of those stocks coming from the bottom quartile. The market is clear: a change in leadership has and will continue to transpire.

Attitude Adjustment

A change in leadership is an opportunity. For the Dolphins, this meant a realignment of the team's attitude, which so far has boded well. Similarly in the markets, we can take these leadership shifts as opportunities to add value to client portfolios. So far, new market leadership is indicating that the market is more wary of risk and less willing to be sold on a good story without first demanding evidence of a clear profit stream. While timing these shifts is difficult, our Investment Strategy Committee anticipated this market rotation and made strategic recommendations throughout 2015 to limit our overweight to large capitalization stocks and take advantage of value opportunities in smaller capitalizations both domestically and internationally. We will continue to monitor the markets closely for signs of strength, knowing opportunities will probably continue to come from dramatically different areas than they did just a few short months ago.



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