NARWHAL CAPITAL MANAGEMENT

The Narwhal Letter
Second Quarter 2016
July 27, 2016

Dear Reader,

While news outlets and other media were no doubt harping on "Brexit" in late June (and several weeks before that), the initial impact was short lived. In fact, even accounting for the two-day selloff on June 24th and 27th, the S&P 500's total return for the month was actually a small gain (+0.26%). While this is nothing to be ecstatic about, all things considered we find it respectable given the headline risk of Brexit.

For the entire second quarter the total return of the S&P +2.46%—a total much easier to stomach. But this equity rise wasn't the only story worth watching for the quarter. A generally less covered development over Q2 was the yield on US 10-Year Treasuries, a common interest rate benchmark. Entering April, the 10-Year yield stood at 1.77%. By the end of June, it closed yielding 1.47%. In a vacuum, a 30 basis point move over three months might not seem like a big deal, but 10-year U.S. treasuries gave up 16.95% (0.30% divided by 1.77%) of their already historically low yield in an extremely short period of time. That decline and its impact on fixed income markets as a whole has made investing in bonds something of a challenge and may also be driving equity markets forward as yields remain incomprehensibly low.

It is tempting to reach for higher income by investing in lower quality bond issues (which often offer higher coupons) or allocate more of the portfolio to equity. But, we believe both of these actions are in a short-term mindset and the downside of such compromises could be more damaging than the potential benefits of slightly more yield. If there is any consolation, gold has been on a tear – for the quarter it jumped 6.76%. The benefits of a diversified portfolio are shining bright (as gold, not diamonds).

As it pertains to Narwhal, we remain focused on discipline and asset allocation control. As a whole, we track our net buy/sells for each month to gauge our trading patterns. What we target is buying in down markets and selling in up markets. Keep in mind, however, this is always backward looking – no one knows what the market will do next month, let alone tomorrow. For the quarter, we sold a net $4.63 million with the S&P 500 up 2.46% over that time (as noted above). Comparatively, we bought a net $9.67 million with the S&P up 1.35% in the first quarter of this year. The majority of this buying was weighted towards January and February – when the market sold off sharply to bring in the New Year.

With regards to specific buys and sells for the most recent quarter, below is some commentary.

Our First Solar (ticker FSLR) investment is an example our value-first approach to stock analysis with an emphasis on a secular growth story. After a strong start to the year, the shares were hit on concerns about financing structures in the industry and the bankruptcy of Wall Street darling SunEdison (formerly SUNE, now SUNEQ). However, FSLR has adopted a different strategy in which the management team prides technology innovation over financial engineering. With a strong net cash position on the balance sheet and a reasonable valuation, we expect FSLR to be in pole position to capitalize on the secular potential of solar energy. We picked this stock up for some of our more risk-tolerant accounts.

Caught up in the negative sentiment surrounding the auto industry and mobile phones, NXP Semiconductors (ticker NXPI) – a supplier to both industries – has seen its share price go nowhere. However, we think that continued technology advancement in the automobile is likely (e.g. TSLA) and expect NXPI to grow its dollar-share content over the next 3-5 years. In addition, at a P/E of less than 15, we think NXPI's shares are already discounting an extension in the mobile phone upgrade cycle. NXPI is a truly "new" name to Narwhal portfolios.

As technology continues to miniaturize, Intel (ticker INTC) continues to demonstrate a lead on its competition as the firm strives to preserve Moore's Law. While the market is concerned that this will result in ever-rising capital expenditures, the bears have been proclaiming such a thesis for years. The more relevant measure is to look at gross margin through the cycle and our view is that gross margin is materially higher than it was at similar points in prior cycles. This is good news and evidence that INTC's competitive position is strong and actually improving.

On the sell side, we exited CF Industries (ticker CF) when it became apparent that the long awaited catalyst for the stock—a merger with OCI and impending tax inversion—was off the table. We might rebuy CF at another date and at a lower price, but the story and investment thesis behind our investment was altered with the termination of the OCI merger.

We also exited Medtronic (ticker MDT) based primarily on raw valuation and broad client allocation needs. We like the company and the space they're in but the stock reached an inflated valuation and this became a position we exited firm-wide to reduce general equity exposure and allow for the purchasing of more "cheap" stocks.

In closing, we couldn't conclude the quarterly newsletter without addressing recent multi-front expansion at Narwhal. As most of you know, we launched Tusk Media in this summer as a way to connect more frequently with clients and the outside world. By the time you read this Tusk Media podcasts and videos will have been viewed more than 50,000 times. We are absolutely blown away by the positive response and thank you for your participation.

Additionally, the team at Narwhal continues to grow. In June, Ben Nye and Sam Frost joined our Investment Committee. Ben came on board as a Senior Equity Analyst and Assistant Portfolio Manager. Sam is serving as a Junior Investment Analyst and Assistant Portfolio Manager. Their arrival combined with the involvement of Matt Krebsbach (who celebrates his 1-year anniversary at Narwhal next week), has greatly bolstered our investment process and convictions. Further, it is great to have all five member of the Investment Committee contributing to this newsletter.

Lastly, as we type this we are surrounded by an incessant hammering sound. While we might be less mentally stable in the short-term (seriously, this thing doesn't let up!), we're excited about our office expansion that should be completed sometime late this fall. The expanded office space will more than double our current square footage and allow for us to put all our new folks (as well as our displaced accounting department) in offices under one roof. Be on the lookout for a housewarming event of some type later this year.

As always, we are truly grateful for the opportunity to work alongside you and your family. We do not take this burden lightly, and if we can ever be of further assistance please do not hesitate to contact us.

Sincerely,

Matthew D. Burton	Andrew D. Hall	Benjamin J. Nye	Matthew T. Krebsbach	Samuel T. Frost
Founder, President	Vice President	Sr. Equity Analyst	Portfolio Analyst	Jr. Investment Analyst

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