The Narwhal Letter
Third Quarter 2017
October 31, 2017

Dear Reader,

Once upon a time, long ago, the U.S. stock market experienced something called a "negative return." Now that is a trite way to start this letter, but why not? For some of today's more brazen investors along with a generation of young people, these alleged "down markets" may sound like a war story told by old veterans. For others, the sting of the financial crisis still seems like yesterday.

But down markets aren't fairy tales and neither is the stock market's current march forward (and upward). Understandably, a market that is defying the popular notion that we're "due for a crash" lends itself to an obvious line of questioning: "What do you think of this market?" "What is driving this market expansion?" "Can this thing keep going up?" "When is this market going to correct?"

Collectively, these questions (which we hear increasingly often) are eagerly straining for an answer to *what's next*?

Spoiler alert: We rarely know that answer. We don't have the Rosetta Stone or a crystal ball. If we did, we'd probably do something more fun than investment management! Even so, the majority of our thoughts and many of our best educated hypotheses are available in our quarterly webinar (the pinned video at YouTube.com/TuskMediaLLC). We don't expect everyone to endure the entirety of that 45-minute endeavor, but we encourage you to give it a try. And if you want the cliff notes, we're altering the format of this newsletter to offer a few observations and answer a few questions.

Observations

Many active investors are currently pointing to narrow market leadership as a new and unique challenge. Interestingly, that trend has been showing itself for some time, but it does hold somewhat true (even though there have been periods for which this challenge has been much more adverse). While debates like "Active vs. Passive Investing" rage on, the reality is that discernible out-performance remains primarily a function of owning the right stocks (which is often a small number of companies). This remains a challenge on a daily, weekly, monthly and quarterly basis, and in many cases we're increasingly able to self-diagnose our "best" and "worst" portfolios simply by looking at a few holdings. As an example, clients who held Orbital (ticker OA) tended to out-perform in the third quarter thanks to a nice buyout bid for that company. On the day that we are writing this (October 26), clients holding Celgene (ticker CELG) are getting punished due to poor quarterly performance and an adverse reaction to forward guidance from the company. Are all portfolios holding OA the best and all portfolios holding CELG the worst? Not exactly. But big moves by single companies can have a real impact—even on a diversified portfolio.

Secondly, exchange traded funds (ETFs) have become the *de facto* go-to investment for an increasingly large class of investors. Specifically, the S&P 500 index (through vehicles like IVV, which Narwhal owns in some client portfolios) is the drink of choice, followed typically by other passive or semi-passive strategies. Since these are the easiest and most accessible assets to purchase, we tend to believe that these assets may also be the easiest to sell when the scent of panic hits the nostrils. We are cognizant of the underlying assets held by these instruments and we are focused on other threats—futures contracts, leverage, etc.—that may accelerate the unwinding of ETFs and therefore increase the downside for underlying stock positions.

Thirdly, we remain convicted that our core investment worldview stems from a fundamental value approach. Put simply: we want to own cheap stocks and watch them become less cheap, then we want to sell them. We might have flavors of growth stocks and occasional turnaround story stocks sprinkled throughout portfolios, but value is the emphasis. Additionally, we are steadfast in our commitment to diversification (both within the stock portions of portfolios *and* across asset classes) as we strive to supply capital preservation and downside protection.

As a result of these leanings, it is a challenge to "out-perform" a racing market. Put bluntly, our balanced portfolios comprised of stocks, bonds, real estate, gold and cash are *not* beating the stock market as a whole. Academically, this is not a surprise. With the S&P 500 up more than 14.2% through three quarters, we would expect that non-equity asset classes may lag and therefore weigh on performance. We're perfectly fine with that. The longer-term expectation is that a balanced portfolio would prove less volatile and less inclined to absolute downside than an equity-only portfolio, and over the course of a full market cycle we would strive for more comparable performance between "balanced" accounts and the "market."

And truthfully, managing equity portfolios from a value perspective is tough in a runaway market. Despite this challenge, however, the majority of our portfolios are performing "in-line" with the market on a stock vs. stock basis—just as they were last year. But understand that this is a struggle, and truthfully under-performance in a year like 2017 is something we will address if necessary. That being said, there are two things worth noting about our view on under-performance as it relates to the previous sentence.

1. This is not a cop-out, admission of defeat or lackadaisical acceptance of inferiority.
2. Rather, this is a commitment to refuse the temptation to "chase" market performance on the backs of mega cap growth stocks which often do not fit our investment parameters.

We are not market chasers; we never have been. But that fact seems to show itself most clearly when the market is begging to be chased—as it is right now, in its ninth consecutive "up" year (as measured by the total return of the S&P 500). As a bit of trivia: Not a single Narwhal client was alive the last time we had a bull market lasting more than nine calendar years. This is historical by that measure.

But does that necessitate a crash? And what's coming next? Let's answer a few questions and look ahead.

Popular Questions

When will the market correct/crash/pullback? Frankly, we're not sure. To provide you with a date or timeframe with no underlying conviction would be nothing more than a parlor game or side bet. We're not going to do that. We acknowledge that the market has run for a long time, but we don't think that necessitates a correction in and of itself. Generally, our team of analysts think the market is on the high end of fair value, but that doesn't mean we're in a bubble. We think an adjustment of some kind (maybe it's 3-5%; maybe it's 10%) could occur the next 12 months, but we think such a move may present us with buying opportunities and likely won't represent a repeat of 2008.

So what about valuations? There are still cheap stocks out there; for the most part the trade confirms you receive reflect that. There are also over-valued stocks (see the sells in your portfolio). This is not a market devoid of opportunities nor is it a market flooded with them. But it's important to note that valuations are not static. Fundamentals are subject to change even if the price of a stock doesn't move. What's cheap today may be expensive tomorrow and vice versa. But we are not currently subscribers to the school of thought that "valuations have never been higher." We think there is room for earnings growth, economic progress and valuation expansion.

What is the current course of action? As always, we will stay disciplined to the asset allocations that have been set for each portfolio. We're not broadly reducing equity exposure in anticipation of a market crash nor are we increasing such allocations to capitalize on a surefire run-up. We're staying true to the targets identified with each client. In terms of intra-portfolio moves, we continue to pursue undervalued assets in every class (equity, fixed income, real estate, commodities, etc.). We will resist, to the best of our ability, over-extending portfolios solely for the sake of big numbers, but we will not be ignorant to our benchmarks.

But what are you all actually doing *day-to-day?* For starters, we are trying to avoid an echo chamber of yes-men who constantly agree on all issues. Case in point: this very newsletter underwent multiple revisions to reflect multiple market perspectives. In the pursuit of outside opinions, we are extremely busy with conferences as we seek varying perspectives on the economy, investment opportunities and asset classes. Our five analysts have attended three conferences in October and will attend two more in November. We continue to build upon our existing investment process and pursue independent valuation methods through in-depth analysis of financial statements, management conference calls, analyst reports and other means. Along those lines, if you ever have interest in a particular stock (be it one in your portfolio or one in the news), feel free to reach out to us. We're always happy to share our informed opinions through our proprietary research.

As always, we appreciate the opportunity to work alongside each and every client. We are grateful for the recent good fortune of the market and we are encouraged by all of your philanthropic and humanitarian pursuits. Related to that, if you have end-of-year giving to arrange, please reach out to Andrea Walker, our Director of Client Services, at awalker@narwhalcapital.com.

Sincerely,

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