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Dear Clients and Friends,

A presidential election is an opportune time to take stock of the historical moment, to examine whether voters are expressing basic agreement with the direction of public policy or, conversely, establishing a turning point of consequence. For investors, one might reasonably conclude that the 2016 election, similar to the unexpected vote in Britain to leave the EU, represents an historic break from a generational consensus around trade, regulation and economic policy.

Those cheered by the election results cite the probability of broad based tax reform, repatriation of corporate cash held in foreign banks and a rollback of regulations affecting industries from coal to investment banking. The Affordable Care Act will be restructured or repealed with the aim of restoring innovation and competition to healthcare. An aggressively pro-business administration supported by a cooperative Congress, goes the thinking, will preside over sustained and robust economic growth. Others see a more precarious scenario as the administration steps back from trade agreements, the Iran nuclear deal and the Paris Climate accord. Consider the Trans Pacific Partnership, decried by candidate Trump and now virtually certain to languish unratified in the Senate. Skeptics wonder whether it makes sense to cede leadership on trade in Asia, the fastest growing region on Earth and home to 40% of the planet, to China. Similarly, they question whether a different policy would be less costly or more effective in containing Iran than the admittedly flawed weapons and sanctions deal in force now. And what of climate change?

A Bull Undaunted

Policy debates aside, investors are siding with the optimists. The S&P500 closed at a record 2238 on December 30, 2016, returning 11.95% including dividends for the year. In contrast to the market's narrow advance in 2015, last year's returns were led by industrial and financial services companies. Bank stocks awakened from a regulatory and interest rate induced slumber as investors bet on a positively sloping yield curve and higher interest income. At long last, interest rates appear to have bottomed; since the election, bonds have sold off aggressively, pushing the 10-year Treasury yield up 80 basis points to 2.6%. A bullish consensus has gripped the markets.

The optimists may well be right but we feel a cautious approach is called for now. Paraphrasing the adage that the best time to buy insurance is when it is cheap and widely available, we advise investors to focus more on capital preservation and value than on catching the next wave higher in stocks benefitting from the market's momentum.

Consider how we arrived here. Measured from the March 2009 recession low, the S&P500 has tripled, returning 17.8% annualized including dividends. Of the 31 calendar quarters since then all but four have been positive. The trailing p/e of the stock market is a moderately high 20x but the cyclically adjusted p/e, which measures 10-year average earnings, is 28x, approaching levels achieved at previous market highs. The market capitalization of U.S. listed companies is roughly 120% of GDP, higher than average, and total household net worth is at its highest multiple of GDP since the 1950s. Bond yields are rising and volatility is low, reflecting complacency among equity investors. According to the National Bureau of Economic Research, the current expansion, which began in June 2009, makes this among the longest periods in recent decades without a recession. Looking ahead, policy mistakes are possible, and there are unknowable risks in international affairs and terrorism. Investors now pouring into equities in hope of rapid and sweeping changes from Washington may be surprised at how long it may take to implement new regulatory and healthcare policies. For these reasons, we advise investors to keep a margin of safety by favoring high quality stocks with strong financial attributes and attractive valuations.

Time for an Imported Beer

Reading the preceding paragraph might encourage one to open a beer, and we hope it is a Heineken! With bonds looking better (but still overpriced), hedge funds delivering poor net returns yet again, and the overall stock market trading at elevated levels, where should investors commit capital? We are confident that the long term ownership of high quality common stocks issued by companies with wide economic moats, strong balance sheets, shareholder-oriented managements and abundant reinvestment opportunity is the best strategy for growing and preserving wealth. Moreover, we believe there are significant opportunities in global equities, which have underperformed U.S. stocks due to economic malaise in Europe and weakness in emerging markets battered by low commodity prices. The world’s largest brewers are a case in point.

Managed well, beer is an exceptionally good business. Brand loyalty is strong and enduring, revenue is predictable, and profit margins are high with low capital requirements. In recent years the industry has consolidated with the best operators, including AB InBev and Heineken, realizing the economies of operating on a global scale while preserving the intimacy and brand strength of a local operator in the markets they serve.

Both stocks are attractive considering their prospects for growth and shareholder returns. Each enjoys the support of informed and patient shareholders, and each has deep roots in emerging markets. Heineken, for example, owns over 250 global beer brands, generating 65% of its operating income outside its home market of Europe. Emerging markets are Heineken's most profitable segment, contributing 15% of consolidated revenue and 23% of operating income. In 2016 Heineken's ADRs fell 10% and are roughly unchanged for the past two years. Currency headwinds, a poorly received vertical acquisition of a U.K. pub business, and investors' preference for more economically sensitive U.S. equities have weighed on the shares. These factors have created an opportunity for patient investors to own a high quality, global beer business in partnership with the Heineken family, which controls the company through majority ownership of Heineken Holding N.V. Last year AB InBev closed its acquisition of SABMiller, making it the largest brewer in Africa. Backed by the Brazilian private equity investor, 3G Capital, AB InBev is a world class operator positioned, along with Heineken, to grow sharply in the years ahead as populations and wealth grow in the emerging markets.

Notes from an Emerging Market

A recent trip to Jordan as part of an economic delegation organized by the U.S. State Department revealed unexpected insights into the opportunities and risks facing global investors in emerging markets. The purpose of the delegation was to meet with the prime minister and business leaders, and to evaluate opportunities for private sector investment in Jordan, which faces an existential economic crisis in the form of nearly two million refugees from Syria and Iraq. How to integrate these people into an economy as small as Jordan's is the question one ponders driving north to the Syrian border from Amman.

Despite the challenges of geography, demographics and war, Jordanians are a tenacious, friendly and outward looking people. One cannot help but admire the generosity of average Jordanians who, at least for now, are working to assimilate refugees representing more than 20% of the country's population. The associated pressure on the country's infrastructure and services is intense, with Jordan already among the poorest and most water stressed countries in the world. With a small population, the Jordanian economy relies on trade with Syria and Iraq as well as the bilateral relationship with the U.S. A free trade agreement has propelled annual trade between the U.S. and Jordan to $3 billion, however there is no venture capital, and foreign direct investment in Jordan is well below what is needed to absorb the refugees, replace the lost economic activity from neighboring countries and create opportunity for young Jordanians, as we learned from business students at the University of Jordan.

With a GDP comparable to those of Serbia and Congo, Jordan is too small a market, and the region too convulsed by war and oil politics, to offer investment opportunities to public equity investors. However, the view from Jordan reminds an observer how integrated the global economy is, and how central is the role of multi-national private sector investment in addressing the biggest crises and opportunities. The companies in our delegation, which included MasterCard, Coca-Cola and Microsoft, all weigh the risks of investing in an undeveloped market against the promise of rebuilding Syria and Iraq and potentially addressing a wider regional market in the years ahead. The rewards for companies who get this equation right could be immense.

Housekeeping items

Careful readers of our quarterly commentaries may note a regrettable decline in the fluency of our prose. While we endeavor to write clearly and informatively, we fall short of the standards set by our friend and partner, Chars Crane, who retires from the firm this month after serving as Chief Operating and Compliance Officer, full time editor of these letters and distinguished research analyst and portfolio manager. He has graciously agreed to chair our board of advisors, so we (and you) will have occasion in the months ahead to visit with Chars and maybe to hear from him in writing from time to time. As Chars retires, we are delighted to announce the promotion of Tim Hughes to Principal of the firm, effective January 1. Since Tim joined the firm in April, he and Chars have been working side-by-side to transition Chars' responsibilities as COO and CCO.

For our clients, we enclose your December 31, 2016 reports, including your portfolio appraisal, performance history and realized gains and losses. Our privacy statement is enclosed and our Form ADV - Part 2 is available upon request. You may note we have added the MSCI World Total Return index as a performance benchmark. We feel this index, which includes international as well as U.S. equities, more closely resembles our investment approach than the S&P 500 alone.

To our clients, we thank you for your confidence in our firm. We wish you all a happy, peaceful and prosperous New Year.

Sincerely,

Douglass Winthrop Advisors LLC