Douglass Winthrop Advisors, LLC
535 Fifth Avenue, 22nd Floor
New York, NY 10017

New York
Boston
Washington, D.C.

Telephone 212 557 7680
Telefax 212 557 7683
douglasswinthrop.com

Douglass Winthrop

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Dear Clients and Friends,

We are pleased to enclose our third quarter letter, including our commentary on the financial markets, some year-end planning items to consider and, for our clients, your account statements for the quarter ended September 30, 2016.

The stubborn bull marches on…

Equity markets continued their steady upward march over the last three months. Including dividends, the S&P 500 advanced 3.9% for the quarter and is now up 7.8% year to date, putting it on pace for a better than average year despite lower than average earnings growth. This extends the current bull market's run to 91 months without a correction of 20% or more, the second-longest streak since 1928.

While some fret that we are overdue for a setback, we see few signs of excess. Valuations are above the historical norm, but interest rates are extremely low, and stock prices appear reasonable when compared to bonds. Initial public offerings and merger activity are far from frothy, and credit spreads are tight. On balance, we think long-term opportunity and risk are balanced, and we remain constructive.

Please, no more about the election or the Fed!

Our sincere apologies. As much as we would like to avoid mentioning the upcoming election or central bank policy meetings, they are both important to how investors view the market and we are compelled to offer a few words on each.

This political campaign has been one of the most polarizing in recent memory. Our crystal ball is no clearer than anyone else's, and we cannot foresee how the markets will react in the short run to the outcome. A Clinton presidency would likely be somewhat more predictable than Trump's, but the dynamic between the White House and Congress could offset that extra degree of certainty. The ideological schism between the right and left will not narrow after November 8, so while the results may provoke some short-term gyrations in the benchmarks, we are more focused on which industries will win and lose in the policy regime that sets the agenda for the next four years.

As sensational and distracting as this year's political spectacle has been, performance of financial assets will likely be more sensitive to changes in reserve bank policies. To avoid any perception that it is influencing the election, the Federal Reserve Board is unlikely to act at its next scheduled meeting on November 2, so all eyes are now squarely fixed on the December 14 meeting. If the Fed takes no action, investors will probably conclude that growth is too weak and ratchet down their corporate profit expectations for 2017. Conversely, a 50 basis point hike could spook the markets as a proclamation of the end of the era of easy money. A quarter-point increase in the policy rate seems just right, and would allow investors to re-focus on other fundamentals, such as the state of the rest of the world.

That state isn't great. China is experiencing a dangerous build-up of debt. Europe has had more than its share of disruption this year with horrific terror attacks, the refugee crisis and Brexit. On top of this, a referendum on constitutional reforms in Italy looms in December which, if it fails, could leave that country with a compromised government that is unable to support growth initiatives and to address its banking crisis. Compared to this, the U.S. looks to be a safe haven and is likely to continue to attract incremental investment from around the globe.

So much liquidity, so little apparent value

The financial markets are reasonably efficient, swiftly discounting new information as it becomes available. Flush with liquidity, investors have left few stones unturned in their pursuit of ideas that will outperform. As a result, the great businesses we favor are generally not cheap, and those companies whose stocks are statistically inexpensive typically have some fundamental issue that raises their risk profile. In this environment, we can add value where our conviction runs counter to prevailing sentiment.

Healthcare has been among the worst performing sectors this year. It has been on the political hot seat throughout the campaign, and more recently news of egregious price increases (such as the ten-fold jump in the retail price of Mylan's EpiPen over the past nine years) have cast an unfavorable light on the pharmaceutical industry. But have investors tossed even the good babies out with the bathwater? Consider Amgen, whose stock trades at a forward P/E multiple of 13.6x projected 2017 earnings, a substantial discount to the S&P. The company enjoys strong cash flow from its stable of established chemotherapy and dialysis drugs, and its new product pipeline is robust. Its focus on operations and improved manufacturing efficiency should help it stay ahead in an increasingly competitive market for biosimilars.

Amgen plans to launch up to five such drugs of its own in the next three years. Regulatory pressure for all drug makers will likely continue but it appears those headwinds are priced into the stock at current levels, and we think it offers an attractive long-term opportunity at current prices.

Hiding in plain sight

We don't always have to plumb the depths of troubled sectors to find out of favor ideas where our views differ from the consensus. Sometimes good opportunities are hiding in plain sight, particularly when it comes to companies with histories of hyper growth. Our tendency to prefer proven performance over promises causes us to forgo the "New New Thing" more often than not when it comes to technology stocks. However, when high-flying companies mature, they tend to fall out of favor with growth-oriented investors, providing buying opportunities for value seekers like us. Such has been the case for Apple over the course of the past few years. As the company's sheer size exerted a gravitational pull on its growth trajectory, the stock's valuation was compressed severely. Today's Apple is a well-managed, cash-rich company paying an attractive dividend, and we think its shares offer above-average appreciation potential. We are patiently waiting for a similar dynamic to play out in other technology companies that we admire but whose shares reflect elevated growth expectations. History teaches us that even the best in class companies are bound to disappoint once in a while and present more attractive entry points.

In short, we relish our role as active investors who focus on companies rather than benchmarks. Within each sector, there are always companies that can reward those who take the time to develop variant perceptions of potential strengths and weaknesses. While it may be easier to find such opportunities in sectors which are out of vogue, even the most widely followed companies can periodically offer opportunities for those with conviction and patience.

2016 year-end reminders

Fall tends to be the busiest time of the year as the goals set at the beginning of the year come back into focus. In this spirit, now is a good time to consider the following reminders from our wealth planning team of Lea Highet, CFP® and Olivia Le Blan:

- Make annual exclusion gifts.
- Make charitable gifts.
- Make retirement plan contributions.
- Ensure that you have taken required minimum distributions from retirement accounts if you are in distribution mode.
- Update your family's planning documents to reflect any changes that have occurred over the last year such as a child turning 18, a death, a divorce or a change of domicile.
- Talk with your attorney if you are interested in taking advantage of the opportunity to transfer an interest in a closely held entity to or for the benefit of family members at a discount. Recently proposed regulations would limit the use of valuation discounts for certain transfers beyond the end of this year.

No one can predict future changes to our nation's tax laws, but keep in mind that by historical standards current income, capital gains and transfer tax rates are relatively low. While investment performance is critical to reaching one's financial goals, planning and execution are equally important, and paying careful attention to simple steps like these can make a meaningful difference to achieving those goals.

Some final comments

It continues to be a dynamic year at our growing firm. This quarter we are pleased to announce the addition of Jeffrey Muscatello, Execution Trader, and Pamela Antonella, Client Relations Manager, to our team. Welcome, Jeff and Pam.

In closing, we thank you for your support and welcome your questions and suggestions. We wish you a safe and happy remainder of the year.

Sincerely,

Douglass Winthrop Advisors, LLC