Bernzott Capital Advisors

PERSPECTIVES

January 2016

2015 Review

For the first time in six years, we look back over the past calendar year and proclaim, “That was not much fun.” After suffering though the global financial crisis in 2007 and 2008, it had been a steady march upward, including some years (2010 and 2013) that were extraordinary. In fact, after a stellar 2013, the lead article in the first quarter, 2014 *Perspectives* was titled “Is This Sustainable?” Well, returns were okay in 2014, we sold many positions in early 2015 because of the appreciating values, and the rest of the year (especially December) was not something to celebrate. What happened, were there any surprises and how does 2016 look?

As we wrote on these pages last year, valuations for many of our holdings were stretched. We have a fair value calculated for every security we own and we sell the position once it reaches our assessment of fair value. This happened with a number of holdings in early 2015. Consequently we held a large amount of cash at the beginning of the year. Then the challenge became discovering companies that were trading well below their values in a market that seemed to push all prices up.

There was not any one event or macroeconomic factor that contributed to the poor 2015 returns. Looking at the big picture, we might surmise that after so many years of increasing prices and admitting last year that valuations were stretched, it should not come as too big of a surprise that we took a small step back in 2015. Simply, things could not keep up at the pace we enjoyed for the prior six years. Very often the next question is, if you admit that valuations are getting a bit rich and you know that the market cannot continue on the streak it has been on, why not take some money off the table and sit in cash while things cool off? If only it were that easy.

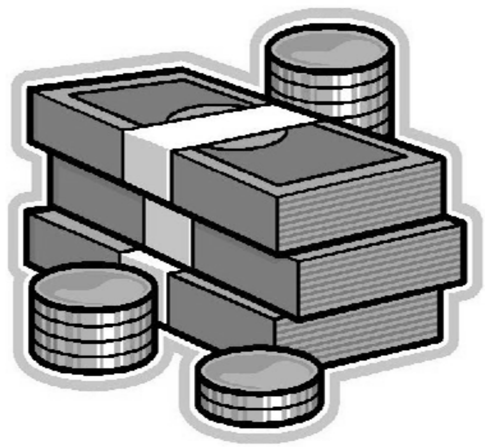
It is well established that trying to time the stock market is a loser’s game. The stock market has a certain amount of randomness on a day-to-day and even year-to-year basis that is unavoidable. Trying to predict where prices will be one year from now is folly. And that is true for markets other than stocks. How many people predicted $30 for a barrel of oil? Who would have guessed at going almost 10 years without a rate hike from the Fed? The fact is we have to live in a world of uncertainty (which is a good thing), short-term traders often have short-term influence on stock prices and if you think you can time the market by getting in or out at just the right time, we think you should prepare to be disappointed.

We know that many of the professionals who trade stocks for a living very often subscribe to a herd mentality. They are greedy when they should be careful and they panic in times when sober thought is required. The results are trends that don’t necessarily make sense to patient investors, but they also result in two other conditions: 1) Prices that don’t reflect fair value; and 2) opportunities for long-term, patient investors.

One clear trend that occurred in 2015 which hurt us a bit was the market’s distaste for stocks that were small, midcap and/or value-oriented. According to Morningstar, small cap value and mid cap value funds were the worst performing fund categories in 2015, down on average 6.7% and 5.4%, respectively. Additionally, as cap size got smaller, so did returns. While we own stocks all over the market cap spectrum, our portfolio is heavier in the smaller companies. And while we don’t necessarily make a distinction between growth and value, many

Wall Street investors do. The result of this trend is twofold: 1) our one year performance number suffers; and 2) our portfolio is trading at a bigger discount to our calculation of fair value than we have seen in a few years.

Other factors that contributed to flat returns include the continued decrease in oil prices and the corresponding pressure put on any company that services oil and gas companies. China's slowdown and Yuan devaluation also have a ripple effect. And while we have very little energy exposure in our portfolio and only indirect exposure to China, a material slowdown in a gigantic industry and a gigantic country will have a deleterious effect on stock prices. Additionally, the strong U.S. dollar makes it more difficult for firms that sell their goods and services in American currency. If you are taking your U.S. dollar to buy foreign goods, a strong dollar is a good thing. But if you are selling goods in a foreign market and you require U.S. dollars for those goods, you will be at a competitive disadvantage.



Making things even more unpalatable, stocks have started 2016 with a thud. By most forms of measurement, the overall market has had its worse start to the year ever. But those sort of headline-grabbing, short-term statistics don't bother us. And they shouldn't bother investors. We remain focused on fundamentals of the companies we own, including market leadership, high operating margins, high returns on capital, reasonable debt and long-term track records of increasing earnings per share and/or dividends. Given these parameters, and given the decrease in stock prices, our portfolio is trading at a significant discount to fair value. This situation looks quite poor on current statements, but we believe it bodes well for the future. A snapshot rarely gives context to what can be seen with a more complete motion picture.

Going forward, we believe that current prices do not reflect the current values of the companies we own. This has happened many times before, and we have always emerged better off than when it started. There will be events nobody predicted that will have an impact on stock prices. Despite everyone's desire to experience a steady upward movement in portfolio values, we know there will be some volatility. The question is, when prices are down, should you panic and run for the door, or should you see the decrease in price as an opportunity?

We appreciate your continued business and your patience during times of market stress. We are confident that this period, like all others before it, will pass and you will be rewarded for that patience. Easier said than done when on a daily basis prices are lower than they were before, but we continue to own businesses that make money, have reasonable debt, are not speculative and exude quality. Short-term traders can cause the price to decrease on a short-term basis, but they will not detract from the long-term value of the business. That value is captured by long-term investors. And that is always the place to be.

Vice Chairman Retires

John Brinker, who has served as Vice Chairman at Bernzott Capital Advisors since August, 2013, has announced his retirement effective December 31, 2015. John was based out of our Santa Barbara office. Tom Derse, CFA, will take over as manager on John's accounts and we anticipate a seamless transition. Bernzott Capital thanks John for his contributions and wishes him the best. If you have any questions, feel free to contact Tom at 805-389-9445, extension 216.

<u>*About the Firm*</u>

Bernzott Capital Advisors is an independent institutional money manager serving foundations, endowments, public and private retirement plans including Taft-Hartley plans, and businesses, individuals, trusts and families. Please feel free to call with questions and comments, or visit us at **www.bernzott.com.**