CIO OUTLOOK

Perkins
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UNCOMMON VALUE℠

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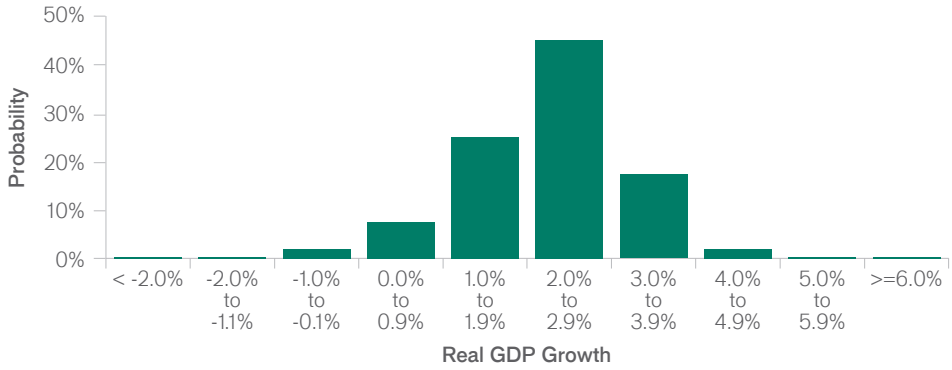
IMAGINE THE POSSIBILITIES

Fall 2008 through winter 2009: Stocks were in virtual free fall, rapidly becoming cheaper compared to average historical earnings and book values. While the merits and demerits of an investment can always be debated, it was clear that contrarian buying opportunities were plentiful. Having been a buyer of equities during this period, I will confess to the following: as I was observing all of the negative developments, and even forcing myself to consider that brighter days might lie ahead (eventually?!), it never once crossed my mind when the S&P 500 Index breached 700 on the downside that it would approach 2,400 on the upside in eight years' time. The payout structure on stocks proved spectacular, not merely good. The lesson? A more active imagination would have helped better understand the circumstance and capture a greater portion of the upside opportunity.

Imagination can help mitigate downside as well. Economists who publish forecasts of GDP growth routinely miss the downturns. The International Monetary Fund (IMF) publishes forecasts for 189 countries twice a year, in April and October, for the year in question and the following one. The Economist conducted an analysis of them, from 1999 to 2014, and notes that the forecasts are especially bad at predicting downturns.[1] Over the period, there were 220 instances in which an economy grew in one year before shrinking the next. In its April forecasts, the IMF never once foresaw the contraction looming in the next year. 0 for 220! Harvard University economics professor and former U.S. Treasury Secretary Larry Summers similarly stated that "If you look at the consensus of professional forecasters, the Congressional Budget Office, or the U.S. administration, they've predicted zero of the past five recessions."[2] Nate Silver's *The Signal and the Noise: Why So Many Predictions Fail – but Some Don't* highlights the startling example of the Great Recession, which the economists badly missed in their forecasts (see chart). So be warned: economic forecasters are unlikely to indicate the

FORECASTED PROBABILITY DISTRIBUTION: REAL U.S. GDP GROWTH (2008)
SURVEY OF PROFESSIONAL FORECASTERS, NOVEMBER 2007



Actual results: 2008 -0.3%, 2009 -2.8%

Sources: *Silver, Nate. The Signal and the Noise: Why So Many Predictions Fail – but Some Don't.* New York: The Penguin Press, 2012. The Survey of Professional Forecasters is a quarterly poll by the Federal Reserve Bank of Philadelphia. Actual GDP results from Bloomberg.

[1] "A mean feat." The Economist. January 9, 2016.

[2] Interview on Here & Now with Jeremy Hobson on Boston's NPR station 90.9 WBUR-FM. January 27, 2016.

> "A truly active imagination, especially in the midst of an impressive bull market, will consider darker possibilities as well."

next downturn in advance. The coast is never clear, in this sense. Investors will therefore benefit from flexing their imagination when considering the downside possibilities, in addition to those rosier forecasts.

What might we imagine today for the stock market? To the positive, corporate profits appear to be growing again across the U.S., Europe and Japan. Interest rates remain low by historical standards, and central banks may refrain from seriously tightening monetary policy. Perhaps excitement will build among investors, and while valuations are high by historical standards, they may expand further. Bulls often point out that valuations reached much higher levels in the 2000 tech bubble than prevail today. All accurate and possible.

A truly active imagination, especially in the midst of an impressive bull market, will consider darker possibilities as well. Corporate profit margins are in many cases quite high by historical standards, and may be threatened by a double whammy of competitive pricing pressure/deflation and wage inflation. Many companies have leveraged their balance sheets to finance acquisitions or shareholder payouts via stock buybacks and dividends, thus limiting their financial flexibility. Interest rates would seem to have little room to fall, but wide scope to rise. There are political considerations as well, which could go any number of ways. Our analysts and portfolio managers at Perkins are looking carefully at the sustainability of earnings and for balance sheet vulnerabilities for each of the companies we are assessing, from the bottom up. As a matter of process we develop/imagine both upside and downside possibilities, think for ourselves, and avoid putting too much weight on the opinion of either the perpetually optimistic economists or bull market cheerleaders on Wall Street.

Valuations were notably low and fear was swirling around in late 2008 and early 2009. The wise move then (with the benefit of hindsight) was to cast an imaginative view toward the potential positives in the future. Those who were expansive in their thinking and long in their portfolios made the right move in that challenging environment. Today, with valuations high around the world and expectations for the economy and earnings rising, there is a sort of cyclical symmetry developing. Rather than get carried away with their optimism, we believe investors will be best served by setting their imaginations free to carefully consider some of the more challenging or even outright negative possibilities – just as it would have paid to think "differently" in '08/'09. Our view is, be defensive, not aggressive, with equities, and consider short-term, high-credit quality, and very liquid fixed income and cash instruments.

Abstract from the present, cast your imagination to the future, and consider that the range of possibilities is probably wider than at first blush. We are mindful of the desire to participate in further gains should they develop, though remain committed to offering our investors defensive portfolios designed to withstand shocks better than our benchmarks and peers. Thank you for your investment.

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There is no assurance that the investment process will consistently lead to successful investing. No investment strategy can ensure a profit or eliminate the risk of loss.

There is no assurance the stated objective(s) will be met.

A client commitment is not a guarantee that a stated objective will be met.

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S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

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