



INVESTOR INSIGHTS – SECOND QUARTER 2017

AND THEN THIS.....

The first quarter returns are interesting: international outperformed domestic, growth outperformed value, large outperformed small, munis outperformed the aggregate index, and our alternatives managers performed exceptionally. Now this is only 90 days, and even longer periods are nearly impossible to predict, but this may speak to some changes in the economies globally. Europe and developed countries outside of the U.S. appear to be uncovering good news as their companies progress. Earnings generally are beating expectations in these countries, all good news for the global economy. Domestic companies as well appear to be surpassing expectations on earnings, and the first quarter absolute returns reflect this, EAFE rose 7.39% while the S&P 500 rose 6.09%. Both of these returns are exceptional. So we can just relax and not worry as much, everything is fine, right!

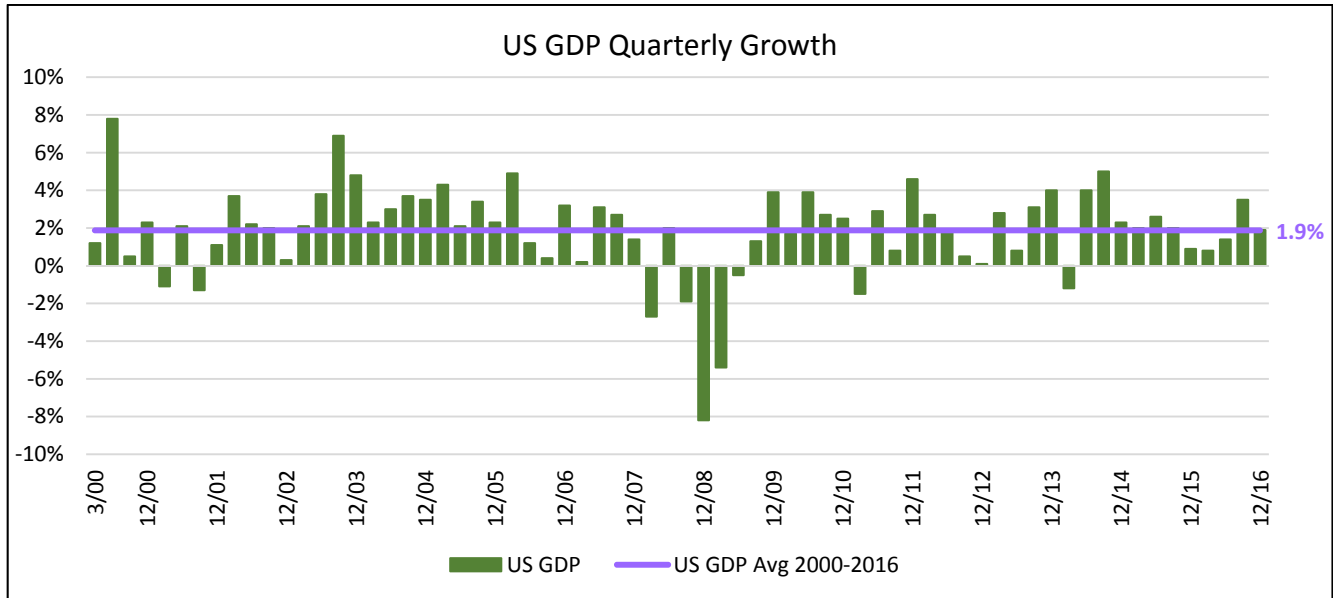
Well, maybe not so fast. Yes the news is good, but if you go back to our five guidelines for developing portfolios this year, as we wrote in our Q1 newsletter, we talked about expecting volatility in equities. Now we believe many people substitute the word decline for volatility because that is the volatility we worry about; but outsided returns on the upside is volatility as well. If we were to repeat first quarter returns for domestic and international stocks throughout this year, they would be up 26.5% and 33% respectively. Possible? Yes. Likely? Hardly.

Realistically, the global economy does not appear to be able to grow at GDP rates that would support these returns. So let's look at our economy and stock market and see what we think could be a realistic way at looking at future returns.

GDP Growth

Chart 1 shows GDP growth in this country from 2000-2016. Average GDP growth over this 17 year period was 1.9%, and you can contrast this growth level with GDP growth from 1947-2000 of 3.7%. So this is how we put this 1.9% in perspective. As you can see in the chart there are six quarters when GDP grew at a 4% rate or higher, really good growth. But all of the other 60 quarters count as well, and less than 2% GDP growth signals a period of well below average equity returns. The S&P 500 compounded at 4.5% during this 17 year period of time, less than half of the 10.41% return for the full period of the S&P 500, 1958-2016.

Chart 1



So that begs the question of what will GDP growth be for the next three years, five years or longer. Well there are some promising developments on the horizon. Lower corporate taxes and less regulation appear to be in the development of our current administration. Our current corporate tax rates are too high and are a huge head wind for our companies. Teresa May has said she would like Great Britain to have the lowest corporate tax rates among the largest 20 developed countries in the world, and we take that to mean something like a 15% tax rate. If we were to match that rate, and it is a rate that has been discussed by the current administration, this would be a bonanza for our corporations. We should make our corporate tax policy in such a way that it makes our companies competitive in the global economy, so if the administration and congress can come together to get this done, we would hail this development. Tom Freidman has suggested that corporate taxes rates should be abolished, so while this may be extreme at one end, we do think lower corporate taxes are part of our future.

Regulation is another area where we could improve the fate of our corporations. This is a delicate topic on many levels because regulation has historically done some great things for this country, child labor laws and indiscriminate pollution come to mind as two of them. But everyone has met regulations they like and others they would easily disavow, so this may be more difficult. The current administration appears to be proceeding with executive orders that some of us love while others criticize, but we do believe there will generally be less regulation of our corporations.

The most optimistic economists that we can find are suggesting that lower corporate tax rates and less regulation will result in .50% increase in GDP growth. So realistically what we can expect from these developments is GDP levels are 2.5%. This is certainly an improvement, but this will not likely get us to the advancements of the 1947-2000 level of 3.7%. Chart 2 shows the GDP possible growth

rates over the next 5 years and attaches a probability of this outcome to growth rates of 1%, 2%, 3% and 4%. It also shows some other outcomes which we will get to later in this letter.

Chart 2

GDP Growth	10 Year Treasury Rate	Probability	Value / Growth Outperformance
4%	5%	5%	Value
3%	3%	25%	Value
2%	2%	65%	Value
1%	1.5%	5%	Value

Growth or Value

In our Q1 newsletter we do not specifically address this issue, rather we do so indirectly. We talk about having confidence in the growing dividend strategy we use. Standard and Poor's addressed the issue of the make-up of growing dividend strategies. They divided the stock market into four categories: those companies that raise their dividends, those that pay dividends, those that do not pay dividends and those that cut their dividends. What they showed was that this was the order of returns over a long time frame. They then analyzed the difference between growing dividend strategies and high dividend strategies. They found that high dividend strategies were 90% deep value stocks, while growing dividend stocks were 2/3 value and 1/3 growth. So you could call it value tilting toward core or core tilting toward value. Whatever you call it, it certainly has a value tilt, and the excess return we have achieved has come when value outperformed growth.

Chart 3 looks at the last 20 years of return of the S&P 500 broken down between growth and value. Growth outperformed value during this time period by 1 basis point, 7.47% v 7.46%. This is as close to a tie as you will ever see.

Chart 3

Year	S&P 500 Value	S&P 500 Growth
1997	31.87	34.73
1998	18.91	38.16
1999	4.88	37.38
2000	-0.51	-19.14
2001	-8.18	-16.12
2002	-16.59	-28.10
2003	30.36	27.08
2004	15.03	6.97
2005	8.71	1.14
2006	20.80	11.01
2007	1.99	9.13
2008	-39.22	-34.92
2009	21.18	31.57
2010	15.10	15.05
2011	-0.48	4.65
2012	17.68	14.61
2013	31.99	32.75
2014	12.36	14.89
2015	-3.13	5.52
2016	17.40	6.89
Annualized Return - 20 Years		
1997 - 2016	7.46	7.47

Chart 4 breaks down these years into those where value or growth outperformed and the two years where the returns were within 1% of each other, we would call that a tie.

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Cumulative Returns		
1997 - 1999	64.5	155.7
2000 - 2006	146.8	90.3
2007 - 2015	45.5	107.5
2016	17.4	6.9

So you can see that growth was the star from 1997-1999 followed by value from 2000-2006. The nine years from 2007-2015 saw growth outperform six times, value one time and there were two ties; but the aggregate return was superior for growth as you can see at the bottom of the page, we are suggesting 2016 may be the beginning of another period of value outperforming.

So Why Do We Believe Value Will Outperform?

Go back to Chart 2. We believe GDP growth will likely be in the 2%-3% area, we put a 90% probability of this outcome. Strong confidence, for sure, but here is how we see it. We have had two periods of outsized GDP growth in this country, 1947-1968 and 1982-1999. The first period was marked by the rebuilding of America after World War II, while the second was marked by the coming of age of the Baby Boomers and the advancements of technology. The period in between these growth periods, 1969-1981, was marked by high inflation and a stock market that compounded at 5% but 4 of the 5 came from dividends. The period we have been in since 2000 has seen a total return of 4.5%. Both of these low return environments were products of low GDP growth. Both of these periods also saw dividends dramatically outperform the general stock market, the first period using a study by Jeremy Siegel saw dividend strategies achieve a 9% return when the S&P 500 achieved a 5%, and the second period saw our portfolios achieve an 8% return when the S&P 500 achieved a 4.5% return. So there needs to be a catalyst for this country to grow at GDP rates above 2.5%, and we do not see those catalysts. Lower taxes and less regulation will not be enough. So our caution of our last newsletter is our caution of this newsletter, trust your growing dividend strategies. Our international manager, Henderson Global, actually outperformed their benchmark during Q1. We suggest in Chart 4 that the period to watch is 2017-2020, but there is no magic to this period. We are only pointing out that the period that started last year will be one marked by outperformance of growth by value. The period reminds us of the period of 2000-2006, not in a scientific way, rather in a market sentiment way.

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data prior to 1970 is Large Company Stock data series from Morningstar's *Ibbotson S&P 500 2009 Classic Yearbook*. Each stock in S&P 500 is ranked from highest to lowest by dividend yield on December 31st of every year and placed into "quintiles," baskets of 100 stocks in each basket. The stocks in the quintiles are weighted by their market capitalization. The dividend yield is defined as each stock's annual dividends per share divided by its stock price as of December 31st of that year. References to "returns" refer to the total rates of return compounded annually for periods greater than one year, with dividends reinvested on the S&P as a whole, or on the Model, as applicable, for the period of time (years) indicated. As such, "returns" are a measure of gross market performance, not the performance of any client's investment portfolio (which would ordinarily be subject to management fees and, possibly, custodian fees and other expenses). Index data is supplied by Morningstar Direct.

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