OBERMEYER WOOD **NEWS**

SUMMER 2017

MARKETPOINT

Supported by improving global growth and continued hopes for market-friendly legislation, the U.S. stock markets continued to rise in the second quarter, with broad stock markets up about 8-9% year-to-date. Foreign markets have also appreciated, responding to similar improvements in fundamentals.

Numerous factors underpin the positive market environment. First, the U.S. economy continues to grow at a moderate pace. Household and corporate spending continues to improve, with the Fed expecting real GDP growth of 2.2% this year. Also, corporate earnings have been solid, particularly given the modest growth environment. Earnings growth is expected to be 6.6% for the second quarter of 2017. Stock buybacks also continue to play a role in earnings per share growth and stock demand.

Across the pond, European growth accelerated, and the European Commission raised its expectations for 2017 GDP growth to 1.7%. Inflation remains subdued, unemployment is relatively low, and political uncertainty has diminished after the French and Dutch elections. However, given recent political developments, the outlook for the U.K. is somewhat less clear, particularly with regards to its withdrawal terms from the European Union ("Brexit"). In Asia, China has been of some concern; however, it posted strong GDP growth of nearly 7% in the first and second quarters, higher than the official target of 6.5%. News from China is likely to be subdued through the fall, when its 19th Party Congress convenes and new senior leadership of the Chinese Communist Party is appointed.

Given the improved momentum of the U.S. economy and labor market strength (as evidenced by May's unemployment rate of 4.3%) the Fed continues to raise interest rates. In addition to economic growth and the outlook for employment, the trajectory of interest rate rises will be impacted by inflation expectations. Should inflation remain subdued, Fed rate increases could slow. Recent inflation data has remained stubbornly low, as technological efficiencies and lower energy costs continue to dampen inflationary pressures. Conversely, an increase in deficit spending for an economic stimulus package or an acceleration in wage increases could offset some of the deflationary influences. We anticipate that inflation and interest rates will rise but gradually over the next several years.

A portion of the market that continues to experience significant volatility is the energy sector. The development of shale oil production techniques in North America revolutionized the global energy industry, adding billions of barrels of oil to the world's reserves. As with any commodity, supply and demand dynamics drive prices. Through most of 2014, supply, and hence oil prices, were controlled by OPEC, but it was losing market share to shale oil. In November of 2014, OPEC decided to end its role ›

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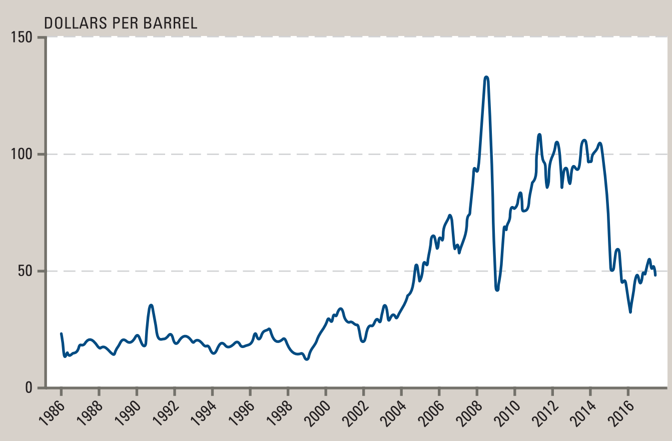
as the global swing producer for oil and no longer cut production to maintain prices. This strategic move was intended to drive oil prices down and negatively impact non-OPEC oil producers, primarily North American shale as well as deepwater and oil sands.

Oil, which had begun 2014 at over $100/barrel, plummeted and by early 2016 was nearing $20/barrel. In late 2016, themselves suffering and satisfied with the negative impact they had had on competition, Saudi Arabia and OPEC reverted to attempting to control oil prices and began to cut production. This resulted in a recovery in oil prices to ~$50/barrel. However, the supply dynamics had fundamentally changed. At $50/barrel North American shale producers were incented to quickly return to the market, as their technologically advanced drilling techniques can be rapidly deployed to exploit significant additional unconventional oil resources. On the other side of the equation, oil demand has historically grown at a relatively constant rate. However, in the future this demand will be subject to long-term disruptive forces, including ongoing energy efficiency driven by both economics and environmental concerns, as well as, ultimately the likely growth of electric vehicles. Overall, the combination of these factors will likely limit significant oil price recovery in the intermediate term, barring some exogenous event.

Historic Spot Crude Oil Prices (WTI)



Source: U.S. Energy Administration

The political environment has remained acrimonious and progress on the Republican legislative agenda has slowed. Some investors anticipate that health care reform, tax reform and infrastructure spending stimulus packages may still be passed in some form this year. Tax reform in particular could have a positive impact on economic growth beginning in 2018. However, if tax reform is not passed, earnings estimates could be lowered, which could result in increased market volatility. The benefits of well-thought-out, bipartisan policies would be substantial in terms of long-term economic and wage growth, and will be a missed opportunity if not achieved.

Today's market levels are a frequent topic of conversation with clients. Currently, the P/E ratio of the S&P index is approximately 18x, at the higher end of its long-term range. In our letters from past quarters, we have observed that market indices and recent market performance have become increasingly concentrated, as excessive worries about low economic growth have driven investors into a handful of popular growth stocks. This concentration could make indices and products that track them, such as ETFs, more volatile than investors expect, as increases or decreases in the largest stocks will create large moves in the index and ETFs. This risk may be underappreciated. This narrowing has created attractive values in other, out-of-favor sectors and stocks. Encouragingly, during the second quarter the market broadened, improving returns in various sectors, particularly those that are more value-oriented.

Overall, major asset bubbles do not appear to be forming. However, in this type of environment the merits of staying disciplined regarding valuation and the quality of one's investments in combination with remaining patient remains paramount. Volatility resulting from the political environment or large swings in the flow of funds in passive investments may well create attractive opportunities. We have been actively looking for nuggets this year and have added what we believe are several attractive new ideas to the portfolios that conform to our long-term, value-oriented investment philosophy.

REPORTING FROM OMAHA

OWIC Team members Ali Phillips, Tod Wood, Wally Obermeyer, Maia Babbs and Will Van Allen (former intern)

Continuing an Obermeyer Wood tradition, several team members traveled to Omaha in early May for Berkshire Hathaway's Annual Meeting. While the gathering is now streamed live each year, it is a true treat to be there in person. Highlights include standing in line starting around 5:15 a.m. to secure good seats (as there are 40,000 attendees), and watching Warren Buffett (86) and Charlie Munger (93) drink copious amounts of Coca-Cola products while nibbling on boxes of See's peanut brittle during the meeting's unscripted six hour Q&A session.

Answering questions posed by financial journalists, industry analysts, and audience members, Buffett and Munger offered updates on Berkshire Hathaway's solid core holdings (including GEICO, Berkshire Hathaway Energy, and BNSF) as well as their perspectives on interest rates, investing principles, and hot-button issues such as healthcare reform. Notably, despite dominating our daily news feeds, the current political environment was hardly mentioned during the meeting, and Buffett and Munger continued to reiterate their optimism about the U.S. economy's long-term potential.

Below are a few key takeaways:

- Buffett and Munger repeatedly stressed the importance of ongoing learning to being a better investor. Referencing their recent purchase of Apple—seemingly a significant departure given past concerns about technology companies—Munger quipped: "It's a very good thing that Warren bought Apple. Either he's gone crazy or is learning. I prefer to think he's learning."
- Buffett and Munger mentioned several companies (Google, Walmart, and Amazon) where they "blew it" by not investing. Being humble is part of learning. "We'll miss out on more, but that's our secret – we don't miss out on them all."
- Each year, audience members ask for a specific formula of how to identify good businesses. Munger argued that there is no precise equation; you have to do the work to understand each business, and of course, make mistakes along the way. "In the early years, we were young and ignorant. We bought horrible businesses which were unfixable and we learned. [This is why] we could see what a great business See's was because of what we learned."
- To illustrate the importance of competitive advantages, Buffett compared companies to economic castles, arguing that, "In capitalism, people are going to try to take that castle from you so you want a moat around it and you want a knight in that castle who is pretty darn good at warding off marauders."
- Finally, Buffett and Munger commented that it would be difficult for them to be as successful today as they were decades ago when Berkshire was smaller. There wasn't as much competing capital and smaller acquisitions made more of an impact. "We told you our size would lead to lower returns and we have proved ourselves right. Other people are trying to be brilliant and we just want to be rational."

Our Team

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TOP OF MIND

MEETING THE NEXT GENERATION

For many, summer offers a chance to enjoy time with children on summer break and reconnect with visiting relatives. We always welcome the chance to meet our clients' families as doing so deepens our relationships and perspective. We have enjoyed several intergenerational family meetings, which sparked some incredible conversations about family values and differing generational perspectives.

We are also always happy to help your family members individually, working with them on accounts or serving as a sounding board on financial questions as they arise. For example, if you have children who recently graduated college and are starting new careers, we can offer some guidance on retirement plans, housing choices, etc. Please reach out if you would like to introduce us to your broader family and we are happy to schedule a meeting or phone call.

WHEN WAS YOUR LAST REVIEW?

Another reason to reach out to schedule a meeting is if has been a while since our last review discussion or you would like to take a deeper dive on your strategy. An ongoing and open dialogue helps our team do the best job we possibly can for each of our clients. As a general rule, we recommend having a detailed review at least annually to discuss your unique situation and confirm your accounts' investment profile. If anything has changed in your life, a brief call is an easy way to see whether any investment adjustments may be appropriate.

As we wrote in our Winter newsletter, we invested in more a robust financial strategy software program in recent years to help answer clients' questions about spending levels, retirement, and gifting desires. If you are interested, we can explore whether such an analysis could be beneficial. Once we create a base model for clients, we can update the program periodically as circumstances evolve.

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