

Market Comments
January 18, 2016

S&P 500	1880
10 Year Treasury	2.04%

The S&P 500 declined 8% during the first two weeks of 2016, the worst start to a calendar year in history. While the decline has been orderly, its speed and magnitude are such that we feel a quick recitation of the key issues investors should consider is appropriate.

1. Time horizon is the most important variable for investors to consider, because one's time horizon dictates the investor's ability to tolerate short term stock price volatility. If an investor has a time horizon that is measured in years, then a sharp price decline that is unaccompanied by a similar reduction in fundamentals, presents an opportunity to position capital at relatively attractive valuation levels.
2. Valuation is the next variable to consider. It is likely that the recent stock price decline is in part the result of investors becoming more concerned about the level and growth of earnings in 2016-17. Currently, the S&P 500 trades at 15x consensus estimates of \$125 per share, a valuation multiple that is essentially "fair value," and implies long-term average annual total returns for stocks, from current levels, of 7-8%.
3. Just because an asset is fairly valued, or cheap, it doesn't mean that its price will stop going down in the short run. There are two important trading dynamics at work in the current environment. First, many sectors and stocks have sustained significant technical damage (i.e., their prices have declined significantly, and rapidly). Second, the market's breadth, or the number of stocks doing well, has narrowed considerably over the past several quarters. These two factors indicate that caution is warranted in the short run. The broader stock market has materially underperformed the largest stocks since last July: the Russell 2000 (a proxy for small and midcap stocks) is down 18%, the S&P 500 is down 9%. The "average" stock has done much worse than the largest, highest quality companies, and typically the stock market doesn't recover until the leaders have been significantly marked down, and the rank and file stop going down.
4. There are significant risks in the current environment: 1) slow, and slowing global economic growth, 2) declining commodity prices (which creates both global instability for countries that are highly reliant on commodity production, and for commodity-based companies that have significant debt levels), 3) a strong dollar (which hurts U.S. multinational company earnings), 4) historically low interest rates (which hurts the earnings of lenders, and which may encourage excessive borrowing), and 5) elevated geopolitical tensions emanating from increased terrorism.

5. We have no ability to predict the direction or magnitude of stock prices in the short run. Clearly, short-term market momentum is negative. We continue to expect that 2016 will be very challenging for investors, and be marked by higher levels of stock price volatility than has been experienced in recent years. The long-term average top to bottom range for the S&P 500 in any one calendar year is 20%. We would not be surprised if the S&P 500's range for 2016 was 1700-2400.

6. We believe the best risk control is accomplished by: 1) understanding one's time horizon, and investing in a way that is consistent with that horizon; 2) maintaining a focus on high quality assets: investment grade debt, and companies that have manageable balance sheet debt, high levels of free cash flow, and underlying businesses that have strong and durable competitive advantages; 3) maintaining enough portfolio liquidity so that a) foreseeable expenses are covered, and b) liquidity can be used to invest as opportunities created by market declines present themselves; 4) maintaining appropriate diversification within the portfolio (caveat: "diversification" only takes us so far; when everyone wants to sell at the same time, correlations tend toward "1" and most asset prices decline. This was illustrated in the 2007-09 capital markets meltdown).

7. We remain constructive on the long-term outlook for stocks, and believe that bonds are relatively unattractive given very low interest rates (although bonds will likely hold up well during sharp stock market sell-offs). We believe stocks are priced to return 7-8% annually over the next decade; the yield on the 10-year Treasury is currently 2%. If interest rates rise on balance over the next five years, bond returns will be marginally positive to marginally negative, depending on how high yields go; if interest rates stay at current levels, valuations for companies that can show solid financial performance should improve from current levels (as capital will seek higher returns in what would likely be a continuation of the current sluggish economic climate).

To sum, we expect 2016 to be challenging and volatile, but significant downside volatility will likely create excellent opportunities for investors with time horizons that are measured in years and decades. We will remain vigilant, discerning, flexible, and opportunistic, and we encourage clients to contact us at any time to review their investment objectives, and discuss their portfolios and the current opportunity set that we face.

Please visit our website at www.bridgesinv.com often, as we plan to provide frequent updates and commentary on the capital markets.

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