July 30, 2014

First Long Island Investors, LLC

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"*Success is not final, failure is not fatal: it is the courage to continue that counts.*"
-- Winston Churchill

The second quarter of 2014 was a successful one for our clients. All of our defensive and traditional equity strategies achieved new highs following record-setting domestic equity markets (certain international markets remain below record levels), bond prices remained high reflecting very low interest rates, and our private equity and real asset investments made progress. Despite these gains on top of significant gains last year, investors, including some of our clients, remain skeptical about the future. Thus, the quote above gives us some insight into why we believe that the uncertainty of the investing future should be viewed with cautious optimism.

Specifically, with each of our strategies at record levels, many are wondering where we go from here. The success achieved is never final because we believe there are future gains to be made over the long term. At the same time, a market downturn should not be viewed as failure, for as history has shown, it most likely will be temporary. We remain cautiously optimistic about sensible investing going forward, as long as our clients adhere to a prudent asset allocation and follow our defensive and traditional equity investing that reflect a philosophy of investing in strategies with high "active share."

We will describe high active share a bit later. First, for the record, let us enumerate the items on the wall of worry that investors are rightfully concerned with at this time:

1. Washington is still paralyzed, which is not good for growth, and controversies are still the word of the day (Benghazi, the IRS, the Veterans Administration, and immigration).

2. The geopolitical map is gruesome with wars in the Middle East, Russia still on the border of the Ukraine and perhaps culpable for shooting down a Malaysian Airlines plane, Iran on the cusp of a nuclear bomb, and the kidnappings and murders of teens in Israel.

3. Oil prices are high, which acts as a tax on all consumers and businesses.

4. The S&P 500 and the Dow have not had a correction in a long time, and some would argue that valuations are quite high.

5. The Federal Reserve continues its tapering, and higher interest rates are expected sometime next year, unless the economy falters.

6. The outcome of the Affordable Care Act remains unknown.

7. The middle class continues to be squeezed with very little wage growth in recent years.

On the positive side, the following must be considered:

1. Corporate earnings, on average, continue to grow and are at record levels.

2. Domestic companies' balance sheets are flush with cash, and some companies have borrowed at very low interest rates.

3. Merger activity is high, causing the price of certain companies to appreciate significantly.

4. Oil and gas exploration in the United States is at a record high, which should lead to energy independence despite certain regulatory hold-ups.

5. Innovative companies with real sales and earnings are going public on a regular basis.

6. Medical breakthroughs are occurring and being led by U.S. companies, including a cure for Hepatitis C.

7. Employment continues to grow on a monthly basis, but with many low-wage and part-time jobs.

8. Consumer balance sheets are stronger than they have been in many years.

9. Housing continues to slowly recover.

So, yes, we have the proverbial wall of worry that is offset by many meaningful positives. While the government's bickering and lack of bipartisan policy remains unpopular with Americans, business is prospering and benefitting from reasonable global growth:

Projected global GDP Growth Rates through the end of 2014[1]:

1. U.S.: 3%

2. Europe: 0-2% (as opposed to recession)

3. China: 6%+

4. Japan: 2%

The above growth rates are encouraging, representing improvement in some cases, and when coupled with certain other emerging countries (such as India, which has just elected a progressive leader), the outlook is reasonably good (however, some countries face the possibility of recession, including, in our opinion, Brazil and Russia). Some U.S. companies are participating in this global growth, which suggests that earnings for some companies will continue to grow. Additionally, the global banking system continues to improve, although some concern lingers in Europe.

[1] Strategas Research Partners.

Considering all of the above, our view remains guardedly positive as long as we continue to maintain a prudent asset allocation. Today, that prudent asset allocation must recognize the reality of, for the most part, certain bond interest rates hovering below the level of inflation. As a result, we continue to underweight bonds and are overweighting our defensive strategies. We are also, to some degree, reducing our traditional equity allocation in favor of increasing the allocation to our defensive strategies. Remember, our defensive strategies are designed and expected to produce good returns over time. However, each strategy has an element or elements that give each defensive characteristics designed to lessen the impact of unexpected market downturns.

Now comes the need to have high active share (and define what it is). Our defensive and traditional equity strategies are following the theme of high active share. In layman's terms, we are using concentrated stock strategies. Our position is that we only want to invest in the best ideas available, as opposed to buying the averages or portfolios that might contain 100, 500, or 1000 companies (diworsification). This position is supported by the research of Cremers and Petajisto[2], which demonstrated over long periods of time that managers who exhibited high active share were most likely to consistently outperform the market. We continue to believe (and the research cited above supports) that performance can be enhanced by using concentrated strategies with weightings that are meaningfully different from the indices. This strategy should ensure that we are finding the best companies with high probability of earnings and cash flow success (or companies trading at prices well below the values attributed to them by our managers). We believe this will result in better performance in good as well as poor markets over the long term. Of course, we or the managers we use can make mistakes, and not all of the companies we invest in will prove to be successful. Nonetheless, we believe concentrating our investments in a limited number of high-quality companies increases our chances for success and appreciation.

We believe the success we achieved in recent years resulted from a bounce back from the "decession" in 2008, strong global central bank support through low interest rates and bond purchases, record setting corporate earnings, and efficiencies in the operations of companies driven by the bone shaking experiences of the "decession." Global growth continues to slowly accelerate. Earnings and cash flow for many companies continue to increase. However, valuations reflect much of this growth and are not cheap in most cases. We believe that low interest rates and earnings growth from the companies we invest in will continue to permit our strategies to appreciate.

On the other hand, because of the unknowns in the future, particularly possible higher interest rates and/or declining profit margins at some point, we maintain a defensive, but positive, tilt (higher interest rates should mean the economy is getting better, but the initial market reaction could be volatile). As a result, our investment success is not by any means final at this point. We believe it will continue. Yet, a set back at some point reflected in stock market corrections or a slowdown in housing prices is not failure. In our view, any such setback would be temporary. When any such set back may occur, no one knows. Meanwhile, hiding out in cash or bonds earning a rate below inflation after taxes doesn't make any sense to us. Valuation, interest rates, earnings growth, and cash flow growth are always in our mind when guiding your asset allocation.

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[2] *Cremers, K. J. Martijn and Petajisto, Antti,* How Active is Your Fund Manager? A New Measure That Predicts Performance (2009).

It is worth mentioning that we continue to be active in guiding our clients, in concert with outside professionals, in estate, income tax, and life insurance planning. We view this aspect of wealth management as a key value add to certain clients and their families to assist in the passing of wealth from one generation to the next.

Finally, in our continuing efforts to do the best possible job for our clients, we encourage and support the further education of all at FLI. Alone these lines, we are delighted to report to you that Michael Bernstein, an Assistant Vice President and member of our Investment Committee, recently earned the coveted CFA designation. Michael worked long and hard, as well as passed numerous rigorous tests, to become a member of this prestigious institute. His enhanced knowledge is already paying dividends for all of our clients by adding further value to our investment process. I am sure you are as proud as we are of Michael's accomplishment.

Enjoy your summer and call us at any time to discuss your asset allocation (or that of your clients). We look forward to writing our next quarterly report to you on or around November 1st, and we hope to see you at our next Thought Leadership Seminar in late October (our last one was well attended and provoked great questions about the redevelopment of the Nassau Coliseum and unfortunate loss of the Islanders to Brooklyn).

Best regards,

Robert D. Rosenthal
Chairman, Chief Executive Officer
and Chief Investment Officer

*The forecast provided above is based on the reasonable beliefs of First Long Island Investors, LLC and is not a guarantee of future performance. Actual results may differ materially. Past performance statistics may not be indicative of future results.