October 31, 2014

First Long Island Investors, LLC

September 30, 2014

"In the world of money and investing, you must learn to control your emotions."

– Robert T. Kiyosaki, author of *Rich Dad, Poor Dad*

The third quarter ended with increased volatility as investors faced a number of conflicting considerations. Interest rates remained very low, domestic stock markets achieved new highs, commodities in many cases declined, Europe appeared on the brink of recession, and the United States and an international coalition commenced an air campaign against an extreme Muslim self-proclaimed caliphate in Iraq and Syria. If that was not enough, the first cases of Ebola reached our shores. This puzzling (and at times terrifying) picture has left no safe haven-where one can earn a return after inflation and taxes without taking on some risk. Further confusing the investment landscape is the decoupling of the U.S. economy from Europe and Japan. Our economy is expanding, while elsewhere rates of growth are declining and concerns about recession and deflation in the Eurozone are once again rising.

So, we at FLI are spending a great deal of time, both internally and with colleagues, seeking an objective evaluation of the various markets we invest in. Our mission is to seek an unemotional bottom-line approach resulting in an asset allocation focused on achieving investment gains over the long term for our clients. At the same time, we continue to focus our investments on opportunities in quality and deep-value companies as well as with proven outside investment managers who we deem capable of navigating this challenging investment landscape.

The good news is that we believe a number of great companies exist, to invest in and among best of breed managers in both the traditional and alternative investment spaces, that warrant our confidence. Thus, we believe that reasonable returns are attainable over the long term, although we will always face volatility and distracting noise as demonstrated in the period immediately following the close of the third quarter. So, balancing the emotions of greed and fear is the task at hand.

Some specifics are required to make our case for long-term gains. Right now we believe interest rates will increase at some point (probably mid-year 2015). This is actually good news, but its probable eventuality will cause volatility in the markets. The U.S. economy is continuing to improve despite little help from Washington. This growth in our economy, although moderate at best, continues to put more people to work (about 200,000 new jobs per month on average for this year) while gasoline and heating oil prices declined (down about 20% from recent highs!). That is a good combination that will provide a substantial nongovernmental stimulus to the domestic economy in the months ahead. Along with continued improvement in housing prices and the number of homes sold, this stimulus is a good sign that consumer balance sheets continue to improve. In addition, many domestic companies, both consumer and industrial based, are continuing to increase their earnings. Our view of corporate earnings remains positive, and we believe that with some help from the still growing emerging markets, the S&P 500 will achieve record earnings both this year and next. This would place the price earnings multiple on S&P earnings in the 15x range based on 2015 earnings. Not expensive, but also not cheap. Of course, this assumes there will not be a recession next year nor do we see any evidence of that. Obviously, some companies will fare better than average and those are the ones that we, and the managers we work with, seek to invest in as long as their valuations are reasonable. Our internal research and discussions with the many managers we work with continue to suggest the opportunity remains to own high-quality companies with strong balance sheets that appear to have good value and continued earnings growth.

Given our quandary with extremely low interest rates ultimately trending higher, we remain cautious about fixed income investing. We continue to keep our bond portfolios with shorter maturities (short duration) thus resulting in low yields. Accordingly, we continue to recommend a greater than usual allocation to our complement to fixed income investing—our defensive strategies, especially Dividend Growth where we can still achieve a current dividend yield of 3.0% with projected dividend growth of 7% to 10% per year. This compares very favorably with money markets yielding almost nothing; 5-year AAA municipal bonds at about 1.2%; and the ten year treasury at about 2.4% (fixed for the next ten years). Of course, there is no escape from market volatility. Both our Dividend Growth companies and our bonds face market ups and downs, but probably less so for our Dividend Growth Strategy than for our traditional equity strategies.

Given the geopolitical uncertainty (including Iraq/Syria, the Ukraine and Russia, nuclear negotiations with Iran, and the cease fire in Gaza/Israel) coupled with the serious economic slowdowns in Europe and Japan, we continue to tilt our clients to our defensive basket of investment strategies. Seeking some comfort using defensive strategies makes sense especially given the robust investment performance of the last several years. Additionally, we do not mind at all having a strong tilt towards investing in U.S.-domiciled companies with substantial U.S. economic exposure. The U.S. consumer is in good shape and inflation is low. In addition, U.S.-domiciled companies are, for the most part, in strong financial shape and many continue to innovate with new products. Our strategy remains simple—over-allocate to our defensive strategies which should be less volatile and are over-weighted to U.S.-domiciled companies while we underweight fixed income and traditional equity strategies (especially foreign-based equities).

Our defensive and traditional equity strategies remain mostly positive so far this year, although many are below the market averages like most active managers. We attribute this to a recent market bias towards lower-quality companies which we believe is temporary and will correct itself. Accordingly, we will continue to own quality and value in our investments. Inexplicably, our fixed-income portfolios remain positive as interest rates, to the surprise of most, remain subdued. We believe that a prudent asset allocation with a strong tilt towards defensive strategies and some fixed-income exposure, will continue to work well for our clients in the future as it has in the past. Finally, irrespective of the political outcome, once we have endured the midterm elections we believe that there is hope that the political paralysis will give way to some bipartisan progress in the areas of taxation, infrastructure spending, and immigration reform. This, in our view, will be a positive for economic progress in the U.S. and positively impact the equity, real estate, and private equity markets. In addition, we believe that global concerns in Europe and the Middle East will continue causing foreign investors to allocate more assets to U.S. investments. This would continue to help our domestic markets as well (the combination of economic growth and a strengthening U.S. dollar is a powerful enticement to foreign investors).

In conclusion, we remain cautiously optimistic despite a growing wall of worry as fundamentals in the markets, and more specifically companies we invest in, remain attractive. Emotions of greed and fear must be kept in check as volatility picks up, reflecting the noise and concern surrounding many of the issues we face.

As always, please give any of us a call to discuss your asset allocation and our wealth management outlook as there is much going on. Also, we are approaching year end and there might be some strategies worth considering that could be favorable from a tax standpoint. Give Steve Juchem or Teri Vobis a call should you have any questions about taxes (on your investments or otherwise).

Best regards and enjoy the upcoming holiday season!

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.

Disclaimer: The views expressed are the views of Robert D. Rosenthal through the period ending September 30, 2014, and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.