October 29, 2015

First Long Island Investors, LLC

September 30, 2015

"In investing, what is comfortable is rarely profitable."

-Robert Arnott (investor, editor, and writer)

The quarter ended September 30, 2015 evidenced significantly greater volatility and the first "correction" (a decline of 10% or greater) since 2011. Both the volatility and correction were overdue as we suggested in both our last quarterly letter and our web seminar on August 6, 2015. We believe the correction is healthy and primarily reflects fears of the softening in the Chinese economy as well as continued uncertainty surrounding the Federal Reserve's interest rate policy (as well as some other factors mentioned later in this letter).

The collision of these fear factors has made investors quite "uncomfortable" thereby resulting in a meaningful decline in equity averages (the S&P 500 and the NASDAQ declined by 6.4% and 7.4%, respectively, in total for the quarter) and led to continued withdrawals from domestic equities. The short-term nature of many investors and the advent of high-frequency trading can exacerbate market movements during periods of volatility, in our opinion. It is at times like this that the investment professionals at FLI are called upon to analyze the economy, both domestic and international, to render an opinion on the attractiveness of investable markets from which we suggest prudent asset allocations for our clients.

We believe that the domestic economy continues to show positive signs. The upward revision of real gross domestic product (GDP) growth to 3.9% for the second quarter, rebounding from a moribund-weather impacted first quarter, gives us some reason for optimism. In addition, the trend of growing employment continued throughout the quarter, although the weaker than expected September employment report and modest downward revisions for July and August were disappointing. Significantly lower energy costs from a year ago should strengthen the consumer in coming months, in our opinion. Also, inventories are not elevated suggesting room for continued GDP growth while demand seems reasonable both from a domestic industrial and consumer standpoint. Further strengthening our case for reasonable economic growth is the continued improvement in the housing market and strong automobile sales, as well as an improvement in other retail sales. This, we believe, is an indication that the consumer is

reasonably strong and the U.S. economy is not facing a recession at this time. Consumers make up about 70% of the domestic economy and their balance sheets are in "good shape" according to Strategas (a strategic economics consultant). In fact, based on their research, consumer balance sheets are the best in 35 years.

The economic growth characterized above is modest to reasonable in our opinion. We still believe that real GDP growth will be between 2% to 3% for this year and next. As such, inflation remains tepid. Labor and commodity costs continue to have slack, which supports this current low level of inflation. This continues to be a concern for the Federal Reserve as its target inflation rate of 2% remains elusive while its mandate for full employment is close to being accomplished despite a low workforce participation rate. This, coupled with concerns about economic growth in many international markets (emerging markets and China, in particular), we believe led to the Fed's decision to not "lift off" (increase short-term interest rates) at its September meeting. The lack of a rate increase upset the equity markets around the world, in our opinion, as it could be interpreted that economic growth is not yet strong enough to take our monetary policy out of its crisis mode of the past seven years. We believe the Fed's decision was a mistake! We believe that a modest increase of 25 basis points (one quarter of one percent) would not have disrupted our economy at all and would have signaled the Fed's intention to start bringing interest rates back into a more normal range. Unless some exogenous event takes place pushing our economy into recession (we do not believe that a recession is in sight for the U.S.), we believe the Fed will raise rates sometime in the near future. However, future rate increases will be modest and gradual in our opinion, especially as the economy, both domestic and international, remains in a slow growth mode.

The concern about international economies probably contributed to the Fed's decision to not raise rates. A specific request to the Fed from Christine Lagarde of the International Monetary Fund, to refrain from a rate increase, as well as weakening economic growth in China were likely factors considered by the Fed. China is transitioning from an industrial/infrastructure driven economy to a more consumer- oriented one. This probably has led to declining raw materials usage and thus pricing on a global basis. In addition, the modest devaluation of the Chinese currency, the yuan, also contributed to recent volatility and uncertainty. However, it is likely that growth in China will remain meaningful. Although Chinese industrial production and retail sales have risen more slowly (6.1% and 10.8%, respectively) than in recent years, this is still meaningful growth. The impact on our domestic economy is modest at best. You can see from the chart below that U.S. exports to China accounts for less than 1% of total U.S. GDP. Additionally, two U.S. domiciled companies that we have investments in, Apple and Nike, have just reported that their business in China is very robust. However, a concern remains as to the impact on other emerging economies from the softening growth in China. We will have to wait and see if there is any significant spill-over to other developed economies.

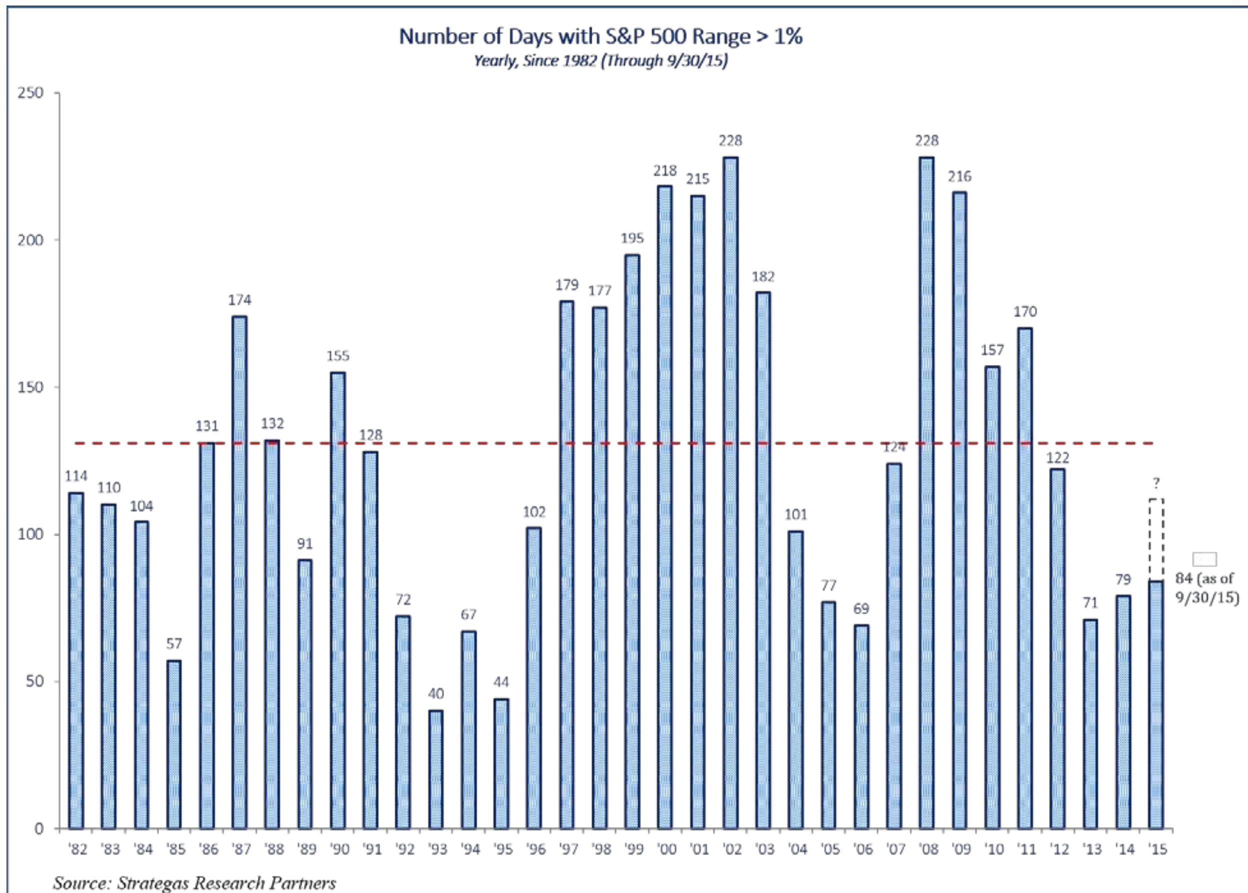
**China's Share of MSCI Countries 2014 Exports and Nominal GDP**

| | % Total Exports | % Nominal GDP | | % Total Exports | % Nominal GDP |
|---|---|---|---|---|---|
| Hong Kong | 53.9% | 87.8% | Israel | 4.0% | 0.9% |
| Oman | 43.0% | 29.4% | Austria | 2.1% | 0.8% |
| Singapore | 12.6% | 16.7% | Argentina | 6.6% | 0.8% |
| Korea | 25.4% | 10.3% | France | 3.7% | 0.7% |
| Malaysia | 12.0% | 8.3% | United States | 7.6% | 0.7% |
| Vietnam | 10.4% | 8.0% | Estonia | 1.1% | 0.7% |
| Chile | 24.4% | 7.1% | Norway | 2.3% | 0.7% |
| Thailand | 11.0% | 6.1% | Ireland | 1.5% | 0.6% |
| Saudi Arabia | 13.3% | 5.9% | India | 4.2% | 0.6% |
| Australia | 33.7% | 5.6% | Italy | 2.6% | 0.6% |
| Zimbabwe | 28.1% | 5.5% | Slovenia | 0.8% | 0.6% |
| Kuwait | 9.9% | 5.3% | United Kingdom | 3.5% | 0.5% |
| Qatar | 7.7% | 4.8% | Jordan | 2.2% | 0.5% |
| Kazakhstan | 13.4% | 4.5% | Bahrain | 0.5% | 0.5% |
| New Zealand | 20.0% | 4.2% | Portugal | 1.7% | 0.5% |
| United Arab Emirates | 5.5% | 3.5% | Mexico | 1.5% | 0.5% |
| Peru | 18.3% | 3.5% | Nigeria | 2.6% | 0.4% |
| Philippines | 13.0% | 2.8% | Tunisia | 1.3% | 0.4% |
| Ghana | 10.9% | 2.8% | Bangladesh | 2.4% | 0.4% |
| Japan | 18.3% | 2.7% | Poland | 1.0% | 0.4% |
| South Africa | 9.6% | 2.5% | Spain | 1.7% | 0.4% |
| Germany | 5.8% | 2.1% | Romania | 1.1% | 0.4% |
| Ukraine | 5.0% | 2.0% | Turkey | 1.8% | 0.4% |
| Russia | 7.5% | 2.0% | Trinidad and Tobago | 0.5% | 0.3% |
| Indonesia | 10.0% | 2.0% | Lithuania | 0.4% | 0.3% |
| Brazil | 18.0% | 1.7% | Jamaica | 2.6% | 0.3% |
| Colombia | 10.5% | 1.5% | Morocco | 1.1% | 0.2% |
| Belgium | 1.7% | 1.5% | Sri Lanka | 1.6% | 0.2% |
| Switzerland | 4.1% | 1.4% | Bosnia and Herzegovina | 0.7% | 0.2% |
| Bulgaria | 2.4% | 1.2% | Greece | 1.0% | 0.1% |
| Hungary | 1.5% | 1.2% | Kenya | 1.3% | 0.1% |
| Finland | 4.5% | 1.2% | Croatia | 0.5% | 0.1% |
| Netherlands | 1.6% | 1.2% | Mauritius | 0.6% | 0.1% |
| Denmark | 3.4% | 1.1% | Egypt | 1.2% | 0.1% |
| Pakistan | 9.4% | 1.0% | Serbia, Republic of | 0.1% | 0.0% |
| Canada | 3.7% | 1.0% | Lebanon | 0.4% | 0.0% |
| Czech Republic | 1.2% | 1.0% | | | |

*Source: Strategas Research Partners*

Nevertheless, equity markets are correcting and some investors have headed to the sidelines. Outflows from domestic equity funds have been substantial while inflows to bond funds have been plentiful so far this year. As reported in the press, well-known hedge funds have suffered bigger losses (double-digit year-to-date) than the equity markets and have grown cautious (Greenlight, Appaloosa, and Carl Icahn, as examples). Meanwhile, interest rates remain stuck in a narrow range near historic lows with the ten-year Treasury ending the quarter at 2.1%. This rate and the rate for high-quality municipal bonds with similar duration remain at slightly below or barely above the expected long-term rate of inflation (2%) on an after tax basis. We consider the current returns available on Treasuries, municipals, and cash to be poor returns for long-term investors, although to some it feels more "comfortable" than the current pronounced volatility in the equity markets. As stated earlier, volatility has picked up and the following chart

demonstrates this. (We used a similar chart in our most recent web seminar but have updated it to reflect the recent market volatility).




From a valuation standpoint, we remain satisfied that current valuations for the market as a whole remain reasonable (but not cheap) in this environment when looked at through the prism of next year's consensus earnings estimates for the S&P 500 of $129 (up from this year's projected earnings of $117). This works out to about a 16 multiple. We invest in a more concentrated way (our in-house strategies and the portfolios of our outside managers are more concentrated and have high active share). Additionally, we believe the valuations for our strategies are more attractive. We again say this is not "nosebleed" territory especially in an economy characterized by low inflation and low interest rates while many multi-national companies' earnings have been compromised by the strong dollar. Also, if one were to extract the depressed energy sector earnings, S&P 500 earnings would be even more robust leading to more attractive valuations. The energy sector is bringing its own volatility not just in the price of oil having declined by more than 50% from last year, but also in terms of possible bankruptcies in energy and energy-related companies. This can impact both stocks and bonds (especially high-yield bonds) of energy and energy-related companies.

The negative investor sentiment and the potential impact of the slowing Chinese economy is actually heartening to us as contrarians. Taking all of these factors into consideration, we remain optimistic about the U.S. economy and believe that any domestic recession is still a ways off. This bodes well for many of the companies we invest in, the bonds we own, the growing dividends we expect to collect, and our recently established domestic mezzanine real estate investment. Real estate will continue to benefit from low interest rates although valuations in certain markets are stretched in our opinion. Strong growth companies and companies with above-average dividend yields increasing annually make us much less "uncomfortable" at this time.

The recent spike in volatility and all of the global economic and geopolitical issues must be reckoned with by investors. Accordingly, our defensive posture should continue to help mitigate this volatile market environment for our clients. In this last quarter, all three of our defensive strategies did better than the general stock market and each of the benchmarks they are compared to. This remains important because the type of volatility we are experiencing can be disheartening. Additionally, fundamentals will work to our advantage over the longer term. However patience and a strong stomach are required for now.

From an investment allocation standpoint, we maintain our bias to being defensive and recommend that all clients overweight the strategies in our defensive basket. We believe these strategies will outperform bonds over the next few years. We remain cautious in bond commitments given their paltry returns and poor valuations. Our traditional equity strategies are not cheap, but we are satisfied owning some great companies whose growth/value characteristics should result in reasonable appreciation over the long term. We are maintaining a reasonable weighting in the traditional equity area as we do not see a looming recession and believe valuations are fair. As mentioned earlier, a 16x P/E on next year's consensus earnings estimates is not unreasonable, based on history, for this environment of tepid inflation and low interest rates. However, we continue to recommend that clients overweight defensive strategies as they possess characteristics which should weather volatility well, while providing reasonable appreciation potential. We also believe that our defensive and traditional equity strategies (which are concentrated to utilize best ideas) will benefit from what we perceive to now be an advantage for active managers (managers that pick individual stocks rather than investing in an index or ETF). Anecdotally, the Wall Street Journal reported on August 25, 2015 that "dozens of ETFs traded at sharp discounts to their net asset value leading to outsized losses for investors who entered sell orders at the depth of the panic." So investors trying to buy a big package of stocks through an ETF in a given area face a danger in periods of extreme volatility. We believe these to be nothing more than a "deworsification" and typically avoid using ETFs, preferring concentrated portfolios of best ideas in our strategies and those of our outside managers. Finally, we should point out that we remain underweighted to international companies, as we still see greater potential in domestic, large-cap companies.

Anecdotally, the third quarter for the S&P 500 has historically been the worst of the four quarters. The best quarter historically since 1928 is the fourth (October – December). We hope that this historical guide is an accurate predictor for the quarter we have just started. The prevailing negativity from a contrarian standpoint, as well as all of the cash on the sidelines earning very little, leads us to believe that stocks will rebound in this fourth quarter once investors become more comfortable with the Fed's evolving policy and China's ultimate growth trajectory. Of course, the geopolitical situation in the Middle East must also be watched carefully.

We invite you to our renovated office to visit with us and review any investment and wealth management issues you might want to discuss. We would then be delighted to introduce you to our three newest colleagues at FLI (Drew Wray, Assistant Vice President, Wealth Management; Chris Butler, IT Professional; and Nicole Villarica, Receptionist). Most importantly, we wish you a wonderful holiday season which is soon approaching.

Best regards,

Robert D. Rosenthal

P.S. We are off to a very positive start of the fourth quarter. This has resulted in meaningful appreciation to all of our strategies as best as we can tell at this point. We are hopeful it will continue.

*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 October 29, 2015, 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. Content may not be reproduced, distributed, or transmitted, in whole or in portion, by any means, without written permission from First Long Island Investors, LLC. Copyright © 2015 by First Long Island Investors, LLC. All rights reserved.