HARMONY
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It's Déjà Vu All Over Again – Yogi Berra

In a client letter I penned on January 10, 1998, I wrote, *"As was the case in 1995 and 1996, large capitalization stocks (S&P 500) outperformed their smaller cap counterparts (Russell 2000) for the year and three months ended December 31, 1997. Indeed the last three years can be characterized as an era when 'bigger was better.' … Close observation of the market reveals that changes in leadership between various sectors are the norm."*

Then in October 1998, I shared the following table and commentary –

Market Statistics – Price Performance for segments of the S&P 500

	12/31/1997 – 10/16/98		*12/31/97 vs. 1998 lows*	
	Average	*median*	*Average*	*median*
100 largest stocks	*11.6%*	*9.8%*	*(18.4%)*	*(14.7%)*
101-200 largest	*2.1*	*(0.8)*	*(21.9)*	*(19.5)*
201-300 largest	*(4.9)*	*(6.9)*	*(25.5)*	*(21.9)*
301-400	*(6.3)*	*(9.0)*	*(26.7)*	*(23.4)*
401-500	*(9.3)*	*(12.3)*	*(31.8)*	*(30.3)*

Summary:

1. *As of October 16th, the 100 largest stocks based on year end 1997 market cap were* ***up*** *11.6% while those in the smallest quintile were* ***down*** *9.3% on average, and;*
2. *There was more volatility as you move down in market capitalization. On average, the largest quintile lost 18.4% from year end '97 to this year's low price, compared with a decline of 31.8% for the smallest quintile.*

The S&P 500 is market cap-weighted. On a year to date basis through October 16, the S&P index is ***up*** *8.9% (price basis) compared with an average* ***decline*** *of 2.4% for the S&P 500 stocks that make up the index. It is also true that the largest stocks outperformed their smaller counterparts in the strong market environment of 1995 – 1997. In light of this you may be inclined to ask:*

1. *Is the trend over the last 4 years the norm?;*
2. *Is the trend of bigger is better likely to continue?*

I went on to explain that the answer to question #1 based upon long-term market data was "no" and the answer to question #2 was also likely to be "no". I am sharing these nearly 20 year old passages because once again we are seeing some similar results in the markets thus far this year. Indeed then and now, not only did the largest stocks outpace returns for companies with more modest market capitalization, but also "growth" trounced "value". ***The key finding then and now, is that diversification is failing to provide either of its hoped-for benefits.*** Specifically, broader diversification can aid results when large caps disappoint and/or adding small & mid-caps and international stocks can also boost returns over the long-term even when the S&P 500 is faring well.

Some astute colleagues in Memphis produce research throughout the year that I find helpful. Today, I want to share highlights they tabulated for various market segments through the close of business on November 25th. As you will see, some of the data looks similar to what I have shared above.

YTD S&P 500 Price Performance Data through November 25, 2015 by Quintile & Dividend Yield

Rank by capitalization			
100 largest	4.4	10 largest	9.4
101 - 200 largest	2.0		
201 - 300 largest	(2.3)		
301 -400	0.6		
401 - 500	(1.4)	10 smallest	(21.7)
S&P 500	0.7		

Investors cannot invest in an index

Dividend yield	# of stocks	Avg Return
>4.0%	30	(8.6)
>3.0%	82	(3.8)
>2.0%	201	(1.5)
>1.0%	358	(0.9)
>0.0%	423	(0.5)
No dividend	79	6.9
S&P 500	502	0.7

The figures above show that this too has been a year when the companies with the largest market capitalizations have performed better than the members of the S&P 500 that are not in the top 100. Indeed the 10 largest are ***up*** 9.4% YTD through November 25th while the smallest 10 are ***down*** an average of 21.7%. This has also been a year when "growth" stocks have performed better than "value" stocks. In addition, there has been an inverse relationship between dividend yield and price return. Specifically the 79 companies that did not pay a dividend at the start of the year are ***up*** an average of 6.9% while the 30 that provided the highest dividend yield (e.g. those that provide a yield of at least 4.0%) are ***down*** an average of 8.6%. Another interesting thing to note (not shown in the table above) is that while the S&P is just about 2.0% below its all-time high price level, some 30.5% or roughly 150 members of the S&P 500 are down at least 20% from their year to date highs. In other words, nearly 1/3 of the constituents are still in bear market territory. This is not usual, but it is certainly possible that the narrow leadership trend may persist in the weeks, months and even years ahead.

Extrapolation can be Hazardous to One's Wealth

The logical question is whether or not the trend of large cap growth providing better returns will persist. If that proves to be the case, diversification strategies like those that we deploy will likely hamper, not aid, portfolio returns. I will once again state the obvious; we don't have a crystal ball. However, we believe that history provides many lessons that can help investors make prudent decisions. Indeed we believe that the case for diversification remains compelling.[i]

You may recall from prior letters that there have historically been pronounced (but not predictable periods) when large caps outperform small caps, value trounces growth, U.S. markets lead international markets and vice versa. Furthermore, there are periods when cyclical sectors like basic materials, energy and industrials lead returns and other periods when sectors like healthcare, consumer staples and utilities perform best. Indeed, sharp reversals often occur when collectively we investors are truly surprised. In fact it is the swings from enthusiasm to despair that happen over time that causes cycles to be so extreme. Today, there is good reason to like the outlook for the U.S. economy and feel far less confident about the prospects for international economies and markets. However as investors, we always need to ask, "How much of the outlook (favorable or otherwise) is already "priced in"/reflected in current prices and valuation parameters like price to earnings ratios?"

Good companies do not necessarily mean that near term investment returns will be favorable and vice versa. Folks who went “all in” on tech in the late 1990s have earned a small fraction of the returns realized by more broadly diversified portfolios. We have no reason to believe the future will be different. Indeed we expect Déjà vu all over again.

As I have also shared in prior letters, our diversified holdings are in fact performing quite differently from each other. Thus far this year, there has been a broad range of returns among the stocks that comprise our 50 stock high quality dividend portfolio. In addition, there have been significant performance differentials in U.S. versus the developed world ex U.S. (Western Europe and Japan) and emerging markets investments. That being the case, I thought it could be instructive to take a look at three of the stocks that are in some respects bookends in our 50 stock model.

The three companies that I selected for illustration purposes are Brown Forman Corporation, Emerson Electric and Caterpillar. Most of you know Brown-Forman to be a company that consistently grows its sales, earnings, cash flow and dividends nearly every year. In other words, Brown-Forman is a prototypical quality company with “Steady Eddie” growth characteristics. The company’s consistent and persistent growth has translated into favorable share price performance in a world where quality growth stories are hard to come by. The other companies I selected exhibit a good deal more fluctuation and less persistence in terms of underlying sales, earnings and cash flow trends. In other words, they are more commonly thought of as high quality ***cyclical*** companies. We own quite a few companies that fit this description. Below please find tables that capture quite a bit of information on each company’s fundamentals and valuation. The data was obtained from the latest report by Value Line (VL) on each company. Please let me know if you would like me to send the latest VL report on each company.

Brown Forman Corporation

Per share data	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	***2004-14 Average***	Current 2015 est	Curr % of 2004-14
Price high	26.7	38.6	44.0	42.6	42.0	37.0	48.7	54.7	71.0	76.7	98.0		103.9	
Price low	22.8	24.9	34.8	33.7	27.0	23.3	32.6	41.4	51.3	60.9	73.4			
Sales	10.12	8.61	9.60	11.42	11.02	11.20	11.89	12.78	13.33	14.01	15.02		15.65	
Cash Flow	1.57	1.75	1.88	2.18	2.18	2.36	2.66	2.64	2.93	3.32	3.52		3.80	
Earnings	1.31	1.55	1.68	1.90	1.91	2.06	2.38	2.37	2.68	3.06	3.21		3.50	
Dividends	0.45	0.54	0.60	0.69	0.75	0.79	0.83	0.89	0.98	1.09	1.21		1.26	
Hi price/Sales	2.6	4.5	4.6	3.7	3.8	3.3	4.1	4.3	5.3	5.5	6.5	***4.4***	6.6	151.3%
Hi price/Cash Flow	17.0	22.1	23.4	19.5	19.3	15.7	18.3	20.7	24.2	23.1	27.8	***21.0***	27.3	130.1%
Hi price/Earnings	20.4	24.9	26.2	22.4	22.0	18.0	20.5	23.1	26.5	25.1	30.5	***23.6***	29.7	125.8%
Hi price/Dividends	59.3	71.5	73.3	61.7	56.0	46.8	58.7	61.5	72.4	70.4	81.0	***64.8***	82.5	127.3%

Source: Value Line report of October 23, 2015

Consensus Analyst EPS Estimates	Year end	# of est.	Mean	High	Low	Median	S.D.	PE Median	YTD Price chg %	Current divd yield
	Apr-16	18	$3.48	$3.56	$3.40	$3.48	4%	29.9	*18.3*	1.3%
	Apr-17	18	$3.80	$3.90	$3.68	$3.81	5%	27.3		

Source: Thomson One as of December 1, 2015

Hopefully my comments here will aid your review. Each table shows the stock’s high and low for each year from 2004 through 2014. In addition I have copied the Value Line figures for per share sales, cash flow, earnings and dividends for each of those years.

I then use the high price for each year and then divide it by the per share sales, earnings, etc. to see what the peak valuation multiple was for each year. I then calculate the average across those years. I then compare it to the current price (e.g. December 1 close shown in top right hand corner) and use the VL estimates for sales, earnings, etc. Finally, I compare the current valuation to each company's 2004 through 2014 average.

Emerson Electric

Per share data	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	*2004-14 Average*	Current 2015 est	Curr % of 2004-14
Price high	35.4	38.9	45.2	59.1	58.7	43.7	58.7	64.6	53.8	70.7	70.3		49.5	
Price low	28.1	30.3	36.8	41.3	29.3	24.4	41.2	39.5	43.6	53.1	57.8			
Sales	18.61	21.07	25.02	28.63	32.17	27.82	27.95	32.78	33.71	34.91	35.22		33.60	
Cash Flow	2.16	2.49	3.05	3.54	4.10	3.26	3.71	4.49	3.85	4.80	4.01		4.50	
Earnings	1.49	1.78	2.24	2.66	3.11	2.27	2.60	3.24	2.67	3.54	3.30		3.30	
Dividends	0.80	0.83	0.89	1.05	1.20	1.33	1.34	1.38	1.60	1.66	1.88		1.88	
Hi price/Sales	1.9	1.8	1.8	2.1	1.8	1.6	2.1	2.0	1.6	2.0	2.0	***1.9***	1.5	***78.3%***
Hi price/Cash Flow	16.4	15.6	14.8	16.7	14.3	13.4	15.8	14.4	14.0	14.7	17.5	***15.2***	11.0	***72.2%***
Hi price/Earnings	23.8	21.9	20.2	22.2	18.9	19.3	22.6	19.9	20.1	20.0	21.3	***20.9***	15.0	***71.7%***
Hi price/Dividends	44.3	46.9	50.8	56.3	48.9	32.9	43.8	46.8	33.6	42.6	37.4	***44.0***	26.3	***59.8%***

Source: Value Line report of October 2, 2015

Consensus Analyst EPS Estimates	Year end	# of est.	Mean	High	Low	Median	S.D.	PE Median	YTD Price chg %	Current divd yield
	Sep-16	27	$ 3.08	$ 3.20	$ 2.90	$ 3.10	7%	16.0	*(19.6)*	3.8%
	Sep-17	23	$ 3.40	$ 3.58	$ 3.15	$ 3.40	12%	14.6		

Source: Thomson One as of December 1, 2015

Caterpillar

Per share data	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	*2004-14 Average*	Current 2015 est	Curr % of 2004-14
Price high	49.4	59.9	82.0	87.0	86.0	61.3	94.9	116.6	116.9	99.7	111.5		71.1	
Price low	34.3	41.3	57.1	58.0	32.0	21.7	50.5	67.5	78.3	79.5	85.9			
Sales	44.11	54.17	64.29	73.22	85.32	51.86	66.67	92.87	100.57	87.26	91.04		81.15	
Cash Flow	5.00	6.46	8.03	8.64	9.25	5.17	7.82	11.93	13.87	10.82	11.82		9.90	
Earnings	2.88	4.04	5.25	5.32	5.71	1.43	4.15	7.81	9.36	5.79	6.37		4.60	
Dividends	0.80	0.96	1.15	1.38	1.62	1.68	1.74	1.82	2.02	2.32	2.70		2.95	
Hi price/Sales	1.1	1.1	1.3	1.2	1.0	1.2	1.4	1.3	1.2	1.1	1.2	***1.2***	0.9	***73.6%***
Hi price/Cash Flow	9.9	9.3	10.2	10.1	9.3	11.9	12.1	9.8	8.4	9.2	9.4	***10.0***	7.2	***72.0%***
Hi price/Earnings	17.2	14.8	15.6	16.4	15.1	42.9	22.9	14.9	12.5	17.2	17.5	***18.8***	15.4	***82.1%***
Hi price/Dividends	61.8	62.4	71.3	63.0	53.1	36.5	54.5	64.1	57.9	43.0	41.3	***55.3***	24.1	***43.5%***

Source: Value Line report of November 20, 2015

Consensus Analyst EPS Estimates	Year end	# of est.	Mean	High	Low	Median	S.D.	PE Median	YTD Price chg %	Current divd yield
	Dec-16	25	$ 3.70	$ 4.00	$ 3.18	$ 3.72	20%	19.1	*(21.80)*	4.3%

Source: Thomson One as of December 1, 2015

As the tables reveal, Brown-Forman, Emerson Electric and Caterpillar all provide investors with different profiles. Brown-Forman has not only had a good year (e.g. the price is up 18.3% YTD) but indeed it is way up from the high share price of 2007. This makes sense as the company has generated healthy and steady increases in sales, earnings, cash flow and dividends per share. Please also note that the company's favorable execution has been recognized by investors as the shares trade at a premium of roughly 25+% over the 2004 thru 2014 price to sales, earnings and cash flow averages.

In other words, we shareholders of Brown-Forman have experienced what I describe as investment nirvana – healthy earnings growth and a rising PE ratio. However, management teams and boards can at best only influence valuation through their actions. Their primary impact is on the business's fundamentals (e.g. sales, earnings and dividend changes caused by their management of the company's financial and human capital. Their decision making has been very beneficial.

Both Emerson and Caterpillar's share prices are appreciably below their 2007 highs despite the fact that both companies have significantly increased per share sales, cash flow, earnings and dividends (in particular). 2015 has been a rough year for each company's investors with share price down approximately 20% this year. That said, the valuation metrics are quite a bit lower than the averages seen from 2004 thru 2014.

Headwinds and Tailwinds

As you know, we like to own well-diversified portfolios. This includes the individual stocks that we own as part of our core high quality dividend portfolio. Along the way, it can be tempting to part company with stocks that have performed particularly well (perhaps especially those whose valuation parameters are above historical norms) and also those that have been disappointing. However, we think it makes sense to consider owning a wide spectrum of companies including those that are by most measures currying favor with investors as well as those that have experienced declines. Using these three companies as an example, Brown-Forman's increased valuation could be a cause for concern (e.g. if the shares revert to average price to earnings, price to cash flow, etc. levels we would likely see some downside). On the other hand, the favorable execution and backdrop for their business may make the increased valuation completely justified in which case future returns may well prove favorable. Emerson and Caterpillar may continue to face challenges due to 1) the strength of the U.S. currency (which makes their cost of manufacturing higher than their non U.S. based competitors) and/or 2) weaker economic growth in overseas markets. That said it would not take much for business conditions, investor sentiment and/or valuation levels to improve such that these stocks could produce handsome returns in the years ahead. It is for this reason that we continue to prefer ownership of high quality Ziggers and Zaggers. We don't know; therefore, we diversify!

Speaking of headwinds, investors in commingled funds may encounter unwelcome surprises come tax time. I say this because we are receiving indications of truly significant realized gains that some of these widely owned vehicles will soon be sending to their investors. As you likely know, even if you don't sell any shares in a commingled fund, there is still exposure to any gains realized at the fund level because the gains are passed along to the underlying investors. Now nearly 7 years into the U.S. stock market recovery, cap gains distributions for many comingled investments will likely be high including for funds that did not fare well this year. That is another Déjà vu that I have seen throughout my career. It is why we prefer ownership of individual securities and other tax efficient investment vehicles. Payments to Uncle Sam reduce investor returns and need to be taken into account.

Last but most importantly, we extend our sincere appreciation for those of you who have engaged our team as your financial advisers. It is a pleasure to serve you and we take our duties to you very seriously. I hope you have a wonderful time with family and friends over the coming holiday season! Also, may you be generous in time and treasure to those institutions and charities that are important to you as well as those who are less fortunate.

Warmest regards,

W. Richard Jones, CFA
Senior Vice President, Investments

[i] Diversification and strategic asset allocation do not ensure a profit or protect against a loss. Past performance is not indicative of future results. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success.

Raymond James makes a market in CAT and EMR.

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