PORTOLACREEK

A California-Registered Investment Advisor

Q1 2018 Quarterly Commentary

Updates

We are now banking with

Beneficial State Bank

bringing together two B Corporations intent on creating a sustainable and meaningful community.

Our pending period is over, and we are now officially a

B-Corp Corporation

PEOPLE USING BUSINESS AS A FORCE FOR GOOD

Certified B Corporation

We joined 400+ other founders in signing the

Founders for Change pledge

demanding diversity and inclusion within our firms, among our partners, and across our investments

FFC Founders for Change

So far this season,

Portola Creek voted on 432 shareholder proposals

at 83 portfolio companies, with 26% of our votes being cast against management recommendations.

Learn more

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Left: *The Pinnacles - thousands of large limestone pillars (Nambung National Park, Western Australia)*

A Call for Truth

Our identification of a company's declining Governance score over time has been an effective sell signal before a significant event occurs

Throughout our careers, we have generally preferred to steer clear of political discussions with those who invest with us. Even in a "blue state" such as California, our client base has generally been representative of America as a whole, with political affinities that are fairly evenly split between the two major parties.

Consequently, there has always been much to lose by raising a hand in favor of one ideology, politician or policy over another. While we don't necessarily intend to change things now, we do feel that it is necessary to speak out. Quite simply, we are calling for truth.

In surveying the political climate, it seems clear that our country is divided not just on policy, but on what is true and what isn't. "He said, she said" debates about important and often consequential topics are increasing in frequency. With this in mind, one lesson we learned in our college statistics courses – to question all reports and numbers, sources and methods, and their interpretations – seems more important than ever.

Indeed, a data-driven focus has proved invaluable in our investment process. One non-financial indicator, in particular, that has served us well is a company's corporate governance score. Over time and especially more recently, we have found that a deterioration in this measure has served as an effective early-warning sign, enabling us to stay clear of numerous adverse developments and avoid large capital losses (see Wells Fargo and Facebook).

Then, after the dust settles, we have the opportunity – and the responsibility – to assess how the company in question has responded and determine whether it has emerged from the experience as a better and more sustainable enterprise.

Governance really matters. On April 13, we made the decision to divest all our holdings in The Walt Disney Company, owing largely to our negative view of its plan to acquire Twenty-First Century Fox, Inc. for $52 billion. No fans of the Murdoch family, we had become increasingly uncomfortable with the cozy relationship that its news arm appeared to have with President Trump. Even so, we could not have predicted that three days later, Fox News host Sean Hannity would belatedly admit that he was a client of Mr. Trump's personal attorney, Michael Cohen. He effectively confirmed that he is a propagandist, not a journalist.

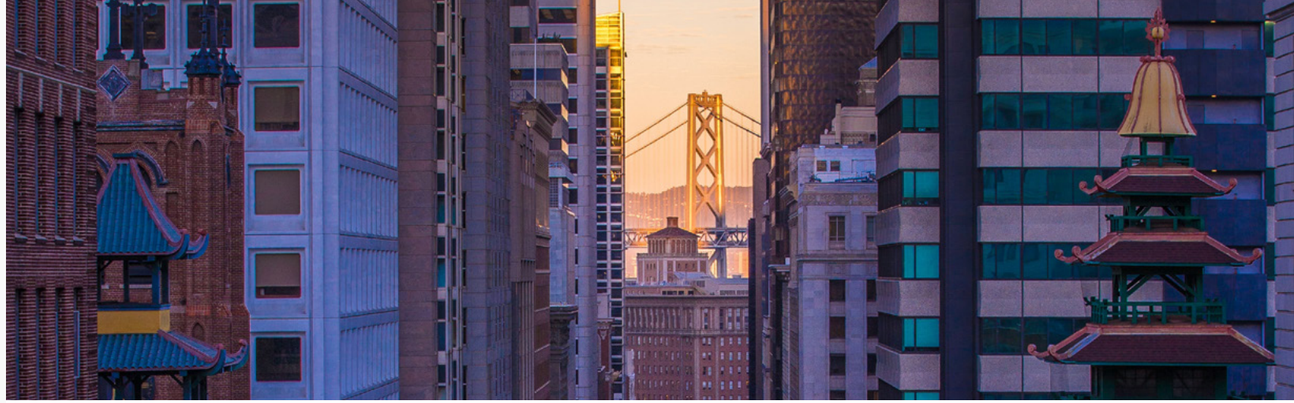
Separately, one important development of note was the April 18 announcement by the U.S. Securities and Exchange Commission that it was considering revising its conflict-of-interest rules for brokers. Although the proposal represented a step in the right direction, it fell short of the stricter fiduciary rule that the Department of Labor (DoL) had implemented in 2016 (which was struck down in March by the U.S. Fifth Circuit Court of Appeals on various grounds).

In fact, while the headlines surrounding the proposed changes suggested that brokers and investment advisors would now be required to put clients' interests first, this was not actually the case.

If advisers (or brokers) are not fiduciaries, they can recommend products and services that line their pockets as long as they are considered suitable for you.

The standard being considered is only a modest step up from that.

Registered investment advisers, in contrast, have a duty of care that is less conflicted. When considering two investments that are more-or-less comparable, it would not be in a client's best interest to choose the one with higher fees. This is not to say that all non-fiduciary advisers take advantage of clients; it just means that legally they can.



Elsewhere on the regulatory front, the DoL detailed a surprising change in guidelines, asserting that ESG investments aren't always "prudent" for retirement accounts and warning investors to refrain from being too hasty in presuming this sort of exposure will lead to positive performance.

The agency's April 23 pronouncement represented a reversal from Obama-era guidance, which had opened the door for investors to consider ESG factors more broadly. Needless to say, we stand by the statement that

"a good adviser should evaluate all material information when making investment decisions," but also consider the non-financial risk that can be measured with ESG data to be absolutely material.

An announcement a few days later by Environmental Protection Agency Chief Scott Pruitt also seemed to give short shrift to the factor we believe is essential to what we do – hard data. The agency proposed a new rule that would change how it uses science to protect public health. Specifically, it would restrict the EPA from relying on scientific studies where the data behind them is not made publicly available online "in a manner that is sufficient for independent analysis and substantial reproduction of research results."

According to Mr. Pruitt, the change will increase transparency. However, a number of scientists outside the agency argue that it would burden researchers and lead, in many cases, to the best science being ignored. Under the rule, epidemiological studies linking air pollution to early death or contaminated drinking water to cancer could be tossed out because they relied on data derived from the confidential medical records of people who took part.

Another development that seemed at odds with a fact-based reality was a recent report that sexual harassment complaints to U.S. state and federal regulators fell 41% in 2017, hitting a 20-year low. On the face of it, it is difficult to believe that the decline means Americans – women, mostly – are facing less harassment than in the past. In our view, what is going on is that the complaint and resolution process is getting more private (as the situation with Trump attorney Michael Cohen seems to indicate). Arguments to the contrary come across as merely the latest in a series of attempts to delegitimize the #metoo movement.

More broadly, the short-sightedness of the Republican party, which has hitched its cart to President Trump's horse, will probably not play out well for them in future elections. Democrats, meanwhile, seem incapable of creating a cohesive opposition strategy. In part, this may reflect a demographic disconnect. Although Gen Xers, Millennials, and others born after 1964 comprise about two-thirds of the U.S. population, they are generally not represented in the executive ranks of businesses or in our government. According to PwC, this cohort accounts for only 6% of S&P 500 company board seats.

Other, more subjective data tell a similar story. As was apparent when Facebook founder Mark Zuckerberg testified before Congress, our leaders seem completely out of touch with respect to how younger generations live and see the world. In the end, the current establishment's outdated positions on race, religion, gender, guns, and marriage will likely spur a sociopolitical sea change that will reverberate in voting booths and at shareholder meetings.

Values-Based Investing in Action

U.S. companies are taking on a larger and more proactive role in tackling the issues that politicians are ignoring. Whether this means more generous benefits for working mothers, support for politically vulnerable groups, or heightened efforts to fight climate change, companies are stepping into the socially responsible void.

Sustainability Disclosures

Sustainability disclosures continue to rise at the largest U.S. enterprises, with 85% of S&P 500 companies reporting last year on issues such as climate change, diversity, and other initiatives, according to a March 20 study from the Governance & Accountability Institute. The total is up from 82% in 2016 and 53% in 2012.

ESG Strategy Assets

Assets devoted to ESG investment strategies rose 37% in 2017, topping $445 billion, according to Bloomberg Intelligence. Twice as many funds were created during the period than in 2014, largely fueled by the launch of exchange-traded funds targeting the segment. Given that the S&P 500 and MSCI World indices were up 22% and 23%, respectively, over the span, this suggests that a sizable share of the increase stemmed from capital flowing into the sector.

Image: Starbucks

Starbucks aims to eliminate pay disparities

Starbucks has announced plans to eliminate pay disparities based on gender and race in an effort to level the field for employees across the globe. The coffee giant said on March 21 that it would achieve and maintain 100% equal pay for employees who perform similar work in all company locations worldwide.

Image: The Wall Street Journal

Corporate responsibility metrics at JPMorgan

At JPMorgan, its quantitative strategists have developed an “ESGQ” metric integrating long-term corporate responsibility scores with faster-moving data that isolates news flow pointing to potential controversies.

Image: Fortune

Disney CEO $36.3m pay package denied

At Disney, shareholders served up a huge thumbs down in an advisory vote on the company’s executive pay plan, which set out $36.3 million in compensation to CEO Bob Iger. Portola Creek joined with other investors in voting against the non-binding resolution at the company’s annual meeting on March 8.

Image: Institutional Investor

BlackRock excludes firearm makers

In the wake of the Parkland, Florida high school shooting, BlackRock announced plans to launch two exchange-traded funds that exclude the shares of civilian firearms manufacturers.

Carrefour & Walmart Blockchain software

Carrefour and Walmart are testing the use of blockchain software as a way to verify product bonafides. Digitized, decentralized ledgers can be used to establish food traceability, potentially allowing consumers to scan a label to learn if, for example, the chickens they are buying had a nice life, roamed free, and subsisted on a diet of healthy grains.

Image: Google

Google increases clean power

Google has secured more clean power than it currently needs with an eye toward the future. Although the search and online advertising leader used about seven terawatt-hours of electricity to run all of its global operations last year, it has sourced more than that.

Demand for Electric Cars Increase

A growing appetite for electric vehicles (EVs) is beginning to undermine demand for traditional energy sources. According to BNEF, the global fleet of passenger EVs should reduce fuel consumption – 84% of which is gasoline – by 46,000 barrels per day this year.

Image: telecom

Solar power cuts telecom bills

Telecom companies such as Vodafone and Orange are also doing their part, cutting cell tower bills by 30% using solar panels and batteries rather than diesel-powered generators at remote base stations.

Founders for Change movement soars

More than 400 tech entrepreneurs and CEOs signed onto the “Founders for Change” initiative, which is aimed at pressuring venture capital firms to increase diversity.

Image: businesstimes

Citigroup seeks director parity

Citigroup said it wants to see parity between male and female managing directors at its markets business in Asia within three to five years, joining with banks worldwide in stepping up efforts to close a longstanding gender gap.

Quarter in Review

Stock markets were choppy in the first quarter amid growing trade frictions. Arguably, investors have every right to be nervous; history suggests that everyone loses in a trade war. A rough simulation conducted by the IMF found that if the U.S., China and Europe each raised import prices by 10%, gross domestic product (GDP) would drop by 2-3% in all three countries and cause damaging fallout around the globe. While such concerns are valid, it is impossible at this stage to distinguish between rhetoric and policy.

The U.S. equity market’s slow and steady melt-up came to a halt with the return of volatility in the year’s early months. During the January-March period, the S&P 500 index registered 23 daily moves of at least 1%, versus only eight and 46 for the whole of 2017 and 2016, respectively. For the first quarter, the S&P 500 posted a decline of 0.8%, the Dow Jones Industrials lost 2.0% and the Nasdaq gained 2.6%. Only two sectors, technology and consumer discretionary, finished in the black, while real estate, materials, energy, consumer staples, and telecom all declined by 5% or more.

Of 266 S&P 500 companies that reported first quarter results (as of this writing), 79% and 72% beat analysts’ consensus estimates for earnings and revenues, respectively. Meanwhile, business confidence has been robust, corporate balance sheets are strong, and the overall outlook remains positive, though our own expectations are a bit more subdued. Regardless, it is probably safe to say that the economy is now ahead of the stock market.

In bond markets, prices were mostly positive in March, though they were generally lower for the quarter as a whole. That said, the upsurge in volatility that rumbled equities during the period bypassed fixed-income markets to a large extent. Unfortunately, while bonds have served an important purpose as a portfolio diversifier, helping to reduce aggregate risk, they have not been an effective hedge against the decline in share prices.

There have been a few standout performers in the fixed-income arena, however. Municipal bonds, for one, closed out the quarter in great shape. There were next to no bankruptcies and credit spreads tightened across many sub-sectors within the segment. We continue to believe that munis represent a solid hedge against a more volatile equity market and offer good value versus taxable counterparts.

Energy and precious metals markets have fared well since 2018 began, lending a measure of support to our overall performance. WTI crude oil rose sharply during March, gaining 5.4% for the month and 7.5% for the quarter, while gold was up 0.7% over the latter span.

As noted previously, we have been winding down our private real estate exposure based on valuation and other concerns, and we are continuing with that strategy. We made no new real estate investments this year.

Investment Outlook

It would be understandable if investors felt like we are in the final innings of an expansion that has already lasted nine years. But until now, companies have, in a low interest-rate and uncertain regulatory environment, been buying back stock and issuing debt to boost earnings, rather than increasing capital expenditures. However,

with U.S. tax reform allowing companies to fully deduct such spending over the next five years and potentially free up trillions of dollars in un-repatriated foreign profits, we should see them making significant investments in their own businesses.

This should improve productivity, a development we have not yet seen during the current expansion, bolstering profit margins and helping keep unit labor costs low enough for the Fed to remain patient about raising rates over inflation concerns.

Inflation

Historically, at least, it has been difficult to keep pushing unemployment down without driving inflation higher. Under the circumstances, this suggests it will be increasingly difficult to hedge equity exposure with fixed-income securities. That said,

if a pattern of rising prices remains among the best leading indicators of recession, it would suggest the current expansion still has a way to go,

providing something of a floor beneath share prices. In our view, we are far from the stage where the Federal Reserve needs to step in aggressively to counteract an uptick in inflation, and probably two years away from a potential downturn.

It helps, of course, **that U.S. consumers remain alive and well, as evidenced by spending offline and online,** and they appear to be enjoying a reduction in tax withholding rates. Indeed, it is somewhat amazing that they remain so confident amid rising market volatility, political cacophony, and where interest rates are believed to be headed next.

Regardless, it's worth bearing in mind that when taxes were reduced in 2003, we saw Americans boost their savings and cut their debt before consumer spending really began to pick up.

Bonds

In the bond market, a flattening yield curve has everyone's attention – as it should, given what it has often signaled in the past. But in our view, this does not mean that it's time to batten down the hatches and exit stocks. Following a similar development in July 2016, share prices actually climbed for another 15 months.

And back in 2003, not only did the yield curve invert, but we also had midterm elections where the Democrats took control of both the House and Senate, and yet the S&P index finished the year with a gain of approximately 26%.

Nevertheless, while we are not necessarily concerned about what the yield curve is doing and don't see any signs that a credit crisis is brewing, we remain wary of bond funds and fear that they are a ticking time bomb. Despite the fact that the correlation between interest rates and fiscal policy has been somewhat tenuous, it's worth pointing out that 10-year Treasury yields jumped from 3.1% to 4.6% in the six weeks following the 2003 tax cut, a 50% increase. With this in mind, **we don't believe most investors fully recognize the risks of owning bond funds in such an environment.** In our case, we continue to prefer short-term, individually-selected bonds.

Domestic Stocks

Outside of economic, political and various bottom-up factors, seasonal trends seem to favor stocks going forward. Specifically, **the S&P 500 has not been down in the year following a midterm election since 1946.** While the market has often struggled to find its footing leading up to the vote, historically at least, it begins to hit its stride in October. As to why this has occurred, many analysts believe it stems from incumbent President efforts to bolster the economy through increased government spending before the next round of elections.

Admittedly, the real wild card this time around is the current administration's trade policies, and the extent to which any of them will actually be put in place. Mr. Trump maintains that he wants $50 billion in tariffs, but we believe this is more rhetoric than reality, intended as a warning to China to be more accommodating on free trade and intellectual property issues – or else. Congress, meanwhile, is unlikely to approve such a broad-based mandate, preferring instead to link trade-related restrictions to particular interests and goals, including those emanating from members' constituencies.

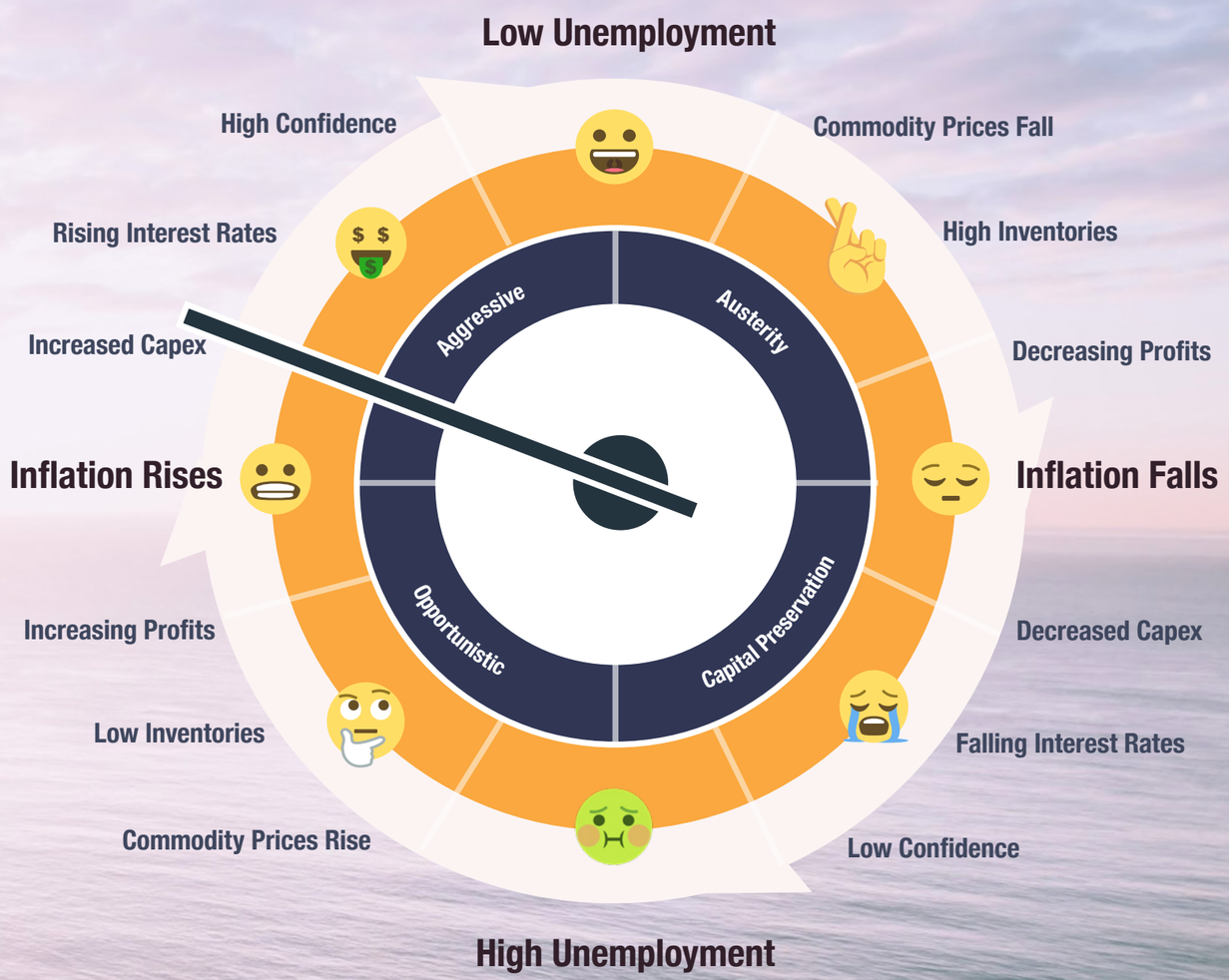
This doesn't necessarily mean that the worst-case outcome is off the table. In any negotiation involving national agendas and cross-border commitments, having strong and consistent leadership overseeing the process – which may not be the case as things stand now – tends to allow cooler heads to prevail. While we and others are generally supportive of any efforts to protect American innovation and prevent the theft of intellectual property, few would welcome the prospect of beggar-thy-neighbor economic warfare.

Indeed, even many conservative Republicans and Trump backers believe that protectionism could hurt the economy and the markets. They appear to be advising the President to dial back the rhetoric ahead of this November's elections. But whether this changes things remains to be seen. Mr. Trump believes that increased trade protections will bolster domestic growth – by reducing imports relative to exports – and boost the share prices of companies based in the U.S. Under the circumstances, he will likely continue moving in this direction, unless and until there is clear evidence that the economy and stock market are suffering as a result.

Regardless of what happens on the trade front, there is evidence that capex is picking up, although it is likely that much of the impact of the tax reform bill passed in late-December remains to be seen, especially given the size of our economy. Remember, GDP growth surged in the first quarter following the 2003 cuts, which may well be repeated this time around. As noted earlier, we don't believe that conditions have reached a peak.

In our view, we may be nearer the middle of this economic expansion than the end.

The Cyclical Nature of the Economy & Stock Market



Admittedly, one big difference between now and then is the size of the U.S. federal budget deficit, which is on track to expand to 4.9% of GDP in 2021 even if economic growth remains solid. More alarming, perhaps, is the scale of federally-issued debt held by the public, which appears set to increase to 83.1% of GDP over the next three years, up from 33.6% at the turn of this century. If and when the next recession strikes, Washington will have less room to maneuver than it had previously.

For now, at least, we believe there are some attractive opportunities for investors to make money. Value stocks, for one, trade at a greater-than-normal discount to their growth-oriented counterparts and have been seeing positive earnings revisions. Using history as our guide, we would note that the final phase of the last great expansion in 1991-2001 witnessed a violent rotation in favor of the former, as well as equity markets in Europe. We expect this to happen again.

Foreign Equities

It helps, of course, that the global economy is doing fairly well, as was the case during the late-1990s upswing, While growth has cooled a tad in recent months, we believe it should remain solidly above average for the rest of this year. By the same token, the rebound in commodity prices should also provide a lift to a number of overseas economies, most notably those in the emerging market regions.

The prospect of a strengthening dollar, which looks to be staging a recovery following a long malaise, will likely also lend support to companies based overseas, especially in Europe, where 40% of corporate revenues are denominated in dollars.

Moreover, equity markets across the Atlantic are also weighted more heavily towards late-cycle sectors and tend to be beneficiaries of higher rates and inflation. In sum, Europe – and probably Japan as well – appear to be setting up for a nice turn to the upside.

Gold

Precious metals have proved to be a good diversifier for our clients' portfolios. Gold, in particular, appears poised to break out of a multi-year holding pattern. Technically speaking, if its price exceeds $1,375 per ounce, we would consider this to be a very encouraging sign for the yellow metal.

Real Estate

Finally, real estate investment trusts (REITs) have experienced tough times for almost two years, and we are thankful that we have had limited exposure to the sector. That said, we believe REITs may be at levels where they could stage at least a reversal back toward the mean, though we would not necessarily view this as anything but a technical rebound. As we see it, with interest rates likely continuing to rise, higher-yielding investments will tend to underperform.

Looking beyond the broader macro backdrop, it is worth noting that residential housing demand exceeds supply, so there is room to grow, but the tax reform-related limitations on the deductibility of taxes in high-tax states such as California, New York, and Massachusetts suggests that some parts of the country will fare better than others. We believe that select private real estate opportunities do exist, though we remain diligent in our efforts to separate the wheat from the chaff.

Would you like your portfolio to be aligned with your personal values and an intelligent investment strategy?

Schedule a Call

A Peak Inside Our Investment Strategy

This quarter we go behind the scenes with **Bank Credit Analyst (BCA)**, a leading market research firm

Bank Credit Analyst (BCA) is headquartered in Montreal, Canada

Bank Credit Analyst (BCA) provides Portola Creek with invaluable technical and fundamental market data

It seems clear from our communications with clients that they want to know just how we measure and evaluate the environmental, social, and corporate governance impact of the investments we consider for their portfolios. Although this aspect carries a lot of weight, we would not want to imply that fundamental and technical analysis are any less significant.

Quite simply, investments that find their way onto the Portola Creek buy list need to have all the boxes checked. In an effort to explore the aspects of our assessment that extend beyond our emphasis on ESG fundamentals, we are taking this opportunity to introduce one of our important research and data providers, Bank Credit Analyst (BCA).

BCA is a highly-respected global research firm based in Montreal, Canada. BCA's Equity Trading Strategy Service (ETS) combines a top down-approach with a 26-factor proprietary model to deliver a solution oriented toward understanding, analyzing, and extracting alpha from global equity markets. Leveraging BCA's technology to perform these tasks enables our investment committee to make timely decisions with greater confidence.

In general, ETS builds on BCA's global macroeconomic thematic research, adding sector and quantitative analytics in a consistent framework that connects the dots from analysis to actionable investment conclusions. By way of the ETS model, BCA ranks and scores individual equities and applies macro and sector views to single-name investments, helping to enhance the value of our investment approach.

In our view, one of the model's most interesting features is its adaptive capabilities. The weighting of the 26 factors changes dynamically, based on which ones look to be most relevant to stock-price movements in real time.

Overall, we have found that the combination of fundamental and technical analysis with ESG scores has been the "secret sauce" that is central to our investment process, helping to promulgate consistent outperformance for our clients over time and across portfolios.

Learn more about Portola Creek's Investment Strategies with Magni and Sustainalytics.

Can we help you?

Let's schedule an introductory meeting so that we can learn more about your objectives.

Schedule a Call

Learn more about **Our Services**.

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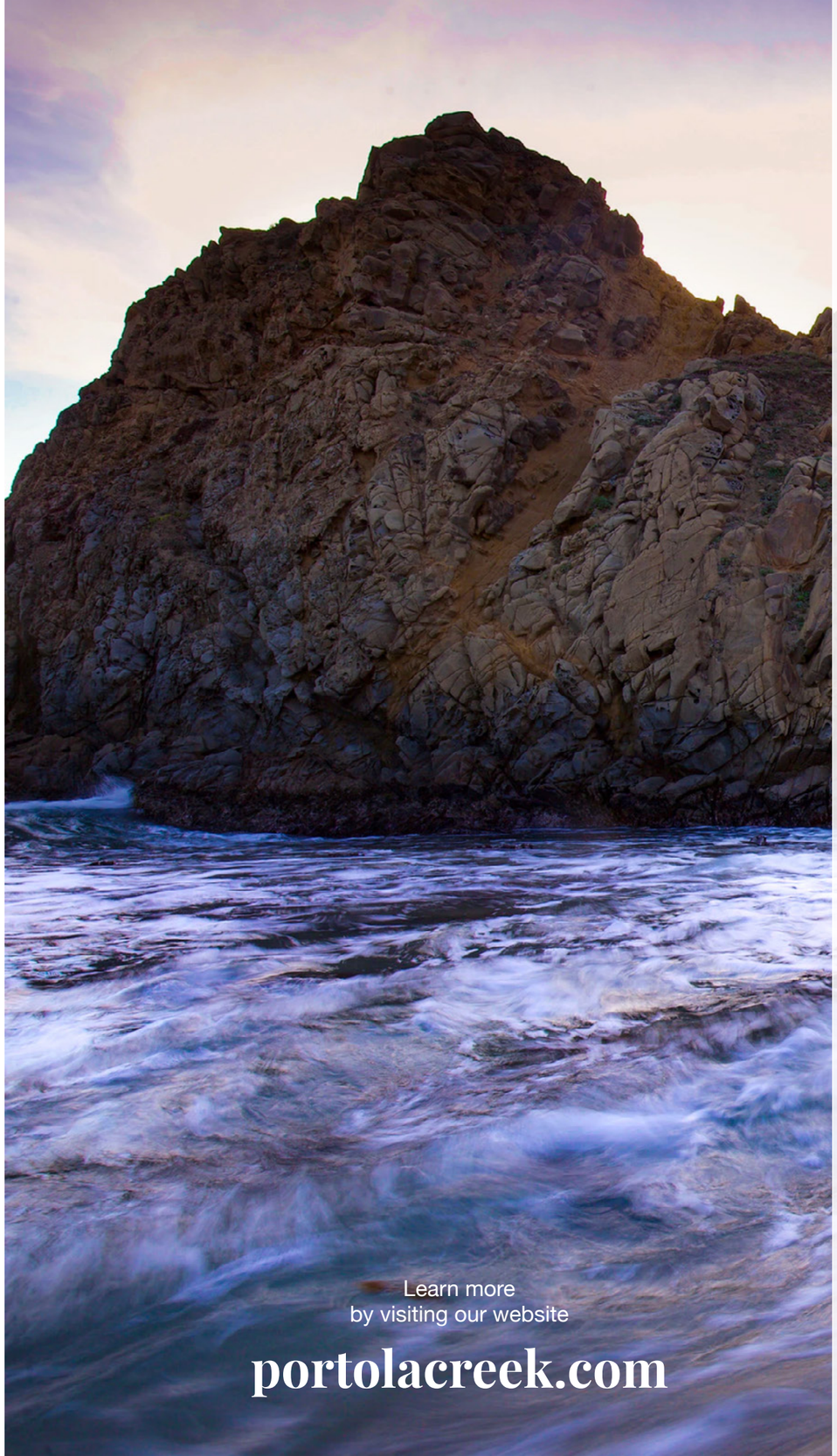

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