May 1, 2017

BLUME CAPITAL MANAGEMENT
Second Quarter Newsletter

The domestic stock market continued its impressive ascent in the first quarter of 2017 as the S&P 500 generated a total return of 6.1% while experiencing low volatility. In fact, from the U.S. election until March 21st, the S&P 500 did not endure a single daily decline in excess of 1%, an anomalous run given, that such a drop has occurred every few weeks on average since 1999.

International equities reversed a trend in place since the start of this recovery and outperformed their U.S. counterparts. Developed foreign stocks (as measured by MSCI EAFE) gained 7.4%, while emerging markets were the top performing asset class in the quarter, returning 11.4%. Fixed income generated modestly positive returns as the 10-year Treasury yield declined from 2.5% to 2.4%, boosting bond prices slightly.

The first two months of 2017 looked similar to the fourth quarter of 2016 -- cyclical stocks outperformed defensive stocks, commodities rallied, and bond yields rose in a correlated move that many labeled the “reflation” trade. For the first time in this recovery, Federal Reserve rate hikes came to be viewed as positive developments that signaled economic strength.

However, in the final month of the quarter market action took on a distinctly different tone as economic momentum stalled and the realities of the U.S. political process hit home with investors. Commodities, cyclical stocks and Treasury yields all faded, while growth stocks reasserted their leadership and outperformed their value counterparts by a wide margin (8.6% vs. 3.0% in 1Q17).

The three and twelve month returns for major financial market indexes are cited below:

Index	Three Months *12/31/16 – 3/31/17*	Twelve Months *3/31/16 – 3/31/17*
S&P 500 Total Return [1]	6.1%	17.2%
DJIA Total Return [1]	5.2%	19.9%
MSCI All-Country World Index Ex-US [1]	7.9%	13.1%
Barclays Int Agg. Bond Index	0.7%	0.3%

MARKET PERSPECTIVE – ACTIVE vs. PASSIVE MANAGEMENT

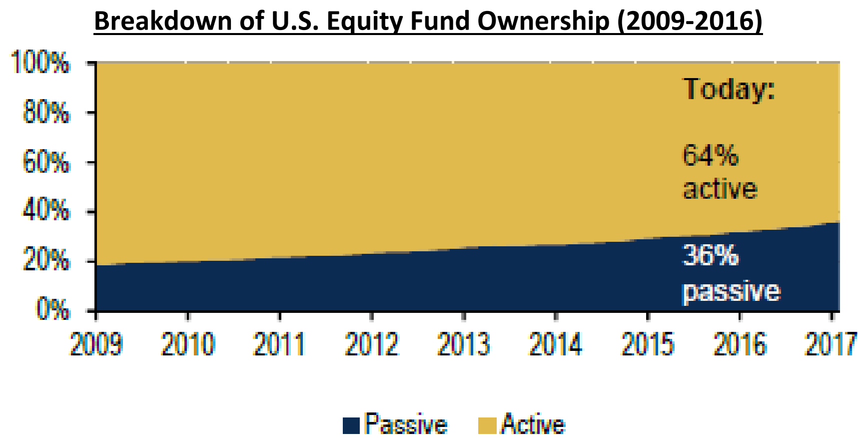
Since the inception of the bull market in 2009, virtually all of the incremental capital coming into the equity market was invested into “passive” vehicles. As a reminder, passive funds are constructed based on an index, most of which are weighted based on the market capitalizations of their constituent

[1]Includes dividends in addition to index price appreciation.

companies. For example, a buyer of an index fund based on the S&P 500, the most commonly followed index, would be allocating .02% of their investment into Teradata (the smallest S&P 500 member) and 185x that amount, or 3.7%, into Apple (the largest S&P 500 company).

During the same time period, actively managed funds (stock picking) consistently lost assets. As shown in the chart below, in only eight years this shift doubled the percentage of total U.S. managed funds controlled by passive vehicles to 36% today.

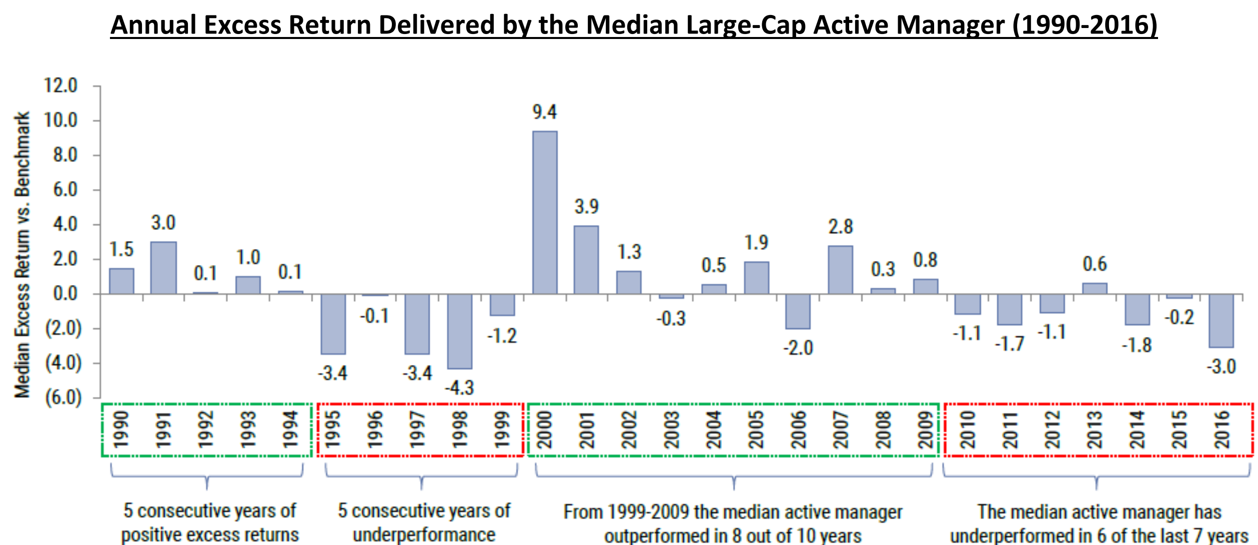
Breakdown of U.S. Equity Fund Ownership (2009-2016)



Source: Strategic Insight SimFund, BofA Merrill Lynch US Equity & US Quant Strategy

This is not a surprising development. Given the lower costs, passive strategies are a sensible approach for the average investor. Moreover, much of the active management industry has done a very poor job of delivering value to their customers (higher fees for less return), while generally underperforming the index in six of the last seven years (as is typical in extended bull markets). The following chart shows the value (i.e. excess return) provided by the median large-cap actively managed fund in each year since 1990.

Annual Excess Return Delivered by the Median Large-Cap Active Manager (1990-2016)



Source: Goldman Sachs

The key question for clients is how the shifting composition of equity ownership changes the investment landscape and what opportunities or risks it may present.

One risk is the potential distortions caused by the capitalization weighting of indexes. As money migrates towards passive management, funds will necessarily flow towards those stocks with higher market capitalizations. On the other hand, when a company has a setback and declines in value, these passive vehicles become forced sellers due to the company's reduced index weighting. Thus, winners become bigger winners and losers bigger losers – propelling a momentum driven market that likely continues until the broader market direction turns.

When that turning point arrives, as it inevitably will, and capital flees the stock market, well-managed active portfolios are likely to outperform and mitigate losses as they did in both the 2000-2002 and 2008-2009 downturns (as shown in the previous chart). Intuitively, when passive management accounts for an ever larger portion of the market, a broad-based sell-off is likely to most negatively impact those stocks with the highest percentage of passive ownership.

In the meantime, with a shrinking active management universe, there are fewer investors to step in and purchase the sinking stock of a company that stumbles, potentially magnifying its decline. This scarcity of natural buyers will create opportunities as price changes exceed the actual change in company fundamentals, which is a value investor's ideal scenario.

Ultimately, we believe the weak hands of active management (high-fee, closet indexers) will, and should, be shaken out and the passive momentum will subside. Over the next several years, we would not be surprised (and frankly hope) to see passive investors' share of equity ownership grow significantly higher, but we fully expect that this trend will provide ample opportunity for the remaining active managers to excel over time.

We recently reviewed several studies analyzing the historical performance of fund managers and found that a common conclusion within each report was that certain characteristics greatly increased the chances of outperformance. Further, when adjusting for the four factors below, the analyses showed that active management had meaningfully outperformed passive indexing over the long-term.

1) Lower than average fees
2) High active share (different holdings/weightings than the index)
3) Low turnover (buy and hold for the long-term)
4) Aligned ownership (owners are heavily invested in the fund or own the same stocks directly)

These characteristics are, and always have been, core to Blume Capital's philosophy. It is no guarantee of success, but we will continue to utilize our approach, which we believe best serves the long-term interests of our clients.

OUTLOOK

Global economic data began showing improvement last summer, but following the U.S. election, investors started to anticipate a further acceleration in growth driven by proposed deregulation, tax cuts, infrastructure spending, and the associated "unleashing of animal spirits". From our perspective, we increased the probability of the organic recovery scenario (return towards historical trend growth

levels) from 10% to 15% in our January macroeconomic review. Concurrently, we reduced the odds of the subpar growth scenario from 55% to 50%.

Why only such a slight adjustment? We, of course, see the potential that such political action could provide a cyclical boost to economic growth, but we are skeptical that any, or even all of those items in combination, would be sufficient to overcome the secular constraints to growth (excessive debt loads, aging demographics, etc.) on a sustained basis, even if (and that's a big if) they could get enacted.

We are not negative at this juncture, but cautious. We still see near-term recession odds as being relatively low, and, hypothetically speaking, if the organic recovery scenario does come to pass at this point in the cycle with unemployment at 4.5%, we believe it would only be a matter of time before inflation accelerates, which would drive the Federal Reserve to tighten policy more rapidly and ultimately bring an end to the expansion.

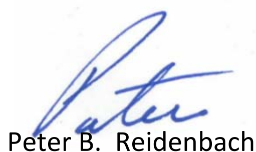
Consequently, we believe that the subpar growth scenario (referred to by some as "Goldilocks" -- not too hot, not too cold) is likely to be the best case for investors over the next few years. Unfortunately, with subpar growth expectations, the stock market is no bargain at current valuation levels. Over the next several years, investors should plan for lower than average returns, likely in the low-mid single digits for broader equity markets. However, this remains superior to bonds, which are unlikely to maintain their purchasing power over time.

CLOSING THOUGHTS

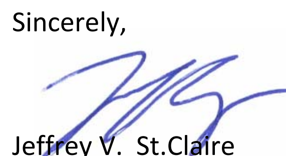
Whether it's the upcoming European elections, North Korean missiles or the Syrian conflict, geopolitical issues are once again topping the headlines and of concern to many clients. While all of these of course could negatively impact markets, it rarely pays for long-term investors to attempt to make decisions based on what are already widely-known risk factors. Over the last 12 months, many "experts" predicted that Brexit and subsequently the U.S. election results would cause widespread sell-offs, but the declines were fleeting. It is the unforeseen events that can produce a sudden, negative market reaction, but this dynamic has always been part and parcel of investing.

One worry our California clients can finally put to rest is the drought! After what seemed like endless rain, we hope everyone is enjoying the start of a warm and lovely spring.

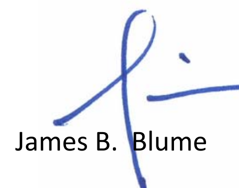
Sincerely,



Peter B. Reidenbach



Jeffrey V. St.Claire



James B. Blume

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