

July 25, 2017

**BLUME CAPITAL MANAGEMENT**  
**Third Quarter Newsletter**

On the surface, the second quarter of 2017 proved relatively uneventful as global equity markets continued their steady upward climb. The S&P 500 generated a total return of 3.1% with scarcely a pullback. International stocks extended their year-to-date outperformance versus U.S. markets as developed foreign stocks (as measured by MSCI EAFE) and emerging markets (as measured by MSCI Emerging Markets) both gained 6.3%.

The action beneath the surface was decidedly more revealing. Through much of the quarter, investors once again questioned the sustainability of economic growth, and, accordingly, abruptly shifted their money towards the “safety” of high-quality bonds (driving interest rates down) and “growth” stocks.

Despite trading at higher valuation multiples, growth stocks, perhaps counterintuitively, tend to outperform in slow growth environments because the companies have the ability to expand revenues organically, independent of the economy. Indeed, growth stocks have now outperformed “value” stocks by 8.5% year-to-date (13.3% vs. 4.8%), the second widest first-half deviation since 1998.

Fixed income generated a return of 0.9% as the 10-year Treasury yield initially declined from 2.4% to 2.1% before rebounding to finish the quarter at 2.3%.

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

Index	Six Months 12/31/16 – 6/30/17	Twelve Months 6/30/16 – 6/30/17
S&P 500 Total Return <sup>1</sup>	9.3%	17.9%
DJIA Total Return <sup>1</sup>	9.3%	22.1%
MSCI All-Country World Index Ex-US <sup>1</sup>	14.1%	20.5%
Barclays Int Agg. Bond Index	1.6%	-0.2%

**MARKET PERSPECTIVE**

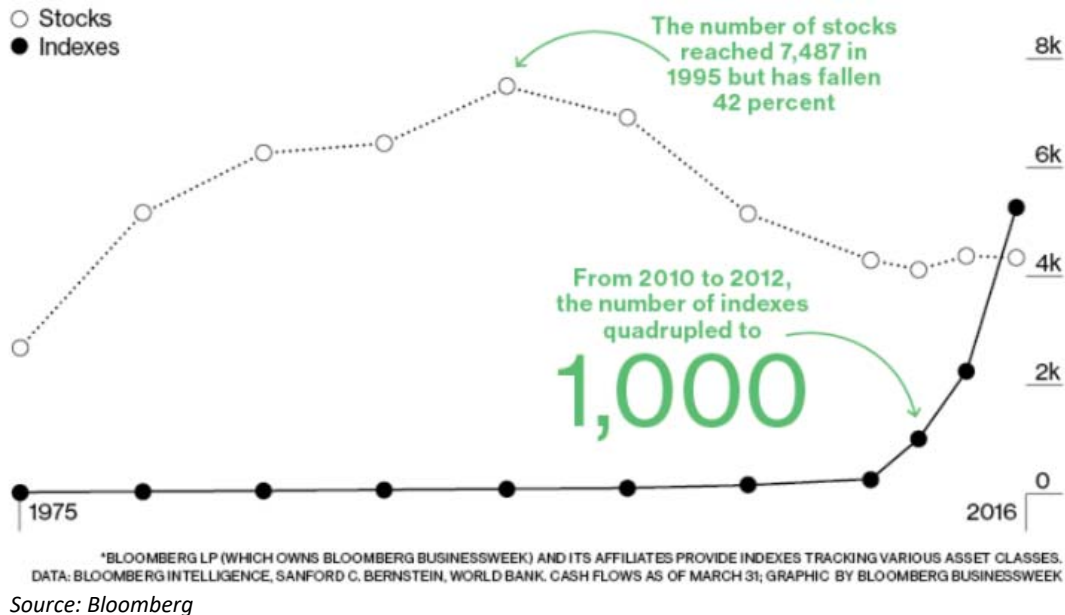
We were stunned by a recent Bloomberg article declaring that there are now more indexes (e.g. the Dow Jones Industrial Average, S&P 500 or Nasdaq) than there are individual U.S. stocks (see chart). By way of background, Charles Dow (founder of the Wall Street Journal) first published the Dow Jones Industrial Average Index in 1896 to satisfy investors’ need for information about market activity. By the 1970’s, when Jack Bogle (Vanguard) pioneered the idea of passive investing (buying an index vs. individual stocks or managed funds), there were still only a handful of indexes in existence. At the

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<sup>1</sup> Includes dividends in addition to index price appreciation.

beginning of this decade the total had grown to a few hundred, but over the last several years that figure has exploded to over 5,000!

Let us pause to let that fact sink in, there are now more indexes than there are stocks!!!



Many of the newer indexes are structured to track to all kinds of “factors” (growth/value, low volatility, geography, industry sector, size, etc.), and the financial industry has created thousands of corresponding ETFs (exchange-traded-funds) to offer exposure to them. The original SPDR ETF tracking the S&P 500 (“SPY”) remains the most popular with nearly a quarter-trillion of assets, but an investor today has countless choices.

If you want to invest in tech stocks buy the Technology Sector SPDR ETF (“XLK”). Do you think China or India offers major profit potential? Buy iShares China (“MCHI”) or iShares India (“INDA”), or, in case you can’t decide, there is always the Chindia ETF (“FNI”). If you believe our aging society is a growth opportunity you can purchase the Long-Term Care Index ETF (“OLD”), or that Americans need to shed a few pounds, the Obesity ETF (“SLIM”).

The index craze is a corollary of the significant and ongoing shift towards passive investing, but the definition of passive appears to have expanded beyond all reason to include the most esoteric of investment concepts. A passive strategy that involves ongoing choices regarding sectors, themes, and geographies is no longer passive and is likely to negate the potential advantages of such an approach (low cost, diversification, and preventing poor decisions).

Further, the rapid “ETF-isation” of the market may be creating broader risks (illiquidity, flash crashes, etc.) that are not well understood, and may not be until the next downturn. At a minimum, we expect that the mass movement of index money that treats all stocks of a certain class the same is likely to enhance the short-term price volatility of individual names. However, we are quite certain that, in time, it will also create opportunities for the fundamentally-driven, long-term value investor.

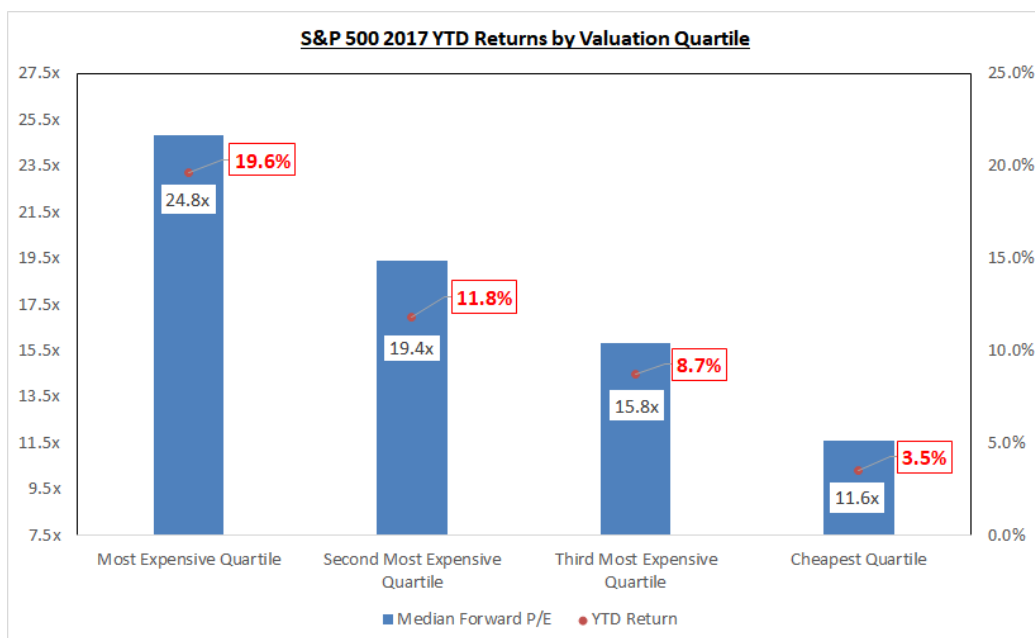
There's an old adage that Wall Street is very good at separating the average investor from his or her money. When a sensible initial idea gains in popularity, the financial industry will seek to maximize profits by turning on the marketing machine and expanding it to extreme levels. As always, we say caveat emptor.

## MARKET REVIEW / OUTLOOK

Ben Graham, long-recognized as the originator of the "value" investing concept, once said that, **"In the short-run the market is a voting machine. In the long-run it is a weighing machine."** In today's "fast-money" world filled with ETFs catering to every possible view it is easier than ever to "vote" with your investing dollars.

It is clear how investors are voting so far in 2017. As mentioned at the beginning of this letter, growth stocks (which, by definition, trade at higher valuation multiples) have significantly outperformed their value counterparts year-to-date, and within the growth category, tech stocks have posted the largest gains. This dynamic is highlighted when market performance is broken down based on valuation.

As shown in chart below, when the S&P 500 is divided into quartiles based on forward price-to-earnings (P/E) multiples, the most expensive quartile gained 19.6% year-to-date (red box) while trading at a median P/E of 24.8x (white box). Meanwhile, the cheapest quartile trades at 11.6x and returned 3.5%.



Note: Excludes REIT and energy sectors where current earnings don't provide a meaningful comparison  
Data Source: Bloomberg

Even more impressive, technology stocks returned 17% in the first half of the year and are up 24% in 2017 as of the writing of this letter. The scale of the divergence between tech/growth names and value stocks is reminiscent of the late 1990's, which is the last time we witnessed such a disparity. However, we should note that valuations remain significantly below levels reached at the top of that cycle.

The advance of the most expensive stocks has propelled the equity market to new highs, but for the gains to continue will require broader participation. There are only so many high-growth companies

that can thrive in a subpar growth environment and only so much that even the most optimistic investors will pay for those stocks.

The good news is that, despite the tepid rate of growth in the economy, our unemployment is approaching the lowest levels we've witnessed since the 1960's. This has given the Federal Reserve confidence to continue raising interest rates. In reviewing the last 10 times the Federal Reserve initiated an interest rate hiking cycle, value stocks outperformed growth stocks by an average of 7% per year over the subsequent five year period.

If the economic expansion continues and the business cycle plays out in traditional fashion (slow reduction in economic slack, eventual uptick in inflation, gradual rate increases, etc.) then we would expect an extended period of catch-up and outperformance for value stocks.

### CLOSING THOUGHTS

Following the Federal Reserve's June rate increase and commentary from the European Central Bank hinting at reduced monetary accommodation, many commentators expressed concerns about the potentially negative impacts of higher rates on all assets and the broader recovery.

While we would note that the Fed's forecasting record is far from stellar, we would also acknowledge that they actually *cut interest rates* prior to the onset of the last three recessions (and ahead of major market declines). While each day and each interest rate hike that passes brings us closer to the next eventual downturn, that time could still be a ways off if recent history is any guide.

That said, for those that are still up at night concerned about interest rates or the next geopolitical crisis, don't worry, Wall Street has designed something for you too....the Inspire Global Hope ETF ("BLES").

Please do not consider that an endorsement, but we do hope everyone is enjoying a care-free start to the summer.

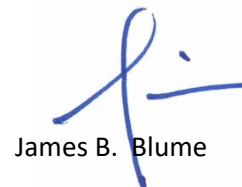
Sincerely,



Peter B. Reidenbach



Jeffrey V. St.Claire



James B. Blume

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