Third Quarter Commentary
October 14, 2016

Dear Clients:

Many thought Brexit, the surprise departure of Britain from the EU on June 23, would be the main influence on the market in the third quarter. The real surprise was that after two sessions of intense selling (June 24, volume +86% and the 27th, volume +31%), the market followed through on June 30, ushering in a confirmed uptrend. Previously, the outlook was bleak. Brexit was a central event in the second quarter; it was not the determining factor for the third. In early 2016, stocks that worked best were high stability, low volatility stocks like consumer staples, and dividend plays like utilities and telecom services. However, those stocks didn't lead in the third quarter. The leaders were innovative growth companies with new products and services with strong and improving revenue and margin growth. Those characteristics are among the most important metrics considered when selecting stocks for inclusion in growth portfolios. It might have been tempting to rotate into defensive plays then, but that would have been inconsistent with a strategy of buying leading growth stocks. Historically, innovative growth companies have provided the best returns and investing in those quality companies is the cornerstone of my stock selection process. To pivot toward a different strategy as market focus changes is not in the best long term interest of a growth strategy.

One of the biggest positive surprises in the quarter was Apple when it reported June quarter results on July 26. Two days before, BCG analyst, Colin Gillis, downgraded Apple at $97.34 with a $85 price target. He thought Apple would trade at $85 before it traded over $110. After reporting better-than-expected results, Apple shot up to $104.35 on heavy volume. The September introduction of the iPhone 7/7+ pushed the stock over $110. For the quarter, Apple jumped 18.25%. One of the key metrics that confirms a stock as a leader is the Accumulation Distribution rating (A/D). Apple's is currently B+, indicating substantially more buying than selling. Other portfolio companies with superb A/D ratings are Facebook and Amazon (A), Priceline and Adobe (A-), Seagate and Netflix (B+), Biogen, Alphabet and Alibaba (B) and Activision (B-). This is important because stocks already outperforming during flat, listless or directionless periods, like August and September, are stocks primed to lead when market tone improves. Imagine a heavy weight (the market) holding down a coiled spring (a stock with strong fundamentals and top metrics). When the weight is removed, the coiled spring releases and surges up. The current A/D rating for the NASDAQ is B-; the S&P 500 is C+.

For the quarter, the NASDAQ led the major indexes rising 9.6%; the S&P 500 rose 3.3%. When the NASDAQ leads, top growth stocks are usually the best performers. Stocks outperforming relative to the S&P 500 are demonstrating Relative Strength (RS). A 90 RS means a stock is outperforming 90% of all stocks. Top portfolio companies by RS are Adobe (81), Facebook (82), Seagate (85), Amazon (90) and Alibaba (94).

Another characteristic of leading stocks is a superb Up/Down Volume Ratio—1.0 is equal buy/sell interest; 1.2 times means 20% more buying. Portfolio companies have high or improving ratios. Netflix, Seagate and Alphabet's readings have improved to 1.1. Apple, Adobe and Biogen's readings are 1.3; Transdigm and Facebook 1.5. Priceline and Alibaba both have 2.0 readings; Amazon's is the highest at 2.3.

The NASDAQ, unlike the S&P 500, traded above its 50-day moving average on June 30 and remained above that support level at quarter end. The S&P 500 dropped below its 50-day on Sept. 9 and has remained there. Strong stocks move above their 50-day lines and stay there. Apple, Alphabet, Priceline, Netflix, Biogen, Transdigm, Alibaba, Facebook and Activision all trade above their 50-day averages. Poor performers trade well below their 50-day lines and get stuck there for extended periods.

Fundamentally, superior earnings and revenue are key predictors of future performance. A strong SMR or Sales Margin and Return-on-Equity (ROE) ratio has predictive value. Better performing stocks rate "A" (superior) or "B". Adobe, Allergan, Activision, Alibaba, Apple, Biogen, Facebook and Priceline are rated A and Netflix B+. Earnings increases of 25% are key. The consensus earnings estimates for Freeport McMoran is up 114% in '16 and +118% in '17. In '15 Amazon earned $1.25. Projections for the next two years are +368% and +80%. Facebook is expected to increase earnings 73% ('16) and +29% ('17), Alibaba +26% and 29%.

Superior growth companies have cash flow that exceeds reported earnings by 20% or more. Amazon has cash flow 1,040% greater than '15 earnings of $1.25. New products are critical to cash flow growth. Apple's cash flow for '15 exceeds earnings by 25%. Netflix's cash flow is $8.60 versus $0.31 of reported earnings. Under Armour's cash flow is 45% above eps, Seagate,+105%, Activision, +52%.

One of Steve Job's favorite expressions was "Think Different." The grammatically correct version is "Think Differently." A recent UBS report on Apple report is entitled "Don't Laugh at AirPods..." What caught my attention was the analyst's effort to pull back the curtain, to illuminate Apple's long term plan. Usually analysts focus on iPhone sales, iPhones in China or the prospects for an Apple car or current Apple Watch sales volumes. The UBS analyst explained that the "ambient paradigm" "consists of many devices providing different input/output methods…flexibly utilized…" or "where the company's iOS …is everywhere through different devices." The result, the UBS analyst suggests, is a "much bigger [Apple] ecosystem…." Further, "Devices become extensions of one another rather than discreet (sic.) computing platforms." It's not about one discrete device like the "functionally modest" iPod. This is an expression of what Tim Cook calls "iOS everywhere." In other words, investors are taking a "linear view…[incorrectly] thinking that volumes of new products such as the Apple Watch falling short of the iPhone reflect a decline." Current thinking about Apple products was molded by the "computer paradigm" then the "mobile paradigm." The UBS analyst's conclusion is that traders are too bearish on Apple and don't fully appreciate the potential success of future products and…shares are undervalued." Perhaps investors have become too accustomed to Steve Jobs' style of dramatically introducing new products. Tim Cook is more low-key. The analyst says, "Apple often introduces important long-term technology in a more modest form that reveals only part of its eventual capability."

Perhaps the first half of 2016 will eventually viewed as a period of transition. Stay tuned as more will be revealed, but it seems likely that companies that continually provide new ideas, products or services will be in the vanguard.

Best regards,
John T. Preston