University of Connecticut

Student Managed Fund

Report – Spring 2017

April 27th, 2017

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**Dear Investment Board Members and Foundation,**

We would like to extend our gratitude for allowing us to participate in this year’s Student Managed Fund. It has been a great hands on learning experience for all of us. This knowledge will prove invaluable for those seeking careers in Portfolio Management and many other tracks in Finance. More importantly, it has been an excellent opportunity to learn and work together as a team towards a common goal. We also wanted to acknowledge and thank you for the time and effort you put into this program. The Student Managed Fund is a very prestigious program for the University, and it would not be possible without your efforts.

We have learned a great deal over the last three months. The Student Managed Fund has given us the chance to put to use the knowledge we have learned in the classroom. Equally important to the gains and losses of our different positions has been learning the process and mechanics of managing a portfolio. While not every aspect of managing the portfolio is glamorous, the process, which requires discipline and patience, makes our final results all the more rewarding.

We hope that you enjoy our report and gain clear insight as to our thought process and investment style as we manage our portfolio.

Sincerely,

The Graduate Student Managed Fund Team

Jeremy Hite – Co-lead & Portfolio Manager

Wei Wang – Co-lead & Portfolio Manager

Azmath Rahiman

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**Executive Summary**

**Benchmark and Style:**

* The S&P 500 is the fund’s benchmark. Accordingly, the fund is structured as a mid- to large-cap value portfolio. However, we do consider growth, small cap and fixed income securities.
* While the fund is welcome to invest in fixed income securities, we made the decision not to invest due to already low interest rates and expected Fed hikes in the near future.

**Philosophy and Strategy:**

* We think of our investment philosophy to be value investing. We sought securities with sound and stable business models, strong balance sheets, and current stock prices that were below their intrinsic value.
* We employed a bottom-up investment approach, relying on fundamental analysis of individual securities.

**Economic and Market View:**

* We believe that the U.S. economy and market is in a mid-expansionary cycle.
* Some pertinent macroeconomic factors such as Geopolitical uncertainty, relative dollar strength to foreign currencies, changes in regulatory landscape, probable interest rates hikes, slowdown of the Chinese economy and historically low U.S. unemployment rates all influenced our investment decisions.

**Process:**

* Each of the ten managers was assigned an S&P sector to research to establish an overall view of the market.
* We used absolute as well as relative valuation methodologies such as discounted cash flow, dividend growth and multiples valuation analyses to establish individual security’s intrinsic value relative to their current market price.
* Each pitch is done with a thorough analysis presented to the other fund managers, coupled with a detailed one page report highlighting financials, relative valuations and risk profile of the security.
* To reach the prospectus outlined 70% threshold approval, seven out of ten members must vote yes to invest in the recommended security.

**Philosophy**

At the core of our investment philosophy is a belief that we are value investors first; we analyze the financials, assess the company's management, and determine the company’s place in its industry. Benjamin Graham, often regarded as the father of value investing, coined the term "margin of safety".  This margin represents the difference between what we assert to be the company’s intrinsic value and the market price of the stock.  To determine each security's intrinsic value, we applied a combination of absolute as well as relative valuation models including discounted cash flow analysis, dividend growth model and multiples valuation.

We select these undervalued securities using a bottoms-up approach by finding well-run companies with outstanding long-term prospects and investing when their stock price is selling at a discount.  This approach sometimes requires having the discipline and patience to wait while maintaining our mandated 5-year investment horizon.  Of course, we cannot avoid the reality of our nine-month academic calendar, therefore our emphasis on value investing is not to be confused with an approach that avoids investing in growth companies.  Companies that can grow their revenues and earnings with an acceptable risk profile still qualify as value investments based on our criteria.

While we will never eliminate our subconscious biases, we work hard to remain forward-looking and sought to eliminate such biases with each individual manager responsible for following trends within each of the S&P sectors and opportunistically buying undervalued companies when we believe our investors will be compensated with better returns in the long-term. Our general strategy is to make meaningful investments in high quality, predictable businesses that can be expected to grow intrinsic value at high rates and that are currently available at cheap prices driving investment returns from not only internal operating results of the business, but also market recognition.

**Style**

Our investment style favors value over growth.  To that point, we are not just looking for strong companies, we are looking at companies that are undervalued.  Our strategy is to find stocks that are trading below their intrinsic value.  We have taken a bottom up approach by choosing individual stocks that have strong fundamentals.  While we have split up our workload into separate sectors, we only invest in a particular sector if there is an individual stock or two that we find attractive.  We do not invest in a sector just for the sake of being invested across different industries.  Our focus is on individual stocks, and that is where we must find our opportunity.

In addition to the foundation mandating a value based strategy, we believe that current political and economic conditions support such an approach.  We bought our first stock about one month before possibly the most intense and unpredictable presidential election in our lifetime.  No one seemed to know how the election would go, and what the implications of the results would be.  As poll numbers change, so did expectations and projections in the market.  During a time of such uncertainty, putting your money on reliable and fundamentally strong companies is a stable approach.

**Strategy**

As our core strategy, we are committed to focus on the safety and prospects of the underlying securities. We are constantly reminded of our core philosophy and thus protect ourselves from speculating based on macro scenarios. We believe in collective intelligence and hence opted for a democratic voting system to make the right investment decisions. Through this approach, we conducted many hours of research and intense discussions acquainting the other SMF managers about the business models and outlook of all the securities that we have interest in.

Our key strategies could be outlined as follows:

1. Protection over prediction

    We have constantly reminded ourselves to focus more on risk instead of return. We make sure that the businesses we invest in have a good margin of safety and are able to generate considerable free cash flows even during the times of negative economic cycle. We view risk in terms of probability of expected loss in earning power rather than the probability of expected loss in price. This strategy helps us to stay immune from the short sighted psychological temptations over price movements.

1. Stocks as business

We view each of our investments as owning a share of the business. Our strategy is to look at each investment as business managers rather than investment managers. We make sure to understand the intricacies of every business we own and thus truly understand the business dynamics.

1. Capital allocation strategy

Our capital allocation strategy is to make sure that our capital flows to the right securities based on the best long term opportunity cost. We think in terms of long term yield and thus focus our investment on the securities which would give us the best risk adjusted yield. We sell our investment only if we find that there has been a fundamental change in the underlying business or if there arises a better opportunity cost after considering the capital gain tax.

1. Collective Intelligence

In order to smoothly conduct our democratic voting procedure, we have made it clear that we focus on substance rather than individual. We do not incentivize our managers based on their stock performance, but we critically judge the arguments made by each of the managers based on our core philosophy. We make sure that all the managers understand the business before voting on any investment decisions.

**Procedure**

Each person was assigned a sector based on preference with a consensus that each individual present at least one stock per sector assigned. For the stock selection, each fund manager conducts due diligence for each industry. Normally the fund managers review the S&P net advantage industry report as the first step to evaluate the landscape of certain industry. It is important because we need to understand the environment of the company. Sub-industry outlook is reviewed and we compare the performance of the sub-industry with that of sector and S&P 500 indices, trying to identify whether the companies’ prospect is promising or not. We also want to know the potential market growth of the sub-industry which can be used to predict the revenue growth of the company. We leverage other sources such as Morningstar and Yahoo Finance to get the industry outlook as well.

Next, the fund managers try to identify several leading companies in the industry. The metrics we look at may be different for different industries. For example, we pay more attention to EV/EBITDA for the technology sector. We also look at the basic measurements for every stock, such as Beta, P/E ratio, EPS trends, Dividend payment, Price stability, etc. Comparable companies are checked via Thomson One Banker and Morningstar. The basic ratios are compared first. From an income statement perspective, we compare the revenue and revenue growth, profit margin, gross margin, EBIT margin, and EPS growth. From a balance sheet perspective, we compare interest coverage, debt to capitalization, and debt to Capex. From a valuation perspective, we look at the P/E ratio, dividend yield, and EV/EBITDA. Free cash flow is another important metric that we evaluate.

Fundamentally, the company needs to generate cash for operations, reinvestment and returns to shareholders. After comparing those ratios, fund managers filter out 2-3 stocks in a particular industry.

Fund managers go deeper and read the analyst's report for each company. The S&P report is the first one that is considered. The company highlights, business model, investment rationale and risk can explain the outlook of the company. Another important part is the analyst's’ recommendation. Fund managers look at Wall Street Consensus Opinion, the number of buy, hold and sell recommendations. S&P fair value rank, fair value calculation, volatility, and other analysts’ opinions are reviewed to get an outlook of the stock.

Fund managers then collect the S&P, Valueline and other relevant one reports and send them to all the fund managers several days before the pitch day. Fund managers read the reports and have a basic idea about the stock. The team processes are based on democracy. The team vote for buying a stock is at least seven people voting for the stock.  Because each fund manager may have their own methodology and opinions on the market prospect, business model, competition situation and the ratios, they also have different comfortable ranges of the metrics, such as Beta, leverage level, P/E ratio, R&D expenditures, etc. Some concerns and questions are raised during the pitch in order for everyone to make an informed decision.

Fund managers need to prepare both the quantitative and qualitative analysis for the stock they select. For the qualitative analysis, they need to prepare the company background, industry outlook, investment thesis, and risk factors. In terms of risk analysis, fund managers evaluate the market tends, future market shares, the diversity of the business line and revenue source. We also look at the company’ operations in foreign markets. Competitive analysis is an important part of the risk analysis. Fund managers look at each business line of the companies and the performance of those business lines. Some fund managers even investigated the key products and the impact of those key products to the company performance. For example, for the pharmaceutical companies, the fund managers do lots of research on the new drugs and patents. The advantages and threads in the competition are summarized. What’s more, some fund managers also did the scenario analysis and provided different valuation suggestions in different scenarios. For the quantitative analysis part, most fund managers conducted the discounted cash flow analysis. We used raw data from the value line report, such as market cap, long term debt to get the weights of debt and equity. We leveraged the beta, risk free rate, risk premium to calculate the cost of equity. We used the Moody’s corporate yield as the cost of debt. With all of this data ready, we calculated the WACC. We then checked the forecasted free cash flow of the company from Bloomberg and calculated the enterprise value. We subtracted the outstanding debt to get the equity value. Finally we got the intrinsic value of each share by dividing the equity value by the number of outstanding shares. We used our intrinsic value as an indicator of whether the current stock price is undervalued or not. As required by SMF, we also checked the governance disclosure, ESG disclosure, social disclosure and environmental disclosure scores from Bloomberg.

Team review, discussion and voting procedure

After we purchased the stock, in the later meetings, fund managers provide regular updates on the companies. Such as AT&T’s potential acquisition of Time Warner, Starbucks earning announcement of Q4 and 2016 fiscal year, and new drug trial results of pharmaceutical companies. The team also had vast discussions on the impact of the presidential election result and why the market reacts to the result in such a way. Those discussions help us learn more about the equity market and make sound decisions in future investments.

**Allocation and Asset Selection**

If one manager was assigned to more than one sector, managers have the discretion to choose the sector based on the economic outlook or whether there are undervalued stocks in the sector. As of April 21st, our holdings cover eight sectors which are consumer discretionary, consumer staples, financials, healthcare, information technology, telecom services, utilities and Energy. We did not pre-allocate capital to certain sectors before the stock pitches because we decided to look at industries and take the quality of individual stocks into consideration.

Even though one sector may have a relatively positive outlook, certain industries within the sector may underperform as compared to the general sector. Therefore we based our decision to allocate capital into the stock based on performance.

Another key focus on the meetings are the decisions taken on the stop loss order and the amount invested. Both these factors were decided on a case by case basis depending on the team’s response and the votes counted.

We set $100,000 as the baseline for each investment and it is subject to adjustments. After the stock pitch, if all managers agree that we can overweigh the stock, we will increase the positions with more than $100,000. If the majority passes a certain stock, but some are still unconvinced on the industry or company outlook, we may under weigh the stock.

For example, under consumer discretionary, there are two stocks which were pitched at one meeting. One is Starbucks, the other is Gentex. We agree that both stocks have good fundamentals and both will perform well. However, given the relative positive outlook for US restaurants and uncertain outlook for the automobile industry, we decide to under weigh Gentex with positions around $50,000 and over weigh Starbucks with positions around $125,000.

For now, our asset allocation is as noted in the charted located below. The biggest sector holding is Technology accounting for 22% and smallest is Consumer Staples with 5.63%. Consumer Discretionary, Telecommunications, Healthcare and Industrials sectors have similar weights of 12% a piece.

**PORTFOLIO**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Sector** | **Company** | **Date purchased** | **Shares Purchased** | **Value today** | **Portfolio Weight** |
| Consumer Discretionary | Starbucks | 10/12/16 | 2,330 | $141,221 | 6.49% |
| Consumer Discretionary | Gentex | 10/13/16 | 2,794 | $55,880 | 2.57% |
| Consumer Discretionary | Hasbro | 2/17/17 | 765 | $73,463 | 3.38% |
|  |  |  |  |  |  |
| Consumer Staples | Skechers | 11/1/16 | 4,806 | $122,457 | 5.63% |
|  |  |  |  |  |  |
| Financials | Citigroup | 10/19/16 | 1,540 | $88,889 | 4.09% |
| Financials | Citigroup | 2/28/17 | 833 | $48,081 | 2.21% |
| Financials | Bank of Internet | 2/28/17 | 4,315 | $111,284 | 5.12% |
|  |  |  |  |  |  |
| Healthcare | Gilead Sciences | 10/19/16 | 1,360 | $89,665 | 4.12% |
| Healthcare | AbbVie | 11/2/16 | 1,324 | $84,498 | 3.88% |
| Healthcare | Regeneron Pharm. | 2/3/17 | 277 | $105,399 | 4.85% |
|  |  |  |  |  |  |
| Information Technology | Alphabet (Google) | 10/27/16 | 250 | $210,798 | 9.69% |
| Information Technology | Visa | 2/17/17 | 1147 | $104,549 | 4.81% |
| Information Technology | Facebook | 2/28/17 | 1108 | $159,197 | 7.32% |
|  |  |  |  |  |  |
| Telecom Services | AT&T | 10/19/16 | 3,175 | $126,778 | 5.83% |
| Telecom Services | AT&T | 11/10/16 | 1,335 | $53,307 | 2.45% |
| Telecom Services | American Tower Corporation | 11/16/16 | 966 | $120,199 | 5.53% |
|  |  |  |  |  |  |
| Utilities | Entergy | 10/12/16 | 1,013 | $77,403 | 3.56% |
|  |  |  |  |  |  |
| Energy | Schlumberger Lmt | 2/28/17 | 1,871 | $140,026 | 6.44% |
|  |  |  |  |  |  |
| Industrials | Lockheed Martin | 2/10/17 | 589 | $160,850 | 7.39% |
| Industrials | Lockheed Martin | 2/28/17 | 371 | $101,316 | 4.66% |
| **TOTAL** |  |  |  | $2,175,259 | **100.00%** |

**RISK MANAGEMENT**

We use 95% Value at Risk, and stop loss at 15% as risk measures.

**95% VaR for portfolio:**

Now we have 17 stocks in the portfolio. They have a diversification effect (benefit). In order to find out how the portfolio will perform as a whole and how much risk the portfolio will take, we want to use 95% VaR to estimate what the largest loss under 95% likelihood. If the portfolio value falls under 95% VaR, we will revisit the portfolio and take action.

Method and steps

·         Generate return matrix for 17 stocks based on the past 3 years adjusted close prices on a monthly basis (ABBV has only 3 years price history); get mean return and standard deviation;

·         Generate excess return matrix for 17 stocks;

·         Calculate variance-covariance matrix based on excess return matrix;

·         Calculate portfolio weights based on the initial market value;

·         Get portfolio variance, volatility and expected return



Our portfolio has 95% VaR of 8.31%, meaning that there is 95% possibility that the portfolio return will not lose more than 8.31% (we are 95% confident that our portfolio won’t lose more than 8.31% of its total value). Therefore, if the portfolio hits the 95% VaR, we will immediately take action to sell some positions.

Though we set 15% stop loss for each stock, the portfolio has the benefit of the diversification effect. The chance of the portfolio losing more than 15% of its value is near zero, as calculated by the VaR formula (where z-score is close to 4).

**15% Stop loss and VaR for individual stocks:**

When we did our stock pitch, we voted on the stop loss and pitch size as well.

Method and steps

·         Calculate monthly return for 17 stocks over last 3 years

·         Calculate mean and standard deviation of the returns for the individual stocks

·         Calculate 95% VaR of each stock





Apparently, the portfolio VaR is way smaller than the individual ones, 8.31% versus a range of -3.86% to 39.24%, which means our diversification works well.

**PERFORMANCE**

Our current portfolio is fully invested in the seventeen stocks.

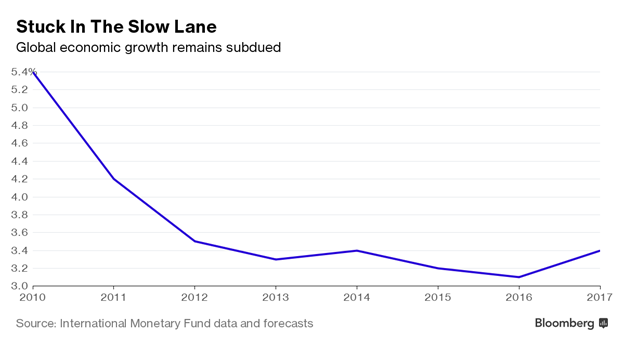
|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Sector** | **Company** | **Value when purchased** | **Value today** | **% Gain or (Loss)** | **Portfolio Weight** |
| Consumer Discretionary | Starbucks | $124,131 | $141,221 | 13.77% | 6.49% |
| Consumer Discretionary | Gentex | $48,878 | $55,880 | 14.32% | 2.57% |
| Consumer Discretionary | Hasbro | $75,116 | $73,463 | (2.20%) | 3.38% |
|  |  |  |  |  |  |
| Consumer Staples | Skechers | $99,965 | $131,348 | 22.50% | 5.63% |
|  |  |  |  |  |  |
| Financials | Citigroup | $76,269 | $88,889 | 8.20% | 4.09% |
| Financials | Citigroup | $49,660 | $48,081 | (1.90%) | 2.21% |
| Financials | Bank of Internet | $135,405 | $111,284 | (17.81%) | 5.12% |
|  |  |  |  |  |  |
| Healthcare | Gilead Sciences | $99,846 | $89,665 | (10.20%) | 4.12% |
| Healthcare | AbbVie | $75,272 | $84,498 | 12.26% | 3.88% |
| Healthcare | Regeneron Pharm. | $99,397 | $105,399 | 6.04% | 4.85% |
|  |  |  |  |  |  |
| Information Technology | Alphabet (Google) | $198,564 | $210,798 | 6.16% | 9.69% |
| Information Technology | Visa | $99,876 | $104,549 | 4.68% | 4.81% |
| Information Technology | Facebook | $151,220 | $159,197 | 5.28% | 7.32% |
|  |  |  |  |  |  |
| Telecom Services | AT&T | $125,381 | $126,778 | 1.11% | 5.83% |
| Telecom Services | AT&T | $49,942 | $53,307 | 6.74% | 2.45% |
| Telecom Services | American Tower Corporation | $100,620 | $120,199 | 19.46% | 5.53% |
|  |  |  |  |  |  |
| Utilities | Entergy | $74,522 | $77,403 | 3.87% | 3.56% |
|  |  |  |  |  |  |
| Energy | Schlumberger Lmt | $150,880 | $140,026 | (7.19%) | 6.44% |
|  |  |  |  |  |  |
| Industrials | Lockheed Martin | $152,180 | $160,850 | 5.70% | 7.39% |
| Industrials | Lockheed Martin | $99,554 | $101,316 | 1.77% | 4.66% |
| **TOTAL** |  | $2,086,677 | $2,175,259 | 4.25% | 100.00% |
| ***Return versus benchmark*** | | |
| **SMF Portfolio (from 09/27/16-4/21/17)** | | **8.16%** |
| **S&P 500 (from 09/27/16-4/21/17)** | | **9.50%** |



**Economic Outlook**

**Global Economy**

The global economy is in a holding pattern according to noted analysts.  Productivity remains weak, as does demand growth.  China is slowing down, and this is further compounded by the fact that demand for its manufactured goods is decreasing.  Going forward, China wants to look inward and become a consumption oriented economy with a robust service industry. It remains to be seen whether the Yuan is strong enough and if people build sufficient spending power for China to become a strong consumption economy.  The European economy is still struggling and the slowdown in China would further hurt any chances of growth because China is an export market for capital goods and luxury cars manufactured in Europe, especially Germany.  The oil price crash and quantitative easing in the EU zone helped in the short run by increasing household incomes, but purchasing power still remains muted.



The US Economy:

The US economic outlook remains stable with annual GDP growth projection at 2.0%.  Further, the US economy is in the midst of its fourth longest expansion since 1850.  This expansion could turn out to be the longest according to an analyst from Market Watch.  The following are several key parameters:

1. Unemployment:

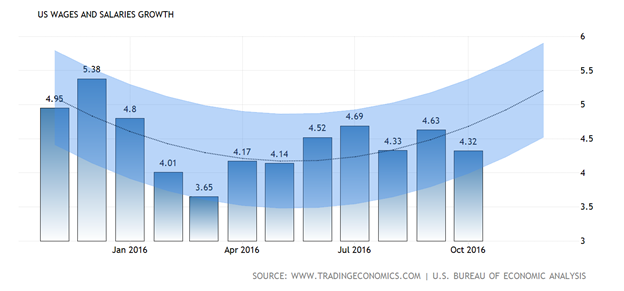
The US economy added 200,000 jobs per month in 2015, which are the strongest figures since 1999.  The unemployment rate has seen a downward trend and no immediate shocks are expected.

1. Interest rates:

The era of super low interest rates may be over. Donald Trump’s economic plan is expected to spur growth by huge increases in investments, mainly in infrastructure.  This investment, along with tax cuts, could lead to inflation and an increase in interest rates.

1. Wage growth:

Wage growth has been muted and this has led to subdued consumer spending. The average hourly wage marginally increased by about 4.32% in October 2016.  Strong wage growth is imperative for robust overall demand growth.



**Global Political Challenges**

The US Presidential election was the most important political event that influenced our portfolio. The election of Donald Trump as the US President has thrown in an element of uncertainty in the economy.  However, this uncertainty has not impacted the market in a negative way. On the contrary, markets have been on an upswing since the election.  Banking and Pharma stocks have surged as these sectors are expected to benefit from loosening up of regulations under a Trump administration.  Much of Trump’s election rhetoric has been focused on an anti-globalization agenda.  This sway towards protectionism and isolationism can lead to the scrapping of trade agreements such as the TPAA and NAFTA.  Brexit was another important political event, and according to political analysts, this could be the tip of the iceberg as more countries may follow Britain in exiting the EU.

The Middle East is still unstable, and it is yet to be seen how the Trump administration will deal with the humanitarian crisis in Syria.  Crude oil prices could be impacted by further complications in the Middle East, especially with Iran and Syria.

**Sector Analysis**

**Consumer Discretionary**

The consumer discretionary sector includes automobiles & components, consumer durables and apparel, consumer services, media and retailing. The sector is considered a coincident to leading indicator of economic activity due to the consumptive nature of the economy.

The American consumer continues to present a mixed picture to us. Wages are starting to rise, but caution still seems to permeate the landscape. However, this may begin to change. Revolving debt, which includes credit cards, has started to rise and bank loans have increased. It can also be seen that online sales are rising while traditional department store sales have been relatively tepid with resulting price competition creating a tough environment. There are several positives for the sector which include:

1. Accommodative monetary policy: The Fed continues to be accommodative which could help support the consumer
2. Improving job market: The US employment rate is low and initial jobless claims continue to indicate further growth in employment
3. Wage growth: Wage growth has improved which should continue

However, there are certain negative factors which counteract the factors mentioned above. There still appears to be a mismatch between candidate’s skill set and those required by companies. Some of the other factors include:

1. Fierce retail competition: Aggravated more by the growing move to online shopping, this appears to be a growing problem for companies in this sector
2. Increase in Fed rates: Higher interest rates could be a hindrance to the consumer discretionary sector
3. Changing consumer: There are recent sales reports that state that consumers, especially millennials, have different spending habits now than they did before the Great Recession

**Consumer Staples**

Although some of the political uncertainty caused by the US election has been resolved, there will still likely to be bumps along the way. The industry has aggressively cut costs and are trying to create more perceived value for customers. The outlook for the US economy continues to be forecasted for decent growth and this could continue to dampen the enthusiasm for the consumer staples sector. Additionally, global growth concerns could begin to fade as foreign central banks aggressively attack sluggish economies, although there seems to be growing skepticism about the effectiveness of those policies. Some of the negative factors for the industry include:

1. Increased competition: Competition continues to accelerate due to the growth of low-cost, emerging market production. This could shrink pricing power in the sector by compressing margins and squeezing earnings
2. Accommodative monetary policy: Numerous central banks are now firmly in easing mode in an effort to simulate the economy which could hurt more defensive stocks

**Energy**

The energy sector makes up $3.57 T of the $21 T S&P 500 by market cap. Two major industries in the energy sectors are Energy Equipment and services ($354.69 B) and Oil, Gas and Consumable Fuels ($3.22 T). The five year CAGR of the energy sector was 2.8% compared to the 13.9% growth in S&P 500. The EBITDA margin of the energy sector is lowest since 2016, possibly due to lower commodity price. Inventory turnover ratio is around 8.8x, which is down from 13.9x in 2014. Low oil prices is an absolute concern for the energy companies. Debt to capital ratio is at all time high of 35%. Interest coverage is 5.8x, down from 21.x in the previous period. We continue to stay cautious on this sector and would stay away from speculating the commodity price movements.

**Financial sector**

We have a positive outlook for the Financials sector, which includes the largest US Banks and Financial services companies. The election of Donald Trump will have a positive impact on these companies. The Dodd-Frank financial reform legislation of 2010 has been blamed for the low revenue growth in this sector including weak lending and trading volumes. There could be a relaxation in banking regulations. In addition, the Volcker rule that prohibits proprietary trading may be relaxed a bit, which could also boost trading in the stock market. The new administration is also likely to take measures to boost investments and increase job opportunities giving a further boost to lending, apart from increased retail participation in financial services and products. The US housing market recovery is stable, even though this rebound has been painstakingly slow due to tightened regulations and lending standards. An increase in interest rate will be indicative of the economy picking up. There may be an increase in M&A activity soon. The sector is not without some risks. There could be increased volatility due to divergence between economies that are growing and economies that are slowing down. Deflationary pressures in the economy may keep rates low which could stress margins in the financial sector.

**Healthcare/Pharma/Biotech**

The long-term factors that make the healthcare sector attractive are: an aging population, rising income with increase in purchasing power within developing economies, and a wave of innovations within biotechnology. Decreasing unemployment is a positive factor for the healthcare services, as employed people utilize healthcare services more frequently. The change in government with a Trump led administration can have a wide ranging impact on this sector. Healthcare services could be negatively impacted if the Affordable Care Act is repealed.

The pharmaceutical industry has been under pressure in the recent past due to increased scrutiny over drug pricing. This pressure seems to have abated with the election of President Trump. Reduced regulation in drug pricing can benefit pharma stocks and biotech. Pharmaceuticals fall under the ‘defensive’ stock category as they are less affected by macroeconomic changes, although individual stocks within the biotechnology space may seem more volatile as the valuations can get stretched due to over optimism in the market about new therapies such as gene therapy and immunotherapy.

**Industrials**

The GICS industrial sector accounts for around $3 Trillion of the total $21 Trillion S&P 500. The biggest contributor per market cap in the Industrial sectors are Industrial Conglomerates ($700 B), Machinery ($618 B), Aerospace and Defense ($579 B) and Road and Rail ($327 B). Industrial sector could be classified into three groups: capital goods (aerospace and defense, building products, industrial machinery), commercial and professional services (commercial printing, office services and supplies) and transportation.

The net income margin of all the three industry groups has increased since 2009, possibly due to lower energy costs. The primary driving force for the industrial growth in is consumer and government spending. The purchasing manager index (PMI), which includes new orders, inventory levels, production, supplier deliveries, and employment is a good indicator of the industrial sector. PMI has been volatile around 50 (below 50 indicated contraction), since 2009. The sector’s earnings growth has exceeded S&P 500 since 2011 by a 3.9%. The inventory outstanding has been significantly increasing since 2006. This may be fueled by the sluggish European economy and slower growth in China.

**Information Technology**

As of July 15, 2016, the information technology sector comprised 20.0% of the S&P 500 and 19.4% of the S&P 1500. The three main industry groups that make up the sector are software & services (i.e., Internet software & services, IT consulting & other services, data processing & outsourced services, application software, systems software, and home entertainment software), technology hardware & equipment (i.e., communications equipment, technology hardware, storage & peripherals, electronic equipment & instruments, electronic components, electronic manufacturing services, and technology distributors), and semiconductors & semiconductor equipment.

The overall outlook for IT services (IT consulting and data processing) is neutral. Healthy fundamentals, along with demand for IT consulting and infrastructure-based services continue to contribute to incremental growth. We also see the proliferation of different methods of transactions (e.g., mobile payments) generating data processing and outsourced service growth. However, we feel that lackluster outlook overseas given recent events (i.e., Brexit) warrants a level of caution.

**Materials**

Materials sector represents 2.9% of the S&P 500 and 3.3% of the S&P 1500, as of May 13, 2016. Materials sector is comprised of 15 sub-industries organized into five industries. The five industries are chemicals (68%), construction materials (4.7%), containers & packaging(12.3%), metals & mining(13.3%), and paper & forest products(1.8%).

From a stock-price perspective, the 11.9% price-decline recorded by the materials sector in 2015 lagged the 0.7% drop in the S&P 500 index. From a profit perspective, as of March 31, 2016, the sector recorded a 5.6% decrease in operating earnings per share (EPS) in 2015, compared with the S&P 500’s 0.6% decline. For 2016, the materials sector is expected to record a 1.5% increase in EPS, versus a decrease of 0.1% for the S&P 500. The sector’s price-to-earnings (P/E) ratio of 17.6x, based on consensus 2016 operating EPS estimates as of April 6, 2016, is slightly above the S&P 500’s forward P/E of 17.3x. The consensus long-term EPS growth estimate for this sector is 10.3% versus the S&P 500’s 10.6%, giving the sector a P/E-to projected-EPS growth rate (PEG) ratio of 1.7x, which is slightly higher than the broader market’s PEG of 1.6x. Finally, the materials sector pays a dividend yield of 2.3% as of May 13, 2016, slightly higher than the yield of 2.2% for the S&P 500.

Revenue growth for the materials sector underperformed the revenue growth for the S&P 1500 during the first quarter of 2016, falling 6.8% from the prior-year period. The materials sector’s gross margin since 2010 had a relatively tight range following a trough of 21.7% in the third quarter of 2009. For the first quarter of 2016, materials sector’s EBITDA growth was -5.7%, lower than the -2.4% EBITDA growth for the S&P 1500. The sector’s EBITDA margin was 17.1%, while the S&P 1500’s EBITDA margin was 18.4%. The sector’s EBIT margin was below the peak at 11.1%, which is 1.4 percentage points below the EBIT margin for the S&P 1500. The net income margin for the materials sector was 2.6% in the first quarter of 2016, versus the 3.2% decline in the fourth quarter of 2009. The net income margin of the materials sector lags that of the S&P 1500. The net income margin of the materials sector was 450 basis points (bps) below the S&P 1500’s net income margin of 7.1%.

Forward price-to-earnings ratio (P/E) is one of the most popular valuation metrics, because it measures an investment based on how it is expected to perform in the future, and not what it accomplished in the past. The S&P 1500 materials sector was valued at 18.4x in the first quarter of 2016, higher than the average of 15.5x since the third quarter of 2009, which represented the period that followed the last US recession. As of the end of the first quarter of 2016, the sector’s forward P/E of 18.4x represented a premium versus its 15.2x historical average since the first quarter of 2005. From the third quarter of 2013 through the first quarter of 2016, the sector was also valued above its historical forward P/E average. The forward P/E for the S&P 1500 was 17.6x at the end of the first quarter of 2016, versus its 10-year average of 14.9x.

The enterprise value-to-EBITDA (EV/EBITDA) ratio has solidly recovered since its trough in 2011, but it is valued at a discount to the market. The materials sector has traded at a discount to the S&P 1500 since the first quarter of 2010.

**Telecommunications**

As of June 17, 2016, the telecommunication services sector makes up 2.8% of the S&P 500 and 2.6% of the S&P 1500. The sector is comprised of three sub-industries. The telecommunication services sector can be separated into three sub-industries, based on the S&P global industry classification standard (GICS). The largest component is integrated telecommunication services, which represents a hefty 94.8% of the total sector. The alternative carrier’s sub-industry represents 4.6% of the total telecommunication services sector, while wireless telecommunication services makes up 0.7%.

From a stock price perspective, year-to-date through June 30, the 21.7% increase for the

telecommunications services sector outperformed the 3.1% rise in the S&P 1500. From an earnings per share (EPS) perspective (as of June 14, 2016), the telecommunication services sector is anticipated to generate 1.7% earnings growth in 2016 (aided by gains from acquisitions), which exceeds the projected increase of 0.3% for the S&P 500. In 2015, the telecommunication services sector’s earnings rose 12.1%, compared with a 0.6% decline for the S&P 500.  The telecommunication services sector is highly capital intensive, as providers need to invest heavily in expanding and enhancing their network. As investments moderate, capital intensity will likely be between 14% and 16% through the end of 2017.

Given the capital-intensive nature of the industry, the telecommunication services sector is likely to remain among the most leveraged sectors within the S&P 1500 market. An ample amount of free cash flow generated within the sector is used toward recurring dividends. We note that share repurchases tend to be less relevant in this space compared with other sectors.

A popular valuation metric, and one that is often used in comparing securities within the

telecommunications services sector, is enterprise value (EV)-to-EBITDA. The EV/EBITDA ratio has stayed at a notable discount to the S&P 1500 since 2009, with the spread increasing in recent years. EV/EBITDA multiples in the industry have remained in a range, with most trading between 5x and 8x on a forward 12-month basis. The valuation for the telecommunication services sector has remained in a tight band of about 5x to 7x. The S&P 1500 has seen much greater multiple expansion over the last six years.

In terms of revenue, the industry grew at an annualized pace of 5%–7% from 2009 through 2014, but it witnessed a notable deceleration to 2% in 2015. The industry has benefited from rising demand for smartphones and the explosion of data growth. However, we expect competition to remain intense and a number of headwinds to hurt sales in 2016.

When looking at a relatively low- or no-growth industry earnings growth trajectory expected for the coming years, P/E multiples appear to be in a range between 11x–13x on a forward 12-month basis.

Since passing the Open Internet Order, various lawsuits and bills have been submitted to overturn the rules. Other legislative battles persist. Several funding house bills were submitted in July 2015 to “defund” the regulation. In March 2016, Republican

Senators Mike Lee of Utah, Ted Cruz of Texas, Marco Rubio of Florida, Rand Paul of Kentucky, and others introduced legislation to repeal net neutrality entirely. Also Mr. Trump won the election and his team criticized net neutrality, net neutrality is likely to prevail domestically, which is a good news to Telecommunications industry.

**Utilities**

We feel that utilities remain a safe and sound choice for income minded investors while being mindful that value is hard to find and available information seemingly captured in most stock prices. Expected electric utility rate increases have benefited revenues in 2016. Rate-case activity has been relatively strong over the past five years, with an annual average of about 57 cases and $2.6 billion in rate increases. S&P Global Market Intelligence expects about 50 cases to be decided this year (21 had been decided through June 30), with a total revenue increase of over $2.2 billion from 2015 (there was a total increase of $425 million through June 30). We also think that the long-term steady decline in allowed returns will likely come to an end this year as interest rates are expected to move higher later this year.

Revenues for electric utilities have been boosted by hotter-than-normal summer weather over the past several years. Year to date through August 13, 2016, cooling-degree-day counts were higher than normal and near last year’s levels. In 2015, cooling-degree-days were 19% higher than normal, and given the warm weather so far this summer, weather-related summer electric usage have remained high in 2016. We expect a return to normal cooling-degree-days in 2017, which will put significant pressure on revenues. Moreover, multi-utilities will likely be hurt by lower gas demand driven by fewer-than-normal heating-degree-days throughout 2016.

We recognize that electric utilities valuations are high, with price-to earnings (P/E) valuations and enterprise value-to-earnings before interest, tax, depreciation, and amortization (EV/EBITDA) valuations well above historical levels. The electric utilities industry has benefited from several years of solid earnings growth and low interest rates. However, rapidly rising interest rates could hurt valuations, as prices would need to drop to make electric utilities dividend yields competitive with fixed income investments.

**Miscellaneous / Other Issues**

In addition to reviewing fundamental and financial analysis of the stocks we pitched, we had been encountering the uncertainties of the presidential election and Fed’s interest rate hike since September when we started constructing our portfolio.

Economic promises of two major candidates during their campaigns differed in many aspects, especially in the sectors of technology, financial services, energy and healthcare. Certain industries could benefit from Trump’s win, but suffer from Clinton’s win. As the presidential race result would strongly impact all business and stock prices, there was no way to invest in securities without being exposed to this uncertainty.

However, as we could not see either Trump or Clinton taking an obvious advantage over the other before voting, any speculation on the election result seemed too risky. We decided to hold a neutral attitude toward the election result. That is, during our weekly pitching, even though we added discussions about the election’s influence on stocks, we still put more attention on the company’s business model and competiveness and reviewed the prices at the time as fair prices.

Regardless of possible impacts brought by the election, only companies with strong fundamental performance and fair prices would be invested in. Take pharmaceutical industry as example. One of the biggest drivers of pharmaceutical business is drug price. As we knew Trump’s victory would not hurt drug prices as strongly as Clinton’s would. The pharmaceutical companies we pitched must have solid fundamentals and bring better-than-S&P 500 performance in the long term even under a pessimistic scenario.

Mr. Trump officially becoming president-elect has implications for all sectors of the economy, from the highly-regulated sectors of health care, energy and financial, to the much less-regulated tech sector that makes most of its parts and products overseas and employs many foreign workers. The trend of prices for stocks in our portfolio has varied by the sector in which they belong. Here is a summary of a selection of affected sectors:

Healthcare

Hillary Clinton was expected to push hard for regulations or price caps, after a series of drug-pricing scandals this year. Biotech stocks are expected to benefit from Trump’s win for the same reason—a less punishing regulatory environment. Besides, as Trump does not insist on repealing Obamacare as he once stated he would, pharmaceutical companies could benefit due to the remaining insurance beneficiary size. Our stocks in this sector (i.e. GILD and ABBV) have been benefiting from Trump’s victory due to the expectation of less intervention regarding pricing.

Financial Services

Banks and other financial institutions are unanimously big beneficiaries of a Trump presidency. New administration is expected to pull back post-financial crisis regulation. Although Mr. Trump, during the campaign, mentioned repealing the Glass-Steagall bill, which had forced banks to separate their retail, commercial and investment banking businesses, this proposal has not been brought up since Trump’s victory. In hopes of a series of deregulations in this sector, the price of our stock in this sector (i.e. Citi Group) has enjoyed a surge under an optimistic atmosphere along with the whole industry since the election.

Technology

During his campaign, Mr. Trump talked frequently of a tech bubble and slammed companies like Apple Inc. for manufacturing their products in China. His trade policy in favor of protectionism is expected to hurt companies that rely on overseas manufacturing and supply chain. Also, some executive leadership from big names like FANG stocks (i.e. Facebook, Amazon, Netflix and Google) were roundly critical of Trump.  Besides, many tech companies are heavy users of the government’s H-1B program for global advanced-degree math and engineering graduates needed to drive innovation. However, new administration could cut or tighten the hiring of international talents.

As a result, Trump’s win has been regarded as bad news for the tech sector. However, on the other hand, Trump’s promise to slash the corporate tax rate may allow some tech players with massive cash holdings overseas to bring cash back. This could benefit shareholders if funds are used to buy back stock and pay dividends. New administration’s impact on the tech sector has not been clear, so our tech stock (i.e. Google) went up and down after a slump along with the whole sector since the election.

**APPENDIX I – Selected Investments**

**Citigroup**

Citigroup (C) is comprised of Citicorp, Citi Holdings and Corporate/Other. Citicorp consists of core banking operations for consumers and businesses, and includes Global Consumer Banking, Securities and Banking and Transaction Services. Citi Holdings contains businesses and assets that the company no longer considers part of its core business, including its Brokerage and Asset Management, Local Consumer Lending and Special Asset Pool units. ICiti Holdings contains a number of businesses and assets that the company intends to exit as quickly as practicable through divestitures, portfolio run-off and asset sales.

The banking industry overall has a pretty positive outlook. The US banking system is dominated by four large banks: JPMorgan Chase, Bank of America, Wells Fargo, and Citigroup—each with assets of well over $1 trillion. US FDIC-insured banks posted net income of $164 billion in 2015, up a healthy 7.4% from 2014. Net income has increased by an average annual rate of 14.0% since the end of 2010, driven by lower loan loss provisions, which made up for weak revenue growth trends over this time period. In March 2015, some of the largest national and regional US banks—such as JPMorgan Chase, Wells Fargo & Co., US Bancorp, PNC Financial Services Group, and KeyCorp—received permission from the Fed to further raise their dividends and/or accelerate their share buyback programs.

Citigroup's total net revenue growth is low, but as the Citi Holdings "run off" portfolio shrinks, total revenue results will improve. We expect Citigroup's total net revenues to fall 6.9% this year, entirely due to Citi Holdings.  Excluding Citi Holdings, we expect flat revenues this year, with 1.0% growth of net interest income. After this "runoff" portfolio shrinks, we expect the revenue, cash flow and EPS to grow steadily. Low interest rates for a longer than expected period is exerting a headwind to revenues. We see strength in trading and investment banking (the Institutional Clients Group), some of which was due to a flurry of activity around the "Brexit" vote. We view credit quality as strong and improving, and see Citigroup's allowance for loan losses being further reduced this year. Metals, mining, oil and gas prices are up, and Q2 provisions to replenish the allowance fell sharply from Q1. For the year, we project provisions for loan losses of $6.1 billion, down from 2015's $7.1 billion, reflecting net charge offs of $7.3 billion in 2015 and our projection of $6.95 billion in 2016. We project EPS of $4.63 in 2016 and $5.13 in 2017. The target price we calculated from DCF model is 61.58, which means the current price is underpriced at 21% discount, while current p/e is also way lower than industry average of 13.

There are three major risks. Citigroup remains on track toward a longer-term goal of strengthening its global presence in consumer and corporate lending, while cutting expenses and returning meaningful levels of capital to shareholders. Higher regulatory and legal costs, and a setback in the U.S. housing market recovery. P/E ratio is below-peer multiples, reflecting C's $23 billion deferred-tax asset and Citi Holdings (3.6% of C's assets), both of which depress C's valuation multiples with respect to peers". This holding has performed very well due to the high expectation of raising interest rate after Trump get elected as President. As mentioned before, low interest rates for a longer than expected period is exerting a headwind to revenues. The change in expectation has a major impact of this thrift of the banking industry.

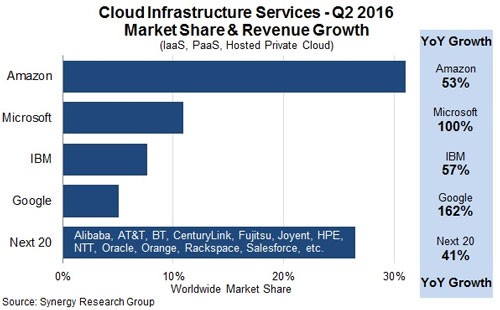
**Alphabet (Google)**

The fundamental outlook for the Internet Software & Services sub-industry for the next 12 months is positive.U.S. online advertising revenues rose 17% in 2013, 16% in 2014 and 20% in 2015, and CFRA estimates increases of 17% for 2016 and 16% for 2017. Corporations are committing larger percentages of advertising budgets to digital formats as people spend more time online and on mobile devices, especially as compared with consumption of other media. Moreover, Internet and mobile marketing offers notable targeting and data-focused return-on-investment capabilities. Mobile has also been driving volumes, and more recently revenues, and we it accounted for over $20 billion in U.S. advertising sales in 2015.

The company’s revenue has increased in recent years at the average rate of 18.9%, The average operating Profit in recent 4 years is 26%, the 4-year average EPS is $19.76 and has increased at the average rate of 13%. Free cash flow increased from $13.3B in 2012 to $16.1 B in 2015. It’s P/E ratio is 30.08, lower than the technology sector average of 35.58. It’s Beta is 1.09, not very risk compare to the market. Alphabet’s credit rating is Aa2 according to Moody’s, pretty safe. This is a growth stock but without significant risks.

Compare to other internet companies, such as Facebook, Twitter, Alphabet’s business portfolio is more diverse. Alphabet’s Google has search, Youtube, Android, Map, Google suits(Gmail, calendar, doc, sheet, slides,etc). Those online services retain the users with Google for longer time and can help Google collect more information of the users, both of which are good for Google online advertising revenue. In addition, adoption of mobile devices, especially smart phones has been increasing, as has usage time on these devices. We have seen Google’s bigger footprint in mobile ads market because of the growing market share of its Android mobile operating system.

Besides online ads revenue, Google has been growing its revenue on Cloud computing business. We can see Google puts a lot of resource and effort to grow its public cloud business. Google has been the No. four biggest player in the Cloud infrastructure Services business. In terms of year-over-year growth, Google enjoys the lead at 162 percent.



Obviously Alphabet is making adequate investments, such as self-driving technology, Virtual Reality, Artificial Intelligence, deep learning, etc. Its AlphaGo software defeated a world champion at Go in a five-game series earlier in March, setting a milestone in computing. We can believe that Google already took a lead place in the AI race. In the VR area, Google laid out different level of products, from the $15 rudimental product “Cardboard” to the $80 middle-level “Daydream View”. Google is also developing more and more VR applications for mobile devices with a purpose to build a specific VR ecosystem.

In the smartphone area, Google released its first smartphone: Pixel. Sales of the Pixel line of smartphones are expected to add $4 billion to Alphabet Inc.’s revenue and $900 million to gross profit in fiscal 2017, according to Morgan Stanley analyst Brian Nowak. It was a good time to release Pixel about 2 months ago. Samsung had a battery problem of its Notes 7 thus recalled this model and cancelled the new sales. Apple announced its financial results for the fourth quarter. The Company posted quarterly revenue of $46.9 billion and quarterly net income of $9 billion. These results compare to revenue of $51.5 billion and net income of $11.1 billion in the year-ago quarter. Gross margin was 38 percent compared to 39.9 percent in the year-ago quarter. The weak financial results was due to the reduction of iPhone sales in China market. Also the consumers and investors are suspicious about Apple’s sustaining innovation capability. At this moment, the market situation is very helpful for Google Pixel to get the market share.

Recently, Facebook admitted its miscalculation of the ad metrics tied to how consumers interact with publishers and marketers. This negative announcement may potentially erode Facebook’s trust and relationship with markers and publishers. This could be an opportunity for Google to expand its advantage in the online ads area as Facebook is the biggest competitors of Google’s online ads business.

**AbbVie**

In our opinion, AbbVie is going to ride on its success with Humira for the next few years. Although the patent on Humira is going to run out by December 2016, the company has declared that it has a strong competitive moat against generics because Humira is not a small molecule drug. It is a biologic, which means that a competing drug has to be a biosimilar. Industry experts believe that it would take at least 3 years for a biosimilar to pass the FDA hurdle. The drug was the highest in gross value sales during last fiscal (2015) at approximately 14 billion USD. The company expects further growth in sales during the current year since the drug is the best in its class for many autoimmune conditions such as Crohn’s disease, Psoriasis, Ulcerative Colitis etc. We purchased this stock considering its intrinsic value, strong cash flows, and qualitative factors such as, strong growth expectations for its blockbuster drug Humira, and a healthy pipeline with drugs in final stages of approval in the anti-retroviral space. The current macroeconomic situation following the election of Donald Trump as the President of the United States, has turned out to be favorable for this stock (and other Pharma/healthcare stocks), as a Democratic victory was expected to be unfavorable for this sector due to expectations of drug price control and tightening of regulations. The stock price has risen post the election and we expect the momentum to continue.

**Gilead Sciences Inc.**

After the launching of its revolutionary HCV (Hepatitis C) medicine, Sovaldi and Harvoni, in 2014, Gilead had been dominating this domain and stock price and earnings had soared as the only supplier. However, as competitors came along, Gilead’s declining stock price in past 15 months has reflected the consequences of increasing competitiveness. Even though Gilead is not dominating the sector as it did, we still think it’s still worth investing in this pharmaceutical due to its solid fundamental and financial performance.

Fundamentals: (1) Unmet demand is huge: 180 million patients are suffering from HCV in the world and GILD still monopolies in HCV treatment with 85% market share. Also, GILD has reached only 16% of the estimated 6.6 million HCV patients in the U.S. and 5 European countries.

(2) Active expansion: Gilead has been entering global or emerging markets like China which has 15 million HCV patients by 2018. Also, after UK high court ruled NHS England (National Health Service) can legally fund new HIV prevention drug PrEP, Gilead is expected to benefit from this verdict.

(3) Product line keeps diversifying: Epclusa, approved in June 2016, is the only pill to treat all six HCV strains. This equips Gilead with new weapon against increasing competition. Regarding HIV medicine, newly released Genvoya has boosted sales in HIV category and offset the declines in HCV.

(4) M&A being underway: Pharmaceutical industry and even Gilead per se are used to leveraging M&A to triggers new growth. Gilead acquired Sovaldi, the company’s flagship product, by purchasing franchise in the first place. When we look into its cash in hand, Gilead has just boosted its debt level by $5 billion, to $27 billion, and has $9 billion in cash. This indicates that the company is waiting for an appropriate target with fair price and ready to merge.

Financial and Relative analysis: (1)  Gilead is having strong and stable margin, cash flow and ROE in the past four years; (2) Gilead’s dividend yield is about 2.5% while the industry wide averaged is 1.16%;(3)  Gilead’s P/E and EV/EBITDA ratio (about 6) are way under the industry’s averaged value (about 14).

Risks: (1) Competing hepatitis C regimens from Merck and AbbVie, are impairing Gilead’s flagship medicine's profit and are giving buyers the ability to negotiate aggressively; (2) Gilead's HIV franchise will see the first important patent expirations in 2018 and 2021, and the firm needs to convert patients to newer products like Genvoya to avoid a significant hit to sales; (3) Results of nine clinical trials will be disclosed by the end of year 2016. If Gilead fails to make it, the disappointment on its effort to diversify product lineup could hurt stock price.

**Starbucks**

Starbucks Corporation retails, roasts and provides its own brand of specialty coffee. It operates over 23000 stores worldwide, with half of them being company owned stores and the other half licensed stores. With US restaurant having a positive outlook and with an increase in consumer spending, Starbucks will benefit from the upward trend of the industry. The main thesis for investing in Starbucks is that we believe it will achieve organic growth through various ways. First, besides serving coffee beverages, the company plans to increase food serving and tea beverage in stores, which will drive traffic and ticket growth in US. In addition, besides traditional stores, companies will open more, such as Starbucks Evenings, Starbucks reserve only store, new drive-through etc to attract more traffic. Second, the revamped rewards program will boost the sales because customers will get more rewards when they purchase more. Third, the initiative of Mobile Order and Pay will reduce the waiting time and increase customer experience. Now the MOP represents 6% of all US transactions in the Q4 2016. Fourth, international expansion is a main strategy in the following years. In the last earnings announcement, though US comps did not reach the expectation with 4%, comps for Americas and China beat expectation with 5% and 6%. In October, Starbucks named its first chief executive officer for China and planned to double its store numbers from 2300 to 5000 in the next five years to 2021. Fifth, it is also engaging in pushing channel development strategy. Two major products, ready-to- drink bottled beverage and single serve coffee are two pillars in this area in expanding into international market. Packaged coffee and food offering will also contribute to revenue. Risks may be embedded in the increase in coffee prices, such as headwind of US dollar index and reverse of consumer spending.

**Gentex**

We have invested in Gentex this quarter seeing long term value in the business. GENTEX was started in 1974 manufacturing fire protection product. The company was founded by its current CEO, Fred Baeur by inventing the world's first dual sensor photoelectric smoke detector. However, currently the major product of GENTEX is auto dimming rearview and sideview mirrors. The company has around 90% market share of auto dimming mirrors, which are mainly used in the Automotive industry. Gentex has also recently launched auto dimming windshields for aerospace. The company manufactures all of its auto dimming mirrors in a highly-automated factory in Michigan. Main customers of GENTEX are automobile OEMs and retail customers. Another major line of business is the SmartBeam technology, a camera based lighting system which optimizes the vehicle's forward lighting environment. In September 2013, Gentex acquired HomeLink from Johnson's Control, thus diversifying further outside the mirror business. HomeLink is the world's most widely used vehicle-based wireless control system. Gentex is planning to launch an integrated toll paying capabilities into the rearview mirror this year. With an eye on mirrorless market, Gentex also developed a Full Display Mirror pipeline, which integrates rear view mirror with the rear-view camera. Gentex has more than 1,000 patents and is currently planning to expand its factory to cater to the growing demand. The company has a consistent history of strong free cash flow and a low-debt balance sheet.

Revenue from automotive accounts for 98% of Gentex's revenue. Auto dimmable mirror accounts for a large portion of the revenue from its automotive products. GENTEX has a market share of around 90% in auto dimmable mirror industry, making it almost monopolistic in the sub-industry. The Kids Transportation Safety Act of 2007 was signed into law in February 2008, which revises federal standards to expand the field of view so that drivers can detect objects directly behind vehicles. In December 2010, the U.S. Department of Transportation proposed rules regarding the required field of view to detect objects directly behind vehicles. The law might further expand the market of camera based rear view mirror giving a significant market share for Gentex's Full HD mirror. However, there is a risk of disintermediation of exterior mirrors as recent research has shown that exterior mirrors can decrease the fuel efficiency.

Light weight vehicle sales are expected to grow just on average 1-2% (in units) in the North America, Japan and Europe (where Gentex has significant exposure). However, global auto dimming mirror penetration is around 25%. Having a market share of around 90% in auto dimming mirror market, Gentex seems to have a lot of scope to penetrate further into the remaining 75% of the total light weight vehicle market.  Thus, there seems to be no immediate threat from market saturation.

Magna, a $ 32 billion company (in revenue) acquired Donnelly on 2002. Donnelly, which was also based in Michigan, was once an arch rival of Gentex following a number of patent suits. There were a lot of speculation, that the acquisition will pose significant threat to Gentex. However, market share of Gentex has in fact increased since 2002. Such a steady growth in the segment, could be attributed to Gentex's existing patents, operational efficiency, management focus on a narrow range of products among others. Thus, we wouldn't expect a significant threat from competition in near term.

Gentex's revenue from its top three clients (Volkswagen, Ford and Toyota) accounts for 36% of its total revenue. That is indeed a risky exposure. However, its dependency on top three clients appears to be decreasing as Gentex is diversifying its business into aerospace (auto dimming aircraft windshield) and other automotive products. Insider trading by Fred Baeur appears to be another concern. However, Fred Baeur (Founder and CEO) has a historical record of trading Gentex stock. Fred, who turned 73 is not a board member of any other company and has devoted almost half of his life on Gentex. We do not see any wrong intention in his insider trading. Gentex's consistent net margin of 15-20% during normal years and a healthy 9% margin during recessionary years shows its business moat in the past. It should be largely due to patent protection (with over 1000 patents) and operational excellence (highly automated, 100% manufactured in US). That said, we do not see a long term economic moat for this business due to patent expiration schedules. Even the best electronic company may not be able to keep abreast with the changing technological needs. However, for the short term (5-7 years) we believe Gentex would maintain its historical profit margin.

An investor overreaction in case of a less favorable results in the next five years is possible. The company has kept a high expectation through its past performance, and any slight negative turn might cause overreaction by the investors. Current earnings yield is around 6%. Conservatively, a 5% of growth on diluted EPS could be expected over the next 5 years. If the earnings yield goes as high as 11% (PE 9) and EPS growth rate is 4%, price will be around $12/share in 2021. That is a downside risk of 33%.  A fair expectation of 10% EPS growth and an earnings yield of 6.67% (PE 15), will bring the price to $ 26/share, an 8% compounded return by 2021.

Driverless car seems to be a risk highlighted in the last quarter investor meeting. We do not see an immediate threat from the advent of driverless cars. Although we believe that driverless cars will take a considerable portion of the auto market, we do not believe that regulators will allow driverless cars without human supervision. Under human supervision, rear-view mirror is a necessity. At the same time, driverless cars could not penetrate the chaotic roads of emerging economies in near future. Gentex is already considering to enter Chinese and other emerging markets, where the light vehicle growth is much larger than the developed markets.

We believe the auto dimmable and full HD mirrors, which is a premium product will be a necessity in future. Last quarter Gentex has launched 21 new nameplates, which is 50% more nameplates than that was launched in 2015. Last quarter, Gentex introduced its Full HD mirror to GM’s new Cadillac. With three more OEMs in the pipeline, GENTEX will have 7 major OEM in the next two years, significantly contributing for its sales.

**Visa Inc. (V)**

Visa Inc. is the world’s largest retail electronic payments network, providing processing services and payment product platforms. This includes credit, debit, prepaid, and commercial payments, which are offered under the Visa, Visa Electron, Interlink, and PLUS brands. Visa hit a transaction volume of $8.2 trillion in 09/16, has 3.1 billion cards, denominated in 160 currencies and relationships with over 16,000 financial institutions. Visa has about 14,200 employees in 107 locations worldwide. Visa accounts for over 50% of overall credit card transactions and an even higher percentage of debit card transactions according to Neilson survey. Key revenue drivers for Visa are:

* Services: Support for client usage of Visa products
* Data Processing: Authorization, clearing, settlement, network access
* International transaction: Cross border processing and currency conversion activities
* Other: License fees for visa brand

Visa grew total revenues 9% in FY 16, and at an average annual rate of 12.3% over the last six years. In FY 15, Visa’s service revenues were up 8.7%, data processing revenues were up 7.5%, international transaction revenues were up 14.2%, while client incentives were up 10.4%.

United States, accounts for over a third of the card transaction volume for Visa. In US credit payment volume grew by 19% in the Q3 and 20% Q4 2016 showing strong growth as economy picks up. As business and consumer spending improve post elections, Visa should be in a stronger position to capitalize on the demand. Debit business could experience pressure from cash substitutes. However, entry into international markets and growth of electronic payments will benefit the industry. Transaction volumes are expected to rise with an increasing trend to move to cashless payments across the globe.

There has been pressure from mobile payment processing applications like Apple pay and Google wallet. Moreover, popularity of Bitcoin from Blockchain is increasing and we are seeing more and more financial institutions and sovereign governments like Dubai endorse blockchain. There is a risk of superior technology killing prevailing moat of Visa but this does not seem eminent. We consider that as a leader in the digital payments market and with an un-matched legal & regulatory framework in over 200 countries, Visa creates a significant barrier to entry for these newer players. Competitors like PayPal, Apple and Alphabet have realized this advantage and have chosen to partner with Visa.

In June 2016, Visa announced the completion of the acquisition of Visa Europe for an upfront consideration of €16.5 billion with the potential for an additional earn-out of up to €4.7 billion. The upfront consideration comprised of €11.5 billion of cash and preferred stock convertible into Visa Inc. class A common stock valued at €5 billion. We consider the synergies of acquisition to provide cost and scale advantage. A 37% increase in client incentives was key growth driver for FY16. Though there is risk of margin growth eroded by increases to incentives, we feel the recent consolidation with Visa Europe should bolster pricing power. The Visa Europe transaction was completed days before the historic BREXIT vote. We feel this has added to the currency and economic growth risk. Finally, Visa has a history of increasing returns to stockholders since it went public in 2008. An active share buyback program with over $7B set aside in 06/16 and $1.4 B dividend for FY16 at 30% growth rate look impressive.