ALAMAR
CAPITAL MANAGEMENT

January 14, 2016

As we expected, equity markets did poorly in 2015. The S&P 500 was down on a price basis and was up a bit over 1% when including dividends. Our equity accounts performed a touch better, up over 2% for the year, net of fees. Since inception in 2010 our accounts are up 14.7% annualized while the S&P500 is up 13%. More interesting is how we achieved these returns. Since inception we have maintained an average cash position of 10% to capitalize on opportunities as they present themselves. We began and ended last year with over 15% cash levels. Due to our aversion to invest in "popular" stocks touted incessantly on business TV channels, we typically have a lower exposure to market gyrations. Our exposure or risk to the market can be measured by a metric known as market **Beta.** A Beta of 1.0 implies full exposure to the overall market. Beta of 0.8 indicates an 80% exposure while Beta of 1.2 implies exposure of 120%. Since inception our Beta has ranged from 0.8 to 0.86 depending on the market benchmark. **Alpha**, the holy grail of investing, is the outperformance over the market adjusting for the risk (or Beta) taken. Our alpha since inception has averaged roughly 5% per year.

We concluded our client note a year ago by stating that "Market valuations are beginning to look frothy to us" (*all our past writings are available on our website*). We reiterate the same sentiment once again and in fact we think it's worse now because investors have piled into a few well-known stocks seeking growth. We will explore this issue and corporate behavior, specifically mergers & acquisitions (M&A), in this note. Our observations on the US economy will also be covered.

ALL ABOARD THE FAMA TRAIN

The market last year was characterized by fear and greed. Fear of the overall market and greed in the success of a few companies. In this note we will call these chosen few: **FAMA.** FAMA stands for Facebook, Amazon, Microsoft and Alphabet (formerly Google). FAMA were the four horsemen that powered overall market returns last year. FAMA represents roughly 7.5% of the S&P500. Without FAMA the S&P500 was down 2% in 2015. Both the Mid-Cap and the Small-Cap markets were down 2% last year. The fact investors rushed into these 4 companies to carry a market of over 3,000 stocks in the US domestic market is amazing and also very troubling. Such over-crowding into a few fashionable names by individual, institutional and hedge-fund investors inevitably leads to tears. There is no one left to buy when the crowd starts to flee.

We have not invested in any of these 4 stocks since we began, not because these aren't good companies, indeed they are, but because they are too fashionable amongst investors of all stripes. Many investors, especially those who invest in passive ETFs that represent the whole market, do not realize that they are part of this crowd. An investment in an S&P500 ETF for instance implies 7.5% of your portfolio is now exposed to FAMA. Our hunting ground has typically been in the small and mid-cap space where we find interesting, albeit unfashionable, well-managed companies generating profitable growth at reasonable valuations.

CORPORATE LOVE-FEST

Lack of investment opportunities is inducing corporate CEO's into a veritable merger mania. Wall Street investment bankers and lawyers are greasing the wheels promoting all kinds of nonsensical deals. Last year was a record year in signings of corporate mergers & acquisitions (M&A). Global M&A hit an all-time high with $4.8 Trillion of deals announced in 2015, 16% more than the previous peak in 2007. The US led with almost $2 Trillion in announced mergers, up 40.6% compared to 2014.

Pfizer's deal to buy Allergan for $200 Billion was the largest acquisition announced last year. It is also the largest transaction that Pfizer has ever done and the largest deal in the history of the pharmaceutical industry. Pfizer is no stranger to making large acquisitions and, in fact, the company has built its existing drug pipeline largely through acquisitions. Therefore, it is informative to look at Pfizer's acquisition history to determine if any value has been created for its shareholders through all this deal-making.

We begin the analysis from the year 2000 when Pfizer began its large acquisition strategy with the purchase of Warner Lambert for over $112 Billion. Since then the company has completed another $154 Billion of purchases with notable ones including the acquisition of Pharmacia for $57 Billion in 2003 and Wyeth for $66 Billion in 2009. The company has also disposed of businesses such as its infant nutrition business to Nestle in 2012 for roughly $12 Billion and spun-off Zoetis to shareholders in 2013. The entire company was valued at $200 Billion at the end of last year. At the end of 1999 the company was valued at $75 Billion. With all these numbers the math is pretty straightforward to evaluate whether the management team of Pfizer has been effective in pursuing growth through acquisitions. Start with a company worth $75 Billion, add $266 Billion through deal making, subtract $53 Billion for selling stuff and shareholders should be left with $288 Billion ($75 + $266 - $53). However, the company is only worth $200 Billion now. Where did the missing $88 Billion of value go? Table 1 below depicts all these statistics.

Table 1: Pfizer's M&A acumen

Starting Value of Pfizer at the end of 1999	$75 Billion
Acquisitions since the end of 1999	$266 Billion
Businesses sold/spun-off	$53 Billion
Current value of Pfizer	$200 Billion
Value destroyed through M&A	$88 Billion

Source: Company Reports

Management teams are fond of making grand pronouncements when they announce large deals. There is talk of synergies on both the revenue and expense side and how shareholders will benefit from long-term value creation. The enablers, investment bankers from Wall Street and consultants, who propose these deals produce wonderful PowerPoint slides of the magic being created and earn their large fees upfront despite the inevitable destruction of shareholder wealth. We have no doubt bankers were very busy last year proposing many deals that looked very good on a slide presentation. We also have no doubt most of these deals, especially the large ones, will end in shareholder value destruction once the dust settles. In the Pfizer/Allergan transaction much talk was made in the press about the so-called tax synergies Pfizer would generate by relocating to low-tax Ireland. Perusing the foot-notes of Pfizer's annual report shows the company's tax rate is already fairly low. For example, last year the company paid $2.1 Billion in actual taxes on $12.2 Billion in pre-tax income for a 17% tax rate. It is doubtful the company can lower these rates much further even after moving its corporate domicile to Ireland.

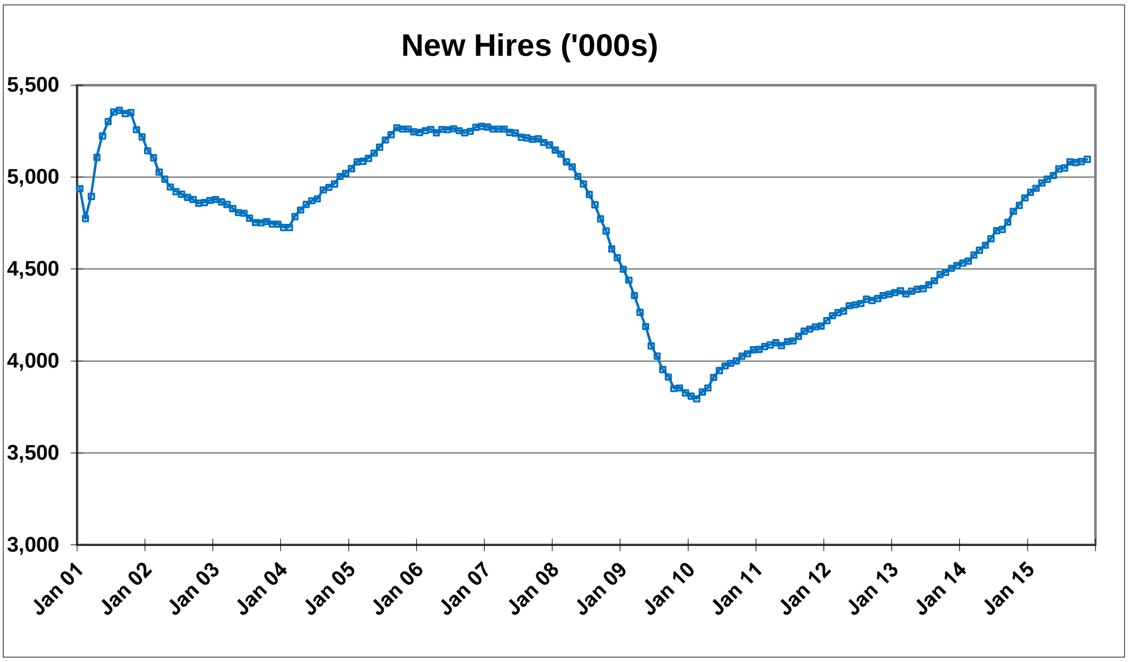
US ECONOMY

The economic malaise that began in the oil patch at the end of 2014 has begun to percolate into other sectors of the economy. Weak oil prices has extended to other commodities such as copper, iron ore, corn, soybeans, wheat, cotton, pork and chicken. Deflation in the commodity sector is now widespread. Even Gold and Silver were not spared, both declined over 10% last year. The strengthening dollar particularly against the Canadian dollar and the Mexican Peso has weakened exporters, particularly in the manufacturing sector. We suspect the domestic manufacturing sector is now in a recession.

The primary culprit for the weakness here and abroad is China. The Chinese, in order to ameliorate the effects of the Great Recession of 2008/2009, went on a massive, debt-fueled investment spree. It is now time to pay the piper and experience the consequences of this mal-investment. The excess capacity built up in many sectors of the Chinese economy will inevitably lead to deflation in Chinese production. The negative effects emanating from China are filtering to other economies particularly those with close trading links such as Australia, Brazil & Malaysia. We discussed much of the issues we see in China in our Q3 2015 writing.

The most important question, in our mind, is whether the weakness in the domestic energy & industrial sectors will spill over to the overall US economy. So far, we have not observed a material weakness in the consumption patterns of the US consumer. Despite the turmoil around much of the world and the weakness in certain sectors of the domestic economy, the US consumer continues to spend, albeit at a modest rate. Will the weakness in the equity markets affect consumer spending through the wealth effect? This is something we will be watching closely in the coming months. Since the bottom of the recession in late 2009, hiring has picked up pace and is almost back to prior peaks. **Figure 1** below charts the progress of hiring over the last decade. As seen from the figure, despite the substantial economic headwinds, hiring has continued at a steady pace since 2010 and if this continues the US consumer will probably keep spending. However, if hiring falters then all bets are off.

Figure 1: New hires



Source: *BLS*

CONCLUDING THOUGHTS

After lowering rates and stimulating the economy for almost a decade the Federal Reserve has finally begun to raise rates. This tighter monetary environment, combined with weakness in countries' economies such as China, Japan & Brazil and a downturn in the energy and industrial sectors is a cause for concern. Investors fled this uncertain environment and took shelter in a few, high-profile momentum stocks last year. We did not engage in this behavior because it looked like a crowded trade to us. It is difficult to leave when the sentiment turns and there is a mad dash to the exits.

Growth in profits is difficult to come by and corporate managements have resorted to acquisitions and financial engineering to show growth in earnings per share. Such gimmicks have a short life span and companies will eventually have to produce sustainable, organic growth. Similar to a year ago, we continue to be cautious deploying capital in this environment and are maintaining a healthy cash reserve. As in the past, we hope to deploy these reserves quickly once opportunities present themselves.

Thank you for your continued trust and confidence in Alamar Capital Management.

Sincerely,

George Tharakan, CFA
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Disclosures

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