

## Total Asset Partners Year End Review

January 2017

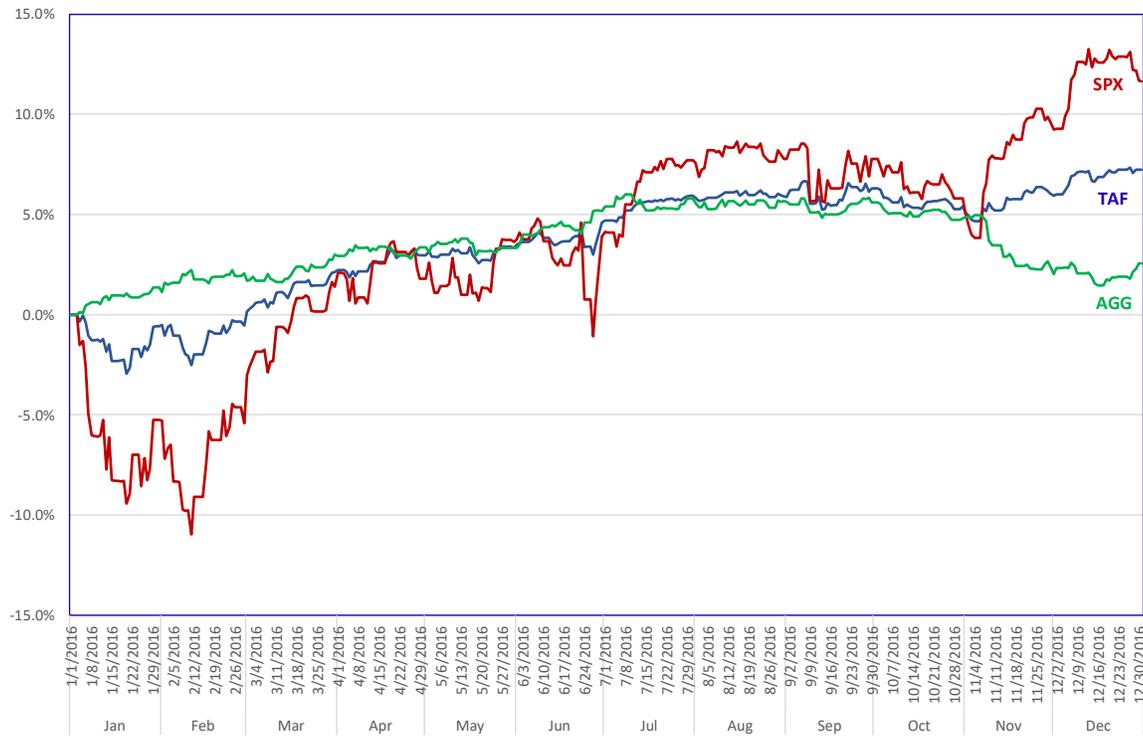
For the year 2016 our Total Asset Partners portfolio returned 7.53% gross, 6.34% net. Returns for the year reflected a solid contribution from our equity portfolio that offset losses in municipal bonds, which took the biggest hit when fixed income markets sold off after the election. Returns for the fourth quarter came in at 0.83% gross, 0.26% net.

We remain focused on providing an attractive and growing level of income with a positive real total return after inflation, taxes, and expenses. As you can see in the chart below, which we introduced in our third quarter letter, our net returns year-to-date have surpassed the Barclay's Total Return Fixed Income Aggregate by 3.7%, have been competitive with the S&P 500, which came in at 11.9%, and posted a real return of 4.24% over year-to-date CPI of 2.1% through December. We have achieved these results with limited volatility month to month.

### Seaport Total Asset Partners

as of December 31, 2016

### Comparative Year-to-Date Returns for Total Asset Partners, S&P 500, and Barclay's Aggregate Total Return



### Politics and Economics

Contrary to expectations in 2016, Brexit passed, Trump won the election, 10-year Treasury yields rose 100 basis points from the end of July, inflation year-over-year accelerated from under 1% to over 2%, and the Chicago Cubs won the World Series! One would expect markets to suffer losses in face of such uncertainty, but the S&P 500, which closed under 6% for the year at the end of October, finished the year up 11.9%. So much for consensus forecasts, including ours!

Over the past 12 months, we have taken a cautious stance in managing our portfolio. Global economic growth has been anemic, valuations expensive, and market liquidity tight throughout the year. Whatever your political views, the results of the election will change the national political agenda and rearrange the various political coalitions in the government. The ultimate outcomes of this regime change are impossible to predict, but we believe they are likely to be positive for growth. A broad consensus appears to be emerging on the need for tax reform, investment in infrastructure, and deregulation—and the Republican party has the levers of power to implement all three.

Investment in infrastructure is a clear and present need. In 2015 some 10% of the 610,000 bridges in the U.S., serving daily over 200 million drivers, were rated structurally deficient. At current levels of maintenance expenditures, it will take almost 20 years to replace them. The American Society of Civil Engineers reports that 32% of our major roads are in poor condition and gives the U.S. a D+ for infrastructure.

Trump has quoted a \$1 trillion target for investment in infrastructure over the next 10 years. With the time required to pass the necessary legislation and clear regulatory hurdles, little of this is likely to occur in 2017, but once the programs are in place, the level of investment could reach 0.5% of GDP, which is a meaningful number in an economy that has experienced growth of just 2.2% since 2009.

On the subject of deregulation, the cost of compliance with federal regulations in 2015 was estimated at \$1.9 trillion according to the Competitive Enterprise Institute's annual survey. The number of pages in the Federal Register, which details every rule and regulation passed by Congress, has almost tripled since the 1970's, and the cost of compliance almost certainly higher today with the regulatory burden of the Affordable Care Act. Small businesses, which account for 50% of all new jobs, are closing at a faster rate than they are opening. Regulation is consistently cited as one of the most significant concerns in surveys of small business owners by The National Federation of Small Business. Any reduction in regulatory compliance can't help but have a positive impact on new business formation and growth.

Two components to the broad based corporate tax reform currently under discussion: repatriation of overseas cash balances and lower corporate tax rates. We don't believe that repatriating corporate cash will increase business investment in the face of limited pricing power and anemic revenue growth. A more likely outcome is the cash will be used to reduce debt and finance share buybacks. Corporate balance sheets and reported earnings per share will benefit, but the impact on economic growth will be marginal.

Unlike repatriation of overseas cash, lower corporate tax rates should support both growth and wages. Among 188 countries surveyed by the Tax Foundation, the U.S. has the third highest corporate tax rate at 35%. Since 2000, most major trading partners of the U.S. have lowered corporate tax rates. While large multi-national companies have the resources and international domiciles to reduce taxes through sophisticated legal structures, this option has not been available to a broad swath of domestic American businesses. The inverse relationship between corporate tax rates, wages, and new business formation has been well documented.

Trump has also proposed lowering marginal rates for individuals while broadening the tax base by eliminating many currently available deductions. In the past, such changes in tax policies have been politically challenging to implement because any tax cut will benefit the wealthy when those with income in the top 20% pay more than 80% of total individual income taxes. However, a tax regime, such as the one outlined by Treasury Secretary Mnuchin that offsets tax cuts for the wealthy with the elimination of deductions and directs the majority of

benefits to the middle class, would be positive for growth since middle class wage earners tend to spend their disposable income while those in the top 20% will save a much larger portion of any incremental income they receive.

Despite what could be highly favorable policies of the new administration, a populist policy of trade protectionism, to which the president appears to be committed, raises the specter of a trade war that could seriously undermine global and thereby domestic economic growth. That does not mean that changes in incentives to encourage domestic production, such as the border adjustments under discussion in the press, might accomplish similar objectives without the adversarial character and consequences of protectionist policies. However, the knock on effects of such policies on the dollar and inflation are difficult to predict and could be highly disruptive.

### **Secular Trends**

Demographics, excessive sovereign debt, and declining productivity have impeded the pace of economic growth and slowed the recovery that began in June 2009. With the decline in birth rates since 1960, the growth of the labor force has slowed dramatically across most industrialized markets as their populations have grown older. It was excessive debt in the private sector to finance a housing bubble that caused the financial crisis and the ensuing recession of 2008-2009. The policies put in place in response transferred significant portions of this debt from private to public balance sheets. At the same time six years of artificially low interest rates have encouraged borrowing, driving private and public debt to record levels.

To reduce real debt burdens, central banks are likely to keep interest rates low and tolerate higher inflation. A strong U.S. dollar from higher rates would threaten domestic manufacturing and employment, creating political risk in the current populist environment. Statements from the Fed to let the economy run hot should be taken seriously, which suggest the Fed will tolerate higher inflation rather than put any economic expansion at risk with higher interest rates.

Over the next several years, deflationary forces are likely to recede as inflation picks up. The degree to which real growth follows depends, of course, on productivity gains and a successful implementation of the Administration's economic programs. From the perspective of the market, however, there is no trend to take the place of the spectacular decline in interest rates from over 15% to under 2% that occurred over the past 30 years and took fixed income and equity valuations to historically expensive levels. Periods of extreme valuation are followed by periods of low returns. Investors who expect the experience of the past 30 years to repeat itself are likely to be disappointed.

### **Economic Outlook**

After a weak start, domestic growth in 2016 staged a modest recovery over the balance of the year. Real growth came in at 1.6% for 2016 after the fourth quarter fell short of expectations due to a drop in exports. On a positive note, final sales to domestic purchasers, excluding inventories and exports, grew 2.5% in the fourth quarter, up from 2.1% in third.

We believe growth in the US economy this year will fall in the range of 2% to 2.5%. With little slack remaining in the labor market, rising wages should continue to support growth in real incomes and personal consumption. A recovery in the energy sector and in manufacturing after a protracted inventory destocking cycle should support

a modest increase in capital spending. Significant commitments to capital investments, however, will be delayed until the outline and timing of anticipated changes in tax and fiscal policy become clearer.

After several years of false starts, there is a reasonable likelihood we will see two hikes in interest rates this year by the Fed. Meanwhile Libor continues to move higher with the benchmark 3-month rate now over 1% versus 0.61% at the beginning of 2016; the 10-year Treasury yield has risen from 1.78% before the election to 2.36%; and the U.S. monetary base, which has been contracting at over 11% year-over-year since the end of September, is down over 10% since the beginning of 2016. So far, the data does not indicate any significant threat of inflation in the near or intermediate term.

The recession in corporate profits appears to have ended after 5 quarters of negative comparisons. We expect a gradual improvement in revenue growth, but a strong U.S. dollar will suppress pricing power for exports, while profit margins will come under pressure from increased wages, higher cost of energy, and to a lesser extent higher interest rates.

A strong U.S. dollar poses the greatest risk to growth and market returns in 2017. By several measures the dollar appears overvalued, in some cases by as much as 20%. Any appreciation in the dollar poses risks to the domestic economy and the emerging market issuers of dollar-denominated debt. The Federal Reserve recognizes this risk and is likely err on the side of caution in raising rates. Nevertheless, the broad consensus of market commentators expects the dollar to remain strong, if not strengthen, which increases systemic risk from reverses in capital flows should the consensus prove wrong.

### **Portfolio Strategy and Structure**

Expectations for the economy have improved with the election and investors have bid up stocks, sold fixed income securities, and bought the dollar. Unfortunately, new policies that get actually get implemented will have minimal impact in 2017 while debate over trade policy, tax reform, and the budget will likely fuel volatility.

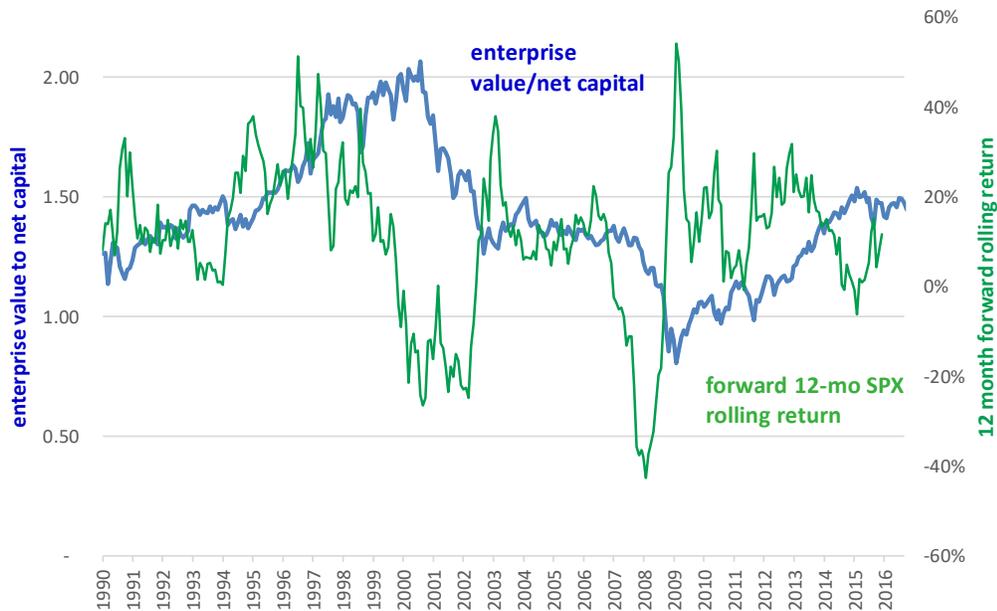
Across the spectrum in fixed income, most asset prices remain distorted by negative real interest rates with a quarter of the global fixed income assets trading at nominal (forget about real) negative yields. In the U.S, equity valuations rank in the 9th and 10th quartiles of virtually every measure of value that we follow.

The chart on the next page, which we introduced in our last quarterly letter, plots enterprise value to net capital and 12-month rolling forward returns for the S&P 500 from 1990 through September 2016. We've chosen enterprise value to net capital as our valuation benchmark because it is based on physical assets and liabilities that can be measured precisely, unlike net income, which includes estimates and other arbitrary assumptions. It is a more stable valuation measure since it can be negative only under rare circumstances. Finally, companies do not trade below their net capital for long periods unless there are significant assets of questionable and hard-to-determine value on their balance sheets. Consider this a simpler version of Tobin's Q Ratio, which measures market capitalization of stock to their replacement value, but requires a vastly greater number of estimates than enterprise value to net capital.

The other element of the chart plots the 12-month forward returns for the S&P 500. In other words, for each point on the chart we've calculated the rolling return for the next 12 months. A comparison of the two series demonstrates the common sense point that lower future returns naturally follow higher valuations.

At the end of December, the S&P 500 closed trading at an enterprise/net capital valuation of 1.51x. As you can see in the chart below, this comes close to the top of the range, leaving aside the elevated valuations that accompanied the telecom internet boom of the late 1990's. We don't consider this to be a tool for market timing, but it is hard to avoid the conclusion that equities are trading at historically high levels.

### S&P 500 Enterprise Value to Net Capital versus SPX Forward 12-month Returns, 1990-2016



Source: Bloomberg, Seaport Investment Management

Against this backdrop, we enter 2017 with a just over a third of the portfolio in equities with a below market beta of 0.91 and above market yield of 3.1%. We have also maintained a defensive position in fixed income, which has limited exposure to rising interest rates with duration of 1.6 and a solidly investment grade average quality, as you can see in the table below.

### Seaport Total Asset Partners

as of December 31, 2016

#### Exposure and Contribution to Gross Portfolio Returns by Asset Class

category	asset class	exposure	beta	duration	yield	rating	gross returns	
							ytd	ytd contrib
Fixed Income	Credit	36.7%	0.09	0.83	2.8%	BBB2	3.61%	1.21%
	Mortgage	8.7%	0.03	3.01	2.4%	B1	4.08%	0.48%
	Muni	4.6%	0.18	5.51	4.9%	BBB1	4.60%	0.23%
<b>Fixed Income Total</b>		<b>50.0%</b>	<b>0.09</b>	<b>1.64</b>	<b>2.9%</b>	<b>BBB3</b>	<b>3.82%</b>	<b>1.91%</b>
Equity	Equity	26.3%	0.94	-	2.3%		14.60%	4.09%
	MLP	3.9%	0.86	-	5.7%		28.16%	0.95%
	REIT	4.5%	0.79	-	4.9%		7.91%	0.33%
	Options	(0.4%)	1.20	-	-		12.98%	0.16%
<b>Equity Total</b>		<b>34.3%</b>	<b>0.91</b>	<b>-</b>	<b>3.1%</b>		<b>15.02%</b>	<b>5.53%</b>
Commodity	Commodity	1.1%	0.14	-	-		6.77%	0.10%
<b>Commodity Total</b>		<b>1.1%</b>	<b>0.14</b>	<b>-</b>	<b>-</b>		<b>6.77%</b>	<b>0.10%</b>
Cash	Cash	14.6%	-	-	-	AAA	-	-
<b>Cash Total</b>		<b>14.6%</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>AAA</b>	<b>-</b>	<b>-</b>
<b>Grand Total</b>		<b>100.0%</b>	<b>0.36</b>	<b>0.82</b>	<b>2.5%</b>	<b>BBB1</b>	<b>7.54%</b>	<b>7.52%</b>

The positions in the table below were the top 15 contributors to portfolio returns in 2016 and accounted for over half of the gross return before fees and expenses of 7.52%. With the exception of the DoubleLine closed end credit and mortgage fund, the rest were high yielding equities from 11 different industries that benefitted from attractive valuations at the beginning of the year. Many of them are positions we have held over several years. Three of them—Brookfield Infrastructure Partnership Units, Macquarie Infrastructure Common Stock, and SJW Corp Common Stock—reflect our longstanding secular focus on companies that will benefit from positions in infrastructure and water supplies.

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#### Top 15 Contributors to Portfolio Returns

security	asset class	industry	exposure	ytd return	ytd contrib
Spectra Energy Common Stock	Equity	Pipelines	1.1%	65.0%	0.55%
DoubleLine Income CEF (DSL)	Credit	Global Total Return	1.9%	30.3%	0.48%
SJW Corp Common Stock	Equity	Utilities	1.0%	65.3%	0.43%
Time Warner Common Stock	Equity	Broadcasting & Cable	0.9%	49.9%	0.35%
AmeriGas Partners MLP	MLP	Pipelines	0.9%	42.2%	0.34%
Xylem Common Stock	Equity	Diversified Manufacturing	0.9%	38.3%	0.31%
Brookfield Infrastructure Ptnrship Units	MLP	Utilities	0.9%	38.9%	0.28%
Republic Services Common Stock	Equity	Environmental	1.0%	31.0%	0.26%
BlackRock CE Bank Debt Fund (FRA)	Credit	US Corporates	1.5%	18.7%	0.25%
Macquarie Infrastructure Common Stock	Equity	Industrial Services	1.0%	25.6%	0.21%
SunTrust Banks Common Stock	Equity	Banking	0.6%	58.4%	0.21%
Seaboard Corp Common Stock	Equity	Food & Beverage	0.7%	38.9%	0.18%
Everest Re Common Stock	Equity	Insurance	0.9%	20.9%	0.17%
Alleghany Corp Common Stock	Equity	Insurance	0.7%	27.1%	0.17%
Ventas REIT	REIT	Real Estate	0.8%	20.2%	0.17%
Total			14.5%	37.0%	4.36%

#### Equities (34%)

Equity exposure, which includes equities, MLP's, REITs, and options, held more or less steady at 34%-35% over the fourth quarter. As a measure of volatility relative to the market, the beta of our equity portfolio increased marginally from 0.87 to 0.91, versus 1.0 for the S&P 500 (the beta for the entire portfolio is 0.35).

To increase our exposure to water utilities and service providers, we added two new positions in the fourth quarter. The first, Consolidated Water Company, operates desalination plants in the Bahamas and several emerging market countries. We believe that operational mistakes in Indonesia have been resolved and that the company is moving steadily towards completion of a transaction to build and operate a large desalination plant in Rosarita Mexico that will supply Baja and San Diego markets, both of which are coping with water shortages. This contract represents a catalyst that would lead to a revaluation of the stock on the back of a substantial increase in earnings. Currently, Consolidated Water yields 3% and trades slightly above book value at a discount to other water utilities.

Our second addition is Econolab, a specialty chemical company that supplies a broad range of chemicals used to purify and process water across a broad range of industries. Econolab should benefit from increasing secular demand for water products and services. The stock currently yields 1.25% and anticipated dividends are expected to grow 6%-8% over the next several years.

To expand our exposure to companies operating or building infrastructure we added Heidelberg Cement and 8Point3 Energy Partners L.P. Heidelberg Cement is positioned to benefit from infrastructure spending in both the U.S and global markets. We believe management's announced strategy to double earnings and cash flow is achievable, even though the stock trades at a discount to its peer group and yields 1.5%.

8Point3 Energy Partners L.P operates solar energy facilities serving residential, commercial, and industrial users. With dramatic increases in solar efficiency and battery storage solar energy is becoming more competitive with other sources of electricity. The stock yields 7% with the potential for low double digit increases in the distribution over the next several years.

#### ***Fixed Income (50%)***

We increased our exposure to fixed income securities in the fourth quarter from 45% to 50% primarily through short maturity bonds to achieve higher returns than we can earn on excess cash balances, which we reduced from 20% to 15%. In a period of rising interest rates, we remain understandably cautious towards investment grade corporate debt. Long term debt issued by the S&P 500 companies has risen 75% since 2010 and leverage ratios have risen to levels that appear excessive at this late stage of the business cycle. The rating agencies have taken notice and downgrades have increased. We continue to manage our fixed income risk actively with a short position in the iShares Investment Grade ETF (LQD), currently at 2.3% of the total portfolio and 24% of portfolio duration. LQD reduces the duration of our fixed income holdings by that amount and limits our exposure to rising interest rates and widening credit spreads.

The incremental yield offered by non-agency mortgage and high yield bonds has narrowed substantially over the past year, and, in aggregate, offers little in the way of returns beyond the current yield. Our positions in these sectors are determined by individual issue selection, rather than a broader allocation to the sectors, which are trading a historically rich levels.

In contrast to mortgages and high yield, which have managed to hold their value, municipal bonds were hit hard after the election. Proposed cuts to individual tax rates would not only reduce the value of the municipal tax exemption, but would also weaken the credit quality of hospitals and states from any repeal of the Affordable Care Act. These concerns drove the ratio of municipal to treasury yield to the highest levels since the summer of 2015.

The biggest factor affecting the magnitude and duration of any move higher in municipal yields may be where corporate tax rates land. At a 20%-25% tax rate, insurance companies and banks, the most significant corporate buyers, would demand higher yields to compensate for lower rates after taxes. The cost to us of the market adjustment to a lower corporate tax rate is less than the capital gains we would have to pay if we sold our municipal holdings. We continue to avoid issuers with substantial unfunded pension obligations while seeking opportunities from potential dislocations in this sector.

We are appreciative of our Seaport clients who share our view of long-term, fundamental, value-driven investing, independent of short-term market moves.

Thank you for your continued trust and support.

Sincerely,

Ben Trosky

January 30, 2017

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