Seaport Investment Management
Registered Investment Advisor

Total Asset Partners Second Quarter Review

June 2016

Most markets remained relatively quiet through the second quarter until June 24, when a majority in the U.K. voted to leave the European Union, an outcome that shocked both media pundits and investors. In the aftermath, equity markets sold off sharply with the S&P 500 down over 5% and Sterling down 30% against the US dollar. Treasury bonds rallied on a global flight to safety, and gold prices rose sharply, up almost 5% at the end of the day. By the end of the quarter, however, U.S. equities had recovered to levels approaching new highs while interest rates plumbed new lows.

Economic Outlook

The Brexit vote raises numerous questions, which ultimately come down to the impact the Brexit vote will have on global trade and economic growth:

- What will be the tone and process for negotiating the many aspects of the separation? Will the EU take an overly stern and counterproductive position towards Britain in order to discourage secessionist sentiment across the EU?
- Will Eurosceptic parties across Europe gain momentum? Will the populist revolt spread to other aggrieved countries in the Eurozone, such as Italy, which faces a constitutional referendum this October that could upend Renzi's government?
- Will the ECB expand its monetary experiment further? Can European banks survive the dual threat of negative interest rates and heightened business uncertainty?

The answers to these questions will unfold over an indeterminate future and add considerable uncertainty to the current economic and market outlook.

Economic performance in the U.S. through the first half of the year has been largely anemic. Continued weakness in manufacturing and exports due to a strong US dollar has been offset by consumer spending on services, autos, and housing. GDP growth of 1.1% in the first quarter is likely to have accelerated to levels approaching 2% in the second, but by most measures 2% GDP growth is not a strong number. Overall economic activity as measured by the Chicago Fed National Activity Index falls in negative territory, which means that economic growth nationally remains below trend. With prospects of accelerating growth in Europe dimmed by the fallout from the Brexit vote, China and the U.S. are the sole engines of global GDP growth and both economies face significant headwinds.

The US economy, in our judgment, appears to be in the late stages of its economic cycle where economic fundamentals are beginning to deteriorate and the risks of recession are rising. There is no definitive evidence yet that the economy is approaching an inflection point, but signs of one are proliferating. The Labor Market Conditions Index has declined every month this year, US banks are tightening credit requirements for homebuilder loans, and monthly auto sales appear to have peaked. Wholesale and retail inventories have seen marginal improvement in the last two months, but remain at historically high levels at the same time that non-defense capital goods orders have been negative for seven months.

In capital markets, the yield curve continues to move in the direction of recession with the spread between 10 and 2-year treasury yields approaching a post-recovery low of 0.85, down from 1.21 at the beginning of the year.

The increasing reliance of monetary authorities on issuance of cheap debt combined with anemic economic growth increases the risk of recession from shocks both minor and major.

In the aftermath of the violent market reaction to the Brexit vote, consensus has emerged among investors that the Fed is less likely to raise interest rates in the face of growing economic and policy uncertainty and that policies implemented by foreign central banks of quantitative easing and negative interest rates will continue.

Artificially low interest rates, in our experience, do not support economic growth, cannot suppress market volatility, and will not elevate asset prices indefinitely. We believe that the massive growth in debt globally has created significant fault lines of risk in the global economy and threatens long-term capital investment and growth in productivity. By favoring growth in asset values at the expense of growth in middle class incomes, it may also be a major factor underpinning the income inequality that has been increasing across the demographic spectrum. The emergence of populist politics in developed markets clearly owes some of its rationale to this trend and adds another element of uncertainty to our outlook.

Markets

We entered the year with a defensive portfolio on expectations of low growth, declining market liquidity, a deteriorating credit outlook, and expensive valuations. Trends of the past six months, if anything, have created a more negative tilt in the balance between returns and risks one must accept to achieve them.

The recent new high in the S&P 500 is hardly a sign of a sound economy. U.S. stocks, Treasury bonds, and the dollar have been taken higher not by an improving outlook for the economy, but by negative interest rates in global sovereign debt markets. The S&P 500 yielding 2.18% compares favorably with 10-year Treasuries yielding 1.47% and 10-year German bunds yielding -0.14%.

Equity valuations, however, remain at historically high levels across most measures of value. S&P 500 companies closed at the end of May with a valuation of enterprise value (equity market value plus net debt) at 10.9 times earnings before interest, depreciation, and amortization (EBITDA, a measure of operating cash flow) according to data cited by the Leuthold Group. This compares to a median of 7.3 times for the 1991-2016 period and ranks in the 100th percentile for the period for which the Leuthold Group has data.

Fixed income markets, meanwhile, have become even more surreal moving into the territory of negative interest rates. Today, an estimated 30% or $13 trillion of sovereign debt trades at negative interest rates. The Swiss yield curve is negative out to 48 years and nearly 80% of German and Japanese government bonds offer negative yields.

This negative interest rate environment imposes a significant burden on retirees, ordinary savers, banks, insurance companies, and pension funds. According to data cited by the Pension and Investments magazine, the funded status of the U.S. corporate pension plans fell 2.1% percentage points in June to 78.1%. The same article also cites a combined pension deficit of $1.5 trillion at mid-year for the top 350 London listed companies.

This unprecedented experiment in monetary policy has severely distorted the market's pricing of risk. A good example is Italy's banking system, which is in dire need of a bailout with an estimated $400 billion of non-performing loans, which is equivalent to about 25% of the country's GDP. Yet, an estimated $1.6 trillion of Italian bonds trade with negative yields and the 10-year Italian government bond yields less than 10-year US Treasuries at 1.21%. We are baffled that any policy maker can think such a monetary policy is a good idea.

Portfolio Strategy and Structure

Total Asset Partners returned 2.52% gross, 2.41% net of fees and expenses, for the second quarter ended June 30. Over the same period returns for the S&P 500 were 2.35% and 2.21% for the Barclay's U.S. Aggregate Bond Index.

Year-to-date through June 30 our portfolio has returned 4.90% gross, 4.66% net, versus 3.82% for the S&P 500 and 5.31% for the Barclay's U.S. Aggregate. The defensive portfolio structure that we have maintained throughout the first half of 2016 has served as a bulwark against the volatility that has buffeted both fixed income and equity markets over the past six months.

Seaport Total Asset Partners
as of June 30, 2016
Exposure and Contribution to Portfolio Returns[1] by Asset Class

						returns	
asset class	**exposure**	**beta**	**duration**	**yield**	**rating**	**ytd**	**ytd contrib**
Equity	24.3%	0.88	-	2.4%		6.83%	1.81%
MLP	2.4%	0.86	-	6.5%		20.93%	0.44%
REIT	4.7%	0.72	-	3.9%		17.28%	0.72%
Options	0.3%	(0.20)	-	-		5.87%	0.08%
Credit	33.2%	0.10	1.24	4.0%	BBB3	1.83%	0.54%
Mortgage	11.2%	0.02	1.79	4.6%	BB3	1.94%	0.24%
Muni	5.1%	0.24	5.65	5.0%	BBB1	11.17%	0.54%
Commodity	1.1%	0.13	-	-		18.14%	0.25%
Cash	17.7%	-	-	-	AAA	-	-
Grand Total	100.0%	0.32	0.90	3.0%	BBB1	4.66%	4.66%

1. Net returns after fees and expenses.

We have changed little in our portfolio this quarter. We have sought to create a structure that will generate positive returns under as broad a range of scenarios as possible, rather than accept more risk in an attempt to achieve higher returns.

Equities *(32%)*

Equity exposure remains towards the low end of our historical range and has a beta of 0.86, a measure of volatility relative to the market, versus 1.0 for the S&P 500 (the beta for the entire portfolio is 0.32). Our security selection seeks companies with strong competitive positions, manageable debt levels, substantial free cash flows, and reasonable valuations. We prune exposures that have grown too large through appreciation, have exceeded our price targets by a substantial margin, or have experienced what we believe to be a negative event in fundamental outlook.

We sold our position in Microsoft after the shares had surpassed our valuation estimates and the company announced the acquisition of LinkedIn, which we believe will ultimately be dilutive. We sold our holdings in Crown Castle when the share price surpassed our valuation estimates by a substantial margin and raised the price risk in the stock to a level where we preferred not to own it. At the same time, we added to our holdings in AmerisourceBergen, Nestle, ABB, Manpower, and National Health Investors, and we recently established a new position in Gilead Sciences, a leading pharmaceutical company focused on treatments for HIV, influenza, hepatitis B and C, leukemia, and lymphoma.

In our option portfolio, we continue to capitalize on heightened volatility through covered options strategies that put us into positions at attractive discounts to fair value and take us out of positions at elevated prices exceeding our estimate of fair value.

Fixed Income & Commodities *(51%)*

We increased exposure in our fixed income portfolio from 45% to 50% in the second quarter with new positions in credit, both as a means to deploy a portion of our significant cash balances as well as to redeploy pay downs in our mortgage portfolio, which is returning capital at a rate of roughly 8% per month. Despite the increase in exposure, overall duration of the fixed income portfolio declined from 2.17 to 1.82, while credit quality remained the same at crossover high yield/investment grade levels of BB+. Including our cash balances, the overall credit quality of our fixed income portfolio remains solidly investment grade at BBB+.

We continue to manage our fixed income risk actively with a short position in the iShares Investment Grade ETF (LQD), increasing the position by 10% over the quarter. With a duration of 9, LQD enables us to reduce the duration of the fixed income portfolio by almost 10% for every 1% invested.

The biggest contributor to returns in our fixed income portfolio has come from our holding of municipal bonds and closed end funds, which have returned 5.9% for the quarter, 11.2% year-to-date, and contributed 40% of the 2.8% our fixed income has returned year-to-date.

Our allocations to commodities, specifically gold, continued to perform well in the second quarter with a return through June of 18%. In hindsight, one always wishes one held a larger position of what performed well.

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
July 18, 2016

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