Your FP/CM

Q3 2016

Table of Contents

Key Investment Takeaways

- ✓ We are still in the midst of a "secular bull market" in equities in spite of a mild earnings-recession since 2014, a narrow trading range, and a quick cyclical bear market in early 2016.
- ✓ The probability of a recession has increased but it is still relatively low.
- ✓ Credit risk has increased and spreads have widened over the past year, but credit conditions remain favorable for the economy. We favor selective opportunities within the better-quality segment of high-yield bonds and lower-quality of investment grade.
- ✓ Political and geo-political risks are high and could have a meaningful impact on markets; however, investors might be over-estimating political risk in the U.S. in the short-term.
- ✓ We believe "Value" can only be properly assessed in relative terms. History is an important guide, but in practical terms, investors can only make investment decisions based on the relative risk-return trade off of the available investment and asset class alternatives. In this context, we believe equities are attractive relative to bonds and other investment opportunities, but expensive when compared to historical data. Stay invested, but with the proper cash-cushion to protect against "tail-risk".
- ✓ Due to record-low interest rates and no earnings growth, investors have favored low-volatility and high- yielding stocks, which has resulted in significant outperformance over the past 2 years. At this time, we believe that these stocks are overvalued relative to the market, and more economically-sensitive groups, and specifically higher-quality companies with durable business models, high free cash flow yields, high net cash and/or low debt levels, positive earnings revisions, and some degree of relative price momentum.
- ✓ The bear market in commodities and energy is in a later-stage. We believe oil prices below $50-60 are unsustainable in the long-term, and we favor building up our energy over the next few months.
- ✓ The U.S. market trades at a premium to other markets thanks to better fundamentals; however, in some cases this premium seems excessive to us, and we will be looking outside the U.S. for investment opportunities.
- ✓ Even though we are positive on equities in the short- and medium-term, we have serious concerns about the economy over the longer-term. Political "populism", extreme expansionary global monetary policies, and fiscal irresponsibility are dangerous headwinds for global economies and equity markets.
- ✓ We continue to be opportunistic and patient, and as always, are keeping an eye on your long-term objectives.

Year-End 2016 Income Tax Planning

VINCENT MARSDEN
Partner, Senior Vice President of Financial Planning

As the holiday season approaches, this is an opportune time to look at possible year-end tax saving strategies. Just remember, before taking any action, review plans with your tax professional, and we are available to assist you as well. Many strategies are complex, and may or may not be well-suited to your individual situation.
Here are some strategies that can be considered:

Realized Capital Gains and Losses Review your current realized capital gain (or loss) position across all of your taxable investment accounts to see whether it makes sense to harvest some unrealized losses to offset year-to-date realized gains (or conversely, to harvest gains to offset realized losses).

Under current tax law, you can take up to $3000 of net realized capital losses against other income on your tax return. However, be aware that you may not repurchase any of the same stocks you sold to realize the loss, for a period that extends from 30 days before, to 30 days after the sale.

Charitable Giving Take care of all remaining charitable contributions that you had planned for 2016. Consider whether it may also make sense to pay this year, some of the charitable contributions that you would otherwise make in 2017. For instance, if it looks like you will be in a higher tax bracket in 2016 versus 2017, then the 2016 pre-payment of 2017 contributions could yield higher tax benefits. Keep in mind that the first choice for charitable gifting should be appreciated securities rather than cash.

Family Giving You may gift up to $14,000 each year (the so-called "Annual Exclusion Amount") to any individual, typically your children and grandchildren, without reducing your Lifetime Exemption from Federal Estate Taxes (currently $5.45M per individual for 2016). The use of the Annual Exclusion can be a valuable tool for estate and gift planning, and married couples can combine their exclusion amounts in order to give up to $28,000 to any individual. Among other things, this approach can be used to fund 529 plans for college education savings for children and grandchildren. Special rules even allow lump sum gifting to the 529's, permitting a one-time gift of $70,000 ($140,000 for a married couple) to 'front-load' each child's plan without incurring gift taxes.

Itemized Deductions Some deductions are permitted only to the extent that they exceed a percentage of your Adjusted Gross Income (AGI), so it generally makes sense to 'bunch' such expenses into one year to get the best tax savings. Opportunities for "bunching" deductions are: (1) medical expenses to the extent they exceed 10% of AGI (7.5% for taxpayers age 65 or older); and (2) miscellaneous expenses, such as legal, accounting, and investment management fees, which must exceed 2% of AGI.

Roth IRA Conversions This can be an effective strategy for many taxpayers. Although the conversion generates current taxable income, future distributions are tax-free, provided they are taken at least five years after the conversion. Another powerful savings and tax mitigation benefit is that a holder of a Roth IRA does not have to take annual Required Minimum Distributions (RMD) after reaching age 70 ½. Roth conversions can be particularly attractive when the stock market has experienced a significant correction, and should also be considered if income tax rates are expected to increase in the future. In addition, the tax arising from the Roth conversion should be paid from your taxable liquidity and not from the IRA account itself.

Alternative Minimum Tax (AMT) The AMT, which now affects millions of US taxpayers, operates parallel to the regular income tax system and requires taxpayers to make an additional tax calculation which subjects regular taxable income to certain adjustments, preference items, and an exemption (subject to phase-outs). The taxpayer pays the higher of the regular tax, or the AMT amount. For individual taxpayers, certain items that are deductible under the regular income tax are not deductible for AMT purposes, such as state and local income taxes and real estate taxes, plus most miscellaneous itemized deductions. There are some limited year-end planning opportunities for taxpayers who are on the cusp between the regular tax and AMT. Taxpayers should have their tax professional prepare an income tax projection to assess their particular situation and determine if any action should be taken.

Procter & Gamble (Ticker: PG)

CRAIG GIVENTER, CFA
Partner, Managing Director, Portfolio Manager.

We have long favored dominant global companies that have strong brands and market share positions. Quite often, these companies exist in the "Consumer Staples" sector, which includes companies that sell products such as beverages, food, and household products. In addition to the defensive-nature of consumer staples companies (how long can one truly defer that purchase of toothpaste!), these companies tend to have very strong brand equities and market share positions, which translate into attractive profit margins and returns on capital.

FPCM owns several consumer staples companies. One such core holding is Procter & Gamble (P&G). With revenues of over $65 Billion across 180 countries, and a stock market capitalization in excess of $230 Billion, P&G is a global behemoth and is the world's largest household product and consumer-care company.

Did you know?

It is estimated that 98% of US households have one or more P&G products in their home.* With such a wide array of brands, including such global franchises as Tide, Dawn, Gillette, Oral B, Crest, Pampers, and Bounty paper products, how many can you find as you look around your home? Just remember, as shareholders you are always encouraged to buy more!

* Byron, Ellen. "As Middle Class Shrinks, P&G Aims High & Low". Wall Street Journal 12 Sep 2011: WSJ.com 7 Sep 2016.

What has been occurring at P&G? Over the past decade, P&G has undergone a massive transformation (as well as a few changes in CEO). In 2005, P&G acquired the Gillette Company, which brought the Gillette, Oral-B, and Duracell businesses into P&G. The Gillette acquisition was a defining moment of the then CEO (A.G. Lafley, 2000-2009), who incidentally was brought back in 2013 after his designated successor was unable to drive growth at the company. In 2015, Lafley was then succeeded by David Taylor, who is the current CEO.

Over the past three years, P&G has embarked on a radical strategy of shrinking businesses, brands, and cost structure; all of which is leading to a more focused, nimble, and profitable company. The company has divested over 100 brands; including the Duracell business acquired in the Gillette acquisition, to a current portfolio of roughly 65 brands. As part of this shrinking process, P&G recently closed on the divestiture of various beauty brands to Coty.

Today's P&G is a more focused company. P&G competes in ten core categories on a global basis. As the company attacks its cost structure by closing facilities and shrinking its headcount, a sizable portion of the cost savings are being reinvested into product innovation and marketing to drive sales growth. By shrinking, the company can grow once again and perform at a higher level

Opportunity & Risks Similar to other consumer staples, P&G is not inexpensive. The shares currently trade at approximately 22x calendar 2017 estimated earnings per share, as the company reinvests heavily back into the business to reset a longer-term growth trajectory. While the company is starting to see accelerating top-line growth based upon recent quarterly performance, the larger opportunity is for P&G to demonstrate a recovery in market share leading to stronger revenue growth, increasing profit margins, attractive long-term earnings growth, and a sizable step-up in the company's returns on capital.

If P&G can deliver on its next stage of growth from a smaller base, we firmly believe that as shareholders, we will continue to be rewarded. The largest risks to our thesis are disappointments related to management execution given the high valuation, competition from new brands especially in emerging markets, and pricing versus competition from private brands.

QuintilesIMS (Ticker: Q)

AMIT FRIEDLANDER
Research Analyst

High quality information businesses, such as Bloomberg, Verisk Analytics, IHS, and IMS Health, tend to own unique, important, and difficult to replicate assets, which establish barriers to entry, relatively low competition, a degree of pricing power, a high percentage of recurring revenues, and high returns on capital.

IMS Health IMS is the leading data provider to the healthcare industry. Its data includes prescription drug sale volumes covering 85% of global drug sales, and historical medical records for 530mm+ anonymous patients. IMS Health's dataset is difficult to replicate because, since its founding in 1954, it has secured 800,000+ data feeds from 100,000+ suppliers. IMS' core data business has a 99% retention rate with its top 1,000 customers.

Ari Bousbib became CEO of IMS in 2010. Prior to joining IMS, he held a series of senior management roles at United Technologies, and we believe that he is a highly skilled leader with a track record of delivering. Facing a saturated market, Bousbib's strategy for IMS has been to grow by building new businesses around its core data franchise. IMS initially did this by building apps, analytics, and consulting services to help clients make sense of the data they were buying.

Quintiles Now, IMS Health is entering the next phase of its growth plan by merging with Quintiles, the largest contract research organization (CRO). Biopharma companies hire CROs to design and execute drug trials.

Industrywide, CRO sales are growing at 7% per year, driven by biopharma's R&D spending growing at 3%-5% per year, and increasing market penetration as drug companies outsource a growing portion of their drug trial efforts. Running a successful clinical trial is one of the largest bottlenecks to getting a new drug to market. As trials become increasingly complex, with drugs targeting increasingly narrow populations, the time and monetary costs of recruiting the right participants (estimated at $300 per participant by a recent government study) has only increased.

QuintilesIMS (Q) The goal of the IMS-Quintiles merger is to use IMS' medical record data to build a better, faster growing CRO business that is able to quickly determine how many patients exist who fit a desired profile (e.g. 65+ non-smoker with lung cancer who has a specific genetic mutation), and where to find them. We believe that this merger will lead to faster revenue, profit, and free cash flow growth, to a degree which is not fully reflected in the current share price.

Risks to Growth

(1) Trading at ~20x next year's earnings, Q's valuation isn't particularly cheap, although this multiple is within the normal range for a CRO or information company.

(2) As in any merger, it is possible that synergies will fail to materialize, and that the combined company won't win any more CRO business than before.

(3) Some 'bears' believe that biopharma R&D outsourcing is already near market saturation, and that the days of 7% industry growth are numbered.

FP/CM Knowledge Corner: Portfolio Risk & Diversification

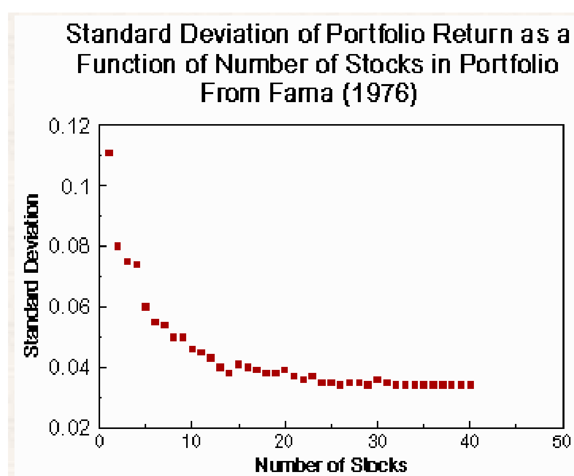
AARON COHEN, Ph.D.
Partner, President, Portfolio Manager,

In this new section of the newsletter we will share our thoughts on financial and economic topics that may be of interest to you. We welcome your ideas, suggestions and questions.

Diversification is both a simple and a complex concept. We intuitively understand it is risky to "put all our eggs in one basket" even if we "watch it closely" as Warren Buffett suggests. However, financial diversification goes beyond basic intuition by dealing with rationality, market efficiency, and equilibrium prices.

According to financial theory, market prices are determined by the trade-off between "risk" and "return"; however, not all "risk" is relevant. The same way a person does not get any reward for going through a train crossing without watching, markets do not compensate investors for risks that could be easily reduced or eliminated altogether. Thus, markets reward investors only for "non-diversifiable" or "systematic" risk. Let us try to illustrate it with a simple example. Assume there are two stocks "A" and "B" in the marketplace trading at the same price, with the same expected return of 10%, but different risk as measured by their standard deviations of 10% and 20% respectively. Our investor owns stock "A" but is considering selling half of his position to invest in "B". Let us look at two extreme cases:

- A & B are perfectly positively correlated (correlation = 1): the "50% A - 50% B" portfolio will have an expected return of 10%, but a standard deviation equal to 15%. This portfolio would have the same expected return as just holding stock "A", but higher risk. A couple of things should quickly catch your attention: (1) our assumptions do not make much sense; if the correlation is one, A & B are identical and should not have different risk levels and (2) under these assumptions, nobody would buy Stock B, which would drive down its price (increasing the expected return) to the point that the risk-return would be acceptable.



- A & B are perfectly negatively correlated (correlation = -1): the "50% A - 50% B" portfolio will have an expected return of 10%, but a standard deviation equal to 5%. The same expected return, but a lower volatility makes this portfolio superior to holding "A".

As you can see in the graph, "diversifying" enables an investor to hold a group of assets that can attain a better risk-reward trade off by reducing (or diversifying away) individual risks. Notice that the key to diversification is "correlation", e.g. increasing the number of positions will not reduce risk, unless their correlation with the existing holdings is low.

At FPCM, we account for diversification within the context of our overall "Risk Management" considerations: asset allocation; security selection; sector diversification; style diversification; geographic diversification; and cash as an investment.

Asset Allocation: Assets types differ in terms of their "liquidity" (how quickly, and at what cost, can an investor buy and sell an asset) and in the structure of the "payout". A security's "payout" can take various forms; such as, (1) "known" payout structures (e.g. fixed income, bonds); (2) "random" cash flows (e.g. equities); (3) "contingent" cash flows (e.g. options); and (4) "speculative", or dependent upon someone else's demand (e.g. gold). Every security can be place into one of these categories or combinations of them. For example, a preferred stock is a hybrid between a bond, stock, and an option. Asset allocation is critical in determining the level of volatility and risk in a portfolio, and investors should consider different asset class allocations; however, we disagree with the idea that investors need to have exposure to all or most assets classes at every point in time. Stocks and bonds are the core of our portfolios, but depending on our outlook and strategy, we could have minor positions in preferred stocks, options (for hedging purposes), gold or commodities. We disagree with the idea of "asset allocators" that clients *always* need to be exposed to most security classes.

Security Selection – Equities: Typically, we hold about 15-20 "core positions" in a portfolio. These could reach up to 6-8% of equities at market value, but usually no more than 3-5% at cost.

Security Selection - Fixed Income: Our bond portfolio is relatively low risk since its objective is to protect riskier or more volatile assets. The bond portfolio can be eclectic from a security type point of view. Depending on market conditions, a bond portfolio could be invested in a combination of Treasuries, munis, mortgage-backed securities, corporates, high yield, or others types of fixed income securities. Each bond's position in a portfolio is contingent upon credit and interest rate risk. The higher the bond's risk, the smaller the position. At the extreme, high-risk, high-yield bond positions (e.g. distress) are considered part of the "equity risk" of the portfolio. Corporate bond positions could vary between 2 - 5% of the bond portfolio, but the position's weight could be higher for US Government or AAA bonds.

Sector Diversification: Even though we do not mimic the S&P 500 or other indexes, we are conscious of managing our sector exposure by making sure we do not unintentionally bias the portfolio in any single direction.

Style Diversification: Our investment philosophy is anchored in buying, at reasonable prices, and under probabilistic scenarios, solid business models, that generate or will generate free-cash flow. At times, our portfolio could resemble more a "value", "growth" or growth-at-a-reasonable-price (GARP) style. Also, because we are very sensitive to the "purchase price", some ideas could be regarded as "contrarian" by the market. Still, and as part of our risk management, we monitor that portfolios are not loaded in the direction of a "style" in a way that would significantly increase the downside risk (e.g. having too many "contrarian", or "momentum" stocks).

Geographic Diversification: Because our clients are mostly US-centered we are more focused in the US than a typical global manager. However, we are opportunistic regarding other regions and markets, and we look into our companies' revenues geographical source to attain a proper geographic diversification level. We believe that in today's global world this is more relevant than diversifying by a company's legal domicile. Typically, 30 - 50% of our companies' revenues are non-US, and about 10 - 25% of the equity portfolio could be direct or indirect (ETFs, funds) in non-US assets.

Tail-risks & Cash as an Investment:

Unfortunately, "correlations" between individual assets and different asset classes are not stable over time, and many times increase dramatically when the markets are in turmoil, exactly when diversification is needed the most. This is why we regard "Cash", understood as readily available cash and Treasury Bills, or other short term high-quality, highly liquid instruments, as an important component of an investment portfolio, and as a critical part of asset-allocation decisions. An appropriate level of cash would allow an investor, beyond covering their regular expenses, to reduce the probability of being forced to sell assets at the "wrong prices", have the flexibility to invest opportunistically and rebalance at lower prices, and protect his/her long-term investments by giving them the peace of mind to maintain a long-term investment horizon at difficult times.

We have to be careful in distinguishing between volatility, as measured by the standard deviation in the example above, and risk. For us at FPCM, this distinction is critical. "Risk" for us is the probability of coming short of our financial goals, being forced to change life-styles because of market conditions, running out of assets earlier than expected, or being forced to sell "good" assets at low prices. Mismanaging "risk" forces the investor to be reactive instead of proactive; to sell because "one has to" as opposed to when "one wants to".

Oil Sector: Half-Full or Half-Empty

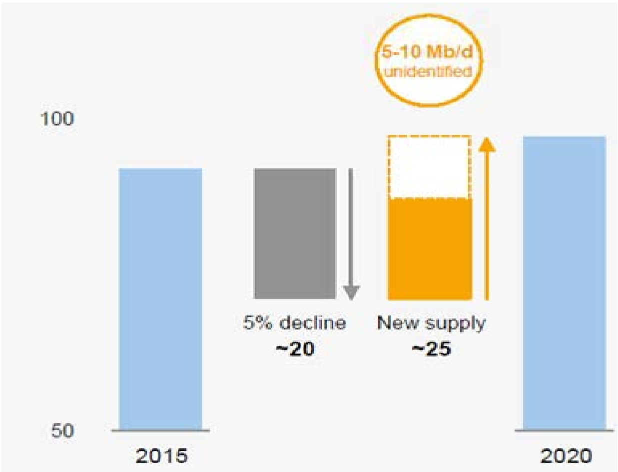
AARON COHEN, Ph.D.
Partner, President, Portfolio Manager,

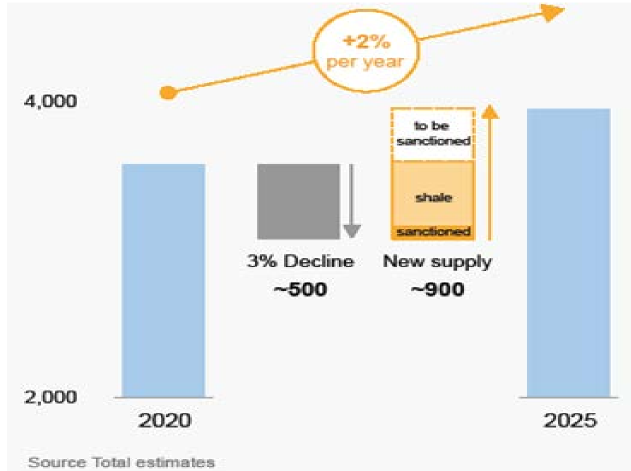
+ **Supply-demand disequilibrium has improved over the past few months.**
+ **U.S. Production is down since 2014, and is unlikely to grow significantly as long as oil prices are below $60 per barrel, and financing opportunities continue to be limited. Less capital equals less drilling.**
+ **OPEC has given indications that they would favor more price stability in the near future. Not surprising given limited surplus, and members' fiscal pressures.**
+ **Long-term equilibrium price is significantly above the current level, as major new development projects are unlikely to be initiated below $65 per barrel.**
+ **Due to high geo-political risk, supply disruptions are expected to recur over time.**

- **Oil inventories are still too high, and it will take some time to work them down. Floating storage has been reduced, but it is still high by historical standards.**
- **In spite of the preliminary agreement reached last month, OPEC supply is likely to rise, as "cheating" has become more the norm than the exception for the cartel. Iraq & Iran continue to increase production, and the Saudis are unlikely to reverse their long-term strategy at this time. Only Venezuela has been calling for a cut in production (by "others", of course).**
- **Highly leveraged U.S. oil producers are under pressure to produce as much as possible and marginal cash cost is still below current price levels.**
- **Crude demand revised down for 2H16 (800 mbd), even though total product demand is flat. India, the bright spot for demand, showing deceleration.**
- **Longer-term technology developments (e.g., electric & autonomous cars) and increased demand for gas could significantly change the growth of global demand for oil.**

Our Strategy: Buy opportunistically when stocks capitalize on oil prices below $55 per barrel. Reduce positions or hedge, when the market capitalizes on prices above $65-70.

Oil & Gas Supply seems constrained in the near future…

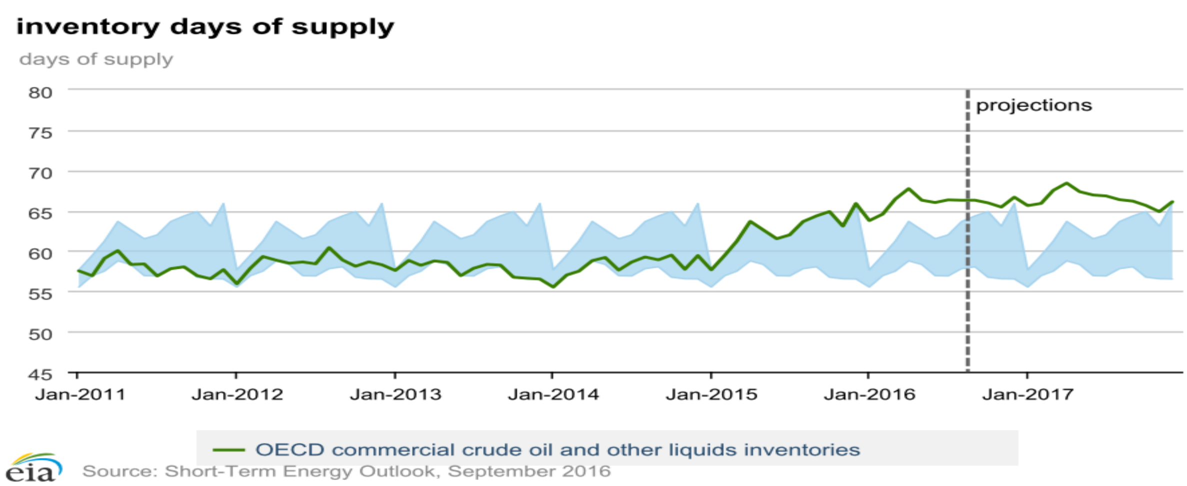




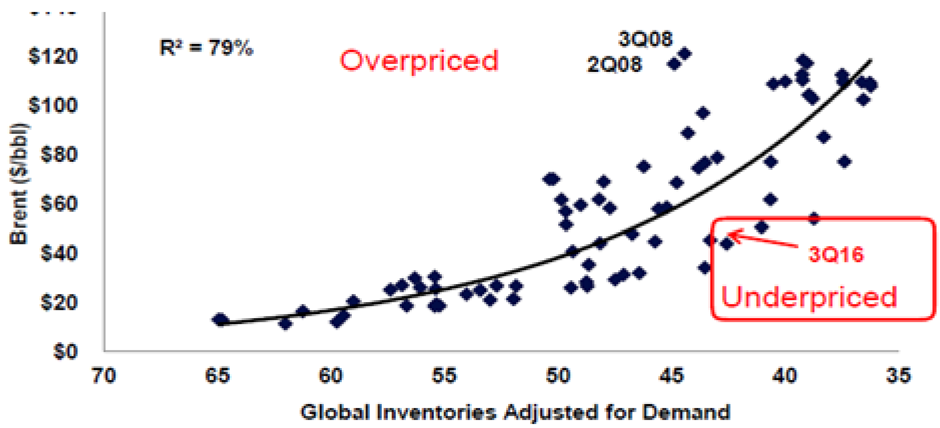
…which should reduce excess INVENTORIES in 2017…

World liquid fuels production and consumption balance

Source: EIA Sep 2016

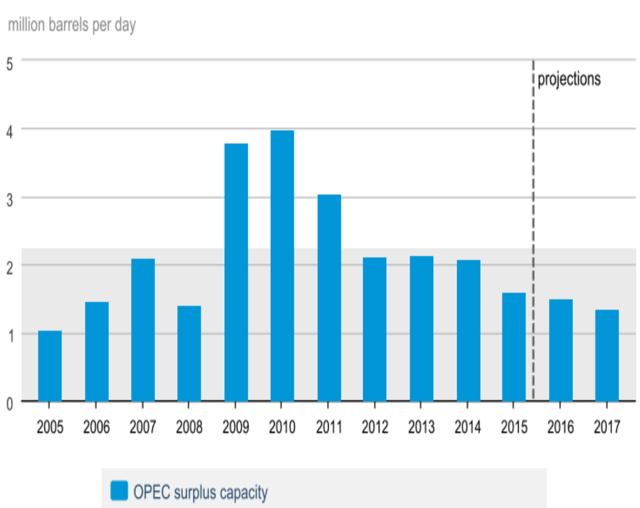


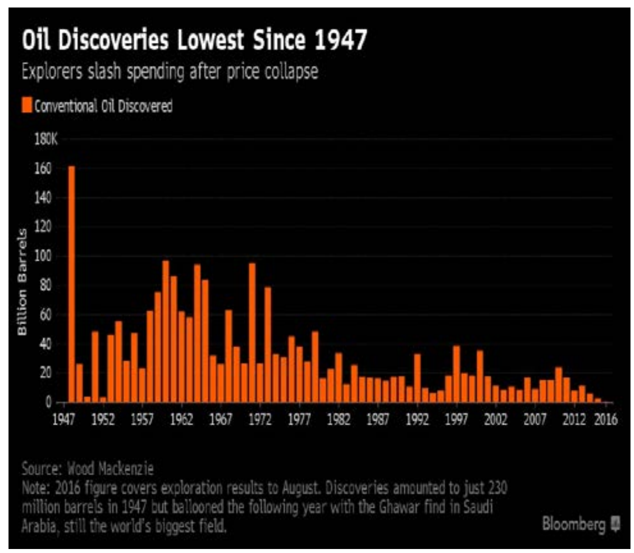
Oil price today seems low even considering excess inventories

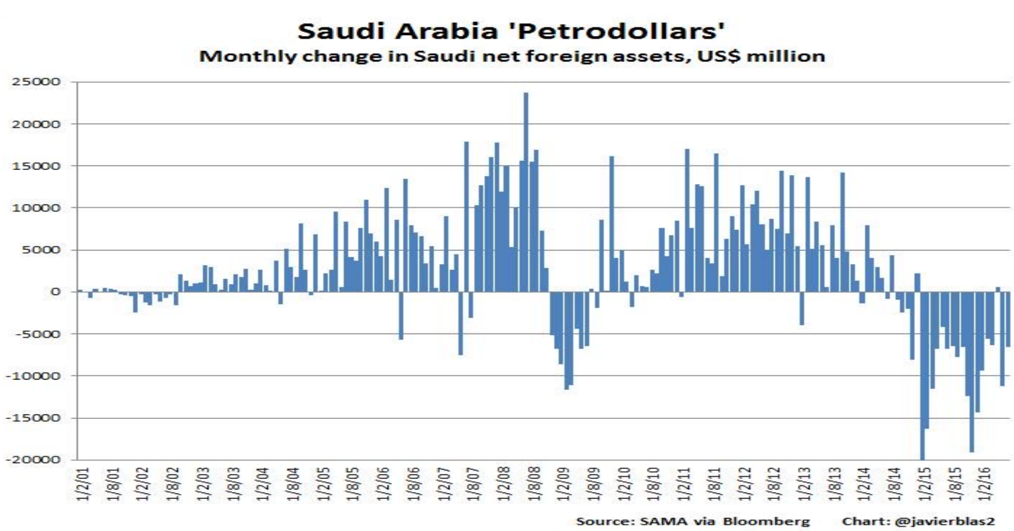


Source: Evercore ISI

Supply growth in the medium-term should be limited by…







Our Investment "Balance Sheet"

POSITIVES	CONCERNS
+ Except for the risk of serious external shocks, it is difficult to foresee another deep recession at this time because the typical down- levers (capital expenditure, auto production, housing, credit) are not over-extended. + Central banks are unlikely to tighten monetary policy aggressively over the next 2 years. + U.S. consumer spending should continue to grow due to increasing employment, a recovery in household wealth, and the end of consumer de-leveraging. + Economic growth in Europe and in Japan, while still lackluster, has improved. Growth is also likely to re-accelerate in emerging economies. + The rate of inflation is expected to remain low in the short- and medium-term. + U.S. Corporate balance sheets are in good shape. Free cash flow is plentiful, return-on-capital is high, and leverage is low. + Slow growth might be exactly what the developed economies can sustain and need at this time: keep inflation tame; keep pressure on consumers and the government to deleverage and increase savings; force firms to remain efficient; and keep speculative tendencies in check.	- The risk of recession, albeit not very high, has increased over the past year. - The global economy, and in particular manufacturing, has slowed down since late-2014. - Earnings revisions have been negative since late-2014. An upturn in earnings is necessary for U.S. equities to move higher. - The Federal Reserve has reversed policy, and further interest rate increases are expected over the next couple of years, albeit at a moderate pace. - The Chinese economy has slowed down considerably over the past 3-4 years, accelerating the decline in commodity markets, and slowing down emerging economies. - Lower productivity, the aging of the population in the developed economies, and low labor participation are important long-term headwinds for global economic growth. - Higher leverage and the drop in oil and commodity prices have placed oil-producing emerging economies in a difficult position. - Inflationary expectations are extremely low. Even a random increase in headline inflation figures could scare the markets and put significant pressure on monetary authorities. - Geo-political risks continue to increase across the globe. - Political "Populism", on the rise across the world, may have major long-term economic consequences. - Valuation: Equity valuations are at best at fair levels.

We hope you have enjoyed this publication. Please contact us with your questions, and with your thoughts and ideas at **contact@fpcm.net**. We look forward to hearing from you!

Thank you for your continued confidence and support.

Your FP/CM Team

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