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Douglass Winthrop

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Dear Clients and Friends,

The first quarter of 2018 was an exciting one for Douglass Winthrop Advisors. We welcomed Pamela Raviol, Diane Scarborough and their wonderful clients into the DWA fold. All of us will benefit from Pam's extensive investment experience and Diane's considerable skills in client service. We are also pleased to have our partner (and Chairman of our Advisory Board) Charles Crane back full-time. Chars has hit the ground running on a number of key strategic initiatives. Our team has never been stronger, and our firm's prospects are bright.

Run Interrupted

The first three months were exciting in the financial markets as well. The year started well enough: Encouraged by the synchronized global economic expansion and the stimulative effect of a large corporate tax cut, exuberant investors lifted the Standard & Poor's 500 Index by more than 5% in January, the 15th consecutive month of positive total returns. While the benefits of the Tax Cuts and Jobs Act of 2017 will vary for individuals depending on their circumstances, nearly all American businesses will enjoy a lift in earnings as a result of the reduction in the corporate tax rate from 35% to 21%. Quarterly earnings reports released in the first few weeks of the year were full of statements about the Act's expected positive impact on the bottom line. Perhaps the most dramatic headline was Warren Buffett's announcement that the new law had lifted Berkshire Hathaway's earnings by a stunning $29 billion, the result of reducing deferred income taxes payable. Growing profits bode well for economic activity, and the outlook remains positive in the U.S. and abroad.

Perhaps too positive. Stocks slid sharply in early February following a jobs report that showed an unexpected increase in hourly wages for American workers. The bond market saw the figures as a long-awaited harbinger of inflationary pressures. Fears mounted that the Federal Reserve, under the leadership of its new chairman Jerome Powell, might raise short-term interest rates too quickly and choke off the expansion. Interest rates rose across the entire yield curve, jarring equity investors from their complacent bullishness. One of the stock market's weakest days coincided with Mr. Powell's first day in office, an inauspicious welcome indeed! At one point, the S&P 500 was down more than 10% from its recent high, its first such correction in almost two years. Some bargain hunters took this as their cue to buy, and for the balance of the quarter the market see-sawed within a trading range. The spike in volatility was so extreme that one exchange traded fund that bet on the continuation of low volatility became insolvent and had to be closed in one day!

While we have no idea whether stocks will rise or fall in the near term, we expect volatility to remain elevated. On the one hand, economic activity is satisfactory domestically and around the globe, and corporate earnings should continue to grow at an above-average rate. Confidence among businesses and the individuals they employ is high. On the other hand, the risk of a global trade war has ratcheted higher in recent weeks as new tariffs were imposed on imported steel and aluminum. Facebook and number of other technology companies have come under increased scrutiny for the way they handle sensitive client information, casting a shadow on some of the market's brightest performers. As long-term investors, we stand ready to take advantage of short-term price dislocations to build positions in great businesses at reasonable prices.

Neither a borrower nor a lender be

With the Fed signaling that additional rate hikes are in store for the balance of 2018 and into 2019, we are reminded of Shakespeare's Hamlet, especially Polonius's warning to his son Laertes about the pitfalls of issuing or buying debt. In previous letters we have cautioned about the high valuation of bonds relative to stocks but conceded that bonds can play an important hedging role in a balanced portfolio because bond prices typically move in the opposite direction of equities. Recently bond and stock prices have been moving together in response to inflation fears, a reminder that owning bonds does not always hedge the risk of owning equities.

We have long believed that owning shares of high quality companies is the best way to protect and to grow wealth. When looking for such companies we keep the other half of Polonius's warning in mind and are wary of firms that are inclined to borrow excessively. Issuing debt for an acquisition or capital project that will lead to predictable future cash flows may be appropriate, but borrowing to buy back shares or to pay higher dividends can put otherwise healthy companies at unnecessary risk. With rate increases appearing more certain, the bill may soon come due for those who have over indulged.

Those that keep their financial houses in order, on the other hand, will be well equipped to thrive in a higher rate environment. TJX, owner of TJ Maxx, Marshalls and HomeGoods stores, is one such company, sporting more cash than debt on its balance sheet. TJX is an off-price retailer; it has a thousand employees whose sole job is to source close-out bargains from over 18,000 vendors around the globe. Its stores attract loyal bargain hunters with prices that average 20%-60% below what can be found on Amazon according to our in-store spot checks. With strong free cash flow and a high return on the capital it invests back into the business, TJX is poised for sales growth at home and abroad and for steadily increasing profitability. Due to the high turnover of closeout goods and the unique in-store experience of hunting for bargains, TJX's business model is difficult to replicate for online sellers like Amazon who are disrupting other traditional retail models. We encourage you to visit one of their locations, enjoy some savings and see why so many shoppers find these stores so appealing.

A debt-free balance sheet is often the hallmark of business that generates lots of cash. Alphabet, the owner of Google, the most dominant internet search provider, generates enviable free cash flow through its high margin advertising business. We believe the global transition of media consumption from cable to digital and internet will continue to fuel a long cycle of advertising dollars moving onto online platforms controlled by Alphabet. While the company uses some of its cash to pursue new technologies which have yet to show commercial viability, its other non-search related businesses such as YouTube and Android prove that Alphabet is adept at using its free cash profitably. Shares of Alphabet have been volatile in recent months due to concerns that its strength in search will lead regulators to label the company as anti-competitive and to take action against it. A number of foreign governments have already levied fines which the company is appealing. We suspect that Alphabet will manage threats while growing its core and non-core business lines, and that negative headlines may provide opportunities to buy shares of this unique and rapidly growing company for attractive long-term returns.

Please call us

We encourage our clients and friends to remain vigilant about the growing threat from identity thieves who attempt to use stolen information to access your financial accounts. Douglass Winthrop invests in sophisticated systems that are constantly being updated to respond to attempted email hacks and other threats. That said, many times the best protection is to conduct sensitive communication over the telephone. For our clients who need to request an unscheduled distribution or change to your account, please give us a call. Our client service team is always happy to hear from you and is ready to help.

Spring is often a time to embark on new adventures. Like a number of our partners, you may be planning a wedding, preparing to send a child off to a new school or considering downsizing as the family nest empties. We hope you will keep us informed of changing circumstances so that we can help plan for your needs. We relish the role of trusted advisor, and we do our best work when helping our clients realize their personal and financial goals. We are grateful for the opportunity to serve you, and we welcome your questions and comments. Thank you for your trust and have a wonderful spring.

Sincerely,

Douglass Winthrop Advisors, LLC