Alley Company Quarterly Letter
Investment Philosophy

October 13, 2015

Periods of market volatility are an excellent time for investors to review their investment program, making sure that it is right for them and that they understand it. Without a program that can be adhered to, market volatility can create anxiety, doubt, and poor investment decisions.

At the heart of a successful investment program is a clear investment philosophy. The definition of an investment philosophy is as follows: a set of guiding principles that inform and shape an individual's investment decision-making process.

At Alley Company, our investment philosophy is to invest in high quality, blue-chip in nature, companies that have proven track records of success and prospects for sustainable future growth. This philosophy is the centerpiece of building investment strategies for our clients. Many other philosophies exist, but we feel that ours is structured to stand the test of time and produce favorable results relative to the level of risk being taken. It's exactly how we invest our own capital.

Examples of other investment philosophies include: 1) a "deep value" philosophy whereby an investment manager will invest in lower quality and/or out of favor companies, and 2) a "momentum" philosophy that invests in companies, typically smaller in size, that are exhibiting rapid current growth. One opposition to these alternative philosophies is that they are inherently "two-decision" in nature, i.e., an exit is already being looked for when the investments are purchased. This approach can increase portfolio turnover, in our view, and hamper long term after-tax investment results.

Investing in blue-chip companies has the added benefit of giving clients comfort in owning great American businesses that in many cases are household names and thus can be understood. But more importantly, we make sure that these companies continue to have dominant market positions, strong financial condition, and astute management teams that can lead them successfully into the future.

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Beyond investment philosophy, is the implementation of an investment strategy which includes the all-important strategic asset allocation decision. This is the decision about how many different asset classes are going to be held and in what proportions. At Alley Company, we simplify this decision to the allocation of assets between equities (stocks) and fixed income (bonds and cash). From there, a client's real estate holdings can also be taken into consideration. The decision should be unique for each client, reflecting their individual objectives and risk tolerance.

We advise against over-diversification and trading in and out of asset classes. Wall Street likes to create asset classes and add them to portfolios in the name of diversification. We, however, see numerous examples of this practice adding complexity, illiquidity, and fees and thus we avoid it. Risk is managed through the quality of our individual holdings and the allocation of our portfolios between stocks and bonds.

The August stock market correction (i.e., more than 10 percent pullback) is normal from a historical perspective. In fact, the average pullback in any given year over the past 35 years is 14.2 percent. The pullbacks in 2010 and 2011 of 16.0 percent and 19.4 percent, respectively, were nerve-racking at the time but easier to live through with a disciplined investment philosophy and an appropriate asset allocation decision.

In the near term, estimates for U.S. gross domestic product (GDP) have softened due to weakness in the energy and industrial sectors as well as the negative effects of a strong U.S. currency relative to international trading partners.

Expectations for corporate earnings have also dipped whereby 2015 earnings per share (EPS) are now likely to be flat with 2014 results. (The energy sector, with profits likely to fall by more than 50 percent, is the primary culprit here.) With that said, the market is always looking forward and current expectations for EPS in 2016 are for growth of 10 percent. At the current index level for the S&P 500, the market is trading at 15.2 times next year's EPS estimates. For reference, the 25-year average multiple is 15.8 times. Also, the dividend yield on the S&P 500 is currently 2.2 percent, in-line with the 25-year average of 2.1 percent. As a proxy for the bond market, the yield on the 10-year Treasury is currently 2.1 percent.

Our investment philosophy has remained unchanged and stood the test of time since we opened our doors in 1998. We don't expect owning high quality businesses in a separate account format to ever go out of style. Nor will managing risk through traditional asset allocation between stocks and bonds.