RITTMANN

Capital Management

Q3 2014 Commentary

I hope you had a nice summer and are enjoying the transition to Fall.

After five years of false starts and hard landings, the United States economy is finally reaching takeoff speed. Revised economic data points to the first quarter results as a one-off, rather than the start of a negative trend.

Economic indicators show that the economy is making broad-based improvement. The economy is strengthening, consumer confidence is picking up, and the job market shifted decisively into higher gear in the third quarter.

Similar to the end of the first quarter, we saw volatility return to the stock market late in the third quarter of 2014 and continuing into the fourth quarter. Geopolitical issues in the Middle East and Russia, the Ebola outbreak in Africa, the pro-Democracy protesters in Hong Kong, and a potential economic slowdown in China dominated the headlines. An economic slowdown in Europe caught a lot of investors' attention, and worry spread if the slowdown would eventually cross the Atlantic to the United States.

Also, market participants have been wrestling with the timing for interest rate increases by the Federal Reserve, and the effects of the Fed ending its Quantitative Easing programs in October.

The Fed is prepping the market for an eventual, and very gradual, rise in short-term interest rates, while keeping a lid on inflation. Even after posting nice gains in jobs, and a unemployment rate of 5.9% in September, the Fed continues to focus on the low labor participation rate figure and the low wage growth figures. Without rising incomes, inflation is less of a concern. That means that although the jobless rate is now at a level at which the Fed might otherwise consider raising rates, it isn't under the gun to do so immediately. Another question the Fed faces is what portion of the labor participation rate reflects cyclical effects (people giving up work) or structural effects (baby boomers retiring). While the Fed continues to deal with such micro-level labor details, we see the big picture as a marked improvement in the labor markets in the first nine months of 2014 and continued gains going forward.

When looking back to 1994 and 2004, (the last two periods when the Fed raised interest rates), once the market anxiety fearing the rate hike subsided, the market experienced significant up trends during both periods because the economy was very strong. This was the reason the Fed increased interest rates in the first place. We expect a very similar market reaction this time as well.

Most of the companies we own are doing well, and have posted better than expected earnings for the second quarter. This trend should continue as they are taking market share and growing at a rapid pace. Some stocks have seen their share prices drop on global worries versus what is going on specifically in the company. Great companies that are early adopters and have disruptive technologies that enable them to take market share are hard to find. So when we find them, we tend to take a long-term view and hold them through market fluctuations. Over time, we will be rewarded for our patience.

The "shale revolution" continues with record domestic oil and gas production. After being one of the leading market sectors for the first half of the year, the energy sector lagged in the third quarter. Crude oil prices dropped to a two-year low, and the energy stocks in our portfolios subsequently lagged the overall market and underperformed dramatically.

There has been a drop in overall global demand for oil. This is a short-term problem and oil will be priced around $100 a barrel in the long-term. Many leading oil producing countries outside the U.S. need crude prices to be at or above $100/barrel to adequately fund their economies and associated social programs. Major exporters, like Saudi Arabia, have the ability to manipulate production in order to raise the price of crude oil. While it was a disappointing quarter for the energy stocks in our portfolios, we remain very confident in our exposure to the overall energy sector.

Last quarter, we introduced the concept of the "Internet-of-Things". These technologies enable machines to communicate with each other to help solve a diverse set of problems. As we continue to investigate this emerging investment theme, one area to look at is the development and proliferation of devices in data-driven medicine. There are apps that look at heart rates, sleep patterns, calorie intake and even "smart" contact lenses that monitor a wearer's glucose level. These apps provide data that is stored and used by doctors. DNA tests also provide troves of data that researchers use to further investigate genetic and molecular level data to help identify positive treatment outcomes. All of these lead to the development of treatments and tailored approaches that are safe and more effective, making sure patients get exactly what they need for better healthcare outcomes. Every large pharmaceutical company in the world is involved in this endeavor. We will continue to explore investing in companies in this booming field.

We continue to be bullish on the market. With an accelerating economy, low global interest rates, and very low bond yields, there is no better place to invest than in the equity markets. The ultimate judge for the financial markets is the performance of the economy. For now, the Fed will continue its path. Accordingly, we expect the underlying strength of the economy and corporate fundamentals to drive equity performance over the long run, despite near-term concerns about the Fed and European central banks actions. We see slow, steady, unexceptional growth going forward.