

Third Quarter 2016 Commentary

The third quarter was a relatively calm one in the financial arena. Between the upheaval caused by the Brexit vote late in the second quarter and the important elections coming up in the U.S. mid-way through the fourth quarter, it appears that the markets took a bit of a breather. Even the Federal Reserve decided to stand pat on any interest rate moves at its meeting in September. Earlier this year, it was nearly unanimous among economic pundits that the Fed would have raised rates at least once by now, but we will have to wait until at least December for that possibility.

After a quick start to the quarter in early July, most U.S. market averages have vacillated in a fairly tight range since then. All told, the S&P 500 Index returned 3.9% during the quarter, and the Dow Jones Industrial Average gained 2.8%, including dividends.

Turnover in Investments Is Not Always Delicious

When most people hear the word “turnover,” their first thought is probably of a warm, flaky pastry with some sort of gooey fruit filling and perhaps a little icing drizzled on top. And now that we’ve typed that description, we’re starting to get a little hungry ourselves. But in investments, the word “turnover” has a much more prosaic meaning: it refers to how often the securities in a portfolio are “turned over.” Perhaps an example is the best way to elucidate the point.

Let’s say your portfolio owns a certain basket of stocks at the beginning of the year, and at the end of the year it holds an entirely different set of stocks. That is, every stock you owned at the beginning of the year was sold—and every stock you own at the end of the year was bought—sometime during the course of the year. In such a situation, your portfolio had turnover of 100% for that year.

Does that strike you as a bit drastic? Think of the headwinds which would be generated by this scenario... capital gains taxes and trading commissions are certainly the two biggest, but others come to mind as well. For instance, the manager of a portfolio that is turned over 100% each year must devote a super-human level of energy to keeping tabs on every security holding. And since we each are allotted just 24 hours in a day, we would guess that there would be a greater chance for mistakes to be made or things to slip through the cracks in a portfolio with 100% turnover.

If you had to guess, what would you say is the average annual turnover for American investors? According to sources like Morningstar, the average actively managed mutual fund has turnover of right around 100%. This pace of activity reminds us of the hare from the classic Aesop fable.

We Are More Like the Tortoise

Inkwell’s average annual turnover has run at about 16% for the portfolios that we manage. That is, at the end of any given year, the average portfolio under our care looks about one-sixth



different than it did at the beginning of the year. Over a period of about six years, then, our portfolios will have completely turned themselves over, on average.

This strategy is quite intentional, because it gives our clients and us a significant leg up. It allows you to experience just one-sixth of the capital gain and trading commission headwinds mentioned above, and it allows us the opportunity to more deeply understand each of the holdings we select for your portfolio.

This Year, We Look More Like the Sloth

But that 16% figure only describes the average level of activity at Inkwel. In the first three quarters of 2016, our annual turnover rate has actually been a little less than half that. From your perspective, what that means is that this year you're receiving fewer trade confirmations from your custodian (Charles Schwab, in most cases) than you would in a normal year. What it does *not* mean is that Inkwel is working any less diligently to take care of your portfolio.

Each day we come to work, we scrutinize the securities held in your account to make sure it still makes sense to hold them, we analyze whether we should be buying more or selling some, and we look at other potential purchases for your account. We do not believe in activity for activity's sake, though, so we will not engage in buying or selling stocks just so that we appear to be earning our keep. We will only act when we believe it is prudent to act on your behalf.

The year 2016 began with a tumultuous January and February, when most stock market averages saw quick declines of about 10% followed by sharp recoveries. Indeed, most of Inkwel's buys and sells this year took place during those volatile months. Since then, however, the stock market has slowly but surely trended higher, with very little volatility along the way. Therefore, we have had precious few opportunities to take advantage of stock market dislocations (of market price relative to intrinsic value), and therefore we have done very little trading in your portfolio.

But keep in mind that just because we are doing less trading does not mean that we are not working as hard. We are always looking for ways to improve your portfolio and, when the right opportunities present themselves, we stand ready to act upon them quickly and decisively. Volatility will return to the market at some point, and when it does we will be prepared for it.

Until then, we hope you will take comfort in the words of Charlie Munger, the billionaire Vice Chairman of Berkshire Hathaway and Warren Buffett's right-hand man for the last 60 years, who has said:

“The big money is not made in the buying and selling, but in the waiting.”

We are grateful that you share that same philosophy, and we thank you for your confidence, support, and especially for your referrals. We are truly honored that you think highly enough of us to brag about us to your friends.



Good News!

Inkwell is thrilled to announce that Felipe and his wife Yanelys welcomed their first child into the world during the third quarter. Victoria Isabel Garcia was born on August 1, weighing 7 pounds 11 ounces. Victoria loves helping her daddy out around the office, so if you notice any drool spots on this report you'll know where they came from.

We look forward to reporting to you again in three months.

Sincerely,

Handwritten signature of Felipe Garcia in black ink.

Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Handwritten signature of Aaron Byrd in black ink.

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC

