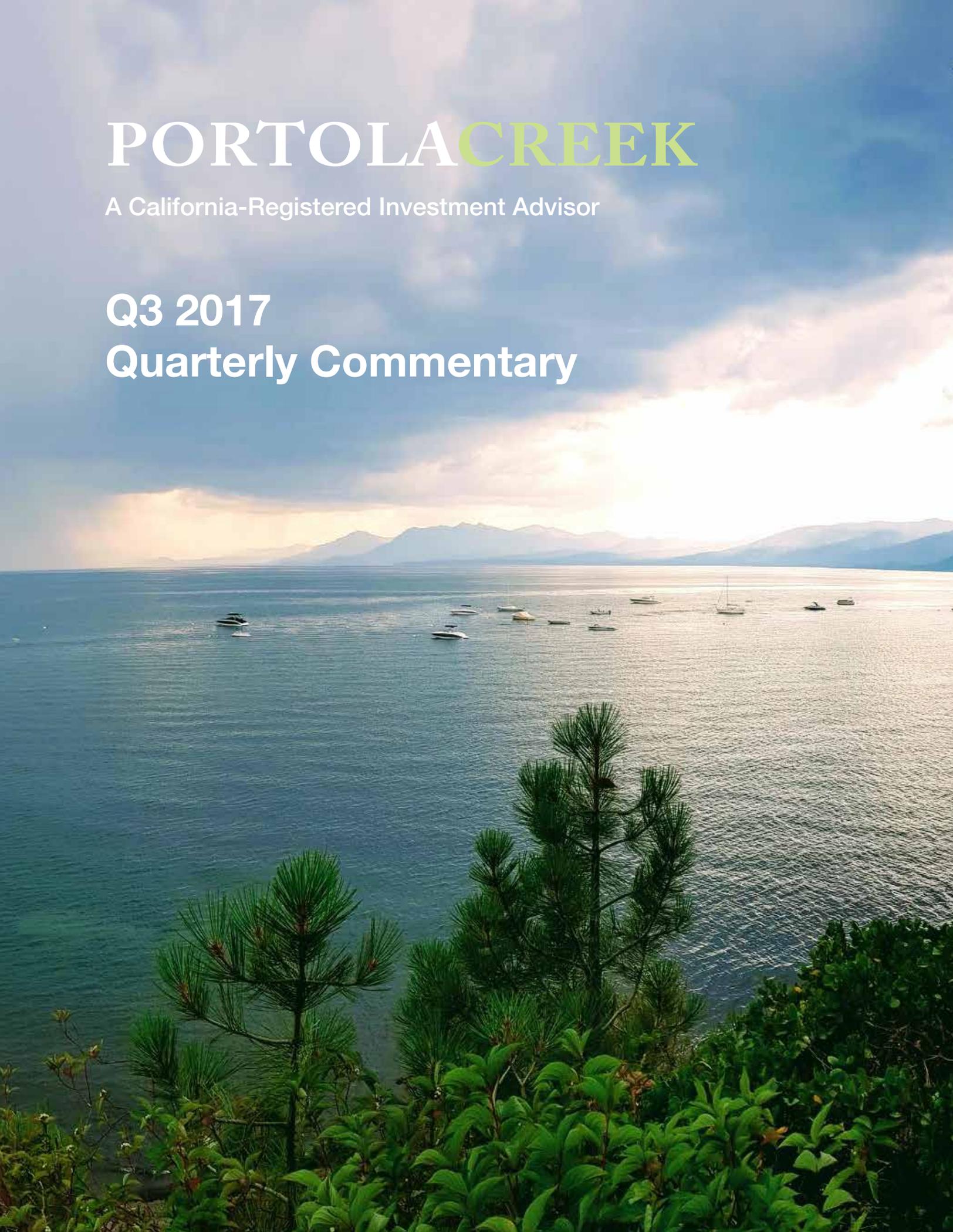


# PORTOLACREEK

A California-Registered Investment Advisor

Q3 2017

Quarterly Commentary



# Updates

## Santa Barbara Office Opened

### Impact Hub

1117 State Street  
Santa Barbara, CA 93101

## App Release

Access your accounts,  
including balances, holdings  
and recent transactions.

Dec 1

We were at:



## SOCAP17

A conference at the intersection  
of money + meaning

Oct 10-13

We were at the  
Alan J. Wyner Annual  
Men's Event for an update on:

**US/World Affairs,  
& the New Geopolitical  
Landscape of the  
Middle East**

See the event online at:  
[medium.com/portolacreek](https://medium.com/portolacreek)

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**Front Page:** Tahoe, California (Photographer - Jeremy Graham)

**Left:** Knapp's Castle, Santa Barbara + Sierra Madre/San Rafael Mountains, California (Photographer - Shaun Hunter)



# Corporate Social Responsibility In Action

North America was wracked by a series of natural disasters this summer. First, Hurricane Harvey slammed into Houston. Then, a massive 8.2 magnitude earthquake erupted in Mexico and Hurricane Irma ran roughshod over the Caribbean and Florida. Weeks later, Hurricane Jose landed on the U.S. East Coast, while Hurricane Maria wreaked further havoc in the islands off our southeast coast, displacing countless individuals from their homes. After that, another earthquake, less powerful than the earlier one, struck Mexico's capital. More recently, we've witnessed inferno-like wild fires in California. Together, these

various tragedies have caused thousands of fatalities and billions of dollars in damages. The devastation they have left behind will linger for some time.

Fortunately, we have seen many individuals, non-governmental organizations (NGOs) and businesses stepping up to provide support and funding for disaster relief efforts. Major companies such as Walmart, Verizon and Amazon, for example, have pledged sizable cash donations. We believe, however, that there are **a number of companies that have taken social responsibility to a higher level, including the following:**



Anheuser-Busch

### Anheuser-Busch

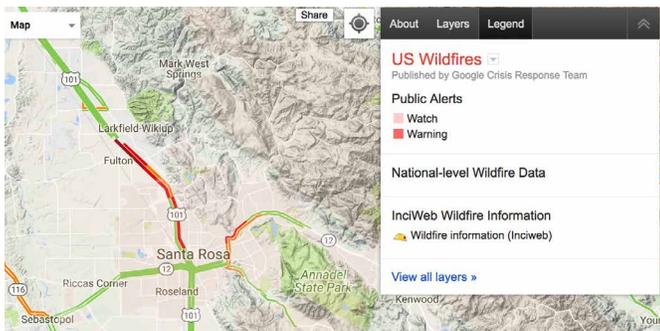
Overall, the company has donated 155,000 cans of water to areas affected by Hurricane Harvey. This effort stems from a longstanding program designed to provide emergency drinking water supplies to those who have been impacted by such disasters. Since 1988, the beverage maker has donated more than 76 million units to U.S. relief efforts.



Fayza A. Elmostehi

### Kroger

This national grocery chain kicked off a social media campaign to drive donations and aid to affected areas. The Kroger Foundation has already committed \$100,000 to the Houston Food Bank, while the company itself is encouraging consumer engagement by donating \$5 for every retweet of the #KrogerCares hashtag, up to \$100,000 in total.



Google

### Google

In addition to a \$2 million pledge, Google has been leveraging what it does best to provide critical, time-sensitive information to those who are in the areas that have been affected by the various disasters. Among other things, the technology company has developed a real-time crisis map to help those on the ground.



Bloomberg New Energy Finance

### Tesla

Tesla is shipping hundreds of power walls to Puerto Rico to help restore electricity to some 3.5 million residents in the territory who have been without power since Hurricane Maria.



Bristol-Myers Squibb

### Bristol-Myers Squibb

The pharmaceutical company's charitable foundation announced that it had provided \$400,000 to support relief efforts related to Hurricanes Maria, Irma and Harvey. The foundation also announced that it was donating \$250,000 to NGOs working on the ground in Puerto Rico.



JetBlue

### JetBlue

The airline's flights into Puerto Rico have been reduced amid the significant damage to air traffic control systems and airport facilities, but many of the flights that have taken place have delivered much needed supplies to the island.



**Lowe's**

Lowe's

So far this year, the home improvement retailer has donated \$2.5 million to fund disaster assistance. This includes \$500,000 recently added to help those who have been affected by Hurricane Maria and the earthquakes in Mexico.



**UPS**

UPS

The logistics and delivery company has sent two of its air freighters to Puerto Rico to deliver ready-to-eat meals (MREs).



**Verizon**

Google

According to media reports, the telecommunications company has pledged \$1 million for disaster recovery efforts associated with this year's hurricanes. In an effort to raise additional funds for the hard-hit residents of Puerto Rico, Verizon has said it will match employees' contributions to hurricane relief-focused NGOs.



**Walmart**

Walmart

The retail giant recently committed \$5 million in support of Hurricane Maria relief efforts. This donation was in addition to the \$35 million in donations, previously announced by Walmart and the Walmart Foundation, designated to support those who had been impacted by Harvey and Irma.

# Quarter in Review

In Q3, the stock market shrugged off a raft of natural disasters, rising geopolitical tensions, and heightened political uncertainty in Washington to end on a positive note for the eighth consecutive quarter. Company earnings have improved and businesses are increasing capital expenditures. So far this year, active management has outpaced its passive counterpart, while investors have remained wary of asset classes other than equities.

***In our view, Portola Creek's Environmental, Social, and Governance (ESG) screening is the best way to discover and evaluate non-financial risk, especially at a time when stock selection appears to matter more than ever.***

The current U.S. administration has released a blueprint for reforms that would reduce taxes for individuals and corporations. However, the process will likely be quite contentious, especially with respect to how the cuts will be paid for, and we do not expect to see a resolution until Q1 2018 at the earliest.

That said, a reduction in the corporate tax rate – a major Trump campaign promise – probably has the best shot of getting passed and, thus, should provide some sort of tailwind to the economy and the stock market. Strategas estimates, for instance, that such a cut could boost S&P 500 earnings by \$5 per share. But the window of opportunity for this administration may be short; the Republicans would likely lose their majority in the House if midterm elections were held today.

## Domestic stocks

Domestic stocks currently have the highest weighting in our portfolios. Sector-wise, tech stocks have witnessed the highest long-term earnings and dividend growth rates, but the group has become rich amid a surge of investment by active managers. Given that, we favor biotechs, which feature attractive median long-term growth rates at half the P/E, as well as industrials and financials, which offer the potential for income growth at reasonable valuations. It's worth

noting that bank stocks, in particular, performed well the last time we had significant tax reform, which was back in 1986. They outpaced the S&P by 10% in the six months prior to the bill being introduced in the House, and another 6% in the lead-up to the House and Senate votes.

## Foreign equity

Foreign equity indices, meanwhile, have outperformed domestic market counterparts. At Portola Creek, our allocations to this segment are developed in collaboration with our research partner, Magni Global Asset Management, whose work incorporates insights on non-financial risk (see "A Peak Inside Our Investment Strategy"). Because there appears to be an inverse relationship between corruption and openness in a country and its economic viability, Magni's research has proven quite valuable to us. According to Sustainalytics, the correlation between a country's ESG momentum and GDP growth is 0.77, indicating that sustainable countries represent attractive places to invest.

## Real Estate

The publicly-traded real estate segment continues to be challenging. Most of the large REITs have significant exposure to the retail sector, which will likely serve as a growing drag on share-price performance and dividend payouts. We have long preferred private real estate investments and remain encouraged by the interest we have seen in the properties we still own.

## Gold

It is a bit surprising, but not unusual, that both gold and equities are faring well. Regardless, we believe our position in the yellow metal is a smart and defensive strategy ahead of a rising interest rate environment. Moreover, it is probably no coincidence that gold rose last quarter amid escalating tensions between the U.S. and North Korea. In sum, we view the metal as a portfolio diversifier and a safe haven against geopolitical instability.



# Investment Outlook

Looking ahead, we remain positive on equities for the near term, largely because of favorable seasonal trends. When it comes to stocks, we are entering the strongest period of the year. Since 1928, the S&P 500 index has risen in the fourth quarter 73% of the time, generating an average return of 2.7%. However, when the benchmark was up through the third quarter, as it has been this year, the fourth quarter subsequently rose 83% of the time, with an average gain of 4.3%.

In addition, the market's strong performance in August and September bodes well for October. Since 1928, the S&P 500 has posted positive returns in both of those earlier two months on 21 occasions; in 81% of those times, performance during the final quarter's first month was also positive, producing an average gain of 2.6%.

Longer term, we are more cautious. Among other things, we expect U.S. unemployment to bottom out in next year's second half, setting the stage for upticks in interest rates and inflation that will likely weigh on share prices. Along with current high levels of investor optimism, this has led us to remain underweight risk in comparison to our benchmark.

Frankly, we find it difficult to reconcile the strong rallies we have seen since last year's election with the various threats looming on the horizon. That said, we believe our ESG screening has given us a leg up with respect to assessing the non-financial risks.

Domestically, we favor the financial and industrial sectors, as noted earlier, as well as selected technology names. In part, this reflects our view that the U.S. economic cycle is ahead of Japanese and European counterparts, which will likely precipitate a continuing shift from domestic to foreign equities in the months ahead. At present, about two-thirds of our foreign exposure is to developed markets, with the balance in emerging markets.

In the real estate market, sellers continue to dominate. Dissuaded by unattractive cap rates and valuations, we have generally passed on the deals we have looked at this year. Nevertheless, we continue to keep an eye out for unique and/or distressed opportunities to invest in private real estate. As an example, we believe that industrial space located near air and sea ports could represent an attractive prospect amid the retail industry's ongoing shift from bricks and mortar to online.

In an environment where cash yields are paltry, bond spreads are historically low, equity valuations are near record highs, and real estate has yet to enter a new bull cycle, it is no secret that investors are searching for additional asset classes to augment their portfolios. Indeed, this was among the key topics we discussed with trusted colleagues at SOCAP last week. Stay tuned for some exciting news on this front in the months ahead.

# A Peak Inside Our Investment Strategy



This quarter we go behind the scenes with our research partner **Magni Global Asset Management.**

**Magni is based in Minneapolis**, a city that ranks third, on a per capita basis, in the number of Fortune 500 companies based there. More importantly, it has long been a hotbed for businesses that believe in treating the environment, their employees, and the community well.



## Portola Creek's foreign equity allocations are largely determined by Magni's country Governance ratings.

**Magni** is the leader in country-level research on corporate governance – its core premise is Countries Matter™ when investing internationally. Magni developed its Sustainable Wealth Creation principles for good governance, which are based on widely-accepted economic concepts, by examining the accounting, legal, regulatory, adjudicative and economic structures of investible countries around the world. The firm's extensive research database covers 12 Economic Standards, and contains data on 280 Qualitative Sovereign Factors collected over the past 16 years.

### How can a country's Governance be measured?

Two words that describe Magni's point of view are transparency and honesty. Their research has shown that the more these factors apply with respect to a country's citizens, businesses and investors, the more wealth that is created in that locale. Lending further support, studies have shown that nation's that have an open, honest, and transparent economy outperform those that do not.

However, the fact that laws and regulations are

on the books to ensure compliance does not mean they are enforced. Governance researchers need to look past official pronouncements and/or stated intentions to assess how businesses and government officials actually behave. In this respect, Magni stands out from other similar organizations in its ability to research and gauge this behavior.

### How does country's Governance impact company performance and investing opportunities?

In our view, assessments of a country's ability to facilitate a high-quality corporate governance environment represent critical investment information. In places where such standards hold true, companies are able to create value for their shareholders without interference from either corrupt government officials or government-sponsored organizations. At Magni, they offer deep insights about governance in each of the world's investible countries and rank them accordingly. Not surprisingly, their efforts have helped them to build a successful track record managing client portfolios.



**Hi** *I'm Melanie*

I hope you have enjoyed reading this quarterly as much as I enjoyed designing it. Recently, I was lucky to have my brother visiting from Australia. He explored various parts of California, immersing himself in all its glory. The grand Golden Gate, solitary hikes through the redwoods, thunder and lightning in Tahoe, an abundance of technology pioneers – these are wonders that are often taken for granted, but which he brought to life in a beautiful photographic story. Some of his images are featured on the front and back covers of this commentary.

I love my job at Portola Creek, not just because I work with equally passionate, proactive people

on a cause that is positive for the earth and its inhabitants. I also appreciate that I can oversee so many areas – **design, marketing, website development, information security**, and all things visually and technically brilliant – that enable us to convey the uniqueness of our offering with the latest tools and technology. What more could a marketing hybrid designer and developer want.

I would be thrilled to hear your thoughts and what you would like to see more of. At Portola Creek, making things great is a team effort.

Email me with your thoughts and suggestions at [melanie@portolacreek.com](mailto:melanie@portolacreek.com)

**Back Page:** *Purisma Creek, California*  
(Photographer - Jeremy Graham)

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