PORTOLACREEK

A California-Registered Investment Advisor

Q4 2017 Quarterly Commentary

Updates

March 15-19

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Portola Creek's Domestic Equity Model Portfolio was up 23.8%

For the year ending Dec 31, 2017, **outperforming the S&P 500 by 440 basis points**

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***Left:** Christmas Day, 2017.*
Half Moon Bay, California.
(Photographer - Melanie Graham)

Turning A Blind Eye

By Todd Wilson

The Portola Creek team rang in the New Year at Lake Tahoe where we also took some time to reflect on 2017. We are extremely proud and thankful for all that Portola Creek accomplished during the year. We made significant investments in our technology and our systems, formalized our business processes, and prepared our firm for the additional growth we have forecasted for 2018.

During our time in Tahoe, it was not lost on us however, that there was barely a trace of natural snow to be found in the Sierra Mountains. If we do not receive sizable winter storms over the next two months, drought conditions in California will be extremely harsh this summer. The bare mountains were a visible reminder of the importance of our work as we use investment capital for environmental and social good.

The equity market was exceptionally good to investors over the past 12 months, but we still find that most remain nervous and wary. Particularly surprising is the degree of skepticism about the near term benefits of the recently passed U.S. tax reform measure and proposed public sector spending on economic growth and stock prices. Overall, the new bill provides for $205 billion in tax cuts, equivalent to more than 1% of gross domestic product. Strategas Policy and Strategy estimates that this should add at least $10 to the 2018 earnings per share of S&P 500 companies.

Nonetheless, many market-watchers are unsettled by the legislation's potential long-term impact on interest rates, the deficit, and the dollar. Generally speaking, there seems to be three reasons for this.

First, the tax bill became increasingly pro-growth in the days leading up to its late-December passage, which probably means it has not been fully digested. There are also worries about the fallout down the road. While the prospect of increasing deficits is troubling, it doesn't really take away from the fact that the economic pump is being primed with a hefty stimulus.

Then there are the headline-grabbing political battles, which are obscuring the focus on economic and other matters. It's a good bet, for instance, that a withdrawal from NAFTA would eat into some of the gains from tax cuts and regulatory relief, but there is little evidence that such a decision is imminent. If we have learned one thing since Mr. Trump was elected president, it is that much of what we hear out of Washington is subject to change on a daily basis.

If you ignore the noise, however, one fact seems clear: most workers will see a boost in their paychecks, which is something to look forward to. In fact, many investors don't seem to realize that the tax cuts that individuals are getting this year will be larger in aggregate than those that the corporate sector received in 2018. Confusion about the effect of a cap on state and local tax (SALT) deductions, which may temper the benefits of the new legislation for residents based in high-tax states such as California and New York, has also muddied the water.

Regardless, the take-home pay for most working Americans will increase, as of February 15, at the latest, without requiring any action on their part. The IRS has announced that the W-4s that employees already have on file will not conflict with the guidance the agency will be issuing in coming weeks. In other words, employees throughout America will soon be getting a raise, all at the same time. In 2003, the last time such an adjustment occurred, GDP surged immediately, almost doubling its prior pace. Needless to say, the Administration is hoping that the economy will expand faster than the deficit, but we believe the opposite may be more likely.

Picture: *Portola Creek's CEO, Todd Wilson. New Years Day 2018. Donner Lake, California.*

Sustainable Finance In Action

As with today's page-view-driven news media, It would probably be easier and more dramatic to focus on last year's negatives. However, we prefer to focus on all the good that occurred in 2017. For one thing, the finance community is (finally) putting more energy and resources into evaluating companies regarding their environmental, social, and governance programs. Increasingly, other investors are joining with us in voting proxies to effect positive change. In this respect, it was a momentous year, but we are only getting started.

Last year, sustainable investing went global, a development likely to gain additional momentum on the heels of increased investor demand and corporate disclosure, along with the launch of more ESG-oriented funds. It undoubtedly helps, of course, that ESG portfolios that excluded fossil-fuel companies and/or that over-weighted exposure to companies with appropriate sustainability metrics were among last year's best performers relative to the broader market.

In addition, increased shareholder activism by the nation's largest fund managers is helping to bring about a sea change. In 2017, for example, Blackrock, Vanguard, Fidelity and American Funds/Capital Group voted in favor of climate-related shareholder proposals for the first time, according to the Ceres and Fund Votes report. Their backing set the stage for some of the first-ever majority-supported climate-change resolutions at companies such as Exxon, Occidental and PPL.

Advances in technology and progressive leadership in the corporate ranks are also encouraging a growing interest in sustainable investment. Electric vehicle adoption rates, for example, appear poised to rise significantly, according to Bloomberg New Energy Finance, aided by a faster-than-expected drop in battery costs and automakers' growing commitment to alternative-fuel vehicles. While unit sales currently account for less than 2% of the overall total, they surpassed one million for the first time in 2017. Several countries, including the Netherlands, India, China, the U.K., and France, have already announced plans to end sales of vehicles with internal combustion engines in the not-so-distant future.

Here are just some of the reports that suggest, to quote Bob Dylan, the times they are a-changin':

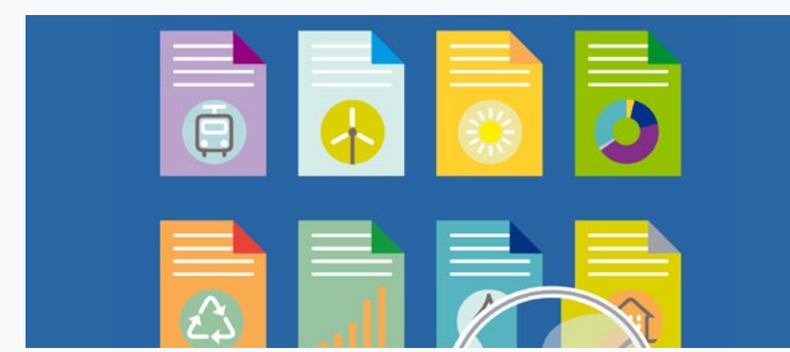
Image: *High purity polysilicon used to make solar products. (Source: SRS, LLC - solarsilicon.com)*

New York City Divesting of Fossil Fuels

New York City officials are expected to announce plans to begin divesting its pension funds of about $5 billion in fossil fuel investments, according to a New York Times report. The city's five pension funds oversee about $191 billion in assets.

BP Returns to Solar

BP returned to solar energy after a six-year absence, marked by a $200 million investment in a British company that develops and maintains photovoltaic farms in Europe. The oil giant bought a 43% stake in Lightsource Renewable Energy, which manages and maintains solar farms.



BlackRock Urges Climate Change Reporting

BlackRock said it's time for companies to start reporting clear information on climate risk. The firm, which oversees almost $6 trillion, sent letters from its corporate-governance team to about 120 companies with material climate risks, urging them to report climate dangers in line with the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures.

Environmental Issues in Action

United Parcel Service announced on December 19 that it had reserved ***125 Tesla Semis*** — the biggest preorder so far for the new electric Class 8 trucks planned for 2019 — which will be added to its existing fleet of alternative-fuel vehicles. According to Morgan Stanley, the Semi may have garnered more than 1,000 orders in its first month, a sign of growing validation from customers.

Right: *Tesla's new semi truck (Source: theverge.com)*

Tesla Begins Solar Shingle Production

Tesla kicked off production of the electricity-producing shingles that CEO Elon Musk says will transform the rooftop solar industry. According to the automaker and solar panel maker, manufacturing of the textured-glass tiles began last month at its 1.2 million square foot Buffalo, New York Gigafactory 2, which was built with a $750 million commitment from the Northeast state and which will eventually create almost 8,000 jobs.

Exxon to Disclose Carbon Footprint

Exxon is poised to disclose the effects of climate change on its business, reversing its previous opposition, following a shareholder proposal approved last May over the board's objections. The oil and gas giant said it will include "energy demand sensitivities, implications for 2-degree Celsius scenarios and positioning for a lower-carbon future" and "seek to issue those disclosures in the near future."

Image: theguardian

Google Increases Purchases of Renewable Energy

Google, the biggest corporate buyer of renewable energy, is boosting such purchases. The technology company agreed to buy 536 megawatts of wind power from four power plants, according to a November 30 statement, and also announced that it had signed sufficient renewables deals to match all of its 2017 energy requirements. Reports indicate that tech firms, many of which operate power-sucking data centers, have now contracted enough renewable energy to displace at least 12 coal generators.

Social Issues in Action

Facebook is making its internal sexual harassment policy public so that it can be used as a model for other Silicon Valley companies. The social media giant's policy extends to work-related social events, off-sites and client events, and includes mandatory sexual harassment training for managers as well as the outline for an investigation process that protects staff. Employees can be fired if they retaliate against co-workers who make harassment claims.

Right: *Facebook headquarters Menlo Park, California (Photographer: Jeremy Graham)*

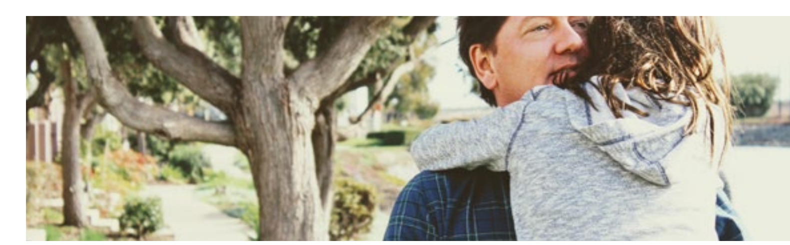
Microsoft Eliminates Arbitration Requirement

Microsoft is eliminating a requirement that employees pursue sexual harassment and gender bias claims through arbitration instead of in court following revelations in recent months of improper behavior across industries. The technology company also endorsed a bipartisan Senate bill introduced by Democrat Kirsten Gillibrand and Republican Lindsey Graham that would prevent companies from contractually requiring employees to settle such actions outside the judicial system.

Image: barrons

Will Pharma Disclose Link Between Prices and Compensation?

Pharmaceutical companies should be required to regularly report whether there's a link between drug-pricing strategies and executive-compensation plans, according to the Interfaith Center on Corporate Responsibility, a coalition of institutional investors with more than $400 billion of assets. The group said December 13 it submitted shareholder proposals on the issue to Abbvie, Amgen, Biogen, Bristol Myers Squibb and Eli Lilly.



CEOs with daughters show more concern for social causes.

Based on a study of the largest U.S. public companies during the period from 1992 to 2012, firms managed by this group scored higher in third-party ratings of their companies' concern for such issues as diversity, the environment and corporate social responsibility than those overseen by chief executives without daughters, researchers at the University of Miami and China Europe International Business School found.

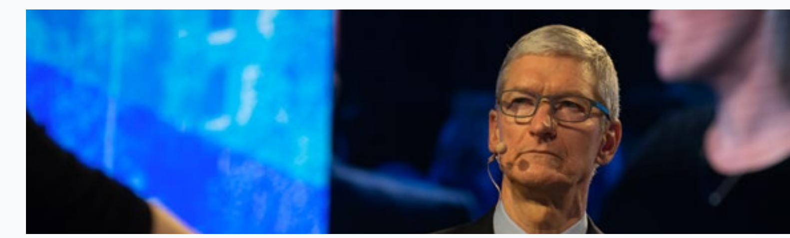
Governance Issues in Action

BlackRock and Vanguard increased engagement with companies to voice concerns on such issues as executive pay and climate change, according to a Morningstar study of large passive investors. Vanguard's corporate engagement team expanded to 21 from 10 previously, while BlackRock's rose to 33 from 20, the study found.

Right: *San Francisco's Financial District, home to many ESG-focused companies.*

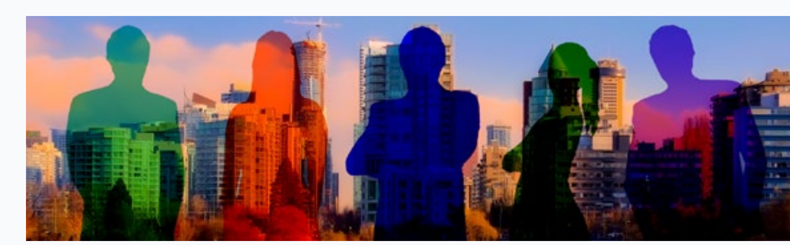
Netflix Disconnecting Performance and Compensation

Netflix's top executives will now get paid in full no matter how well the video-streaming firm performs, thanks to the new U.S. tax law. Because companies can no longer deduct the performance-based incentives of named executive officers who earn at least $1 million, Netflix has decided to lump cash bonuses in with their salaries. Beginning in 2018, its executives' pay will consist of salary and stock options.



Apple Disconnecting Sustainability and Compensation

Apple can leave an investor proposal that requested the technology company consider linking executive pay to performance on diversity and other sustainability metrics off its ballot next year, SEC staff said. Past proposals on diversity didn't garner enough shareholder support for the investor, Zevin Asset Management, to submit another one, the SEC wrote in a December 15 letter that was recently made public.



Shareholders of Public Companies Need a Voice

Companies that give public investors little-to-no say in board elections and other matters shouldn't be allowed to refer to the shares they sell as common stock, according to a draft recommendation from the SEC's investor advisory committee. "If you take a security public and it has zero voting rights, I don't think that's common stock anymore," Harvard Law School professor John Coates said at a December 7 committee meeting.

Quarter in Review

Last year, the S&P 500 index was up 19.4%, and for the first time on record, it recorded a gain in all 12 months. More than 75% of stocks rose over the span, representing a far broader advance than was seen during the dot-com heydays. In 1999, for instance, the market rallied a similar amount, but it was largely carried along by strength in the technology sector, which rose roughly 80%, while less than half of publicly-traded issues were positive.

For the year ending December 31, 2017, the Portola Creek Domestic Equity Model Portfolio was up 23.8%, outperforming the S&P 500 by 440 basis points.

In some respects, this was not all that surprising. A FactSet **backtest of the Portola Creek portfolio, as well as other ESG and sustainable investment counterparts, revealed similar outperformance over the past decade.**

Based on this, it appears that **you don't have to sacrifice returns to invest in accordance with personal values.** Indeed, as more investors "vote" with their conscience, it seems a good bet that the stocks of companies with exemplary environmental, social, and governance standards will warrant even higher valuations, helping to keep the sustainable value story intact.

Fixed Income

Of course, other factors are also important. While the yield on the 10-year Treasury ended 2017 near a historically low 2.4%, the prospect of two or three Fed rate hikes, accelerating inflation, and the impact of tax reform suggest the path of least resistance is up. Following the 2003 tax cuts, longer-term yields spiked from 3.1% to 4.6% over six weeks, a scenario that doesn't seem out of the question in an economy that is near full employment.

In fact, the overall environment for fixed-income securities appears somewhat unsettling. At present, the yield on the two-year Treasury note looks poised to surpass the S&P 500 dividend yield for the first time since the financial crisis unfolded roughly a decade ago. Credit has tightened and it is hard to feel comfortable when junk yields are rising faster than investment grade counterparts.

In our view, however, the alarm bells have not fully sounded. Over the past year, we have found that carefully selecting attractively-priced corporate, municipal, sustainable, and green bonds has generated considerable income and reduced the risk in our portfolios. Indeed, a number of the bonds we purchased last year benefited from intra-year credit upgrades, augmenting portfolio values.

Equities

We would be remiss if we did not acknowledge that equity markets — domestic and foreign — were very kind to us last year. That said, while it is not uncommon for passive investing strategies to garner the attention when "a rising tide is lifting all boats," the reality is that active management did seem to pay off, at least in our case. **Investing in companies — and countries — with higher governance scores helped the Portola Creek total diversified portfolios to outperform most equity indexes with less risk.**

Moving on to the bigger picture, economic conditions worldwide remain on an upswing, with unemployment hitting cycle lows in Japan and Germany.

In fact, the latter country's jobless rate is at its lowest level since reunification in 1990. Meanwhile, eurozone manufacturing data has maintained its upward momentum even as the ECB appears set to be somewhat less accommodating.

European stocks have also been buoyant, with the UK equity market, in particular, pressing higher despite concerns about a potentially messy exit, or "Brexit," from Europe.

In China, at least some indicators, including the Caixin Manufacturing PMI, have remained in expansion territory despite concerns that a reorientation of the economy and an increased focus on protecting the environment could weigh on growth. Across the East China Sea, Japanese bank stocks appear to be breaking out while the breadth of the overall market remains strong. Emerging markets have also been on a tear. As 2017 came to a close, more than 40% of EM stocks were trading at their 20-day highs, marking a burst of momentum that could keep things moving for a while.

Real Estate

Inflation-adjusted home prices in Canada, Australia, New Zealand, and parts of Europe are well above pre-global financial crisis peaks, buoyed by ultra-low interest rates across most of the world. In contrast, real home prices in the U.S. are still below their 2006 extremes, though commercial real estate (CRE) prices have galloped to new highs. That said, slowing rental growth in the latter segment suggests that supply may be catching up with demand. At Portola Creek, we've sold most of the real estate investments we made since 2009 and believe there is not a lot to go for right now.

Precious Metals

When it comes to precious metals, the outlook still looks bright, with gold finishing 2017 within a hair's breadth of its September interim peak. Although we believe the yellow metal must break through resistance in the $1,375-$1,400 range to confirm its uptrend, we remain comfortable with our position, which serves as a hedge against inflation and geopolitical tensions. Regardless, the fact that palladium is now trading at a premium to platinum for the first time since 2001 signals a positive economic backdrop that may lend support to the segment as a whole.

Energy

Energy markets have also been resilient, with U.S. crude oil trading at $60 a barrel for the first time since June 2015, capped by a roughly one-third rise in 2017's second half. However, with prices now comfortably above a breakeven cost of production in the low-$50 range, accord to energy strategists at research firm BCA, further gains may be harder to come by. Still, amid strength in the economy and heightened tensions in the Middle East, the downside seems limited.

Bitcoin

Of course, it is hard to present an overview of what is going on in today financial world without saying something about a very popular topic: Bitcoin. One thing that seems clear to us is that the supply of this and other cryptocurrencies appears to be growing at an accelerating pace, boosted by a frenzy of initial coin offerings (ICOs), setting things up for a market that eventually collapses under its own weight. While such an opinion may not be popular or surprising, history suggests that the combination of dramatic price appreciation and a captivated public is a sign to stay clear.

That said, the blockchain technology that underlies these digital currencies potentially holds great promise for social good, because it can enable access to traditional banking and other financial transactions for people and countries that might not otherwise have that option.

Investment Outlook – Room to Run

At this juncture, the U.S. economic expansion appears on track to become the longest on record. As we have noted previously, growth has averaged a modest 2.2% since June 2009, with few signs of overheating. With that in mind, **we believe the current upswing can continue for another 12-18 months**.

The fact that U.S. consumers, who comprise a segment that has long been the largest contributor to economic activity, have remained upbeat is also reassuring. With consumer confidence and home prices trending higher, and the economy near full employment, they will continue to open their pocketbooks and wallets. Throw in the positive impact of lower taxes and rising earnings, and it seems that the stars are aligned for further growth in the period ahead.

While some analysts maintain that the tenure of the post-financial crisis expansion is a reason for caution in and of itself, **we believe that current economic and market cycles remain well supported and are not yet mature.** Bolstered by spending momentum and a lift from tax reform, profits should continue to improve. We recognize, of course, that various headwinds are lurking, including prospects for economic overheating, geopolitical tensions, and tighter financial conditions. Nevertheless, our base case is for positive equity returns in 2018, albeit at more modest pace than last year.

In contrast, our outlook for fixed-income markets is more guarded, favoring only municipal bonds and emerging market debt. We remain bearish on U.S. Treasuries and other developed market government securities, and are becoming cautious on corporate and mortgage-backed bonds. **In our view, the one-two punch of central bank balance sheet reductions and interest-rate hikes in the U.S. — and perhaps elsewhere — will likely spell the end of what has been a long bull market**.

Although we are comfortable with the calculated yield-to-maturity on the bonds we hold, **we expect to be net-sellers of fixed-income securities in 2018**.

Our views on the bond market are also tempered by our outlook for stocks. **While U.S. equity valuations are high relative to history, they continue to offer an attractive premium over other assets**, including various fixed-income securities. Beyond our shores, the opportunities in European, Japanese, and emerging markets seem even brighter. That said, earnings growth will likely normalize at more subdued levels as year-over-year comparisons become more challenging. Regardless, while rising rates may heighten day-to-day volatility, the risk that we are at an equity market inflection point seems far off.

In fact, the technical picture for equities appears supportive. Although the past is not a predictor of future performance, given that the market's current breadth, or the proportion of winners to losers, remains above levels seen just prior to earlier downturns (i.e., 27% in March 2000, 43% in October 2007, and 51% in August 2015), it is probably too early to call for a top. **Stock prices may be somewhat stretched, but we'd characterize this as a "good" overbought.**

Even so, it's a good bet that the environment going forward will be less sanguine than it has been. Monetary tightening will likely boost volatility across asset classes. While bond markets probably represent ground zero in this respect, currency markets may be the most vulnerable — whatever the case, equities will likely be rattled by at least some of the fallout. Nevertheless, markets seem well-prepared for a gradual and well-telegraphed decline in central bank balance sheets and an accompanying uptick in rates.

One theme that many analysts expect to come to the fore is rising prices. While efforts to boost inflation have fallen short so far, there are some indications that a shift is underway. Among other things, workers are changing jobs at a record pace — suggesting that many are not content with current pay levels — the minimum wage is rising in 18 states this year, and Netflix, Comcast and many other businesses are raising prices.

In reality, if the U.S. cannot consistently generate core CPI of 2% year-over-year with unemployment below 4%, wages rising more than 2.5% year-over-year, and a tax-reform induced fiscal boost, then one can only wonder when it will ever be able to do so.

For businesses, the fact that uncertainty over tax reform is out of the way may lead many of them to loosen the purse strings. One big question, of course, is where will they direct their cash? At this point, it's not necessarily a given that workers will receive the lion's share of any tax-reform-related windfall, especially given corporate America's professed interest in increasing automation.

Indeed, capex still looks to be in recovery mode, with analysts forecasting 2.7% year-over-year growth in the 12 months ahead, bolstered by changes that allow such expenditures to be written off over five years. While it is not common to see an acceleration in capex at this stage of the cycle, the way things have unfolded since the global financial crisis seems anything but normal.

Turning back to equity markets, it's reassuring that prices began 2018 on a firm footing, with roughly 30% of S&P 500 index constituents trading at new highs in the year's early days. At the sector level, financials, industrials, and materials seem particularly attractive to us, and as a result, we are overweight these groups in our portfolio. We are also beginning to warm to the energy and consumer discretionary groups.

In contrast, we remain neutral on the consolidating technology and inconsistent healthcare sectors, and continue to be underweight utilities, real estate, telecom and staples, with the latter still at risk from Amazon's disruptive influence (now with the help of Alexa).

A Peak Inside Our Investment Strategy

This quarter we go behind the scenes with **Sustainalytics,** a leading ESG research provider

Sustainalytics' ESG data is an important *slice* of Portola Creek's investment management process.

Sustainalytics provides a valuable set of ESG data for Portola Creek's Portfolios

We are often asked how we gauge and evaluate the environmental, social, and governance impact of the investments we consider for our client's portfolios. Admittedly, there's no single source or simple solution we rely on. For us, it's important that we understand exactly what data is being gathered and how, as well as the way in which it all ties together. In an effort to provide more insight about our strategy, we are taking this opportunity to introduce one of our key ESG data providers, Sustainalytics.

What is Sustainalytics' research methodology?

Sustainalytics' research methodology addresses a broad range of macro-level ESG issues and trends that can impact industries and companies, creating risks and opportunities for investors. Their "Company ESG Reports" highlight indicators that are critical in assessing how well the firms in question manage their exposure to such issues. The reports also include trend signals that detail how things have changed over the course of the previous 12 months.

How does Sustainalytics integrate with Portola Creek?

At Portola Creek, we connect to Sustainalytics' information through FactSet, the provider of our robust market data dashboard. To better understand companies' policies, programs and preparedness to manage ESG risks, we use Sustainalytics data to evaluate four distinct management dimensions: disclosure, preparedness, quantitative performance, and qualitative performance.

In compiling their trends and data points, Sustainalytics analysts read through corporate reports and filings in an effort to identify ESG issues that may be affecting a company and others in its industry, and then assign scores to 7000+ securities. Broadly speaking, these readings summarize ESG performance in absolute terms, as well as relative to industry peer groups.

Portola Creek's pledge to the Principles for Responsible Investing

When we founded the firm and developed our sustainability-focused investment strategy, one of the first decisions we made was to pledge to adhere to the Principles for Responsible Investing, or PRI. Sustainalytics' data has helped us to remain aligned with our core principles and guidelines.

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