PORTOLACREEK

A California-Registered Investment Advisor

Q2 2018
Quarterly Commentary

Updates

Version 4.1.0 of the Portola Creek App

was released on June 26

Our Wealth Access Widget was added to the Portola Creek App

on June 29

Our B-Corp Impact Assessment score of 147 qualifies our firm to be placed on the list

"Best for the World"

Certified B Corporation

This proxy voting season,

We have weighed in on 511 shareholder proposals across 99 companies

with 25% of our votes going against management recommendations.

Table of Contents

Cover: *The beautiful coastline of Santa Barbara, CA. We are proud to set roots in this region with our Santa Barbara office.*

Left: *Varadero Beach, Cuba*

ESG Investing Becomes Increasingly Mainstream

"To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society."

Quote by Larry Fink, CEO of Blackrock

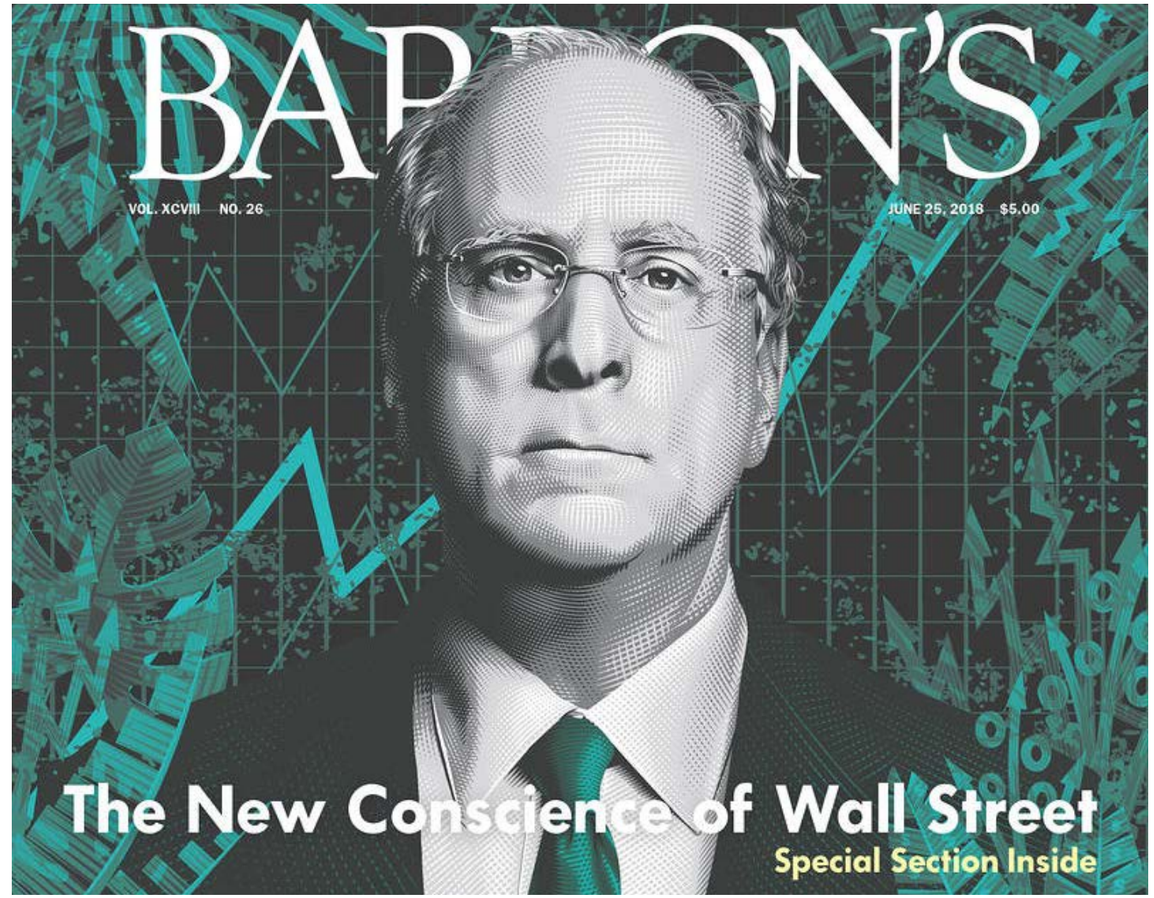
Our goal in founding Portola Creek Capital was to ensure that environmental, social, and governance (ESG) factors are considered as part of the investment process. Academic research and our predictive analytics have made it clear that no material information should be left out of the equation.

Indeed, if anyone required further proof that this perspective represents the future of investment management, they need look no further than the June 20 issue of Barron's, entitled "The New Conscience of Wall Street." The magazine included commentary from a number of influential individuals, including Larry Fink, CEO of Blackrock.

"To prosper over time," Mr. Fink says, "every company must not only deliver financial performance, but also show how it makes a positive contribution to society." Quite simply, he adds, "companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."

Fink would probably be the first to say that Blackrock is by no means the poster-child for ESG investing. But his point, and that of other experts, is that it is irresponsible for asset managers to ignore the mountain of academic evidence affirming the materiality of ESG factors with respect to the investment process.

In fact, studies published over the last decade reveal that the shares of companies that practice exemplary behavior tend to outperform the broader market over the longer run. Perhaps more importantly, a deterioration in a company's governance score often represents an important sell signal, presaging a significant decline in its share price.



Many investment management old-timers believe that portfolio performance suffers when you invest with your conscience. Meanwhile, a majority of Millennials seem to focus more on whether their investments have a purpose than on how profitable they are.

In our view, both perspectives are off the mark. As alluded to earlier, how a company performs with respect to ESG criteria has been shown to be closely linked to the performance of its shares. The evidence suggests that sustainably-oriented firms lead the pack over the long term because they are better at adapting to a changing world.

Given that, it is not surprising that this understanding is having an impact, especially among certain segments. Audrey Choi, Chief Sustainability Officer at Morgan Stanley, notes that the annual growth rate between 2014 and 2016 of assets under an ESG mandate was 23%, with demand being driven by women and Millennials, who will comprise 75% of the workforce by 2025.

For Ms. Choi, the situation is clear: "My apologies to Kevin Costner in Field of Dreams, but it's not 'if you build it, they will come.' We are at: They have come, so build it," she said.

But there are also other supportive forces at work, both within the institutional investing community and across society more broadly. With each passing year, shareholder voices on environmental, social, and governance resolutions are growing louder. In fact, more and more firms are looking to improve their business practices even before any proxy votes are tallied.

As always, Portola Creek Capital is proud to be at the forefront of this burgeoning wave, positioning our clients' portfolios for both sustainability and profitability.

Above image: *Barron's*

The Great Trade War of 2018

On July 6, the United States and China announced the imposition of $34 billion in tariffs on each other's imports. President Trump has publicly threatened to add a further $500 billion in levies. No matter how things shake out, our leader has, for better or worse, effectively put an end to two decades of "normal trade relations" with the world's now second-largest economy.

The phrase, "normal trade relations," is not merely a figure of speech. It dates back to 1980, when the US levied the same tariffs on Chinese goods as those on the imports of other trading partners. Characterized as "most favored nation" status, this treatment was conditional and subject to annual review. However, since the World Trade Organization does not permit one member to treat another in this way, China wasn't permitted to join the WTO until the US made these arrangements permanent.

When America did so in 2000, the effects were profound: the removal of political uncertainty and prospects for a US trade embargo bolstered the appeal of China as a foreign investment destination.

We all know what happened next, of course. Manufacturers that relied on global supply chains made the most of China's low-cost and highly-educated workforce, triggering a boom in exports from the Asian nation. It's a good bet that US multinationals and their partners would not have moved forward in this way if Washington could arbitrarily revoke Chinese access to the American market.

Regardless, the threat of higher prices for Chinese goods is not necessarily the most damaging aspect of the current administration's proposals, which – based on a 25% tariff on exports of $50 billion – would impact only 0.1-0.2 percentage points of GDP growth a year. The real concern is a rise in political uncertainty. By taking such actions, Mr. Trump is essentially asserting a unilateral right to limit or regulate trade however he sees fit, regardless of whatever arrangements had been in place previously.

Following this and other policy actions, it remains to be seen whether Mr. Trump will ultimately be seen as a dealmaker or a deal-breaker. As president, he has not established any real record of serious negotiating or deal-making. Rather, he seems intent on boosting his party's chances in the upcoming midterm elections by taking actions that resonate with his base. He is likely also emboldened by resiliency in the stock market and economy, which he sees as evidence that his approach is working.

The problem for China, meanwhile, is that their attempts at retaliation will likely prove more difficult and painful for them than their counter-threat rhetoric makes it sound. As many observers have already pointed out, the US imports goods valued at $500 billion from China each year, which is almost four times more than the Asian nation imports from the US annually.

Bear in mind that the US stance doesn't just impact trade flows. It also has implications for the dollar. In effect, the Trump administration is telling the world, "We don't want to give you US dollars anymore." Many investors likely assume that other countries have little choice but to use our currency, which would suggest the current round of trade actions is bullish for the dollar.

In reality, the US seems intent on moving Asia away from using the greenback as its primary trade and reserve currency. Once such a shift is underway, reversing it will be nearly impossible.

Regardless, we continue to believe that tariffs are a wholly unwelcome tax on US businesses and consumers. That said, we believe the benefits accruing from the US tax reform measures passed in December outweigh the hit from rising tariffs. Assuming that neither goes away in the near term, we believe that the net impact remains positive.

Environmental Resolutions in Action

Fast-fashion Companies Go Green

Fast-fashion companies are using mushrooms, lumber scraps and algae, among other natural products, to go green. Inditex-owned Zara and H&M are developing textiles that reduce the environmental costs associated with "throwaway clothes."

Learn more about a company's
Environmental Contributions

Kroger Reduces Insecticides

Kroger, America's largest supermarket chain, adopted a policy just days before its June 28 shareholder meeting of curtailing the use of decorative outdoor plants treated with insecticides that have proved harmful to honey bees. Environmental activists handed out thousands of petitions regarding the issue to executives at last year's meeting.

PG&E Helps Customers Obtain Solar Panels

PG&E announced that it had signed an agreement for its first "community solar project," which offers customers who can't, for one reason or another, install solar panels on their roofs the option of buying energy generated in this way from a facility nearby.

Starbucks and McDonalds Eliminating Straws

Starbucks has announced plans to do away with plastic straws in its stores worldwide by 2020 and to offer cold drinks in cups with "sippable" lids. The move follows an earlier decision by McDonald's to replace plastic straws with paper ones at its UK locations amid concerns about single-use plastic ending up as ocean waste.

Image source: Ikea

Ikea Chooses Renewable Recycled Materials

Ikea pledged to use only renewable and recycled materials in its products, reflecting the company's push to reduce its climate footprint by roughly 70% per product by 2030.

Social Responsibility in Action

More Women Leaders in the Power Industry

The power industry's "old boys club" is breaking down at the same time that utilities are prioritizing clean power. Women now lead more than a dozen such companies in the US alone, including Duke Energy, El Paso Electric and Sunrun. In contrast, less than 2% of oil and gas companies in North America and Western Europe are led by female chief executives.

Learn more about a company's
Social Contributions


Image: matchtech

Blackrock & Goldman Sachs Support LGBT in Hong Kong

BlackRock and Goldman Sachs are fighting to protect the rights of LGBT workers in Hong Kong, where same-sex marriage isn't legal, pleading for equal protection for members of the group before the city's High Court.

Image: Chicago Tribune

United Airlines Ends NRA Discounts

United's CEO Oscar Munoz decided to end discounts for National Rifle Association members because one of the 17 people killed in the Florida massacre was the teenage daughter of a United captain.

Image: Lowe's

Lowe's Rejects Cancer-Causing Paint Strippers

Lowe's announced that it will stop selling paint strippers containing methylene chloride and N-methylpyrrolidone (NMP) by the end of 2018. Methylene chloride is a toxic chemical known to cause cancer, which has been linked to three deaths since last October.


Image: International Business Times

Companies Using Less Conflict Minerals

Fewer companies submitted conflict-mineral filings to US regulators in 2017 amid changes in supply chains and M&A activity. Adobe, Autodesk and Overstock were among those that haven't made submissions this year because they stopped making or contracting for products containing tin, tantalum, tungsten or gold.

Corporate Governance in Action

Amazon Commits to Board Diversity

Amazon adopted a new policy that requires the online giant to consider women and minorities for all open board seats. The move followed the introduction of a shareholder proposal from CtW Investment Group calling for increased diversity.

Learn more about a company's
Governance Contributions

Image: Amazon

Image: waonews

Facebook Empowers Audit Committee

Facebook expanded the role of its audit committee to include overseeing risks associated with privacy, data use, community safety and cybersecurity. The changes were introduced in the wake of its most recent annual meeting, when a number of shareholders withheld votes for directors & sought to force the board to create a separate risk-management committee.

Image: Zynga

Zynga Addresses Shareholder Rights

Zynga founder Mark Pincus said he would eliminate his super-voting privileges amid growing signs that tech companies are beginning to rethink unequal shareholder voting rights and multi-class shares.


Image: Wall Street Journal

Anadarko will have to Report on Climate Risk

Anadarko's shareholders voted in favor of a climate risk reporting proposal, over the board's objection, at the energy company's latest annual meeting.

Opioid Epidemic Hits McKesson CEO's Pay

McKesson cut CEO John Hammergren's pay by about 10% following a shareholder revolt. Support for the US healthcare firm's pay practices has ebbed amid concerns about its alleged supporting role in the nation's opioid epidemic.

Quarter in Review

Despite all the noise of tariffs and the midterm elections, the U.S. economy and S&P earnings are in great shape.

Following a challenging first three months of the year, most equity markets fared well during the second quarter. The Nasdaq, up 6.6%, was the best performing index over the span, while the S&P 500 gained 3.4% and the Dow Jones Industrial Average rose 1.3%.

For the economy overall, the picture was also positive. Consumption returned to good health after hitting a soft patch during the first quarter. US retail sales grew in May by more than 6% year-over-year, and unemployment fell to 3.8%, its lowest level since 1969.

Conditions were buoyant enough, in fact, for the Fed to hike interest rates in June and signal two further increases this year. US 10-year Treasury yields also rose during the quarter, as did the dollar, which continued to benefit from monetary conditions in the US that remain tighter than elsewhere. Oil prices were firmer as well.

Heightened political and geopolitical uncertainty lent further support to both the dollar and oil. Worries about a potential trade war were at the forefront, with escalating tensions in the Middle East adding to concerns.

Against this backdrop, investors piled into technology and growth stocks. The Russell 2000 was also strong amid perceptions that small-cap stocks are somewhat immune to trade and certain other macro threats, at least for now.

The technical picture is not particularly reassuring, however. Market breadth last quarter was uncomfortably narrow: three stocks – Amazon, Microsoft, and Apple – accounted for more than 70% of the rally in the S&P 500. Moreover, those three, along with Netflix, Intel, Mastercard, Nvidia and Facebook, were responsible for 100% of the gains seen this year, creating a challenging environment for active managers.

Despite all the noise regarding tariffs, tensions with trading partners, and regional instability – not to mention the upcoming midterm elections – the outlook for the economy and corporate profits remains bright. US GDP is expected to come in at an annualized rate of around 4%, while S&P earnings are forecast to be up over 20% in the second quarter.

Above Image: *World Trade Center Station, New York*

Investment Outlook

After a nine-year run, many investors are worried that the equity rally may be nearing its end. As we have long argued, however, longevity is not necessarily a negative in and of itself. The slow rate of economic growth we've seen over the span may well have set the stage for the longest bull market on record.

That said, there are some noteworthy divergences. On the one hand, robust corporate profits and small-cap stock outperformance are reminiscent of what we tend to see during the early stages of an economic upcycle. On the other hand, low unemployment and strong business confidence are more representative of the final stages.

Under the circumstances, the direction of asset prices going forward will likely rest on how well we navigate the shift away from an accommodative monetary policy to a regime where tax cuts, government spending, the rollback of regulations, and heightened trade-related issues are at the fore.

Taxes

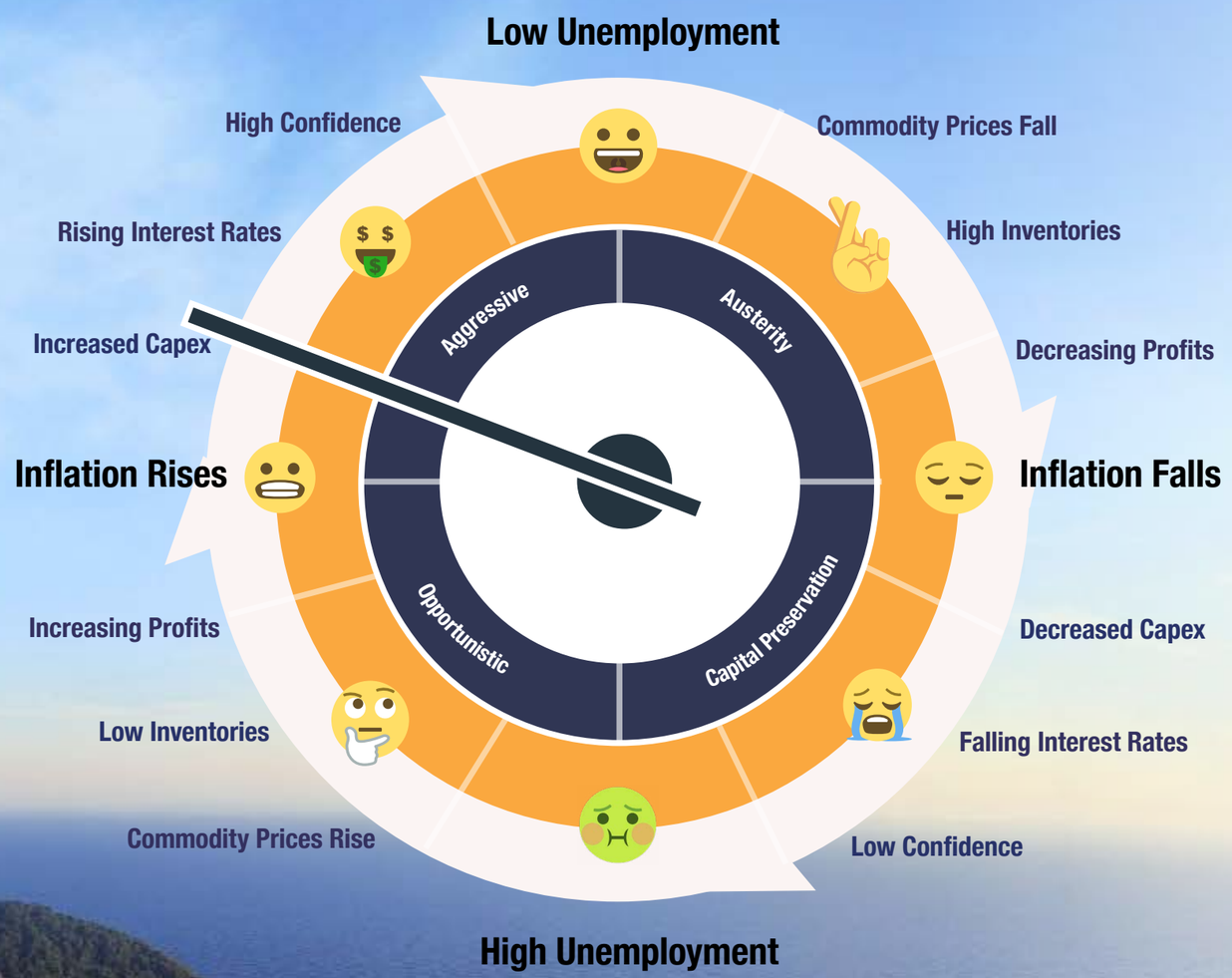
With respect to tax reform, in particular, it is interesting how investor concerns have morphed from "tax cuts will do nothing but increase the deficit" to "tax cuts will cause the economy to overheat." In our view, such fears are overblown. We believe that increased capital spending will boost productivity, wages and earnings, while also keeping a lid on unit labor costs, to the ultimate benefit of share prices.

Regulations

Structurally speaking, a more business-friendly environment will likely have a positive impact on confidence and capex. The fact is that burdensome regulations have been a drag on growth for some time. Effective measures to protect our environment and financial system should remain in place, of course, but for the most part, cutting red tape and other regulations tends to be a good thing.

Background Image: *Navagio, Greece*

The Cyclical Nature of the Economy & Stock Market



Foreign stocks

Over in Europe, economic confidence and conditions remain supportive, but this could change quickly should protectionism increase and a full-scale trade war unfold. Regardless, unlike here, it seems that potential drivers of future demand growth – a pick-up in fiscal and monetary accommodation, an accelerating global economy, or an upsurge in entrepreneurial activity and consumer spending – are lacking.

In reality, the only country in the region that might be able to pick up the slack by cutting taxes or boosting outlays is Germany, but policymakers in that country seem more intent on paying down debt than increasing demand. Add that to burgeoning uncertainty in the UK and elsewhere in the region over the Brexit mess, and it appears that the path of least resistance for eurozone growth is lower.

Bonds

In fixed-income markets, the prices of high yield bonds have strengthened amid a late-cycle reach for yield and concerns about heightened event risk for investment grade bonds. Nevertheless, we continue to believe that the long awaited "great rotation" from bonds to stocks has not begun. As we noted previously, yields on 10-year Treasuries rose from 3.1% to 4.6%, a 50% increase, following the 2003 US tax cuts.

With long bond yields making higher highs and lows, it seems a good bet that fears over rising prices are also at play. Everywhere we look – whether referring to rising oil prices, stronger wage growth, or the impact of higher tariffs on the cost of imports – it's apparent that inflation is creeping into the economy. Even so, we are not overly concerned at this stage. If anything, the modest upside pressures we're seeing simply provide cover for the Fed to carry on in the slow, methodical way that it has.

Oil

A potential shortfall of oil supply means we shouldn't be complacent. In the energy markets, prices are being bolstered by the differential between a global demand increase of 1.5 million barrels per day and a two-million-barrel daily shortfall in supply from Mexico and Venezuela. Other nations are hard-pressed to make up the difference, especially amid heightened tensions in the Middle East, which could be a serious problem should the situation worsen.

US stocks

In the end, many factors, including the November midterm elections, make US stocks an attractive destination for capital. Historically, equity performance during such periods has often been back-end loaded, with markets treading water until the political posturing ends. If history is any guide, share prices should benefit from some sort of tailwind come October.

Taking everything into account, we believe that investors may be underestimating the positive impact of tax cuts, fewer regulations, and increased infrastructure spending, while overweighting the threat of a trade war and the near-term risks of recession. As we see it, the likelihood of increased capital spending places us nearer the middle of the cycle than the end. Given that the age of our corporate fixed-assets is the oldest it's been since the 1960s suggests there is lots of pent-up demand ready to be unleashed.

A Peak Inside Our Investment Strategy

This quarter, we would like to introduce another important contributor to our investment process: **Strategas**

Strategas provides Portola Creek with economic forecasting and research

Strategas' Policy Research team, for instance, seeks to identify federal, state, and local policy initiatives that have direct investment implications. Based in Washington, DC, this group wades through the legislative, executive and regulatory landscape to provide us with forward-looking information that is relevant to our holdings and strategy.

Their Economics group, meanwhile, employs an analytical approach based on high-frequency economic forecasting and thematic research to provide us with a coherent and consistent macroeconomic framework. Better yet, their focus is global: they offer insights on fundamental trends in both mature and developing economies.

They also have an Investment & Equity Sector Strategy team that works to unearth any number of major themes with implications for global financial markets more broadly.

Finally, Strategas' Technical Analysis team picks up where the fundamental specialists leave off in an effort to identify developing trends among asset classes. Their focus is on providing actionable investment conclusions and a thoughtful yet concise short-term market outlook.

Strategas defines the principles they adhere to as Quality, Transparency, and Perspective. As long-time subscribers to their research – across various firms – we could not agree more.

Definintion:

STRATEGAS
noun

Their name is a variation on "strategy," which is derived from the Greek word, "strategos," or "general." In Athenian Democracy, the strategoi stood between elected officials and military leaders to provide counsel that tried to strike a balance between individual liberties and the security of the state.

For us, the range of insights that the independent research boutique provides have proved valuable. We appreciate the way their various specialists distill complex investment concepts into understandable and actionable ideas and themes that fully complement our other efforts.

Learn more about
Our Investment Strategies

Can we help you?

Let's schedule an introductory meeting so that we can learn more about your objectives.

Schedule a Call

415 990 9499 info@portolacreek.com

Keep in touch,
LIKE us on Facebook

Our Office Locations:

San Francisco
44 Tehama Street
San Francisco, CA 94105

Santa Barbara
1117 State Street
Santa Barbara, CA 93101

Our Services:

Portfolio Management
Tax Planning
Small Business
Wealth Transfer
Decision Analysis
Insurance

Services

Right: *Santa Barbara, CA.*