TORRAY LLC

Investment management since 1972

TorrayResolute Concentrated Large Growth

Market Overview

Investors were whipsawed in the first quarter of 2016 as the first six weeks produced a loss of 10.5% for the S&P 500, only to recover and close the quarter with a modest gain of 1.4%. It was an unpleasant reminder of how volatile markets can be when simple narratives dominate a complex system. In this case, the culprit was primarily the price of oil, which declined 30% through mid-February, but recovered by the end of March. As the price of oil declined, investors became more risk-averse, assuming that lower oil prices were the result of deteriorating global growth rather than continued excess supply. The logic reversed, as did the markets, when Saudi Arabia announced an effort to freeze production levels among major producers on February 11th and evidence of slowing global growth didn't materialize. It was a curious period which begs the question of how investors should manage short-term headlines and long-term fundamentals.

> The lesson to take away from the first quarter is to avoid simple narratives and follow fundamentals.

Portfolio Commentary

During the first quarter, the TorrayResolute Concentrated Large Growth Composite gained 1.91% (1.82% net of fees), outperforming the benchmark Russell 1000 Growth Index's advance of 0.74%. Positive stock selection in eight of ten sectors outweighed a modest drag from allocation. Top performance contributors included Fiserv (FISV), Enbridge (ENB) and Cooper Companies (COO). Primary detractors were all from the Health Care sector, which included Express Scripts (ESRX), BioMarin (BMRN) and Roche (RHHBY). For the trailing twelve months, the Composite declined 2.21% (-2.55% net of fees), underperforming the benchmark's gain of 2.52%. In this case, the principal source of underperformance was the portfolio's overweight position in Energy, which averaged 7.2% for the period versus the benchmark's 1.6%. While the difference in allocation was modest on an absolute basis, sharp declines in the sector (-22.7% for the portfolio, -44.9% for the benchmark, a 50% downside capture ratio) had a disproportionate impact on the portfolio's performance.

Volatility has not been limited to the Energy sector. The Biotech industry has experienced a sharp decline of approximately 30% over the past eight months (August-March). While we agree this sell-off has some basis in fundamentals, we also believe it has created some attractive investment opportunities. To this end, we purchased shares of Incyte (INCY) during the quarter, a profitable $14 billion company focused on the development of small molecule drugs treating cancer and inflammation. To date, Incyte has developed three drugs: one approved product, Jakafi, for a rare blood cancer which is generating more than $1 billion in annual revenues and royalties, one FDA-filed product for rheumatoid arthritis, and one phase III product which improves the body's immune system response to cancer.

Another source of market volatility has been and continues to be expectations around the pace of the Federal Reserve's interest rate hikes. This particularly impacts the Financial Services sector. As the Fed communicated a pause in rate hikes toward the end of the quarter, the sector sold off and we took the opportunity to purchase shares of Charles Schwab (SCHW). Ranking in the top 20 U.S. financial companies by assets, Schwab is an industry leader in the online brokerage business, has generated strong organic growth, maintains a solid core deposit base, and stands to benefit from eventual Fed rate hikes; for each incremental 25 basis point increase in the Federal Funds Target Rate, Schwab will gain approximately $650 million in net interest revenue, a 26% increase over 2015 levels.

Outlook

Markets recovered in the second half of the quarter, largely because concerns that reached a fever pitch in February moderated, the price of oil recovered, the Fed lowered its rate guidance, the dollar weakened, and China's economic expansion continued at a reasonable pace. Global growth remains slow and as such, vulnerable. On the domestic front, positive economic data continue to outweigh negative. The lesson to take away from the first quarter is to avoid simple narratives and follow fundamentals. Long-term investors maintain a disciplined philosophy and process, resisting the urge to rely on simple explanations. Volatility is a risk, but also provides investors with opportunities. As the saying goes "It's time in, not timing." If anyone needed a reminder that timing the market is a fool's game, the first quarter provided it.

As ever, we appreciate your interest and trust.

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