



Hemenway
Trust Company_{LLC}

Fourth Quarter 2015 Report

Looking back at 2015, and witnessing the turbulence that we have seen in early 2016, should serve to reinforce a series of investment essentials. Among those essentials are these: that investors tend to overreact, both on the upside and the downside, and that long term investing requires patience, discipline and an approach to portfolio construction and management designed to allow the investor to ride out market cycles and, often, to benefit from them. This is why we focus primarily on high quality common stocks, investment grade bonds with relatively short maturities, and adequate cash reserves. It is that balance which allows our clients to navigate through these market storms.

We invite you to read the comments of our CIO, Michael O'Leary, and to call us with any questions or concerns.

Michael J. Puzo
Chairman, HTC Investment Committee

Fear and loathing in the equity markets

As we enter 2016, the market continues to confront some now familiar issues – slower growth worldwide, particularly in China, a strong U.S. dollar and lower energy prices. While these are not new issues, the combination of erratic efforts from the Chinese government to calm markets, coupled with a lack of capital discipline across the energy patch, has created more uncertainty and driven oil prices well below the marginal cost per barrel. Add in a Fed that may well be raising interest rates over the next year, and voila, you have another pull back in the equity markets.

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We do not want to make light of some of the real issues across the globe – it is clear China is slowing, the continued decline in oil will only increase geopolitical tensions, and a strong U.S. dollar will lead to lower profit margins for many U.S. companies. Companies are just starting to release Q4 earnings and guidance for the next 12 months, but best estimates are that the S&P 500 earnings per share (EPS) will likely end 2015 down 5% from 2014's earnings. That said, if you exclude the 60% decline in energy earnings, you see more resilience with EPS growth of 1-2%. So far, Q4 earnings and '16 estimates have been slightly ahead of expectations due to continued cost containment. The earnings season is still young, but if we are to see more micro data that shows companies are not battenning down the hatches, we should see markets settle down.

As of January 28th, the S&P 500 was down 10.3% from its 52 week high, with small cap and international stocks down between 17-30%. In times like these, it's easy to explain why we focus

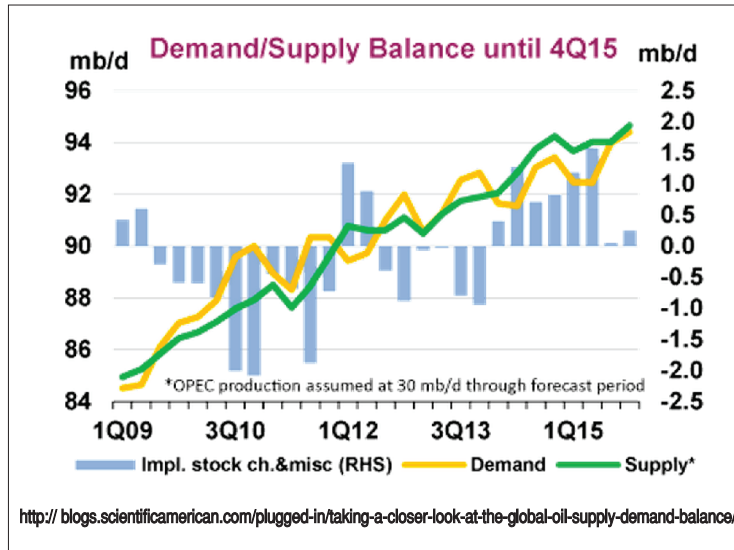
Equities	1 Year	3 Year	5 Year	10 Year
US Large Cap	1.4	15.1	12.6	7.3
US Small Cap	-4.4	11.7	9.2	6.8
Developed Non US	-0.8	5.0	3.6	3.0
Emerging	-14.9	-6.8	-4.8	3.6

a large portion of portfolios in large-cap, high quality dividend growth stocks. Not only have our stocks outperformed the global indices in this downturn, the companies we favor have been able to grow their free cash flow and have increased their dividends by 12% over the last 12 months. No one likes to see declines in their portfolios, even temporary ones, but generally these difficult times lead to attractive investment opportunities and price recovery.

Can there be good deflation?

Inflation remains anemic across the globe, despite extensive monetary policy from central bankers. The fear is that once deflation (expectations of lower prices for the same goods) sets in, it will create a vicious cycle, where people hold their money because they think prices will continue to fall. Keep in mind, deflation can arise from two very different

causes: (1) a collapse in aggregate demand, or (2) a rise in aggregate supply. For example, yes, oil prices have come down substantially over the last year, but this has largely been a supply issue, as shown in the EIA chart below. The EIA data also shows that global demand of oil and liquid hydrocarbons has increased from 93.2 million barrels per day (bpd) in 2014 to 94.3 million bpd in 2015, and is expected to increase to 95.9 million bpd by the end of 2016. We have seen similar deflation in other major goods and services, such as agricultural crops, industrial metals and the cost of computer storage. In most



cases, technology – not a collapse in global demand or trade – played a major role in these lower prices. This “good” deflation increases real wages and provides consumers with flexibility to either purchase additional goods or reduce debt – both positives for a sustainable economy.

When will oil prices recover (or at least stabilize)?

With the removal of Iran sanctions and Saudi Arabia's struggle to defend its market share and political power in the region, we dare not guess. We continue to see low energy prices as a net positive to the U.S. economy and do not expect that they will spur the dreaded deflationary spiral. We still hold our core energy stocks, but have not added to positions. In certain accounts, we've added a new position, Spectra Energy. Spectra owns and operates a large diversified portfolio of natural gas-related infrastructure assets in North America. About 95% of its sales are not tied to the price of oil and natural gas; the pipeline business has seen 9% growth in revenues, and 6% growth in its book value and dividend rate.

Outlook for 2016

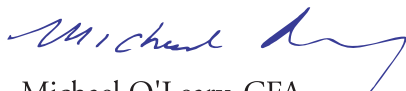
In our weekly and monthly investment meetings, we continue to debate the state of the

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economy and the intermediate outlook for stocks. We dig into the most recent manufacturing data, inventories, jobless claims, and company specific data for core holdings. We do not see a recession looming, which is typically a necessary precursor to a true bear market. While some of the macro data points to a continued weak economy, balance sheets and equity valuations look attractive. Good companies still have multiple levers to generate attractive returns on capital, even in a low to no growth environment. As a result, we continue to overweight sectors that are less commoditized and have pricing power, such as healthcare and technology, or are linked to a strengthening consumer base across the globe.

As you know, we do not manage a model portfolio. Investments are made account by account, based on a client's particular needs, taking into consideration taxes and client goals and objectives. For many clients, we will have a direct conversation about where we see the markets and why we recommend specific trades for their accounts. These conversations allow clients to understand they are not investing "in the market," but are taking an equity interest in a given company with a long term growing stream of earnings and an opportunity for capital appreciation over time.

Being patient, disciplined investors has served our clients well over many years. We will continue to pursue that thoughtful approach to our work.



Michael O'Leary, CFA
Chief Investment Officer

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