The Weekly Letter

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Unicorns Exist: This week we provide some observations on "unicorns"—companies that achieve a valuation of $1 billion or more while privately held. The innovation and disruption embodied by many former unicorns that are now publicly traded is one reason Information Technology is one of our favored sectors. We believe the sector's returns may be more subdued in 2017, but that attractive valuations historically and versus the broader market continue to make it appealing.

Markets in Review: Last week equities fell, with the S&P 500 down 1.4% and international equities, as represented by the MSCI EAFE Index, remaining flat. Bond prices rose, with the 10-year Treasury yield at 2.41%, down from 2.50% on Friday of the prior week. Commodities overall, as measured by the Bloomberg Commodity Index, fell 0.7% as WTI crude declined 1.7% to $47.97, while gold appreciated by 1.2% to $1,243.45 per ounce.

Looking Ahead: In the U.S., investors will look to readings of fourth-quarter gross domestic product and consumer sentiment. The former is expected to indicate that rising consumer and business sentiment produced better growth in the last quarter of 2016. In the Eurozone, Eurostat is set to release its Core Consumer Price Index for the region.

Recent Publications

Weekly Letter
Oil's Balancing Act
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Europe's New Challenges

Monthly Letter
Volatility and Sentiment: What Gives?

ISC Viewpoint
The Madness of March

Unicorns Exist

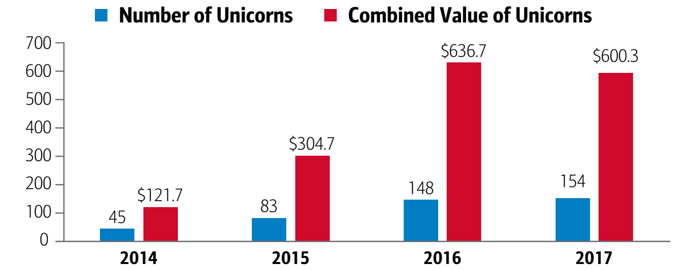
"A million dollars isn't cool. You know what's cool? A billion dollars."

Thus proclaimed venture capitalist Sean Parker upon meeting Facebook founder Mark Zuckerberg in a dramatized scene in the 2010 movie *The Social Network.*

Having sprung from the dorms of Harvard and matured into one of the largest public offerings in history, Facebook represents the quintessential "unicorn"—a private company with a valuation of $1 billion or more. The term was popularized in 2013 by venture capitalist Aileen Lee, who sought to convey the rarity of start-ups reaching that threshold. However, just four years later the herd of unicorns has grown from 39 to over 150, representing a combined market value exceeding $600 billion.

In addition, several one-time unicorns have moved on to become publicly held. (While the term is relatively new, past innovation leaders such as Microsoft, Apple and Google are unicorns of an earlier era.) The levels of innovation and disruption that many of these former unicorns embody is one reason Information Technology is one of our favored sectors. We believe the sector's returns may be more subdued in 2017, but that attractive valuations historically and versus the broader market continue to make it appealing.

Exhibit 1: The number and value of unicorns has grown rapidly



Source: The Wall Street Journal, online graphic "The Billion Dollar Startup Club,". Data as of March 2017.

The Lifeblood of Unicorns

Venture capital (VC) tends to be the unicorns' lifeblood, along with the management expertise that may accompany it. In return for their investment, venture capitalists take ownership stakes, in the form of preferred shares, often with stipulations intended to mitigate their downside risk or dilution.

The upside for an early investor is clear as a unicorn may mature into a "decacorn" worth more than $10 billion or even a "hectocorn," upon surpassing $100 billion. All is not rosy in the land where the unicorn roams, however. The potential for major loss looms large. Target companies can be unprofitable, maintain high cash-burn rates or fail to retain a unique value proposition or their human or intellectual capital. Harvard Business School Senior Lecturer Shikhar Ghosh has suggested that about 75% of VC-backed firms in the U.S. fail to return their investors' capital. With the odds seemingly stacked against them, private investors tend to rely on the rare "home run" to make up for these losses.

What do the founders and managers of the companies get out of these deals? While there are ancillary benefits, such as access to key industry contacts, the driving force behind start-up companies sourcing venture capital is to acquire funding at levels and with conditions they otherwise may not have the ability to secure. They also provide formal valuations, which can differ from those of public companies.

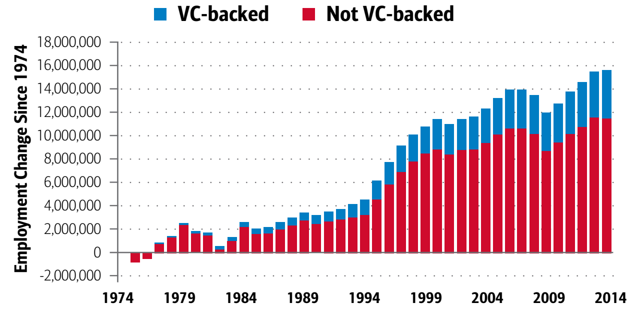
Growing up can be difficult

While the prospects for incredible wealth creation lure many to investigate opportunities within this space, the outcomes for unicorns vary wildly, even after they have become available in the public markets. Going public can bring them significant funding, along with exit opportunities for the early investors, but it may also saddle them with additional regulatory costs and otherwise disrupt business strategies. In fact, many experts note that the number of unicorns has grown as companies have increasingly foregone the opportunity to go public, opting to remain private for longer. The average time from founding to initial public offering (IPO) for start-up companies was six years in 2000 and had risen to nine years by 2015, in part due to greater availability of private capital. Even then, not all unicorns flourish to the same degree or in a linear manner upon their public debut.

Incubators of innovation

Startups, the most successful of which go on to become unicorns, have emerged as an incredibly potent source of innovation and entrepreneurship, having gained an increasing share of "idea capital." One way of quantifying their impact on innovation is to examine U.S. public companies that had acquired venture capital. A 2015 study by Gornall and Strebulaev found they accounted for four million jobs and approximately 44% of research and development expenditures of U.S. public companies. The vast majority of them are in IT, retail trade and biotechnology.

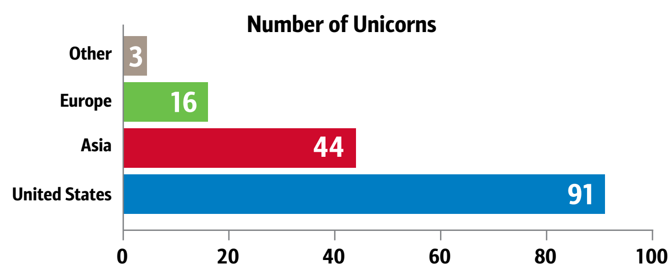
Exhibit 2: VC-backed companies do a growing share of R&D



Source: Stanford Graduate School of Business working paper "The Economic Impact of Venture Capital: Evidence from Public Companies," November 1, 2015.

The overwhelming majority of unicorns are based in the U.S., where entrepreneurial talent from around the globe leverages a legal framework and market structure that, to this date, remain the most conducive to supporting innovation. That said, it is interesting to examine the expansion of successful start-ups in other regions such as Asia, Europe and, most recently, Africa. For example, Stockholm boasts one of the highest "unicorn per capita" measures in the world, having spawned such brands as Candy Crush Saga and Spotify. The management consulting firm McKinsey & Co. notes that emerging companies in Asia tend to be centered on reseller platforms, such as e-commerce, while the business models for American unicorns are becoming more diverse as firms involved in security, payments, collaboration software, advanced analytics and the sharing-economy have earned their stripes (or horn?) as unicorns. What's clear is that technology and globalization have given innovative companies, even private ones, global reach. Perhaps even $1 billion is no longer cool enough.

Exhibit 3: Unicorns are a global phenomenon



Source: Source: The Wall Street Journal, online graphic "The Billion Dollar Startup Club,". Data as of March 2017.

CASE STUDY:

Facebook—The Social Network

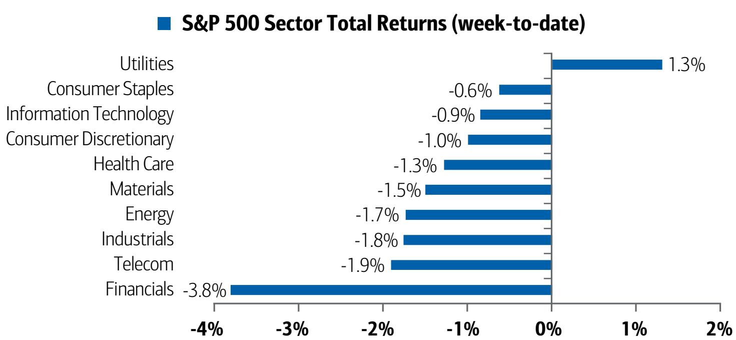
As portrayed in The Social Network, Mark Zuckerberg did indeed preside over a colossal success as Facebook's IPO transcended the business world in becoming a cultural event. For years Zuckerberg had fended off takeover offers—Yahoo! reportedly offered $1 billion in 2006—and stressed his patience in going public. In February 2012, Facebook filed for an IPO and, after conducting one of the more memorable roadshows in recent memory, in which Zuckerberg jettisoned a suit in favor of a hoodie, the company was valued at $104 billion. Public trading, beset with technical glitches, began on the NASDAQ exchange on May 18, 2012. While the shares gained on their first day of trading, they shed over 50% of their value by that September, yet by January 2014 they rebounded and added 43% to the initial offering price. During that period the trough-to-peak gain was an astounding 226%. As demonstrated by this level of volatility for one of the most iconic IPOs of all-time, financial markets may struggle in valuing unicorns as they mature into public companies.

Markets in Review

Trailing Economic Releases

- On Thursday, the U.S. Census Bureau reported new home sales for February of 592,000, surprising to the upside with a 6.1% month-over-month (MoM) increase from February. Housing data continue to strengthen, a good indicator of improved consumer and investor sentiment.
- On Friday, the U.S. Census Bureau reported preliminary Core Capital Goods orders for February declined 0.1% MoM, short of an expected rebound of 0.5%. Investors are searching for signals that increasing confidence is translating to greater business investment, which appears to be lagging.
- In the Eurozone, on Friday Markit's release of its preliminary March Composite Purchasing Managers' Index surprised to the upside with a reading of 56.7, above the BofAML Global Research expectation of 55.8. Since mid-2016, the bloc's service sector has reaccelerated, providing an important tailwind for a stronger-than-expected growth in the region's corporate profit cycle.

S&P 500 Sector Returns (as of last Friday's market close)



Equities

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
DJIA	20,596.7	-1.5	-0.9	4.9
NASDAQ	5,828.7	-1.2	0.1	8.6
S&P 500	2,344.0	-1.4	-0.7	5.2
S&P 400 Mid Cap	1,694.4	-2.1	-1.9	2.4
Russell 2000	1,354.6	-2.6	-2.2	0.1
MSCI World	1,845.8	-0.9	0.5	5.8
MSCI EAFE	1,797.7	0.0	2.8	7.2
MSCI Emerging Mkts	969.1	0.4	3.6	12.6

Fixed Income

		Total Return in USD (%)		
	Yield (%)	WTD	MTD	YTD
ML US Broad Market	2.55	0.6	-0.1	0.8
ML 10-Year US Treasury	2.41	0.8	0.0	0.9
ML US Muni Master	2.47	0.6	0.1	1.2
ML US IG Corp Master	3.32	0.7	-0.2	1.4
ML US HY Corp Master	6.03	-0.2	-1.1	1.8

Commodities & Currencies

		Total Return in USD (%)		
	Level	WTD	MTD	YTD
Bloomberg Commodity	171.1	-0.7	-3.6	-3.3
WTI Crude $/Barrel[1]	48.0	-1.7	-11.2	-10.7
Gold Spot $/Ounce[1]	1,243.5	1.2	-0.4	7.9
Level	Current	Prior Week End	Prior Month End	2016 Year End
EUR/USD	1.08	1.07	1.06	1.05
USD/JPY	111.34	112.70	112.77	116.96

Source: Bloomberg.[1] Spot price returns. All data as of last Friday's close.
Past performance is no guarantee of future results.

Looking Ahead

Upcoming Economic Releases

- On Thursday the Bureau of Economic Analysis is set to release its reading of gross domestic product for the fourth quarter of 2016. BofAML Global Research expects 2.0% growth quarter-over-quarter, in line with consensus estimates and 0.1% above third-quarter growth due to stronger inventories and a reduced drag from structures investment.
- On Friday, the University of Michigan will report its consumer sentiment data for March. BofAML Global Research expects a reading of 97.0, below the consensus estimate and February's 97.6. Consumer confidence has recently ticked higher with improving wage growth.
- On Friday, Eurostat is set to report its Core Consumer Price Index for March. BofAML Global Research expects 0.7% year-over-year growth, down from 0.9% in February.

BofA Merrill Lynch Global Research Key Year-End Forecasts

S&P 500 Outlook	2017 E
Target	2,450
EPS	$129.00
Real Gross Domestic Product	**2017 E**
Global	3.5%
U.S.	2.1%
Euro Area	1.5%
Emerging Markets	4.6%
U.S. Interest Rates	**2017 E**
Fed Funds (eop)	1.38%
10-Year T-Note (eop)	2.85%
Commodities	**2017 E**
Gold ($/oz-period average)	$1,286
WTI Crude Oil ($/bbl-eop)	$59.00

All data as of last Friday's close.

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Asset allocation, diversification dollar cost averaging and rebalancing do not ensure a profit or protect against loss in declining markets.

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