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ASSET MANAGEMENT

Q3 2017 Investment Review

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"Socrates used to call the opinions of the many by the name of Lamiae, bugbears to frighten children."
Marcus Aurelius: ***Meditations - Book XI: passage 23***

"The universe is transformation: life is opinion."
IBID - ***Book IV: passage 3***

This quarter was essentially a continuation of trends established during the first half of 2017; persisting growth in equities, with no appreciable summer pullback. Once again, the emerging world saw the greatest gains and since the U.S. Dollar declined in relation to international currencies, the stock gains for U.S. (dollar-based) investors outpaced those experienced by local investors. Notably, bond yields edged down (again), as bond prices rose. Oil rose on supply and demand developments from OPEC and gold climbed – perhaps due to the ratcheting up of tensions between the U.S. and North Korea. All in all, it was a relatively quiet summer with generally positive results.

Benchmark Index Returns

	S&P 500	MSCI All Country World	MSCI Emerging Markets	MSCI EAFE	Bloomberg-Barclays Aggregate Bond	Gold $/Troy Oz.	Crude Oil $/bbl.
Q3 2017	4.5%	5.2%	7.9%	5.4%	0.8%	3.3%	12.2%
Q2 2017	3.1%	4.3%	6.3%	6.1%	1.4%	-0.5%	-9.0%
Q1 2017	6.1%	7.0%	11.5%	7.4%	0.8%	8.4%	-5.8%

More and more, the financial press is reporting about the current phase of synchronized, global economic growth. Whereas the fragility of China's debt-fueled economy and the political uncertainties in Europe stemming from populist uprisings in France, Germany, Netherlands, and Italy were significant worries at the beginning of the year, it appears that investors have been yielding to an increase in positive economic news that is worldwide in nature. Your team here suspects that some of the relentless advance in stocks (without significant retracements) has been due to investors with money outside of stocks bringing those funds in after having observed and reconsidered the prevailing atmosphere of the global markets. As John Maynard Keynes is reported to have said about reversing opinions; "When the facts change, I change my mind. What do you do, sir?" To wit; interest rates continue to stay low and earnings estimates for this year and next appear well supported by favorable business trends. This isn't a brand-new story, perhaps the duration of the encouraging narrative is changing minds.

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We humans are inclined to learn by analogy. Certainly before the written word, knowledge was passed down from generation to generation via stories. Stories are told to warn, instruct, or validate actions using experiences that the narrator had in the past. The problem is, stories are an imperfect way to understand complex issues. Times change, and often the specific circumstances of the past do not translate well into the future. It is one thing to teach a child not to touch a hot stove because cousin Bobby burned his hand once, quite another to say that since the overall stock market trades at ~21.5 times reported earnings, future positive returns are doomed. Many cries and statistics currently being thrown about the financial world are approaching the level of an echo chamber – where everyone in the room is convincing themselves that "the market" is horribly overvalued simply because they, and everyone else, are repeating the same information over and over.

We embrace an analytical framework that seeks to concentrate on the First Principles of an issue - rather than narratives. For instance, we believe that, over time, a company's operating earnings drive its stock price. Further, the intrinsic value of a company is equal to the total amount of owner's earnings the firm will produce over time, discounted to present dollars using an appropriate rate. If earnings grow and the growth is durable, it stands to reason that the intrinsic value, and stock price, is also very likely to grow. Likewise, if future dollars earned are mathematically discounted to present dollars by a rate that is going down, the present value increases. Using this First Principle reasoning, and utilizing inputs that we have analyzed ourselves, we avoid being taken in by noisy narratives about the past with tenuous connections to the present.

Sources: Bloomberg Finance L.P., Board of Governors of the Federal Reserve System, Deutsche Asset Management Investment GmbH; as of 10/10/17

Another bedrock of our analytical process is to focus on logarithmic calculations of returns, not simple arithmetic returns. Logarithmic studies present data as compounding rates of return - which can then be used in comparison to other returns. This approach requires a willingness to favor longer-term perspectives. Over time, we are most interested in achieving a sustainable compounding effect for your

investment portfolio that is suited to your needs, where each year's gains are accumulated and used to produce more gains the next year, and so on and so on.

It is arithmetically correct to say that the S&P 500 has advanced 268.6% since its low in March of 2009 through September 30th of this year. This naturally creates an uneasiness in our minds. This is based on an anchoring opinion in our psyche that understands what goes up must come down and that falling from the highest branch of the tree hurts more than from the lowest. But is this burst of gains that began from the depths of a historically huge waterfall decline the best way to view today's investment world? Another perspective is presented in the chart – which shows the logarithmic growth of U.S. corporate earnings since 1950. This orange line is then compared to the price gain of the S&P 500 (blue line) over the same period. Finally, a constant compound growth rate of 7.5% is fitted into the exhibit as the dotted line. As we would expect from First Principles, the path of earnings growth and stock prices are very similar. Another observation is that stock prices have recently been exceeding the growth rate of earnings (since the end of 2014). This bears watching, but the magnitude of the deviation from trend, taken into historical perspective, is not extraordinary. The financial markets are a place of constant change. Factors justifying the divergence include the low interest rate environment, meager inflation expectations, and a grinding upward bias to the economy (among others). There are very few straight lines in human behavior, but our belief is that the basic relationship between earnings and stock prices will hold.

- **"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."**
  - Sir John Templeton
- **We do not believe we have reached a phase of "euphoria" in the broad U.S. stock market.**

A macroeconomic way of viewing the world generally revolves around three "policy" levers with some level of governmental control; monetary policy (a central bank's influence over short-term interest rates), fiscal policy (the taxing and spending priorities of governments), and finally the regulatory regime under which a society operates. For most of these past years following the Great Recession, monetary policy – the various mechanisms by which the U.S. Fed attempted to stimulate growth – has been the dominant lever investors have been paying attention to. This is partly due to the inability of the federal government to enact substantial fiscal policies designed to do the same. Over the same period, the regulatory regime has been one of generally increasing regulations (especially within the financial sector). An observer of the atmosphere for U.S. stocks might reasonably conclude that the monetary lever has been very accommodative for stock prices, but that – on balance – the fiscal and regulatory levers have not been as favorably engaged. We are not making a social or political commentary here, rather simply stating a financial, market-oriented opinion. In an optimal world, all three levers would interact to foster sustainable, equitable growth for society as a whole.

From an equal, standing start during the war years of 1950 to 1953, the North Korean and South Korean economies have grown in completely dissimilar ways, with dramatically different results. The difference, as an example of macroeconomic analysis, is not so much due to central bank authority and

influence, or even the spending priorities of the ruling parties, but rather a reflection of regulatory pressures. Using United Nations data from 2015, South Korea has grown its economy to be 11th in the world in terms of size, placing it between Canada and Russia. North Korea, meanwhile, was 113th, between Nepal and Iceland (out of 211 countries). The 1980s and 90s in South Korea were a time of lessening governmental intervention in the economy, whereas North Korea's authoritarian dominance over the economy was stifling. The international press highlighted the 1990s in North Korea as a place of severe famine and widespread starvation. Yes, this is an extreme analogy about regulatory levers and economic results, but what we sense may be happening in 2017 is a shift in the atmospheric pressures for stocks and the incentive structure for U.S. economic activity. Fiscal and regulatory policy levers (e.g. tax reform and trade agreements) are being activated with the intent to help incentivize domestic economic growth. Whether or not this comes to pass is another issue, but our opinion is that the rise in the U.S. stock market may be partly due to investors positioning themselves to a transformation in the macroeconomic landscape.

There's a strong case to be made that stock markets are not euphoric right now - in fact, lots of investors are worried and many are downright pessimistic. We are not beating a drum for ever increasing total stock market returns, cycles do occur, but our orientation toward what we believe to be high quality investments gives us confidence in achieving your long-term goals. We continue to emphasize a low interest rate environment in our outlook, while keeping a weather eye toward risks that would surprise the market and push rates higher. Incentive structures appear to be favoring prudent risk taking by business owners and investors - and when we combine these factors in our analysis, we remain on guard, yet confident in our existing portfolio allocations.

"That, of course, is the great secret of the successful fool - that he is no fool at all."
Isaac Asimov: *Guide to Shakespeare*.

We are very grateful for your confidence and support.

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