

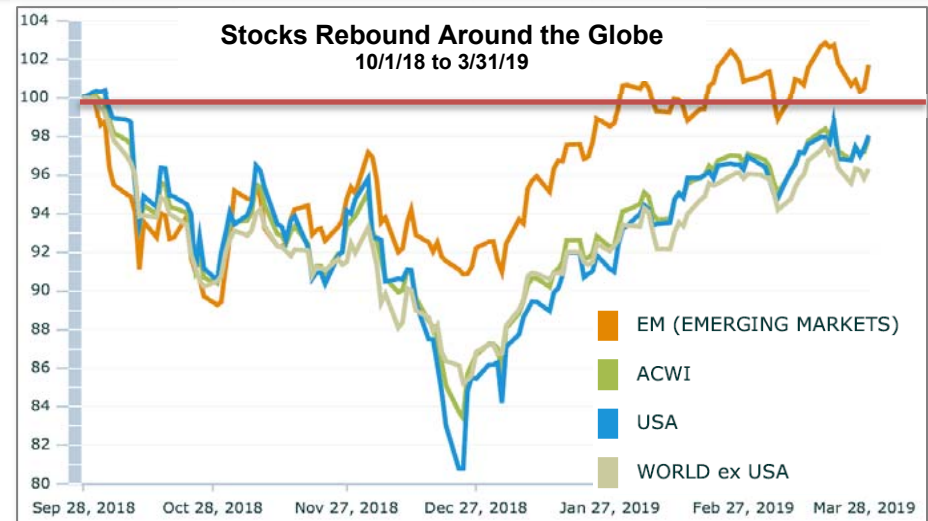
To: Aequitas Client

From: Aequitas Investment Advisors

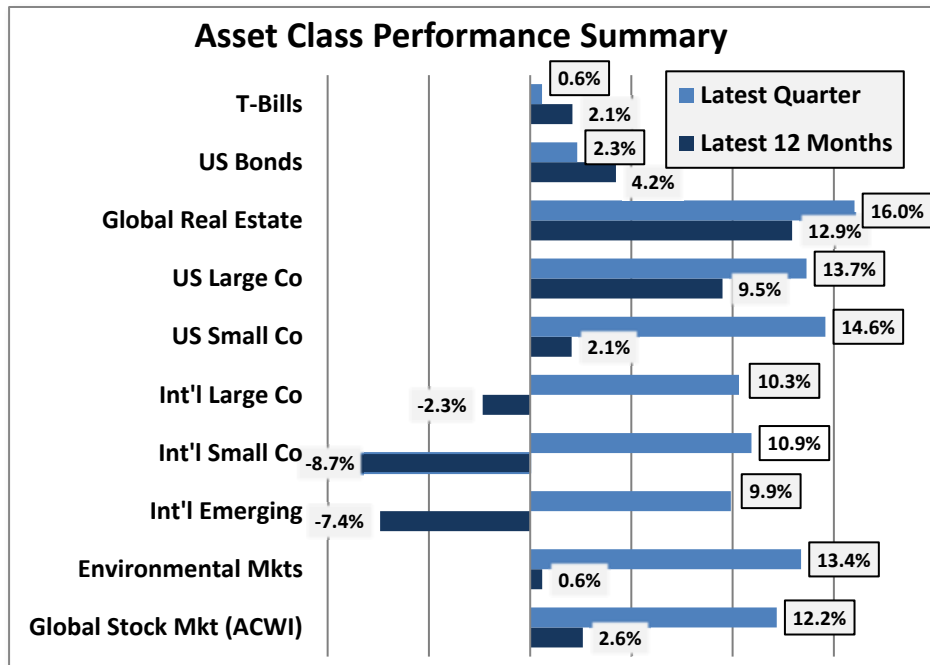
**Subject: Rebounding to a Slower Growth Scenario**

Dear Client,

The rebound in the first quarter of 2019 was just about as dramatic as the sharp downturn in last year's fourth quarter during which U.S. stocks fell by close to 20%. Late last year, corporations began issuing guidance which warned of slower future earnings growth as higher interest rates, trade war pressures and slowing global economic trends were beginning to take their toll. The windfall benefit of lower corporate tax rates was also beginning to fade. Most notably, Apple, a bellwether for global growth, issued their first profit warning in 16 years which sent shivers through the market. Between October 1<sup>st</sup> and December 31<sup>st</sup>, the share price of Apple fell by more than 30% as the company lost \$450 billion of its market value (slipping from the world's largest company to #3 at the time). Not only were investors concerned about Apple and a slower growth outlook, concerns about China's slowdown and a slightly inverted yield curve created a spike in the investor fear gauge (inverted yield curves are thought to be a recessionary warning sign). Perhaps prompted by rising recessionary fears and waning investor confidence, Fed Chairman Jerome Powell announced in mid-December that while the economy remained "healthy" and "solid," the Fed would phase down its plans for further interest rate hikes in 2019. While designed to reassure investors, his message had the opposite effect and sparked a sharp sell-off. According to Heather Long of the Washington Post, "Stocks have dropped after every Fed decision since Powell took over the top leadership role at the central bank in February, with his words and actions failing to calm markets." Nonetheless, by the end of December (with no further statements from Powell), the three-month stock market correction bottomed out and stocks began a sharp rebound with prices climbing back close to their October highpoint. Of the major asset classes included in the chart above to the right, stocks in the Emerging Markets held up the best during the fourth quarter's plummet probably because their prices had already been discounted earlier in 2018 for various economic risks. U.S. stocks, however, dropped the most given their loftier price levels entering the fourth quarter.



While global economic growth has been slowing by most measures over the past twelve months, the market's reaction during the fourth quarter appears to have been more severe than warranted by subsequent data. Since the beginning of 2019, economic reports have remained favorable in the U.S. with strong job growth, low unemployment and rising wages. These positives, coupled with persistently low inflation and the Fed's decision to delay further interest rate hikes, suggest conditions remain in place for continued economic expansion at least in the U.S. Overseas, the slowdown has been more pronounced over the past year, yet there appear to be signs of a bottoming in some regions. While global manufacturing has slowed sharply, activity in the service sector remains strong. Even the latest manufacturing reports from Asia point to a slight improvement. Further, the latest analysts' estimates from Thomson Reuters confirm a slowdown in corporate earnings growth in 2019, but their estimates also indicate a pickup in growth in 2020 with Emerging Markets Asia near the top of the list. Of course, there remain short-term risks to the outlook, including the severity of China's economic slowdown, unresolved trade disputes and the outcome of Brexit all of which are reasons we remain cautious. Longer-term, we believe that stock prices in various asset classes and regions around the globe appear to be discounted for many of these risks and offer the potential for meaningful capital appreciation. Our recommended strategy of maintaining a substantial low-risk allocation in the portfolio (i.e., high quality bonds) will serve to lessen the impact of short-term risks while providing ample liquidity for our clients' financial needs and allowing time for global equities to appreciate.



#### Asset Class Performance Review

During the latest quarter, every major asset class posted a positive return ranging from a low of 0.6% (US T-Bills) to 16% (Global Real Estate). The All Country World Index (ACWI) rose by more than 12% for the quarter in sharp contrast to its 13% plunge in the fourth quarter of 2018. The “risk on” attitude by investors was in full display across all major stock asset classes around the globe.

Over the trailing 12 months, the picture was mixed with Global Real Estate and US Large Co’s delivering the strongest gains of 12.9% and 9.5% respectively. The All Country World Index was only slightly positive with a gain of just under 3%. International stocks landed in the loss column with only modest gains in the Environmental Markets and US Small Co’s. T-Bills and US Bonds posted meaningful gains of 2.1% and 4.2% respectively.

#### A Few Words About Brexit.....or How About Portugal?

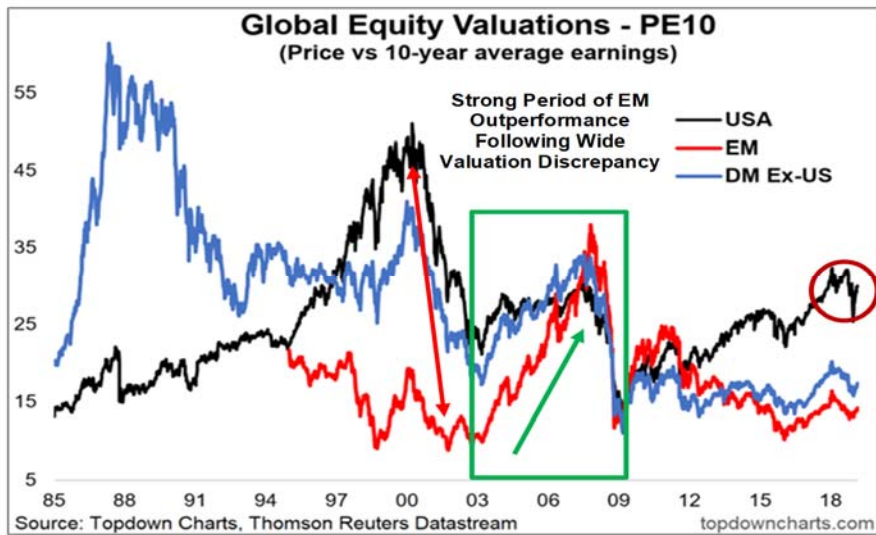
Two words sum up the progress on Brexit: further delay. The UK and European Union agreed to extend the Brexit deadline for another six months to October 31, 2019. Certain conditions must be met, however, including a requirement that the UK participates in the EU’s May 23<sup>rd</sup> elections; if not, the deadline accelerates to June 1<sup>st</sup>. The extension, however, buys more time for the fractured UK

government to form a consensus and reach compromise which has been all too elusive to this point. Given these uncertainties, we continue to recommend underweighting stocks in the UK and Europe, despite their relatively attractive valuations, as we see comparable or even better valuations elsewhere around the globe. (For an excellent article outlining the various directions the UK and Brexit may take, please visit [www.bbc.com/news/uk-politics-46393399](http://www.bbc.com/news/uk-politics-46393399)). We will also be posting this article in the Chart Room of our website).

While the economic futures of the UK and EU are shrouded in uncertainty, there is one shining light coming out of Europe which is the success story of Portugal. Yes, the same Portugal that was mired in debt and high unemployment with a bleak outlook during the European debt crisis not long ago. The *Financial Times* recently reported that Portugal’s center-left government, led by António Costa, has the country on track for an economic turnaround with unemployment down by half to 6.7% and *the possibility their budget deficit might be eliminated for the first time in over 40 years!* Rather than implementing severe austerity measures, Costa’s government bucked the directives of the EU and went the route of creating more stimulus which initially ran up the debt, but ultimately bore fruit. “People were highly skeptical about our economic policies, but we have shown that it is possible to raise incomes, lift private investment, cut unemployment and still have sound public finances.” (Portugal’s stock market is up 13% this year and, by the way, several of our clients have reported that the country is an excellent place to visit; especially with our strong dollar.)

#### Global Equity Valuations

Stocks in Portugal are not particularly cheap compared to the rest of the world probably due to their strong economic turnaround and higher level of optimism (economists forecast Portugal’s corporate earnings to grow by 23% this year compared to just 4% for the U.S.). Stocks in Portugal are trading at a Price-to-Earnings Ratio of about 16 which is somewhat expensive and roughly the same as the U.S. stock market, but stocks elsewhere in Europe and around the globe, however, appear to be reasonably priced and relatively cheaper than in the U.S. Of course, non-US stocks have been “cheaper” for a few years for good reason, including trade war tensions, Brexit concerns and faster growth in the U.S. due to the economic stimuli of tax cuts and less regulation (as well as low interest rates). In the chart below (Global Equity Valuations – PE10), you will note that the price level of US stocks based upon Cyclically Adjusted 10-Year Earnings (CAPE Ratio) has climbed significantly higher than stocks in other Developed and Emerging Markets. Historically, when wide valuation discrepancies have developed, stocks in the lower-priced regions tend to outperform for a lengthy



period of time. In comparing US stocks with Emerging Markets (EM) stocks, particularly, the “spread” in price levels is the widest it’s been in more than 15 years. Back in 2003 (where the green box begins), U.S. stocks were trading at about 22 times earnings and EM stocks were trading at about 10 times (i.e., more than 50% lower). Over the ensuing five years, EM stocks appreciated by more than 380% compared to 82% for the US stock market as measured by the S&P 500. Today, the U.S. stock market is trading at a CAPE Ratio level of close to 30 compared to the EM stocks which are trading at about 15 (i.e., about 50% lower). Underweighting non-U.S. stock regions over the past 5 or 6 years would have been beneficial, however, with such a wide discrepancy in prices currently, the opposite may be the case over the next five years, or so. (We focused our observation to the period beginning in 2003 as the CAPE valuation spread then is comparable to the current spread. The widest CAPE valuation spread between U.S. and EM stocks was in the late 1990s during the technology stock bubble when U.S. stocks were trading at record high CAPE levels of more than four times the price level of EM stocks.)

### Is the Pendulum About to Swing Toward Value Stocks?

As with EM stocks, perhaps the pendulum might also swing back in favor of Value stocks versus Growth stocks. Academic studies have demonstrated that stocks trading at low Price-to-Book valuation levels (i.e., Value stocks) have outperformed higher priced stocks (i.e., Growth stocks). Historically, the average annual outperformance for Value versus Growth stocks has been about 3.5% over the past ninety years. However, there have been extended periods when Growth stocks have outperformed Value stocks which has been the case for the past ten

years and especially the past five years. In the table below, the median spread in Price-to-Book (PB) value has been 5.1 times which means that Growth stocks have typically traded at a PB level of 5.1 times the PB of Value stocks. When the spread widens significantly, as it had by the end of 2018 when it reached 7.6 times, there is strong academic evidence to support the expectation that Value stocks might outperform over the subsequent 5 years. In the table below, when the spread has reached the 7 times level (i.e., “Cheap Value”), the outperformance of Value stocks over the subsequent 5 years has been significant (34% to 36% higher cumulatively). Of course, these expectations are based upon historic performance and academic research and there is no guarantee such results will repeat in the future. However, we believe it makes sense to factor in the findings of sound academic research rather than making the assumption that “things might be different this time.” Economic history tends to repeat itself, perhaps in different patterns and to different degrees, which is why we believe the application of academic science to portfolio construction can improve the odds of a successful investment outcome for our clients over the long run.

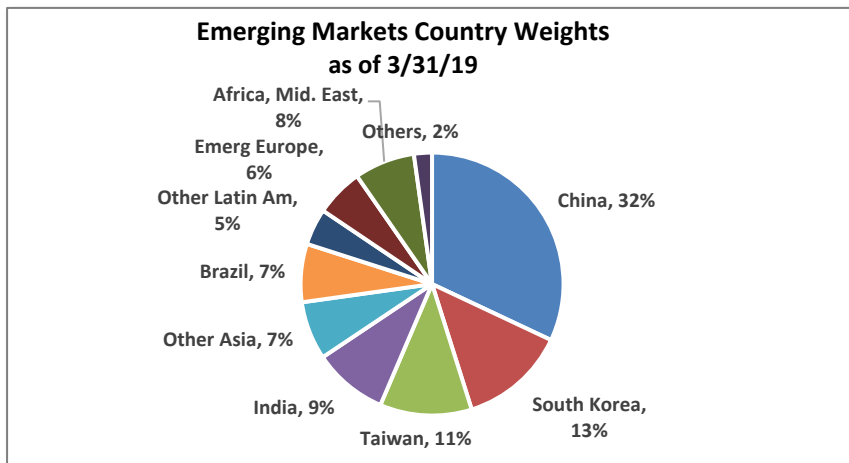
Relative Annualized Alpha for Academic Value, Equal-Weight Decile (Since 1940)						
	Spreads	Period	5 Yr Prior	1 Yr Fwd	3 Yr Fwd	5 Yr Fwd
2018	7.6x	2018 (+47%)	-3%	?	?	?
Cheap Value	7.7x	Median +50%	8%	46%	53%	36%
	7.2x	Median +40%	9%	46%	48%	34%
	6.7x	Median +30%	8%	35%	38%	29%
	6.2x	Median +20%	9%	33%	31%	23%
	5.6x	Median +10%	9%	25%	23%	19%
	5.1x	Median (All)	14%	16%	16%	15%
	4.6x	Median -10%	17%	7%	9%	10%
Expensive Value	4.1x	Median -20%	22%	-4%	12%	14%

### More on Emerging Markets Equities

In March, Tim Nash served on an investment conference panel in Boston on the topic of the Emerging Markets (EMs). One of the questions asked was, “Why invest in such unpredictable parts of the world amidst the uncertainty of trade wars and potentially higher investment risks?” Realizing that lunchtime was fast approaching and with only 15 minutes to respond, Tim boiled his answer down to the four most compelling components of our investment thesis for the audience seated in the cavernous echo chamber known most affectionately as Harvard Hall:

- **Relative Valuation:** Based upon our most reliable valuation measures, EM Equities are trading at close to a 50% discount to the valuations of





U.S. stocks based upon Cyclically Adjusted Price-to-Earnings Ratios (CAPE) and Price-to-Book Value Ratios. Such valuation ratios would suggest higher future relative returns over the long-term.

- **Faster Economic Growth:** EMs are the source of 80% of global GDP growth while representing only 10% of the world equity market capitalization. Further, Asian EM personal income levels have been growing at 5-9% annually and the EM working age population is growing at a rate that is 2% higher than that of the Developed Markets. So, what does all this mean? As with our own recent experience here in the U.S., higher economic growth typically leads to higher corporate earnings, and higher earnings typically lead to higher stock prices over time.
- **Risk and Diversification:** Certainly, the EMs offer different risks, including currency and geopolitical risks, but within a well-diversified portfolio, these less correlated risks can dampen the risks we are already exposed to in the U.S. With EM historic returns having a 0.6 to 0.8 correlation to U.S. stocks, overall portfolio volatility in a long-term investment portfolio can be reduced over time by including EM exposure in portfolio construction.
- **Getting Paid to Wait:** Finally, EM equities have an average Earnings Yield of 9%, while here in the U.S., the average Earnings Yield is closer to 6% (the Earnings Yield is calculated by dividing the aggregate earnings of EM companies by their aggregate share prices). What this means is that a dollar invested buys 50% more corporate earnings in the Emerging Markets than here in the U.S.

## Serving Their Clients' Best Interests?

Recently, the *Financial Times* reported that the world's largest asset manager, BlackRock which manages \$6 trillion, was reorganizing its management team to focus on *more profitable* products given the industry's trend toward lower cost investment solutions, including index funds and ETFs. BlackRock has become the largest provider of ETF's, but the company's profitability has suffered due to the lower fee revenue generated from ETF's (good for their investors, but not so good for the company). To improve profitability, according to the FT article, "The biggest change is in BlackRock Alternative Investors, which focuses on areas like private equity, direct lending, hedge funds, infrastructure and real estate..... These asset classes are among the hottest in the global investment industry, thanks to the high fees they charge and the ravenous demand from pension funds, insurers and endowments that are tiptoeing away from traditional 'public' stock and bond markets."

Let's hope, for the sake of Blackrock's clients, that the results for their higher cost products turn out better than they did for hedge fund investors in general over the 15-year period ending in 2013. According to a study by Simon Lack, author of *The Hedge Fund Mirage*, hedge fund managers over that timespan kept 84% of the profits leaving just 16% for investors! High fees, of course, and poor investment decisions were the primary culprits. Simon Lack concluded that investors would have been better off simply investing in US Treasuries. Since the time Lack's book was published in 2013, hedge fund fees have been falling, but are still astronomically higher than low-cost index and passively managed funds where performance has been favorable for investors. Take, for example, Warren Buffett's million dollar bet with a hedge fund manager in 2007 that an index fund would outperform a portfolio of hedge funds over the ensuing ten years with the loser required to donate \$1 million to a charity. At the end of the bet in 2017, the S&P 500 Index had returned 7.1% compounded annually while the hedge fund portfolio had returned a paltry 2.2%! You can be sure the hedge fund managers were nonetheless paid handsomely despite their pitiful results - sufficiently paid to have coughed up \$1 million for the charity!

At Aequitas, we understand that one important way we serve our clients' best interests is to minimize mutual fund fees and investing costs in general. In that regard, we're proud of the fact that the mutual funds we currently recommend are considerably less expensive than industry averages. We may not be the largest asset manager, but we believe we are better at serving our clients' best interests.

In closing, here's to the advent of spring and a time to renew hope for the future!