CROWELL WEEDON ASSET MANAGEMENT
MONTECITO INVESTMENT PORTFOLIOS

January 1, 2020

Dear Fellow Investors,

We've outlined the major topics & takeaways of our annual letter below – details follow!

MAIN MESSAGE HIGHLIGHTS:

- MUCK AND UP: THERE'S BEEN A CLEAR, LONG-TERM PATTERN OF U.S. STOCK RETURNS. AFTER LIVING THROUGH A PERIOD OF MUCK, WE BELIEVE WE'RE ON THE CUSP OF A PERIOD OF UP.
- FACTORS WE SEE INFLUENCING OUR LONG-TERM UP PREDICTION: CORPORATE TAXES, ANIMAL SPIRITS, INNOVATION, THE FED, VALUATION, & SENTIMENT

FORECASTS

- **Economy:** No negative GDP quarters and full year at 3%
- **S&P 500:** A positive, average return from U.S. stocks
- **Short-term rates**: No Federal Reserve rate movement
- **Long-term rates**: 10 year treasury yield up to as much as 2.4%
- **Oil prices**: $54 to $69 price range for WTI
- **Inflation**: remains under 3% for the year ahead
- **Commercial real estate**: FTSE NAREIT All Equity up 1 to 5%
- **Residential real estate**: Case-Shiller Index continues its climb

Three more forecasts not entirely investment related:

- **Politics:** Trump not convicted on impeachment charges and the Democratic Presidential convention will be brokered
- **Investing in Disruptive Technology:** The rise of vertical farming
- **A new acronym for market leadership:** TADAA (Tesla, Apple, Disney, Amazon, Alphabet)

CONCLUSION

MAIN MESSAGE

A few years ago we wrote about the Lost Generation. This was a generation that endured the dot-com crash, accounting scandals, the housing bubble boom and bust, and near financial system implosion all within a single decade. These events etched fear and distrust into the hearts and minds of many, impacting investment decisions to this day. The evidence is rather overwhelming. In spite of stock markets climbing to all-time highs, unemployment near all-time lows, and innovation / technological advancement progressing at a rate the world has never seen before – the typical investor is more likely to hit the eject button and sell every stock they own rather than bang down our front door rushing to invest as much as possible into the market. According to the Wall Street Journal, 2019 saw over $135B pulled out of US stock-focused mutual funds and ETFs, which is the greatest amount ever recorded!
It is easy to fall victim to the belief that what recently happened will repeat itself in the future. This is human nature and we covered this topic last year when writing about anchoring and recency bias. Humans tend to give disproportionate weight to recent events and discount information from the more distant past. However, when it comes to investing we must remember that markets are long-term and our perspective must be long-term as well. With this in mind, a study was born. Our country has certainly been through rough times in the past. What did those other eras look like? How long did they last? What were returns like? We examined monthly return data on the US stock market and made some fascinating discoveries.

Our main takeaway is that there has been a clear pattern of long-term movements for US stocks in what we refer to as "Muck and Up". The Muck refers to long stretches where the market struggles to eclipse previous highs. The market action is violent with big swings taking place. The drops are severe and take a long time to recover from as fear runs rampant.

TIME PERIODS OF MUCK

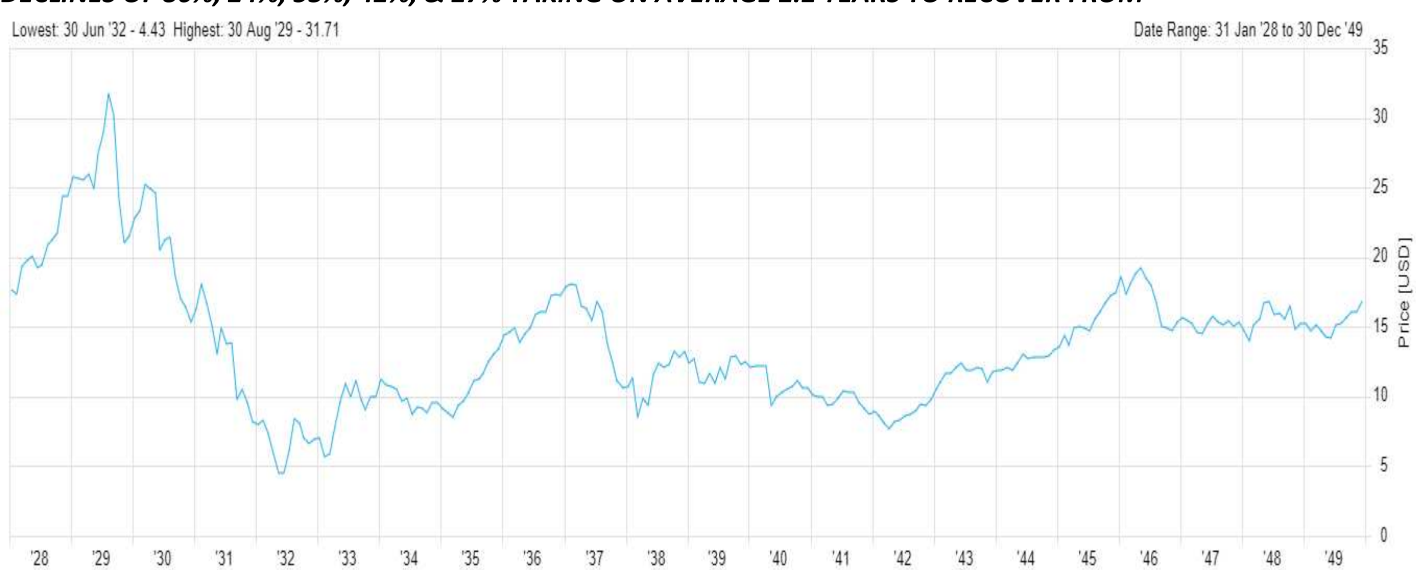
(All monthly return data and charts courtesy of FactSet)

FEBRUARY 1928 TO DECEMBER 1949

21.9 YEARS

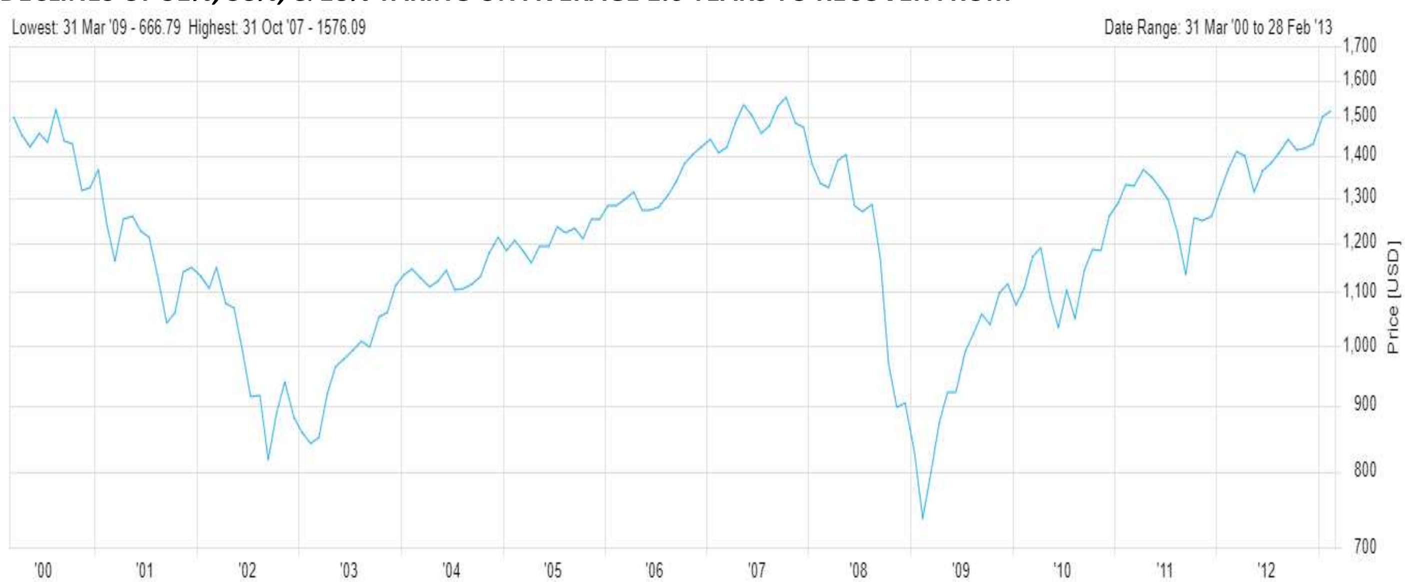
RETURN: -2.72%

DECLINES OF 86%, 24%, 53%, 42%, & 27% TAKING ON AVERAGE 2.2 YEARS TO RECOVER FROM



NOVEMBER 1968 TO JULY 1982
13.8 YEARS
RETURN OF -1.18%
DECLINES OF 33%, 46%, 19%, & 26% TAKING ON AVERAGE 1.6 YEARS TO RECOVER FROM

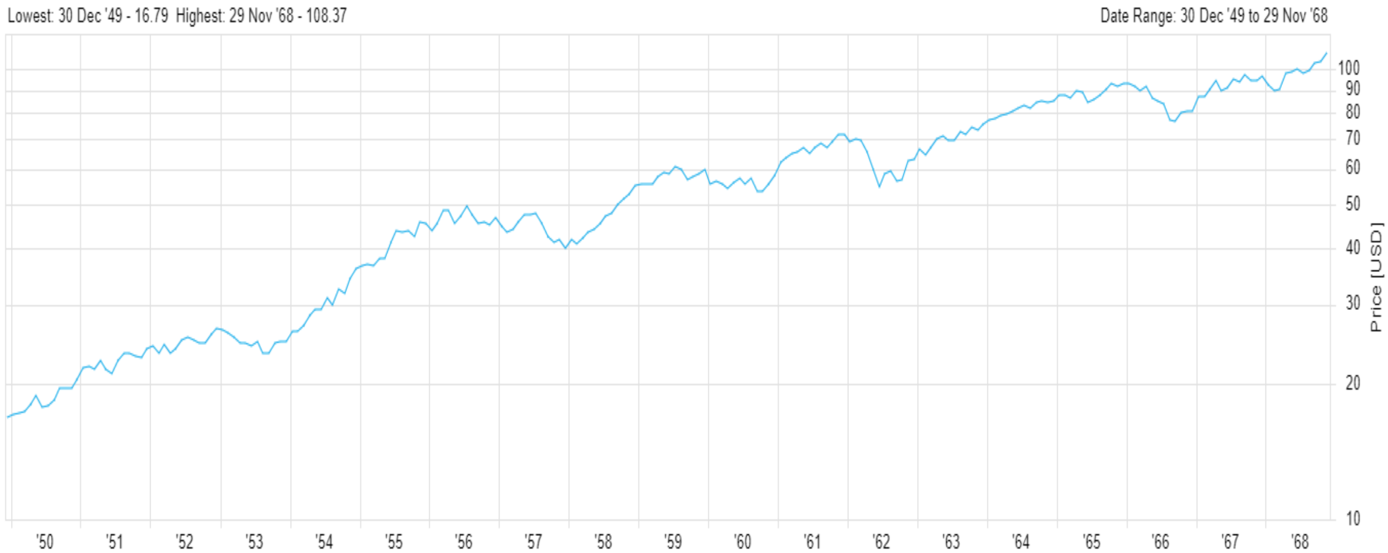
MARCH 2000 TO FEBRUARY 2013
13.0 YEARS
RETURN OF 1.07%
DECLINES OF 51%, 58%, & 18% TAKING ON AVERAGE 1.6 YEARS TO RECOVER FROM



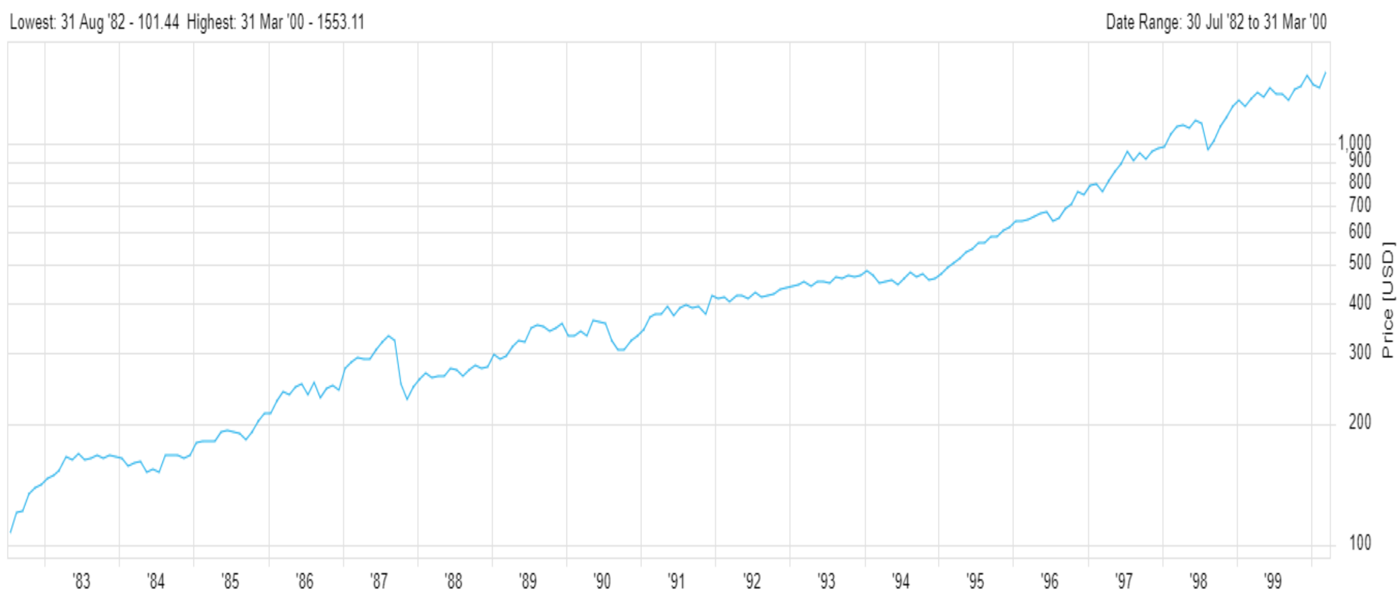
Eventually, the market clears through these periods of Muck and then embarks on a long journey of moving significantly higher. These stretches still go through downturns but the drops are far less severe and declines are quickly recovered. Market declines shift from being viewed as the start of the next crash to being viewed as buying opportunities.

TIME PERIODS OF UP

DECEMBER 1949 TO NOVEMBER 1968
19 YEARS
RETURN: 545%
DECLINES OF 8%, 19%, 12%, 21%, & 18% TAKING ON AVERAGE 1.1 YEARS TO RECOVER FROM



JULY 1982 TO MARCH 2000
17.8 YEARS
RETURN: 1,377%
DECLINES OF 33%, 19%, 9%, & 20% TAKING ON AVERAGE .3 YEARS TO RECOVER FROM



These long-term trends are difficult to identify when we're bombarded with a sensationalized 24 hour "news" cycle. However, after analyzing our study we believe there are numerous ingredients in place that could see us currently in the early stages of the next major Up move for the US stock market.

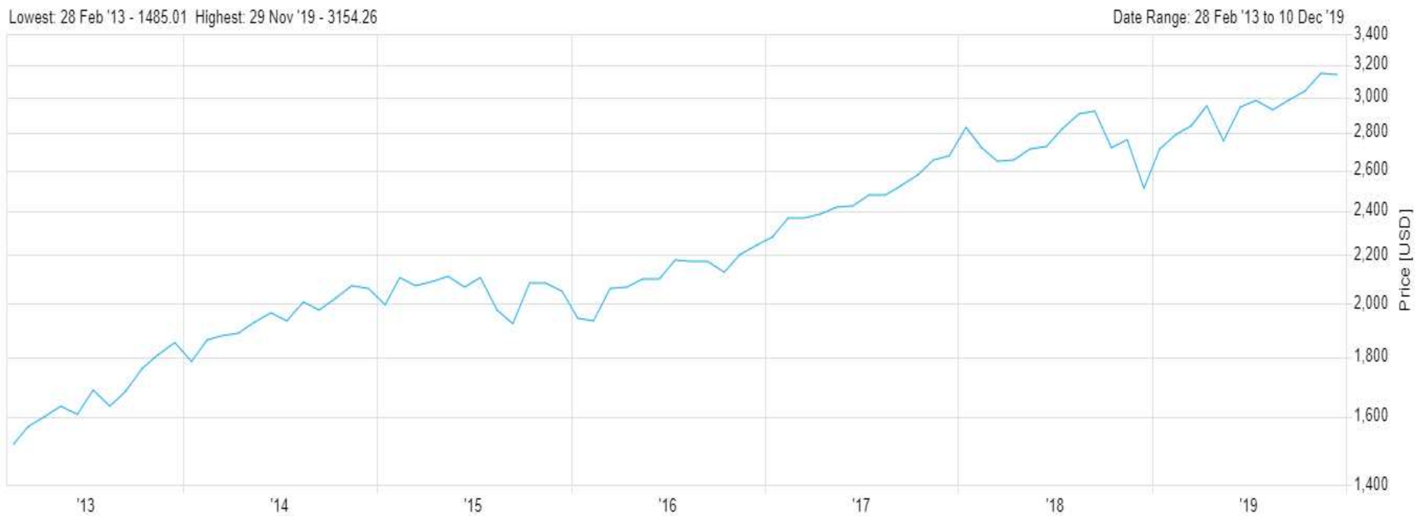
THE NEXT MOVE UP?

FEBRUARY 2013 TO TODAY

6.9 YEARS

RETURN: 112%

DECLINES OF 15% & 18% TAKING ON AVERAGE .9 YEARS TO RECOVER FROM



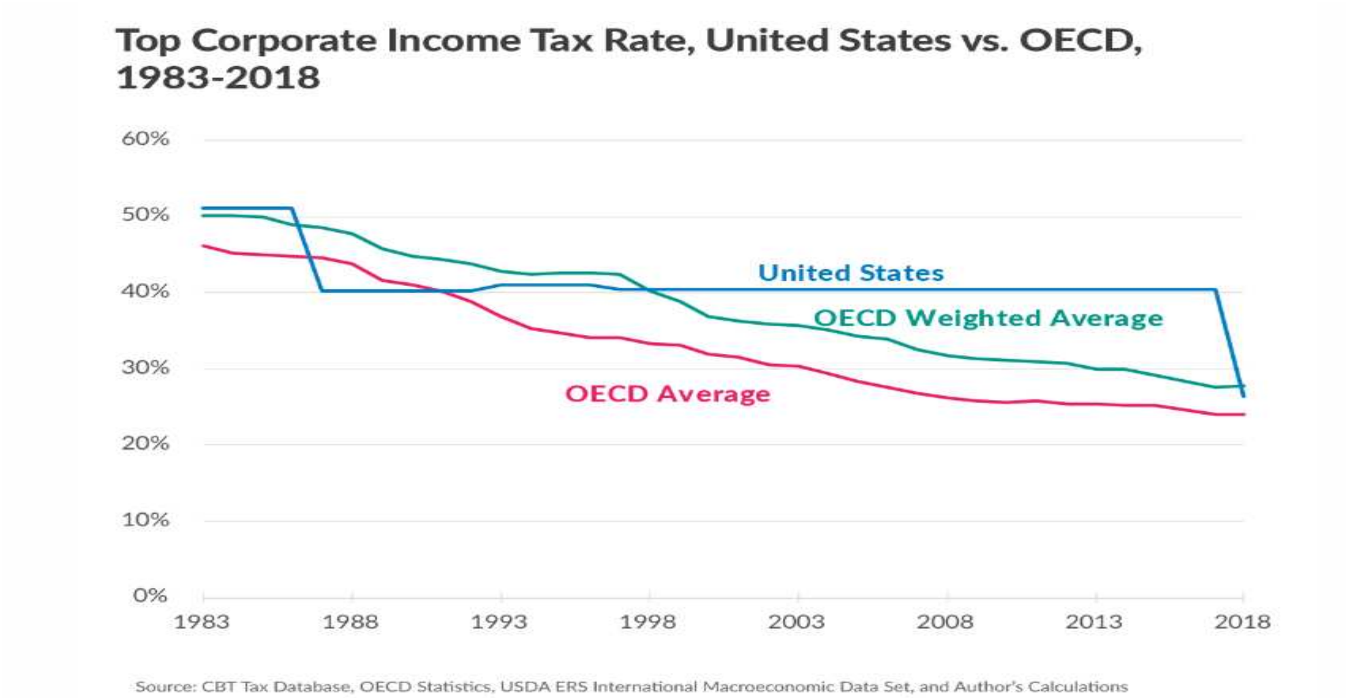
It may sound outlandish to predict we're in the early stages of the next significant Up move when we constantly hear how close we are to the next recession, how late stage we are in this economic expansion, and how we're in the last innings of this bull market. However, we challenge these assumptions. Very few investors felt that we have been in a roaring bull market at any point over the last 20 years. **It is unfair to measure the start of an upward market from a trough that was catastrophic and emotionally damaging to those that experienced it.** If you had the worst possible timing in the world and invested in October 2007 it took you 5 full years to get back to even! If we are correct it doesn't mean we won't experience recessions or even bear markets. However, there will be a shift in sentiment when they do occur. Instead of causing catastrophic panic these dips will be viewed as opportunities and not the start of the next crash that scars an entire generation.

These up moves cannot simply be fueled by stock prices moving higher. There must be fundamental ingredients in place that will drive the economy, create growth, and justify valuations. Fortunately, we see numerous factors contributing to the next move Up.

FACTORS WE SEE DRIVING THE MOVE UP

#1 CORPORATE TAX RATES ON PAR WITH THE REST OF THE WORLD

Congress recently passed a piece of legislation that received a lot of attention at the time, yet is rarely mentioned anymore. The Tax Cuts and Jobs Act was signed into law on 12/22/2017 and cut the U.S. corporate tax rate from 35% to 21%. Prior to this, the US had the fourth highest corporate tax rate of 202 jurisdictions surveyed in 2017 and the highest among OECD (Organization for Economic Cooperation and Development) nations. It wasn't just slightly higher than OECD members either. When combined with average state taxes the US corporate tax rates were 60% greater than the average OECD member!



https://taxfoundation.org/benefits-of-a-corporate-tax-cut/

Although the passage of the tax cut was a one-time event, it is leaving a lasting impact on employment, wages, capital investment, research and development, and overall business sentiment. It has been referenced numerous times by some of the most respected business leaders in the world:

"Last year, however, 40% of the government's "ownership" (14/35ths) was returned to Berkshire – free of charge – when the corporate tax rate was reduced to 21%". – Warren Buffett 2018 Berkshire annual letter

"The economy is ripping. Salesforce's own customers are benefiting from changes that have come about as a result of recently enacted U.S. tax reform. Hundreds of CEOs have told me they are investing more because of confidence stemming from the tax breaks." – Marc Benioff, Salesforce CEO

#2 SHIFTING ANIMAL SPIRITS

In John Maynard Keynes' 1936 book "The General Theory of Employment, Interest and Money" he described "animal spirits" as instincts and emotions that influence and guide human behavior.   Humans have a spontaneous urge to action rather than inaction. We strive to make decisions that result in positive outcomes. There is a common misunderstanding that these spirits have recently been released. Keynes said these spirits are always around – they just drive differing actions. Having lived through a period of major accounting fraud, high-tech blow-ups, massive foreclosures, and near financial system collapse, the animal spirits drive decisions to hunker down, be safe, and distrust everything. People who did this believed they were acting positively, trying to preserve what they had, and avoid catastrophe. This is the exact sentiment associated with periods of Muck, however, we feel this is gradually changing. The farther away we move from the dot-com blow up and Great Recession, the more likely we are to see behaviors shift to decision making driven by confidence and optimism.

#3 WE ARE IN THE MIDST OF A TECHNOLOGICAL AND INNOVATION BOOM

We've written at great length on this topic. We are living in arguably the most innovative time in human history. Virtually every industry is being disrupted. This trend is not slowing – it is accelerating. Gains in computing power continue their exponential growth rate giving rise to the digitization of business, importance of data analysis, and evolution of artificial intelligence. This advancement continues to remove layers of expense, making the world faster, more efficient, and displacing stagnant businesses and processes with far superior solutions.

#4 ACCOMODATIVE FED

We do not envy the job of Jay Powell. As the 16th Chair of the Federal Reserve he has been under constant scrutiny since taking over the position in February 2018. Regularly blasted by President Trump on Twitter and named as the cause of the market sell-off in Q4 2018, we feel the criticism is rather unjustified. The Fed has merely been trying to find the neutral rate of interest. Although they are technically raising interest rates we believe when you're coming off a base of 0%, the first several moves are quite meaningless. There is a point at which interest rates become so low they no longer have any material impact on an economy. All we have to do is look at every single country around the world with 0 or negative rates – their economies are certainly not booming. Instead, cutting rates to extreme levels seems to be interpreted more as a sign of serious weakness than economic prosperity. Because of this, we're pleased to see the Fed trying to find neutral. Until we get rates closer to 3% we do not view this as tightening and therefore see very little meaningful impact to stock prices.

#5 U.S. STOCK MARKET VALUATIONS ARE IN-LINE WITH HISTORIC AVERAGES

The S&P 500 Index trades at a long-term, historic average of approximately 15 times earnings. By the very nature of an average, that implies you spend time both above and below this number. During times of uncertainty and fear this multiple has dipped below average. We've also witnessed this multiple spend significant time below average when there were attractive alternatives available such as 10 year treasury bonds yielding 14% (this happened in 1981).

Currently, the S&P 500 trades at approximately 17.6 times 2020's earnings estimate. While this is above average it is also within one standard deviation of the mean. Further, one could argue that with today's innovation boom, and alternatives such as fixed income yielding paltry amounts, an above average earnings multiple would be justified. (Keep in mind, the average earnings multiple of the S&P 500 when the 10 year US treasury yields below 4% is approximately 20.) The big takeaway – this is not the late 1990s and we are nowhere near euphoric valuations.

#6 SENTIMENT REMAINS WEAK

It is worth repeating, 2019 will go down as the year with the greatest amount of money pulled out of U.S. stocks on record. Consensus keeps waiting for the next crash. But in investing, consensus is usually wrong. **Remember, the only times in US history where the S&P 500 endured two greater than 20% annual declines within a 10 year time period was 1929 to 1939 and 2000 to 2010. Those waiting for the next crash might be waiting for a long time. After the decline in 1937 you had to wait 37 years before the next 20% down year in the market!** Without sentiment rising to euphoric levels we are lacking the stretch in valuations that becomes unsustainable and leads to truly dramatic market declines.

SUMMARY

Rather than following the herd and proclaiming that we're nearing the end of this economic expansion and bull market, we prefer to take a different perspective. Ours is a perspective grounded in long-term analysis that clearly illustrates a pattern of market behavior. Perhaps that is why it is never mentioned in the media – they want you to react by the day. Looking through a multi-decade lens doesn't create the same sense of urgency. You'll never know the exact starts and ends of these long-term moves until you've lived through them. However, there are signs to look for. Analyzing those signs leads us to believe we are in the early stages of the next significant, long-term Up move in the market.

FORECASTS

This is the section of the annual letter where we discuss forecasts made in the past and discuss the bullets on the opening page of this annual letter. As we do every year, we remind ourselves it's a foolish section where we think we can actually make forecasts for the future! While we had 7 ½ of our 10 possible forecasts correct last year (yes we score favorably for ourselves), score isn't what this is about. We enjoy using "What If" in our thought process as it allows for outside-the-box thinking and challenges our (and your) assumptions. As a reminder, these forecasts are our thoughts as of the writing of this annual letter in mid-December. Markets are dynamic and ever-changing. When change occurs, so too must our thoughts to adapt to the then current investment environment. This is similar to our health. We get check-ups on a regular basis and develop a plan to maintain or improve ourselves. However, should we get sick we must be flexible enough to alter our plan to adapt to the new diagnosis we have been dealt.

We received good feedback on the new format last year so we will continue it again. Each major area is discussed as a continuum of thought, the past and the future. And yes, we will have a few forecasts outside of conventional thinking – just to keep us all on our toes! We reiterate, our portfolios are managed substantially from the bottom up. This means we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2019's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2020.

The Economy:

Last year we believed the economy would continue to expand around a 3% rate for the year. We believed the long awaited recession was not inevitable – and spoiler alert, we still hold to that thought. While the indoctrinators of fear (otherwise known as the media) will have you believe it is right around the corner, most measures of the economy are at odds with this short-term outlook. While recessions are a normal part of the business cycle, one certainly could occur. However, as you can tell from this year's Main Message, we would treat a contraction as an opportunity to invest and not believe the severity of another "Great Recession" was in the offing.

As highlighted in our Q2 Market Commentary, viewing today's economy solely through the lens of Gross Domestic Product (GDP) can drastically distort reality. While GDP is a really useful statistic when measuring a manufacturing led economy, it has grown woefully out of touch with today's digital economy. Even the Bureau of Economic Analysis (BEA) https://www.bea.gov/ publishes different calculations of GDP. For example, during the 3rd quarter of 2019 Current Dollar GDP increased by 3.8% while the traditional GDP measure increased by 2.1%. We feel the economy was even stronger than the "official" GDP numbers. Unemployment is near record lows, wages are strong and improving, companies are once again investing for the future, and innovation is happening like never before. The key points of our 2019 prediction held true allowing us to take a **full point**: GDP continued to grow and the economy did not slide into a recession.

In spite of GDP's limitations, we must work with the tools we are given. **For 2020, we once again predict GDP growth around the 3% range and no quarters of contraction.** We remain optimistic that thought leaders will continue to push for new tools to measure today's economy and better capture reality. As Jerome Powell recently noted in an October speech: "GDP measures the value of products and services that are bought and sold. But many of the greatest technological innovations of the internet age are free. How should we value the luxury of never needing to ask for directions? Or the peace and tranquility afforded by speedy resolution of those contentious arguments over the trivia of the moment? Good decisions require good data, but the data in hand are seldom as good as we would like." **https://www.cnbc.com/2019/10/11/fed-tries-to-figure-out-value-of-free-internet-services-to-americans.html**

The Stock Market:

A few years ago we wrote: *"Earnings drive markets over the long-term. Expectation of future earnings drives markets in the short-term, along with some event-driven, emotional volatility."* That could truly become our mantra. We should add to it though that *"Return potential amongst asset classes will impact the valuation levels of other asset classes over the short to intermediate term*." **Last year we forecast the S&P 500, driven by earnings growth, would reach a level close to 2,850 by year end.** Today, the index is well in excess of 3,000. We got the earnings growth right but missed the multiple expansion that took place led by interest rates declining to historic lows. This relative valuation differential continues to this day with the S&P 500 yielding more than a 10 year US Treasury bond. This has produced one of the easiest no-brainers of all time. What would you rather own: an investment paying a fixed 2% rate for 10 years or 500 of the best companies in the world, generating a growing income stream also paying approximately 2%? In the end, we got the direction right but not the magnitude and will therefore **take a half point for that**. Also, maybe a tiny bit of extra credit for this bit of foreshadowing: "*Democrats may flex their muscles in the House and impeach the president over one thing or another, but chances of a conviction in the Senate are remote*." Choosing simplicity over complex, we'll stick to our full, half, or no point system as this impeachment hasn't really had any effect on the financial markets.

In 2020 we see continued growth of earnings for the S&P 500. While Wall Street is known to overestimate for the upcoming year only to revise downward as the year progresses, we would not be surprised to see the current earnings per share estimate of $178 met or exceeded for 2020. The trick to forecasting the index level is correctly calling the multiple that markets will place on those earnings. We see several items that could meaningfully impact the market multiple:

1. Trade disputes – while these are grand talking points for our indoctrinators of fear (the media), we feel trade disputes are largely a non-event to corporations on a long-term basis and really only impact the behavioral finance aspect of valuation on a short-term basis.

2. Politics – this Presidential election could have a more fundamental impact on the forward looking valuation of the market. If the Democratic candidate is rather moderate we believe there will be little meaningful impact on valuation. However, if the candidate is viewed as extreme, not business friendly, doesn't care if taxes go higher to fund their agenda, and pushes hard to break up big business, we feel this could certainly have a negative impact on the market multiple. At present, we feel the markets are pricing in no change of leadership in the oval office or no significant change of policies even with a Democratic victory.

3. Interest rates – we believe the greatest impact on the market multiple will be the predicted and actual direction of long-term interest rates. The Federal Reserve has direct impact on short-term rates, but financial markets have a far more direct impact on the movement of long-term rates. As evidenced in 2019, relative valuation does matter. (We'll cover our complete prediction for rates in the next section.)

When forecasting, we are reminded of the old saying "There are lies, damn lies, and statistics." In year's past we've used some rather complex statistics and fancy models to predict a single point target for the S&P 500. These can certainly be useful tools, but we believe focusing on a single number misses the point of why we're actually investing. We are trusted to allocate capital amongst various investments, balance risk vs. return, and find opportunities for our investors. Going forward, we feel this is best put into perspective by simply predicting if we believe returns from stocks will be up or down and have an above-average, average, or below-average year. With that said, **we believe the S&P 500 will have a positive year in 2020 and produce a total rate of return in line with historic averages.** Now, as with any statistic there can be some debate as to what the historic average return of the stock market is. According to Investopedia, the average return from 1926 to present is close to 10%, from 1957 to present is about 8%, and from 1950 to 2009 about 7%. If we do some simple math, we expect the economy (as measured by GDP) to grow around 2.5%, Inflation to be around the FED target of 2%, approximately 2% in dividends, some share buybacks, and little change in the market multiple. Adding this up, gets you a positive return somewhere in-line with whichever historic average return you choose.

https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp

Short-term rates:

For 2019 we predicted a maximum of two, 25 basis point rate increases. We certainly did not see the Fed cutting rates, making a "mid-course adjustment". We did note, the Fed would be conscious of the perceived negativity an inverted yield curve could cause. In our opinion, if the Fed would have focused solely on the US economy's underlying strength they could have continued to raise rates in search of normalcy. As this clearly did not take place, we are left with the conclusion that the Fed either succumbed to political and market pressures, or cut rates due to slow growth and fragile recoveries in worldwide economies. Whatever the reason, **we were wrong and get no points here.** - See, we told you this forecasting exercise was not an exact science!

For 2020 we continue to see a very strong US labor market and benign inflation. The dual mandate is well in hand. If there ever was a time when the Federal Reserve could raise rates to give themselves more room for adjustments later, now would be the time. They may not want or need to be accommodative here in the US, but we operate in a broader global economy. Weakness in many economies around the world should keep a lid on any further rate hikes and see the Fed prefer the US economy to run a little hotter than expected meaning inflation above their target range. We believe cutting rates again will send the wrong signal. Further, with the upcoming Presidential election the Fed will want to refrain from any appearance of being political. Although we do not predict any rate movements, keep in mind they do have other mechanisms to influence money supply and will utilize those as needed to fine-tune accommodation / tightening. In fact, they may be more engaged in smoothing the financing of the US budget deficit with open market activities than worrying about the discount rate. **For 2020 we see no rate movement by the Federal Reserve all year long.**

Long term-rates:

For 2019 we saw the economy still growing, corporations making more money, and no signs of a recession. Given this outlook, we believed the Fed would be able to raise rates long-term bond yields would follow suit. We were wrong. With short-term rates being cut the entire yield curve declined and long-term rates will end the year lower than where they started. **No point for us here**.

For 2020 we see the 10 year treasury yield rising a bit and ending the year where rates were at the end of 2017 – 2.4%. The lower for longer crowd will have their resolve tested a bit, but on a historical basis we will remain in the lower camp. We do feel the lows in long-term rates may have been established and the multiyear bottom we're currently putting in will continue for the next year. However, as Brexit transitions from political football to reality, clarity may finally come out of Europe. We believe financial markets will embrace this clarity and foresee a better international marketplace as the year unfolds pushing the US yield curve to a more normalized positive slope. Further, inflation remains a traditional influence on long-term rates. While the Federal Reserve has signaled they're fine with inflation running above their 2% target, we do not see the inflation genie being let out of the bottle just yet.

Inflation:

Last year we forecast, "*Given the potential Washington gridlock, passing a Federal minimum wage increase seems unlikely. Resolution to trade and tariff issues with China seems possible but may take longer than many think given the negotiating styles of both sides. Further, even if oil does bounce back in price, the continued impact of disruptive technology on industry after industry will serve to keep* *inflation under 3% for the year ahead*." **Full Point**: The year over year increase in inflation for the 12 months ending November 2019 was 2.1%. As important as the number our influencing factors were correct as well. https://www.bls.gov/cpi/

For 2020 we once again forecast inflation remains under 3% but starts to see a bit of an upward trend. Many of the factors discussed in our interest rate section will be the influences that keep inflation in check. While there may be a resolution to Brexit, we feel it will not be as smooth an exit as the voters in the UK hoped for when giving Boris Johnson his mandate. Further, the Phase One trade agreement with China has yet to be signed let alone approved by Congress. Lastly, we'll have political paralysis in Washington going into a hotly contested election. Absent any stimulating event or program, **we see inflation staying benign and under 3%**

Oil:

Once again the fundamentals have driven the marketplace without any artificial shocks to impact the pricing. As we said last year "*We maintain when the price gets close to $50 a barrel you see efforts to prop up the price. It may go lower until those efforts take hold, but $50 seems to be the fundamental floor to the long-term range of oil. Likewise, when the price closes in on $65 we see oil companies selling future production to lock in the revenue side of their budgets at nice profits. Drilling activity begins to increase and production growth is not far behind. The price may go above our fundamental top of range number of $65, only to fall again when supply increases."* **Full point** here as that is what happened in 2019.

For 2020 we would think that the fundamentals will continue to see a range bound price. However, we are slightly raising our range to reflect rising costs of production and a new variable in the equation – Aramco becoming a public company. Aramco coming public will put pressure on Saudi Arabia to keep the price of oil higher so that they can continue to raise capital from the financial markets to fund the transition of the Kingdom away from an oil-based economy (a stated long-term objective). This could influence OPEC policy to manage the price of oil higher if developing markets show enough economic strength to weather price increases.

We continue to believe that electrification is a trend, but will not significantly impact oil demand until the electric fleet of vehicles is much larger. However, even electric vehicles need the batteries recharged. The idea that solar and wind will completely replace fossil fuels as a utility's main fuel source could be even further out than mass vehicle electrification. **Our forecast range for this year is $54 to $69 for WTI**.

***Commercial Real Estate**:*

Our 2019 forecast: *As we are not forecasting a rapid rise in the 10 year interest rate, we believe rental increases will be able to offset the negative impact of cap rates creeping up. Therefore, for 2019 we see returns from commercial real estate coming from cash flow and not appreciation. The only exception will be those portfolios adding incremental value though accretive acquisitions or property enhancements that drive additional revenue. Otherwise, not much will change in 2019 and we would continue to emphasize Industrial, Manufactured Homes, Health Care and Data Centers.*

Through November 2019 the top performing sectors in the REIT universe were: Manufactured Homes (Up 59.40%), Industrial (Up 52.38%), Single Family Homes (Up 46.64%) and Data Centers (Up 41.13%). We are pleased to have identified three of the top four sectors for 2019. The one other sector we highlighted (Health Care) was up 22.09%. **Full Point.**

Source: https://www.reit.com/data-research/reit-indexes/historical-reit-returns/performance-property-sector-subsector

Commercial Real Estate offers some very important characteristics in a long-term investment portfolio:

- A growing income stream driven by the ability to increase rents over time
- A non-correlated asset class that helps reduce the volatility of a portfolio

In the past, real estate investors had to own the properties directly. This offered both pros and cons:

Pros

Possible tax advantages such as depreciation
Possible estate planning strategies
No daily pricing helps keep your investment focus on the long-term

Cons

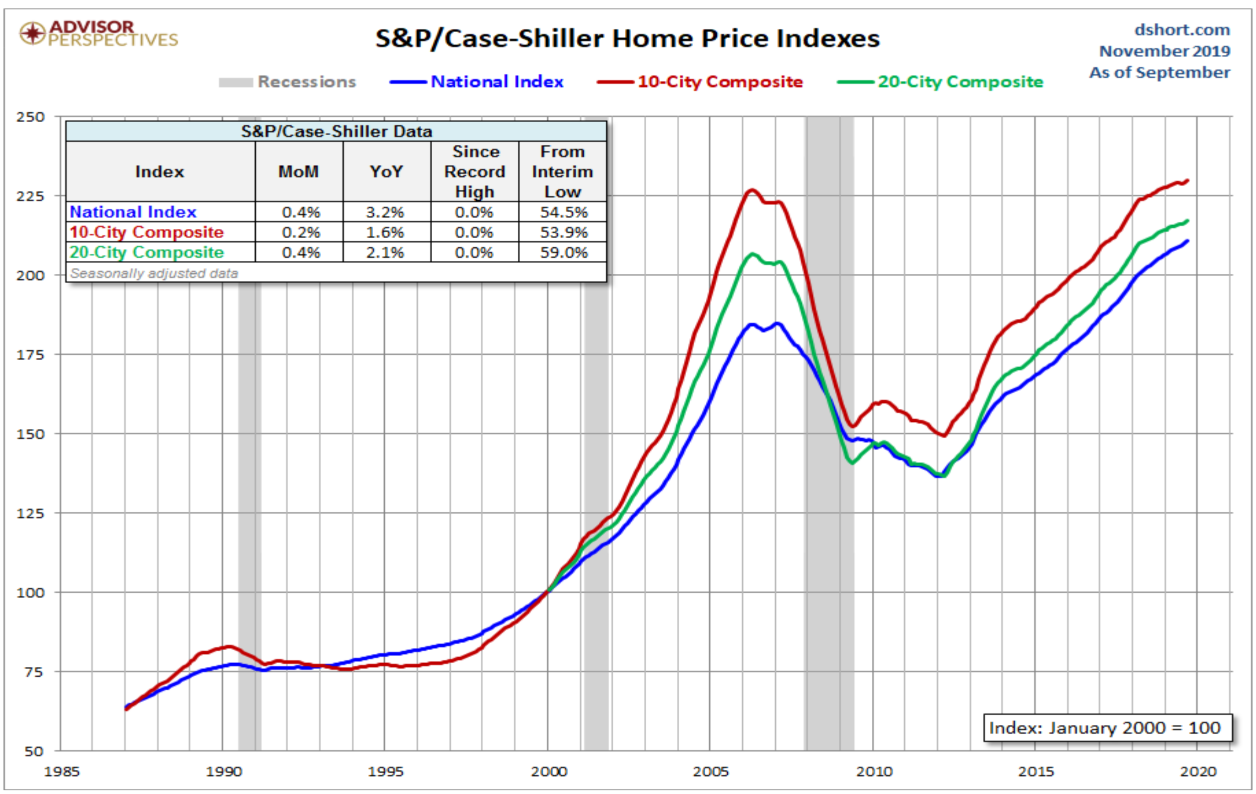
Do I want to be a landlord?
Easy to become concentrated in a few large properties

Today, we can build portfolios utilizing publicly traded Real Estate Investment Trusts (REITs). REITs are portfolios representing numerous properties from various industries. While investing in publicly traded REITs can add the anxiety of seeing the emotional valuations of daily pricing, we believe the benefits far outweigh this cost. One of the largest influences on these daily prices tends to be the valuation of competing, income producing asset classes with the most significant being the 10 year US Treasury bond. If 10 year Treasury rates increase, we would expect general weakness in REIT prices until those companies can raise rents, allowing them to raise dividends, and thereby justify higher share prices.

For 2020 we are forecasting a slight upward move in long-term bond yields. As such, we would anticipate the stellar returns for REITs that occurred in 2019 will probably not be repeated in 2020. In most cases those REITs that have the ability to add value by making portfolio moves or raising their dividend should fair best in 2020. Further, REITs operating in sectors perceived to have the greatest growth potential should do well. In a more challenging environment, there may not be any sectors that will stand out. The best returns will most likely come from REITs led by strong management and those with ample financial flexibility. For purposes of tracking our forecasts we will focus on the **FTSE NAREIT All Equity REIT index and forecast it to be up 1 – 5% on a total return basis for 2020.** While our expectations for REITs is not all that great, we do believe it remains important to comment on certain sectors within the commercial real estate asset class.

With cap rates coming under slight pressure and the majority of return coming from income, we still see manufactured housing, industrial, & data centers as bright spots. Long-term, we do not envision healthcare being as strong. The Greatest Generation may be using senior facilities but technological advancement will allow Baby Boomers to stay in their homes longer. If we had to focus on healthcare, we prefer hospitals and medical research / office properties. Bricks-and-mortar retail is turning into local warehouses for online order pick-up and delivery. As retailers transition to today's omni-channel world, location closures could slow for those that embrace this shift. As you can see, there are numerous long-term factors at play in commercial real estate. In spite of a potentially challenging year, we still believe the asset class deserves a spot in investor portfolios.

Residential Real Estate:
Our 2019 forecast was to see the Case-Shiller Index advancing once again – but this increase would not tell the whole story. The affordability of homes in major metropolitan areas is now at levels that begin to defy logic. However, our forecast was for the nationwide average and as the graph illustrates, those prices do continue to increase. **Full Point**



Beneath the national statistics there are trends emerging. High-end homes are beginning to feel some pressure (there are only so many people that can afford multi-million dollar homes) but smaller homes continue to see strong demand especially in tax-friendly and retiree-friendly states. Millennials and Baby Boomers continue to compete in the lower end of the market.

Baby Boomers still want to be homeowners but are looking to downsize, take equity out of their real estate piggy bank, and live out their last days in their own homes (even if it is a smaller one). While most would prefer to live out their last days in their home, this has only recently become a possibility. As technology has advanced, health care has become more efficient, and in-home palliative care options are now available. This has allowed more people to stay in their homes far longer than was anticipated just 5 years ago. According to the New England Journal of Medicine, the home has surpassed the hospital as the place of death in the United States. https://www.nejm.org/doi/full/10.1056/NEJMc1911892

Millennials want to own homes but cannot afford to in most major metropolitan areas. Because of this, the allure of working remotely and businesses relocating to more affordable housing markets should continue and accelerate. With mortgage rates near historic lows and ample assistance for first time homebuyers, the demand for lower priced new construction should remain strong. Areas like Austin, Texas, Nashville, Tennessee, and Raleigh, North Carolina should see continued growth over the next few years. Low taxes, affordable housing, and a young "vibe". **So for 2020 we once again see the Case-Shiller Index advancing**. That trend should not abate until interest rates make a significant advance and impact mortgage rates, or some unknown "Black swan" event.

SPECIAL FUN FORECASTS

Last year's three "fun" forecasts were not exactly investment related, but designed to stretch our (and your) thinking a bit. A continued thought on each for this year.

#1 Trump is a one term President – We obviously cannot score this as the next election has not happened. But as a reminder, last year we highlighted that demographics are pointing in the favor of the Democratic party and their candidate. If a more "middle of the road" candidate is put forth, then Trump is in danger. However, if a socialist candidate is put forth, then Trump may win regardless of demographics. If Trump can actually deliver on even more of his initial campaign promises (like a truly solid, all-encompassing trade deal with China) and get some of the negative headline news behind him (impeachment, campaign shenanigans) then he may also push aside the Democratic favoring demographics until 2024. **For 2020, we have 2 predictions in regards to the political landscape: #1 Trump will not be convicted in the Senate on impeachment charges #2 the Democratic Presidential convention will be brokered.** *http://www.pewresearch.org/fact-tank/2018/03/01/millennials-overtake-baby-boomers/*

#2 Investing in Disruptive Technology – This is more of a gimmie point to pad the results than anything else. If you don't think that technology will disrupt your business, then you're probably next to be disrupted. We are in the midst of our generation's "Industrial Revolution" – it is the "Disruptive Technology Revolution". To illustrate, this year we will focus on how technology will save resources (including massive amounts of water), feed more people, and be less damaging to the environment. No, we are not talking about plant based or synthetic meats from companies like Beyond Meat or Memphis Meats (although we think they are part of the trend), but rather vertical Agriculture.

The concept of vertical farming has been talked about for years but the practical execution has been far from successful. The sky high costs of land, rent, and wages in densely populated, urban areas have always been difficult hurdles to overcome. Add to that the costs involved in testing which crops can be successfully grown indoors, developing hydroponic trays to drastically reduce water, creating artificial lighting systems, and writing the AI needed to optimize yields, and you see why the lead time for vertical farming has been so long. However, we believe vertical farming is about to really blossom and reach its full potential, doing far more with far less, and feeding an ever growing population in a responsible way. Within the last year there are major projects in San Francisco, New Jersey, and Japan that have the scale to prove the concept and produce food utilizing 95% less water and no pesticides. Leafy greens and

peas are among the crops believed to be most efficiently grown in these high-rise food factories. As the technology is refined and perfected, there is hope that on day it can even be done on a smaller scale with “farms” in everyone’s homes as well. **In 2020, we believe that breakthroughs in the economics of vertical farming will allow for a significant ramping up of the concept worldwide.**
https://www.bloomberg.com/news/articles/2018-10-30/skyscraper-farms-are-about-to-go-global

#3: A new acronym for market leaders – Last year we focused on what we believed could become the new acronym for market leadership with FAANG (Facebook, Apple, Amazon, Netflix, Google) being replaced with TADAA (Tesla, Apple, Disney, Alphabet, Amazon). We saw potential struggles for Facebook and Netflix and big opportunities for Tesla and Disney. As of year-end, the price performance of those removed with those added was close. However, public sentiment has started to change dramatically. Tesla has found its way to profitability and continues to push the world towards sustainable energy. Their advantages in battery technology and autonomous driving are forcing a century-old industry to quickly evolve or get left behind. Disney’s content advantage was on full display in 2019. They decimated their own 2016 global box-office record surpassing $10 billion by the beginning of December. This figure doesn’t even include the December 20 release of Star Wars! Further, their Disney + streaming service is a Hulk-like hit, seeing over 10 million users sign up on day 1. Meanwhile, Facebook is becoming the target of regulatory and legal scrutiny and Netflix has seen its growth rate slashed as competitors launch their own streaming services. **We feel the shift in sentiment allows us to give ourselves a point here.** Sadly, the financial press has not picked up on our acronym yet, but maybe that is because they know of our low opinion of the press in general! https://collider.com/disney-box-office-2019-10-billion/

For 2020 we believe these companies are still representative of the current trends that will gather investor interest. There are numerous companies embracing disruptive technology today. However, we caution that in revolutions past, there were also numerous companies with solid ideas and prospects that did not make it. Investing in new companies is risky. It should be done carefully in a diversified way with constant monitoring to be sure the business is executing successfully on their plan.

CONCLUSION

We will always strive to cull through information, ferret out the important from the unimportant, and take short-term emotions out of the long-term investment process. Our goal is to help our investors achieve their financial independence and the freedom to focus on what they want to do in life and not what they have to do. As always, we welcome your feedback and would love to talk about these and other topics that may be important to you. We thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility. ***Montecito Investment Portfolio’s Mission: To provide diversified, disciplined long term investment solutions, service and guidance to help our clients achieve, and maintain, their “Financial Independence”.***

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Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.

Past Annual letters are available by request. 2016, 2017, 2018, and 2019 Letters are available on our website at: http://www.cwam.dadavidsonfa.com/Our-Commentary.4.htm