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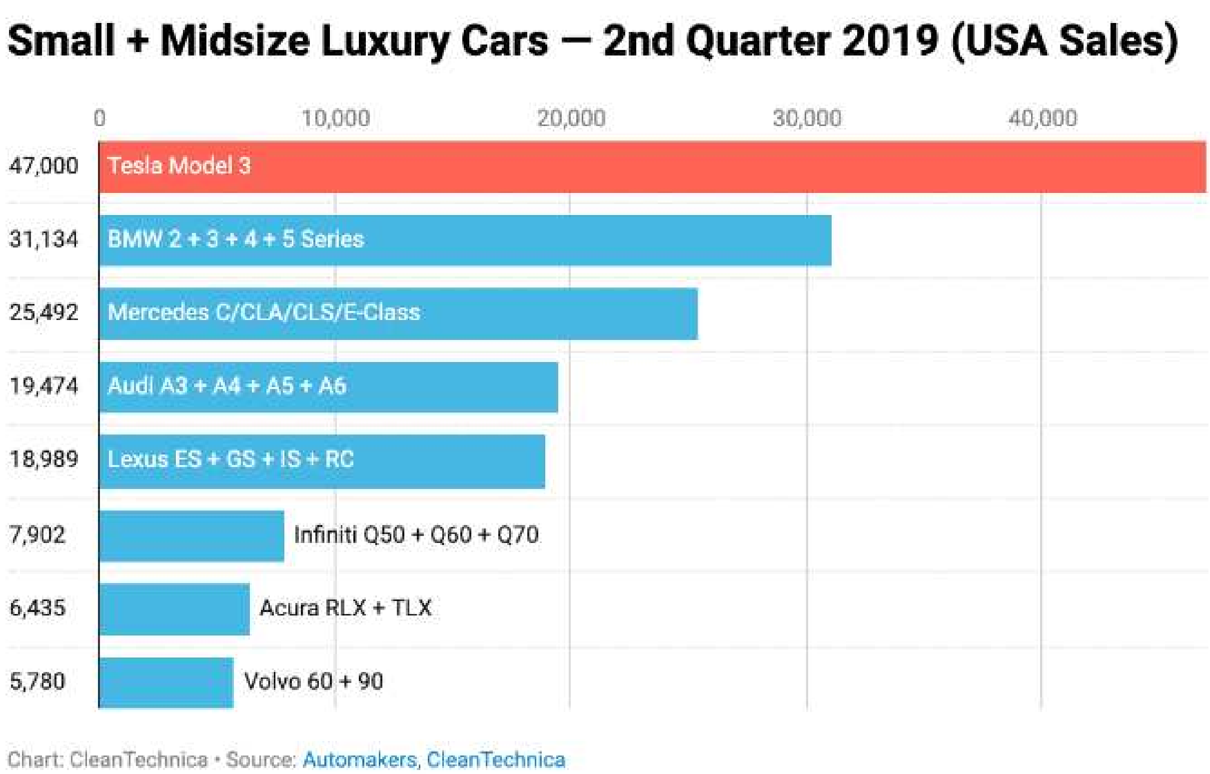
Mid-Quarter Update – August 2019

Dear Fellow Investors,

With the Dow Jones Industrial Average already providing 500 and 800 point declines in the first few weeks of August, we wanted to reiterate our views that form our long-term investment decisions. Currently, our markets are wrestling with numerous concerns:

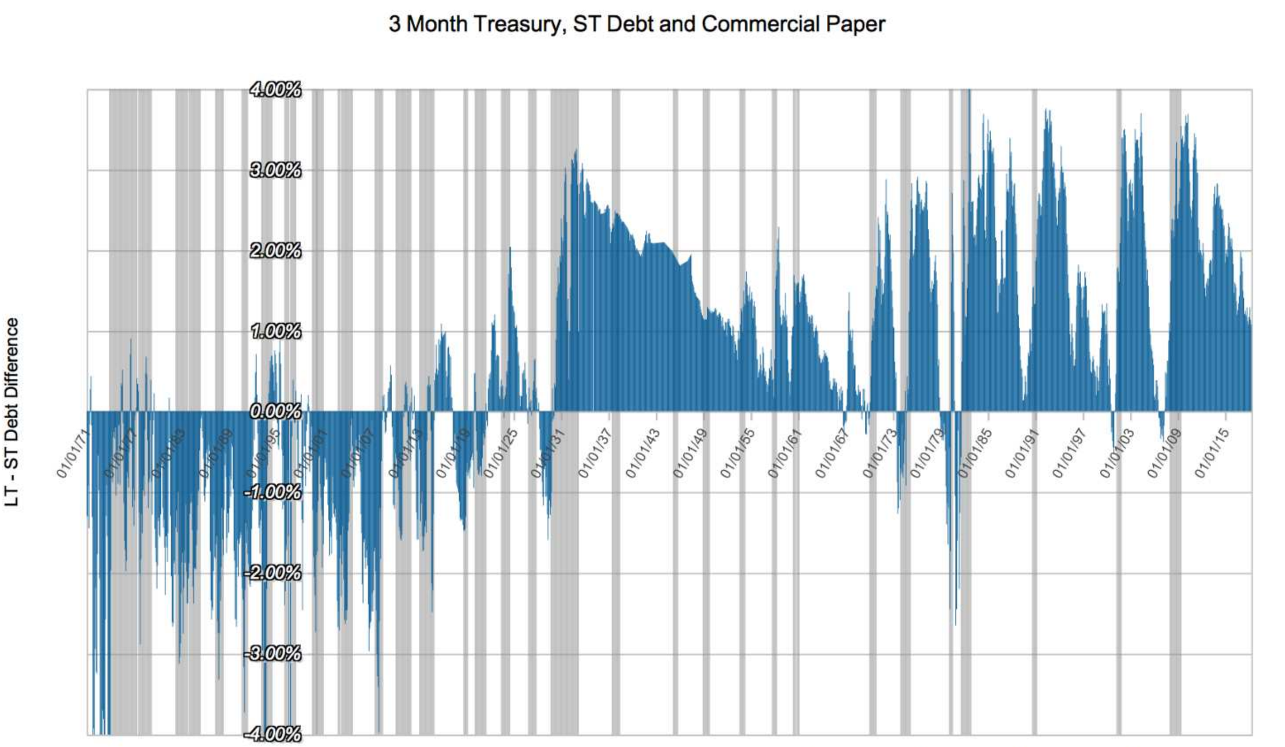
THE WORLD IS SLOWING: Fear of a spiraling, global slowdown intensified after Germany said their economy shrank in the second quarter. Keep in mind, Germany is the 4th largest economy in the world and the largest in the European Union. They are an export-driven economy with automobiles and vehicle parts accounting for nearly 20% of this. While they are viewed as the powerhouse of the EU we think their slowdown is more a reflection of not adapting to the future of the auto industry as employment and consumer spending are actually strong in Germany. Their 3 primary brands (BMW, Daimler, & VW) are under attack as the world requires more stringent emission standards and moves towards transportation-as-a-service, electrification, & autonomous. Germany has fallen woefully behind and still sounds reluctant to embrace the future as the head of diesel engine development at VW says the engines will continue to be part of the future for VW. The fact is an American company led by an entrepreneur from South Africa is leading the transition to sustainable energy as sales of Tesla's Model 3 outsold each of BMW's combined line-up of Series 2 through 5, Mercedes combined line-up of C/CLA/CLS & E Class, and Audi's combined line-up of A3 through A6!



INVERTED YIELD CURVE: For the first time since 2005 the yield received from 10 year US Treasury bonds fell below the yield received from 2 year US Treasury bonds. While this inversion seems to be a good predictor of future recessions we would like to point out a few items:

- ***Seems to only work in the U.S.*** - The predictive power of yield curve inversions only seems to be true here in the United States. Recently the UK yield curve has inverted for years at a time with no recession, Japan's yield curve hasn't inverted since 1991 in spite of numerous recessions, & Australia has experienced 4 inversions with none being followed by a recession.

- ***It isn't always correct*** – even here in the U.S., the predictive power of the inverted yield curve only dates back to about the 1970s. Before then, we went through extended periods of time (1870 – 1930) where it was actually common to see short-term yields above long-term yields.



Sources: dqydj.com, Robert Shiller, NBER, F.R. Macaulay, Federal Reserve Board

- ***Predicting a recession is not the same as predicting market returns –*** Nobel Prize winning economists Eugene Fama & Kenneth French recently released a study on inverted yield curves and expected stock market returns. Their study included data for 12 countries from 1975 to 2018. They tested whether an investor would have higher returns from staying invested in the stock market or moving to cash when the yield curve inverted. The results – ***"There is no evidence that inverted yield curves predict stocks will underperform treasury bills for forecast periods of 1, 2, 3, & 5 years."***

- ***Past inversions were caused by the Fed tightening –*** As the Fed directly controls short-term interest rates, all prior inversions were caused by a Fed that was tightening monetary policy. This recent inversion was not caused by Fed tightening, but rather a Fed trying to get the economy back to a normal level of interest. They were attempting to find neutral after a decade of being artificially low driven by alternative monetary policy such as Quantitative Easing.

MARKET CORRECTIONS AND ECONOMIC RECESSIONS ARE NORMAL – as we've referenced in the past, the below chart shows how common it is for the stock market to decline in price:

A History of Declines (1949-December 2018)

Type of Decline	Average Frequency[1]	Average Length[2]	Last Occurrence[3]
-5% or more	About 3 times a year	44 days	December 2018
-10% or more	About once a year	114 days	December 2018
-15% or more	About once every 4 years	270 days	December 2018
-20% or more	About once every 7 years	431 days	December 2018

Source: RIMES, Standard & Poor's.

[1]Assumes 50% recovery rate of lost value.

[2]Measures market high to market low.

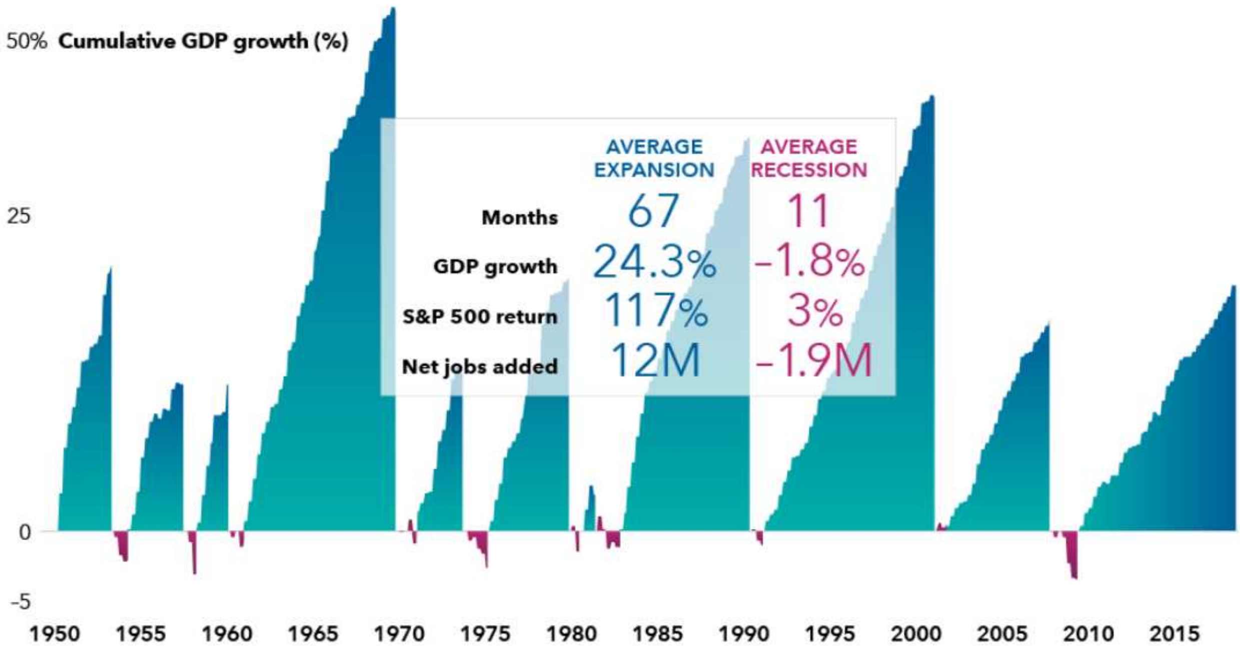
[3]The average frequency and average length rows exclude the most recent decline in December 2018 because the 50% recovery of lost value occurred after 12/31/18.

With the 24 hour news coverage of today, even the slightest decline in stocks create sensationalized headlines full of terrible advice for long-term investors. We urge investors to recognize that volatility is part of investing but certainly worth tolerating when it comes to saving for long-term goals.

Recessions are also a normal part of the business cycle usually evidenced by rising unemployment, declining activity, contracting profits, and central banks cutting interest rates. They can occur for many reasons but are usually the result of imbalances that build up in the economy and eventually are corrected. In 2001 we had the bursting of stock prices related to technology companies that should have never come public. In the years leading up to 2008 we saw home prices skyrocket as lending standards became non-existent and financial institutions were more than happy to collect fees on mortgage loans.

Recessions should not be feared but viewed as an essential component needed to keep an economy as strong as possible. As the below chart shows, although recessions grab headlines they pale in comparison to the amount of time the economy spends growing. Further, even during recessions, the average return seen from stocks is actually positive (+3%).

Recessions are painful but expansions have been powerful



Sources: Capital Group, National Bureau of Economic Research, Thomson Reuters. As of 9/30/18. Since NBER announces recession start and end months rather than exact dates, we have used month-end dates as a proxy for calculations of S&P 500 returns and jobs added. Nearest quarter-end values used for GDP growth rates. GDP growth shown on a logarithmic scale.

ARE WE IN A BUBBLE? – Looking back through history, one of the requirements of a true asset bubble is that the majority of people don't believe we're in one. Consensus is on the side of prices moving higher. If we examine the world today, even though our stock market is near all-time highs, we don't believe it is in a bubble. If you scroll through your Stocks app on your phone you will see story after story of what will cause or how close we are to the next recession and therefore the next 40% market crash. If we were in a true stock market bubble the stories would be of the opposite narrative and consensus would believe that stocks only go up and everyone should invest all their money in them. That is certainly not the case. However, we are seeing an investment that is now perceived as the safe place to put money, the investment that will avoid the next crash, and one in which nobody is talking about how outrageous the price of it actually is – BONDS.

25% of government bonds around the world now yield less than 0%. This means investors are willing to lock in a known loss on their investment! Further, the 30 year US Treasury bond hit an all-time low in yield (and therefore all-time high in price) at 1.98% today. In spite of the sky-high prices on bonds we are yet to see a single article discussing the potential losses you can see as an investor. So, we thought it was worthwhile to illustrate just how risky investing in long-term bonds currently is. If rates on 30 year US Treasury bonds climb back to where they were just 3 months ago prices would decline by about 20%! If rates were to climb back to where they were just 9 months ago prices would decline by about 30%!

TO SUMMARIZE – It is important to remember that the American economy is unique. We compete on a global stage and just because other countries (such as Germany) are contracting doesn't necessarily mean we have to. When we examine the U.S. economy we see a lot to be optimistic about – people are working, interest rates are low, the average consumer is in solid financial shape, our financial institutions are in solid financial shape, and rapid innovation can be seen everywhere. Although there are always issues that create fear and uncertainty (example: U.S. – China Trade War) we've shown the ability to weather past storms and emerge as a stronger and more vibrant economy. We don't believe the next recession will do anything to change this and do urge investors to focus on the long-term. The returns seen from staying invested and being long innovation, entrepreneurs, & creativity has outpaced any short-term reward you may see from trying to correctly time a market decline.

We do believe bond prices reflect the rampant fear in the world. Having 2 market crashes sandwiched around a housing collapse that brought the financial system to its knees will do that to people. Everyone wants to avoid the next crash. But with the majority of people having these crashes fresh in their mind, we are not seeing the excessive risk taking and complete lack of fear needed to truly create the unsustainable excesses that cause severe recessions. Because of this, we believe the media might be sorely disappointed to find the next recession might be rather mild. Further, we remain of the mind long-term investment goals will not be achieved by earning historically low returns from supposed "safe" investments. The S&P 500 index represents 500 of the best and brightest companies the U.S. has to offer and now generates more income than lending your money to the U.S. Government for 30 years does. Comparing the two is a no-brainer as we'll take higher income with infinitely more growth potential everyday.

Sincerely,

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