

THE INVESTMENT STATE OF THE UNION

Investment Strategy at Westshore

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Introduction

Dear Clients and Colleagues:

We here at Westshore Wealth are extremely excited to welcome Mr. Robert Sigler to our team! We have known Rob for more than a decade. His addition to Westshore has been a top priority for us in 2018 and has been a particular focus over the past 9 months.

Most recently, Rob was Managing Director and Head of Institutional Equities for the West Coast at UBS. Prior to that, he served as Managing Director in charge of the central risk book for US equities at Merrill Lynch and among other roles, he managed a proprietary trading team at Morgan Stanley.

With over 20 years of experience, Rob brings a wealth of knowledge to our team, which we are confident will help us continually improve client portfolios and firm strategy. In addition to serving as Chief Investment Officer, Rob will regularly author market commentary in an effort to better communicate our thoughts on everything from general investment philosophy, to portfolio construction, to the impact of current events on investments.

We hope that you enjoy this inaugural “Investment State of the Union” and look forward to hearing your feedback.

Sincerely yours,

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The Investment State of the Union

The most important lesson I learned advising institutional asset managers and investing capital for the likes of Morgan Stanley, Merrill Lynch, and UBS over the past 20 years, is that great investors think in terms of probabilities. It's a simple concept that essentially considers where you are on the risk/reward curve when making your investment decisions. You want to place heavier bets when you have a higher likelihood of success and either downsize or avoid situations where the odds are stacked against you or you have low confidence. Consider the casino game of Blackjack. When approaching the table with a perfectly shuffled, undealt hand, any astute gambler realizes that the odds of winning slightly favor the house. This is due to the fact that the gambler must place his wager before seeing any cards, and subsequently draw first, risking bust, while holding limited information (only seeing one dealer card). Now imagine a game of Blackjack where you could bet after the cards were dealt. It would shift the odds dramatically. It wouldn't take a genius to know that he should upsize a bet when he holds 20 while the dealer is showing 6 and refrain from betting when holding 16 while the house is showing a face card. Inevitably, even in this highly advantaged situation, our gambler might still lose that individual hand. It's still gambling after all. However, wagering on those types of favored situations will yield a positive outcome over time. Here is the good news. Investing is analogous to walking up to the Blackjack table after the cards are dealt. You are still going to be wrong plenty of the time. That said, if you play the probabilities over the long term, your winners will far outweigh the losers.

Now comes the tricky part. How do we put a probability weighted investing strategy into practice? The answer is not a binary decision to either invest or sit on the sidelines (also known as Market Timing). A recent Morningstar study illustrates the point perfectly. An investor who mimicked the return of the S&P 500 from 1997-2017 earned an annual return of 7.2%. However, the study showed another shocking reality.

We believe a diversified portfolio that seeks to reduce asset correlation, spread risk, include shock absorbers, and be dynamically allocated based upon the business cycle, relative valuation, and the emotional state of the investor base will win over the long term.

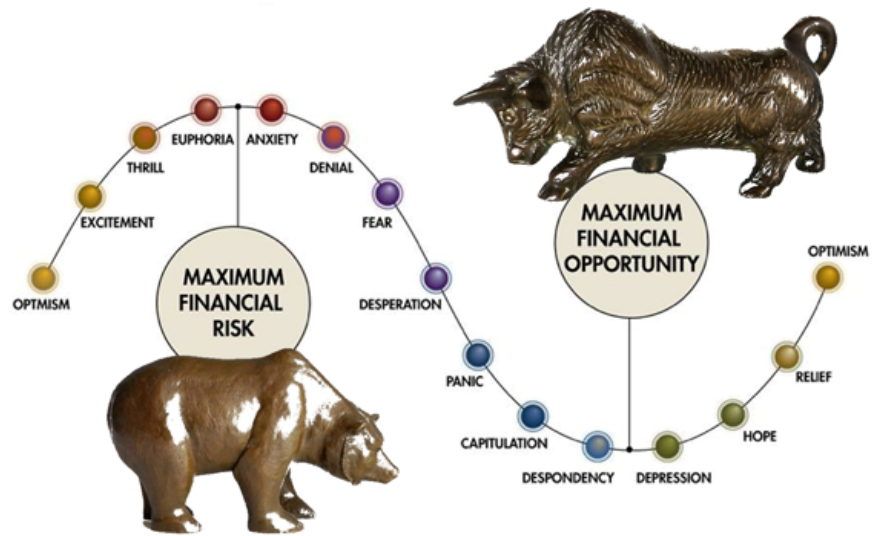
"Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria."

Miss the best 30 days of market returns over those 5,217 days, and your return would actually have been negative 0.9% annually! So, is the answer just to buy and hold? If humans could be relied upon to religiously do just that, the strategy would clearly work as demonstrated above. After all, history favors being present. The market has registered three times as many positive years as down years over the past century. That said, in practice, human nature usually intervenes for a suboptimal outcome. Recall, that twenty-one-year period of 1997-2017 was not without incident. In fact, it included two of the largest drawdowns in modern market history, namely, the Dot.com collapse where the Nasdaq Composite registered a 78% drop, and the Great Recession which saw a peak to trough drop of roughly 56% in the S&P 500. If you were wise enough to sell towards either top, were you equally smart enough to buy back in at the bottom? Unless you are one of the very fortunate few, you probably bailed well after the peak and were very tardy to get back involved. So here is the million-dollar question. How do you stay involved and circumvent the weakness of human nature that tends to make poor decisions based on fear and greed? We believe a diversified portfolio that seeks to reduce asset correlation, spread risk, include shock absorbers, and be dynamically allocated based upon the business cycle, relative valuation, and the emotional state of the investor base will win over the long term.

So where are we now? Our sense is that we are in the late innings of the game. The market is now in its tenth year of a bull market (a record). Valuations relative to historical averages are high. The Federal Reserve is now firmly in tightening mode. Investors who wouldn't have touched a stock at the lows of March 2009 are now eagerly buying equities. Don't forget the advice of the great, Sir John Templeton, one of history's top investors. He once remarked that "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." Understanding where you are on the psychological journey is a key feature in deciding how to risk-weight your portfolio.

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The Cycle of Market Emotions



What makes us think that the end is approaching?

Optimism and euphoria abound, but make no mistake, the bull market is maturing and risks are rising. The first investing lesson that I ever learned was that the stock market is a discounting mechanism, meaning it doesn't value stocks based on news and information that is coincident. Rather, its values stocks on what is likely to happen some six to twelve months in the future. Right now, corporations and individuals alike are awash in good news. Driven by record unemployment, 3.9% most recently, the consumer is in a great place. Consumer balance sheets have been buoyed by a strong job market, healthy income gains, rising home and stock values, and tax reform which has added a cherry on top for discretionary spending. Individuals learned hard lessons after the housing collapse and have dramatically deleveraged and increased their savings levels. Finally, low interest rates have placed their debt service ratios at historical lows. Meanwhile, corporate confidence is bubbling up to levels not seen in roughly a decade according to Fortune and Deloitte Consulting surveys. It stands to reason. GDP accelerated to 4.2% in 2Q18, the fastest growth in six years. Corporate profits are following suit, with July after-tax earnings tracking growth of 16.1%, according to the US Commerce Department.

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So, with all that positive news, why worry? The answer, unfortunately, is that the economic cycle is self-limiting. The faster the economy and production grows, the greater number of workers that are required to fulfill that output. This drives unemployment lower, drives up the competition for qualified workers, and eventually pushes wages higher. In a vacuum that would be fine. However, eventually a point is reached where there is no longer excess capacity to continue to throttle up production. Bottlenecks form and delivery delays occur. Overtime is likely required. Corporations may respond by building more inventory or risk outages. All these drive cost pressures and inflation takes root. Inevitably, central bankers respond by targeting inflation using higher interest rates as a weapon. As a result, financing costs rise, debt service becomes more burdensome, and ultimately asset values stagnate or fall.

This leads to the obvious next question. What are the signposts that indicate that we may be near such a transition?

First, we are running out of workers. US Unemployment is at multi-generational lows not seen since the late 1960s, and is getting to a functional speed limit. Economists debate the exact number, but there is a general understanding that there will always be a level of unemployment in a “fully employed” economy. Economists refer to this as the natural rate of unemployment. It is a combination of Frictional unemployment, where individuals find themselves between jobs, Voluntary unemployment, where a person makes a conscious decision to remain out of the workforce, or Structural unemployment where there is a mismatch between workers skills and employer needs. The Federal Reserve estimates the natural rate of unemployment should run between 4.5% and 5% which implies that we are operating at nearly full tilt. It is important to realize that the United States has never experienced zero unemployment. The lowest rate observed was 2.5% in May/June 1953, coinciding with the Korean War. The result wasn't pretty. The economy overheated and subsequently kicked off the recession of 1953.

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The bottom line is this. To attract more workers, more incentives are required to motivate them to enter the workforce, work overtime, or take a second job. It is no doubt possible, but it is inflationary.

Compounding the problem is anemic labor force growth. The Baby Boomer generation of the 1950-60s ushered in a bolus of labor force participation in the 1970s. The labor force grew at a 2.6% compounded rate. By contrast, the trend for the last 20 plus years has seen that level continuously drop, most recently registering at an anemic 0.2% growth rate. The driver of this is simple. Couples are marrying later in life and are having fewer babies. In fact, the US fertility rate dropped to the lowest rate on record last year. The Bureau of Labor Statistics estimates that the US economy will create 11.5 million jobs between 2016-2026. Unfortunately, they also estimate there will be one million fewer people in the workforce to fill them. That deficit didn't used to be a problem for the United States. We relied upon immigration to fill the void. However, with nationalism rising and immigration policies changing, that influx likely can't be counted upon in the future.

When it comes to fiscal stimulus, there is such a thing as too much of a good thing. Much like alcohol consumption, opening that last bottle of wine with friends feels like a great idea at the time, but often is accompanied by regret the next morning. The San Francisco Fed in a recent study suggested that the boost expected out of the latest tax cuts and spending initiatives was unlikely to provide either the magnitude or duration of benefit as traditional fiscal stimulus measures typically do. The key is the timing. At recessionary bottoms, stimulus provides a more durable uplift. In a fully employed economy, the result may simply push the economy to an unsustainable speed, overheating it, and ultimately proving inflationary. Another consequence that needs to be monitored is that that it pushes the US deeper into deficit. The Congressional Budget Office forecasts the latest stimulus package will add \$1.6 trillion to the federal deficit over the next ten years. By itself that may be palatable. However, when you consider the fact that two major

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Trade Wars are inflationary, and ultimately, stagnate growth. At present we are engaged in dust-ups with our four major trading partners China, Europe, Canada, and Mexico. At first glance, these appear to be slight when measured on an American economy that is \$20 trillion in size. However, that belies three very important facts. First, tariffs are always inflationary and that has consequences for consumption and interest rates. Second, it tends to pervert the timing of demand. By way of example, my wife and I are in the midst of remodeling our kitchen. In response to steel and aluminum tariffs, we saw many appliance manufacturers announce price hikes of between 4-12%. To avoid paying those extra duties, we purchased the entire kitchen set two months in advance of our contractor's need to "beat the timing" of the hikes. The same thing happens in business. Corporations stockpile goods that they believe will see a price increase. Often times that leads to an inventory correction down the road. Third, and perhaps most problematic for future growth, corporations make capital investment plans over the long term. When there is uncertainty inserted into the equation on such issues as their competitive positioning, where they want to operate plants, where they source components, etc. making decisions becomes difficult. It will slow the economy down over time.

Corporations are heavily indebted and ill-prepared for rising interest rates. While consumer balance sheets are quite healthy, corporate balance sheets are actually quite leveraged. Debt of non-financial companies rose to 73% of GDP recently, an all-time high. When I share this fact, investors frequently retort that corporate cash levels are enormous. This is indeed true. US Corporations in aggregate hold \$2 trillion of cash. Unfortunately, deeper examination reveals that just 24 corporations account for more than half that figure. Peeling back the onion further, when you adjust debt minus cash,

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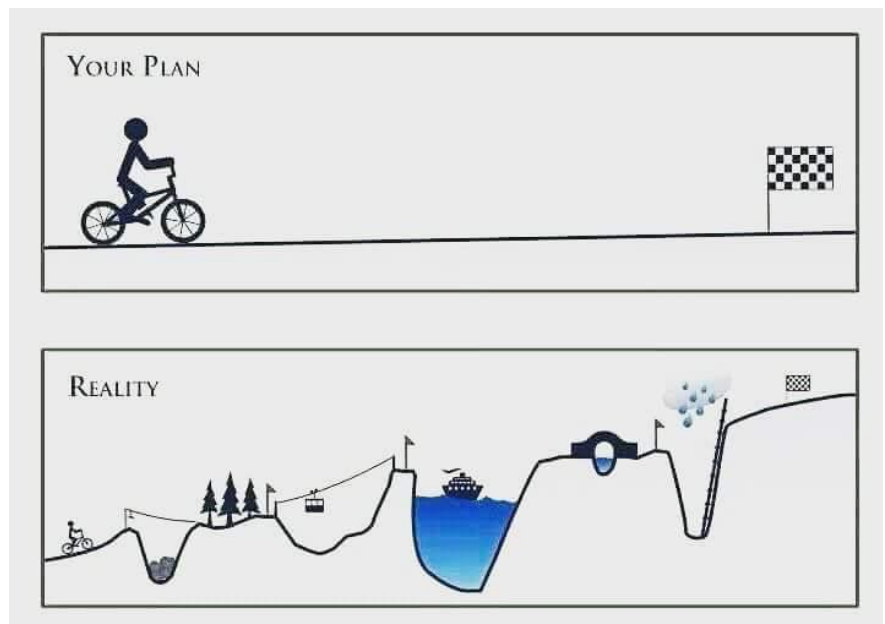
corporate America's leverage resides at 1.5x EBITDA (Earnings stripped of interest expense, depreciation and amortization). That is the highest level in 15 years. Why does it matter? If the Fed is forced to keep raising interest rates, eventually corporations will feel the pain in higher interest expense that will filter into earnings per share. If the economy were to slow while rates were rising, you could get a double whammy to earnings growth.

Expectations are elevated and there is little room for error. Twenty years of Wall Street experience examining analyst security models taught me an important fact. When faced with the very difficult task of predicting future sales and earnings growth, analysts tend to use the most recent history as a future proxy. In general, that strategy tends to work most of the time. However, there are occasions when linear thinking doesn't get the job done. Consider Peyton Manning's football career as an analogy. He threw a record 55 touchdowns in 2013, his sixteenth year in the league. If asked at the conclusion of that year how many TDs Manning would throw in the next season, most educated NFL fans would guess fewer given the enormity of the figure, his age, and a bevy of historical averages that point to 55 being a statistical outlier (mid 30s would be outstanding). Interestingly, that phenomenon is often ignored when setting expectations in the stock market. Due to tax cuts and other fiscal stimulus measures, corporate profits of the S&P 500 have swelled in 2018 to a growth rate approximating 20%. Instead of considering this performance a statistical outlier, and one that will ultimately mean revert over time, analysts have started to model this kind of success with permanence. Blame it on analysts wanting to stay on the "Buy" train, or corporate optimism running too high, but, Wall Street analysts now model S&P 500 profit growth at 15% per annum for the next five years. Consider this fact first before you bite on that hook. US corporate profits have grown at a 5.6% clip over the past 70 years. During one of the great booms in market history, 1982-2000, corporate profit rose at a 6.5% rate. Let's just say, pigs will be flying if we manage to see 5 years of 15% annual growth.

At Westshore, we believe the key to a successful investment plan is to understand where you are on the risk/reward continuum and to position accordingly.

Why do you care? Expectations drive valuation. If earnings fall short, the market will likely stall or retreat.

At Westshore, we believe the key to a successful investment plan is to understand where you are on the risk/reward continuum and to position accordingly. We want to keep your plan looking much more like the first illustration below than the latter.



Our focus is on portfolio construction and asset allocation. When our indicators are telling us the market risk is rising like today, we lower risky asset weights, favor value securities over growth, imbed more shock absorbers, comprise the portfolio of more uncorrelated assets, and deploy protective put strategies. This strategy isn't designed to completely sidestep a market correction, nor will it completely miss out if the market continues to rally. It's simply designed to dampen volatility during a period of lower conviction such that we are ready to swing again when we see the next fat pitch.

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