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the serious investor

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THE SERIOUS INVESTOR: SUMMER 2018

Welcome to the summer issue of *The Serious Investor*. Our Market Overview and Outlook explains why we think the U.S. economy is in the late stage of its cycle, and how that perspective is informing the ways we're positioning portfolios. It also addresses the ways our positioning reflects the enormous question marks facing today's markets, from the unwinding of quantitative easing to potential trade wars.

MARKET OVERVIEW & OUTLOOK:

Second Quarter Market Review: Late-Cycle Investing

Quick take:

- U.S. and international economies and markets diverged in the second quarter
- The largest growth stocks pulled the U.S. market higher
- The U.S. economy clearly is in the late part of its cycle
- We are maintaining exposure to risk assets but emphasizing capital preservation within asset classes

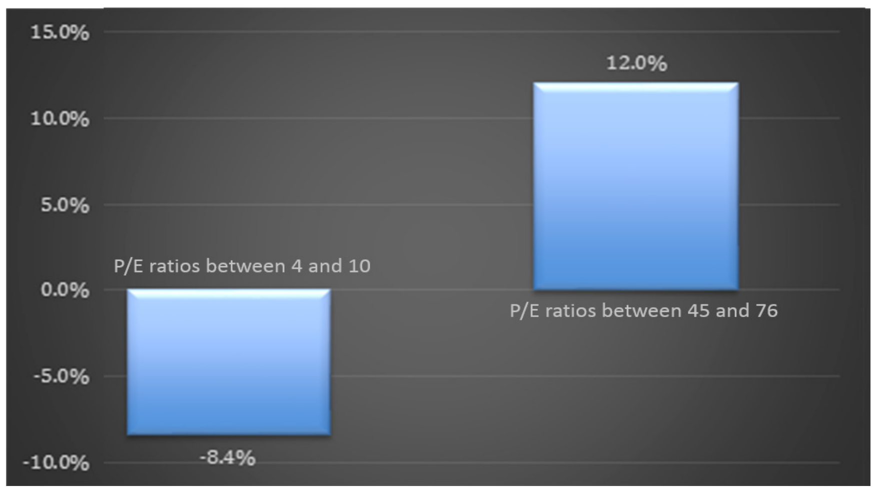
A prominent theme in the second quarter was the performance gap between the United States and the rest of the world. U.S. economic growth inflected higher between April and June, reaching 4.1%, while Europe and Japan continued to decelerate. Renewed economic vigor in the U.S. further squeezed an already-tight job market, which we believe contributed to higher inflation.

Central bank policies continued to diverge: The Federal Reserve raised interest rates for the sixth time since 2015 and sped up its balance sheet reductions. Meanwhile central banks in Europe and Japan remained fully accommodative, although the European Central Bank introduced plans to taper its quantitative easing program. These differences in economic trajectories and monetary policies pushed up the dollar 5.3% in the second quarter. A stronger greenback contributed to acute pain for emerging markets, where several central banks raised interest rates, risking stifling economic growth to defend their currencies and protect against capital flight.

Investor sentiment and fund flows rotated away from foreign markets. The S&P 500 gained 3.4% during the second quarter while the rest of the world lost 2.6% in dollar terms (as measured by the MSCI ACWI ex-US Index), pushed down in part by the dollar's gains.

A tiny handful of growth stocks drove the S&P 500's advance, with Amazon, Microsoft, Apple, Netflix and Facebook accounting for more than 90% of the S&P 500's return in the first half of the year. The top 10 contributors—all growth stocks—provided 122% of the market's return; in other words, the other 490 stocks in the index lost ground, in aggregate. Stocks with high price-to-earnings ratios trounced low-P/E stocks (*see chart below*), making it a hard time to be a value investor.

HIGH FLYERS FLEW HIGHER



THE TOP TEN CONTRIBUTERS PROVIDED 122% OF THE MARKET'S RETURN THIS QUARTER.

In the bond market, yields rose on short-term bonds and fell on long-term bonds, flattening the yield curve. As of this writing the 10-year Treasury note yields only 0.35 percentage points more than the two-year note.

ANALYSIS AND POSITIONING

Economic growth remains solid worldwide and economic indicators continue to suggest that a recession is unlikely this year. Job growth is strong, business and consumer sentiment are positive, the June ISM non-manufacturing survey reported powerful economic momentum, and high yield spreads, which historically jump prior to a recession as investors anticipate rising defaults, have stayed low and stable.

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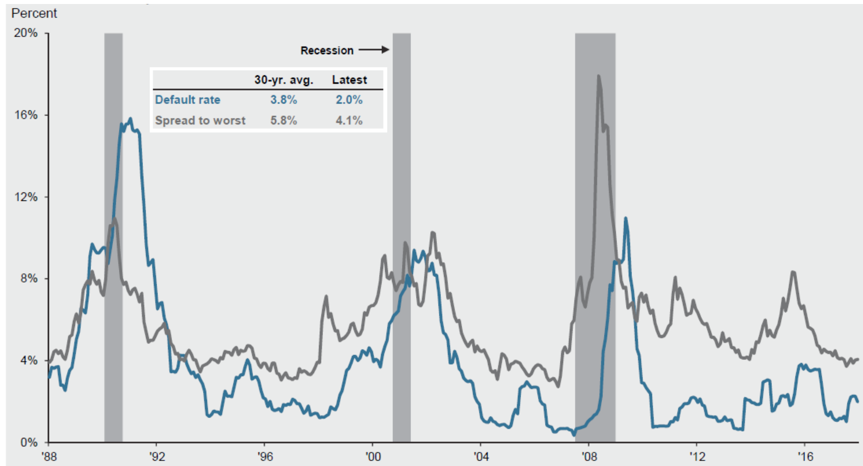
DEFAULT RATE AND SPREAD TO WORST



Source: J.P. Morgan Global Economic Research, J.P. Morgan Asset Management.
Default rates are defined as the par value percentage of the total market trading at or below 50% of par value and include any Chapter 11 filing, prepackaged filing or missed interest payments. Spreads indicated are benchmark yield to worst less comparable maturity Treasury yields. Yield to worst is defined as the lowest potential yield that can be received on a bond without the issuer actually defaulting and reflects the possibility of the bond being called at an unfavorable time for the holder. High yield is represented by the J.P. Morgan Domestic High Yield Index.
Guide to the Markets – U.S. Data are as of June 30, 2018.

That said, we may be past peak global economic growth: Purchasing Managers Indexes around the world remain positive but have declined in major markets outside of the United States, and China's economic growth has slowed at the same time the country contends with U.S. tariffs and higher borrowing costs.

Although the U.S. economy accelerated in the second quarter, we believe it is noticeably in the later stage of its cycle. The United States has all the classic late-cycle signs:

THE U.S. ECONOMY GREW AT THE STRONGEST PACE IN NEARLY FOUR YEARS DURING THE SECOND QUARTER AT 4.1%

- The Fed is tightening, flattening the yield curve
- A tight labor market is driving higher inflation
- A few stocks are driving the majority of equity market returns
- Corporate profit margins are near cyclical highs
- Corporate debt has reached 45.4% of GDP, near its highest level ever
- M&A and IPO activity is on fire

Consider the AT&T-Comcast merger. With $180 billion in debt, AT&T not only will become the most indebted company in the world; it will have larger debts than all but 32 countries (*source: Grants*). Deals and leverage like this don't happen near market lows.

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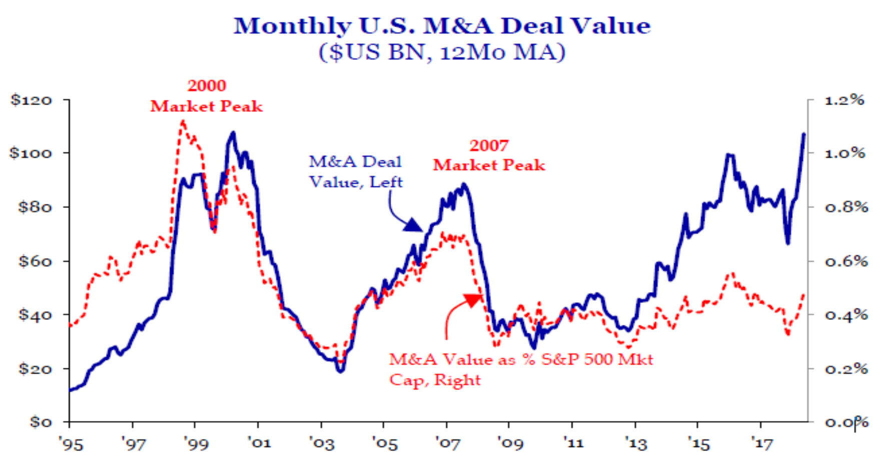
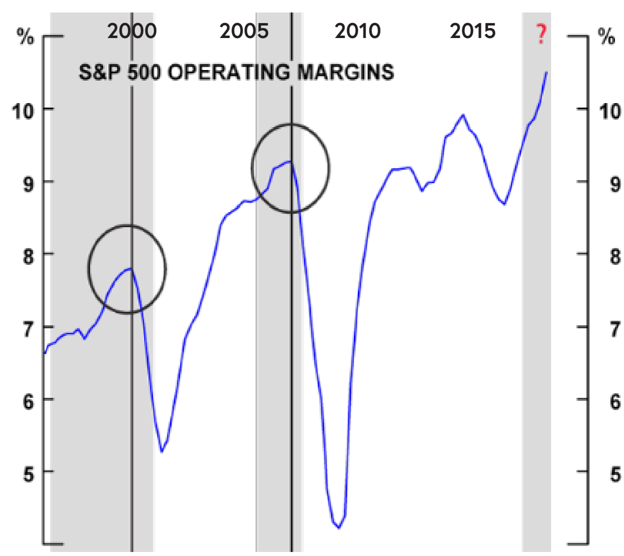
WE ARE FOCUSED ON MAINTAINING EXPOSURE TO GROWTH WHILE MANAGING RISKS.



It's impossible to predict with any certainty how long this stage will last. The last part of the cycle takes years in some economic cycles but only months in others. The stock market and other risk assets tend to rise strongly during much of the late stage, so abandoning risk assets at this point can severely undermine a portfolio's long-term returns. But stocks and other risk assets historically have fallen sharply toward the very end of the cycle, so it becomes especially important to be mindful of risk now.

We are focused on maintaining exposure to growth while seeking to manage risks. One of our research providers analyzed performance in the late part of the business cycle during the 1990s and mid-2000s. The study found that risk assets tended to rise while U.S. profit margins increased, and tended to fall after margins peaked.



SOURCE: BCA WEEKLY REPORT 7/9/18

NOTE: SHADING DENOTES PERIODS WHEN THE UNEMPLOYMENT IS BELOW NAIRU; VERTICAL LINES DENOTE PEAK IN OPERATING MARGINS

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HISTORICAL LOOK ON HOW VARIOUS ASSET CLASSES PERFORM

-SOURCE: BCA RESEARCH

Asset class	Late cycle before margin peak	Late cycle after margin peak	In recession
U.S. stocks	20.8%	-2.1%	-12.3%
U.S. small caps	17.2%	-3.1%	-5.1%
Global stocks	19.1%	-5.2%	-15.4%
Dividend aristocrats	13.0%	1.1%	1.3%
U.S. direct real estate	16.9%	12.7%	-2.5%
U.S. REITs	12.7%	-6.6%	-10.3%
U.S. Private equity	34.7%	-7.7%	-11.8%
Commodities	-1.1%	20.6%	-31.7%
High yield bonds	7.1%	-0.2%	-1.7%
Investment grade bonds	5.1%	11.4%	6.9%
Government bonds	5.2%	15.4%	6.9%
Cash	5.4%	6.2%	3.3%

THE MARGINS PICTURE IS ONE REASON WE HAVE MAINTAINED SIGNIFICANT EXPOSURE TO U.S. GROWTH ASSETS.

Margins in the United States continued to rise in the second quarter, thanks in part to tax cuts. The margins picture is one reason we maintain exposure to U.S. growth assets. We held a slight bias toward international developed equities, due to their lower valuations and more accommodative monetary policies, but unhedged foreign markets were hurt by a strengthening dollar and the slowdown in economic growth.

We can't predict when margins will peak. However, we feel that they're clearly under pressure from a tight labor market and rising commodity prices. Actions we are considering during this period include emphasizing shares of high-quality firms that are likely to increase their dividends, which historically have held up well through the late cycle and recession. We also are exploring direct real estate investments, looking for discounted opportunities on the secondary market. And we're performing due diligence on private credit investments, which offer a number of potential benefits:

- The opportunity for manager skill to add value
- Returns not correlated to other asset classes
- A degree of protection from interest-rate risk, since most private credit carries floating rates
- A variety of strategies that we believe are suited to the periods before, during and after previous recessions

Every economic cycle is different, of course. This time around a set of geopolitical and macroeconomic factors amplifies the risk and uncertainty in the markets.

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There's a long list of powerful unknowns:

- *Trade:* Today's skirmishes could escalate into a damaging trade war or could ultimately lead to more pro-growth policies.
- *The impact of the tax cuts:* The new tax code is boosting growth in the short term, but the impact on the deficit and national debt will have negative longer-term repercussions. We've never had huge fiscal stimulus late in the economic cycle—this is unknown territory.
- *Central bank policy:* Central banks around the world are trying to unwind the policies they invented to drag the globe out of the Great Recession.
- *China:* China's policy makers have to navigate a minefield as they seek to transform the world's second-largest economy.

OUR CURRENT FOCUS ON PRESERVATION ALIGNS WITH THE INVESTMENT DISCIPLINE WE ALWAYS PRACTICE.

We don't know how any of these factors will play out—no one does, therefore we view certain risks are becoming more likely. Restrictions on trade, a tight job market and fiscal stimulus all are inflationary. The Fed's preferred inflation measure, the price index for personal consumption expenditures, already sits at 2.3%. The Fed, concerned about its limited firepower in the event of an economic downturn or financial crisis, is trying to restock its ammo by raising interest rates gradually to neutral without undermining the health of the economy. That backdrop increases the possibility of stagflation, which would be damaging to financial assets.

Higher inflation isn't a foregone conclusion. The labor participation rate remains below historical levels, which is only partly explainable by the retiring of baby boomers. There may be more slack in the labor pool than what meets the eye. If that's the case, it would help explain why wage growth hasn't increased more strongly and pushed up inflation.

Inflation is just one example of the ways the unknowns in the world today confound forecasting. So while we maintain exposure to risk assets, we are examining shifting our emphasis within each asset class toward capital preservation.

In equities, our current focus on preservation aligns with our investment discipline. We are making sure we truly understand our investments, favor quality companies with healthy balance sheets and growing cash flows, and invest at valuations that we believe provide a margin of safety.

This approach doesn't mean foregoing exposure to the growth stocks that have led the market. This is not the dot-com bubble: Amazon, Google and the like are disrupting the global economy to their own benefit, and are high-quality companies with powerful earnings, cash flows, growth rates, balance sheets and cash hordes. We have held exposure to such issues primarily through Vanguard's Growth ETF (VUG). Historically, active management rarely adds value in growth stocks, and indexed exposure gives us access to not only today's leaders but may also give us access to future growth leaders.

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We are concerned that the market leaders are priced for perfection, and that earnings disappointments or other problems could trigger a large sell-off. So we monitor our exposure to VUG, and ay in certain circumstances pair it with value-focused dividend strategies as well as value-oriented long-short strategies.

Not going all-in on the FAANGs hasn't helped returns lately. But loading up on market leaders historically has produced poor results. Research Affiliates recently examined the world's ten largest stocks by market cap at the beginning of each year between 1980 and 2018.

LOADING UP ON MARKET LEADERS HISTORICALLY HAS PRODUCED POOR RESULTS.

The analysis found that:

- The largest stock had a 95% likelihood of underperforming over the next 10 years
- As a whole, the top 10 stocks had roughly 90% odds of underperforming the global market
- The largest holding in each sector or country underperformed that sector or country by an average of five percentage points per year over the following decade

To give just one example, eight of the 10 largest companies in the world at the beginning of 1990 were Japanese banks (which were routed during the '90s). Today, eight of the 10 largest companies are in the United States, and seven of them are in the tech sector. We can't predict the future, but history shows that chasing recent winners generally has been a losing strategy and that valuation matters over the long term. Historically, markets have reverted to the mean eventually.

As you can see in the chart on the next page, value under performed growth to this degree during only one period in the last 20 years. Also note that value outperformed growth by a wide margin during the years that followed.

Investors who have pegged their equity allocations to market-weighted indexes have tied their fortunes to the fate of today's high-momentum growth stocks. Concentrating portfolios in such high-valuation, high-expectation stocks may prove to be extremely risky, despite the strength of the companies. For this reason we may often seek to pair growth exposure with investments run by value managers, with a particular emphasis on dividend growth strategies. Today's unloved sectors are full of stocks with what we believe to be more attractive valuations as well as attractive and growing dividend payments. We expect this kind of value discipline to be rewarded over time.

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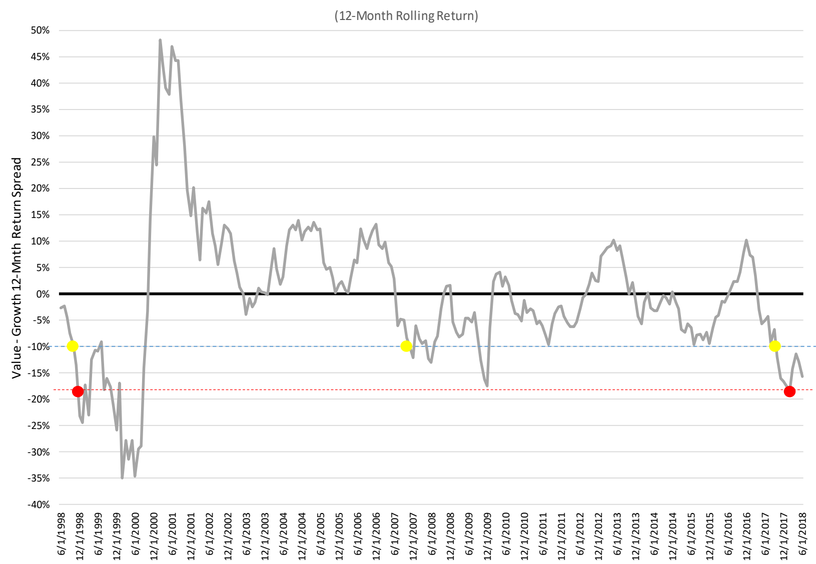
CASH HAS CEASED BEING TRASH.

RUSSELL 1000 VALUE - RUSSELL 1000 GROWTH



We have concerns regarding foreign developed markets, and believe concerns about Europe and Japan may be overblown. Weaker currencies are likely to help the countries' economies, and earnings growth is projected to increase:

- EPS growth for the Eurozone is estimated to hit 7.3% this year and 9.5% next year
- In Japan, EPS growth is estimated to be 2.3% in 2018 and 5.1% in 2019

In the bond markets, we are concerned about issuance-weighted indexes' historically low yields and high duration. At the same time, cash has ceased being trash: Even the three-month Treasury bill yields 2.0%. In this environment, we consider the position of bond portfolios in a barbell, seeking to capitalize on the liquidity, safety and relatively appealing income at the short end and securing diversification and somewhat higher yield in longer-term bonds.

The credit markets look unappealing given low spreads, a tightening Fed and high leverage. Investment grade is less a stamp of quality than it used to be—more than half of the investment-grade market is rated BBB. It is currently our view to underweight credit and focus on quality.

We also are being increasingly selective and judicious with respect to the liquidity of multi-strategy investments. In regard to liquidity of multi-strategy investments, we recognize that liquidity becomes increasingly important late in the economic cycle. We continue to seek investments that have low sensitivity to rising interest rates and can mitigate the equity market risk present in our clients' portfolios.

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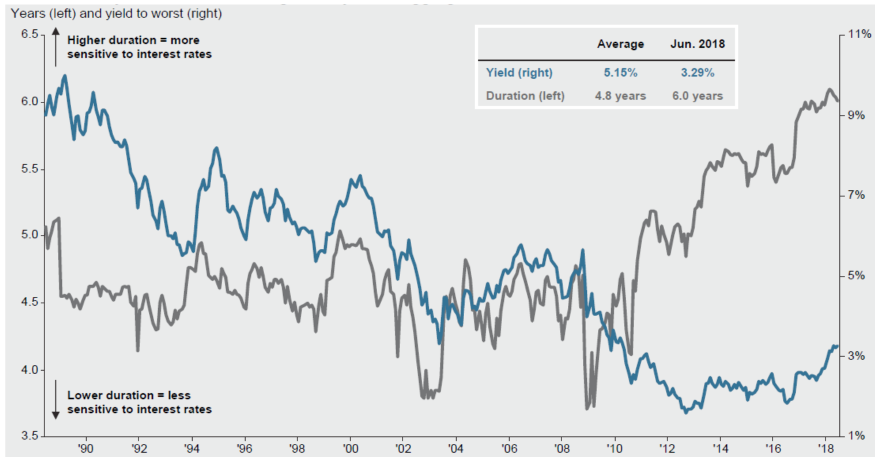
LIQUIDITY BECOMES INCREASINGLY IMPORTANT LATE IN THE ECONOMIC CYCLE.



DURATION AND YIELD OF THE BLOOMBERG BARCLAYS U.S. AGGREGATE

Source: Barclays, Bloomberg, FactSet, J.P. Morgan Asset Management.
Duration measures the sensitivity of the price of a bond to a change in interest rates. The higher the duration the greater the sensitivity of the bond is to movements in the interest rate. Yield is yield to worst.
Guide to the Markets – U.S. Data are as of June 30, 2018.

While we believe bonds will be a strong diversifier in an eventual market downturn, they come with a high opportunity cost in a low and rising interest rate environment. Seeking strategies that we believe can deliver a return premium and offer downside protection is a significant focus of our research efforts in a later stage economy.

In private equity, we are continuing to invest with managers that we believe have demonstrated the ability to navigate through cycles in this environment. We look for managers that patiently deploy capital and have the ability to react quickly if they deem that valuations have become more attractive. We continue to believe that the small and mid-size companies are more compelling as valuations are more attractive and leverage levels are lower compared to their larger counterparts.

We think there's little doubt that the U.S. economy is now in the last phase of its cycle. But the last phase shouldn't be confused with the end of the cycle: Historically, this period has offered strong returns as well as escalating risks. We are focused on pursuing today's opportunities in a prudent fashion, while using our investment discipline to manage the risks to our clients' portfolios.

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LVW NEWS:

Awards & Accolades

Lori Van Dusen CIMA, Founder and CEO, has been ranked fifth on Barron's 2018 Top 100 Women Financial Advisors. This is the third year that Barron's, a leading financial industry magazine, has ranked Ms. Van Dusen among the nation's top ten women financial advisors. Ms. Van Dusen has also appeared in the publication's Top 100 Financial Advisors ranking twelve times.

Founder and CEO, **Lori Van Dusen**, CIMA, has been recognized by Forbes in the ranking of America's Top Women Wealth Advisors for 2018. Van Dusen, who is ranked 8th nationally, earned the top spot for advisors from the State of New York.

Lori Van Dusen, CIMA, Founder and CEO has been ranked fourth Wealth Advisor in New York on Forbes' Best-in-State Wealth Advisors list for 2018. The list, which spotlights over 2,000 top-performing wealth advisors across the country, is pulished on Forbes.com

Employee News

Kathryn Leenhouts has joined LVW as Client Operations Associate. She brings over 12 years of industry experience in operations, investor relations, and hedge fund consulting to our team.

In her new role at LVW Advisors, Kathryn is responsible for the operational, custodial and trading support of our client base

We are thrilled to have Kathryn join our team Welcome Kathryn!

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