LVW ADVISORS
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the serious investor

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THE SERIOUS INVESTOR: FALL 2018

Welcome to the fall issue of *The Serious Investor*. October historically has been a difficult month for the stock market, and that pattern held this year. After the powerful U.S. economy drove strong gains in the third quarter, stocks fell on concerns about future growth and interest rates. We believe this correction may be the beginning of a long-awaited rotation from growth equity into value equity.

Quick take:

- The U.S. economy and stock market surged in the third quarter.
- Most foreign economies and equity markets softened, and emerging markets plunged.
- The early October downturn looks like an overdue rotation toward value stocks and away from a narrow group of growth and momentum stocks.
- In the equity market segment, we continue to favor broad-based exposure and more defensive strategies.
- Rising rates favor short-duration Treasury securities.

EQUITY MARKET REVIEW: The Market Regime Changes

2017 was the year of global synchronized growth, with acceleration among economies and markets around the world. The script flipped during the first three quarters of 2018: The U.S. economy and stock market continued to surge, but international equities lagged. To put the divergence into perspective, the S&P was up 10.6% through September, while an index of non-U.S. equities was down 3.1%. Global stocks were up just 3.8% through September 30.

Through this 21-month period, one constant was the strength of U.S. growth stocks such as the FAANGs (Facebook, Apple, Amazon, Netflix and Google). That changed in October. At that point the market regime shifted abruptly as the U.S. stock market approached its second correction of the year, with value stocks holding up much better than higher-priced shares of tech and consumer companies.

We published the following Market Observations and Portfolio Commentary on October 1; it offers a snapshot of the state of the markets just before the downturn. (*This version has been edited slightly*):

THE SILVER LINING OF HIGHER INTEREST RATES IS THAT SHORT-TERM FIXED-INCOME AND MONEY MARKETS FINALLY ARE PAYING INVESTORS.

> As of the end of the third quarter, three trends had been driving portfolio performance for most of the year:
>
> *The de-synchronization of global financial markets.* Global financial markets moved from a period of synchronized growth in 2017 to the polar opposite in 2018. In 2017, most financial assets posted strong positive returns, while the global economy looked to be its strongest in two decades. So far in 2018, however, the U.S. Federal Reserve's concerted effort to normalize interest rates has put significant pressure on all fixed-income and non-dollar denominated assets. As a result, most globally diversified portfolios have underperformed U.S.-centric diversified portfolios. A representative index for a global blended portfolio with a 50% equity allocation returned 1.1% year to date through September 30 *(Index: 50% ACWI / 50% AGG).*
>
> *The persistence of higher U.S. interest rates.* The Federal Reserve has raised interest rates three times in 2018, and the probability of an additional hike in December has increased. Although higher rates have far-reaching impacts, they did not seem to hurt the total returns of major U.S. stock market indexes through the third quarter. Higher rates put pressure on fixed-income returns, with the benchmark bond index *(Index: Barclay US Agg Bond)* returning -1.6% for the nine months through September and the iShares 20-year Treasury ETF losing 6.5% over the same period.
>
> The silver lining of higher interest rates is that short-term fixed-income and money markets finally are paying investors. Some money market funds now yield more than 2%, and as of September 30 the one-year U.S. Treasury yield was 2.55%. We are maintaining a short duration exposure through short-term U.S. Treasury bills.
>
> *In the U.S., a large disparity between the returns of growth and value stocks.* U.S. equities at the end of September were very expensive by historical standards. Average valuations of both the S&P 500 and the Russell 1000 were in their top 15th percentile, historically, meaning the indexes had been cheaper 85% of the time. When markets have been at this level in the past, one-year forward returns have averaged only 2% to 4%.*
>
> *The markets were speculative for most of this year.* The S&P 500 as of September 30 was on pace for an annualized return of more than 15% for the year, well above average. The MSCI US Momentum Index

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looked poised for an annualized return of more than 25% for 2018, suggesting that investors increasingly were buying winners.

Growth dominated value, with the Russell 1000 Pure Growth Index surpassing the Russell 1000 Value Index by 25.7% through August 2018. Only two previous periods, 2009 and 2017, had a larger disparity between growth and value. Money-losing companies led the market: Through September, companies in the Russell 1000 with negative cash flow had a 15.7%* year-to-date return, and those with negative earnings yield surged 31.5%.*

Strong earnings growth and consumer optimism have powered these gains, but could eventually give way to higher interest rates, stretched valuations and trade tensions in the U.S. The final three months of 2018 should prove interesting. What we are watching:

- Fourth-quarter earnings reports and the messages from companies about the impact of higher rates, a stronger dollar and trade tariffs
- Economic reports on inflation, employment and productivity
- Mid-term elections and the rhetoric out of Washington
- The Fed, the bond market and the yield curve
- The message from the market-price action over news. Market breadth has narrowed meaningfully. Recent winners like the FAANGs are lagging, while more defensive sectors are beginning to perform better on a relative basis. This could point to trouble and increased volatility.

* Gotham Asset Management, Bloomberg Terminal, Wells Fargo Advisors. Data as of 09/30/2018 unless otherwise noted.

Stocks started to drop two days after we ran this post. The Russell 3000 Index, which includes both large and small stocks, fell 6.7% in the six trading days following October 3, with roughly half the decline coming on October 10.

The end of our October 1 piece reads like a list of the reasons for the downturn. Bonds began to compete with equities. Even the 3-month Treasury bill's 2.3% yield now exceeds the 1.9% dividend yield on the S&P 500, and the minutes from the last Fed meeting make clear that they intend to push rates higher in the months ahead.

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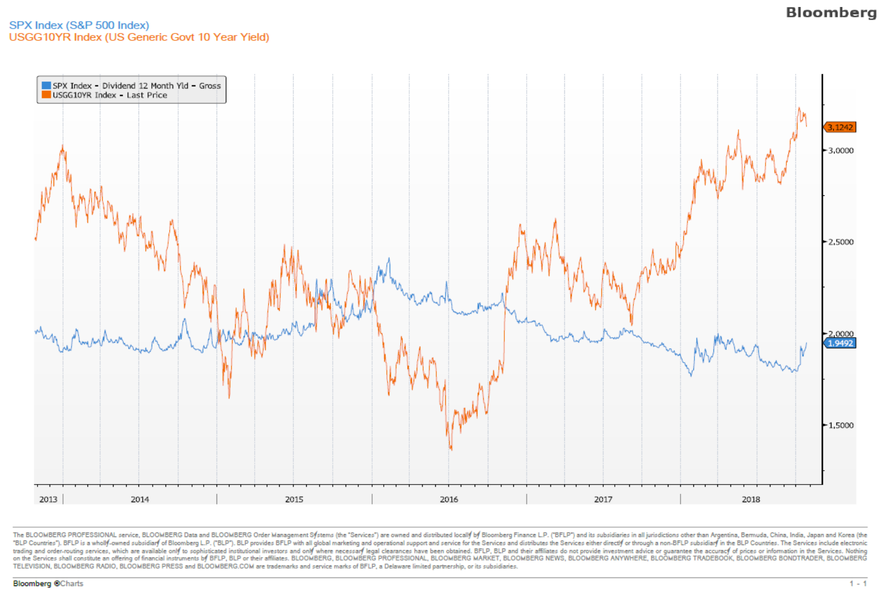
ANALYSTS PROJECT PROFIT GROWTH WILL SLOW FROM 20% THIS YEAR TO HALF THAT LEVEL NEXT YEAR.



With riskless assets paying more than 2%, investors thought harder about the prices they were willing to pay for risk. They looked ahead to 2019 and saw many reasons to expect slower economic and profit growth: tough comparisons to strong 2018 numbers; no more one-time boost from tax cuts; cost pressures from rising wages, interest rates and materials prices; and the drag on international revenues from the strong dollar and tariffs. Many analysts currently project that profit growth will slow from about 20% this year to half that level next year, and even that may prove overly optimistic depending on the impact of rising costs, tariffs and the dollar.

Stocks that had been priced for rapid growth took it on the chin. The Nasdaq fell 8.7% between October 3 and October 11. The Russell 3000 Growth index also lost more than 8%, compared to a 5.2% decline for the Russell 3000 Value Index.

MARKET OUTLOOK: Prepared for a Value-Focused Market

A period of gradually rising interest rates does not necessarily mean the end of a bull market. Still, investors' options increase as fixed-income yields start to become more competitive.

Having said this, the U.S. economy may have reached its peak, but it remains strong. Interest rates remain accommodative for now; consumer and business confidence is near an all-time high; credit, employment and wages are rising; and balance sheets are healthy among both banks and households. At the same time, the Fed is shrinking its balance sheet while raising its policy interest rate, and the federal deficit estimate has been revised higher.

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We are watching the quarterly earnings season unfold against these cross-currents.

We think the rotation from growth to value could persist. Many stocks have struggled for some time, even as the FAANGs and other growth stocks pushed the benchmarks higher.

As of October 15:

- About 70% of the stocks in the S&P 500 and 90% in the small-cap S&P 600 were in correction (down 10% or more from their highs).*
- Half of S&P 500 stocks were down 20% or more from their all-time highs.*
- 162 of the 500 stocks in the index were down 30% or more.*
- 69 S&P 500 stocks—about one in seven—traded at least 50% below their all-time highs.*

SOURCE: ***From MarketWatch, data provided by FactSet**

We believe some of these beaten-down stocks likely offer good value and could benefit as the prospects for higher interest rates and slowing economic and profit growth make investors more value-conscious.

The risks today look outsized, especially for expensive stocks. Earnings forecasts may be too aggressive, and the market has been punishing stocks that miss them recently. Any downturn is likely to be exacerbated by the dominant role of passive investors, which now manage half of all U.S. assets. (*Discretionary fundamentals-based traders account for only 10% of market activity.*) With fewer active value-seeking investors to buy up bargains, the market could struggle to find a floor in the event of a decline. We think if this scenario occurs, patient, active value managers will be in good position to seize opportunities that present themselves.

The flood into passive investment vehicles such as ETFs has created enormous demand for instant liquidity, even as liquidity has come under pressure from post-crisis bank regulations, rising interest rates, quantitative tightening and the strong dollar. Declining liquidity wasn't a problem while the steadily climbing market made it easy to match bids with asks. But downturns can cause market mechanisms to seize up. Christopher Cole of Artemis Capital Management wrote of February's drop, "The volatility spike in February is widely misunderstood…it was not a 'volatility event' but instead a 'liquidity crisis'." The October 10 plunge followed a similar pattern, as trading imbalances magnified losses. The upshot: Investors who focus on fundamentals have the ability to act nimbly and initiate or add to positions in healthy companies while they sell at discounted valuations after indiscriminate selling.

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Debt is another risk, and another reason to maintain quality and liquidity. Bloomberg reported recently that investing titan Stan Druckenmiller expects soaring debt to make the next financial crisis worse than the last. The article pointed out that his sentiments echo those expressed by other notable investors, including Citidel's Ken Griffin and DoubleLine Capital's Jeffrey Gundlach. Corporate debt is a higher percentage of GDP than it has ever been, and the trend toward issuing covenant-lite obligations has watered down protections for lenders. Many of today's liabilities are being bundled into collateralized loan obligations (CLOs)—securities backed by a pool of debts—and sold. It's not hard to imagine a scenario in which rising interest rates lead to a cycle of defaults that undermines CLOs and the liquidity of institutions that own them.

THE SEVERITY OF THE RISKS TODAY MAKES IT ALL THE MORE IMPORTANT FOR US TO BE PREPARED FOR CRISIS EVEN AS WE INVEST INTO A STRONG ECONOMY AND ROTATING STOCK MARKET.

It's possible that today's debt levels won't be problematic for the economy and markets: Interest coverage ratios are relatively high; average maturities of corporate debt have increased, pushing out the time until companies need to roll over their debts; and most rates are fixed, so borrowers aren't hurt much by Fed moves. That said, debt-related risks tend to manifest themselves in unpredictable ways. The shadow banking system of private, lightly regulated lenders has ballooned in response to Dodd-Frank's restrictions on bank lending, and it received the equivalent of a steroid injection earlier this year when a rule change allowed private banks and investment vehicles to hold more leverage. The Financial Stability Board estimated these debts at $45 trillion in 2016, and there's no question they've jumped since then—but we can't know where they are, how big they are, who owns them or what would happen if they failed.

The severity of the risks today makes it all the more important for us to be prepared for crisis even as we invest into a strong economy and rotating stock market. That means monitoring liquidity carefully, hedging growth positions and seeking to maintain truly diversified portfolios.

OUR VIEWS

We believe that the U.S. equity markets in the late cycle, therefore, we favor more attractively valued areas of the equity markets and defensive approaches such as dividend growth and long/short strategies. From experience and research we believe that these types of strategies will hold up better during corrections and in periods in which equity returns are driven by underlying company fundamentals. In regards to small caps, we believe average valuations are on the high end of their historical range, 40% of index constituents have negative earnings and the earnings growth forecast of 35% (for companies that have earnings) looks overly optimistic.

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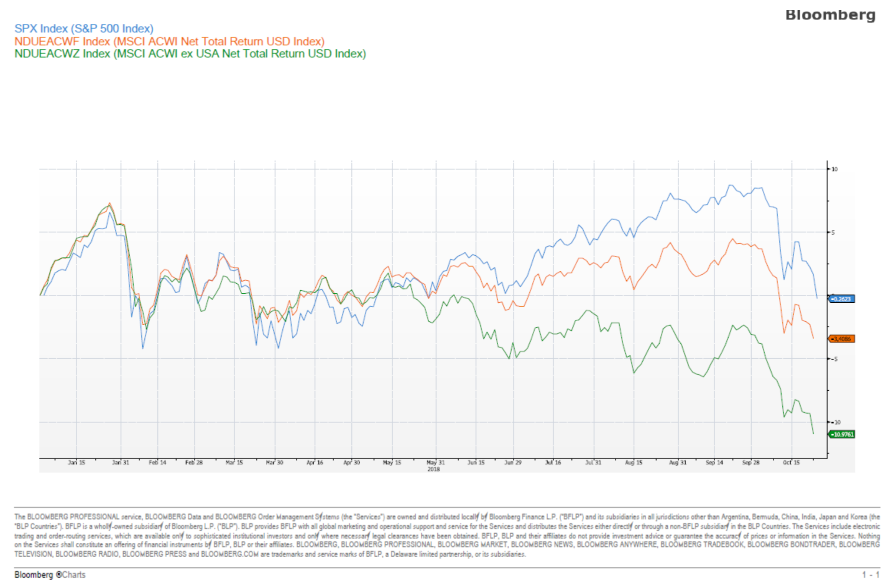
As a somewhat contrarian position, we continue to favor international diversification. Stocks around the world joined the U.S. market in moving lower during the October downturn.



LOWER VALUATIONS DON'T GUARANTEE GOOD SHORT-TERM RETURNS BUT HAVE CORRELATED TO BETTER LONG-TERM PERFORMANCE.

In addition, we favor value over growth globally. As we have noted many times in this newsletter, lower valuations don't guarantee good short-term returns but have correlated to better long-term performance. And the case for international diversification still stands. "The message from history is clear," Zappia writes. "International diversification, with no currency hedging, will be a long-term benefit to your portfolio, both in reducing volatility and in enhancing returns."

That said, we are not as favorably disposed to emerging markets. Emerging markets have sold off sharply due to concerns about the strong dollar, rising U.S. interest rates, liquidity pressures, trade, debt and economic troubles in China. Valuations in emerging markets equities are approaching the point where they may return favorable.

Within the credit markets we seek to be careful about risks, where our investments sit in the capital structure and what is paid for the risk we assumed. The compensation to own non-investment grade debt is very low in today's environment, leaving very little margin of safety in the event corporate defaults increase.

Although we remain sanguine about the role top-tier private equity managers can play in adding return to a portfolio over time, the combination of record-high deal multiples, rising interest rates and exploding debt has made large leverage buy-outs (LBO) overall less attractive—for example, Warren Buffett has said he can't find private companies that are more appealing

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than Apple stock these days. We continue to believe that the small to mid-sized companies are more compelling as valuations are more attractive and leverage levels are lower compared to their larger counterparts. In private equity we are committed to a call-down structure, which we believe may be attractive over the next few years allowing managers to be patient and disciplined.

WE SEE NO REASON TO DIP INTO THE CORPORATE DEBT MARKETS.

On the defensive, we favor very high-quality bonds shortened duration in seeking to protect from falling bond prices as rates normalize. We do not favor the corporate debt markets at current levels with Treasury yields approaching 3%. We seek to secure sources of income and returns that have low sensitivity to moves in the stock or bond market, by providing true diversification.

We seek to meet client needs in both the short and long-term. To succeed at that mission, we strive to capture exposure to growth, stay disciplined and defend against a wide variety of risks. This challenge is especially acute today: It demands ***serious investing.***

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LVW NEWS: Awards & Accolades

Joseph Zappia, CIMA, Co-CIO will serve as moderator on the RIA executive panel discussion, "What Would It Take for You to Hire (or Fire) a Manager" at the RIA Senior Delegates Roundtable in November.

Joseph Zappia was profiled in the September 24 issue of City Wire magazine.

Joseph Zappia was appointed to the Institutional Investor RIA Insititute board.

Lori Van Dusen, CIMA, Founder and CEO, was recently given the 2018 New York Community College Trustees Alice Holloway Young Award for Distinguished Service by a Retired Trustee. This award recognizes Van Dusen for her support toward student success at Monroe Community College. A maximum of three of these awards is given each year.

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Lori Van Dusen was listed in *Forbes'* 2018 Top Ten Wealth Advisors in America. This list is taken from a pool of 250 advisors across the nation who collectively manage more than $733 billion in client assets. Rankings are based on several qualitative and quantitative factors, including personal interviews, industry experience, compliance records, revenue produced and assets under management.

Lori Van Dusen has been ranked #21 on *Barron's* 2018 Top 100 Independent Wealth Advisors. This ranking reflects the volume of assets overseen by the advisors and their teams, revenues generated for the firms and the quality of the advisors' practices.

Lori Van Dusen was featured in the September 30 issue of *Forbes* magazine. The article "How Top Financial Advisors Are Using Behavior Science to Rethink Your Investments," highlights Lori Van Dusen's goals-centric investing approach and philosophy to determine a client's overall risk tolerance. *Read the article in its entirety.*

Lori Van Dusen was a featured panelist at the 7th Annual RIA West Investment Forum in Marina del Rey, Calif. The goal of the presentation, "Elevating the Role of Women Advisors in the RIA Industry," is to empower a new generation of women advisors and to make the case that gender-diverse firms are more profitable, sustainable and successful.

Employee News

Congratulations to **Cassie and Kurtis Luster** on the birth of their baby boy, **Finnegan James**! We are excited to welcome Finn to the LVW family!

Tiffany Van Etten has joined LVW Advisors as Receptionist in our Pittsford office. Welcome Tiffany!

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