ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary

July 2, 2019

Dear Clients:

Markets can be influenced by a number of variables. Variables that exhibit repeatable patterns are of greater importance to portfolio management than those that appear randomly. As we observe the current market conditions, we try to answer the following questions:

1. What variables or themes are driving market returns?
2. Is there an identifiable pattern to follow?
3. How long will the pattern or theme persist?
4. What would cause the market to move against that pattern or theme?

We identify three market themes that continue to shape this current investment environment – the effects of low interest rates, the impacts of global diversification, and the debate over active vs. passive (indexing) investing.

Low interest rates have been a constant theme of this bull market since The Great Recession of 2008. As a result of low rates, fixed income has become a challenging asset class for generating attractive forward-looking returns as well as current income. These conditions may continue on for a while as the Federal Reserve (Fed) considers whether the economy can support higher rates. As mentioned in previous updates, lower rates support higher stock valuations. This isn't the first time the Fed has used its power to influence the market cycle. From 1984 to 1998, the Fed used similar rate-cutting strategies and stocks responded favorably each time, aka the Greenspan Put. Extended periods of low rates can lead to an oversupply of credit. Higher amounts of debt combined with a slowdown in earnings growth are headwinds that will eventually interfere with the lift in stock prices from low interest rates.

Implementing global diversification seems reasonable, but is it helping? International markets have seen lower returns compared to domestic markets for over a decade. And yet non-US stocks make up about 45% of investable equities by market capitalization. One point to make is that international markets offer a more attractive investment opportunity due to their lower PE multiples. However, there is an argument to be made that US markets deserve a premium to other parts of the world for a variety of reasons (government structure, more capitalistic society). Another difference to point out is foreign markets hold higher weights of traditionally lower PE sectors like financials, industrials, utilities, and basic materials. These mentioned sectors make up about 45% of the non-US market compared to just 33% of the US market. It's also worth noting the US has played a major role in innovation (Healthcare, Finance, and Technology). These issues must be considered when determining how much international exposure is appropriate. Holding less than the global standard seems reasonable, hence our current weight is around 25%. Aside from non-US stocks, the foreign bond market is currently sitting on more than $14 trillion of negative yielding securities. That sounds worse than receiving a lump of coal for Christmas!

Lastly, market efficiency has been a heavily debated subject, especially over the last decade. Indexing has increased in popularity and has seen tremendous inflows while the majority of active managers have seen outflows and been justifiably criticized for higher fees with lower returns. It's worth noting this has been the longest bull market in US history. As the saying goes, "A rising tide lifts all boats." However, if everyone goes to one side of the boat, it usually capsizes. We appreciate the traditional indexing approach, but we continue to see more exotic index offerings such as double and triple leverage which can do more harm to investors than good. Should stock selection become a thing of the past, portfolio attribution will place a greater emphasis on segment selection such as large cap, small cap, US REIT, non-US, etc.

Most investors will be pleasantly surprised by the results of the first half of 2019; it's hard to imagine the second half of the year matching or exceeding those results. We will continue to observe these market conditions and make portfolio adjustments accordingly.

Investment Market Returns as of June 30, 2019
It has been a strong first half of the year for most asset classes with US stocks leading the way. The S&P 500 gained 18.5% YTD and 10.4% over the last twelve months. Developed international stocks (MSCI-EAFE) were also positive with a 14.0% YTD return and 1.1% over the last twelve months. Looking back over the last 10 years, the difference is just as noticeable. A $10,000 investment in the S&P 500 would have grown to slightly under $40,000 compared to only $20,000 while investing in developed foreign stocks. We have decided to reclassify REITs as equities for performance reporting. We acknowledge some of the unique characteristics of REIT's, but the high correlation with traditional stocks warrants the move out of the alternative asset class. US REITs gained 16.7% YTD and 9.8% over the last twelve months.

Returns on fixed income assets were also impressive as the Fed paused its interest rate hike program and could potentially cut rates during the second half of 2019. The broad US investment grade bond index had total returns of 6.1% and 7.9%, respectively, for the first half of 2019 and last twelve months. The YTD return for non-US bonds was 5.0%, despite the yield to maturity being less than 1%. Almost all of the return has been made from price appreciation from long duration bonds. The risk for extending duration at this time doesn't justify the reward, in our opinion. Those positive returns could evaporate quickly if the Fed's tone were to change on rates or if the foreign bond market demand for negative yielding securities were to dry up.

Returns on Alternative Assets were mixed as commodities rebounded slightly with gold leading the way. The price surge in gold could be a result of global trade disputes or unstable currency relationships. Quantitative focused strategies have had an unusually bad run. The algorithms that primarily analyze hard data such as quarterly financial statements have been used to buy underpriced securities only to see them sink further and to sell winners only to see them continue winning; such strategies have been clearly off. Overall, hedge strategies generated positive single digits for the year but have struggled over the last twelve months. The benefits from these types of investments are less effective when market returns are one-sided.

Summary performance of your aggregate portfolio is included on page 3 of your quarterly report. Detailed performance of asset classes, class subdivisions, and individual holdings are included starting on page 5.

Our Look Forward
We were surprised to see a change in monetary policy by the Fed. Its decision to halt the reduction of the balance sheet and leave interest rates unchanged implies the stock market will continue its upward march and leave bond investors with unattractive forward return expectations. We expect stock returns for the second half of the year to be lower than the first half as we anticipate a slowdown of earnings growth. The effectiveness of the Fed's intervention in support of the market may be tested once again.

In Closing
We look forward to visiting with each of you about your investment results and expectations for the future and to make sure your portfolios are aligned with your specific circumstances. We greatly appreciate the opportunity to serve as your investment adviser and pledge our best efforts to meet your expectations.

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