ADKINS SEALE CAPITAL MANAGEMENT, LLC

Investment Commentary
July 5, 2018

Dear Clients:
A client suggested we read Scott Adams' book, Win Bigly – Persuasion in a World Where Facts Don't Matter, to gain some insight into how and why an "unconventional" Donald J. Trump became the 45th President of the United States of America. Mr. Adams, perhaps best known as the creator of Dilbert, has penned an interesting deep dive into the vagaries of human nature and the behaviors of individuals as group members with various sociological affiliations. Two of the more significant behavioral concepts he used in the book – cognitive dissonance and confirmation bias – strike us as relevant in understanding current yield/return characteristics in US and foreign capital markets. One of Adams' insights about these concepts was that most people readily understand the risk these factors present in personal decision-making but think such risks only apply to "other people."

Cognitive dissonance can be described as "people rationalizing why their actions are inconsistent with their thoughts and beliefs." Over the years, many professional investors trained in fundamental valuation principles have fallen victim to chasing "certain" fortune in the form of tulips, sunken treasure, dot.com anything, can't miss high yields (e.g., master limited partnerships and private debt), and, most recently, cyber currency anything. Dispassionate analysis of the underlying economics of such activities would have revealed the low probability of large and enduring success from such pursuits.

Confirmation bias is the "human tendency to see all evidence as supporting one's beliefs." In the investment world, the "no other option" label for equity investments in a near zero interest rate environment is a stark example of this factor. Another is the belief that the "Quantitative Easing" creation of massive monetary stimulus throughout the developed world will have no adverse consequences since none have appeared to date.

We find recent performance of the S&P 500 Index as evidence of these two factors at work. The top 30 stocks in terms of market capitalization comprise almost 40% of the total index value and generated total returns over double the overall index average of 14.4% for the trailing twelve months. Recent performance has been driven by companies with generally lower levels of profitability, higher use of borrowed money, and optimistic expectations for future growth. Two stocks deserve special mention – Amazon.com and Netflix. Neither pays a dividend nor generates large net profits, yet the total return for these stocks for the twelve months ended June 30, 2018 was 75.6% and 162.0%, respectively. By comparison, the quality bellwether stock, Berkshire Hathaway, Inc., with its ultra-strong balance sheet and consistent profitability, generated returns more in line with the overall index. Time will tell whether the high growth disrupters will create a lasting economic success like that of Berkshire, but for the moment, **bias** for out-sized growth stories with minimal visible earnings generation is setting the market trend despite the **cognitive** contradiction with factors that have historically driven stock returns. One metric we find interesting is the relationship between market capitalization and cumulative net profit since inception. Berkshire's market capitalization and accumulated net profit are currently $461 billion and $316 billion, compared to Amazon's $822 billion and $11 billion and Netflix's $170 billion and $2 billion. Those are big bets on an uncertain future success!

Investment Market Returns as of June 30, 2018
Market returns for the first six months of 2018 reflected subdued results in US equity prices and continued weak results for foreign stocks as a stronger USD and concerns over slowing global economic activity restrained stock prices. The year to date and trailing twelve month returns on the total US stock market were 3.3% and 14.8%, respectively, with smaller company stocks out performing their larger brethren. The trailing twelve month return on non-US stocks was 7% as negative returns year to date offset stronger performance in 2017.

Returns on fixed income assets trended lower in the first half of 2018, reflecting rising interest rates (and falling bond prices) both in the US and abroad. Yields on US bonds are leading the rest of the world's bond markets to higher levels as the US Federal Reserve Bank is targeting a return to normal yield conditions. We define normal yield conditions as a fed funds rate equal to or slightly above the rate of annual price inflation and an upward sloping yield curve over longer maturities. Higher US interest rates also act to depress foreign currencies in jurisdictions with lower interest rates which also acts as a drag on foreign investment returns in USD terms.

Returns on Alternative Assets, meaning assets with different return characteristics than stocks and bonds, have been mostly a disappointment since the peak in equity prices on January 26. Hedge strategies generated larger negative returns than overall equity returns as long positions in high quality stocks were more than offset by short positions in low quality, high growth story stocks. These are times that try "investors' souls" in terms of maintaining faith in traditional valuation principles. With all the turmoil in the world, the weakness in gold prices and miners' stocks was also a surprising disappointment. As we have said before, insurance premiums seem very expensive until coverage is most needed.

The return on US REIT assets rallied strongly after March 31, despite the continued rise in interest rates. This movement suggests a modest preference for somewhat low but possibly stable cash returns from real estate over even lower cash returns from stocks and bonds.

Our Look Forward

We believe the bedrock foundation of marketable securities pricing is the US Treasury bond yield curve. The yield on the one year UST-Bill is about 2.3%, slightly above the expected inflation rate suggested by the pricing of UST Inflation Protected notes. The current UST 10 year and 30 year bonds are yielding around 2.8% and 3.0%, respectively. These yields suggest some combination of a low probability of higher future inflation supported by intense global competition, a meaningful probability for a slowdown in economic activity, and continued global preference for safe harbor US Treasury securities. Since we view the yield spread between short and intermediate term notes as abnormally low and insufficient compensation for taking duration risk, we think the more likely forward path for interest rates is to continue higher until the UST 10 year yield spread (aka the real yield) is back to "normal" levels of 2%+/-.

Our outlook for equity returns remains cautious for a number of reasons. First, recent equity index returns have been driven largely by a relatively small cohort of fast-growing, low-profit disrupters. Future returns from such stocks regularly disappoint as competitors react to maintain market share and to adopt business practices pioneered by the disrupters. Furthermore, price performance for fast grower story stocks is substantially enhanced by historically low interest rates that do not discount future earnings so much. For example, as the required return on equity assets rises from 5% to 10%, the present value (current price equivalent) of future earnings received five years in the future falls by 20%+, while earnings received ten years in the future are worth nearly 40% less in present value terms. Of course, no one knows for sure what will happen to future profitability and required investment returns. As a consequence, our clients will have meaningful exposure to US and foreign equity investments and bonds with portfolio weights managed to absorb the risks outlined above.

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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