ASHDON
Investment Management

Global stock markets experience a period of notable volatility during the fourth quarter. The S&P 500 index was down -13.5% for the fourth quarter and -4.4% for 2018. International markets were not immune and ended the quarter down -12.9% (MSCI EAFE Index – USD) for the quarter and -16.1% for the year. Bond prices benefitted as some investors shifted portfolios to bonds after selling stocks. The Barclay's Aggregate Bond Index was up for the quarter (+1.6%) and flat (+0.01%) for the year. Weak equity markets were no surprise to us. We commented last quarter that, while the rally continued in the third quarter, the rally was dependent on a narrowing group of stocks for momentum. The S&P 500 was still up double digits at the end of the third quarter, but the Industrial sector was down more than 20% - not an obvious conclusion if looking only at index levels.

Our expectation of a more volatile period is not the same as expectation of a recession or other cyclical downturn. A period like that will come, but economic parameters indicate that the US economy is stable and modestly growing. This is very encouraging. Instead, we believe volatility is a more natural market state. Volatility has been low throughout the post-GFC period due to a broad range of causes. Most investors' instincts will not welcome a volatile period. We encourage long term investors to see the volatility as opportunity. First, the volatility is normal and healthy. The long period of low volatility since 2009 is unusual. The fourth quarter was in no way unusual compared to the long history of stock markets. Second, changing prices creates opportunity for active managers to bring value to their investing clients. I had a call with a manager in late December, in the midst of the sell-off. I was checking to see how his portfolio was holding up and if he thought it was a good time to add to the portfolio. We discussed several of his positions, all selected based on fundamentals. The common features of each of the companies were: revenue growing annually at high single digit/low double-digit rates, low debt, unique access to end markets, and significantly lower stock prices. He noted that the change in stock price had no impact on the company fundamentals like revenue. The obvious conclusion is that, over the short term, the price of stocks is not what skilled investors focus on. Focusing on price in a quarter where stock indexes are down 13% means that one doesn't see that the underlying portfolio value continues to compound intrinsically at a very attractive rate. Throughout history, price has met value over time. Only patience is required.

When portfolios are volatile, investors often want advisers to do *something*. It is important that the things we have done are all centered on being sure that the real, intrinsic value of the underlying portfolio stocks – the actual companies selected for the portfolio – is in fact worthy of our confidence to hold on. During the quarter, the price signals from the market supported our confidence. While our portfolios were not immune to the sell-off, the bulk of the stock portfolios outperformed the equity indexes significantly. We believe this is because of our focus on fundamentals and quality. Generally speaking, our portfolios have better valuation metrics than the overall market. In frothy bull markets, fundamentals are often discounted by the market. However, in times when investors begin to lose confidence in "the market" or "the economy", fundamentals matter. We are happy to be invested this way now, as a more volatile period seems to be the future for the markets. But that is not all we have done. We have taken the opportunity in the market to either add to equity positions that were underweight (when prices were lower) or to trim equity positions that were overweight (when prices were higher). As we enter what we believe is a period of more normal volatility, we expect to be more active in this regard.

As we write this letter the S&P 500 has recovered almost 10% in value. The index hasn't returned to its highest levels yet, and it may not for some time, but the rebound shows that volatility hasn't created real losses. Investors who stuck to fundamentals continue to own valuable, productive assets that can be used to meet their goals well into the future.

As always, please contact us if you have any questions. Thank you for your confidence.

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