ASHDON
Investment Management

The strong rally in global stocks that started in January continued through the second quarter with the S&P 500 Index gaining +4.30% while the EAFE Index gained +2.50%. For the year, the S&P 500 is up 18% and the EAFE is up 11%. Bond price changes were also notable during the quarter as long bond yields fell back to 2016 levels and the yield curve flattened. The Barclay's Aggregate Bond Index was up for the quarter (+3.11%).

We have been active in client portfolios through the quarter, but only on the margins. Our primary action has been to be sure that the equity exposure of each portfolio allocation was on target. This work started months ago and has been a change since 2016. Looking back at that 2015/2016 period, earnings data in the US not only decelerated, but declined, coinciding with the FOMC's (Federal Open Market Committee) change in policy; short term rates began to increase. That information combined with softening economic data globally and the promise of a near term recession caused us to pull back on stock allocations mid-2016. After a historically long market rally, we reacted to the increased probability of a more significant, prolonged pull back and simply made an incremental shift in portfolio allocations.

The same has been true this year. We've simply been shifting back to targets. Now that we've made the changes, we thought it would be worthwhile to review our thesis to help our investors understand our process. The first step is to understand what has changed in the environment to compel us to implement changes in portfolios.

In a word — yields. Specifically, the level of the US treasury yield curve and the yields on other sovereign debt have returned to very low levels as central bankers around the global have all returned to more accommodative postures.

Why are yields so important to stocks? Yields are a key determinate of the relative value of future earnings from companies. When yields are high, future earnings are discounted – potentially significantly, as in the 1970's. But with yields low, the discount is modest and future earnings are highly valued. We can expect market indexes to continue to rise as yields decline. In such an environment, whether you are looking for aggressive compounding or you are an investor seeking the preservation of spending power into the future, stocks are good investments.

When it comes to the actual process of investing in stocks, we have learned a tremendous amount through the years and strive to put that knowledge to work every day. While we have always had a strong bias toward fundamental, intrinsic value investing, our industry has commoditized the idea of "value investing" so thoroughly that investors are right to question that it means anything. For us, the idea of value investing certainly includes buying assets that are priced too low due to sentiment or misunderstanding, but it also means buying the assets of businesses that are growing but have yet to be recognized by the market (e.g. "growth at a reasonable price" or "GARP"). We have historically been very good at finding investing teams with processes that capture value the way we see it and who have obtained good historical results. We have carefully watched as markets have evolved, seeing good firms adapt and new ones emerge. Through all this, we have strengthened our bias toward the value principles.

We understand that there are other factors that affect stock prices (e.g. trade wars, commodity shocks, politics, etc.) outside of company fundamentals. There is always the risk that these kinds of factors can disrupt markets and trigger volatility. These events are very hard to predict, but we believe that fundamentals will remain important across periods of volatility: growing earnings, low debt, and rational valuations set the portfolio up for predictable returns in economic expansions, and value preservation in contractions. With this frame of reference, volatility becomes a buying opportunity. Through the last 12 months of volatile markets, the strategies of our managers have shown their power, but we understand that investors can struggle to keep the faith during periods of uncertainty. For us, the antidote to the uncertainty is the knowledge of the fundamental value of portfolio holdings and the execution discipline of our investing partners. We say that we "know what we own and why we own it". This is true and gives us confidence that we encourage our investors to share.

Thank you for your trust and confidence.

ECONOMIC OVERVIEW

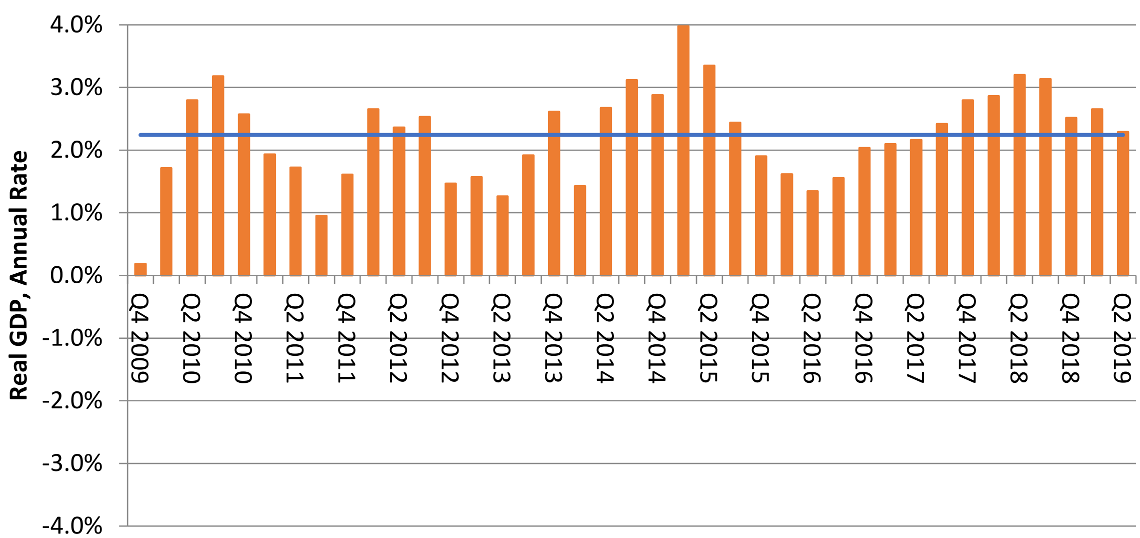
The US economy remained on a trajectory of moderated growth with low unemployment and low inflation for the second quarter. Asian and European economies also continued to grow. Global economies have slowed recently in response to changing trade policy and the inefficiencies and uncertainty associated with the changes.

The most recent release of US GDP data (chart below) shows that the growth of the US economy has averaged about 2.2% since the lows of the Global Financial Crisis. The average has been largely unchanged over several years and seems to be anchored in a range bounded by 2.0% at the low end and 2.5% at the high end. More recently, the data show that US economic growth peaked in the second quarter of 2018 and has declined back toward the post-GFC average recently.

It is broadly accepted that the 2015/2016 decline and the upward trend toward the 2018 peak were attributable as follows:

1. The trough in GDP in 2015/2016 was oil-related. Oil prices dropped on slack demand fears of oversupply from fracking, driving energy prices lower, driving lower investment, and a negative impact on GDP.
2. The recovery in 2016/2017 was related to recovery in energy sector and simulative action by the People's Bank of China, stabilizing global financial markets in addition to anticipation of corporate tax relief in the US post-election boosted sentiment.

REAL GDP



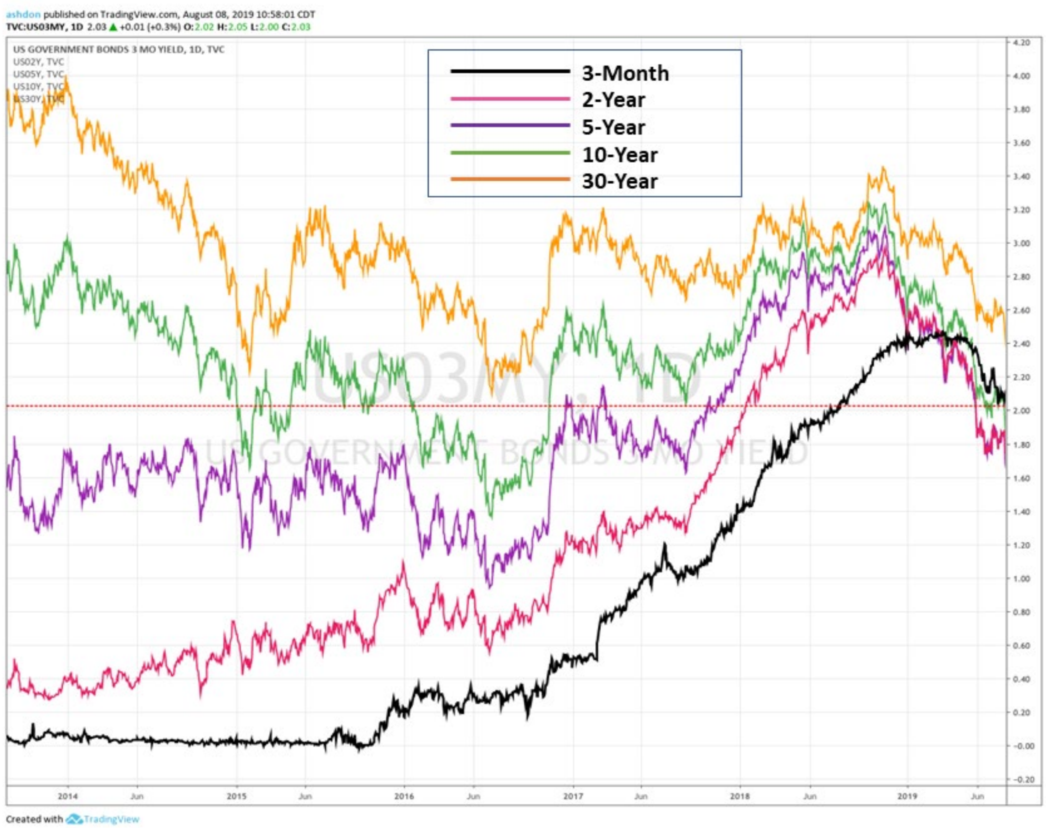
Preliminarily, the decline in GDP since peak is due to:

1. The lack of an ongoing stimulus from tax relief.
2. A trade policy-related global slowdown as companies and governments react to restructure supply lines, adjust pricing, and establish new trading agreements.

In our view, the variation in GDP represents fluctuations within the range we discussed above. And as we have previously discussed, this level is likely due to global demographics (aging populations in developed countries) and high levels of excess outdate production capacity, and government debt. It will simply take time to work through the excess. In the meantime, a moderated GDP growth rate isn't a necessarily negative. Without excess in growth driving misallocation of resources, the growth trend is likely to persist for longer than it would in a "normal" cyclical economy.

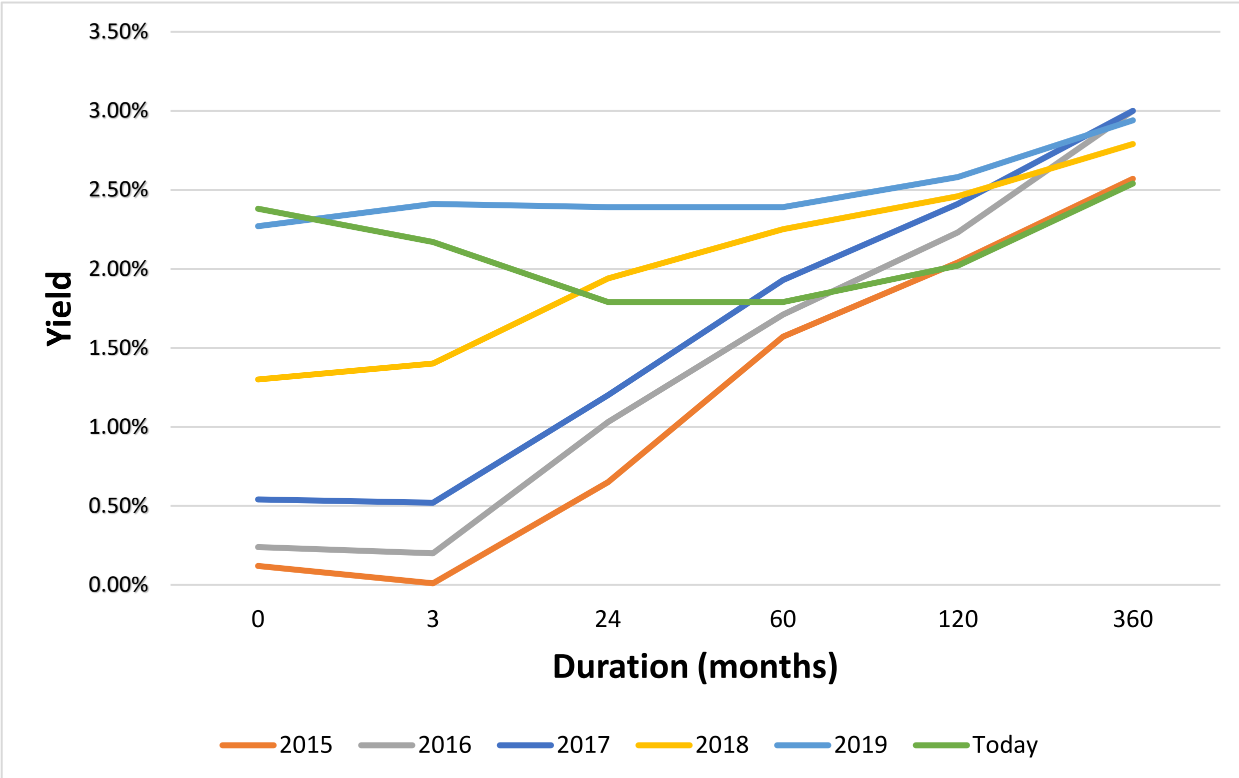
The economic environment we have just described is also largely responsible for the level of interest rates around the world today. Much of the recent stock market volatility is related to changes in central bank interest rate policy. In the US, the FOMC, the committee of the Federal Reserve responsible for monetary policy, began to move rates higher in 2015, at the time a reasonable policy choice. Since inflation is so persistently low there is little market pressure to move long term interest rates higher — economists talk about the "natural rate of interest" having shifted to a lower level. The chart below illustrates how interest rates of varying durations (3 months, 2 years, 5 years, 10 years and 30 years) have changed since the FOMC started raising rates. At first, rates responded as expected, but as the FOMC continued to raise rates, longer duration yields moved lower, responding to other economic pressures. After the 2016 election in the US, yields spiked higher, but that proved to be temporary and they soon resumed moving lower even though short duration rates moved higher as the FOMC continued to raise rates.

BOND YIELDS



The chart also shows that the 3 month rate crossed the 2 year, 5 year and even the 10 year yields in early 2019. This is called *yield curve inversion*. The chart below shows how the shape of the yield curve has changed since 2015. A steeply sloped curve, as it was in 2015, has historically been associated with periods of high GDP growth. A flat curve, as it was at the beginning of 2019, has historically been associated with slowing growth. An inverted curve has historically been associated a coming recession. That may not be true in the current cycle. When the FOMC cut rates in May it was consistent with the evidence of a moderated growth economy with a low natural interest rate. Future policy changes are likely to adjust the rate even lower, and other developed country central banks are also working to keep rates low.

YIELD



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