ASHDON
Investment Management

The pace of the stock market's advance slowed during the third quarter. The S&P 500 Index gained +1.70% for the quarter while the international EAFE Index fell -1.07% (in USD terms). It isn't surprising that the pace of gains moderated given the strong year for stocks, with the S&P 500 up +20.6% and the EAFE up +12.8% for the year. We expect the final quarter will also see modest gains. US market indexes have tracked a modest upward trend since June and broken through to new highs after overcoming stiff resistance. 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 (+2.27%) and is up +8.52% for the year.

Stock market indexes are now at or near all-time highs. Yields on bonds remain near all-time lows and, as we discussed last quarter, low yields (interest rates) help to keep stock prices high. With stocks at high levels and interest rates low, one might think that investor sentiment metrics would reflect a degree of optimism. However, sentiment indicators have deteriorated this year — while economic data show that the global economy continues to grow, particularly the US economy, investors have had to digest some disappointing data. With the soft data as a backdrop, popular news outlets have increased reporting on the mere possibility of an imminent recession. All investors would love to have the ability to predict the timing of the next recession. We are comfortable saying nothing more precise than, after a decade-long economic expansion, there will be another recession at some point and that contraction is closer than a decade away. We are wary of a statement that is any more precise than that.

So, what should investors do? Our investing principles long term ownership of companies that exhibit high cash flows, good return of invested capital, good operating margin, low debt and stable earnings — compel us to think over long time frames; to think across the business cycle and beyond the next recession. This philosophy alone has proven to protect and grow invested capital. There are, however, steps that investors can take along the way — steps that, on the margin, can help to avoid investment losses and to take advantage of the opportunities that have always appeared during a recession:

1) Be invested in a portfolio that is allocated appropriately for a specific time frame: Most investors' portfolios are in place to meet a future need as investing is the decision to defer compensation now in exchange for future consumption; e.g. retirement savings or generational transfer. An allocation heavily weighted to stocks is not "risky" if the investment time frame is long. However, if the portfolio is needed in the near term (e.g. a construction project, loan collateral), then being heavily weighted to volatile stocks may be unwise. It is wise to be confident that portfolio time frame and asset allocation are aligned.

2) Remove unproductive assets from your portfolio: Like our closets, our financial lives can become cluttered, and space that could be used to make our lives more comfortable is occupied by something we don't need. Today is always the right day to clean out a closet. The same is true for portfolios. We spent a lot of time earlier this year "cleaning up" portfolios. If there is something in a portfolio that isn't specifically in place for a portfolio goal, get rid of it. The cash proceeds from sale of unneeded assets can be valuable (see below).

3) Execute investment plans for portfolio in a timely manner: As investors, we often deal with something that looks like procrastination. That is, as investors we find that we've made a decision, but then we drag our feet on execution. Complicating things further, we sometimes even delay the decision. It is important to keep in mind that decisions and execution are infinitely more difficult during periods of uncertainty and fear. Investors need to plan, and execute, when times are good. Understand that good times can lull us into a complacency and complacency can be a trap. Today, while our minds are clear, is the right time to be active in our investment lives. Our decisions and actions will not have perfectly ideal outcomes, but the planning and execution will be much better when our heads are clear.

4) Lower stock prices are good for investors who are buying: While the economic cycle and market cycle are not perfectly correlated, we all have the correct sense that the stock markets will have a period of sharp decline at some point during a recession. If we have cash on hand, either from a disciplined rebalancing or liquidation of unneeded and unwanted assets, we can buy assets, like stocks, at steep discounts during times when the market prices get dislocated. It is good to have a plan for this before markets sell off. It is easy, but only if the plan is in place before the moment. For many portfolios, a disciplined rebalancing process satisfies the need for a plan. For a normal portfolio of stocks and bonds, bonds are likely to become highly desired, and over-allocated, during a period of crisis. Selling bonds back to your target allocation will generate the cash needed to buy discounted stocks as a matter of normal practice.

Sometimes we have particular, targeted opportunities before us. In these cases, the discipline is more nuanced, but still important: due diligence must be completed, scenario planning must be completed, and a plan to free up cash in a timely way is needed. For taxable portfolios, there is clearly a risk that liquidation of performing assets will generate a tax liability. However, the ability to execute these targeted opportunities should offset the tax liability, creating excess profits overall.

We are creatures governed by fear and greed, which always makes the behavioral side of investing difficult. Globally, many people feel an increasing uneasiness now, a growing uncertainty. We can never know when investors will tip the balance and stocks will sell off broadly. As we said last quarter: 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 should add that our own execution discipline can also help our investors protect and grow assets. We strive to “know what we own and why we own it.” Every day.

ECONOMIC OVERVIEW

The US economy remained on a trajectory of moderated growth with low unemployment and low inflation for the third quarter, as did developed economies around the world. Broadly speaking, changing trade policy and the inefficiencies and uncertainty associated with these changes continue to present a headwind to economic growth.

GDP: Anchored in a range near 2%, post-GFC, economic transition (more automation, changing value of labor, low capacity utilization), monetary policy (transfer of risk to sovereign balance sheets, ultra-low interest rates), and policy uncertainty (trade, political divides) all continue to weigh on the ability of the global economy, including the US economy, to grow as fast as it might. In our view, there is no force in place to shift the GDP growth trajectory to a new higher, or lower, state. Moderated growth continues to be our central expectation.

GDP Components: Consumption is the largest component of US GDP and was the strongest growing part of the economy for the last two quarters: a bit above 3%. Private investment was very weak – attributed to trade policy and uncertainty – flat to slightly down.

Inflation: Headline level remains low and frustrating for monetary policy makers, and central bankers don’t seem to be able to stimulate inflation anywhere. This is due, in part, to the economic transition discussed above. Creation and distribution of value is changing, but there are problematic pockets of high inflation, particularly US health care, that is offset by pervasive low inflation. Again, there appears to be no force to change inflation levels. However, the monetary policy experiment is not fully tested, and we do not know the extent of the impact over long time. Inflation could accelerate.

Labor: Headline job creation results remain positive. The trends in wages, both broadly and internally (wage level, race, gender, education) are trending higher. This is positive for consumption in the near term. Labor participation rate is higher across cohorts, as is job creation. However, growth rates are modest, consistent with the modestly growing economy. There are negatives in the jobs and wage data. Real wages are also growing, but there is evidence that, for the lower half of wage earners, sector inflation presents a challenge for consumers. Modest wage growth is good when there is excess, but when the worker gets behind inflation, there are problems. This is a threat to future consumption (and GDP, and wage growth, etc.).

Rates: Monetary policy loosened around the world. Rates across the curve are at or near historic lows. This is usually good for growth, but this isn’t a normal recovery. It appears that the economy requires low rates to sustain the growth trajectory. In the US, the FOMC cut again, but telegraphed no further cuts unless the data weaken further. We are unconvinced that rates will stay at current levels. There is unusual, and dangerous, political pressure to cut further.

ISSUED BY

Ashdon Investment Management
214 East Grundy Street Tullahoma, TN 37388
Phone: 931 461-5733 Fax: 931 461-5735
INFO@ASHDON.COM

DISCLAIMER

In the preparation of this presentation, Ashdon relied on data taken from sources it believes are creditable. As such, Ashdon believes such data to be accurate and reliable. While Ashdon has taken efforts to insure the data's accuracy, Ashdon cannot verify that the data used are free of error. Ashdon has relied on such data to calculate and offer hypothetical scenarios in this presentation. Ashdon has presented such data in historical context and for historical hypothetical purposes. Historical results are not a guarantee of future investment performance. Ashdon has not used such data to intentionally mislead, nor has Ashdon intentionally omitted data that is relevant to its hypothetical scenarios. Ashdon assumes no responsibility for errors or omissions that result from the data it has relied on in this presentation, the sources of the data, or the calculation of such data.

This presentation makes no offering of investment. The investment options discussed here must be offered through specific presentation of the terms and risks of the specific offering.