January 2019

> ***"Time is your friend; impulse is your enemy."*** *-John "Jack" Bogle*

Nowhere to Hide

Dear Investor,

Our firm started during the heart of the financial crisis – July 2009. Up until last year, our long-term investment results were amongst the best that I have experienced in my career.

Over the past couple of years, I had commented to clients and colleagues alike that the good times we and our clients have enjoyed could not last forever. A number of factors that had been driving investor returns were becoming less pronounced. Following the financial crisis, investors benefited from massive central bank stimulus, including record low interest rates, which resulted in a prolonged economic recovery and a significant boost in corporate profits.

Over the past year, the U.S. Federal Reserve continued down its path of rate normalization, raising interest rates several times. Concurrently, it began to reduce its balance sheet, putting upward pressure on longer-term yields. With global debt at record levels, rising interest rates will have a negative impact on economic growth.

Toward the latter half of 2018, slowing growth in China, the world's second-largest economy, also became a much larger issue. China's growth has been fueled, at least in part, by a massive increase in debt-financed expansion. However, even with this stimulus, China's growth trajectory has been on a downward trend; and with the Chinese government trying to reduce the pace of borrowing, growth will likely continue to slow in 2019. All of this is independent of the U.S. trade issues, which adds to the uncertainty.

Throughout the past year, we maintained a defensive strategy, with a significant cash position in our equity portfolio. Despite holding 30% cash, we were not immune to the volatility, and the 70% that was invested was impacted by the market decline. In 2018, there was truly nowhere to hide. Market drivers, such as the so-called 'FAANG' stocks of Facebook, Apple, Amazon, Netflix, and Google, suffered along with nearly everything else. The financial and energy sectors were amongst the worst performers; the former due, in large part, to a flattening yield curve, and the latter due to weak energy prices. Rising U.S. interest rates also caused investors to shift funds out of foreign markets, which negatively impacted emerging markets and Japan. Even bonds performed poorly.

Japan is the third largest economy in the world and the fourth largest exporter. Its stock market remains, by far, the most inexpensive in the developed world. The low valuation levels in Japan have not gone unnoticed, as some of the world's largest private equity funds (such as KKR and Apollo) have raised tens of billions of dollars over the past few years, aimed at acquiring Japanese companies.[1] That said, in 2018, our Japanese stocks declined with the rest of the market.

Price vs. Value

Stock prices do not move up in a straight line and volatility is unsettling to many investors. In a recent letter to shareholders, Warren Buffett pointed out the four different periods during his long history managing Berkshire Hathaway where his net worth (as defined by the value of his Berkshire Hathaway shares) declined by 37% - 59%. His comment was that investors spend far too much time focusing on short-term stock price movements, without paying attention to the intrinsic value of the underlying businesses.

Buffett's letter resonated with us, as current price fluctuations have little to do with the assessment of value. This past quarter saw the price of businesses that we own decline. However, nothing changed in our calculation of the value of these businesses. A disciplined focus on intrinsic value is the driver of long-term wealth creation, so long as one can successfully manage the impulse to become fearful along with the herd and abandon fundamentals for headlines.

Going forward

The current recovery since the Great Recession has been one of the longest on record, and whether or not there will be a recession in the near to medium term, it appears that global growth has peaked.

For the balance of 2019, we expect rising interest rates and slower economic growth. Neither is positive for corporate profits. Of course, the 24-hour news cycle focuses a lot of time on the various political risks that exist, including trade wars and a potential Brexit. However, even if these issues are resolved, the reality is that we are in a rising rate environment with a decelerating global economy.

All of the above suggests that investors should fasten their seatbelts and be prepared for a bumpy ride. We have maintained a healthy cash position, which will allow us to take advantage of opportunities in this environment.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly. High Yield continues to be the solution for clients looking for meaningful yield in the fixed income asset class, and we remain very positive on our High Yield fund heading into 2019.

Fundamentals and Process

When we evaluate our holdings in companies such as Allstate, Cisco, Microsoft, Philips NV, and Yamaha Corp, each of these companies created value last year through increased earnings and cash flow, yet their share prices declined from their peak. If these companies continue to improve their operations, they will continue to raise their dividends and their share prices should reflect that progress over time.

The quote at the start of this letter from the late Jack Bogle (1929 - 2019) reflects this sentiment. When holding strong businesses that meet our strict financial criteria, time is indeed our friend.

While the risks highlighted earlier in this letter are certainly present, we remain enthusiastic about the companies we hold over the long term. We are also comforted by our large cash position -- not only to take advantage of stock specific opportunities and any larger macro or geopolitical events, but also to protect the downside and recover faster on the upside in the process. Preserving capital by actively managing risk remains the cornerstone of our investment philosophy.

Final Thoughts

Over the past decade we have been fortunate in attracting a talented team of colleagues, each bringing with them a unique set of skills that have strengthened our investment process and benefited our clients. Our people are the assets in this firm, and we all continue to strive to deliver, over time, the long-term results that our clients have come to expect.

Sincerely,

Lorne Steinberg
President

[1] Financial Times. Retrieved October 20, 2018, from https://www.ft.com/content/a2336f46-d1a4-11e8-a9f2-7574db66bcd5