GOLUB GROUP
BUILDING SUSTAINABLE WEALTH
Quarterly Commentary

Q1 2018 Quarterly Commentary – April 1, 2018: The Return of (Normal) Market Volatility

In the first quarter of 2018, the stock market—as measured by the S&P 500—declined by -0.8%, its first negative quarterly result since the period ended December, 2015. The Dow Jones Industrials declined by -2.0%; the NASDAQ logged a positive quarter at +2.6%; major foreign stock markets offered no shelter, with declines that exceeded our broad domestic indices; bonds also ticked lower, with the Barclay's Aggregate Bond Index declining by -1.5%, driven by a rise in yields. The 10-year Treasury bond's yield rose by 33 basis points during the quarter, to 2.74%. The modest market losses, when measured by beginning and ending values, mask a change in the underlying market dynamic—the return of market volatility.

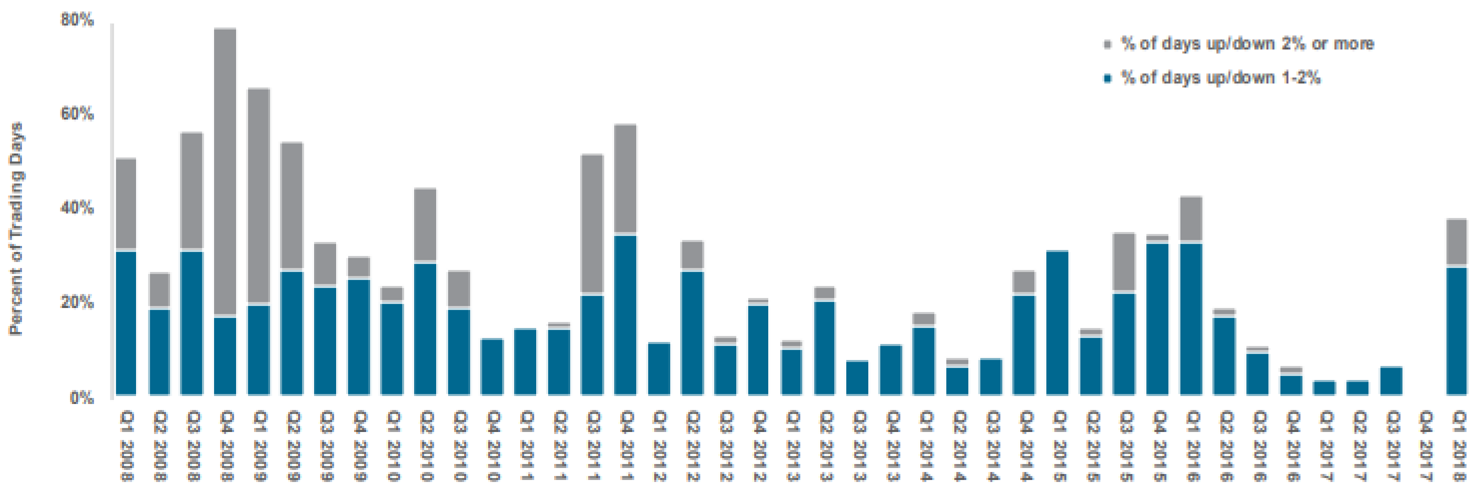
We have an administration in Washington that seems to enjoy keeping people on all sides of the political divide guessing, but when it comes to economic policy the Trump administration has been fairly clear on its goals, and has followed through with proposals to match them. Perhaps, then, it should come as no surprise that 2017 was one of the least volatile on record for the stock markets. The whole of 2017 saw only eight days in which the S&P 500 rose or declined by one percent or more. Contrast this with the first quarter of 2018, when the market has already risen or declined by that magnitude 23 times. It is said that the markets hate uncertainty, and clearly something has changed.

The first "shock" came at the end of January, when interest rates in the global bond markets moved higher on strong economic data and the Federal Reserve signaled it would likely raise interest rates four times instead of three during 2018. The move triggered fears of an overheating economy and the prospect of rising inflation. After an initial rise into mid-February, long-term interest rates settled at a level well below what many had feared, temporarily mollifying investor concerns. The second shock came in March, when the Trump administration fired an opening salvo of tariffs at China, threatening to set off a trade war with the world's second largest economy and one of the United States government's largest creditors (China held approximately $1.2 trillion of U.S. Treasury securities at 12/31/17).

Both of these factors (the potential for interest rate increases and for large-scale tariffs) are concerning to us as investors, but they also come on the heels of some very positive developments for our economy, namely a return of business confidence across corporate America, a recovery in energy prices, a reduction in overly-burdensome regulations, corporate tax cuts, the repatriation of offshore profits, and other policies that contributed to profit growth at S&P 500 companies of 11% in 2017, an estimated 17% in the quarter just completed and an expected 18% for the full year 2018.

Our view is that while market volatility is always unsettling, it is important to keep the following in mind: (1) the level of volatility that we are seeing today is actually fairly normal in a healthy, well-functioning market, and (2) market volatility is not something that should impact the investment policy of any investor with a long time horizon (which includes virtually all of the firm's clients). On the first point, the data below collected by Baird & Co. illustrates that the level of volatility experienced in the most recent quarter was no aberration. On the other hand, the lack of volatility in 2017 was extremely unusual. On the second point, while volatility might drive markets in the short term, equity market movements over the long term mostly depend on the direction of corporate profits and interest rates. If an investor can draw conclusions about these factors and invest accordingly, he or she can weather the storms that are offered up by the markets.

Quarterly S&P 500 Trading Volatility



We also think one of the contributors to recent volatility may be the high level of overall valuations in the market. Most members of the investing public recognize that the market, valued at roughly 21x the past twelve months' earnings, isn't cheap relative to historical norms. Should corporate earnings materialize as expected, this will not have been an expensive market, but earnings estimates are nothing more than educated guesses, and are anything but certain. This recognition has some market participants operating with a hair trigger, willing to rush to the exits at the whiff of uncertainty. This kind of concern likely wouldn't exist if stocks were cheap.

We are aware of the market environment in which we are operating, and are executing our role as managers of your wealth with care. Prudent long-term investing requires that we maintain price discipline. Given the dearth of bargains in today's elevated markets, it makes the search more difficult to find an asset that is priced appropriately, but they do exist. The companies we hold in our core accounts, for example, currently trade at an average discount of roughly 21% versus our estimate of intrinsic value. Average Wall Street analyst estimates of 2018 revenue and earnings growth for this same set of companies, per Thomson Reuters' I/B/E/S database, are 8.6% and 18.3%, respectively. Time will tell if the businesses we hold will perform as analysts project, and if our estimates of value are realized. This is not an exact science.

Meanwhile, we should all brace ourselves for a continuation of volatility, because this is the normal state of markets. During these periods, please don't hesitate to contact us for our views and advice.

Q1 Portfolio Changes

Please keep in mind, these commentaries should not be construed as a recommendation to buy or sell the securities discussed. Such decisions are made only within the context of the market environment as we perceive it at the time of the decisions and the structure of the diversified portfolio of which the securities are a component[***].

During the quarter we exited our positions in Chipotle Mexican Grill (CMG) and Mondelez International (MDLZ) and initiated positions in General Electric (GE) and Facebook (FB). A discussion of these changes is below.

<u>Chipotle Mexican Grill (CMG)</u>

We initiated our position in Chipotle last July in the wake of a 2015 health scare that led to a sharp decline in store traffic and, consequently, in the company's share price. Our original thesis was predicated on our belief the management would be able to reinvigorate traffic levels given their initiatives to: improve food sourcing and food preparation procedures, add new menu items that would entice customers to revisit the stores, increase marketing dollars and effectiveness to restore what was once a stellar restaurant brand, and develop technology to facilitate online and mobile ordering. Our research suggested that these initiatives, combined with new store openings, would reaccelerate the company's growth in earnings.

Unfortunately, the initiatives fell flat and traffic patterns did not improve to levels projected in our valuation model. In addition, subsequent to our purchase, management announced their decision to slow down store growth. Combined, these factors led to a reduction in our fair value estimate and, consequently, to our decision to sell the name.

Importantly, our decision to sell was not made in haste. In contrast, we performed extensive research on the name including: speaking with company management, visiting several locations to observe new menu items and operational procedures, speaking with store staff about various aspects of the business, and closely following all earnings calls and relevant news events. While these efforts didn't bear the fruit we desired in the form of a favorable stock return, we believe our efforts will prove to be beneficial to client portfolios over the long-term.

<u>Mondelez International (MDLZ)</u>

During the quarter, we also exited our position in Mondelez. Mondelez is one of the largest snack food companies in the world and possesses a highly diversified portfolio of brands with dominant market share across the majority of its product categories. In addition, the company benefits from enormous economies of scale in manufacturing, distribution, and marketing.

We initiated our position in Mondelez in 2015 after management embarked on a major turnaround plan following the company's spin off from Kraft Foods. The turnaround plan, which was designed to accelerate the company's sales growth and improve margins, included reconstructing the company's supply chain, revamping procurement and supplier practices, and implementing cuts to overhead costs. Our confidence in the turnaround was augmented by the fact that activist investors Nelson Peltz of Trian Partners and Bill Ackman of Pershing Square owned stakes in the company and supported the turnaround plan.

Over the course of our holding period, management was successful in making dramatic improvements to overall company profitability, but the outlook for further improvements has diminished, as evidenced by management's recent announcement that profit margin improvements for 2018 would be below previous guidance. After updating our valuation model to reflect our new expectations for margins, we no longer felt a position in the Mondelez was warranted and, thus, exited during the quarter.

General Electric (GE)

General Electric is an industrial conglomerate that owns several wide moat businesses that dominate their respective industries. The two most important businesses are GE Aviation and GE Power. GE Aviation is the largest manufacturer and servicer of commercial and military jet engines. GE Power manufactures and services natural gas and steam powered turbines for use in electricity generation. This segment has the largest installed base of equipment globally, producing roughly 30% of the world's electricity. Both of these segments generate a large portion of revenue from recurring, highly-profitable service agreements on their installed base of equipment that span over several decades. Accordingly, GE's customer attrition rates are very low and new competition is largely impeded from entering the company's core markets.

Despite the favorable attributes mentioned above, General Electric's stock sold off significantly over the past year for a variety of reasons. First, the Power business suffered from a cyclical decline in the demand for their natural gas turbines, further exacerbated by the roll out of a new turbine model whose performance has been temporarily impaired by issues with certain underperforming internal components. Secondly, management announced a dramatic cut to the company's unsustainably high dividend, which caused many yield-seeking investors to exit their position. And thirdly, the SEC launched an accounting investigation against the company related to an insurance charge and revenue recognition practices.

Based on our research, we believe the aforementioned issues are solvable and/or are already reflected in the company's depressed share price. Over time, the cyclical softness at GE Power should subside and issues with the gas turbine components will be resolved. Additional cuts to the dividend don't seem necessary given our estimates of future company profitability. And lastly, our research suggests that the SEC's investigation will not lead to any material impairment of future profitability.

At the current share price, we believe GE's competitively advantaged businesses are selling at a material discount to our estimate of intrinsic value. Therefore, we initiated a position during the quarter (and added to the position after quarter-end).

Facebook (FB)

As evidenced by over two billion monthly active users, Facebook has become the premier social networking platform globally, where users interact with their friends, share photos, consume news, and watch videos. To facilitate these interactions, users willingly share personal information (e.g. age, gender, location, interests), which makes Facebook uniquely positioned to provide advertisers with both broad reach and highly targeted capabilities.

We believe Facebook will continue to benefit from two secular trends, both of which are intertwined: (1) growth in digital advertising spending overall; and (2) growth in total users. Regarding the first trend, in addition to the continual shift from TV/print media outlets to digital outlets at companies with large advertising budgets, we're also seeing an incremental increase in total digital advertising dollars driven by small businesses that traditionally could not afford to reach their target audience via traditional outlets. In addition, our research suggests that Facebook still has ample opportunity to grow its user base overseas where population growth is much higher than in Facebook's core developed markets and where quickly increasing per capita income is allowing for greater internet connectedness and social platform engagement. Combined, we believe these two factors will drive significant long-term growth for the company.

Investing is not without risk, and Facebook is no exception. One risk you may have read about recently in the media concerns changes the company is making to its News Feed. Specifically, in January 2018, CEO Mark Zuckerberg announced plans to de-emphasize branded content (which is produced by third-party products, brands, and sponsors) in the News Feed and to emphasize personalized content created by users' friends. The goal of this strategic change is to drive more meaningful personal interactions between users on the platform and, in turn, provide for a happier, more engaging user experience. Our research suggests that while there may (or may not) be some near-term impact on profits, this strategic shift will ultimately prove favorable to shareholders as it will lead to longer-term user growth and user engagement.

Another risk that's been prominent in the media is the scandal that took place when Cambridge Analytica, a political data firm hired by President Trump's 2016 election campaign, gained access to private data back in 2014 on more than 50 million Facebook users that was utilized to influence voting behavior in the 2016 election. Although Facebook has since changed their policy, at the time of the alleged offense this data was routinely provided by Facebook to researchers as long as it was utilized for academic purposes. As a result of this scandal, investors are concerned that Facebook has damaged users' trust in the network. While this indeed may be the case, we do not believe there will be any lasting long-term effect from the scandal as the enormous value provided by the network to its user base will prevent any material exodus, as has been the case historically when Facebook has been accused of compromising users' trust.

Lastly, Facebook faces the risk of adverse financial impacts from new regulations that could be proposed around data privacy and ad targeting in the U.S. However, our research on Facebook's success in Europe, a much more regulated market, suggests the long-term U.S. impact from such measures will be manageable. And in fact, regulators' efforts may, counter-intuitively, increase the company's dominance given that regulation to curtail data sharing would make Facebook's data even more exclusive to the company.

In conclusion, we continue to believe that the beneficial secular trends at Facebook more than compensate for the aforementioned risks, but we will continue to monitor the situation closely as the situation develops. At this point in time, our research suggests that Facebook is materially undervalued.

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