GOLUB GROUP
BUILDING SUSTAINABLE WEALTH
Quarterly Commentary

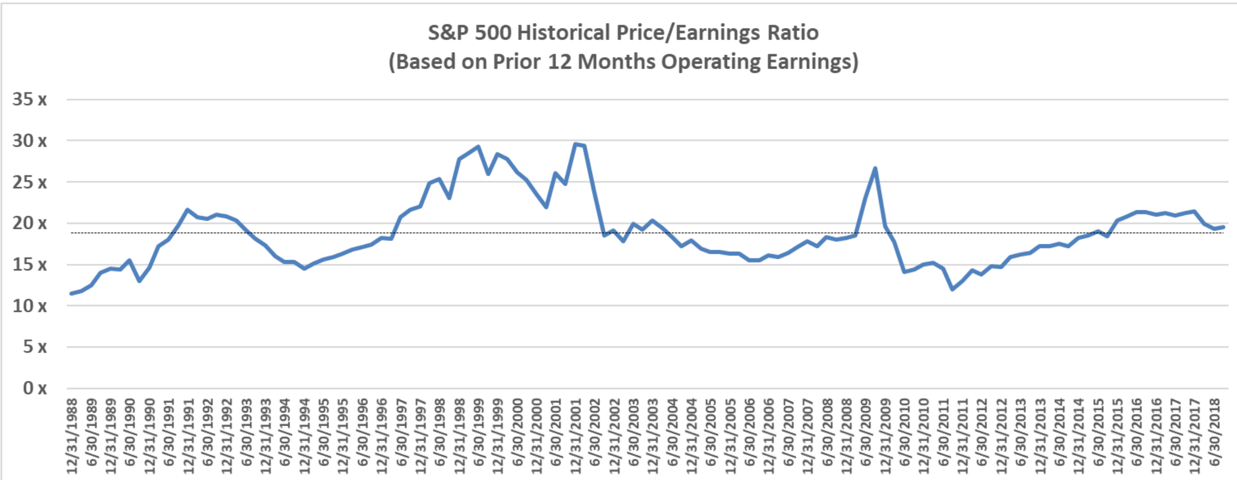
Crosswinds: Corporate Profits and Interest Rates

Q3 2018 Quarterly Commentary – October 1, 2018

Investors in U.S. equities enjoyed a strong quarter, with the S&P 500 returning 7.7%, including dividends, for the three months ended September 30, 2018. The year-to-date total return for this index reached 10.6%. Technology, discretionary and health care sectors have generally enjoyed strong returns during the current year; consumer staples, financials, basic materials, and telecommunications and real estate sectors have lagged. Short-term bond yields have risen by roughly 75 basis points (0.75%) this year on the heels of three actions by the Federal Reserve Open Market Committee to raise bank borrowing rates. Longer-term bond yields have more-or-less followed suit, weighing on the returns of bonds and "bond proxies," such as high-dividend common stocks. The Barclays Aggregate Bond Index, a broad measure of fixed income performance, returned only +0.02% in the third quarter and has fallen by -1.60% for the first nine months of 2018.

It is easier for us to talk about the level of the market, in terms of its price versus our view of its "fair" valuation, than it is to predict its moves in the coming weeks, months or year. There is no crystal ball here that informs us about the market's future, and frankly, looking at past relationships of price and value of the overall market does not provide us much guidance as to which direction the market might go in the near term. Nevertheless, the current valuation of the market is important to us when we set our own expectations as to what kind of returns our clients might expect over the long term from exposure to the stock market. Simply put, expensive markets lead us to believe that future returns will be lower than average; inexpensive markets suggest higher than average future returns.

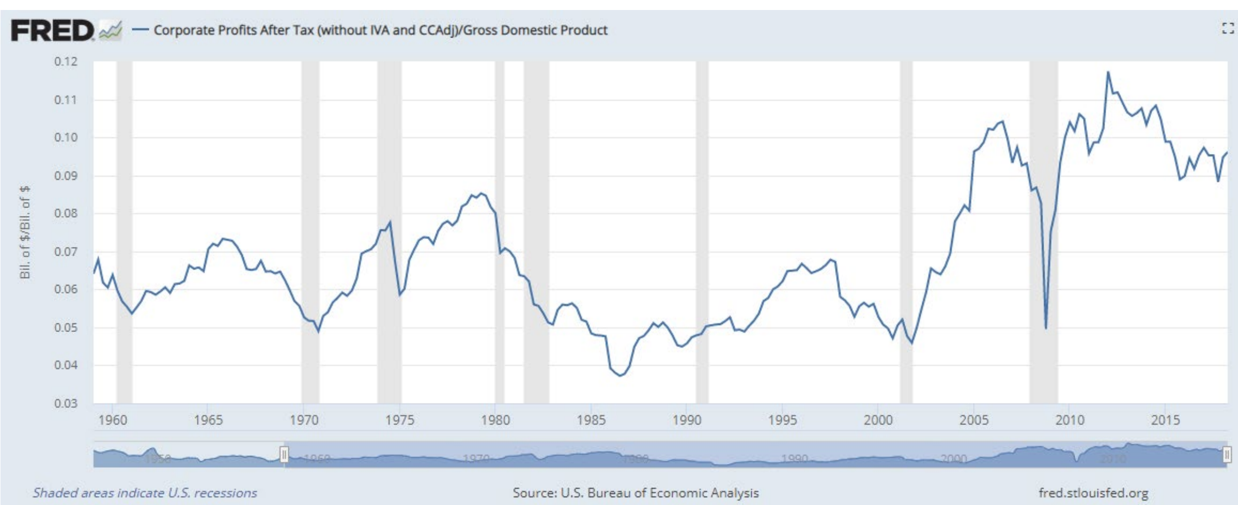
Let's start with current valuation metrics. As you know, one straightforward measure for evaluating the level of equity prices is the Price/Earnings ratio ("PE ratio"). It doesn't tell us everything we need to know to evaluate how attractive or risky stock prices are at any time, but is a good place to start. Since December 1988, the S&P 500 has traded at an average PE ratio of 18.9x, when price at any point in time is measured against operating earnings generated over the preceding four quarters. At September 30, 2018, the market traded at 19.6x operating earnings, a slight premium versus the average over the past 30 years. This particular measure therefore does not point to an equity market that is overvalued.



Source: Standard & Poor's

While this is helpful to frame the present, we spend more of our research time focused on the future, and on the factors that might impact the rate of growth of the market over the years ahead. Two of the most fundamental and important drivers of market valuations over the long term are corporate profit growth and interest rates.

Corporate profits: Stocks represent the ownership of corporate profits, and a rising bottom line naturally boosts the value of the companies who produce them. A look back over time shows that the level of corporate profits as a percent of the country's gross domestic product has rarely been higher than they are today. This is a reflection of a strong economy and a focus by corporate managements on maintaining high profit margins.



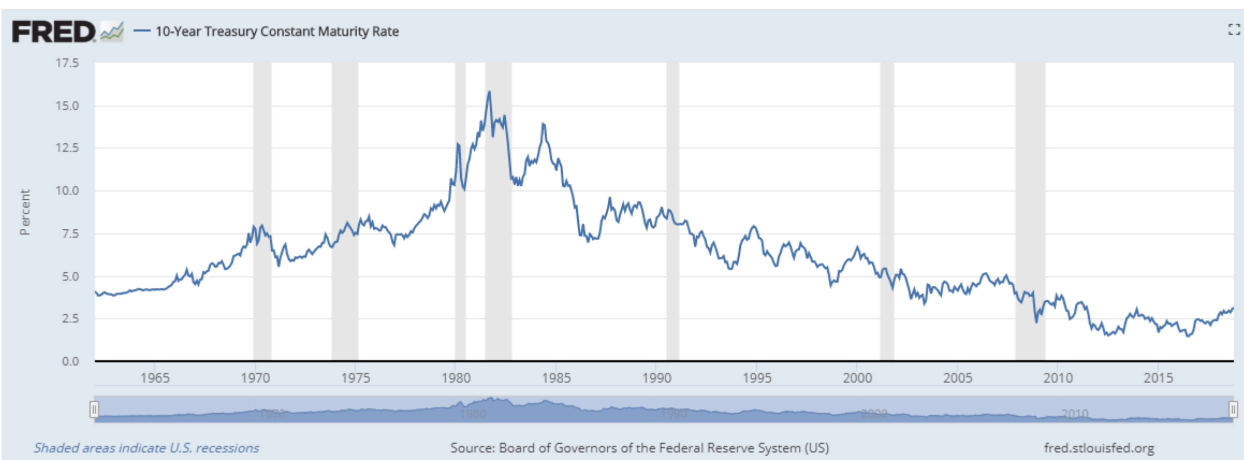
Source: Federal Reserve Bank of St. Louis

The question is whether something about the U.S. economy leads us to believe that the higher levels can

be sustained, or whether corporate profits might revert to a lower mean. Two key factors lead us to believe that profit margins can remain higher than in previous cycles. The first is globalization. U.S. corporations have increasingly augmented their bottom lines with rising overseas profits. As shareholders, we have a claim on profits generated both here and abroad. Second, with the growth in the knowledge economy, a sizeable and growing share of U.S. corporate profits are derived from companies that leverage technology to produce what we believe will be sustainably high profit margins.
Wall Street seems to agree. Bloomberg's survey of analyst estimates points to earnings margin expansion within the S&P 500 from 12.5% of revenues in the next 12-month period, to 12.7% and 13.3% in the subsequent two annual periods, respectively.

Interest rates: It can be a more complicated matter to grasp the importance of interest rates to the valuation of the stock market, but we will try to explain. First, bonds are less risky than stocks because in the event the party obligated under a bond indenture fails to pay on a timely basis, the holder of the bond has legal recourse. Stock holders do not have such strong protections. Therefore, stocks should offer the holder a higher expected return than bonds commensurate with the higher risk assumed. If the rates of return required by bondholders rises for whatever reason, so too should the rates of return required of stocks. Second, we know that bond prices rise and fall inversely with a change in interest rates. As interest rates rise, bond prices fall, and vice versa. Given what we said earlier about the relationship between stocks and bonds, it holds that when rates rise, stock values face similar price pressures as bonds.

The following chart, which shows the long-term path of the rate paid to holders of 10-year U.S. Treasury notes, reveals two important things. Given what we discussed in the previous paragraph, the decline in interest rates since 1981 explains at least some of the strong return in equity markets since that time. There have been four economic recessions and four bear markets since 1980, but the downward glide path of interest rates has certainly helped to fuel stock markets over this long period.



Source: Federal Reserve Bank of St. Louis
We have argued for several years that this tailwind from falling bond prices is a thing of the past. In fact, rates on the U.S. 10-year have risen from a low of 1.36% in July, 2016, to the current level of 3.06%, but nevertheless it has provided little headwind to date. Despite the expansion in interest rates, the S&P 500 rose by 40.5% over that time, including dividends, suggesting that the upward pressure on valuations caused by a strong economy, expanding corporate earnings (due in part to a corporate tax cut) and a more

optimistic investor sentiment far exceeded the negative pressure on valuations caused by a rise in interest rates. We do not know whether the upward movement in rates we have experienced is a precursor to even higher rates in the future, something that could pressure stock markets, or if rates will remain range-bound at levels closer to what we're experiencing today.

Our best guess, knowing what we know today about the factors driving the U.S. and global economies, is that the two forces of rising corporate profits and rising interest rates will remain in opposition in the coming year or two, and that this will lead to growth in valuations across the market perhaps somewhat slower than the growth in corporate earnings. It should be noted, however, that the equity market is made up of thousands of individual stocks, each of which represents ownership in individual companies, and that a stock market index's return is simply an average of the stocks that comprise it. When we build our client portfolios, we spend far less time thinking about the level of the market than we do thinking about the prices and valuations of the individual holdings in our portfolios. We think that by focusing on individual businesses, we can derive greater conviction about the likely future growth of profits of the corporations that make up our portfolio than we could about the overall economy. We can build a better understanding about the effect of changing interest rates on our individual companies than we can about the market as a whole. We can decide which companies provide opportunity given these factors, and given the prices that they are offered to us by the stock market.

Q2 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 initiated a position in The Walt Disney Company ("DIS").

The Walt Disney Company (DIS)

The Walt Disney Company, commonly known as Disney, needs no introduction. Disney delivers its premium media content to millions of people around the world through several prominent assets such as the Disney Channel, ESPN, ABC broadcasting network, Marvel movie studio, and many others. The company also owns world-renowned amusement parks, resorts, and cruise lines. If this isn't impressive enough, Disney is in the process of substantially increasing its dominance in the media space by acquiring more premium media assets from 21st Century Fox, a transaction that will solidify its lead in the global media space.

We think Disney garnered itself a wide economic moat that stems from its ownership of an enormous library of original premium content and unrivaled scale in the production of new content. Disney's parks business includes a collection of trophy assets that benefit from synergies with the media content and significant barriers to entry that protect from the competition. The House of Mouse is a powerful force in the media and entertainment space.

But why did we buy the stock? The short answer, near term uncertainty creates a substantial long-term opportunity for patient investors. The media industry is going through a shift in the way we consume video content. More and more people around the world choose to stream their video content online and "cut the cord" from cable and satellite providers. We think that this secular trend in the media space creates an opportunity for Disney to shift its business model from relying on third-party distributors, to a direct-to-consumer distribution model through the internet. By making this transition, Disney will be able to better monetize its content, produce content more efficiently, customize content to different population segments, and scale its business globally.

This transition isn't going to be quick or easy. Disney will have to make substantial investments in streaming capabilities and new content which might weigh on profits in the next year or two. But we think the benefits for Disney owners from this transition are substantial, and even more important, we don't think these benefits are being priced in the stock.

Year-end items

As we approach year-end, there are two items that need your attention. First, some of you are required to take a distribution from your IRA accounts (an "RMD") before December 31st. We will reach out to those of you who are subject to this requirement to confirm your instructions on how you would like this distribution to be handled. Please give this some thought in the meantime, and perhaps we can create together some "standing instructions" on how to deal with RMDs in future years. Second, the IRS allows "realized" losses to be paired against the current year's realized gains, thereby reducing taxable income and one's current-year tax bill. You may wish to explore the possibility of using some of those that may exist in your account against realized gains. Don't hesitate to call us to discuss either of these issues.

Golub Group

Kurt Hoefer, CFA®

Partner

[***]The securities identified do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable.