GOLUB GROUP

BUILDING SUSTAINABLE WEALTH

Quarterly Commentary

Q3 2019 Quarterly Commentary – October 10, 2019 Rate Risk

U.S. equity and fixed-income markets advanced in the third quarter of 2019 in reaction to declining interest rates and *mostly* resilient economic data. Including dividends, the Dow Jones Industrial Index rose by +1.8%, the Standard & Poor's 500 Index increased by +1.7% and the NASDAQ Composite Index advanced +0.2%. The Barclays Aggregate Bond Index powered to a +2.3% quarterly return. Since the end of December, the Dow, S&P500, NASDAQ Composite and Barclays Aggregate produced total returns of +17.5%, +20.6%, +21.6% and +8.5%, respectively, leaving the impression that this has been an investor-friendly market. The truth is more complicated, of course. These strong numbers reflect a stock market that rebounded from a nearly -20% decline in the fourth quarter of 2018, and in fact, the equity markets stand today roughly where they were twelve months ago. The fixed income market has been the star performer over this period, with the Barclays Aggregate Bond Index posting a twelve-month return of +10.3%, but the strong bond market is actually further indication of heightened investor concerns over the broader economic outlook.

As we noted three months ago, we have seen increased signals from the markets that the longest recovery on record in the United States may be in its latter stages. As the quarter came to a close, cracks began to show in the manufacturing sector of the U.S. economy, tempering expectations for corporate earnings. The service economy, which comprises the bulk of U.S. Gross Domestic Product, has held up far better, but the rate of expansion has slowed markedly. As we noted in last quarter's letter, we take these signs of economic change seriously, and our process for addressing the markets is not to retreat from investing, but rather to ensure that we have a portfolio focused on well-priced stocks in economically-resilient businesses. This letter, which is worth another read, can be found at https://www.golubgroup.com/july-1-2019-economic-cycles-and-market-signals/.

One of the more unusual developments through this market cycle, and one that has a clear implication for all investors, is the dramatic decline of interest rates mentioned above. The ten-year U.S. Treasury note began the year yielding 2.66%, but by the end of the third quarter its yield fell to 1.67%. This 99-basis-point decline (-0.99%) in yields fueled unusually strong results for owners of bonds, since bond prices move inversely with the direction of interest rates. The Barclay's Aggregate Bond Index's return of +8.5% for the nine months through September 30th stands out in stark contrast to the three, five and ten-year annualized returns for that index of +2.9%, +3.4%, and +3.8%, respectively. It's important to note that the forces behind the strong recent performance of bonds can reverse. An increase in interest rates would have the opposite effect, and simple bond math dictates that the price of a 10-year U.S. Treasury would fall by 9.0% if interest rates were to recover to their levels of December 31, 2018.[1] . As investors in bonds for many of our clients, we have to take special care in this environment to balance the need to produce interest income against the need to manage downside risk from shifts in the yield curve. Our preference today is to ladder bond maturities, with a skew to shorter issues. As we receive coupons and principal from maturing bonds, we will acquire new positions that complement the remaining portfolio. If rates rise, so too will the yields on the new positions purchased. While there is always a temptation to buy very long-term bonds to capture higher yields, we do not believe the few extra basis points of current return compensate us for the significantly increased interest rate risk today.

The decline in interest rates also helped lift the stock market out of its funk of last December. Low interest rates (or more to the point, the expectation of persistently low interest rates) increase the value of all so-called "risky" assets, including dividend and non-dividend-paying stocks, real estate, private equity, venture capital investments, etc. Today the S&P 500 currently trades at 17.8x current year earnings, and 16.0x analyst expectations of 2020 earnings, a level that is roughly in line with historical averages. While the current low-interest-rate environment, global economic malaise, uncertainty around trade, elections and impeachment, and many other factors add to the challenge of equity portfolio management, they also create an environment where we can find opportunities to invest. We think the changes in the portfolio discussed below illustrate the kinds of opportunities that arise when investors feel as uncertain as they do today.

Q3 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 new position in Ulta Beauty, BlackRock, and Lowe's.

Ulta Beauty

Ulta is a leading beauty retailer in the United States, offering a wide range of beauty products and services, a niche that is relatively protected from online competition. The company's growing store footprint, strong brand recognition, and a sizable loyal and expanding customer base create strong competitive advantages that drive rapid earnings growth and attractive returns on capital.

Ulta's future growth prospects look compelling. We think Ulta has the potential to substantially grow the store base over the next 5 years, attracting customers in new geographies, while also taking market share from struggling department stores and drug stores that offer inferior shopping experiences. Execution is key for any growth story, and in this case, we think Ulta is managed by a very capable team that excels in operating the business and allocating capital.

After following the company for some time, we got our opportunity to buy this solid business at a substantial discount to intrinsic value after management lowered guidance for the current year due to an industry-wide slowdown in make-up sales.

Lowe's

Lowe's is one of the two dominant home improvement retailers in North America. The company has a national footprint and offers products for construction, maintenance, remodeling, and decorating to both "Do-It-Yourself" and "Pro" customers. Lowe's operates in a segment that is relatively isolated from online competition. The company also benefits from scale and brand advantages that shield it from competitive pressures, which allows Lowe's to generate attractive returns on capital for both firms.

But despite Lowe's solid performance, the company has consistently reported lower revenue growth and profitability than its closest competitor, Home Depot. While previous management made some attempts to improve the operation, the company has never engaged in a major effort to close the performance gap with Home Depot. This changed last year when a large shareholder of the company forced the board of directors to replace the CEO with a Home Depot veteran. The new CEO immediately brought several new executives from Home Depot and launched a plan to revamp the company's systems, merchandising processes, and supply chain structure.

After conducting an extensive research of Lowe's new direction and analyzing the potential outcomes, we concluded that the stock was priced at a sufficient discount to our estimate of intrinsic value.

BlackRock

BlackRock is the world's largest investment management firm with over $6.5 trillion in assets under management. The company is a global leader in passive investment strategies and alternative assets, such as infrastructure, real-estate, and private equity. BlackRock owns iShares, which is a leading ETF platform with over $2 trillion in assets under management.

BlackRock benefits from strong competitive advantages that stem from unrivaled scale, leading brands, and switching costs for both retail and institutional investors. We think BlackRock's sizable asset base makes it a cost leader in the industry. The company's leadership in passive strategies benefits from the low level of redemption among passive investors, while Blackrock's strong brands and close relationships with institutional clients create additional switching costs to keep assets within the firm's four walls.

Future asset and revenue growth look promising. BlackRock is very well positioned to capitalize on the growing demand for passive investment strategies and illiquid assets. We think these trends will continue in the future and will lead to solid revenue and earnings growth for many years. There is also a free option embedded in this investment. BlackRock owns a software business that is growing very quickly. While still in its early stages, this business could become a significant contributor to the bottom line in a few years.

After taking a close look at numbers and the range of potential outcomes for this business, we concluded that the current price represents an attractive opportunity for long term-oriented investors.

Promotions and Achievements

We are pleased to announce that Adam Govani has been promoted to the role of Financial Advisor, and will assume primary responsibility for serving a number of the firm's clients. In the relatively short time that Adam has been with us he has shown, through his creative and intelligent solutions for clients, as well as his proactive approach with both clients and his colleagues, that he deserves the added responsibility. We're confident that those of you who have experienced Adam at work will certainly agree.

In our industry, several credentials stand out above the rest, and their achievement by individuals shows a commitment to building the knowledge base, analytical tools and judgment in order to bring the highest-quality service to clients. The **Certified Financial Planner**® credential is awarded only after rigorous training on 72 areas of financial planning designed to comprehensively cover the needs of financial planning clients, the passage of an intense examination showing a mastery of these principles, and the logging of thousands of hours of applicable work experience. During the quarter, the CFP® was awarded to Charles Angle, bringing the total number of CFP® certificate holders at Golub Group to eight. The **Chartered Financial Analyst** designation is generally considered the highest distinction that can be earned by professionals involved in investment research and portfolio management, and the achievement requires that candidates pass a series of three exams covering areas such as accounting, economics, ethics, money management and security analysis. It is a grueling process, and completion rate for candidates seeking the credential is less than 13%[2]. We are lucky to have five on the team with the addition of Jack Zhao, CFA and Mandy Pham, CFA. The **Certified Private Wealth Advisor®** credential is earned by industry professionals seeking the latest, most advanced knowledge and techniques for accumulating, preserving and distributing wealth for families with high net worth. John Wei, CPWA®, earned this distinction this quarter.

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Kurt Hoefer, CFA®
Partner