

ANNUAL LETTER

“Landlord or Tenant?”



“Be fearful when others are greedy, and be greedy when others are fearful!”

-W. Buffett

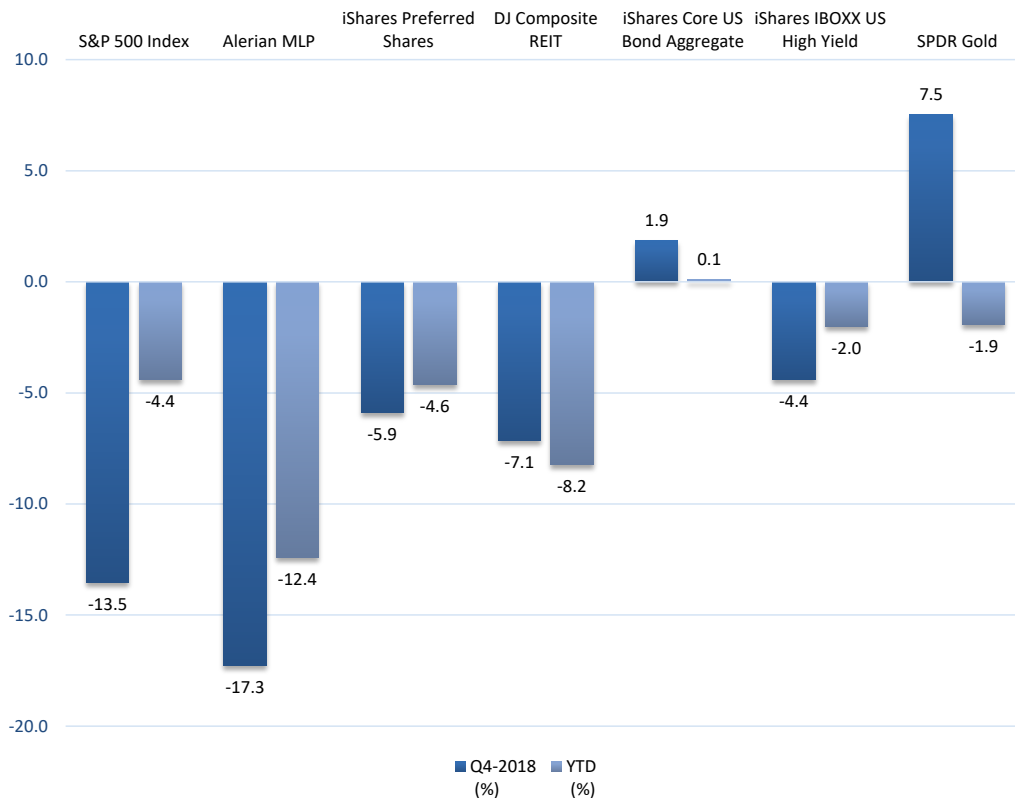
1. 2018 REVIEW: ECONOMY UP, MARKETS DOWN!

2018 turned out to be the worst year in the financial markets in a decade. What made it particularly painful for investors was the fact:

- (1) that they were unaccustomed to volatility, after many quiet years
- (2) that the sell-off occurred over a short concentrated period of time (last quarter of the year)
- (3) that the vast majority of investment categories fell at the same time. The touted benefits of diversification did not help much (temporarily in our opinion).

The market downturn is interesting because it occurred during a year in which the US economy grew at its fastest pace in ten years (GDP grew at a 2.7% rate), earnings of the S&P500 companies grew around 25%, inflation stayed at around 2%-2.4%, and US unemployment was at a 50-year low. Possible reasons for the market weakness are (a) the Federal Reserve monetary policies, (b) the trade war with China, (c) the government shutdown, (d) the anticipated earnings growth slowdown (the impact of the 2017 tax cuts will wane), (e) algorithmic trading, etc.

Asset Class Performance



Source: Bloomberg Professional Services

Financial markets are imperfectly looking into the future. In the short term, they may over- or underreact, but over the longer term they generally get things right. Investors should not forget that 2017 was a stellar year for stocks. Markets were anticipating a strong economic performance for 2018. 2018 markets dropped precipitously, hinting at a likely weak economy in 2019. As an investor, it is important to understand how much expectations overstate or understate the actual outcomes. In our opinion, markets are currently bracing for a 2019 environment that looks gloomier than what it is likely to be the reality.

A recent report by JPMorgan analysts shows that at the end of 2018 their predictive model based purely on financial variables (stock market, yield curve and credit) put the probability of a

recession in the US in 2019 at 91%. At the same time, their model based on leading macro-economic variables (car sales, building permits, unemployment rate) put the probability of such event at 26%¹. The market and the economy seem to paint two wildly different pictures.

Three macro themes and dynamics of 2018 are worth reviewing, as they may determine how 2019 shapes up for investors.

- 1) The **Federal Reserve** has **hiked** short-term interest rates three times in 2018 while winding down its decade-old quantitative easing programs. It will not be long before other major central banks in the developed world follow suit. The rising interest rates on the US dollar, compared to those on the Euro and other currencies, pushed the US currency +4.5% on the year. The stronger dollar has very adversely affected stocks and bonds of those countries with large debt balances denominated in USD. At the same time, many US corporations with significant revenue denominated in foreign currency have been penalized in the stock market.

President Trump has expressed his disappointment with Federal Reserve Chairman's Jerome Powell decision to **continue** raising rates. The perceived acrimony between the politically elected President and the appointed technical central banker risks undermining the credibility of the Fed. The **associated** uncertainty contributed to market jitters.

We are optimistic. As economic growth and inflation figures come in softer than anticipated, we expect the Federal Reserve to take a pause with rate hikes in 2019. This will likely be supportive for US and international markets.

- 2) **Trade Protectionism and China.** While the confrontational approach assumed by the US administration on trade issues with Mexico, Canada and the European Union has yielded some results, China, throughout 2018, seemed unwilling to come to terms with President Trump (at least until very recently). The trade and tariff war has contributed to a sharp economic slowdown in Europe and Asia in the second half of the year. Despite the bold Chinese rhetoric, the economy of the Asian giant has been slowing down rapidly, pointing to a more constructive interaction with the US. In early January, Apple cut its revenue guidance significantly, blaming an unexpected, sharp slowdown in iPhone sales in Greater China. The latest Purchasing Manager Index (PMI) survey in China came in below 50, hinting at a possible contraction of the Asian economy.

¹ "Whoosh, what the end of the year turmoil means for 2019", The Economist, January 5th, 2019

We are optimistic. Our assumption is that the Chinese and US authorities will find some kind of initial resolution to their trade disagreements, while China tries to avoid further economic pain. We expect the Chinese authorities to provide both fiscal and monetary stimulus to their economy. We see this as supportive for markets.

- 3) **Brexit and Populism on the Rise.** Unconventional politicians keep on rising, riding the tide of discontent around the world. Depending on one's political inclinations, protest votes may translate into anti-capitalism, anti-CEO and anti-globalization voices or, equally, into anti-immigration, anti-Europe or xenophobic ones. Decades of technological innovations, globalization and free people/capital movements helped economies around the world expand but also caused income inequality to rise.

Most people today have access to food, shelter, clean water, sanitation and education. Nevertheless, many in the Western world feel that they have been left behind. Following the 2008-2009 Great Recession, middle-income earners are struggling and are voting to change the status quo. The number of countries with "unconventional" governments has grown in 2018--Trump in the US, Bolsonaro in Brazil, Lopez Obrador in Mexico, Orban in Hungary, Di Maio e Salvini in Italy, etc.

Brexit (the departure of the UK from the European Union) is perhaps the most glaring example of what populism may yield. In 2016, a referendum surprisingly determined that the UK would leave the EU. The political chaos that emerged has not been resolved while the ultimate deadline for Brexit is approaching on March 29, 2019. At the time of this writing, a disorderly exit from the EU seems a likely option, even if it is in no one's interest. We hope that reason ultimately prevails.

We are not sure. The rise of populism on the left and on the right is the most serious risk we see. We are confident that over time populism will subside. In the short run, it is very difficult to make any predictions. The evolution of the Brexit saga will be very telling.

2. CORRECTION OR BEAR MARKET?

It is not yet clear whether the current market downturn is just a painful pause in a bull market or the beginning of a new bear market. There are solid arguments that speak to both. As long-term optimists, we tend to favor the odds on the former over the latter.

The case for a temporary correction (followed by a resumption of the bull run):

(1) Markets are cheap(ish). History shows that deep and long bear markets follow periods of extreme overvaluation. Despite the media sensationalism, this is hardly the case today. The market P/E (price divided by earnings of the S&P500 Index) generally fluctuates between 21x (expensive) and 11x (cheap). Currently the forward P/E ratio is slightly above 15x. The average for the last 10 years was closer to 16x.

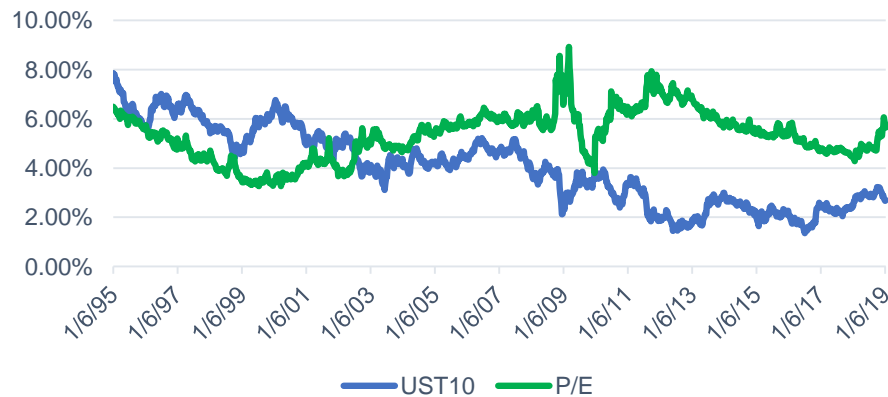
S&P500 Index Forward P/E Ratio



Source: Bloomberg Professional Services

Another way to look at the market valuation is to compare the trailing earnings yield (the inverse of the P/E ratio) of the S&P500 Index to the yield on the 10-year US treasury bonds. Currently the stock market sports a yield of 5.9%, whereas the government bonds yield stands at 2.7%. The stock market is not expensive compared to the bond market.

S&P500 Index Earnings Yield (E/P) vs. 10Y US Treasury Yield



Source: Bloomberg Professional Services

(2) No signs of an imminent recession. Bear markets typically start near recessions. Our dashboard of leading economic indicators suggests continued economic expansion in the US. Even the weaker aspects of the US economy, such as housing, are in our opinion undergoing a temporary adjustment. Weak housing activity has much to do with mortgage rates that rose very quickly (from their July 2016 lows) and some aspects of the tax law passed in 2017. Nevertheless, housing affordability is still favorable, housing inventory is low compared to history, demographic and income trends are supportive, and the mortgage market is healthy. With positive leading economic indicators, a sound housing market and banking sector, we see very limited vulnerabilities in the US economy.

(3) This has been the most hated bull market in history. Bear markets follow periods of investors' euphoria. The recent peak of the market was registered on 9/20/2018. Prior to that date there were no signs of investors' euphoria and most individual and professional investors were skeptical about the stock market. At the market lows on 12/24/2018, pessimism was at extreme levels. The American Association of Individual Investors (AAII) mid-December weekly poll reported only 20.9% of investors being Bullish. These high levels of pessimism historically coincided with sharp market rebounds.

According to Citi's chief US equity strategist Tobias Levkovich's Panic/Euphoria proprietary model, late in 2018 we dipped into panic territory. Prior levels of such extreme negative readings coincided with large market rebounds over the following 12 months.

(4) History is on your side. Records since World War II show that after a quarter like Q4-2018, market returns have been positive 79% of time over the next quarter and 74% of the time over the next 12 months. The statistical edge is too large to ignore. Note, furthermore, that three of the four exceptions involved quarters in which the US economy was already in a recession.

S&P 500 10%+ Down Quarters Post WWII

Quarter	% Chg	Next 2 Qtrs		Next Year
		Next Qtr %	%	%
9/30/1946	-18.83	2.27	1.40	1.00
9/30/1957	-10.45	-5.73	-0.75	18.01
6/29/1962	-21.28	2.78	15.25	26.70
6/30/1970	-18.87	15.80	26.72	37.10
12/31/1973	-10.03	-3.66	-11.84	-29.72
9/30/1974	-26.12	7.90	31.19	32.00
9/30/1975	-11.89	7.54	22.53	25.48
9/30/1981	-11.45	5.48	-3.63	3.65
12/31/1987	-23.23	4.78	10.69	12.40
9/28/1990	-14.52	7.90	22.60	26.73
9/30/1998	-10.30	20.87	26.49	26.13
3/30/2001	-12.11	5.52	-10.29	-1.12
9/28/2001	-14.99	10.29	10.23	-21.68
6/28/2002	-13.73	-17.63	-11.11	-1.55
9/30/2002	-17.63	7.92	4.04	22.16
12/31/2008	-22.56	-11.67	1.78	23.45
3/31/2009	-11.67	15.22	32.49	46.57
6/30/2010	-11.86	10.72	22.02	28.13
9/30/2011	-14.33	11.15	24.49	27.33
12/31/2018	-15.55	?	?	?
Average		5.13	11.28	15.94
Median		7.54	10.69	23.45
% Positive		78.9%	73.7%	73.7%

Courtesy of Bespoke Investment Group

- (5) Third year of a presidential cycle. The third year of a new US presidency has very frequently been a positive year in the markets. This is regardless of a Democratic or Republican President and regardless of the executive and legislative branches being held by the same political party. One explanation of this phenomenon is that during their third years Presidents tend to enact policies that favor their re-election.

The case for a bear market:

- (1) Technical patterns point to a bear market. If one looks exclusively at market charts, the current configuration often coincided with bear markets. The S&P500 Index 10-day Exponential Moving Average (EMA) dropped below the 200-day EMA; the 200-day EMA is sloping downward. The number of S&P500 index member companies trading below their 200-day moving average is close to 80%. Some serious technical reparation needs to occur prior to a bull market resuming.
- (2) Yield curve flattening leading into an inversion. One of the most accurate predictors of recession, the shape of the yield curve (difference between the yield on the 10-year US government bonds and 3-month US Treasury Bills), is inching toward an inversion. If and when that inversion occurs, we are very likely to see a recession in the not-too-distant future. Investors should however note that a simple flattening with no inversion does not foretell a recession. Once an actual inversion occurs it may take up to 18-24 months before a recession starts. During those interim periods markets have historically

performed well. Typically, markets start to perform very poorly much closer to a recession start date than when the yield curve first inverts. There is no reason to panic about a yield curve inversion.

So what is an investor to do? Landlord or tenant

While we hope that we are experiencing just a correction, we know that bear markets are a fact of life and that they can't be predicted. We also know that timing the markets is a mistake: the worst days in the markets are closely clustered with the best ones. If one misses some of the up days the damage to the portfolio may be long-lasting. We also know that over a long period of time markets rise. Since the Great Depression, there have been only two rolling decades where annualized returns were not positive.

Investors should view themselves as either **landlord or tenant**, to use a real estate analogy. If you are a landlord and property values go down you may be upset, especially if you need to sell soon. If you are a tenant, you may actually rejoice if property values go down because it may now be affordable for you to buy and become a homeowner at attractive prices.

If you are a retiree and need to withdraw money from your account, you are a landlord: you should make sure that your exposure to risk is adequate for your circumstances. Conversely, if you are accumulating wealth for your future, you should stay the course or possibly even take more risk. The recent sell-off has sharply increased the long-term expected returns of many asset classes. The above reasoning is unrelated to a bull or bear market.

This is a great time to reassess your risk profile and time horizon. Your exposure to risky assets should be a function of your time horizon (and age) and risk tolerance (net worth, income, discretionary spending, willingness to take risks). If your horizon is shorter than 5 years (for instance, if you will retire within 5 years) or your tolerance for risk is low, make sure you reduce your exposure to risky assets. If this is not the case, you should make no changes; forget about the markets, TV, newspapers; and look forward to a bright future. Trying to time the market is very dangerous and chances are that you will lose money in the attempt.

3. A FEW OBSERVATIONS ABOUT INTEREST RATES

The US economy, on balance, still looks healthy and inflation risks are contained. Foreign economies are weakening. We believe that in this environment the Federal Reserve will have a limited desire and ability to hike rates substantially in 2019. The Fed Fund Target Rates are currently in a range between 2.25% and 2.5%. We see room for only one or two more hikes in 2019, if any.

Our models now indicate a much lower equilibrium level for the 10-year US Treasury yields at close to 2%. To stay conservative with our assumptions, we still assume that the 10-year bond yields will rise to 3.5%, but see this as an unlikely scenario.

Income investors should not fear interest rate risk in the current environment. We believe that the Federal Reserve will have limited scope to raise the Fed Fund Target Rates and that the US Treasury Bond yield will be range-bound for some time with an upper limit at 3.5%.

4. INVESTMENT STRATEGY IN 2019

Cash and equivalents are an asset class again

There are four main asset classes that investors can allocate to: cash, bonds, stocks and real estate. For almost a decade cash was no longer an asset class because of the “repressive” Federal Reserve interest rate policies. Currently, short-term US Treasuries offer respectable yields with no downside other than the loss of purchasing power over time. We think that, compared to some other fixed income categories, in 2019 cash and equivalents offer a decent risk/return profile. Accordingly, we have made provisions for the cash balances in your accounts to be invested in either money market funds or short-term US Treasury Bills with yields ranging from 2.1% to 2.6%.

Preferred securities

The 2018 sell-off did not spare preferred stocks. At the end of 2017, 84% of the issues in the ICE BofAML Fixed Rate Preferred Securities Index were trading above par. It was hard to find attractive values under those conditions, since preferreds are typically callable at modest premiums to par. The upside was very limited on many issues and investors risked losses through calls on preferreds that were trading above their call prices. At the end of 2018 the situation was very different, with only 24% of fixed-rate preferreds above par. High-quality preferred stocks, in our opinion, still offer some of the best opportunities in the fixed income world.

Corporate debt and bank loans

Despite some credit spread widening on US corporate bonds towards the end of 2018, our analysis indicates that both investment grade and high yield bonds are quite expensive and offer limited reward for a lot of risk. The same applies to “leveraged loans,” a high credit risk category that has become very popular due to its floating interest rate features. These investments have been gradually offering less and less contractual protection to the creditors. After ten years of very low interest rates, aggressive bond issuance and a dramatic deterioration in average credit ratings, we think investors should be extremely cautious. As a very simple

example just think of General Electric, once a blue chip company and a symbol of US industrial power. Today its bonds are trading at junk levels and are barely rated investment grade.

Unloved energy midstream and MLPs

Energy midstream companies and master limited partnerships (MLPs) are probably one of the most unloved corners of the financial markets. After the oil collapse in 2014-2015, MLPs dropped dramatically and never really recovered. Retail investors, who used to purchase these securities for their large tax-advantaged distributions, have now abandoned the space. In 2018 a less advantageous tax treatment of MLPs and an adverse Federal Energy Regulatory Commission ruling dealt a final blow to the asset class.

As all of the above occurred, the economics of the energy midstream industry have quietly improved:

- (1) First and foremost, we are near the end of a large capital expenditure cycle in the US energy infrastructure. The majority of the US large pipeline projects should be completed in the next two years. This means less capital needed by midstream companies and more cash flows available to investors.
- (2) The industry has undergone significant consolidation and corporate governance simplification. Since 2015 many companies have merged and created joint ventures. Many midstream companies in 2017 and 2018 decided to convert from master limited partnerships to c-corps to take advantage of the lower 20% corporate tax rate. Many of the MLPs that maintained their structure eliminated their Incentive Distribution Rights (IDRs). Investors highly dislike IDRs as they favor the General Partners of MLPs over the unitholders. Consequently, the midstream space is less competitive (more profitable) and more investor-friendly today.
- (3) At a consolidated level, the industry is much healthier than formerly, characterized by higher distributable cash flows, better distribution coverage ratios and lower financial leverage ratios.
- (4) As some MLPs converted into c-corps, they started attracting the attention of institutional investors that previously had to avoid this space for tax reasons. Tax-exempt and tax-deferred investors have very restrictive limitations when it comes to investing in partnerships. We believe that institutional money flows will increasingly play an important role in supporting these companies in the future.

Given the attractive valuations of the energy midstream sector, the favorable long-term outlook for US liquid and non-liquid fuels and the new environment described above, we remain very constructive on the MLP space.

Stocks

After the global sell-off, equity markets are offering attractive opportunities for long-term investors. However, we expect the volatility to continue in the short term. We can't even rule out a shallow bear market in the near future.

Our approach is to focus predominantly on very high-quality companies with defensive business features at reasonable valuations. In particular, we are buying into companies with high levels of profitability (ROE, ROIC), strong products and management, sustainable competitive advantages, low financial leverage (Debt/EBITDA) and low operating leverage (ability to reduce costs in response to a slower economy). As we repositioned our client's equity portfolios throughout Q4-2018, we have also raised some cash that we are planning to put to work in the next few weeks or months.

5. OPERATIONAL UPDATES

Where suitable, in December 2018 we implemented some year-end tax loss harvesting for clients with large stock exposure and considerable realized gains. This may have temporarily altered the structure of their portfolios, but not their exposure to the different markets.

Late in 2018 we also launched our first digital investment platform, **LivX**, designed for smaller and younger clients who are just entering the investment world. We construct the LivX investment portfolios with our customary models but in a less elaborate fashion than for larger accounts. If you have children who are taking their first steps in investing, we encourage you to have them check out the service at www.livianco.com/digital. We think they will really enjoy the technology and experience.

As usual, we remain at your complete disposal should you have any questions.

Sincerely,



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