Q3 **MARKET REVIEW AND ECONOMIC OUTLOOK** 2017

"Never buy expensive stocks. Period." – Wes Gray

The U.S. equity markets continued their march higher in the third quarter of 2017, with the S&P 500 and Russell 1000 large cap indices setting fresh all-time highs. The S&P 500 is now 270% above the low that occurred in 2009, which makes it the third most powerful bull market in history. Despite the fact that value stocks remained out of favor in the third quarter, our Large Cap Equity, Small Cap Equity, and Small Cap Value portfolios all outperformed their respective benchmarks.

The trend of growth stocks outperforming value stocks continued in the third quarter, although the effect was less pronounced than it was during the first 6 months of the year. For the year, the Russell 1000 Growth index has returned 20.72% compared to the Russell 1000 Value index at 7.92%, a difference of 12.8%. Similar trends have been seen in the small cap universe, with the Russell 2000 Growth index returning 16.81% through the first 9 months compared to the Russell 2000 Value index at 5.68%.

When broken down by price/earnings (P/E) ratios similar patterns have been seen this year. Within the Russell 1000 universe, stocks with trailing P/E ratios over 20 (expensive stocks) returned an average of 15.6% during the first 9 months of the year, while stocks with P/E ratios below 10 (cheap stocks) returned an average of only 4.6% over that same time frame. Given the fact that all of Bowling's portfolios have exposure to value metrics such as low P/E ratios, the current environment has not been ideal for our relative performance. As we will discuss later in the letter, however, buying expensive stocks to chase performance is never a good idea.

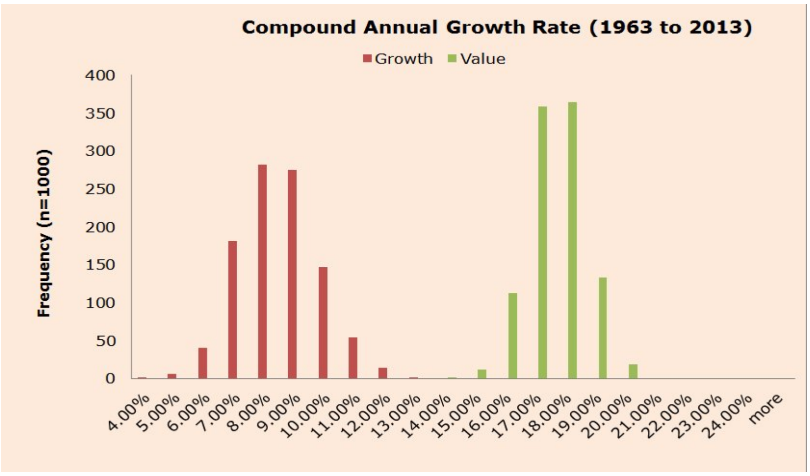
Despite some rather scary headlines as of late, stock market volatility continues to remain near historical lows. The S&P 500 has now gone more than 430 days without a 5% correction, the longest streak in over 20 years. It's possible that this lack of volatility is due to improving U.S. corporate earnings, which we will discuss later in the letter. Or perhaps it's due to the lack of returns from other types of investments (such as bonds). But there is also a possibility that a growing number of investors realize it's a mistake to day-trade and sell into scary headlines. Regardless of the reason, as we have pointed out in past letters the presence or lack of stock market volatility provides no predictive power with regards to future stock market movements. It simply is what it is, so enjoy it while it lasts!

On the economic front, the economy continues to move along at a moderate pace. In late September second quarter real gross domestic product (GDP) growth was revised upward to 3.1%, which was a two-year high. This was the 13th consecutive quarter of growth in the economy. Unemployment is hovering around a 16-year low at 4.45%, while consumer confidence remains near a 16-year high. What's remarkable is that all of this is happening with relatively subdued inflation, as the core number came in at 1.7% for September.

Never Buy Expensive Stocks

In recent newsletters we have discussed at length Bowling's belief in value investing, which is essentially purchasing stocks that are trading at a discount to the overall market with respect to ratios like price/earnings, price/book value, and price/cash flow. Historically, buying things that are cheap (even if they are rather unloved by investors) has led to better performance than buying stocks that are expensive (and tend to have very high expectations already built into the price).

Alpha Architects conducted a study in which they simulated the performance of so called "value" and "growth" stocks over a 50-year period from 1963 to 2013. In this study, they calculated the operating earnings yield for all U.S. large and mid-cap stocks each month and ranked them by quintiles (five buckets from most expensive to least expensive). From there they ran one group of 1000 simulations that randomly picked 30 stocks from the most expensive quintile each month (so called growth stocks). They then ran another 1000 simulations that randomly picked 30 stocks from the cheapest quintile each month (so called value stocks). The results of the 1000 simulations for both growth and value stocks are charted below.



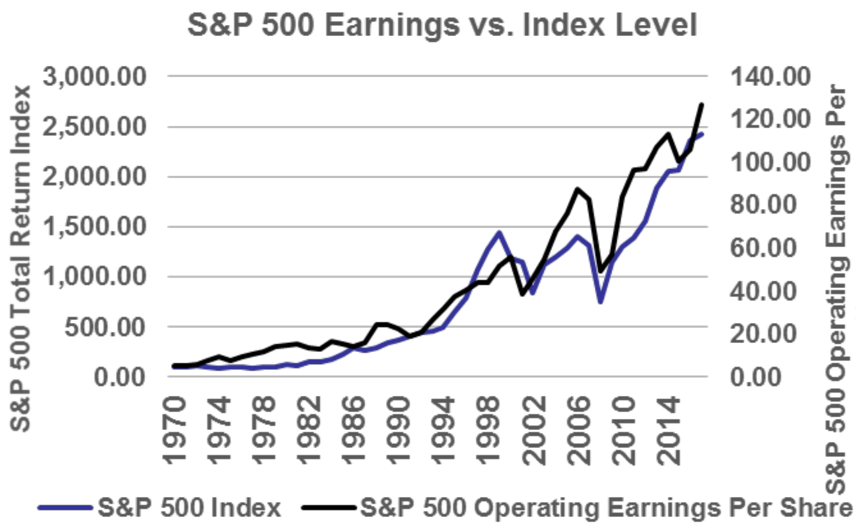
In the chart above, the red bars show the various frequencies of annualized returns generated by the most expensive stocks (growth stocks which are shown as red bars) compared to the returns of the least expensive stocks (value stocks shown by green bars). As you can see, the average returns of the least expensive stocks beat the most expensive stocks handily (as represented by the mid points of the green and red bars). What's surprising however, is that worst simulations among the cheapest quintile of stocks still outperformed the returns generated by the best simulations of the most expensive quintile. In other words, being bad at picking from inexpensive stocks would have led to better returns than being very good at picking among expensive stocks. This is yet another study that reinforces our belief that value investing works over the long haul.

What's more, the study also found that the simulations of growth stock returns had dramatically more volatility compared to value stocks (almost 50% more volatility as measured by standard deviation). The average maximum drawdown (maximum loss) for growth stock simulations over the 40-year period was nearly 90% (anyone who owned the NASDAQ index in the late 1990s can commiserate with this). This was much higher than the average maximum drawdown of 55% for value stocks (which would have occurred in the 2008-2009 Financial Crisis).

It's All About the Earnings

The media would have you believe that the stock market is a random motion machine, the direction of which can be decided by events ranging from politics to societal strife to the nuanced language of the latest Federal Reserve statement. This can be very confusing to investors and results in many inquiries to our office about how we believe all of these things will affect their portfolio in the coming months. This short-term focus by the media is extremely self-serving since it encourages people to tune in so they don't miss the next bit of wisdom about where the market is going.

Bowling believes in being long-term investors in the U.S. economy (via the stock market), and the good news is that the direction of the market becomes very predictable in the long run. The following chart shows the S&P 500 total return index compared to the S&P 500 operating earnings per share since 1970.



When you look at this chart, the mysteries of the stock market quickly unravel and it becomes very apparent what drives stock market returns over the long term. Since 1970, S&P 500 operating earnings have gone from $5.51/share to an estimated $127.04/share in 2017, an increase of approximately 2,200%. During that same period an investor who invested $100 in the S&P 500 stock index would have seen it grow to approximately $2,400, an increase of approximately 2,300%. While the direction of these two metrics can deviate in the short term, over the long term the correlation is clear.

Our belief in the growth of the stock market over the long haul is very simple: a decade from now it's very likely that there will be more and more people in the world who want more and more stuff. U.S. companies, through innovation and technological advances, will figure out a way to meet this demand. In the process, corporate earnings and the stock market will go up. History has shown that this trend tends to be very predictable over the long haul.

The market's recent strength in the midst of some rather scary headlines is most likely due to the recent strength in corporate earnings. Overall S&P 500 earnings for the second quarter (which were reported in the third quarter) rose 12% with revenues rising 5.0%. The number of companies beating revenue estimates was the highest in 13 years, while 73% of companies beat earnings estimates. The second quarter marked the second consecutive quarter of double digit earnings gains, something not seen since 2011.

The rise in company earnings has correlated with another metric that is important to investors: dividends paid. S&P 500 cash dividends per share in the third quarter were up 6.9% compared to a year earlier, and are up over 60% from the pre-Financial Crisis high set during the fourth quarter of 2007.

The Psychology of Finance

Earlier in October it was announced that Rich Thaler of the University of Chicago was awarded the Nobel Prize in Economics. What's interesting about this is that Thaler's contributions to economics and investments are primarily in the area of behavioral economics. We frequently write about how important it is for investors to understand behavioral biases, and thought this would be good opportunity to discuss a few of the theories Mr. Thaler helped establish.

One example of a behavioral bias would be the idea of mental accounting, which was explored in a paper by Mr. Thaler in 1999. With mental accounting, investors tend to open a new "account" in their minds each time a financial asset is bought. Over time these mental "accounts" tend to drive their investment decisions, rather than fundamental changes in the underlying investments. If a stock is purchased and the value falls below the purchase price, investors will have a tendency to hang on until they break even, thus avoiding the pain of realizing a loss. Conversely, if investors experience a gain relative to their purchase price, they are more likely to sell and "book" the gain. In each of these cases investors will let their mental "accounts" override changes that may be occurring in the companies' business outlooks, which in turn impairs investment returns over time.

Another area that Mr. Thaler helped revolutionize is the default options in company 401(k) plans, which have been chronically underfunded by U.S. workers. Historically these savings plans have followed an "opt in" strategy that requires participants to make an active choice to participate in the plan. The default option in such a plan would result in no participation. In 1994, Mr. Thaler suggested that increased retirement savings could be accomplished by changing to an "opt out" strategy in 401(k)s and other retirement plans. Under this type of plan, employees are automatically enrolled in the plan at a pre-set savings rate unless they opt out.

If all investors are rational, it should not make any difference whether a retirement plan is "opt in" or "opt out." In either scenario investors have complete control over whether they participate, and how much they save. However, in 2006 the Pension Protection Act was passed by Congress which, among other things, encouraged automatic participation in 401(k) plans. It's estimated that by 2013 changes to the default option in 401(k) plans had increased annual savings by over $7 billion, while participation rose from 49% to 86%.

We believe that an understanding of behavioral biases and investor psychology is critical to long-term investment success. One of the most important things we can do is to help our clients understand these issues so they remain focused on a disciplined investment plan.

PAST PERFORMANCE IS NOT A GUARANTEE OF FUTURE RESULTS.

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The Large Cap Equity Composite includes all discretionary, tax -exempt accounts investing primarily in large cap value equities, with account market values above $50,000. Effective January 1, 2006, closed end funds are no longer utilized in the strategy. Effective January 1, 2012, taxable accounts are no longer included in the composite. The benchmark for the firm's Large Cap Equity strategy is the Russell 1000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Equity Composite includes all discretionary accounts investing primarily in small cap equities. The benchmark for the firm's Small Cap Equity strategy is the Russell 2000 Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.

The Small Cap Value Composite includes all discretionary accounts investing primarily in small cap value equities. The benchmark for the firm's Small Cap Value strategy is the Russell 2000 Value Index, which is an asset-weighted index of U.S. based companies that includes income but does not have any expenses.