2018 Annual Investment Forum

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The notes below are a summary of the remarks and views expressed by the speakers at the 2018 Annual Investment Forum and do not necessarily reflect the views of Canterbury. A full transcript of the speakers' remarks is available on our website, www.canterburyconsulting.com.

MACROECONOMIC OUTLOOK: JIM PAULSEN, PH.D., THE LEUTHOLD GROUP

Introduction

We still have a couple more years of the recovery ahead of us, making this the longest recovery yet. What sticks out the most from previous years of this recovery? Optimism. This is the first time in the recovery that things are going well for everyone, including policymakers and Main Street. That said, when there is a lot of optimism, it portends challenging times for the market (as the saying goes, when it gets good for Main Street it tends to get bad for Wall Street), and as a result this year will likely be a gut check for interest rates and equity valuations. The key questions to consider this year are: 1.) How fast can we grow? 2.) Do we have capacity to grow, given where we are in the recovery? and 3.) When is the next recession?

How Fast Can We Grow?

— Some have posited the United States can grow at 4-5%. While there may be periods of this rate of growth, it will not happen on a sustained basis.

— The United States is still stuck in the slow-growth stage, presently at about 2%, and it is predominantly caused by a declining work force and low productivity—the lowest it has been since the postwar period. The low productivity is a result of under-investment by both the public and private sectors, and while this can be addressed (through increased capital expenditure), it cannot be changed overnight. The remedy for the declining workforce is simple—immigration.

— The good news about the state of the recovery is that it has spread globally and, in the United States, has broadened out to the middle class, which is evidenced by the 4% rate of unemployment and the rising income of the median wage earner.

— Finally, confidence and sentiment took off starting in 2016 and likely does not have much to do with politics, which means it is fundamentally driven.

Do We Have Capacity to Grow, Given Where We Are in Recovery?

— In short, yes. Balance sheets of both households and corporations are in really good shape, and we have not used much leverage, compared to previous recoveries, to grow. That said, there are some pockets of overzealousness, such as in auto loans/sales.

— Millennials have just stepped in to take the baton from the baby boomers and will soon be the biggest demographic participating in the U.S. economy. As they start to buy homes, grow families, and enter peak spending years en masse, their contribution in the economy will be felt. Lastly, they already have had a big impact on the recovery of the economy and are feeling very confident given the degree of job creation they have just experienced.

- Up until more recently, the mediocre growth of the global economy has not made it appealing for corporations to expand operations. However, with their strong balance sheets and the growing global demand for goods and services, they are now in a position to increase their capital expenditures. A downside to the current environment, however, is the more recent increase in resource and labor costs.

When Is the Next Recession?

- A recession in 2018 is not likely, but beyond that it is less certain.
- Right now, we do not have signs of any excesses in the system (both the consumer and corporate sector are in good shape), and confidence has only just now started to creep in. There is also little to no chance the Fed will allow the yield curve to invert, which would be another key sign of a pending recession.
- The recovery has been very fundamentally driven and thus justifies the current valuations in the stock market. This also means that any increases in interest rates by the Fed will not be met with market corrections. The Fed has consistently indicated that any rate increases will be a result of the economy doing better.
- Inflation could be the catalyst to push us into a recession, but while it is moving up, it is not going to become the runaway scenario that some have predicted. Instead, the likely outcome is inflation of about 3%, which will be a significant change for most of the population since we have not experienced much inflation during the last quarter century.
- Lastly, while bond spreads are low, they are not low enough to be an indicator of an overbought market or of a pending recession. In fact, having some level of higher-yielding securities in a portfolio is not a bad idea at the moment (though owning core bonds right now is a stretch from a risk and return perspective).

General Market Observations

- Stocks are the most compelling asset class, but we should expect a 10% to 15% correction this year.
- U.S. small cap, non-U.S. stocks, and commodity-related assets are more compelling from a valuation and growth perspective.
- Conventional wisdom that rising interest rates leads to a stronger dollar is incorrect. The data instead show the inverse. Why? The Fed historically has raised rates because of inflation and rising inflation is detrimental to a currency. Hence, we should expect the U.S. dollar to decrease in value as the Fed rate begins to increase.
- Wage inflation is almost certainly going to rise, both here in the United States and in the G7 and OECD countries. This will drive up inflation globally.

STATE OF HEALTHCARE: HOWARED FEDEROFF, M.D., PH.D., UCI HEALTH

Affordable Care Act (ACA)

- One of the main goals is to preserve and improve the general population's health by going from a fee-for-service model for provider reimbursement to an outcome/quality model. The goal emphasizes lowering the cost of delivery and driving patient value.
- Another goal is to reduce healthcare waste. The trend has been more expenditures per capita on healthcare in the United States, but results are lowest compared to our global counterparts. There has been an increasing rate of growth above inflation in healthcare costs.
- What contributed to the creation of ACA?
    - Aging Population: the number of individuals over 65 is projected to double in the near-term.
    - Rise of Chronic Diseases: This is the number one cause of death and disability.
    - Systemic Inefficiencies: Additional healthcare spending has not been producing any health benefits. There have been unnecessary services performed, fraud committed, and no clinical health benefits; ultimately, lots of healthcare waste.
    - Incentives for Higher Volumes: The current system rewards providers that see many patients, but it does not reward improving patient care. There is also no collaboration amongst different providers treating a patient's illness. The ACA is creating a model where providers are forced to take financial risk, institutional risk, and shared accountability for providing value. There will be quality metrics.
- The ACA has led to 14.5 million people being added to Medicaid for the first time.
- The efforts to repeal the ACA were based on reducing expenditures. Particularly reducing disproportionate share hospital (DSH) payments. The DSH payments were reimbursements provided for giving charity care. Additional efforts to repeal the ACA, like the Better Care Reconciliation Act, would have led to potential job losses and the loss of penalties when providers do not improve patient care.
- The ACA also created bundle payments for entire procedures (placing more risk on providers to show results), and expanded 340B drug programs (providing lower cost drugs to poorer Americans), which were followed by the 2015 Bipartisan Budget Act's creation of site neutrality (allowing Americans the option of using a hospital versus a free-standing clinic).

Future of Healthcare

- Bring care closer to home. It is likely that technology and data will become more prevalent in creating a closer provider-patient relationship. Individuals younger than 45 want more of a digital interface. Further, there will be more potential experiments with popup clinics.
- Social media data and data from wearables might become a link to analyzing your health. It would allow for tracking an individual in a HIPAA-compliant way. This would potentially reduce expenditures.
- Genomic information is the way of the future, and to understanding the environment you grew up in. Providers will understand what your greatest risk factors are at birth. This will also create a new understanding of what drives disease.
- Healthcare has been teaming up with computer scientists to save dollars and lives. It is expected that once your data is uploaded to the cloud, it will assist in making better choices

(e.g., in restaurants of the future, diabetics will only see menu choices that are good for them).

- Expect to see earlier starts of Alzheimer's disease due to childhood obesity. We are already seeing more diabetics in our system due to obesity issues during early life stages, and there is believed to be a link between diabetes and Alzheimer's.

OPPORTUNITIES IN U.S. EQUITIES PANEL

Panelist include: Paul Bouchey, CFA; CIO, Parametric Portfolio Associates, Michael Hunstad, Ph.D.; SVP and Director of Quantitative Research, Northern Trust Asset Management, Chris Wallis, CFA, CPA; CEO and CIO, Vaughan Nelson Investment Management

Investment Philosophy

Chris Wallis, CFA, CPA

- Invest money by trading time for value. Target a 50% return over three years.
- Intrinsic value is driven by ROIC (Return On Invested Capital).
- Study and understand what's going on in the world of liquidity, because that's what creates bubbles and excesses. Avoid the excesses as they occur and take advantage of the bubbles that burst.

Paul Bouchey, CFA

- Build diversified, low-cost, and transparent (passive) portfolios.
- In order to get returns, you have to bear the costs in terms of risks, taxes, etc.
- Building a portfolio is like building a space suit that has to survive the vacuum of space, meteorites, and other dangers.
- The right question isn't whether you can beat the market. It's whether you can survive the market.

Michael Hunstad, Ph.D.

- Capture systematic risk premia from factors in an efficient manner.
- There are three pieces that explain the return of the equity market: beta, stock picking, and systematic factor exposures (value, size, quality, volatility, momentum, etc.).
- Most people structure their portfolios to remove factor content. However, you can use these factors as building blocks to create portfolios.

Valuations and Risks

Chris Wallis, CFA, CPA

- Markets are moved by liquidity, and excess liquidity drives them higher. Factors, attributes, and fundamentals move individual securities.
- This cycle is different from others because liquidity did not emanate from other areas. It has been extraordinary and unprecedented, and came from printing money.
- It takes liquidity leaving the market to create a bear market.
- Fundamentally the economy's in great shape.

— Valuations are high, but that doesn't tell you the next move. It just tells you how much room there is to run.

Paul Bouchey, CFA

— P/B ratios in the U.S. are at 10-year highs. Emerging and international stocks are not as expensive, but are still highly valued because of central bank liquidity.
— Clients are tilting toward defensive equities: lower volatility, higher profitability, higher dividend yield, and derivatives.
— Today's risks include things that are hard to understand, like negative interest rates and cryptocurrencies.

Michael Hunstad, Ph.D.

— Everyone is worried about overvalued markets, but value stocks today in virtually every geography around the world are as cheap as they have been in two decades.
— We're essentially back to dot-com era valuations for value stocks.

Factor Investing

Michael Hunstad, Ph.D.

— Factor investing is a recognition that there are independent dimensions of return. There is a return premium from accessing smaller, cheaper, and higher-beta stocks.
— Factor investing is about harnessing those independent dimensions of risk and return in equities.
— The outperformance of many active managers can be attributed to their factor exposure. If you can get those returns from factor exposures at a considerably lower price, why not do that?

Paul Bouchey, CFA

— Factors have gotten more popular because of the broader trend towards index-based investing.
— Investors are becoming more interested in low-cost and transparent solutions as opposed to expensive and opaque strategies.
— Factors are like nutrients. You can combine foods in cooking, but you can also then look at the underlying macronutrient profile (the factors) that make up the meal.
— Fewer investors are asking about whether active or passive is better, more people are doing it all.

Chris Wallis, CFA, CPA

— As active managers, we are familiar with each company's investment thesis, but we also look at the underlying factors to ensure proper diversification, avoid unintended factor bets, and enhance portfolio consistency.
— Factors can also change over time, as people observe them and they attract capital. It's important to be able to explain where your returns are coming from.
— Factor strategies are also squeezing out closet indexing active managers. Truly active managers (90%+ active share) who can earn repeatable alpha are actually gaining market share.

STATE OF PHILANTHROPY: PAUL SCHULZ, CALIFORNIA COMMUNITY FOUNDATION

California Community Foundation and Mr. Schulz' Experience as a Board Member

— California Community Foundation ("CCF" or the "Foundation") is a public charity that consists of approximately 1,600 individual funds with the goal to serve the Los Angeles area. Currently the foundation's assets are $1.7 billion, which makes it one of the larger foundations in the United States.
— CCF has raised approximately $500 million in the last two years through 12 fundraisers, and have granted out over $400 million.
— Currently, CCF focuses on the systemic change of those who are most vulnerable in Los Angeles County, with change coming from the following areas: (1) Health, (2) Housing, (3) Education, and (4) Immigration.
— CCF is currently experimenting with donors in providing loans to such areas like permanent housing projects in Los Angeles to get the project going. As soon as these projects get a secured loan for construction, the project pays back the initial cost of the loan.
— The typical culture of a for-profit board has been centered on active engagement of the firm's operations, while non-profit boards have been somewhat passive in their involvement.
— Mr. Schulz believes that non-profit boards can benefit a great deal through the improvement in: (1) financial reporting, with an emphasis in having an audit committee; (2) making sure that performance measurement was tied to the organization's strategy; and (3) meaningful board self-evaluation and ensuring that what you are doing actually makes a difference.
— Mr. Schulz believes that non-profit boards should employ a more analytically rigorous approach and much like for-profit boards, take on a more active role rather than a passive one.

The State of Philanthropy

— Within the United States, philanthropic giving reached $390 billion in 2016, with the largest source continuing to come from charitable giving to religious organizations. As a whole, philanthropy makes up about 6% of U.S. GDP and is projected to keep growing.
— 90% of charitable giving comes from individual donations. Foundations are mostly entirely individual wealth that has been moved into a private foundation and when combined with bequests, about 90 cents on every dollar is coming from individuals.
— In the United States, six of the top ten charitable organizations are donor-advised funds, which are an easy and efficient way to give to charity over time. Many financial intermediaries have already established these types of funds (i.e., Goldman Sachs, Charles Schwab, and Vanguard).
— Giving to a donor-advised fund has the following benefits: (1) you get a full tax deduction immediately, (2) you can invest over time, either with an institution or you can keep your fiduciary interest in your money, (3) easier to give to a variety of charities, and (4) advantageous to those who have some sort of liquidity event.
— However, donor-advised funds have been receiving a lot of attention, especially regarding transparency issues and whether the appropriate funding is being given to donors.
— Philanthropy currently suffers from a "tale of two cities", where the top charitable groups are thriving and growing their revenue base, while others, particularly social services, are struggling to grow revenues.

Challenges within Social Services Charitable Giving

- Of the six primary philanthropic sectors, social services has the lowest five-year growth rate (5%) with respect to gains in contributions, far less than the aggregate inflation rate over this period.
- The biggest challenge facing the social services sector revolves around the funding level, with so many small and medium-sized social services organizations dealing with half the revenue streams they dealt with five years ago.
- Most donors, many of whom are high net worth individuals, choose not to give to social services.
- Many of the donors CCF works with choose to give to universities, hospitals, or religious organizations, which makes it quite challenging for the social services sector.

OPPORTUNITIES IN CREDIT

Panelist include: Jeffrey Aronson, Managing Principal at Centerbridge Partners, John Fekete, Managing Director at Crescent Capital Group, and Tad Rivelle, CIO of Fixed Income at The TCW Group

What influences shaped your approach to investing capital over time?

Tad Rivelle

- Bill Gross emphasized the importance of looking at the big picture and not getting caught up in the details.
- It takes a long time to know a lot in this field. Fixed income is a complex asset class to invest in.

Jeff Aronson

- Learned from mentors that capital preservation is of the utmost importance.
- One cannot be frivolous with someone else's money. A person can invest their own money as they wish, but a different standard is required when managing other's capital.

John Fekete

- Commercial loan training program early in career helped set a solid foundation going forward.
- It's important to take the time to learn the intricacies of fixed income and credit.

The Fed is expected to hike interest rates 3-4 times and continue to gradually unwind its balance sheet over the course of 2018. Where are we in the cycle, and how would you characterize the magnitude of risk to fixed income at this point in time?

Tad Rivelle

- If you cannot raise rates now, when would be a better time to do it?
- The Fed and central banks have effectively falsified liquidity through QE in order to encourage animal spirits and credit creation.
- Important to know where the yield curve is going. Every financial intermediator lives on leverage and net margin. The cycle is over once leverage and net margin shrink so low that it doesn't make business sense to create credit (lend) any longer.

- If the yield curve continues to compress from Fed tightening, it's a good signal that the party has gone really late in the morning, and it's time to go home.

Jeff Aronson

- Centerbridge deeply believes in cycles and the various risks that are associated with them
- The world will not continue like this forever.
- The team constantly calls CEOs and has found that it's hard to hire people. This hasn't translated into wage pressure, however.
- Predicting the timing of a cycle is futile. Centerbridge is leaning more toward the cautious side. Cash as a percentage of assets is 20%-30%.
- One has to consider what people say versus what they actually do.

How do you view the health of the economy through the lens of the businesses to which you lend money? In the midst of what has seemed (until recently) like a sluggish multi-year recovery, is the state of the economy stronger or weaker than many people think?

John Fekete

- The perception is that we are late in the credit cycle. When you separate out that feeling, the data says otherwise.
- Revenue and EBITDA growth are accelerating, and leverage ratios are not at unsustainable levels.
- Defaults, which are the number one headwind in credit, was cut in half in 2017 and will continue to trend lower.

Which industries or sectors have the greatest risks? What opportunities are there in distressed credit?

Jeff Aronson

- Business is good as we examine it in real time.
- It is important to understand the difference between a company's health and the underlying expected return. Are we getting paid enough?
- The current environment is tough for allocators given that they always need to always be invested.
- Could be great opportunities down the road in commercial real estate and automobile lending; however, distressed opportunities are currently limited.
- Retail has always been a cyclical sector. While there have been cracks in the market, now may not be a ripe time to invest in distressed retail.

How will this cycle end?

Tad Rivelle

- One must recognize that there's a degree of mean reversion. When valuations or metrics have gone to historical highs or lows, there is a reason.
- The Fed couldn't put it together four months in advance of the 2008 recession. The economic picture can change quickly.

- A slowdown in China could be a game changer and could signal a delayed-cycle environment ahead of us.

John Fekete

- The team is waiting for something bad to happen and has had that feeling for the past few years.
- Companies with unhealthy balance sheets are not receiving capital from the debt markets, which is encouraging.
- Bank loans losing covenants is a relatively new phenomenon. The team prefers private credit, given the better protections.
- The level of EBITDA add-backs is worrisome (i.e., companies that secure credit for future projects or initiatives before the actual cash flows) and we should expect this to exacerbate the level of stress in the next downturn.

What opportunities do you see in credit?

Jeff Aronson

- Self-storage may be interesting in the future. It is a simple business with high margins and sticky tenants.
- Centerbridge's anticipatory thinking led to the self-storage thesis.
- Centerbridge is buying bits and pieces today and will be more aggressive once excesses lead to a distressed opportunity.