BIECHELE ROYCE ADVISORS

1st Quarter 2018

2018 started off the year with stock markets extending their gains into January. After peaking at 2872 on January 26, the S&P 500 experienced what it had been lacking for well over a year- - volatility! When volatility came roaring back in February, the market fell over 10% from the high and has taken on a much more erratic tone since. Much of the initial decline was recovered later in February, only to give some of it back again towards the end of March. For the first quarter of 2018 the major indices were all lower- snapping a nine-quarter winning streak for stocks. The Dow Jones Industrial Average declined 2.49%, the S&P 500 (-1.22%), EAFE International (-2.44%). The broad bond market experienced declines as well with the Barclays Aggregate Bond Index falling nearly 2% for the quarter.

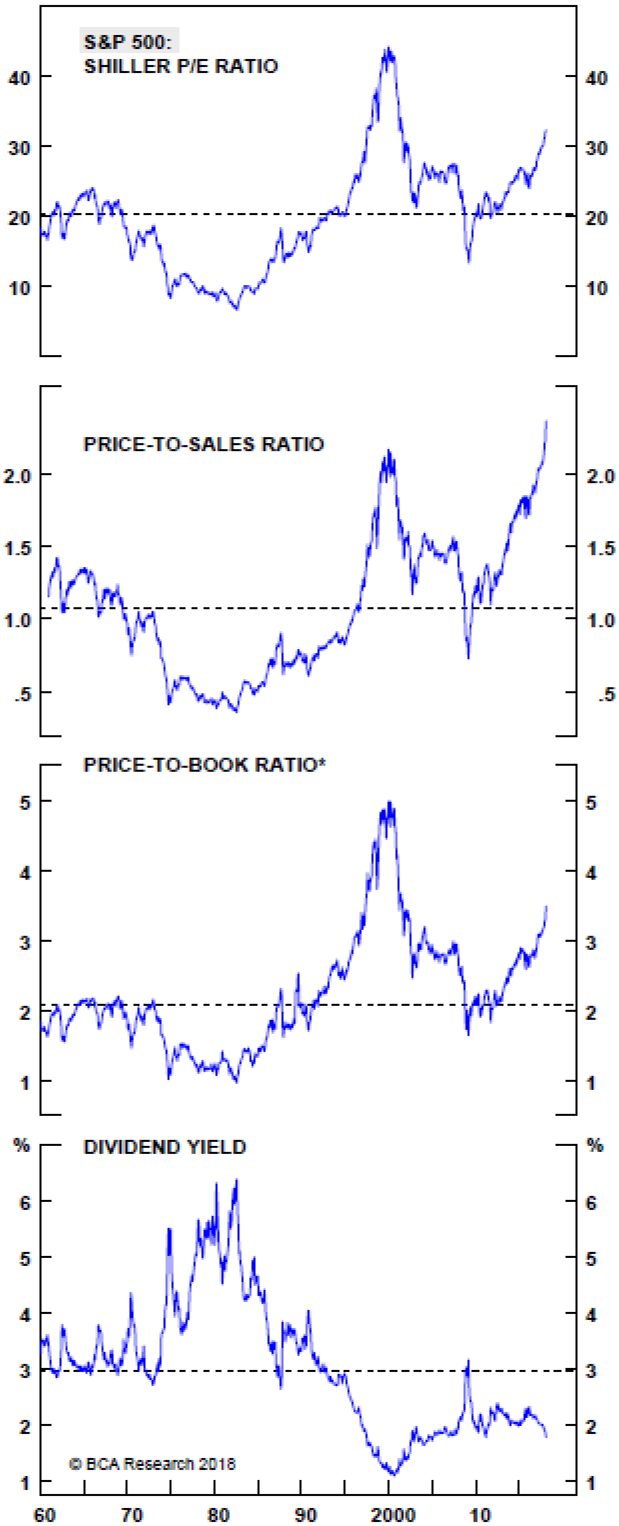
Prior to the rush of volatility that hit the market early in the first quarter, the S&P 500 had gone a record 400 days without so much as a 3% decline from the highs and had risen for 15 straight months. To put that into historical context, stocks have usually experienced at least a 5% decline every year; and declines of 10% or more have occurred in about two out of every three years. Looking back over the last 38 years, the median decline in any year has been 12%. So, while stocks are an excellent source of long term growth for portfolios, it should not be lost on investors that they can be a volatile asset. (We put out a detailed note on February 8, 2018 regarding the resurgence of volatility that week and the importance of risk management and portfolio construction. We're happy to send it to you if you missed it.)

The fact that stocks had gone so long with so little in the way of volatility may have lulled many investors into a false sense of complacency. The combination of complacency and fear of missing out, drove many to pile indiscriminately into such things as passive, index-based products, momentum strategies, and esoteric products that were designed to profit from shorting volatility (under the dangerous premise that volatility was going to stay low indefinitely). Risks were rising as these investments have no valuation filter. We recognize and expect that dislocations will occur in markets when we see things happening like $465 billion of flows into passive ETF's in 2017 (beating the $287 billion in 2016) at a time when stock volatility was sitting at multi-decade lows, and bond yields at 30-year lows. The absence of a valuation filter (sizing up price and value relative to the downside risk) and lack of an appropriate equity investment time horizon (at least 3-5 years) are two factors that go a long way in determining whether stock volatility will result in a temporary or permanent loss of capital. Temporary loss of capital brought on by stock market volatility can be made up over an acceptable investment period if the investment was purchased at an attractive valuation. Permanent loss of capital doesn't have to be that the business goes bankrupt- It can simply be the result of paying too high a price and suffering a large enough decline, and then being forced to sell at a loss because the time frame for recovery is just too long, or impossible. Valuation discipline and the sizing of the equity portion of your portfolio to your liquidity needs/time horizon should help investors ride out the inevitable periods of market volatility.

From a valuation perspective stocks remain richly valued on many measures. The following charts (courtesy of BCA Research) show the current level of valuation relative to the median level since 1960. While economic growth and earnings have been strong, stock prices have reflected this for a while.

CHART 1A

U.S. Stocks Are Expensive…



* EXCLUDING FINANCIALS, UTILITIES, AND TRANSPORTS PRIOR TO 1977.
NOTE: HORIZONTAL DASHED LINES INDICATE MEDIAN (1960 - PRESENT).

In recent years investors have been willing to pay a higher multiple on company earnings, sales, and net assets as reflected in these ratios. Factors such as low interest rates, low and stable inflation, and extraordinary asset purchases by central banks (QE) have influenced this willingness to pay up. It's important to note that the structural tailwinds of low interest rates, low inflation and central bank easing are all in the process of reversing trend. It may be gradual, but the point is that the tailwind is fading.

At the same time, we are likely in the later innings of both the market and economic cycles. The global economy is showing strength and a synchronized global expansion. Recent developments related to fears of a trade war have questioned the sustainability of this growth. If trade restrictions escalate, the result would be higher inflation; which would mean higher interest rates; and eventually a contraction in the PE (Price to Earnings) multiple investors are willing to pay for future stock growth.

While recession risk is not imminent, a policy mistake could help pull it forward. Valuation risk (independent of a recession) is still front and center in our minds. It is likely that PE multiples have peaked for this cycle. This would put more pressure on earnings growth to be the main driver of stock returns. Stocks most at risk in this environment are those whose earnings growth cannot overcome the downward re-rating in the PE multiple.

Some of the same high PE mega-cap names that drove the major indices higher last year are the largest contributors to the market declines so far this year. According to data from Bespoke Investment Group, the average stock in the S&P 500 was down 1.65% in the first quarter, but the 50 largest stocks in the index were down nearly double that at 2.96%. The result is that stocks performed better on an equal-weighted basis versus a capitalization-weighted basis. We expect to see continued dispersion of returns like this as the most overvalued names in the index come back to reality.

The historical composition of stock returns since 1950 has fallen roughly along the lines of 2% from PE multiple expansion, 6% from earnings growth, and 3% from dividend yield. In the most recent years, we've seen stocks overshoot this level because the contribution from PE multiple expansion has been considerably higher at 9%, while earnings growth and dividend yield have contributed about 3% and 2% respectively. This rise in PE multiple, while not a valuable short-term timing indicator, does offer a good view into long run future returns for stocks in that lower starting PE's are associated with higher future returns while the opposite is true for higher starting PE's. Therefore, we adhere to our valuation filter, or valuation discipline as one way to manage risk in portfolios.

Absent a major trade war, we don't see a sharp slowdown in global growth as imminent. We do see higher inflation and a more restrictive Federal Reserve policy as a source of continued volatility. Valuation risks in both the stock and bond markets keep us focused on risk management while constructing our portfolios. Market performance could be set up to begin diverging from the better economic performance given where stock multiples are and the bottoming out of interest rates. Our equity portfolios stay focused on a select collection of quality businesses where the overall valuation proposition is more attractive on a reward to risk basis than the broad market. In fixed income allocations we favor shorter maturity and lower duration investments as well as managers who actively allocate across various fixed income markets where they find adequate compensation for the risks taken. Where appropriate we also incorporate both liquid and private alternative investments into the mix to seek unique return streams, lower volatility and lower correlations to traditional stock and bond portfolios. These portfolio characteristics help up stay in our lane and not be distracted by market noise, while clearly knowing what we own and why we own it based on valuations, protecting capital and gaining varied market exposures.

Thanks as always for your continued trust and confidence.

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