BIECHELE ROYCE ADVISORS

3rd Quarter 2018

A combination of strong corporate earnings and a resurgence in economic growth led stock prices higher and bond prices lower in the 3rd quarter. Stock markets are now just shy of their all-time highs. The S&P 500 Index gained 7.2% during the quarter, while the Dow Jones Industrial Average rose 9%, and the NASDAQ Composite was up 7.1%. The divergence in performance between growth stocks and value stocks continued in the latest period. The largest growth stocks as measured by the Russell 1000 Growth Index rose 8.85% while the Russell 1000 Value Index rose 5.04%. For the year to date period, the outperformance of growth over value in the Russell 1000 index is nearly 14 percentage points.

International stocks lagged the U.S. markets with developed international markets up 1.5% and emerging market stocks down 1% for the quarter. Bond yields rose during the quarter with the 10-year Treasury yield rising from 2.86% to 3.06%. Rising yields caused the aggregate bond index to decline in price for the quarter by 0.75%, putting the year to date decline for the bond index at 3.48%.

The U.S. is now in the 10th year of economic expansion, approaching the longest expansion in history. Much of the expansion has been characterized by low volatility, low interest rates, and high returns for risk assets. The current environment can be framed up with stock prices near all-time highs, and valuations only higher on two occasions historically; and credit spreads on bonds at very tight levels leaving both major asset classes vulnerable to any shift in investor sentiment. The upturn in economic growth as measured by real GDP and business and consumer sentiment, as well as the near-term boost from fiscal stimulus (tax and regulatory), has given the Federal Reserve confidence in raising interest rates. While we don't see any imminent recession risk in the U.S., we are certainly aware of the market risk posed by high valuations and the potential for more volatility surrounding the mid-term elections, trade policy, and the implications for global growth.

Bear markets, recessions, and market shocks that come out of nowhere are always risks within a portfolio owning equities. Recognizing this, a key to our investment philosophy is to invest with a margin of safety so that when these adverse periods occur, investments can be held with conviction that the price paid can still drive a positive return over a reasonable holding period based on the quality and valuation characteristics of the business.

When investing in a company for our portfolios, we take a long-term view on the business and its future earnings power relative to the current valuation. Companies are routinely over penalized with price declines due to short-term biases of investors, driving a company's valuation to a discount. A high- quality business combined with a stock price that has declined to an irrational level can create asymmetric reward to risk ratios that can be well rewarded over time. We never know exactly when the valuation discount will be realized by the market, but our reward to risk estimates place the upside greater than the downside, putting both time and a margin of safety on our side. A stock that moves against us in the short run is no reason for us to abandon our conviction and realize a loss. We've had many holdings end up with large long-term gains after being down 20% or more during our holding period. Some of our largest detractors in the equity portfolios last year are the best performing holdings this year. Not every stock we own will perform in line with the market, or other holdings in the portfolio during a given quarter or year - but what we care most about is that they perform over a reasonable equity holding period.

One investment theme that is represented in our equity portfolios is the strong demand growth for automation and intelligent products- whether they be on the factory floor, automotive design, security products, or any host of interconnected devices. Chips, sensors, cameras, integrated modules all go into making these applications faster, smarter, and more energy efficient. We own companies in these markets because they were first identified as quality businesses with market-leading products, priced at attractive valuations; not because we sought exposure to a theme up front and then found the businesses to fit that theme regardless of the valuation risk. We think this is a valuable and important distinction given that many investors tend to get caught up in a particular theme; sometimes buying into it without ample consideration of the downside potential. You, our valued clients, pay us in part to be "nervous Nellie's" and to always consider both the downside and the upside when investing your (and our) hard earned capital.

While there are always plenty of things to be nervous about, we continue to focus our efforts on ideas where we can be adequately compensated for the risk we are taking. This starts at the portfolio level in determining the optimal weights to various asset classes relative to risk and return objectives. It then carries forward to the individual investments that are used to diversify the risks and seek differentiated streams of return within each building block of the portfolios. Within this process we are cognizant of the growing complacency in the environment with markets and expectations high, valuations rich, and investor and consumer sentiment high. None of these preclude markets continuing higher still, but they do raise our contrarian eyebrows a bit more.

As always, we are here to serve you if you have questions or comments.

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