Investment Commentary: 8/2017

As investors waded through politics and global events on both sides of the Atlantic, global equities continued their upward trajectory in July. The S&P 500 reached record highs—over 2,400—and returned a little more than 2% for the month. Small-cap stocks had a modest gain of 0.74% and continue to lag larger cap stocks by a wide margin year to date. Foreign stocks are outpacing the U.S. market this year, led by emerging markets up over 6% for the month, and developed market stocks were up 2.9%. In the fixed-income markets, credit outperformed government bonds. In July, the Barclays Aggregate Bond Index was up 0.43% and high-yield bonds were up 0.87%.

> "With investor sentiment perking up and volatility at all-time lows, we would not be surprised to see the markets pause or see a correction."

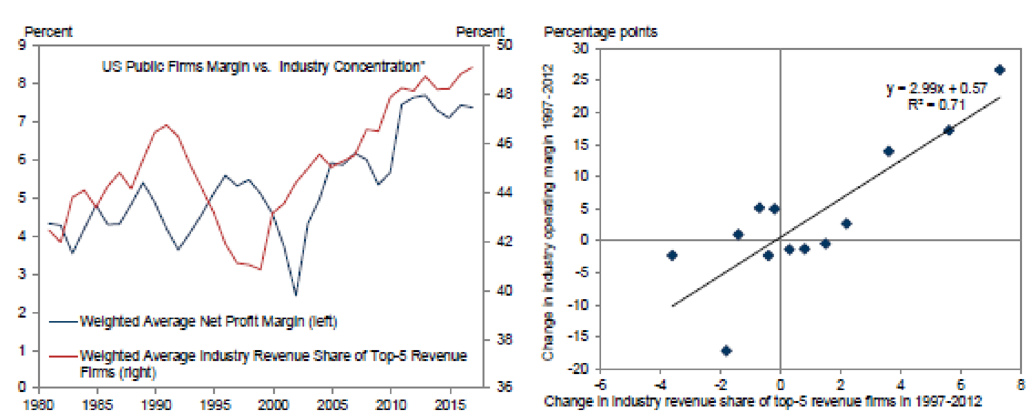
Despite positive global growth momentum, the market seems to have abandoned the "reflation" thesis and inflation trends in most major developed economies remain weak. This may offer support to bond prices in the near-term. Through early August, most global equity markets are up double digits for the year and investor sentiment seemed to reach new highs at the end of July. ***With investor sentiment perking up and volatility at all-time lows, we would not be surprised to see the markets pause or see a correction -*** especially as we enter the notoriously volatile months of August and September. Below are a few research topics we thought were worth highlighting in this month's commentary.

Superstar Firms and Profits

U.S. corporate profit margins have risen over the last two decades to historic highs, especially for the most profitable firms. Several recent academic studies suggest that increased industry concentration has led to higher profit margins, higher stock returns and a lower share of earnings going to labor. In fact, the chart below shows how the most concentrated industries have shown the highest increase in margins, with the trend has been most prevalent during the 1997 to 2012 period.

According to Goldman's research there are three main reasons for the rise of industry concentration, margins and profits. The first is new technologies have allowed a small number of "superstar" firms to ***widen their productivity advantage, tap into network effects, and gain disproportionately large market shares*** (i.e. Google, Facebook, etc.). The second reason is globalization and superstar firm's ability to reap most of the ***benefits of global access to new customers, supply chains, and talent***. The third reason is superstar firms have ***monopolistic properties and enforcement of antitrust rules have only been selectively enforced and have tended to favor the incumbents***. Historically, profit margins always tended to mean revert back towards their long-term averages (much lower than today's levels). However if

Exhibit 3: Margins and Industry Concentration Are Positively Correlated



*We exclude energy sector firms from the weighted average calculations.

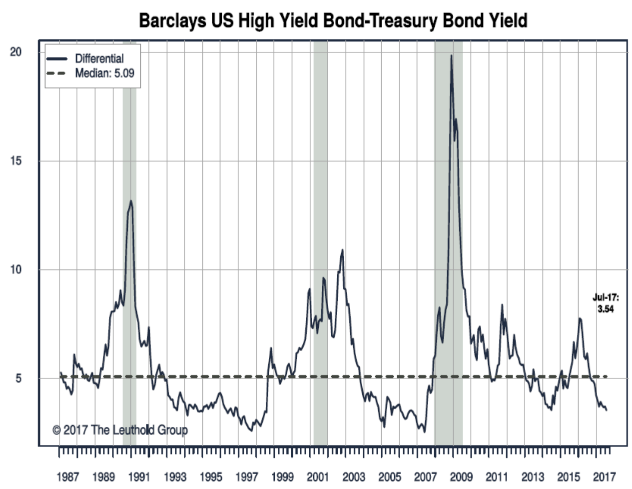
the above three trends stay in place we could expect higher industry concentration levels and corporate profit margins to persist for longer. At some point, we may even see more pushback from antitrust regulators which could hinder the growth and profitability of these firms, a risk that we will watch for.

Do Stocks Outperform Treasury Bills?

A recent study by Hendrik Bessembinder, a finance professor at Arizona State University, asked this very question. The answer, of course, is yes, stocks in aggregate, outperform Treasury bills. Not exactly earth-shattering news, however, looking deeper into the study there were some very interesting findings. For example, the ***study found that 58 percent or the majority of individual stocks since 1926 have actually failed to outperform one-month Treasury bills over their lifetime***. This is surprising, given the low bar that Treasury bill returns represent, currently yielding lower than 1%. It's only when you look at the stock market as a whole that stock returns beat bonds and Treasury bills by a wide margin. In fact, his study found that ***a scant 4% of the stocks in the entire market—led by companies like Exxon, Apple and GE—accounted for all of the net market returns from 1926 through 2015***. Clearly the findings in Bessembinder's study support the rise of Superstar Firms and Profits discussed above. The key takeaway from the study is that if investors want to participate in the potential returns of the stock market they need to either be very good stock pickers or invested in the whole market to make sure they participate in the results of the best performing firms (the 4%). Our approach to investing combines a core component of low-cost and broadly diversified funds to ensure we participate in the long-term of upside of the entire market, and a very-disciplined stock selection process that improves the odds we will invest in the best performing companies and avoid the majority that underperform.

Don't Blindly Chase Yield

When it comes to bonds it's important to know what you own and why you own it. Simply chasing after the highest yielding bond can be a very dangerous strategy. The chart below from Leuthold shows the yield spread between high-yield bonds and Treasury bonds. The grey bars on the chart are recessions and illustrate how the yield spread can rise dramatically when recessions occur, in other words, they could lose a lot of money. When the yield of a bond goes up its price goes down. ***Clearly the yield spread is relatively and absolutely low today, meaning that investors are not receiving much of a premium for owning riskier high-yield bonds***. Regardless of this skinny premium, investors have piled into high-yield bonds the last few years, without regard for value or risk. When the next recession arrives yields will likely widen (again) and investors will suffer big losses. It's ok to own some high-yield bonds, but don't be fooled by the high yields and think they will provide safety. In recessionary times, these bonds tend to act more like stocks than high quality bonds.



--AWM Investment Team (8/17)