2017 Annual Investment Forum

Summary Notes | January 5, 2017 | Newport Beach Marriott

The notes below are a summary of the remarks and views expressed by the speakers at the 2017 Annual Investment Forum and do not necessarily reflect the views of Canterbury. A full transcript of the speaker's remarks is available on our website www.canterburyconsulting.com.

ASSETS ALLOCATION: MIHIR WORAH, PIMCO

Mihir Worah, CIO Asset Allocation and Real Return, presented PIMCO's latest global asset allocation views and thoughts. His presentation focused on how to invest in a period of low returns and high volatility.

Backdrop & Current Environment

- Lower discount rates fueled asset returns which have supported higher valuations. This boost will soon fade across all major asset classes.
- The stock market has shrugged off the recent rise in interest rates. This may not be the case going forward.
- Bouts of volatility will likely persist, however market indicators are not pointing to an imminent recession. On the other hand, tail risks have grown and there is a higher chance for the U.S. economy to overheat.
- U.S. business cycles usually last for seven or eight years and the current cycle is approaching that timeframe. However, expansions do not die of old age, but die of certain causes.
- The current equity risk premium is close to historical averages (4.2%: cyclically-adjusted earnings yield – 10yr TIPS yield). As a result, the stock market is fairly valued from a historical perspective.
- Since the U.S. election, the market is pricing S&P earnings growth at a 10% faster rate than before.
- Corporate bonds are slightly overvalued when compared to the stock market, however current spreads do not indicate rich valuations on an absolute basis.
- In any given year, there is a 15% probability of a U.S. recession.

Boosting Returns

- Broaden betas by adding differentiated and alternative sources.
- Diversify alphas by diversifying between 'structural alpha' and 'skill-based alpha'
    a. Structural Alpha: Value, Carry, Momentum, Volatility factors
    b. Skill-based Alpha: Tactical Asset Allocation, Hedge Funds
- Take advantage of liquidity and complexity premia (i.e. distressed debt & private equity). Utilizing skilled managers in these fields can lead to excess returns over what the average investor charges.
- Responsibly use leverage to boost or hedge exposures.

Investment Views

- Modestly overweight overall risk positioning.
- Stocks have a higher chance of outperforming bonds on the upside (right tail). Stocks and bonds equally underperform on the downside (left tail).
- European equities are where U.S. stocks were 6-9 months ago. Cheaper currencies will lead to higher exports.
- Emerging market equities have been a value trap since the Taper Tantrum as lower commodity prices and higher volatility have hampered returns. Dollar strengthening and EM currency depreciation could persist as a result of Trump's secular trend.

— For global rates, stay underweight interest rate duration. Government bonds still have an important role in the portfolio as a defensive diversifier.
— Inflation, priced at 2% over the next 10 years, is undervalued. TIPS make sense in both the short-term and long-term
    a. Short time horizon: should outperform Treasurys over the next 6-12 months as inflation expectations come into view.
    b. Long time horizon: High inflation is more likely to persist over low inflation. TIPS should be used as a defensive position instead of Treasurys. PIMCO is very sure that inflation will be present, but unsure what the level of growth will be.
— Expect U.S. home prices to continue to rise alongside mortgage rates.
— REITS have underperformed since the election as interest rates have increased. Improving real estate fundamentals and prices should eventually boost REIT returns.
— From a currency perspective, overweight the dollar and underweight EM.

Q&A

Q: How will the Fed react going forward?
A: The Fed is targeting an inflation overshoot of 2.5%, but they remained worried about expansionary fiscal policy. The biggest risk for the Fed is if inflation moves past 3%. One of the 'Fed dots' moved higher in 2017 indicating that the Fed may tighten at a faster clip.

Q: What will be are the market implications from Trump's potential policies?
A: There are both positives and negatives from Trump's potential policies. Lower taxes and deregulation are positive, however trade wars and tariffs are negative. Time will tell of which side wins out.

GLOBAL EQUITIES: HARRY SEGALAS, HS MANAGEMENT PARTNERS

Harry Segalas, Managing Partner & Chief Investment Officer of HS Management Partners, presented an overview of his investment methodology, stock-specific examples, and the outlook for growth stocks given the macro backdrop heading in 2017.

Investment Methodology

— Focus on good businesses, avoid commodities and macro-themed investments.
— Own businesses that can play in developed and emerging markets and have earnings and cash flow growth.
— Pay close attention to valuation, not momentum investors.
— Multi-dimensional approach to growth (stable, variable, rapid).
— Believe in active portfolio management—determine the best use of capital every day.

Bottom-up, Fundamentals First Approach

— Information has been commoditized with Reg FD and information gathering is not value-additive
— Focus on value-added activities: idea generation/conceptualization, research/immersion, valuation discipline/portfolio decision.
— Example: Marvel Entertainment. Idea was generated when a report came out saying that the company had already licensed its good products (Fantastic Four, Spider Man) and would have to go towards a more difficult manufacturing model. HS conducted research on the superhero movie genre and determined that there was significant upside potential.

Multi-Dimensional Approach to Growth

- **Stable growth example: McDonald's**. The market is focused on all-day breakfast and difficult comps, but HS believes that the value here is in the transformation of the company from the top down, starting with its CEO Steve Easterbrook. He has been changing the business model to focus more on U.S. and Europe and franchise more restaurants in Asia in order to increase stability and lower the cost structure.
- **Variable growth example: Marriott**. The company's shares weakened after a bidding war for Starwood Hotels, but HS used this as a buying opportunity because they believe the transaction will result in many synergies. The combined entity will have more power with online travel agencies and better operational strength.
- **Rapid growth example: Lululemon Athletica**. HS is comfortable with management (co-chairman was former CFO of Starbucks). They have grown in infrastructure to accommodate rapid front-end growth, and have a strong online/men's business.

Macro Matters

- Stimulative fiscal policy—tax reform, lower regulation, and increased spending—have the potential to boost growth and raise inflation. But there may be unintended consequences (trade wars) that could hurt
- We are approaching 8-year mark of bull market with only one down quarter in the last 16. There has been very low volatility and markets haven't displayed a lot of fear. Flows have increasingly moved towards passive. Would not count on this trend going forward
- Top-line and demand growth is important because it's difficult to get anything more from price as margins are high

Q&A

Q: What will companies do with overseas cash that gets repatriated?
A: Most of these are technology companies (Apple, Google, Facebook) that do not need capital to grow, so we will most likely see more share repurchases. May see some acquisitions.

Q: What is the impact of disrupting technologies on the portfolio?
A: Two main themes are media (favoring intellectual property/content) and advertising (Facebook and Google capturing greater share of overall advertising dollars). Don't just go after disruption unless it's a good business model.

Q: Where do you see top-line growth coming from?
A: E-commerce, mobile, international, and company-specific. Not so much from mature industries like food and beverage.

GLOBAL FIXED INCOME: SONAL DESAI, Ph.D., FRANKLIN TEMPLETON INVESTMENTS

Sonal Desai, PH.D, Portfolio Manager & Director of Research, presented her latest global macroeconomic views. Dr. Desai delved into global inflationary pressures, interest rate differentials, and current region-specific economic policies and reforms.

2016 Review

- This time last year, oil prices were in the sub-$30's and high volatility was forecasted for the rest of the year.

— Brexit was expected to create a massive selloff. In reality, the UK is a midsize domestic-based economy that has little impact on global growth.
— Market sentiment was heavily influenced by headline inflation which was ultimately the catalyst for deflationary concerns. This should not have been the case.
— The current Fed has been the most ‘dovish’ Fed in U.S. history.

U.S.

— Base effects from oil will drop out and headline inflation will converge with core inflation. Higher oil prices and looser U.S. fiscal policy will be a tailwind for inflation.
— The U.S. is at full employment and wage pressures are starting to appear. This should lead to more inflation.
— The Fed will have a tough time being ‘dovish’ if headline inflation rises above 3%.
— Productivity growth is low, however actual U.S. GDP growth is still higher than potential GDP growth.
— The Fed is already ‘behind the curve’. Moreover, an entire generation of investors have yet to experience inflation. Therefore, inflation does not need to rise to the 4-5% levels to have a significant impact on markets.

Japan

— Imbedded deflation warrants extended QE and loose monetary policy.
— Depreciation of the yen needed to happen eventually. Up until the end of 2016, the BOJ was effectively ‘outeased’ by the Fed due to their accommodative stance.
— Most Japanese companies benefit from exporting. As a result, there is a negative correlation between the yen and the Nikki stock market.
— Nominal GDP growth during the post-financial crisis has helped ease Japan’s debt burden
— The BOJ does not want to resort to ‘helicopter money’ (directly giving cash to stimulate growth). However, hyperinflation would be a ‘champagne’ problem for the central bank to have.

Eurozone

— Very few countries in the Eurozone are domestic demand-driven economies. Export growth is imperative for overall growth
— Through QE, the ECB is effectively buying member countries time to implement structural reform before inflation appears

Emerging Markets

— China will be okay in the short run. Issues may arise in the long run as credit expands and structural policies change
— Mexico
  a. Peso will continue to depreciate as long as the markets use the currency to hedge against potential trade wars or NAFTA reform
  b. Even though removing free trade will negatively affect market sentiment, trade with Mexico would not stop
  c. Fiscal policy and structural reforms are moving in the right direction

Q&A

Q: How will changing demographics affect the U.S.?
A: U.S. GDP growth will decline in the long run unless meaningful immigration occurs. Lack of household formation may affect future growth. The current millennial generation is more willing to rent for a longer period of time.

Q: What is the true level of unemployment?

A. The U6 unemployment rate (U3 plus part-time workers) has historically been double the U3 unemployment rate (the official rate). U6 has typically been a less accurate representation of unemployment however, the rate has followed the same trend as U3.

ECONOMIC AND MARKET OUTLOOK: LIZ ANN SONDERS, CHARLES SCHWAB & CO., INC.

Liz Ann Sonders, Chief Investment Strategist, and Debashis Chowdhury, President, discussed the impact the U.S. presidential election had on the markets, central bank policy and the impact on growth and interest rates, inflation, and jobs growth.

U.S. Election, The Whitehouse, and Policy

— President-elect Trump's cabinet is the most pro-business as measured by number of years of business experience since before the Obama administration. The Obama administration had a collective [six] years of experience whereas Trump's will have over 80 years. Combine this with a republican controlled congress and there is the potential for very pro-business regulatory changes.

— The prospect of pro-business regulatory changes on the horizon can already be seen in the strong stock market performance since Trump won the election in early November. That said, it's not a stretch to conclude investors may be overly optimistic on the Trump growth effect.

— Additionally, regulatory and tax reform should add straight to the bottom line of U.S. corporations with tax reform making them even more competitive relative to their global peers.

— Trump has proposed a large fiscal stimulus package for the U.S. economy, which while it will provide a jobs and growth in the short term will not solve longer-term growth needs. The fiscal stimulus package will also add to the already high public debt levels.

Central Bank Policy, Growth, and Interest Rates

— Since 2007 there has been net zero flows into US markets. This bodes well for stock market performance in 2017. That said, the growth of assets invested in ETFs and increasing use of ETFs has made it more challenging to calculate fund flows into the market.

— S&P 500 earnings are now forecasted to be $130 - $148, which most analysts did not expect and therefore did not factor in the "Trump effect".

— Politicians and commentators have a tendency to conflate deficit and debt and while there is a relationship between the two they are certainly not the same. It is worth noting the deficit has come down from 10% to 3% and as long as we have one the public debt will continue grow.

— On debt, total U.S. debt, which include all private and public components, is now at 350% of GDP and if one factors in future entitlements it is closer to 950% of GDP. At some point we will need to make changes and will need to make efforts to bring down total debt. In contrast, U.S. households have deleveraged significantly since the Global Financial Crisis ("GFC") and are in good financial shape.

— It is safe to assume the Fed will issue three rate hikes in 2017, which should be viewed as a good sign given the Fed's dual mandate of approximately two percent inflation and lower unemployment. Looking back historically, when the Fed has moved quicker than the market has expected the market did not perform well.

— Unemployment is down drastically since the end of the GFC as measured by both U3 and U6, with U6 at 9.2% and almost at its pre-GFC low of 7.9%. Additionally, while globalization has put pressure on all parts of the job market a lot of the jobs that have been eliminated have come from technological innovation. This can be seen when looking at the number of job openings that remain in the skilled part of the job market. The Job Openings and Labor Turnover Survey (JOLTS) data, which captures unfilled jobs, provides a more accurate picture of the labor market.

— Wage growth has actually been higher than typically noted. The wage growth calculation has been low because a lot of low paying jobs have come back online and as a result has diluted the impact of the wage growth experienced by those already employed. Looking at the skilled end of the market there has been significant wage growth and as noted above this has been exacerbated by unfilled skilled job openings.

Q&A

Q: Should investors be concerned given the amount of corporate debt that has been issued since the GFC?

A. No. For the most part corporations have taken on more debt because terms have been in their favor and rates have been so low. So, their decision to do so has been based on a cost of capital perspective and not because they need the capital. Corporations have also used the cash to buy back stock