Opportunistic Total Return Strategy (OTRS) Mid-Year Update

The OTRS has returned 2.78% on a gross[1] basis through the first six months of the year. That is slightly ahead of its benchmark which is up 1.01% so far this year.[2] Whereas last year there were almost no negative returning stocks and many holdings had returns in the high double digits if not triple digits, there has been quite a few stock with significant negative returns through the first part of 2018 and that have limited the strategy return.

From a geographic standpoint, the strategy allocation to emerging markets has hurt returns this year. Currency weakness has been a problem. India, for example, which has an overweight in the EM allocation had close to a flat local stock market return through the first half of 2018 but was down over 7% in USD terms.[3] While trade to United States is important to economic growth in many emerging markets, and certainly China, the emerging markets discount to the S&P 500 on many basic valuation metrics warrants a continued allocation. The strategy also was hurt by allocations to developed international stocks. The euro has weakened in 2018 after its big move up in 2017. Economic data has been stronger in the United States than Europe.

Stock selection more than geographic allocation has been a larger impediment to strong returns. There are a number of stocks who have contributed double digit negative returns so far this year. Impinj (PI), a small cap leader in high frequency RFID plunged over 50% in early 2018 only to recover all of those gains and then some, but the strategy sold out of the position after it recovered half of its year to date losses. Deutsche Bank (DB) has had very poor returns this year as management missteps continue to plague this company. It seemed Deutsche Bank was on the verge of leaving its troubled past behind it and with QE winding down in the Eurozone, DB has as much leverage as any bank to rising interests rates in Europe. Unfortunately, rising rates in Europe is a 2019 event if that and Deutsche Bank continues to struggle with profitability, particularly in its Corporate and Investment Bank division. With a market cap a little over 3% of deposits (large US banks trade closer to 25% of deposits) and a valuation in my mind that can be justified by the private and commercial division alone, the OTRS will continue to hold Deutsche Bank. Stricter rules in Germany make cutting costs a little more challenging than in the US but it won't be too long before Deutsche Bank rationalizes its cost base and interest rates do rise some in the EU.

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[1] Net of max 50 bps return is 2.52%. See disclosure for more information.

[2] Benchmark is 45% Russell 3000, 20% FTSE All World ex US net tax, 20% Bloomberg High Yield, 15% CBOE S&P 500 Buy-Write. See disclosures for more information.

[3] bloomberg

Cooper Tire and Rubber (CTB) is another example of a stock that has had very poor returns this year. Cooper Tire is a Tier 2 tire supplier and continually operates at lower margins than Michelin, Bridgestone, Continental's tire division and Goodyear. The company has an extremely clean balance sheet with more cash than debt. Although I had my reservations about the ability of Cooper to execute, the discount to peers, lower US tax rate and positive outlook for the tire replacement cycle led to a position in the company. Commodity costs are rising, end market demand is sluggish and supply is rising from US expansion plans and imports. That is creating a challenging market. Cooper has been investing a lot in capex for the last few years in hopes of bringing more efficiency to its plants so it can close the large operating income gap it has to its peers. Cooper doesn't need to reach the mid teens operating margins of its peers, an 8% level would cause the stock to rally from where it is currently trading. Cooper trades at an EV/previous EBITDA level in the mid 3's, a very depressed level. All of its peers trade at EV/EBITDA levels in the 5's and Cooper arguably has more ability to raise its EBITDA margin than some of its peers. Although I don't have a whole lot of confidence in Cooper's ability to execute, a sub 4 EV/EBITDA level for a company with very little debt in a market that should see a decent pickup from a coming replacement cycle makes this stock a hold. However, if the stock rallies and market conditions don't improve it may be time to cut losses in this one.

The OTRS has exposure to a couple copper miners and the recent angst over global trade wars has led to poor stock performance in 2018. The materials sector likely will be volatile in 2018 and may present opportunities in certain areas as the year progresses.

In addition to some large negative return stocks, some of the big winners in 2017 are having a sluggish start to 2018. Profit taking and weakening market conditions have created modest losses with a number of holdings, particularly financials. The good news is the return of the strategy is still close to 3% which implies there have been plenty of positive developments as well. Verso Corp (VRS), Sabra Healthcare (SBRA), Nokia Oyj (NOK), Macy's Inc. (M) and CVR Refining LP (CVRR) have all provided solid returns for the strategy.

The OTRS is agnostic between growth and value and is looking for the best risk vs. reward investments. In the first part of 2018, that has led to many high dividend/distribution companies. The OTRS owns a handful of very high distribution companies including a few REITs and MLP's. More importantly than that, many holdings are currently paying dividends in excess of 3 or 4%. While these companies don't have very strong growth prospects they still have solid growth prospects ahead and the discounted cash flow models are stronger for these companies than the very high growth stocks. The outperformance of high growth stocks that has continued into early 2018 is in my opinion starting to get absurd. The presumed growth these companies are expected to experience for years and years to come without any regard to the "laws of large numbers" or marginal difficulty winning new business beyond a core offering baffles me.

Amazon, in the 1st six months of 2018, has added almost 300 billion in market capitalization, more than the entire market capitalization of Walmart, which has been built up over decades of growth. Amazon's growth in new areas, such as advertising, is presumed to be a slam dunk without any regard to where those advertising dollars are going to come from. I recently saw an analyst note stating Amazon could generate advertising dollars of 35 billion in 2023. The entire global advertising market is a little over 400 billion ex China with about 200 billion being in the US, Amazon's primary market by far. Advertising has historically grown at GDP growth rates and likely will continue to do that so perhaps by 2023 there is a 500-600 billion market ex China. Amazon will have 6-7% of the global market, and an even higher percentage in the US? What about the ad dollars needed to support the growth of Alphabet, Facebook, Twitter, Snap, etc., etc.? The math just doesn't add up unless Television ad dollars get decimated. It could happen but TV will put up a much better fight than newspapers and magazines did.

Growth stocks have done a nice job growing revenue or earnings, if that is even the focus, and have been rewarded by investors. What I find interesting is the stock prices tend to be moving up as much as the EPS growth is without any multiple compression. For instance, if a stock is trading at 40x earnings and it is able to grow earnings at 20% a year for the past few years, in many cases we have seen the stock move up close to 20% a year. That could make sense as eps growth and dividends are the two long term drivers of stock returns. Yet, what would often occur is if that stock is able to grow earnings at 20% due to strong revenue growth, the stock appreciation may only be something like 10 or 15% as the earnings multiple slowly compresses in anticipation of slower growth days ahead. That cycle of stock appreciating a little less than eps growth would continue over a number of years while the company is in a high growth phase and then by the time the company's growth started to slow down closer to GDP rates, the Price to Earnings multiple would be closer to perhaps 20 than its previous 40.

It does not appear in the current environment investors believe there every will be a growth slowdown for many of the high growth stocks. The law of large numbers will most certainly make that not the case. The software stocks in particular are one area that I believe have valuations disconnected from reality. Software will grow more than GDP but we are not so early in a software expansionary cycle that price to sales ratios should be 10x consistently for many companies. I have seen prominent managers justify these multiples by adjusting revenue to account for the annuity like revenue stream of cloud software and also cutting marketing expenses as these are presumed to drop significantly as the high growth cycle matures. By making those adjustments, the software stocks have earnings multiples that are not so extreme. However, yes switching costs are high with software and businesses just don't like to do it but switching costs will be easier for cloud software programs than the traditional license and maintenance model. There are many capable software programs out there to accomplish a businesses' needs and the lower costs to deliver via a cloud program apply to all. In a recessionary environment, which we haven't seen since the big rise of cloud software, it may become apparent that this revenue is not a perpetual annuity and requires competing for to keep. As for adjustments to marketing expenses, there certainly will be good operating leverage in these business models but it seems to me when one of the software companies cuts expenses because growth is slowing, the stocks tend to sell off hard. There haven't been that many of those situations because even the large dominant players like Salesforce continue to invest aggressively in selling and marketing. When the risks to a slowing US economy are mounting, is it really the time to be investing aggressively in selling expenses? Are we really that early in a software upgrade cycle? Most large businesses seem to have already garnered many benefits from software upgrades or modifications. It seems like 6th or 7th inning for them vs. 1st or 2nd. Small businesses probably are closer to that early innings software cycle but these companies don't have as sophisticated needs as larger ones.

Additionally, stock compensation is through the roof in the software industry. There have been a number of software companies I have thought really had unique compelling offerings and have been tempted to buy the stocks. In hindsight, I should have. Earnings reports back out stock compensation because it is not cash but it certainly leads to higher share counts and is a very real cost. Unfortunately, some of the most talented software companies are also the most egregious issuers of stock compensation.

Often times, recessionary conditions create an environment that slows down growth stocks and there is a big correction in many of the stocks. There is a big risk that type of correction will repeat in the next couple years. The June labor report was a very welcome report that breathed some life into the notion that the labor force participation rate can move higher, prolonging the current phase of solid job growth with muted wage growth. There may be some expansionary time bought by that type of development but it won't buy much time. The Fed is raising rates, slimming down its balance sheet and worker productivity is nowhere to be found. Judging by the recent JOLTS quits rate, which hit a 17 year high, is productivity going to have a sharp move higher when employees are able to switch jobs and improve wages? The Atlanta Fed Wage Tracker tracks wage growth of "job switchers" and "job stayers" and a pretty decent gap has opened up in the past year where job switchers are earnings over 1% higher in wage growth than stayers. The switching trend has legs and that is not good for business costs if so.

We are already seeing prices move higher for many producer prices. The producer price index for final demand most recently was up 3.4% YOY and the core is close to 3%.[4] Tariffs will only increase input costs and add more pressure on sellers to raise prices. Goods inflation, due to the competitive global economy, has been far less than services inflation in our country for a long time. Services inflation will continue to pick up due to a tight labor market and if goods inflation picks up as well, the Fed will be forced to continue its tightening path. Meanwhile, the fiscal stimulus that is propping up GDP growth in 2018 will wane. Also, a pickup in inflation that is not accompanied by meaningful wage growth will diminish real incomes. How can consumer spending, the dominant driver of our economy, pick up if real wage growth is stagnant as it currently is? It can't and the likely high 2Q GDP is being propped up by transitory stimulus.

The one dynamic that bears watching is if investments in automation and machines can cause productivity to improve. The tax plan creates incentives to invest in machinery and software. There are wonderful opportunities for this over the long term but I am doubtful those type of investments can start to bear fruit at a national GDP type level in the next couple years.

Our current fiscal situation in this country combined with political discord will start creating problems that the markets won't be able to ignore. It is one thing to run almost 1 trillion dollar deficits when we are trying to regroup from a nasty recession, it is another when economic times are good. The Fed needs to raise rates now while the fiscal stimulus is currently distorting the economy because if we do have another recession, the Fed dropping rates will be the only game in town. The US is tapped out for more fiscal stimulus. An additional risk is if small businesses start to lose confidence. The biggest drop in the NFIB Small business Optimism Index in the past 6 years came after Barack Obama was reelected. The biggest jump seen was after President Trump and the Republican Party took control of congress. It is clear small business owners like Republicans and that optimism is leading to positive economic developments, tax cuts aside. The 2018 mid-term elections brings risk of that optimism waning.

The Opportunistic Total Return Fund added a few new positions in the second quarter. Avnet (AVT) was bought as a low cost way to invest in continued semiconductor growth with a tangible margin improvement story to boot. Cummins (CMI) was recently added as pessimism drove the stock

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[4] Bloomberg

down to compelling levels. The truck upgrade cycle should continue well into 2019 and Cummins will be able to maintain share. In addition, Cummins has very little debt and plenty of runway to acquire assets if the markets continue to drive transportation valuations lower. Mylan (MYL) was entered. Mylan continues to face competitive generic challenges that likely will not subside anytime soon. However, the roster of biosimilar releases this year and into next can't be ignored. They have lots of shots on goal to grab meaningful share from blockbuster drugs that sell in the billions. There is starting to be evidence Mylan is making solid inroads on Copaxone's market share and the recent price cut should continue that trend.

US Steel (X) was entered. Even at peak pricing, anything other than sharp steel price declines makes US Steel an attractive company. The balance sheet and pension liabilities are in much better shape than they were in previous years. In addition, their revitalization efforts, irrespective of pricing, should help to improve margins over the next few years. Another addition was Leucadia, now Jefferies (JEF). The recent business sales are bringing cash in that management is returning to shareholders through buybacks. Jefferies management, which has for years been very proud of its ability to invest in undervalued companies, is starting to realize that maybe it isn't so great and returning cash to shareholders when the sum of parts valuation is far higher than the market cap may be a smart move to make. Hopefully, that type of thinking will continue.

Western Forest Products (WFT CN) was added as a means to invest in improving forestry markets. Western is a little different than the commodity lumber producers as most of its business is cedar lumber but with no debt, an over 3% dividend and a margin improvement story, it has value. Aquantia (AQ) was added. It is an investment in high speed networking moving from the data center and edge to access points. Additionally, it is an early mover in autonomous vehicles. The networking port requirements to sync all the data capturing devices will create a large target market for networking companies with the right technology for vehicle networking.

The bond allocation, while still below benchmark has been raised, as the market is starting to present some more opportunities. In addition, a cautious view on equities is starting to make 6% yielding bonds for 3 or 4 years appealing. I have high confidence these businesses will be able to repay even if a recession hits.

Looking forward, I am being patient as caution is warranted. I refuse to invest in momentum as an investment style. I read about many of the high fliers and am challenging myself to see what I am missing in the story. Yet, for a Discounted Cash Flow Investor the same conclusion seems to be reached. There are better opportunities elsewhere despite short term stock price moves.

Chris Harrington

OTRS Portfolio Manager

DISCLOSURES

Past Performance does not guarantee future results.

Any investment contains risk, including the risk of total loss.

The new account minimum size is $250,000.

1 Gross Performance does not reflect the payment of Investment Advisory Fees, but does reflect the deduction of trading expenses.

Returns reported above represent a time weighted average composite of the separate accounts in the strategy, net of trading fees. New accounts are included in the strategy after 60% of available funds have been invested, or one month after start date whichever is sooner. Returns are geometrically linked over monthly periods or shorter periods if a new account or large cash inflow or outflow occurs within a month. Large cash inflow or outflow was earlier defined as over $50,000 but has been raised to over $100,000.

All returns are reflected in US dollars, and because no adjustment is made for any foreign withholding taxes on foreign dividends, the FTSE All World ex US Net Tax is used as the applicable benchmark.

A standard deviation dispersion measurement is not presented at this time because the strategy does not yet have three years of return history. After which however, standard deviation dispersion calculations will be included.

Return calculations rely on data from TradePMR/Wells Clearing, the custodian, and Easy ROR Pro 15, a Hamilton Software product used for calculating the returns of a composite of separately managed accounts. Such outside sources are believed to be reliable, but no representation is being made regarding their accuracy.

2 Custom Benchmark consists of a 45% weighting to the Russell 3000, a 20% weighting to the FTSE All World ex US Net Tax, a 20% weighting to the Bloomberg US Corporate High Yield Unhedged Index, and a 15% weighting to the Chicago Board Options Exchange S&P 500 Buy-Write Index.

Index Definitions

Russell 3000: This index is composed of 3000 large US companies as determined by market capitalization.

The FTSE All World ex US Net Tax tracks approximately 2,220 large and mid-capitalization stocks in countries around the world, including both developed and emerging markets, but excluding the United States. Index returns are adjusted for withholding taxes. With 1866 constituents, the index covers 85% of the global equity opportunity outside the US.

Bloomberg Barclays US Corporate High Yield Total Return Index Unhedged: This index measures the USD-denominated, high yield, fixed rate corporate market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/ BB+ or below.

Chicago Board Options Exchange S&P 500 Buy-Write Index: This index is designed the track the performance of a hypothetical buy-write strategy on the S&P 500 Index.

3 Net of Fee Performance reflects the deduction of the maximum charged annual investment management fee of 0.50%. The net compounded effect of the deduction of fees over time will be affected by the amount of fee, the time period and investment performance. Investors that are also clients of Waterfront Wealth Advisors pay a lower investment management fee of 0.30%. Not deducted from the performance net of fees are WaterFront Wealth Advisor Fees (which may range from 0.50% to 1.50% depending upon account size) which will lead to reductions in return. Investors in the strategy that are not clients of Waterfront Wealth Advisors will not pay any wealth advisor fees but will pay a management fee.

Additional information on compliance methodology is available on request. A complete list of all prior purchases in the strategy for the last year is also available upon request.

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Actual client trading may vary from strategy. Consequently, actual client account performance may differ. Strategy returns are unaudited.