2ND QUARTER 2018 UPDATE

July 16, 2018

> *The reason that capital markets are, have always been, and will always be inefficient is not because of a shortage of timely information, the lack of analytical tools, or inadequate capital. The Internet will not make the market efficient, even though it makes far more information available, faster than ever before, right at everyone's fingertips. Markets are inefficient because of human nature—innate, deep-rooted, permanent. People don't consciously choose to invest with emotion—they simply can't help it.*
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> *Seth Klarman, The Baupost Group*

These words were written in 2004, at a time when clamshell-style phones were being swapped for BlackBerrys or nifty Nokia handsets, and the internet was typically accessed on desktop computers. Klarman couldn't possibly have envisioned a world years later where we can tap into almost every fact, idea, work of art or piece of music on a smart phone. For those of us in the investment business who are inherently curious this is a marvelous time to be alive, but it has its downside in the form of information overload. The companies we invest in are guilty of it too, packing their annual reports and 10-Ks so densely with numbers and verbiage that only the most dedicated are able to plow through them. Fortunately, success in our business is not solely dependent on the skill set needed to absorb and process all of this, but relies more on an ability to tune out the noise and pay attention to the basics of our discipline.

One of the challenges we at Peak have faced in the past few years has been that we now work in a market environment where overpaying for most assets is endemic. This is true with both stocks and bonds. It is common in our research on companies to find a business that has been growing its earnings at a mid-single digit rate selling for a price-to-earnings ratio of twenty or more, versus the 1:1 relationship we like to see but haven't since 2008-09. This is unsurprising after almost ten years of steadily increasing prices, and it reflects not so much a feeling of optimism or euphoria as it does a strong desire on the part of money managers not to be left behind. Value investors such as ourselves have generally dealt with this in a range of ways: at one extreme, hanging on to the positions purchased years ago that have now escalated into the fully-valued or overvalued range, and accumulating a hoard of cash to take advantage of the inevitable downturn. At the other end of the spectrum are money managers who have sold their high-priced stocks and traded down towards what they have historically been most comfortable with, i.e., the companies sometimes referred to as "cigar butts," cheap but with a few good puffs left in them. These are the people in our business who have recently become, or soon may be, unemployed.

Underlying the high valuations of some of Peak's Model Portfolio* stocks is good news: in December, Trump's tax overhaul created an incentive for tech giants such as Apple and Microsoft, which have large overseas profit stashes, to repatriate the cash and return much of it to shareholders via stock buybacks and dividends, or pay down debt and invest more in their own businesses. Another of our holdings, S&P Global, estimates that its corporate tax rate will decline from 28.9% in 2017 to around 21-22.5% in 2018, generating approximately $200 million of additional cash flow. The company says it will increase its quarterly dividend by 22% and has boosted the outlook for its earnings by over $1.00 per share, a 15% improvement.

But the Trump administration has also created an atmosphere of confusion and uncertainty by instituting protective tariffs that American executives now must try to analyze and deal with. As an example, it is obvious to anyone who has driven a late model sedan or SUV that the technology underlying the operation of these vehicles, while impressive, has become increasingly complex and interconnected. Lear Corporation, one of the U.S. based businesses I have been researching as a potential buy, supplies car seats and power management systems to Lincoln, Cadillac, Alfa Romeo, Audi, BMW, Ferrari and Porsche, among others. To keep its products competitively priced, Lear must expand its manufacturing and assembly lines into emerging countries. It says, "Individual circuits are assembled together on a jig or table, inserted into connectors and wrapped or taped to form wire harness assemblies. The assembly process is labor intensive, and as a result, production is generally performed in low-cost labor sites in Mexico, Honduras, Brazil, Eastern Europe, Africa, China, the Philippines and Thailand." The company states that it is now being required to produce its systems with higher U.S. domestic content to avoid paying Trump's tariffs, and further, that Mexico, Canada, China and the EU are now taking retaliatory action on U.S. imports and investments. With typical corporate understatement, Lear's annual report says, "Any such potential actions could adversely affect our financial performance." Given the uncertainty facing a well-run and strongly profitable company that would ordinarily be a good fit in our Model Portfolio, I am holding off putting a buy recommendation on Lear. When a cloud of potential bad news hangs over a good investment prospect, normally its share price declines enough to tempt bargain hunters like ourselves. In Lear's case its stock remains close to all-time highs, so we will keep our cash ready on the sidelines.

As far as what kind of long term and possibly negative repercussions such protective tariffs might have, I recommend reading the excellent recent biography of Herbert Hoover by Kenneth Whyte: Hoover, An Extraordinary Life in Extraordinary Times. It describes in detail the 60% decline in global trade from 1929, when the Smoot-Hawley tariffs became law, to 1934, and the 89% dive in the Dow Jones Industrial Average from 1929 through 1932. The minutes of the most recent meeting in June of our Federal Reserve express its worry about the adverse effects of today's tariffs on the U.S. investment climate, saying that their contacts in some of their districts have already scaled back or postponed plans for capital spending due to uncertainty over trade policy. We share the Fed's concern.

Returning to the subject of smart phones, we now have a mobile app where you may view your Peak Asset Management portfolios and report data from your smart phone. Download the app from the App Store on your phone or mobile device by searching for "Peak Asset Management." If you already have a Peak Portal, the login information will be the same. If you do not yet have a portal and would like to access your information on your phone or online, we would be happy to get you set up. Please give us a call at (303) 926-0100.

Best regards,

Noel F. Bennett

**The Model Portfolio is not a real cash portfolio. It represents the core direction of our portfolio management strategies. Individual client portfolios are managed in accordance with the clients' specific investment objectives and constraints. Historical results are available upon request.*