ACCRETIVE WEALTH PARTNERS

Accretive Wealth Partners Fourth Quarter 2018 Client Letter

Dear Clients and Prospective Clients,

This is our introductory client letter, expect a communication from us quarterly. In these letters we expect to detail things going on in the market and share some thoughts on the current environment. We also expect to share our perspective on investing and how it impacts decisions we make on behalf of our clients. Some letters will be longer than others, as some quarters there will be more to discuss than others.

We thought it would be helpful, in addition to the usual commentary, to detail how we think good investing is done and share some perspective on how decisions get made, before getting to the year in review and our current outlook.

How we think about investing

For many of you, detailing how we think about investing may be more of a review, for many of you, this is your introduction to Accretive's Chief Investment Officer. We hope this will be useful to all.

First and foremost, we believe investing is a process. That process should be guided by what research has shown to work over time. This begs the question: what has been shown to work?

The short answer is all kinds of things. It's pretty easy to torture data to support whatever conclusion someone has already drawn and financial companies sponsor lots of academic research with the goal of getting supporting documentation for something they are trying to sell. What we need to do is distinguish good research from bad and if we think the research is good, then determine what it means for our portfolios.

What works over the long term in general?

Generally speaking, the market itself tends to work over time. That said, there are lots of ups and downs. We are super skeptical of anyone's ability to make market calls with any reliability. We tend to think about it in terms of amount of risk out there. There are times when it is elevated and that is usually due to excesses in optimism. Excesses in optimism lead investors to abandon skepticism, bid up asset prices, and take too much risk. Lots of optimism is the enemy of prospective returns. Excesses in pessimism produce the opposite effect (extreme skepticism, low prices, and risk avoidance), and tend be good for prospective returns. Over time, it has paid to be moderately optimistic and adjust expectations for prospective returns based on the environment.

Generally speaking, research has shown that buying less expensive stocks works out better over longer periods than buying expensive glamour stocks.[1] We think this is true enough, but the devil is in the details of the execution. What is cheap? What is expensive? Is something changing about the definition of those things and how one would execute on that insight? It's an interesting question that might influence how one chooses to allocate capital. Simply buying quantitatively cheap may be a riskier strategy and less effective than it once was.

There are other things that have been shown to work, some more investable than others. Buying smaller companies has tended to produce higher returns over the long term, but it also comes with more volatility and the benefits tend to come in spurts. Buying quality has been shown to work, but what the definition of quality is varies widely. Buying momentum has tended to work, but it is essentially a trading strategy and it is hard to invest confidently in a trading

[1] Fama, Eugene F. and French, Kenneth R., A Five-Factor Asset Pricing Model (September 2014). Fama-Miller Working Paper. Available at SSRN: https://ssrn.com/abstract=2287202 or http://dx.doi.org/10.2139/ssrn.2287202

strategy. Many people also have difficulty with the reasons why momentum is effective. Since many of the strategies are based strictly on movements in stock price, essentially buy what's gone up the most, maybe this is simply a back-door growth strategy.

We feel confident that these things all work well to some degree over time, but we are also confident that they don't work all the time. *We think the reason they work well over time is because they don't work all the time.* When we construct our portfolios, we ask ourselves: what is something we think works well but isn't working well right now?

Sources of Advantage

In investing there are very few ways to get an advantage or as we like to think of it an "edge." We think there are three main sources of edge: informational, analytical, and behavioral. An informational edge is knowing something others don't about an investment and very rarely is informational edge legal. An analytical edge is being able to analyze a situation better than the countless others analyzing it and drawing better conclusions, believing you consistently have better insight than all the smart analysts combined is the height of arrogance. A behavioral edge is the ability to act differently and better than other investors. This is probably the most important edge and the simplest, but also most difficult to act on, and mostly likely the only edge individual investors have over institutions.

What does it really mean to have a behavioral edge? You can avoid the traps institutions fall into. A recent survey of investment managers by State Street indicated 52% believed their investors would only allow them to underperform for 18 months before firing them and hiring another manager.[2] One can infer from this that "long term investing" for the average institutional investor is 18 months, but it may be much shorter than that. Actively managed stock portfolios commonly have a turnover ratio pushing 100%, meaning a portfolio of stocks on January 1 may be completely different by December 31.

In markets, an advantage can be gained by having a time horizon that is different than the average investor. We tend to select securities with the expectation that our holding period on an investment is more than 5 years. Sometimes things change and so does our holding period, but our individual equity portfolios have turnover ratios in the mid to high teens, implying a 6-year holding period on average, so we've tended to deliver on this expectation. We think this mindset gives us an important advantage over more short-term oriented market participants and aligns our portfolios with our clients' time horizon.

Being longer term focused also allows us the freedom to do something unpopular in the short term, holding our nose to buy something out of favor when everyone "knows" all the reasons to avoid it. This is not human nature. Human nature says to run from what everyone else is running from and run to whatever the herd is running to. Herd mentality may have aided our ancestors in the wild, but we think that kind of mentality hurts investors in markets today.

Important Investing Lessons Learned Over the Years

I am often asked for my best piece of investment wisdom. My belief is that the wisest thing one can do is invest in a sound investment strategy that one can stick with, through good times and bad. It sounds simple but it is hard. Keeping your excitement in check when the market is strong and everyone is chasing hot returns is hard, keeping your negativity in check when the market is difficult, and everyone thinks the end is nigh is probably harder. Knowing yourself well enough to have an idea of how you'd respond in either scenario is the key to success.

Sometimes folks want to talk about individual securities. I'm a stock dork and usually happy to share thoughts, I have lots of them, but when we talk about securities and markets, I always tell people the same thing. The best guidance I

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[2] https://www.cfainstitute.org/-/media/documents/survey/motivation-as-the-hidden-variable-of-performance.ashx

can give on investing in securities or various markets is also good marriage advice: learn to admit that you're wrong, and quickly, it'll cost less over the long run.

What I've learned over time is that one needs to separate the investment process from the outcome. In the short term a bad process with a good outcome is dumb luck, a good process with a bad outcome is simply bad luck. Over a long enough period of time the process wins out and a good process should result in justifiable success, the person with a bad process will likely get just desserts.

2018: The Year in Review

2018 was a forgettable year for investors. Markets got off to a strong start in January but since then it has been tough sledding. The S&P 500 was down 4.4%, the Russell 2000 was down 11.0%, and the MSCI EAFE was down 13.4%. Bonds were better with the Bloomberg Aggregate Bond Index squeezing out a barely positive return. Cash was king in 2018.[3]

Throughout the year markets gyrated. What drove them day to day varied, somedays it was Fed news or rumors, other days it was the latest in the trade war, still other days it was volatility begetting more volatility. All the while the economic data and corporate profits were generally pretty good.

The Fed hiked rates 4 times in 2018, the last time being in mid-December, bringing the Fed's target rate to 2.5%. Expectations for future rate hikes have been reduced with the Fed telling the market to expect two in 2019, the market seems to only be willing to tolerate one and would ideally like none. The Fed has maintained its "data dependent" stance, even in the face of political pressure from the White House. We think the market has more pull with the Fed and expect a wait and see approach.

Throughout 2018 the yield curve flattened, and as we write this has inverted in certain spots. This seems to imply the market expects future short-term rates to move lower at some point, possibly in response to weakness in the economy. Generally speaking, this is a view we would agree with. Corroborating this some is the market for riskier borrowers: high yield and bank loans. Based on market rates, more indebted issuers will pay more, so financial conditions seem to be tightening. For what it is worth, the Fed knows all these things and follows these types of conditions.

Does this mark the beginning of the end to our expansion? Maybe, but maybe not, it's too hard to know. If we look around, it is hard to see glaring excesses that usually spell the end of an expansion and the beginning of a significant downturn. There are pockets of excess to be sure, but it seems localized. Our hunch is that this represents more of a reset than something more significant, but we're cognizant that no one really knows for sure.

Our Model Portfolios

We run globally diversified portfolios, which do have a US bias, and individual equity portfolios. For larger diversified accounts we use our individual equity portfolios for our core US equity exposure.

Given the challenging year, it's worth reviewing how our model portfolios behaved. We try to position portfolios for a variety of market environments, contemplating both good and bad markets. We have some positions that were difficult early in the year that proved valuable late in the year. The high-level review is that our diversified portfolios met our expectations: conservative portfolios behaved conservatively, and our more aggressive portfolios behaved more aggressively. In our individual equity portfolios, the Equity Income and Capital Appreciation portfolios both exceeded our expectations.

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[3] Source: Morningstar

Outlook for 2019

In my previous role, I cautioned clients that 2018 could prove more difficult than 2017. We are less sure that 2019 will be more difficult than 2018, but if it is simply a repeat of 2018 that is as much difficultly as we'd like.

Right now, all eyes are on the Fed, who recently told the market to expect two hikes in 2019. We think it's possible the market tells the Fed, via price levels, that only one or no hikes are necessary. Our stance is that we are at or slightly above where short-term rates would be if the Fed chose not to control them, so progressing is contractionary policy and could be a policy error. So, we proceed with caution but also the idea that the Fed doesn't want to cause a recession, so we'll look for things to do in the volatility. We're interested to see what we find.

Closing Remarks

I wrote this letter to introduce, or refresh for you, our thoughts and investment philosophy. I hope I accomplished that, but if you have questions or would like to discuss anything in the letter, I would welcome the conversation.

I'd like to close with a couple comments on our team and why I am so excited about this new venture. To me, it all comes down to the partners: Steve and Eric. They are both truly talented financial professionals that care about their clients and put client interests first.

I've worked directly with Steve for years, witnessing his professional growth and his passion for serving his clients. All his development is due to his internal drive and his desire to be the best advisor he can be.

I've known Eric for more than ten years, I've witnessed his professional growth as an advisor. Many of his clients might not know this, but he is also a good investor in his own right. In my prior role, I carried the responsibility for making the firm's investment decisions. I'm happy to have a qualified, smart, investment professional on the team alongside me providing valuable input and insights.

The most important thing I can say about Steve and Eric is that both have a passion for this business, have a client-centric mentality, and attempt to end every day a little better or a little smarter than the day before. This is, at its core, a people business and I'd put our people up against anyone. I'm proud to partner with them both and over the coming years build something special.

Thank you for your interest in our company, we look forward to serving you.

Gary

Gary C. Ribe, CFA, CFP®
Managing Partner, Chief Investment Officer