



Dear Clients and Friends of Accretive,

The second quarter is over, and the market continued its upward trajectory. Since many clients joined us after January 1, 2019, this was the first full quarter as clients of Accretive Wealth Partners. For those clients that have been with us a full quarter, we will be posting quarterly performance reports to your client portal. We encourage you to review your report, so you can see how your accounts performed relative to their respective benchmarks.

You may recall from past letters that we intend to use these communications as an opportunity to help educate you on something that we would want to know if we were in your shoes. We felt it appropriate, with the first performance reports being posted, that we dedicate some space in our letter to benchmarks. We will then review the past quarter and finish with some thoughts on the investing environment.

Accretive On: Benchmarks

At its simplest, a benchmark is a tool an investor can use to evaluate investment performance. Just like any other tool, it can be useful, or it can be misused. For a benchmark to be useful, it needs to be comparable to the investment strategy being evaluated. One needs to compare apples to apples, not apples to broccoli. The S&P 500, for example, would be an inappropriate benchmark for a government bond portfolio, but a good one for a diversified portfolio of large cap US stocks.

We have benchmarks on our portfolios because they provide a guidepost for our clients. As it relates to our equity portfolios, we use a value benchmark for our value-oriented strategies and a growth benchmark for our growth-oriented strategies. For our globally diversified, asset allocation portfolios we use a global equity benchmark and a bond market benchmark that is blended appropriately to the investment objective of the portfolio. With that all said, we don't manage specifically to a benchmark, so account performance varies around the benchmarks we have chosen. We tilt portfolios based on a variety of prospective inputs, including prospective risk. Unmanaged benchmarks are typically market weighted and risk agnostic.

Most investors psychologically feel the pain of a loss more heavily than the joy of an equivalent gain. This is something that influences our mindset as we construct and manage portfolios. As part of that mindset we have positions that we hope help mitigate risk in rough markets, but sometimes this makes it difficult to keep up with a very robust market. We saw the value of that mindset in May, when equity markets were down more than 6%, and in the fourth quarter of 2018 when the S&P 500 fell 13.52%. We also saw some cost associated with that mindset in some recent months and quarters where the market marched straight upward. For every given strategy, whether it is conservative or aggressive, we are trying to provide clients with an experience they can stick with by focusing on risk-adjusted returns over the cycle. This is what helps portfolios grow and allows wealth to compound over time.

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Some investment advisors choose inappropriate benchmarks for their portfolios or avoid having a yardstick altogether. In our view, not having a benchmark is only appropriate if a strategy cannot be properly benchmarked, but in practice this applies to very few investment strategies. In our opinion, not having any benchmark is simply a strategy on the advisor's part to avoid accountability for outcomes. Worse yet, in our view, is an inappropriate benchmark as it may mislead investors. As an example, I once had to talk an advisor out of using the Consumer Price Index as a benchmark for a diversified asset allocation strategy.

For clients, a benchmark should be helpful in making sense of the outcome, but one also needs to be cognizant of its uses and limitations. At Accretive, we use benchmarks to evaluate whether our portfolios are performing as we would expect, given what happened in the market. They also help us evaluate our decisions and the effectiveness of our strategies.

This Second Quarter

The second quarter of 2019 was not as strong as the first quarter, but it was still a good one for investors, as stock and bond markets rallied globally.

The S&P 500 was the leader, up 4.30%, but small cap stocks also participated with the Russell 2000 up 2.10%. Looking outside the US, the MSCI EAFE rose 3.68%, while MSCI Emerging Markets Index eked out a 0.60% return. The unexpected rally in the bond market continued, as the Bloomberg Barclays US Aggregate Bond Index was up 3.08% and the High Yield Index increased 2.50%.

While markets overall posted gains, the quarter was not without drama. There was a May sell-off in stocks, followed by a June recovery. There was no shortage of noise with financial media outlets amplifying the sound. We suggest our clients that consume financial media do so with the volume turned off.

The key issues going forward are likely more Fed and economy related. We think the level of interest rates and growth in the economy drive corporate earnings and market valuation more than anything else. The recent data has been soft, which is not the same thing as bad; though commentators certainly spin it that way. It is worth noting that the market has tended to rally on soft data. "Bad" news has become good news because it gives the Fed legitimate cover to cut short term interest rates. Offsetting that some is a White House that seems to be challenging the Fed's independence by publicly agitating for rate cuts. Whether the desire to look apolitical influences the Fed's ultimate decision remains to be seen.

The Outlook

Halfway into 2019 it is worth stopping to evaluate where we were and where we might be going.

In the first half of 2019 global markets rallied, both stock and bond markets. In the equity market, earnings estimates actually came down, which means that the rally we experienced was really more of a re-rating upward in valuation. Investors were willing to put a higher price on a given amount of

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earnings, which is called multiple expansion. In our view, the multiple expansion was a response to expectations of lower interest rates.

To help set expectations for the second half of the year and beyond, it is helpful to examine where equity returns come from. Returns from stocks are derived from Dividends, changes in Earnings Per Share (EPS), and changes in Valuation. To think about this as an equation:

Prospective Returns = Expected Dividends + ▲ EPS + ▲ Valuation

When we look at a company for our individual equity portfolios, we are evaluating (among other things), the sources of return. We ask a lot of questions. Does the company pay a dividend? Is that dividend growing? What are the company's earnings? Are they growing on a per share basis? How are they growing? Is it organic revenue growth, inorganic growth, cost cutting, or share repurchases? What do we think those earnings can grow to over several years? What is the risk to those earnings? How is this company valued? Is it an attractive price? How does the valuation compare to the broader market, other companies in the sector, and a company's own trading history? In what scenarios could the valuation improve or worsen over time? Is this a company selling for 14 times earnings that could sell for 20 times earnings?

Usually the dividend policy is well known and ascertainable. Projecting future earnings is more difficult, and mistakes will be made in forecasting, even if you use a range of plausible assumptions. The most difficult and unpredictable part however is the change in valuation as it has so many different drivers and a large component is based on sentiment. As an analyst, I prefer to focus on the first two inputs to the equation and let the third one take care of itself, as long as the starting valuation is not crazy.

This analysis can just as easily be applied to the S&P 500. We know the dividend is a little under 2%, earnings are expected to be a little stagnant in the near term, and that the valuation multiple just re-rated upward. Perhaps there is some room on the valuation multiple to go higher, given how low rates are and the expectation they fall further, but we think we'll need to see a return to growth more broadly in order to really move the market higher.

On the fixed income side, the equation is simpler. Entry yield tends to drive returns. Currently the 10-year US Treasury hovers around 2%. Outside of treasuries there is some incremental yield for taking corporate risk and high yield bonds have spread in excess of investment grade; however, compensation for taking incremental credit risk is relatively thin today. Some investors say, "Cash is king", and while short-term rates are currently higher, if the Fed starts cutting interest rates investors hoarding cash may have a reinvestment problem.

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Consequently, we have fuller valuations and returns may be more difficult to come by for a time. To stick with our math theme, if we think about happiness as an equation it tends to equal reality minus expectations. Part of our job as an investment advisor is to set and manage those expectations.

Our Portfolios

In this quarter our portfolios performed in line with our expectations or better, depending on the strategy. As I mentioned in our discussion on benchmarks, our portfolios tend to be positioned to handle a more difficult market than outperform a robust one.

In our equity portfolios, we had participated well in the upside and less in the downside, which is a good outcome for the quarter. While we had some cash drag, we continue to look for ways to put some of the cash allocation to work. In our asset allocation portfolios, the results were in line with expectations.

Closing Remarks

The first half of the year has come to a close and it was strong. At Accretive things are going well, we are growing and building the business. We expect to hit a few key milestones in the third quarter, and we couldn't have gotten to this point without strong support from many of you. Steve, Eric, and I are extremely appreciative of all your support.

If you have any questions, please feel free to call or email us. We'd welcome the opportunity to speak with you. For those readers that are clients of ours, we thank you for the trust and confidence you have placed in our company. We don't take it lightly, nor for granted; we strive to earn it every day. For those readers who may be thinking of becoming clients, we appreciate your interest and look forward to serving you one day.

Thank you,

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Chief Investment Officer, Managing Member