ALAMAR
CAPITAL MANAGEMENT

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SUMMARY

With sustained good earnings fundamentals, the market continued to digest a multitude of fears and marched higher in the 3rd quarter. The S&P achieved a 7.7% return in the quarter and was up over 10.6% on the year. However, as you undoubtably have realized, things changed dramatically in October, a month famous for Halloween and, even scarier, market corrections.

With significant volatility the S&P was down -6.8% in October, erasing much of the year's prior gains. The chart below depicts the impact the past month has had on broader US equity markets returns.

Figure 1: US Equity Market Returns – Through October

	YTD 9/30	October '18	YTD 10/31/18
DJIA	7.0%	-5.5%	1.2%
S&P 500	10.5%	-6.8%	3.0%
NASDAQ	16.6%	-9.2%	5.8%

Truth be told, returns were considerably lower in earlier periods during the month, and subject to dramatic inter and intraday swings. The pullback felt more painful than the figures above indicate, as the markets benefited from big gains in the last two trading days of the month. Both the S&P and NASDAQ entered correction territory, defined as losses greater than -10% during the month. The drawdown was broadly based, as 9 of the 11 economic sectors in the S&P were down, lead lower by growth components energy (-11.3%), consumer discretionary (-11.3%) and industrials (-10.9%). Defensive sectors consumer staples (+2.1%), and utilities (+1.9%) proved to be the only places to hide.

For their part, heavily out of favor international stocks fared even worse, providing little respite for investors in search of diversification. The international developed market EAFE index was down -10% on the month and is now down -13% on the year. Emerging markets proved even more volatile and were down -11% and -20% over the same period.

Though the temptation to identify and predict volatile swings in the market is strong, the effectiveness of such an effort is probably overstated. Market sentiment is impossible to predict in the short-term, and its root cause can be difficult to determine. It is uncanny the extent to which investors can overlook near term risk for a stretch of time, only to be overwhelmed by it in others. At Alamar we are familiar with this phenomenon as it applies to our equity portfolio. Oftentimes, positions we foresee owning for several years can see their prices fall dramatically based on a single quarter's performance. These swings present us the opportunity to add to our position in a company, and we are happy to purchase stock from investors that do not carry our same conviction. In exchange for this, we must adjust to the reality that the ride towards solid long-term investment results is not always a smooth one.

As painful as a market correction can feel for investors, it is useful to remember that historically short-term volatility is much more the rule than the exception. The chart below helps to put the market's recent decline into perspective. It shows the average drawdown in the S&P, the frequency, and typical time for

the market to recover since 1980. Notably, over the period the S&P 500 index experienced an average intra-year decline of nearly 14%! Yet despite this, it has managed to produce a positive return in 29 of the past 38 calendar years, or 72% of the time. This brings credence to the notion that most of the time investors are much better served to buy dips than sell them.

Figure 2: S&P 500 Frequency of Pullbacks (1980 – Present)

Drawdown	Historical Frequency	Typical # Occurrences Per Year	Typical Recovery Time
-2%	Often	18	1-4 weeks
-3%	Once Per Month	11	2-6 weeks
-5%	Once Per Quarter	4	2-3 months
-10%	Once per Year	1	8 months
-20%	Once per Market Cycle	0	20 months

Source: Standard& Poor's, FactSet, JP Morgan Asset Management
Returns based on price index and do not include dividends.

The recent bull market run is one of the longest and largest in modern history. Whether October's move turns out as a hiccup, prior to new highs, or a precursor towards recession should have little concern for the long-term properly positioned investor.

At Alamar, we prefer to focus on the underlying fundamentals of individual companies and not investor sentiment. In our minds, the single most important driver of stock market performance is corporate profits, specifically earnings per share (EPS). In our equity portfolio we strive to identify well run companies that are projected to achieve solid and predictable earnings growth and with reasonable valuations. At the same time, we avoid exposure to momentum and fad stocks. We have discussed in the past the extent to which much of the recent market's gains can be attributed to just a few companies. We have coined these companies FAMAA (Facebook, Amazon, Microsoft, Apple, Alphabet) and have never owned them as we have struggled with their tremendous size, valuation risk and/or narrow product lines.

Figure 3: FAMAA stocks starting to lose steam?

	RETURNS		
TICKER	YTD - 9/30	MTD - 10/29	YTD - 10/29
FB	-7%	-8%	-14%
AMZN	68%	-20%	34%

MSFT	34%	-7%	25%
AAPL	33%	-3%	29%
GOOG	12%	-10%	1%

To put their impact into perspective, since the market's 2009 bottom through the end of the most recent quarter, the market capitalization of companies listed in the S&P 500 has grown by over $18 trillion. The 5 FAMAA stocks alone have seen their market capitalizations grow by almost $4 trillion, making them responsible for 22% of the S&P's total gain!

It is our view that periods that witness only a few names driving stock market performance may not be ideal for the markets over the long run. First, there were the Nifty Fifty stocks in the early 1970's, and more recently the late 1990's when most of the S&P 500's movements were driven by just 4 names – Microsoft (again), Intel, Cisco, and Dell. In both instances, the outcome was eventually unfavorable for investors, and as the saying goes history may not repeat, but it rhymes.

For our part, we continue to focus on our portfolio of stocks ability to continue to achieve meaningful earnings growth. We recognize that the economy is slowing from peak levels. Fortunately, for us our internal requirements for attractive growth in a business is considerably less than that being achieved by the market in recent months. On the valuation front, the S&P currently trades at 15.5x times forward earnings. This does not strike us as overly expensive and is considerably less than 2000 and 2008.

CONCLUSION

Whether the recent correction in the market is short-term, or a more meaningful correction remains to be seen. In either event, and over the course of time, the cyclical nature of the economy can prove to be advantageous for patient long term equity investors. Further, even in times of difficulty opportunity can be found in the markets.

Thank you for your time and consideration -

John Murphy, CFA

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