CROWELL WEEDON ASSET MANAGEMENT
MONTECITO INVESTMENT PORTFOLIOS

January 1, 2019

Dear Fellow Investors,

We've outlined the major topics & takeaways of our annual letter below – details follow!

MAIN MESSAGE HIGHLIGHTS:

- BEHAVIORAL FINANCE: RECOGNIZING HUMAN BEHAVIOR CAN LEAD TO BETTER INVESTMENT DECISIONS
- AVOIDING A CRASH: IS IT WORTH TRYING?
- A MENTALLY ACCEPTABLE INVESTMENT STRATEGY TO MAXIMIZE YOUR WEALTH
- SHORT-TERMISM: NOT GOOD FOR YOUR FINANCES OR THE GLOBAL ECONOMY

FORECASTS

- **Economy:** continues to expand around a 3% rate for 2019
- **S&P 500:** ends the year around 2,850
- **Short-term rates**: max of 2 25 basis point hikes with a Fed Funds rate of 2.75% to 3.00% by year-end
- **Long-term rates**: 10 year treasury ends 2019 with a yield near 3.10% to 3.35%
- **Oil prices**: $50 to $65 price range for WTI
- **Inflation**: remains under 3% for the year ahead
- **Commercial real estate**: cap rates will come under slight pressure with majority of return coming from income. Still see manufactured housing, healthcare, industrial, & data centers as bright spots
- **Residential real estate**: high-end homes feel some pressure but smaller homes continue to see strong demand especially in states that are tax-friendly or retiree friendly – Millennials and Baby Boomers continue to compete in the lower end of the market

Three more forecasts not entirely investment related:

- Trump is a one term President
- Investing in Disruptive Technology
- A new acronym for market leadership

CONCLUSION

I'm only human, of flesh and blood I'm made
Human, born to make mistakes
-The Human League, 8/11/1986 -

Traditional economic & financial theory assumes people are rational "wealth maximizers" who seek to increase their own financial well-being through reasonable decision making. This rational, reasonable wealth maximizer is referred to as Homo Economicus. Through decades of observation, it is clear to everyone that actual human behavior differs greatly from traditional ideals. Asking questions as to why actual human behavior differs so much from Homo Economicus seeded a new school of thought called Behavioral Finance. This fresh look centers around the acceptance and understanding of our flaws and tendencies. The hope is that improved recognition may lead to better decision making. As this is an entire field of study we will just scratch the surface here and highlight a few of these behaviors we find fascinating.

Prospect Theory* - *There is a greater emotional impact associated with a loss than with an equivalent gain. Because losses cause greater emotional impact, people will choose an option offering them perceived gains rather than perceived losses even though the final outcome is the same. For example, suppose you have two choices to receive $50.

- Choice A: receive $50
- Choice B: First receive $100, then lose $50

People are more likely to choose Choice A because the gain is observed as more favorable than receiving more cash and then suffering a loss. This tendency has led to the asymmetric value chart which displays this relationship.

Source: https://www.investopedia.com/university/behavioral_finance/behavioral11.asp

Another quick example gives some insight into decision making that shows people who consider themselves risk averse actually exhibit risk-seeking behavior when faced with the possibility of a known loss. If given the choice of:

- Choice A: a sure Gain of $900
- Choice B: a 90% chance to receive $1,000 or a 10% chance to receive $0

Most respondents choose Choice A as they don't want to take the risk of possibly receiving $0. ***This is risk averse behavior.*** However, if we flip the above example from being a gain to being a loss:

- Choice A: a sure loss of -$900
- Choice B: a 90% chance to lose -$1,000 or a 10% chance to lose $0

Most respondents choose Choice B taking the gamble of most likely losing even more money but with the small hope that nothing is lost at all. ***This illustrates risk seeking behavior and shows how differently the human mind thinks about gains and losses.***

Fairness - A truly human behavior, fairness is best illustrated naturally at a bar. A bartender offers to give the winner of a coin toss $100. However, after the winner receives $100, they must share the money with the loser of the coin toss. The loser gets to name the split of the $100 to be shared. The winner and loser have one opportunity to agree on the split or the $100 is given back to the bartender. In traditional finance, the loser should be willing to accept $1 as it is only additive to their net worth and therefore, rational. However, when demonstrated in the real world, it takes a split around the $30 level as it is viewed as far more "fair". Not surprisingly, the fairness split only gets higher the longer the patrons have been enjoying the bar!

Equity Premium Puzzle - according to traditional finance, investors holding riskier assets should be compensated with higher rates of return. Long-term studies prove stock returns exceed bond returns by 6 - 7% on average. This excess return flies in the face of the assumption that stocks are riskier than bonds. As the asymmetric value chart shows, people are overly preoccupied by the negative effects of losses compared to an equivalent amount of gains leading to an extremely short-term view on investing. ***Behavioral finance theorists believe equities must yield a high enough premium in order to compensate investor's for their outsized aversion to loss, not the false assumption that stocks are riskier than bonds.***

Gambler's Fallacy - ***to erroneously believe that a random event is more or less likely to happen following another event or series of events.*** The best example of this is a coin flip. Those that believe a side is "due" to hit because of the outcomes of prior flips exhibit gambler's fallacy. In actuality, each coin flip is an independent event and the likelihood is always 50% of turning up heads or tails. Any previous flips have absolutely no bearing on future flips. If you've ever heard talking heads on TV say we're ***due*** for a recession, correction, bear market, etc. you're witnessing gambler's fallacy.

Herd Behavior - tendency for individuals to mimic the actions of a larger group whether those actions are rational or irrational. Stems from strong social pressures to conform or be accepted by a group. There's a strong belief that the more people that buy into a decision, the less likely it is that the decision is incorrect. Herd behavior is very common amongst analysts or investors especially in market bubbles and market crashes.

Overconfidence - tendency to overestimate or exaggerate one's ability to successfully perform a given task. Studies illustrate that overconfident investors typically trade more believing they are better at picking ideas. Not surprisingly, their returns were significantly lower than the market.

Anchoring** - **the tendency to attach our thoughts to a reference point - even though it may have no logical relevance to the decision at hand. If you've ever heard the reference: "Spend two months salary on an engagement ring" you've experienced anchoring. There is no logical reason that two months is the amount to spend. Another example was our 2017 Annual Letter's main message where we see a Lost Generation of market participants anchored to the fear and pessimism caused by the dot-com bust, real estate collapse, and Great Recession all occurring within the same decade. These crashes turned an entire generation off to the stock market and investor sentiment has never swung back to the euphoric peaks witnessed during the late 1990s.

These are just a few examples from the growing field of Behavioral Finance. We share them with the intent to give a better understanding of the thoughts and emotions all humans experience when it comes to investing. Seeing a stock price or your account value go down does trigger emotions. Wanting to avoid the next dot-com melt down or Great Recession can alter decision making forever. Hearing stories of how much money friends or colleagues made by doing this or that will continue to happen and make you want to jump on board. Our goal is to provide insight into how we think and how we apply this behavior to our decision making process. Keep in mind, we are fellow investors as well. We also experience the same emotions and concerns you share. We are also saving towards financial goals such as retirement and college educations. We are here to help you maximize your wealth. While none of us may be the ideal, wealth maximizing Homo Economicus, we can be aware of our human biases and tendencies. ***Awareness can go a long way towards making better decisions, helping us overcome our emotions, and allowing long-term investment disciplines the time needed to work.***

AVOIDING A CRASH – IS IT WORTH TRYING?

With markets being volatile and investors about to experience a down year in the stock market for the first time in several years, we're hearing a lot of talk about when is the right time to hit eject, pull the plug, and sell everything. The hope is to protect what you have by getting out now and avoiding the next disastrous downturn. While this sounds good in theory, the question remains: is this market timing strategy actually a good decision? Being long-term investors that own businesses and not broad-based indexes, we decided to pull some historical data on a few companies we currently own in portfolios: FedEx, McDonalds, & Apple.

The info below shows the year each company became publicly traded, how many significant declines the stock went through, the dates of those declines, and how much money you would have made if you invested in each of their IPOs. Next to the peak-to-trough dates we show how far the stock price declined and how many multiples of your investment you would be up if you held through that decline phase.

The info is really quite astounding. As an example, if you invested in McDonald's in 1979 (7 years after it came public) you would have seen the value of your investment decline by 40%. That means a $100,000 investment would have been worth $60,000 by the time shares bottomed. If you could have avoided this $40,000 decline in value you were probably feeling pretty good about yourself keeping your $100,000 safe and in tact. However, if you held McDonald's stock through the decline of 1979 - 1980 your investment would be 122 times more valuable today. That means your $100,000 would be worth $12,200,000!

	FedEx		***McDonald's***		***Apple***	
Year Public	1978		1972		1980	
# of year's public	41		47		39	
# of declines > 30%	8		6		10	
# of declines > 50%	4		2		7	
Return since IPO (X)	112		97		273	
	Peak to Trough	***Return on investment if held through downturn (X)***	***Peak to Trough***	***Return on your investment if held through downturn (X)***	***Peak to Trough***	***Return on your investment if held through downturn (X)***
	1980 - 1981 -84%	30	1973 - 1974 -72%	96	1980 - 1982 -70%	258
	1983 - 1984 -43%	15	1976 - 1977 -43%	112	1984 - 1985 -59%	271
	1986 - 1987 -52%	10	1979 - 1980 -40%	122	1988 - 1990 -49%	98
	1989 - 1990 -49%	13	1983 - 1984 -32%	66	1992 - 1993 -69%	67
	1999 - 2000 -51%	3	1986 - 1987 -39%	28	1995 - 1997 -75%	93
	2006 - 2009 -72%	2	1999 - 2003 -76%	4	1999 - 2000 -77%	39
	2010 - 2011 -34%	2			2001 - 2003 -53%	86
	2015 - 2016 -35%	1			2007 - 2009 -61%	6
					2012 - 2013 -45%	2
					2015 - 2016 -33%	1

Source: FactSet - Ending prices for calculations as of 12/17/2018

A few takeaways from our study:

- Even quality businesses see extreme volatility in their stock prices and can go extended periods of time where they look like lousy investments.
- There was a combined 24 times in the last 47 years when the stock price of FedEx, McDonald's, and Apple declined by greater than 30%!
- If you keep a long-term perspective, owning shares of quality businesses through significant downturns pays off as shareholders earned multiples on their investment by exercising patience.

While market timing may sound good in theory, it greatly complicates matters. Instead of making investment decisions about the best companies to own, you now have to make decisions on when to sell and buy them back. If we showed the above illustration as if an investor had perfect timing (selling at peaks and buying back at troughs) returns would be substantially better. However, we have yet to come across this super human with impeccable instincts for market tops and bottoms. We've run across a few that think they are as they remain anchored to their perceived brilliance of sidestepping the dot-com bust, housing market collapse, and Great Recession. Overconfidence runs rampant but odds are, most market timers never even check to see how they would have done if they stayed the course.

Is it worth trying to time market crashes? In our opinion – NO. Although investors may feel really good about avoiding a major downturn, if they looked years into the future, they would realize they gave up far more than an equivalent amount of gain. ***This does not mean we are in favor of holding the same***

companies forever or accepting the market for what it is and just invest via indexes. Instead, we believe active management should absolutely take place but with long-term, fundamental disciplines at the core of the strategy as opposed to short-term, emotional based trading.

A MENTALLY ACCEPTABLE INVESTMENT STRATEGY TO MAXIMIZE YOUR WEALTH

The main reason financial plans fail is fear – people just get scared out of them during market downturns. We showed many behavioral biases proving that humans are just not wired correctly to maximize their wealth. So how do we construct portfolios balancing human behavior with wealth maximization? Blake wrote a white paper about this topic a few years ago that is available on our website and certainly worth the read:

http://www.cwam.dadavidsonfa.com/files/88200/Old%20Paradigm%20with%20a%20New%20Reality%203-2018%20White%20Paper.pdf

To summarize, the plan calls for setting up the following:

PEACE OF MIND COMPONENT

- Short-term emergency reserve fund with 1 year's worth of expenses
- Short-term Fixed Income investments covering additional years worth of annual living expenses that gives each investor comfort

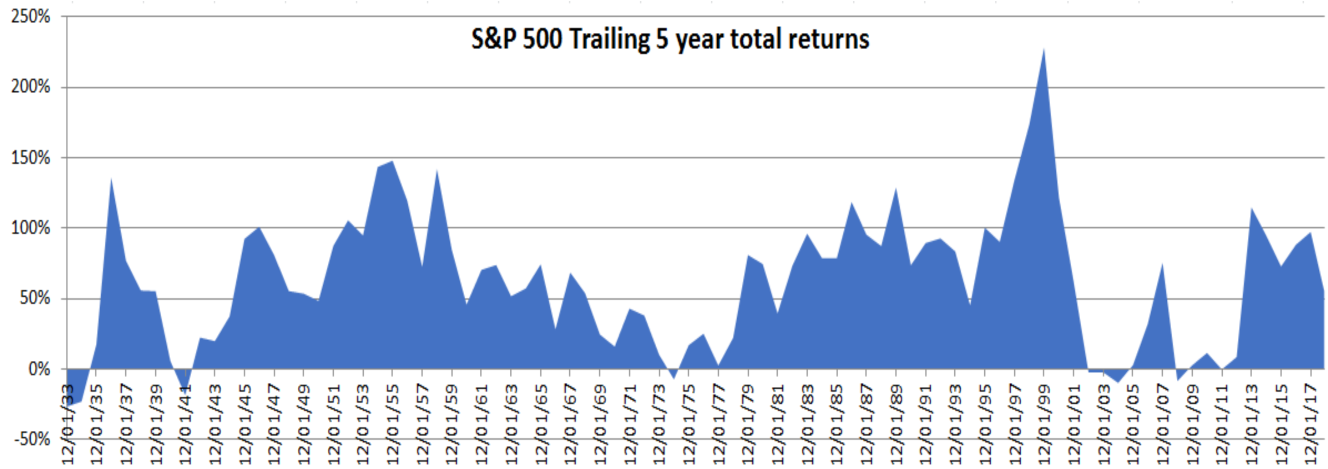
GROWTH COMPONENT

- A diversified, total return strategy focused on quality, cash flow generating businesses and real estate investments providing capital market rates of return

WEALTH CREATION COMPONENT

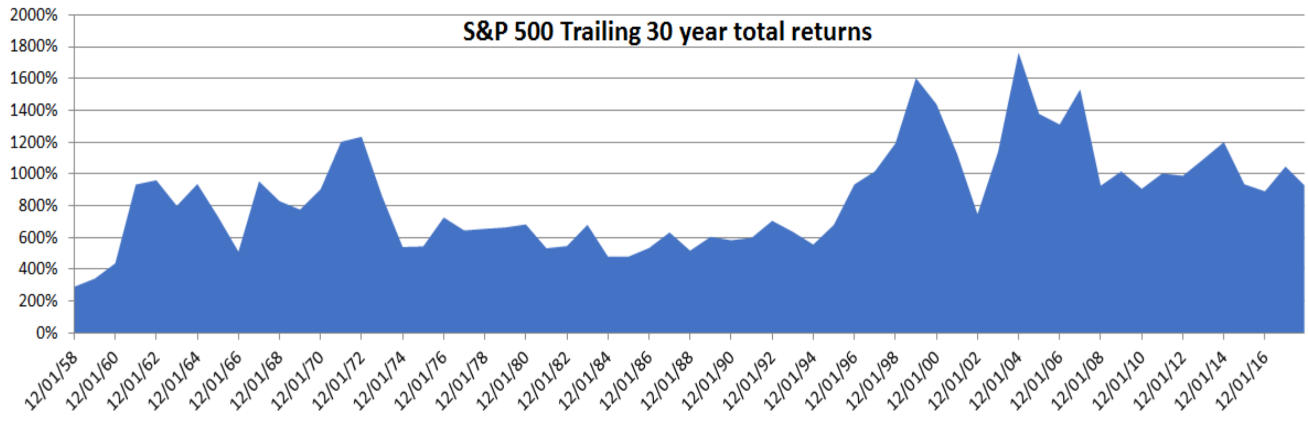
- Searching for the leading companies of tomorrow in an attempt to earn significant returns on your investment

When constructing portfolios in this manner we embrace, rather than fight, our inherent behavioral biases giving investors peace of mind to stay invested for the long-term and maximize their wealth. Staying invested for the long-term is essential in order to maximize your wealth. If we step back from the month-to-month tracking of your portfolio and instead approach it with a 5 year look, you will find it's extremely rare (we only count 9 times in history) to see your investment worth less than what you started with:



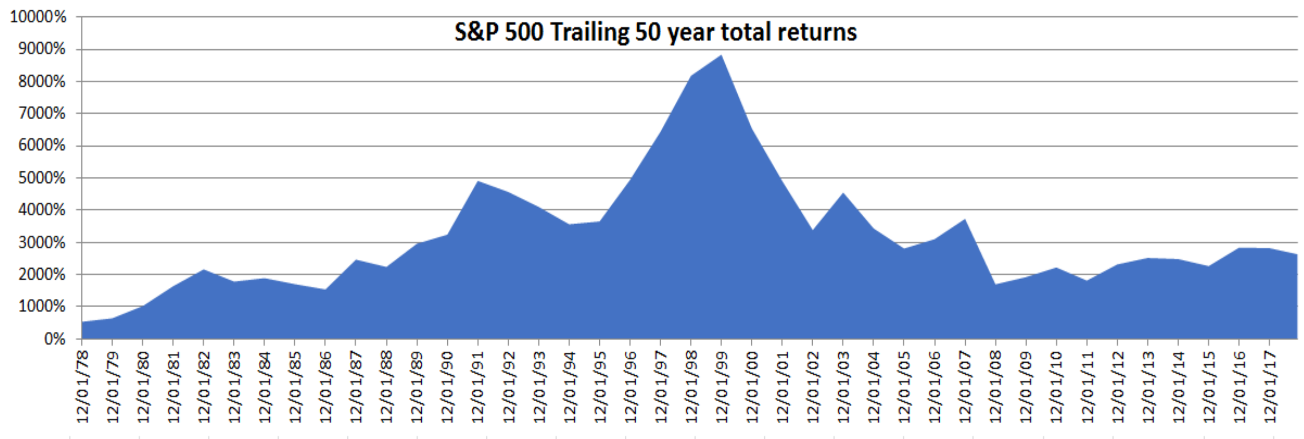
Source: FactSet and internal calculations

If we look at it in terms of a typical 30 year working career, it's never happened:



Source: FactSet and internal calculations

And if we look at it in terms of a 50 year adult lifetime (this may seem too long-term for one person but certainly realistic when managing family wealth), staying invested for the long-term has created significant amounts of wealth:

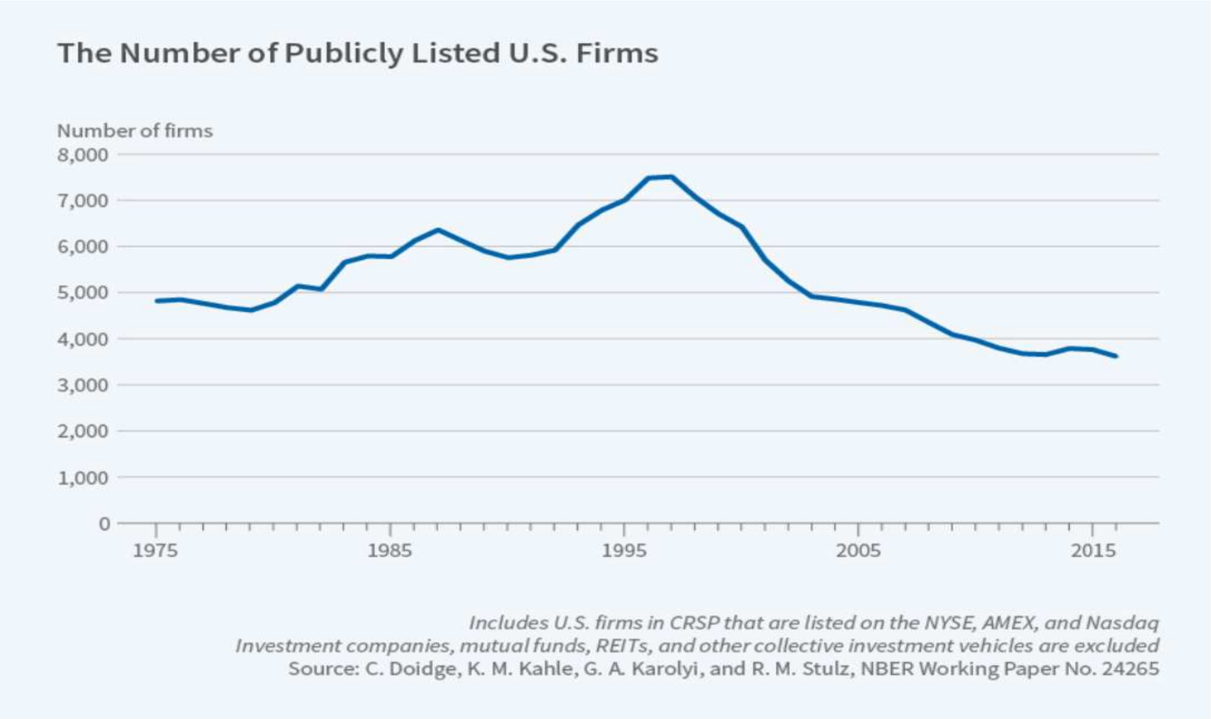


Source: FactSet and internal calculations

SHORT-TERMISM – NOT GOOD FOR YOUR FINANCES OR THE GLOBAL ECONOMY

This summer Jamie Dimon & Warren Buffet wrote an opinion piece for the Wall Street Journal talking about how businesses are the engine of the U.S. economy and having good corporate governance is imperative. Though publicly traded companies are only a sliver of the more than 28 million businesses in America, they represent a third of private sector employment and half of business capital spending. These public companies drive job creation, opportunity, and economic growth. Dimon and Buffet believe companies and markets have become too focused on the short-term, obsessed with beating expectations given for an ultra-short timeframe - the next 3 months. They argue this short-term focus comes at the expense of companies making long-term investments in areas such as technology, people, and research and development.

Another argument against short-termism is that fewer companies now want to become publicly traded. According to Rene Stulz's from The Ohio State University, in 1976 the U.S. had 23 publicly listed companies for each 1 million people in the country. Today, there are 11 publicly listed companies for each 1 million people.



Mr. Stultz believes there are many reasons for the shrinking number of companies in the U.S. stock market, but one major reason is that markets have become unfriendly to small, up and coming firms. Today's technology companies hold more assets in intangibles (patents, intellectual property) as opposed to fixed assets and spend more heavily on research and development (which must be expensed) versus fixed assets (which can be capitalized). This leads to accounting figures that look worse for smaller, research driven businesses leading to higher borrowing costs

Rather than looking to a hypothesis from a professor as to why the number of companies in the U.S. stock market is shrinking, we should look no further than the drama of this summer associated with Elon Musk and his attempt to take Tesla private. He spelled out his reasons on the company's blog:

- Being subject to wild swings in the stock price can distract everyone working at Tesla as they are all shareholders
- Being subject to quarterly earnings cycles puts pressure on Tesla to make decisions that might be right for a given quarter, but not necessarily right for the long-term
- Removing the incentive of short sellers to attack everything the company does

Musk did leave the door open for coming back to the public markets when Tesla enters a phase of slower, more predictable growth. This was an unprecedented move delivered in an unprecedented way by an entrepreneur leading two of the most innovative and disruptive companies in history (SpaceX and Tesla). This was no longer a hypothesis as to why the number of companies in the U.S. market is shrinking, this was proof.

We believe Wall Street, for many reasons, tends to be a skeptical bunch with a long memory. R.I.P. former "Titans of Industry" whose bankruptcies left a lasting impression on a generation of investors who are dead set on not being fooled by yet another financial debacle:

- Enron $63 Billion bankruptcy
- WorldCom $104 Billion bankruptcy
- Lehman Brothers $691 Billion bankruptcy
- Washington Mutual $328 Billion bankruptcy

While skepticism has its place in investing, there is also a breaking point at which it turns into short-sightedness and negativity, becoming a hindrance to funding creativity and making money. As more companies choose to stay private and existing public companies are taken private, the shrinking pool of publicly traded U.S. corporations may be left without rising stars and devolve into the home of the mature, boring, and predictable.

The short-sightedness needs to change. We can start by embracing a long-term view of investing, updating accounting rules, educating investors, and perhaps even holding journalists and analysts accountable for the sensationalized and editorialized headlines constantly thrust in front of the investing public. We'll leave you with a perfect example of missing the forest through the trees:

> *"We believe that the combination of negative cash flow, poor working capital management and high debt load in a hypercompetitive environment will put the company under extremely high risk. We believe that the company will run out of cash within the next four quarters, unless it manages to pull another financing rabbit out of its rather magical hat."*

No, this wasn't a quote about Tesla. Instead, it was written 18 years ago about a young upstart called Amazon. Ironically, the firm that published this piece is listed above on our R.I.P. list as the biggest bankruptcy in history (Lehman Brothers). Amazon, meanwhile, is now one of the largest companies in the world.

FORECASTS

This is the section of the annual letter where we discuss forecasts made in the past and discuss the bullets on the opening page of this annual letter. We remind ourselves it's a foolish section where we think we can actually make forecasts for the future! While we had 9 of our 11 forecasts correct last year (yes we score favorably for ourselves) – the 9 and 2 score isn't what this is about. We enjoy using "What If" in our thought process as it allows for outside-the-box thinking and challenges our (and your) assumptions. As a reminder, these forecasts are our thoughts as of the writing of this annual letter. Markets are dynamic and ever-changing. When change occurs, so too must our thoughts to adapt to the then current market environment. This is similar to our health. We get check-ups on a regular basis and develop a plan to maintain or improve ourselves. However, should we get sick we must be flexible enough to alter our plan to adapt to the new diagnosis we have been dealt.

We changed the format a bit this year. We will discuss each major area as a continuum of thought, the past and the future. And yes, we will have a few forecasts outside of conventional thinking – just to keep us all on our toes! We reiterate our portfolios are managed substantially from the bottom up. This means we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2018's annual letter and make some new and bold (and perhaps foolish given our longer term perspective) forecasts for 2019.

The Economy:
A few years ago we predicted: "*While there will be a lag effect of the change in corporate mentality, the growth rate of the economy should be better in 2017, and much better in 2018. We see GDP for 2018 at the 3% level, and the momentum being higher as the year progresses*." The belief was that the corporate tax law changes and a new deregulation bias in Washington, coupled with disruptive technology efficiencies, would create a more business friendly environment in which corporate board rooms would once again think about the future.

Full Point: The tax cuts had a material impact on corporations. After all, the government effectively gave 14% ownership back to the shareholders of corporations when they lowered the maximum corporate tax rate from 35% to 21% and freed up that cash flow for corporate board rooms to work with. The impact on earnings was immediate, and the lag into GDP was not nearly as long as many thought it would be. GDP that had not been above 3% since late 2015 came in at 4.2% in the second quarter of 2018 and 3.5% in the third quarter. The Federal Reserve used the strength of the economy to continue to raise rates – but more on that in the interest rate section.

2019 forecast: ***The economy continues to expand around a 3% rate for the year.*** The animal spirits of early 2018 have been replaced by a narrative heralded by the press and impatient prognosticators that a recession is overdue – that doesn't mean it has to happen. The corporate tax cuts leave a lasting impact and have companies investing in their future. Tax savings are being invested in people (we now have 3.7% unemployment) and long-term investments as noted by the record amounts of dollars spent on Capital Expenditures and Research and Development in 2018. This tax cut was felt in wage growth, earnings growth, cash flow growth and acted as a stimulus for the economy. The "sugar high" of the first year is over and the Federal Reserve recognizes that the economy's strength allows them to raise rates from accommodative to neutral. While there are numerous global economic pressures that many are focused on we continue to see the U.S. economy growing, albeit at a slightly slower pace surrounding the 3% level. We do question how steady the ride will be with the Fed searching for normalcy. As the training wheels are removed from the economy, there certainly could be some wobbles along the way. However, we do not believe the economy is as fragile as many are predicting and see a recession in 2019 as rather remote.
Source: FactSet

The Stock Market:
A few years ago we wrote: *"Earnings drive markets over the long-term. Expectation of future earnings drives markets in the short-term, along with some event driven emotional volatility."* That could become our mantra. For 2018 we forecast the earnings of the S&P 500 should increase because of tax relief, revenue growth, share buybacks, and further productivity (margin) increases from disruptive technology. We also called for some regression to the mean as far as the market multiple was concerned. While we did predict far more volatility during the year, in the end we saw multiple contraction caused by an increase in earnings, not because prices decreased significantly.

No Point: While we could give ourselves a point based on our logic; robust earnings growth, increased volatility, and P/E contraction regressing towards the long-term mean, the S&P 500 is enough below our forecast of 2,800 where we cannot say we got this right. Revenues grew nicely, cash flow expanded, share count declined, and many other metrics of valuation were better as well. However, short-term emotional reactions to a potential escalation of trade tensions, an incoming Democratic majority in the House of Representatives, the Fed Funds rate being raised to a "neutral" level, a nearly inverted yield curve, and whatever other stories are hyped to gather news junkies attention, have put a near-term bias to lower valuations.

2019 forecast: While earnings will not grow at the same rate we witnessed in 2018, we do believe current forecasts of 7% growth are achievable. Yes, there has been a peak in the growth rate of earnings, however, **not a peak in earnings**. There will be more potential headwinds again – there always are. At the same time, we can have both negative and positive surprises during the year. Democrats may flex their muscles in the House and impeach the president over one thing or another, but chances of a conviction in the Senate are remote. Posturing for 2020 elections may lead to a lame duck President (more on that in our "fun" forecasts at the end). The "Trade War" may continue or be resolved and go down as the quintessential example of Trump's "who blinks first" brinksmanship. While these are the headlines of today, the headlines we worry about are "black swan" events not currently on our radar. These can lead to emotional reactions in the market and we may have yet another year of significant volatility. Coming back to fundamentals, we believe the consensus view of S&P 500 earnings of approximately $175 for 2019 is right in line with our thinking. If we then increase 2019 earnings another 7-8% for 2020 (keep in mind it is very tough to forecast earnings out that far) we might have earnings of $190 for the S&P 500 in 2020. Under normal circumstances the market at the end of 2019 will be anticipating those 2020 earnings and valuing companies on a forward-looking basis. The key will be what multiple will be applied: the average multiple for the past 30 years, a lower multiple driven by negative sentiment generated from a sensational press and vitriolic politics, or a higher multiple driven by disruptive technological advancements creating optimism about the future. ***We believe the long-term average and therefore forecast the S&P 500 around 2,850 by year-end 2019.***
Source: FactSet and internal calculations

Short-term rates:
For 2018 we forecast two rate hikes – maybe three – but believed the Fed understood market players closely monitor the yield curve. As such, we believed they would not want to "cause" a major market disruption by creating an inverted yield curve. Further, we felt the language and indications from the Fed would be for even higher rates during the year.

Full Point: The Fed wound up raising the fed funds rate 4 times during the year and several of the Federal Reserve voting members did indeed address their concern with causing an inverted yield curve. However, the whole curve moved up and the concern never came to fruition. The economy has been firing on all cylinders for a while now. The Federal Reserve's goals of maximum employment, stable prices, and moderate long-term interest rates are all being achieved. As such, the Fed has prudently been raising rates to remove the accommodative money policy and return interest rates to a "Neutral" range.

2019 forecast: We applaud the Federal Reserve for keeping its eye on their dual mandate and not succumbing to political pressures or a false assumed mandate of smoothing out asset prices in various market places. There are some real questions they will wrestle with in 2019: What is the "Neutral Rate"? How do you shrink the Fed balance sheet without negatively impacting the velocity of money? We believe the economy is different now than when the baby boom generation was driving the labor force. That post World War II rebuilding / growth phase was accompanied by a technological revolution leading to growth rates that may not be consistently achievable going forward. This thinking could be proven wrong if our immigration quotas were greatly expanded. However, without a dramatic labor force expansion we feel the economy is at full employment and economic growth will be in the 3% range going forward. Therefore, we see the "new neutral" fed funds rate being in the 2.75% to 3.00% range. With the December 2018 hike putting us just 50 basis points below our estimate of neutral, **we see a maximum of 2 rate increases of 25 basis points each in 2019.** Any hikes beyond this may prove

to be the Fed's "one step too far" that causes an economic slowdown and eventually a recession. We will continue to monitor the shape of the yield curve closely. As a reminder, when we've seen inversion in the past, equity markets peaked 6 to 15 months later, not at the time of inversion.
Source: FactSet

Long term-rates:
Leading into 2018 we wrote of the potential long-term concern for US Government deficits to crowd out corporate borrowers. We did not believe the tipping point would be in 2018 and forecast the spread between short and long rates would stay close to the same level we entered the year with. With our forecast of 50 to 75 basis points of increase in short-term rates, we forecast the 10 year rate to end 2018 between 2.9% to 3.15%.

This tipping point was not reached and corporate bond issuance in the U.S. continues at a strong pace. We have said for many years that corporate boardrooms would tell us when rates were low enough to justify a major shift in their balance sheets and take advantage of the historically low borrowing costs. This was absolutely spot on as 2017 saw a record $1.8 Trillion of global corporate bonds issued marking the bottom of this interest rate cycle. Since 2008 global corporate bond issuance has more than doubled! One potential worrying point is the quantity of BBB rated corporate debt is greater today than the entire corporate debt market in 2008. While BBB is considered "Investment Grade" it is still something that we are watching closely.

The yield on the 10 year treasury ended 2017 at 2.405% and currently the yield is 2.75%. It did indeed rise to the range we forecast and just in the last few days pulled back to the lower end of that forecast. **Full point!**

2019 forecast: We see the economy still in growth mode (see our GDP forecast above) and do not see a recession during 2019. Given this outlook, we see corporate earnings growth of 7% to 9% for 2019 and much the same environment for long-term rates that we saw going into 2018. As short-term rates rise, long-term rates will keep pace. With our forecast of no more than 2 fed fund rate hikes, ***we believe the 10 year treasury will end 2019 in a range of 3.1% to 3.35%.***
Source: FactSet

Oil:
Our forecast for oil over the past two years has been right on. The economics of oil is based on the cost of development and production on the one hand and the political will of the largest producing nations on the other. Technological advancement has driven down the cost of production over the years. Depending on the well and its location, $40 a barrel production cost seems to be in the ballpark. Most oil producers can hedge the revenue side of the equation in the futures market by selling future production. With a fixed revenue side and a known cost of production, the speculation comes down to the amount of reserves to be found. With today's radar, echo sonograms and even satellite imagery, the reliability of finding reserves makes that speculation less risky than it ever has before. Today's oil companies are in a better position than ever to be able to make a profit with more known's than ever before. Importantly, before the drill bit hits the dirt, the economics of that well are substantially locked in for the first 18 months to 2 years. The United States has become the swing producer on the global stage using the price of oil as the catalyst for exploration decisions. Because of this, the United States

moves at a much slower pace than an authoritative regime that can literally turn off the spigot and impact the supply and demand equation on an immediate basis. However, those regimes have found that flooding the market with oil to try and capture market share is more detrimental to their budgets than they ever dreamed. Knowing where the downside price of oil becomes so painful as to warrant production cuts to prop up the price (and thereby the revenues into their countries) has been a point of conjecture.

We maintain when the price gets close to $50 a barrel you see efforts to prop up the price. It may go lower until those efforts take hold, but $50 seems to be the fundamental floor to the long-term range of oil. Likewise, when the price closes in on $65 we see oil companies selling future production to lock in the revenue side of their budgets at nice profits. Drilling activity begins to increase and production growth is not far behind. The price may go above our fundamental top of range number of $65, only to fall again when supply increases.

Full Point: Although the price briefly went outside the $50 to $65 fundamental range, that range once again turned out to be where the greatest number of observations of price points occurred.

2019 forecast: ***Our $50 to $65 range will once again hold true.*** Political disruptions of supply due to sanctions tend to be dealt with by increased production somewhere else. Once again it's worth mentioning, although electrification of the transportation industry is happening, it will be a number of years before it should have a major impact on demand for hydrocarbons.
Source: FactSet

Inflation:
Last year we forecast, "*Inflation will start to rise a bit in 2018 – still below 3%, but nudging above the 2.2% rate we have seen for the past few years. Toward the end of the year we may see the surprise that it is above 2.5% for at least one quarter.*"

Full Point: The year over year increase in inflation peaked with a 3.0% reading in July of 2018 after steady increases each month prior. The rate then ebbed and in November grew 2.5% year over year. The decline after July was substantially attributed to the significant decline in the price of Oil.

2019 forecast: The main drivers of inflation could be:

- Wage increases in a predominately service oriented economy
- An increase in the velocity of money should there be a resolution with China on trade
- A significant rebound in the price of oil back to the upper end of its fair valuation range

Given the potential Washington gridlock, passing a Federal minimum wage increase seems unlikely. Resolution to trade and tariff issues with China seems possible but may take longer than many think given the negotiating styles of both sides. Further, even if oil does bounce back in price, the continued impact of disruptive technology on industry after industry will serve to **keep inflation under 3% for the year ahead**.
Source: FactSet

***Commercial Real Estate**:*
The beauty of Commercial real estate is investor expectations are truly long-term, therefore, investment trends are multi-year as well. Perhaps it's from properties not being priced on a daily basis like public ownership of businesses (stocks) that leads to a longer average holding period. More likely it's from the judicious use of leverage, strict underwriting standards, long-term leases, and high transaction costs that make for a more stable investment encouraging multi-year holding periods. This does not mean we shouldn't pay attention to long-term trends in real estate that favor one sector over another. We believe active management adds significant value by identifying those trends allowing investors who participate via publicly traded ownership of commercial real estate (via REITs) the opportunity to increase their rates of return.

Demographic shifts, business environments, and business trends all play into identifying real estate sectors that potentially will fare the best. As an example - online purchases continue to grow year over year. This is to the detriment of bricks-and-mortar stores and to the benefit of warehouses and distribution centers. This is a long-term trend we expect to continue for some time into the future. Therefore, we focus a portion of our holdings in warehouses and distribution centers and avoid investing in malls and other retail locations. Another example - for a number of years, Millennials and Gen Xers have stayed home longer. When they did leave home they went to apartments. They seem to be a more fiscally responsible generation. They have not wanted to add a large mortgage on top of their student loans or lack the down payment money needed to buy their own homes. So, apartments have been attractive. As these younger generations have now been working longer and saving money, we are seeing this trend shift as demand for entry-level housing has grown nicely (at least in the affordable areas of the country). Should this trend continue, we will consider moving out of an over-weighted position in apartments. Finally, a very long-term trend that appears to be accelerating is growth of the cloud. Obviously, we're not talking about buying pieces of the sky, but rather the data centers that house all of the technology that is the cloud.

In 2018 we forecast manufactured homes, healthcare, data centers and industrial would be the sectors to focus on. According to NAREIT, through November 2018 these sectors were three of the top four performing sectors with only data centers being negative year to date. We therefore will give ourselves a **Full Point** for this category.

2019 forecast: As we are not forecasting a rapid rise in the 10 year interest rate, we believe rental increases will be able to offset the negative impact of cap rates creeping up. Therefore, for 2019 we see returns from commercial real estate coming from cash flow and not appreciation. The only exception will be those portfolios adding incremental value though accretive acquisitions or property enhancements that drive additional revenue. Otherwise, **not much will change in 2019 and we would continue to emphasize Industrial, Manufactured Homes, Health Care and Data Centers.**
Source: https://www.reit.com/data-research/reit-indexes/historical-reit-returns/performance-property-sector-subsector

***Residential Real Estate**:*
In 2017 we laid out the thesis that the Millennial generation was looking to start getting into entry level homes and that Baby Boomers were starting to find they wanted (and in some cases needed) to downsize their residences. We used the Case-Shiller Index as our measuring tool to track the nationwide median prices of homes. It started 2017 at 184.71 and ended 2017 at 204.42. We forecast

this index would continue to trend higher in 2018. At the end of September 2018 the index was 213.76 – certainly the growth we were expecting. **Full Point for this forecast!**

2019 forecast: We see the Case-Shiller Index advancing once again. But that does not tell the whole story of a residential real estate market that will vary substantially based on where you are located. According to Zillow.com, the median sales price of a home in the United States is $225,900 but that number is laughable to anyone living in Los Angeles or San Francisco. Location, location, location – the three words to consider when buying real-estate. We believe location will certainly play into real estate market values in 2019.

The Millennial generation (to be fair it spreads out on both sides of this group a bit) is a potent buying force of real estate. As previously stated, they have become a far more fiscally responsible group, not buying homes until they can afford them and not buying more house than they think they will need long-term. At the same time, Baby-Boomers, who by and large used their homes as spending accounts for a lifestyle they could not really afford, are finding they need to downsize to become more fiscally solvent. As Boomers downsize they are competing for homes in the same marketplace as Millennials, creating more demand in the bottom end of the market and not the high end. Further, in 2019 owners of more expensive homes in high income tax states will feel the sting of losing a great amount of federal subsidy via reduced tax deductions for income tax, property tax, and mortgage interest. This could remain a limiting factor going forward and lead to a growing migration out of those high tax states. Should this continue, we could see downward pressure on the prices of homes selling for above the maximum conforming Fannie Mae loan amount of $453,100.
Source: FactSet

SPECIAL FUN FORECASTS

2018 "Fun Forecasts"
Last year's "Fun Forecasts" were designed to give us something to talk about. They challenged us to be aware of items that may lead to future investment opportunities or raise warning signs for existing investments we currently embrace. To summarize, they were:

- Disruptive technology – every industry will feel the impact of technology as time goes on. We talked last year about higher education being an area ripe for disruption. The utilization of Internet based education has grown tremendously over the last year and continues its rapid advancement. There is a long way to go before traditional higher education institutions are displaced but there is no denying the disruptive impact online education is having around the world. Stay tuned to this trend – it could make a debt free, higher education degree affordable to everyone with an Internet connection. **Full Point** – it was a given to get a point on this one! Now, finding the new winners in online education and how to invest in them is the challenge.

- Climate change (regardless of its cause) is a scientific reality. We maintain that political answers are difficult to come by and still harder to maintain and enforce. We believe necessity is the mother of invention. As corporations embrace the idea that being environmentally friendly is good business, we see human ingenuity as our best chance of adapting to scientific reality.

Full Point – if only because this was as much to raise our consciousness again and keep the dialogue going. We note some significant advancements here:

- Ocean Cleanup launched "Wilson" for sea trials to help clean up the Pacific Garbage patch
- Tesla demonstrates the public will buy electric vehicles and reduce emissions
- 2018 set a record in the U.S. for corporate renewable energy procurements thanks to companies like Apple and Facebook investing in clean energy
- China passed a law requiring 100% of vehicles produced be electric by 2025
- And the most gratifying of announcements by the United Nations – the ozone hole could actually heal in our lifetimes!

- 3D printing - we forecast a leap in technology taking it from industrial uses to everyday home uses. While we still believe this is coming, it is not here yet. **No Point Here**.

2019 "Fun Forecasts"

This truly is where we get to take all the inputs we read, see and feel during the year and bring them together with a forward looking perspective. We could talk about the Cannabis legalization trend and opine whether the Federal Government will embrace the change. Or we could pat ourselves on the back for prior forecasts that were embedded in other commentary – like the crypto-currency mania having all the earmarks of a bubble (A+++ on this one!). But this year we want to chat briefly on who will win the 2020 presidential election, Investing in disruptive technology, and changes to FAANG.

#1: The 2020 presidential election – and beyond! The Baby Boom generation and their parents are fast becoming less of a factor in American politics. They are being replaced by an even bigger population group – the Millennials. Recently, the U.S. Census Bureau revealed in 2019 Millennials will number 73 million and Baby Boomers will be down to 72 million. Over 10,000 Millennials are becoming voters every day with the majority registering as Democrats. As they showed in the mid-term elections, they are certainly having an impact. Millennials had the highest disapproval rating of Trump in any age group at over 60%. This isn't entirely unexpected as our education system has become more and more liberal as the years have passed. Many schools that were sponsored by conservative churches have become secular institutions of liberal philosophy. Further, those who do not have the opportunity to attend higher education may come from large population centers where the Democratic Party is exceptionally strong. Recently, the Republican Party achieved success by appealing to current and past voters but today appears fractured and out of touch when it comes to appealing to Millennials. Simple math shows the Republican Party may have a difficult time in the near future. Based on this, we forecast ***Mr. Trump will be a one-term President.*** Not so much because of the constant controversy he embraces, his war against the media, and brinksmanship style of negotiations, but simply because math is now on the side of Democrats.

Source: http://www.pewresearch.org/fact-tank/2018/03/01/millennials-overtake-baby-boomers/

#2: Investing in disruptive technology

We've written at great length about technological innovation advancing at a rapid pace. It's easy to say but sometimes we lose perspective on just how far we've come in such a short amount of time. Keep in mind Moore's Law is alive and well. Computing power has doubled approximately every 2 years. ***Based***

on a simplified example, if we assume 1980 was the start of computing power and it doubles every 2 years, in 2018 we are 524,000 times more powerful than 1980. Also, what took us 38 years to achieve in computing power growth, will be doubled once again in the next 2 years thus having us at over 1 Million times more powerful than 1980. If Moore's law continues, over the next 10 years we will be nearly 17 Million times more powerful than 1980! As we laid out in our 3 step portfolio construction process – having a piece of your portfolio invested in disruptive companies offers the ability for true wealth creation. As referenced in our investment discipline description for this strategy:

> *"Since the beginning of our nation, American entrepreneurs have developed many of the world's greatest disruptive technologies and business models. The American Dream – to start from nothing, take an idea and turn it into a successful business in which many can prosper, remains alive and well today. The American Dream portfolio seeks companies that represent this spirit. They have started with an idea and through entrepreneurship, hard work, vision, and the benefit of a capitalist free enterprise system, have broken out of the development phase of their existence and are now in the (early in many cases) phases of high growth. Finding companies in this high growth stage of their corporate life offers investors the potential to achieve true wealth creation. While investing in these periods of high growth offers the potential for substantial wealth creation, there is also a greater risk of failure due to the very spirit of the American Dream. The American Dream is an opportunity, not a right. This opportunity to try and fail is the ultimate driver of continued advancement towards future prosperity & success."*

Many of these companies are changing entire industries and people's lives at a rapid pace. They are all growing revenues greater than 20%. Keep in mind, growing this quickly will see a company double revenues in just over 3 ½ years! Finding those companies that turn into leaders of tomorrow will be the key to success and exactly what we attempt to do with the portfolio. It is naïve to think we will have success with all of the investments but do believe we will continue to find some real game changers. If you are lacking exposure to these types of companies the recent pullback offers a great entry point in our opinion.

#3: A new acronym for market leaders

For years Facebook, Apple, Amazon, Netflix, & Google were leaders in the market and referred to as FAANG. Market leaders do not always represent the best fundamentals but rather those companies doing exciting things attracting large flows of money. There appears to be some cracks forming with a few of these names and we believe 2019 will see some new companies injected into this leadership group:

Tesla — As Facebook continues to catch flack for their lack of privacy protection, we see a newcomer stepping into their leadership position. The only company offering a sustainable living ecosystem consisting of energy generation, energy storage, and energy transport - Tesla. They are rapidly achieving their mission of transitioning the world to sustainable energy. A beloved, passionate leader with aspirational visions now being translated into reality – T will be part of the new leadership acronym.

Amazon — Companies recognizing the efficiency of being based in the cloud has AWS continuing their rapid growth. Meanwhile, shopping preferences continue to migrate towards the convenience of online / mobile channels leading to further growth for Amazon's retail business. The other services such as music and entertainment keep the ecosystem sticky and Amazon fully entrenched in the acronym for 2019.

Disney — 2019 could be a truly monumental year for Disney. With plans to pull all their content from Netflix, launch their own streaming service (Disney +), a film slate that includes massive potential, Star Wars lands opening at the theme parks, and continued strength from live sports, you can see how 2019 could see Disney displace Netflix in the leadership group.

Apple
Alphabet — For 2019 we'll recognize the name change at Google and allow them to stay in the group as Alphabet. We also believe growth at Apple's Services segment will ease fears over a saturated smartphone market and see them continue to produce significant amounts of cash flow. Both companies continue to invest significantly with Research and Development budgets greater than a vast majority of entire company's market caps! While always tight-lipped, we believe these significant investments in incubator type start-ups keeps Apple & Alphabet at the forefront of tomorrow's technological trends.

So **TADAA**, there you have our 2019 forecasts!

CONCLUSION

The end to 2018 was rough. While the worries you hear about today such as the Fed raising interest rates too fast or Trump working through a trade deal with China are valid, we would like to remind you of all the worries we've endured over the past decade:

- *2/20/2009: George Soros says the world financial system has effectively disintegrated adding that there is yet no prospect of a near-term resolution to the crisis*
- *4/3/2009: 663k jobs lost in March, 5.1 million lost since January 2008, unemployment up to 8.5%*
- *5/28/2009: Bill Gross of PIMCO gives keynote speech saying U.S. is in for a "New Normal" of high unemployment, high inflation, & slow economic growth*
- *5/31/2009: General Motors files for bankruptcy while Chrysler's bankruptcy asset sale was approved*
- *7/24/2009: H1N1 (Swine Flu) virus could infect 2 Billion people*
- *1/13/2010: 7.0 earthquake in Haiti leaves more than 270,000 dead*
- *5/6/2010: Flash Crash sees Down Jones Industrial Average plunge 998.5 points within minutes*
- *5/27/2010: Gulf oil spill now largest in U.S. history*
- *6/1/2010: European Financial Stability Facility created as a temporary crisis resolution mechanism by euro area Member States provides assistance to Ireland, Portugal and Greece.*
- *3/11/2011: Japan hit by tsunamis after 8.9 earthquake. Nuclear reactor meltdown imminent.*
- *8/6/2011: S&P downgrades U.S. debt for the first time*
- *8/31/2011: Gold peaks above $1,800/oz.*

- *5/22/2013: Taper Tantrum - Federal Reserve announces it would begin tapering back its roughly $70 Billion/month in bond purchases*
- *9/30/2013: Government shutdown begins as gridlocked Congress gives up*
- *9/25/2014: Ebola – It's far, far worse than you thought*
- *7/9/2015: Shanghai stock market falls by 30% over 3 weeks as China's economic slump has many concerned it will trigger a new financial crisis*
- *7/1/2016: U.S. 10 year treasury note hits record low yield of 1.34%*
- *11/30/2016: Paris Massacre: At least 128 die in attacks*
- *1/12/2016: Oil crashes below $30 a barrel for first time since Debember 2003 seeing a 72% plunge from the June 2014 peak of $108*
- *1/28/2016: Zika Virus "Spreading Explosively" in Americas WHO says*
- *4/5/2016: Wall Street Journal reports around one quarter of global government bonds have been trading at yields below zero*
- *6/23/2016: Britain votes to leave E.U.*
- *11/9/2016: Donald Trump is elected President in Stunning Repudiation of the Establishment*

As mentioned in our 2017 Annual Letter, we have an entire generation that has lived through nearly 2 decades of market crashes, panic, and fear. Because of this, investor sentiment has never reached the "euphoric" level witnessed during a true market top. We have seen euphoria in other areas as pointed out in 2018's Annual Letter when we warned about a crypto-currency bubble. However, when it comes to the stock market, this recent pullback has already seen sentiment fall near the level of fear and panic witnessed during the Great Recession. As shown in our behavioral finance section, people have long memories and anchor to things that are familiar to them. As long as everyone is anchored to the doom and gloom of the past 2 decades, stock prices don't have much of a chance to climb to stratospheric valuation levels that then set up for a crash we will be looking to avoid. In our opinion, this will happen again. We are just not there yet.

The communications revolution has brought the world closer together more than any time before. Yet, simultaneously face to face communication is being replaced with texts, tweets, and posts. Our lives are being captured as data and privacy is one of the casualties of this revolution. Social media platforms and news outlets are all vying for content. This demand is leading to lower standards of journalism tainted with bias or outright fabrications. Yes Mr. Huxley, it is a brave new world. We will always strive to cull through information, ferret out the important from the unimportant, and take short-term emotions out of the long-term investment process. Our goal is to help our investors achieve their financial independence and the freedom to focus on what they want to do in life and not what they have to do.

As always, we welcome your feedback and would love to talk about these and other topics that may be important to you. We thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility. ***Montecito Investment Portfolio's Mission: To provide diversified, disciplined long term investment solutions, service and guidance to help our clients achieve, and maintain, their "Financial Independence".***

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Disclaimers

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There are risks inherent in any investment and there is no assurance that any money manager, asset class, style or index will provide positive performance over time. The investment return and principal value of an investment will fluctuate, so that an investor's shares, when redeemed, may be worth more or less than their original cost.

Real estate investments may be subject to a higher degree of market risk because of concentration in a specific industry, sector or geographical sector. Real estate investments may be subject to risks including but not limited to declines in the value of real estate, risks related to general and economic conditions, changes in the value of the underlying property owned by the trust and defaults by borrower.

The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.

Past Annual letters are available by request. 2016, 2017, and 2018 Letters are available on our website at: http://www.cwam.dadavidsonfa.com/Our-Commentary.4.htm