Annual Call – Knights of Columbus Asset Advisors – January 2018

Thomas Duffy, VP for Investment Strategy:

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Welcome:

Welcome to the Knights of Columbus Asset Advisors' 2017 market year-in-review and outlook for the New Year. Thank you for joining us this afternoon. This is Thom Duffy, Knights of Columbus Asset Advisors' VP for Investment Strategy, and it is our privilege to have you join us today. Before I introduce our speakers for an entertaining discussion. I have a few housekeeping items to share.

First, during the presentation, all lines will be muted to ensure that any background noise does not distract from your listening pleasure.

Second, if you have any questions, please submit them using the Go-To-Meeting chat function that was included in your invitation and we'll get to as many of them as time permits.

Finally, before we hear from our two speakers today, I am obliged to state that:

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Introduction(s):

Now it is my pleasure to introduce you to Mike Vogelzang, the President and Chief Investment Officer of the boutique investment management firm, Boston Advisors, where he has served for the past 20 years, as well as Tony Minopoli, the President and Chief Investment Officer of Knights of Columbus Asset Advisors where he has spent the last 12 years overseeing the growth of the Order's investment portfolio to nearly $24 billion.

Tony and Mike, thank you so much for joining us. The conference line is yours.
If you would like to ask Mr. Minopoli or Mr. Vogelzang a question, please type it in the space provided below and, in the drop down box that will appear under the triangle immediately to the left of the "send" button, please select the "Organizer(s) Only" option before clicking "Send."

Tony and Mike, thank you so much for joining us, the conference line is yours.

Tony:

Before we kick off into this, what I wanted to do was discuss very briefly the growth of Knights of Columbus Asset Advisors over the past year. We are very pleased to say that in 2017, we saw roughly a 44% increase in assets which was a very good year. Markets were good, but a lot of new business. We thank everyone for their business and fully appreciate your trust in us. Know that we work very hard on your behalf each and every day. We are also very excited because February 27th of this year marks a very important milestone when we hit our three-year anniversary, which is a pretty big deal in the institutional investment world. We are very excited about that as well.

What I wanted to do, because the macro economy really has a much larger impact day to day on bonds and necessarily in individual stocks, I was going to kick off the call with some brief comments on both what is going on in the macro economy and its impact on our views on fixed income, talk a bit about what we see going forward, then ask Mike to talk about more exciting things, which will be the stock market. We will then answer questions jointly or separately, depending on the nature of question.

When we look at 2017, generally it was a very good year in fixed income. The Barclay's Aggregate Index returned 3.5%, shorter duration bonds in the 1-3 year area returned about 0.8% and it was essentially a coupon kind of year. It was really a year where you clipped your coupon, but we also made a little bit of money as yield curve spreads tightened on the credit side. When we look at the U.S. bond market, it was largely the recipient of continued strong cash flows as investors generally avoided the bull market stocks, that's both domestic investors as well as international investors concerned with the general safety of the U.S. Market. Mike will fill us in a lot more on the stock market in a few minutes.

The dollar had been strengthening, but more recently we've seen some weakness and that was basically due to a few things. First, the deficit imbalances are certainly starting to take hold; people are paying a bit more attention. Also, we are likely seeing an increase in the deficit imbalance due to tax reform. The other side of this coin is that many foreign countries have been experiencing economic growth and their own fiscal balances, so I think what we are seeing is strong economies around the world which have been taking a bit of the luster away that had been providing so much strength for the U.S. dollar.

When we look back overall, I don't think it's a big shock to anyone on the call, interest rates are still quite low. Although we are seeing spreads fairly tight, making bonds a potential challenge in 2018. But, we think when you take a step back and look at the economic backdrop, it remains pretty moderate and we think fairly stable on long term rates. Stable to narrower credit spreads means that this year is going to be a year where fixed income returns will almost entirely come from coupon income. 2018 also starts with a lightly continued process of withdrawn quantitative easing that was introduced globally during the global financial crisis. So the U.S. was not the only country engaged in the bond-buying program to try to push down rates. This was a great experiment because what it really did is it caused lower long term rates to lessen the cost of mortgages and lessen the cost of longer term borrowing, to take down the borrowing cost in automobiles and to try to spur economic activity. We exercised it in the U.S., the ECB exercised it in Europe and the Bank of Japan has exercised it as well. The challenge, and for us the interesting part is what happens now. This experiment has been going on for quite a long time and no one really knows with certainty what happens when the punch bowl is full. That's the real reason, if you strip away everything else, that we think the unwinding is really going to be a longer-term type phenomenon. The Federal Reserve (Fed) recognizes the havoc that this will wreak on the markets if they in fact take away stimulus too quickly.

The things that I really wanted to review were inflation and employment. Because at this point in the cycle, I know we have been talking about the very long part of this cycle, this current recovery is 103 months old, and it is one of the longest economic recoveries on record. And we currently have the very rare environment of not only U.S. growth but global growth at the same time. Many people have been focusing on the length of the recovery, but we think what is more important is the trajectory. So far, we don't have the excesses of many of the previous expansionary periods. Stocks have done great. Mike will talk more about this. Housing has certainly improved off the bottom, but it is pretty hard to argue that housing has gotten overheated in excess. Bond prices have softened a bit and spreads are somewhat tight. I think, if there is any market that may be feeling the most heat, it is most likely the bond market. We also think that what you are seeing are some interesting mid-cycle things that are occurring that normally, given how long this recovery has been, nine years in the making, people think "gosh this recovery is awfully long." But with the changes in the tax policy, we may really have a game changer. Apple, as many of you probably heard or saw, recently announced a repatriation of hundreds of billions of dollars that they have had in their Irish subsidiary to the tune of about a $38 billion tax bill, but they also equally announced the building of a new factory and 20,000 new jobs. JP Morgan recently announced very recently they are increasing their minimum wage associate pay scale to $18 per hour and also adding roughly 400 branches in 20 of their key markets. So, we are starting to see the potential of other expansion in other parts of the economy. I recently saw a statistic that during the first nine months of 2017, capital spending grew at a rate of over 6% on an annualized basis. These are not the kinds of activities that you see at the end of the growth phase of an economy. I have really been looking, but have not been able to find one prediction that believes interest rates are going to start going materially higher. Really everyone is within this more gradual appreciation. Sometimes when you have group think, it's the other thing that surprises you and I think that things that can surprise us are largely of the geopolitical nature. What's going to happen with, as our President named him, "Rocket Man," and clearly Iran, Syria and Iraq remain wild cards. And now that we have been engaging with some protectionist measures with the Chinese, are we going to see the potential for global trade war as it relates to terrorists? I think if we get back home and away from large exogenous events related to forces that are outside of the United States borders, the two things that we are trying to figure out are: What happens with inflation, and how does that marry what is happening in the employment market? When we look at core inflation, some of the transitory factors that were weighing on core inflation 2017 we think are receding. Medical price inflation has bottomed, the weakening dollar is putting inflation on import prices and there is some tightness in the labor market that is having an impact on inflation.

When we look at the labor market, and I went back and looked back at the previous 20 years, the December release for headline unemployment was 4.1%. The lowest we saw was 3.8% back in March 2000, and the high was in October of 2009 when we hit 10%. We always like to look at unemployment in the scope of underemployment, which has also fallen, hitting a recent low of 8.1%. That number, believe it or not, peaked at 17.9% in October of 2009. Keep in mind that underemployment not only references those that are not employed, also included are those that are working in a position that is below their educational level or training, e.g., an engineer who is working as a stocking clerk in a grocery story. Not saying that one is better than the other, it is just the way they are accounted for. The low in underemployment was 6.8% in 2000. You read quite a lot about the tightness in the labor market, but there is a little fly in the ointment when you look at that in its totality. And that fly is the labor participation rate. We are currently operating at a labor participation rate (adults that are able to participate in the workforce) at 62.7%, which is only marginally higher than the recent low of 62.3% that we hit in September of 2015. The issue is that it is way below the 67%+ peak that we hit back in 2000. That 4.6% difference between peak employment participation and where we are now is the difference between 4% unemployment and a much higher number. The question is, if this wage growth that we are starting to see begins to take place, does that draw people off the sidelines and back into the labor participation ring? The biggest wildcard (some of the folks on the phone certainly fall into this age bracket) is what is going to happen to the baby boomers? What does retirement look like for the baby boomers? With the eradication of the traditional defined benefit pension plan, are people going to work longer, or are Americans deciding now that they prefer the luxury of leisure to being engaged full time. These are some wildcards that we are continually looking at: What's happing in the employment market? How is that met with wages? As we see wages increase, do we see people come back in (to the labor market)? Because we think wage inflation is really the most virtuous kind of inflation. It means there are more dollars flowing into the pockets of people, those people are spending, demanding more goods and services, corporations are turning out more goods and services, which is in turn causing a general rise in prices. Much more preferable to a general rise in prices due to spike in commodity prices.

Lastly, on the jobs front, job openings are just off the recent high that we experienced in 2017. There're a lot of people looking for a lot of workers. In many cases, looking for specified skills. If you fit neatly into one of those compartments, you will find all of the work you could want. The wage trend indicator is still pointing to higher wages but again at a very measured pace. We think we are going to see higher rates, but they will meander higher as opposed to a spike in the rate environment. Which brings us to our portfolios and the way we manage them.

Speaking more of our core bond portfolio that tends to have a five to six year duration and to buy bonds with maturities of up to 5 to 10 years. In that environment the worst thing that can happen is you buy a bond on Monday and interest rates go up a percent and a half on Tuesday. A bit factitious but really an issue in the environment that isn't good for us. What we have found is that in a meandering environment, where interest rates are moving up in a more of a stair step fashion, it gives us a chance to use maturing securities and the natural cash flow of the portfolios to reorient the portfolio for these higher interest rates. The other thing is that we manage our portfolio to participate in the widest array of market environments possible. What does it mean? It means that we don't make bets on interest rates, we try to stay pretty close to home as it relates to the duration of the benchmark. It means that we run a very broadly diversified portfolio. It is benchmark aware, meaning we know what is going on in the overall index. But, certainly not a closet index fund. I think the greatest proof statement is that roughly 30% of our short duration portfolio, for example, are in securities in sectors that are not heavily weighted in the benchmark. We always try to find where value is available.

The last thing I will tell you, we are very pleased about. We have been looking at our attribution analysis and for those that have been long time clients, or have been following us since our beginnings, we told you that we were going to generate our alpha from sector and security selection and what we found, whether in 2017 or since our inception numbers, is that the excess return we generated, and we are now above benchmark in all trailing periods for both core and limited duration quarter, year-to-date, one year, two year and since inception relative to the benchmark, that all of the attribution is coming from sector and security and the only drag of any significance on the fund are fees, and I do not see that we are going to make those go away any time soon, because we do still have to charge fees.

Overall, I wanted to provide you with a bit of a backdrop on the macroeconomic environment and, just in summary, we think that inflation is going to come back or be slow. We think that there is still some room to roam in this economic expansion because the tax change is certainly a big game changer, but we are still seeing some wage growth, and while labor markets are tight, we still have some of that slack on the sideline that can continue to keep wage inflation from getting too far out of hand. So that is a basic overview of the fixed income market and the macroeconomic market. I will turn it over to Mike to talk about the more exciting things in the stock market.

<u>Mike</u>:

Thanks Tony.

I'm still trying to get over the backhanded Baby Boomers comment. Did I somehow just get called old?

<u>Tony</u>:

Since I am not a Baby Boomer, Mike, I couldn't resist.

<u>Mike</u>:

This is a wonderful call to have. Global equity markets in 2017 were absolutely spectacular. They were wonderful. It has been a euphoric year for investors across the entire equity spectrum. It was certainly a growth year for being part of an equity market. We had sort of the best of all worlds. One is the international markets were up over 30%, the U.S. Large Cap markets were up about 20%, and U.S. Small Cap was up about 15%. But all of that wonderful return came from a period of extremely and, in fact, historically low volatility. We are now in the middle of the longest period in U.S. equity markets where we have not had at least a 3% correction. This has been a remarkably stable period. The biggest concern we have at the moment is that folks are very complacent in the market.

Complacency is beginning to set in because people are expecting high returns with frankly, bond-like volatility. As I mentioned we had a very low level of volatility last year. In terms of looking forward, the challenge we have is that this is beginning to remind us of some of the themes in 1997, '98, '99. The stocks that did the best this past year were large cap growth stocks, without saying all of the names: Tesla was up 46%, Facebook was up 53%, GOOGLE was up 33%, Microsoft was up 40%, Apple was up 50% and Amazon was up 56%. Those are some really big companies that had tremendous increases in value. Those are the names that drove the U.S. benchmarks much higher. With Small Cap only up 15%, you are beginning to get a sense of where the returns were in the stock market.

Tony:

Mike, I had a client meeting the other night; they wanted to know if they could comfortably pencil in a 15% return on a balanced portfolio for 2018. Getting to your point, Mike, they were making the same comment that it is almost getting easy to expect these returns with what we have been seeing.

Mike:

In some ways, the contrarian in us is starting to get a little nervous about what is happening here. It is just becoming too easy. While chatting with some of our high net worth clients here, we were talking about 2017 almost being the reverse capstone of the global financial crisis back in 2008. Where we have seemingly finally put to rest the worry of having another meltdown. That, of course, is exactly the time you need to at least start being worried about it.

Echoing some of Tony's thoughts about the global economic environment, we, too, see a strongly synchronized global environment. The economies around Asia, Europe, the U.S., South America and Australia are all very, very strong. They are all improving. The problem is valuations, in the U.S. at least, are reasonably high and are becoming more concerning. We think the value today is increasingly in the international space. We feel like the international equity markets are about 2-3 years behind the U.S. in terms of their recovery from the financial crisis. We see opportunity there, the economies have not grown as fast but are beginning to accelerate. We agree with Tony, we are not heading toward recession, but the economic environment in the U.S. is certainly long in the tooth at worst and there could certainly be some more length here, but we are talking about higher valuations.

The other observation I would make is that this does cap a 10-year run since 2008 and the markets are up over 300% from the bottom for the U.S. equity markets. We have had a remarkable recovery. This is mostly brought along by the really deep insight from Ben Bernanke and his handling of that crisis with quantitative easing. Certainly the rest of the world has taken his lesson and applied it, as Tony said – around Europe, and around Asia. As a result, what we are seeing is stress levels at exceptionally low levels.

We have already talked about volatility but we also measure through something we call the market stress indicator, which measures the stress levels in the financial sector. Many of the Federal Reserve banks publish their own; we do something similar. These are at historically low levels. Think about stress as the fragility of what happens in the economy. So, if there is a shock in the system, how sharply will asset prices correct if there is a negative shock. Without a lot of stress, the market can be pretty resilient. We do believe that there is a fair amount of resiliency here. Until we see stress levels increase, we will remain relatively bullish and optimistic. Corporate profitability is pretty strong. We had a great year in 2017, and we are starting to see those results from the fourth quarter right now. A lot of improvement and we expect 2018 to be another solid year. Again, unless some exogenous variable comes in and knocks the economy off a rail.

Lastly, as many of you know, we think of the market in terms of regime. We have a proprietary model that helps us understand what type of an environment we are in in a market. It does not take a rocket scientist or a regime model to tell you that we are in a bull market. Our market regime model is very solidly in the bull camp and has been. We sort of use the regime model and the stress indicator to give us some earlier warnings if things begin to seem out of whack. Right now, it is all systems go. The foot seems to be firmly planted on the accelerator. We are going full gas in terms of the market, in terms of investor psychology. We just do know that this will end, as it does each time we get this euphoric look of the world. Things are certainly as positive as they can be. We will let you know when things begin to change.

Tony:

A question really from me. Within the factors of that regime model, are there any underlying pieces of it that are showing any stresses that concern you?

Mike:

Very little. It has been a very quiet thing. The way the regime model works is we look at a number of different macroeconomic factors. Things like savings rates and GDP growth and inflation and so on. We also look at a number of market indicators. Things like yield spreads, volatility in the market and return levels in the stock market. All of those are very quiet. Same as with the stress index. It is just very quiet with little going on. There is nothing seemingly upsetting the market.

Part of what we do is we measure the behavior of different asset classes to each other. Every week we measure how U.S. equities are acting relative to international equities. It can be a sign if international equities are going in one direction and U.S. equities another. That may be because there is stress building up in the system. We do the same thing with about nine other asset classes and there remains very little stress in the system.

Tony:

Thom are there participant questions at this point?

Thom:

Are there any closing comments?

Tony:

We continue to see the markets as Mike does and that is not group think. We are just approaching this saying there are a lot of good things going on. We cannot look at a nine-year recovery as having a statute of limitations. There is no time limit on how long these things can run. It really has a lot to do with the fundamentals. I think one real big wildcard that we did not speak about on this call, due to the fact that we did not want to bring too much politics into it, is the mid-term election affect. There are a lot of folks that would want to give the President a kids phone that does not send out Tweets, but look at the economic policies that have been very positive: the rolling back of some onerous regulation, the tax policy -- these are the things that take root. As my father told me when I was a young boy, people vote with their pocketbooks, so we are very acutely interested to see what comes out of this mid-term election and how it may reshape the two years remaining for this President before the next presidential election.

The old saw is that the markets climb a world of worry and we are certainly at no shortage of things to think or worry about.

Mike, unless you have further input, we would like to thank everyone for being on the call, thank you for your business and know that we continue to work very hard for you each and every day.

Mike: Thanks very much.

Tony: Thank you everyone. Have a great day.

Asset Advisors' 2017 Year in Review & 2018 Outlook Call Concluded --