TRIAD INVESTMENT MANAGEMENT

1301 Dove Street, Suite 1080
Newport Beach, CA 92660
Tel: (949) 679-3991
www.triadim.com

4th Quarter 2018 Investment Review

"All the signs are right this time
You don't have to try so very hard
If you live in this world
You're feelin' the change of the guard"

Change of the Guard, Steely Dan

Investment Thoughts

If there seems to be a familiar ring to this Review, it's because the quote above is making a repeat appearance. Not only am I a Steely Dan fan, but the words resonate with me at this particular juncture in the investment landscape.

The biggest change in the past three months is a rather sudden, sharp decline in global stock markets. While investors could sense that markets were vulnerable, I don't think many investors anticipated, or were prepared for, the roughly 20% decline from the market peak in late September through the bottom—so far—on Christmas Eve. Merry Christmas? Let's hope for a Happy New Year, in stock market terms.

The recent declines have restored valuations to more reasonable levels. Lower prices have a way of doing that. While the broad market S&P 500 dropped 20%, many individual stocks declined far more, 30% to 50% in many cases. While it may seem counterintuitive, cheaper valuations means risks have gone down. That's right, down, not up. While we don't like the impact of market declines on client emotional wellbeing, declines do reduce valuation risks and provide buying opportunities.

Another potential benefit of a market decline is the tendency of some investors to "***throw out the baby with the bath water.***" When markets experience sudden, significant declines, investors tend to panic, and everything gets sold. The not-so-good companies go first. When further fretting and panic ensue, the better companies start getting jettisoned out of portfolios. That gets our attention.

We've been fairly busy the past month or so, looking to upgrade the quality of our portfolios by selling good businesses to buy great businesses. The fire-sales occasioned by emotional investors make this possible.

Economic Conditions

The R word—Recession—has become much more talked about lately. We haven't had a real downturn since the Great Recession and Global Financial Crisis (GFC) of 2008-2009. The economy had a significant slowdown in 2015 that was an industrial recession led by the oil industry downturn. But it didn't drag down the rest of the economy, so the bean-counters—sorry, I meant economists—who decide this stuff declared "no recession."

In any case, a recession we shall have, eventually. The current economic expansion is ten years old, and perhaps past its bedtime. It's just a matter of when. And truth be told, nobody knows when. The Federal Reserve thinks a recession is a 2020 or later event. We'll keep watching for signs of obvious weakness.

For now, the global economy keeps growing, but there are signs of strain. China is feeling the impact of trade skirmishes, especially since the Middle Kingdom has ramped up spending and debts over the past ten years to counteract the effects of the GFC. If you think the U.S. has been a big borrower, you should take a look at China. Except you won't see as much since many debts are kept hidden from public view. China needs to keep growth positive to satisfy a population that has become much richer over the past thirty years and has greater expectations. China is such a major part of the world economy now that it's important to keep an eye on developments there.

We've also been concerned about rising inflation, but not many folks share our concerns. I'm no inflation expert, but everything I buy seems to cost more today than a year ago. I guess I'll just quietly worry about inflation and wonder why my haircuts keep costing me more money.

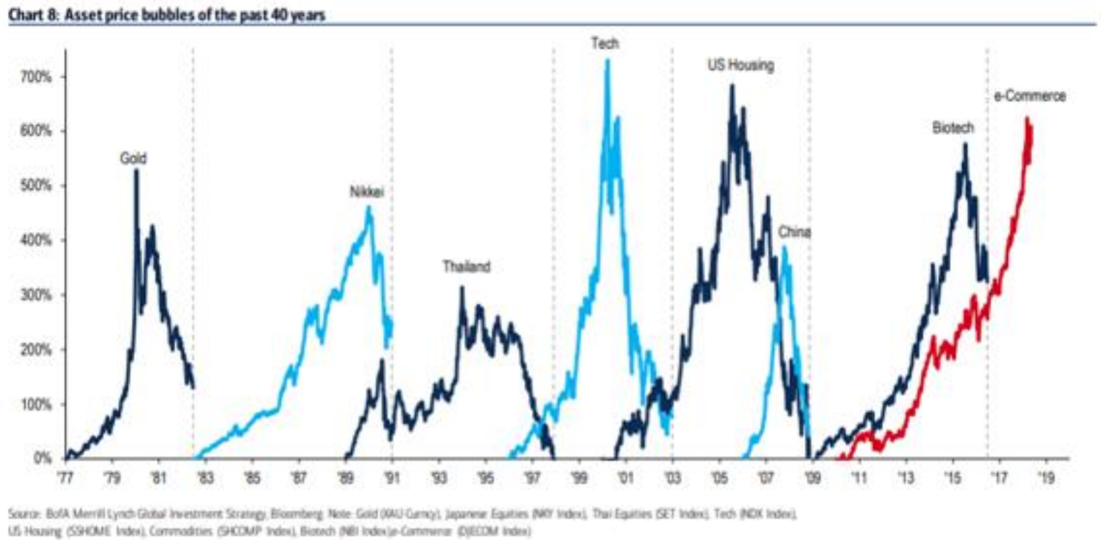
Investment Conditions

The stock market spoke loudly and clearly during the final quarter of the year. While the first nine months of the year were pretty good, the last quarter was surprisingly weak. The usual culprits are at work: recession fears, global political squabbles and economic concerns, trade policies, weakness in emerging economies, slowing growth in China, and higher U.S. interest rates.

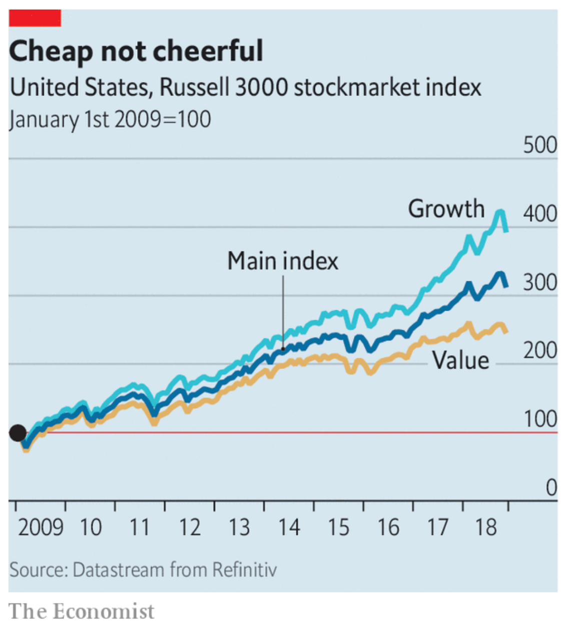
Uncertainty—which is always with us, just in varying degrees—has been elevated and reflected in stock market weakness. It's nearly impossible to predict stock market declines ahead of time. But once the market declines, the "*experts*" go on television to explain that they saw it coming, and furthermore trot out a bunch of reasons for why the market declined. Ignore them. If the market instead pushed higher, they'd have explanations for that as well.

I do think recession fears, along with higher interest rates and "Trump" fears are probably responsible for the recent stock market declines. Cyclical companies whose fortunes are tied to economic activity have been hit harder in this decline than stable demand businesses. Investor fears may be right. Or wrong. Some of these economically sensitive companies look pretty attractive to us. We've been using this period of market weakness to "***turn lemons into lemonade***" by selling some good businesses to buy great businesses that are now on sale. In fact, in the past three months we've turned over about 40% of the stock portfolio, increasing the quality of your portfolio at what we think are very attractive prices.

We've been concerned for many years that cheap money—courtesy of rock-bottom interest rates—has distorted asset values and encouraged investors to pay up for stocks, real estate, art and collectibles. In turn, turning assets of value into assets with very little value, at least to us as investors. But these things eventually turn, as do all cycles. Some of the biggest bubbles of the past 40 years are depicted in the chart below, including the current E-commerce bubble. At least in magnitude of stock price movements this one is right up there with the best (or should I say worst?), rivaling the housing bubble of 2005-2007 and the prior Technology bubble of 1995-2000:



The chart below graphically demonstrates the preference of investors for so-called "Growth" stocks over the past five years, and especially the past three years. A picture is worth a thousand words:



10/27/18

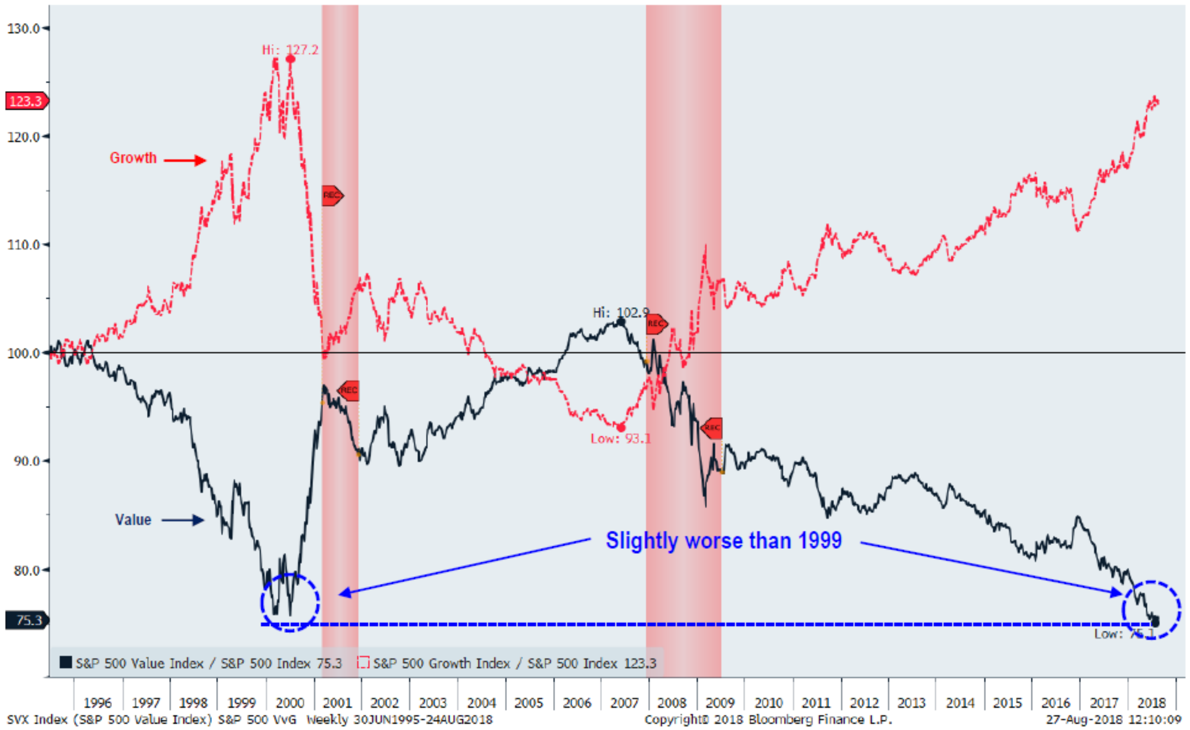
The next chart is one of my favorites, as it also illustrates the current enormous disparity between Growth and Value indices. The only other time that Value-oriented strategies underperformed so dramatically was during the late 1990's Internet/Dot-Com Bubble. We know what happened next. The bubble kept inflating as investors sold cheaply valued stocks to put more money into highly valued stocks. This went on for a number of years. At the point of maximum underperformance of Value, in late 1999, was when the Growth bubble peaked and was ready to pop. And pop it did in early 2000. Value stocks went on to rule the stock market for the next eight—yes eight!!—years.

This chart demonstrates the sobering reality that trends can continue in one direction for a long time. It also shows the difficulty of remaining disciplined and resisting the siren call and temptation to join the crowd when trends get elongated and it seems obvious that the action is where you're not. As economist John Maynard Keynes famously observed long ago: "***Markets can remain irrational longer than you can remain solvent***." Irrational markets have been with us a long time, and human nature isn't likely to change much in the next 100 years.

Many investors have made the mistake in the past to capitulate and abandon a particular strategy that isn't currently working. It's usually at the point of maximum tension when others are making a lot of money, and the temptation to join the easy money party overwhelms good sense. When relative valuations get to extreme levels, as it appears to us now, some investors start to think that "***This time is different***." Which can be the four most expensive words in the investment business.

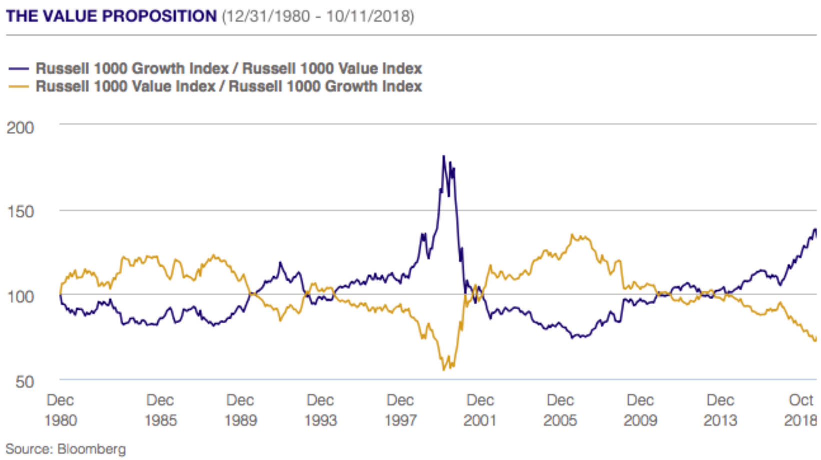
Figure: S&P 500 Growth and Value relative price performance (vs S&P 500) past 25 years

Price ratio: Style / S&P 500. Since 1995



Source: Fundstrat, Bloomberg

The final chart demonstrates the cyclicality of investment styles. Value dominated in the 1980's. Growth was the favored approach in the 1990's. After the "dot-com" bubble burst in 2000, Value came back to lead for the next eight years. Since the end of the Great Financial Crisis of 2008-2009 Growth stocks have been in charge for almost the past ten years. If history repeats itself, we should expect another change in leadership:



Though the index history is somewhat shorter, similar mean reversions can be seen over the last 22 years in the MSCI ex-US Growth and MSCI ex-USA Value Indices.

We've enclosed with this Review Value Line research reports for many of the companies that we own. For those of you not familiar, Value Line Investment Survey has been around since the 1930's and is widely recognized for independent investment advice. We use it ourselves. Take a good look at the reports. I've highlighted areas that are important to review. The bottom line is we have a portfolio that we believe is dramatically undervalued—in our opinion of course—and we won't be surprised if we experience very good results over the next few years.

Company Commentaries/Spotlight

Each quarter we highlight a few of our current holdings to help clients understand our reasons for investing in companies.

Goldman Sachs

Goldman Sachs is a global financial institution involved in helping businesses raise money via stock and bond offerings, merger and acquisition advice, trading services in fixed income, equities, currencies, and asset management services. The company has not only survived numerous financial declines, recessions and panics, but has managed each time to emerge stronger as competitors falter.

We were able to invest in Goldman due to general market fears, along with some specific concerns with Goldman's fundraising for a Malaysian investment fund. Our view is simple. Goldman will survive, and we bought the stock at a significant discount to tangible book value. We expect to be holding our Goldman shares for quite a while.

CarMax

CarMax is the largest used car retailer in the United States. You've probably seen their television commercials, and perhaps driven by one of their retail stores. We've been a fan of their no-haggle, transparent business for quite a while, and the recent market selloff has given us the opportunity to buy an above-average growth company at a below average valuation. Despite being the largest used car retailer, CarMax has around 5% market share in its target market. This means lots of room for long-term growth. We look forward to years of growth and value creation by this outstanding business.

LabCorp. Holdings

LabCorp is one of the largest operators of clinical testing labs in the United States. In addition, through acquisitions, LabCorp also operates as a Contract Research Organization (CRO), providing outsourced clinical trials and associated services to major pharmaceutical and biotech companies worldwide.

Lab tests are a critical part of the healthcare system, as lab tests are involved in roughly 70% of total healthcare spending. As healthcare continues to consume a larger portion of the national budget, tests are a relatively inexpensive way to improve outcomes and restrain spending. We were able to buy LabCorp shares at a very modest valuation and look forward to long-term growth prospects.

Let us know of any changes to your financial situation that might suggest altering your investment portfolio and if you'd like a current copy of our SEC Form ADV Part 2.

We encourage your questions and comments. As always, ***your*** LOYALTY and PATIENCE remain our secret weapons. We remain diligent, disciplined, and optimistic.

We continue to eat our own cooking, which means investing alongside clients in the same securities—yes, even those that haven't necessarily gone up. It's the right way to operate.

Sincerely,

John

John Heldman, CFA
January 22, 2019

"Many shall be restored that are now fallen and many shall fall that are now in honor." **Horace**

"Always do right. This will gratify some people, and astonish the rest." **Mark Twain**

Past performance does not guarantee future results. Results are presented net of fees and include the reinvestment of all income. The opinions expressed herein are those of Triad Investment Management, LLC and are subject to change without notice. Consider the investment objectives, risks and expenses before investing. The information in this presentation should not be considered as a recommendation to buy or sell any particular security and should not be considered as investment advice of any kind. You should not assume that any securities discussed in this report are or will be profitable, or that recommendations we make in the future will be profitable or equal the performance of any securities discussed in this presentation. The report is based on data obtained from sources believed to be reliable but is not guaranteed as being accurate and does not purport to be a complete summary of the available data. Recommendations for the past twelve months are available upon request. In addition to clients, partners and employees or their family members may have a position in any securities mentioned herein.

Triad Investment Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®). Triad has been independently verified by ACA Compliance Group for the period from the strategy's inception, April 30, 2008, through September 30, 2017. Triad has been subsequently independently verified by Alpha Performance Verification Services from October 1, 2017 through December 31, 2018. Triad is an SEC-registered investment adviser. The composite includes all fully discretionary separately managed accounts that follow the firm's Concentrated All-Cap Equity investment strategy, including those accounts no longer with the firm. Triad's strategy is to invest in a concentrated portfolio (usually holding 20 to 30 securities) of common stocks, unrestricted as to market capitalization, of both domestic and international companies. The U.S. Dollar is the currency used to express performance. Past performance is not a guarantee of future results, and there is a risk of loss in investing in equities. Results are presented net of fees and include the reinvestment of all income. Investments made by Triad for its clients differ significantly in comparison to the referenced indexes in terms of security holdings, industry weightings, and asset allocations. Accordingly, investment results and volatility will differ from those of the benchmarks. As of June 30, 2013, the Triad Equity Composite was renamed the Concentrated All-Cap Equity Composite. For more information or for a copy of the firm's fully compliant presentation and the firm's list of composite descriptions, please contact us at (949) 679-3991.

%	4Q18	YTD	1 Year	3 Year	5 Year	Inception*
Concentrated All-Cap Equity Composite	(25.8)	(18.4)	(18.4)	(2.6)	(5.7)	3.6
S&P 500 Index	(13.5)	(4.4)	(4.4)	9.3	8.5	8.0

As of December 31, 2018. Periods over one year are annualized. Results presented net of management fees.
*Inception date April 30, 2008