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

2nd Quarter 2019 Investment Review

"C'est la vie", say the old folks, it goes to show you never can tell

Chuck Berry (1924-2017), *You Never Can Tell*

Investment Thoughts

Yes, sometimes you never can tell. For instance, early last year, the Federal Reserve Board was continuing to raise interest rates, and pundits opined that more rate hikes were coming in 2019. Then, after the last hike in December 2018, markets threw a temper tantrum—led by El Presidente Trump—and the Fed began to rethink its position. Economic data showed some softening in activity, and now it appears the Fed may start reducing interest rates at the next meeting in late July. Confused? Good, you're not alone.

We have no special insight into the prospects for a recession in the next six to twelve months. It's not a special inability that we hold. The vast majority of investors have no idea when a recession will hit. It's possible we've already entered a recession. The economy officially hasn't been in recession since the Great Recession of 2008-09, so we're ten years into this long recovery. We're probably due, even overdue, based on historical patterns of recession on average every 4 to 5 years. On the other hand, the "recovery" we've had over the past 10 years has been lackluster by historical standards. Therefore, the optimists hope, perhaps the imbalances that typically occur from too much borrowing, spending and investment—the party—that historically leads to a hangover, just aren't present yet.

It's not a bad argument. Technology advances and "just-in-time" inventory management methods have helped to smooth business cycles. So maybe the four most dangerous words in finance, "*It's Different This Time*" don't apply? Maybe we'll never have another recession? Maybe the Central Banks of the world have figured out how to engineer a smooth trajectory for economies to grow forever without any negative consequences? Maybe the Easter Bunny will finally show up one year. Yeah, not likely.

So sometimes you never can tell. The Fed has hundreds of Ph.D. economists, statisticians and so forth. With all that firepower, the Fed is still playing a guessing game on the direction of the economy. Their guesses are better than yours or mine, but they're still guesses. For us, it's time to be cautious, as easy-money policies have bid up prices for stocks, real estate, private equity, government bonds, junk bonds, art, vintage cars, etc. The world is awash in cash. When something is freely available, people tend to use it more indiscriminately. We're attempting to navigate this environment by staying focused on downside risk for common stocks, and also maintaining fairly short-term bond maturities. If we don't find reasonable opportunities, we're perfectly happy to let cash reserves build up, since we can actually earn a modest return now compared to zero yield a few years ago.

Economic Conditions

As noted above, the economy hasn't experienced a recession for 10 years. But more signs are pointing to at least a slowdown, if not an outright recession. Our trade spat with China isn't helping, as soft Chinese demand is affecting our farmers, manufacturers and some technology suppliers. China has feasted on government and private debt for the past 10 years to drive its economy, and the debt levels are so high that a major slowdown could be under way. In the past this wouldn't have been an issue for the U.S. But China is such a big player in the global economy that any decline there will have an impact here.

Of course, there are other concerns. President Trump is engaging in a game of "chicken" with Iran in his attempt to restrain Iranian nuclear ambitions. Iran is reacting in a predictable manner to avoid further economic hardship. Europe, the land of $13 Trillion of negative yielding bonds, struggles to grow, and is dealing with Brexit as well. U.S. budget deficits fuel increased spending in the short-term but at what cost to our long-term financial condition? U.S. budget deficit exceeds $1 trillion per year and is clearly unsustainable. The piper, it would seem, is going to need to be paid. Otherwise, as in the fairy tale, the kids—our future generations—will be lost.

Investment Conditions

I read an article in Barron's last month titled "***Value Stocks Are Cheaper Than They've Ever Been***." I thought to myself, "*They must be looking at our portfolio*." The article quotes the chief equity strategist for a rather large U.S. bank who proclaimed in a June 17 article:

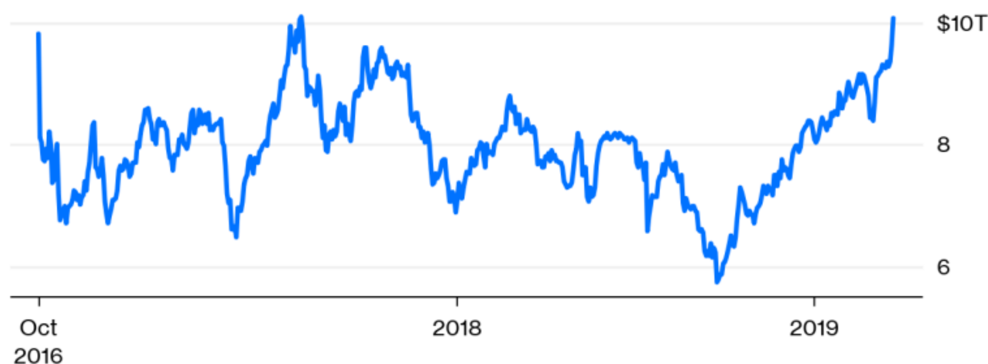
> "*Despite intermittent reversal rallies (2009, 2012-13, 2016), value is currently trading at the biggest discount ever and offers the largest premium over the past 30 years*."

That's a pretty bold statement. It also happens to align with our thinking on the subject. We see lots of very highly valued investments, including stocks and bonds. But at the same time, we see very reasonably priced investments, mostly in common stocks. The high-growth, not-making-any-money stories are very popular right now. Why? Because they're growing revenues, despite losing buckets of money in many cases. As economist Herbert Stein once opined, "*if something cannot go on forever, it will stop*."

While one group of investors seek rapid growth, another group is concerned with safety and security. Call it the stock market equivalent of Linus Van Pelt's security blanket. You remember Linus, Charlie Brown's best friend? Always holding his security blanket. And sucking his thumb. Well, in the stock market we have another group of investors who want to participate, and would like a little income to boot, but just don't want the insecurity of a nasty decline should a recession or some other calamity hit the market. Which is a perfectly reasonable goal. So, these investors have loaded up on "security blanket" stocks: Healthcare, Consumer Staples, Utilities; anything that's perceived to be "safe" and pays a dividend.

The irony is this rush to one side of the boat by a large number of "safety first" investors has pushed up the valuations of what were relatively safe investments, in the process creating highly valued, riskier investments. Utility stocks, for example. Historically they've been valued at a discount to the overall market since they're mature, regulated businesses. But in today's upside-down investment world, utilities have been trading at a premium to the market. It's the classic example of a good idea driven too far. Just my opinion.

The fuel for much of this behavior is supplied by low interest rates. Low rates are like a magic elixir, slowly dulling the senses and inuring the mind to the risks that abound. Europe has taken low interest rates to a new level, with around $13 trillion—yes trillion, one thousand billion—of bonds trading in Europe right this minute priced to yield less than zero. You're guaranteed to lose money if you hold the bonds to maturity. You'd be better off sticking your money under the mattress. And this is before factoring inflation into the equation. After inflation it's even worse. Why would investors knowingly accept an upfront loss on an investment? Good question. Fear? Yes. A lack of alternatives? Yes. Too much money floating around in the financial system? Yes. It's a $13 trillion puzzle. Whatever the reason, it doesn't seem to indicate a "normal" economic environment. Just my opinion.



Low interest rates continue to make our job challenging in finding income producing investments such as corporate or municipal bonds. Municipal bonds are very pricey. Ten-year municipals yield around 2%. A twenty-year muni gets you 3% yields. Corporate investment grade bonds offer only a little better income at around 4-5%, but that's taxable. We have owned some non-investment grade corporate bonds as yields are higher at 6-7%, but we're keeping the maturities very short and watching them closely, as the economic cycle gets longer in the tooth. We've also found reasonable levels of income in selected REITS, BDCs and LPs focused on corporate loans, commercial and residential property, and infrastructure assets. We'd welcome a higher level of interest rates as it might dampen speculation in high growth stocks and safety stocks, while providing more income-oriented opportunities. But it's out of our hands, so we just have to be patient and wait. The opportunities have a way of showing up when you least expect them.

While we've had a strong rebound in the first six months of 2019, we're just recovering from last year's decline. We're still disappointed that many of our common stocks behave like wallflowers at the high school dance. In fact, large chunks of the stock market seem to be ignored by investors. Partly it's due to investor fears about a recession, as many economically-sensitive stocks have declined in price since September 2018. The good news is even if a recession is imminent, we may have already absorbed the stock price impact in anticipation of the actual event. It's common for the stock market to lead the real economy. As Warren Buffett has remarked, "*Be fearful when others are greedy, and be greedy when others are fearful.*" I'd add that some pockets of the

stock market exhibit greed. We're avoiding these areas. Other sectors offer good value where investors are fearful about the impact of recession on those companies who depend on a stronger economy for better results. The bargains in the feared areas seem more attractive to us.

Company Commentaries/Spotlight

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

Discovery Inc.

Discovery operates one of the largest collections of global cable television channels, including Discovery, HGTV, Food Network, TLC, Animal Planet, Travel, History Channel, Oprah Winfrey Network and many others. The company reaches 4 billion viewers in over 220 countries and 50 languages. Discovery gets revenues roughly equally from affiliate fees paid by cable operators along with selling advertising on its channels. Discovery is also unique among cable programmers in that around 50% of revenues are from international markets, with lots of future opportunities outside the U.S. Discovery mostly owns its content, rather than licensing as many competitors do. Ownership allows Discovery to control costs and distribution options. Discovery also benefits from its programming having universal appeal, and "evergreen" characteristics that create a long shelf life, similar to Disney's classic animated films.

Discovery bought Scripps Networks last year for around $15 billion, adding more channels to create greater bargaining leverage with cable operators, and expand HGTV and the Food Network around the world. Cost-cutting over the next few years should add meaningful income to the bottom line while improved cashflow is helping to rapidly pay down the debt taken on in the Scripps purchase. Discovery is also experimenting with direct to consumer offerings as competition grows from Netflix, Apple, YouTube, Disney and others. We think the company has enough appealing content, diversity of channels and geographic reach to grow successfully over the long-term. While it's never a factor in our analysis, we wouldn't be surprised if one of the larger players offers to acquire Discovery in the next few years.

Knight-Swift Transportation

Knight-Swift is the largest provider of truckload services in the United States. The company was founded in 1990 by four cousins and is still controlled and managed by some of the original founders, who remain sizable investors. We like the cost-conscious, customer-focused culture that allows Knight to thrive in a very cutthroat business with thousands of competitors. Although one of the largest players in the trucking business, Knight has single-digit market share and has lots of room to grow in a very large U.S. trucking market. With their proven ability to operate more efficiently than almost all competitors we see the company growing for many years as customers consolidate their business with cost-efficient providers.

Mohawk Industries

Mohawk is the largest flooring manufacturer in the world with market leading positions in every category including carpet, ceramic tile, laminate, wood, stone, vinyl flooring and countertops. The company has a strong international presence with 25,000+ customers in over 170 countries. Sales are 60% from the U.S., 25% from Europe and the balance from the rest of the world. Since present management—which owns a 14% stake worth over $1

billion—took over in 1992 the company has grown aggressively through 44 acquisitions, and we'd anticipate more over the coming years. While flooring is a mature industry in the U.S. it's an attractive growth area in many developing economies throughout the world.

What all three of these companies have in common is this: they are either the ***global leader*** in their industry or one of a small number of leaders. We like to invest in businesses where the companies control their destiny through market leadership. In addition, the ***management teams own a significant amount of common stock***. We like to see "***skin in the game***" when it's time to invest. We prefer "owners" to "agents." Lastly, they have a ***long runway of future growth*** in their businesses.

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 Heldman, CFA
July 15, 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 June 30, 2019. 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.

%	2Q19	YTD	1 Year	3 Year	5 Year	Inception*
Concentrated All-Cap Equity Composite	5.30	18.68	(8.82)	3.38	(4.01)	5.06
S&P 500 Index	4.30	18.54	10.51	15.38	10.71	9.30
Russell 3000	4.10	18.71	9.06	15.25	10.21	9.32

As of June 30, 2019. Periods over one year are annualized. Results presented net of management fees.
*Inception date April 30, 2008

The Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Russell 3000 Index is a market-capitalization-weighted equity index maintained by the Financial Times Stock Exchange Group (FTSE) that provides exposure to the entire U.S. stock market. The index tracks the performance of the 3,000 largest U.S.-traded stocks which represent about 98% of all U.S incorporated equity securities. All indices are unmanaged and may not be invested into directly.