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**4th Quarter 2019 Investment Review**

**"*All I want to know is where I'm going to die so I'll never go there*"** **Charlie Munger, Vice-Chairman, Berkshire Hathaway**

***"Where equities are quite fully valued, credit is pretty expensive, sovereign bonds are expensive, private equity is really, really expensive, maybe the only thing I can go buy is value—with the enormous caveat that it's very important that I have absolutely no clients at all."***

***Inigo Fraser Jenkins, S. Bernstein Head of Global Quantitative Strategies, quoted in Bloomberg***

## Investment Thoughts

The investment world continues its remarkable upward progress, with apparently no clouds on the horizon. Stock markets, bond markets, real estate markets, art markets; you name it and it was up, up and away last year. Chalk it up to a resilient U.S. economy, extremely low interest rates, off-the-charts government budget deficit spending, corporate tax cuts, and a willingness by investors to believe that nothing on the short-term horizon is going to upset the apple cart.

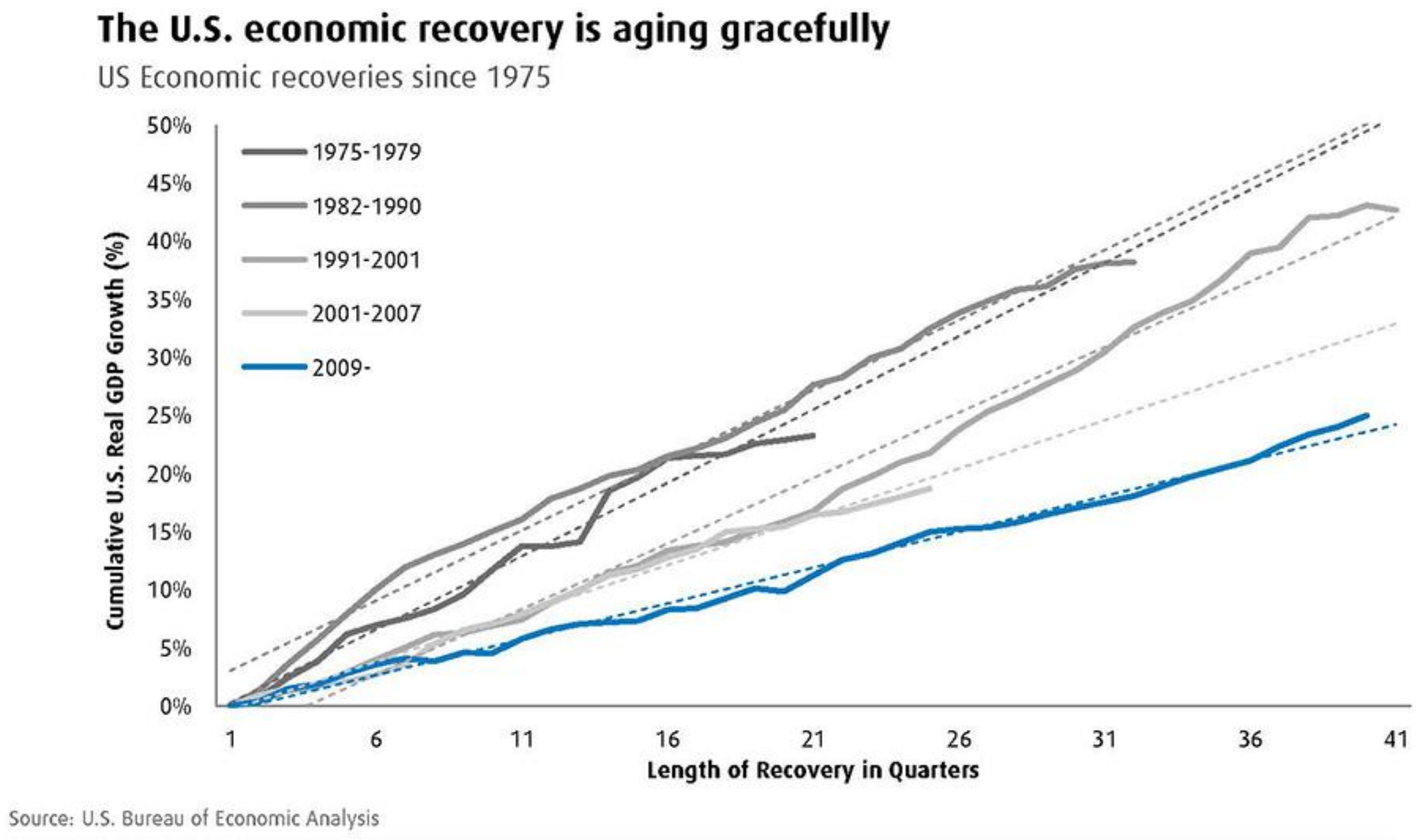
How long can this continue? We don't know. Neither does anyone else. We can make guesses, but that's really all they are, guesses. Taking a cue from the quote above, just tell us when the economy and stock market are headed south, and we'll adjust accordingly. But the reality is we usually can't know for sure, or even with enough conviction to warrant taking action. We usually don't know the timing of a market downturn or the magnitude—making major changes when the outlook is muddy isn't usually constructive.

If the economy continues to grow, and if interest rates don't rise appreciably, and if investors don't get spooked by some global catastrophe, then perhaps things can continue to roll along. That's a lot of ifs. Usually, some unexpected event comes to the forefront and we get a change in direction. As the saying goes, you can't predict, but you can prepare. That's what we aim to do.

Investors always want to know when the party will end, so that they can, in effect, "***never go there***." Unfortunately, as Charlie Munger might acknowledge, life—and the stock market—just doesn't work that way.

## Economic Conditions

The economy continues to defy conventional wisdom, which suggests we're long overdue for a recession, judging by past economic cycles. But here we are, in year ten of our "recovery", and most indicators say no recession on the immediate horizon. The longer we go without, the greater the odds should be of an impending recession. But that's just common sense. As noted in the chart below, this recovery has been weak by historical standards:



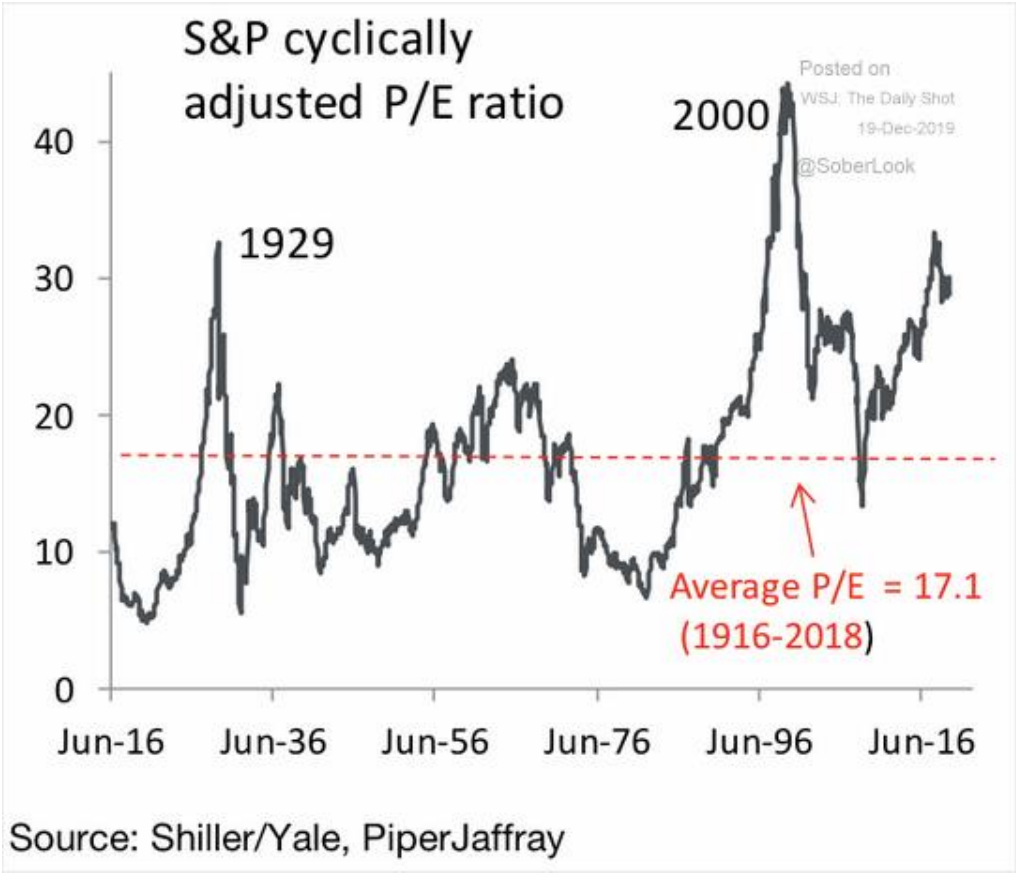

The dark blue line is our current economic trajectory from the point of growth, way back in 2009. As can be seen, cumulative growth so far has been lackluster. This is negative as a lot of growth hasn't happened, depriving the country of higher levels of wages, consumption and wealth. The positive news is the normal excesses that eventually build up in a long expansion, such as overinvestment in housing, autos, business capital equipment, etc. aren't as apparent during this cycle. So maybe we just continue with subpar growth without a deep recession. That wouldn't be the worst outcome.

Recessions typically start after a long period of growth, when demand outstrips supply, causing inflationary pressures. The Fed raises rates to cool things off and preempt inflation. The rate increases often lead to a recession. But now inflation is so weak, according to the Fed, that they're actively trying to raise inflation via monetary stimulus. I guess we can throw out our economics textbooks, which would have predicted rising inflation at this point in the business cycle.

## Investment Conditions

At the risk of sounding like a broken record—for younger folks, that's repeating the same sound over and over—we haven't seen much change in the investment landscape. Yes, the stock market has recovered from the big selloff in late 2018, and last year was a pretty good year overall. But the same forces are at work. Large, technology-focused businesses continue to hog the investment limelight, to the exclusion of many other investments. This despite the political/regulatory apparatus cranking up for heightened scrutiny and increased regulations for Facebook, Google, Apple, Amazon, etc. Technology investors apparently believe the regulators won't get their act together anytime soon, and if they do, it won't amount to much. Perhaps. Increasing scrutiny combined with high valuations would seem to suggest caution. But the partygoers are still partying.

Overall stock market valuations remain high, especially since last year's runup. The Triad broken record has shown this exhibit before, but since it's still relevant, we feel compelled to keep it front and center:



As we've pointed out a multitude of times over the past few years, you'd have to go back to good ol' 1929—the end of the "Roaring Twenties"—or the year 2000—the end of the "Roaring Nineties"—to find similar periods of high stock market valuations. The chart on the previous page depicts the cyclically adjusted price to earnings ratio of the stock market over the past 100 or so years. While the numbers say high, at 30X earnings versus 17X average, the market could go higher still, approaching "dot-com" levels of insanity. We just don't know. It's also possible the market will continue to trade at high valuations for a long period of time. After all, as the thinking goes, inflation is nonexistent, and correspondingly interest rates are at rock-bottom levels. That provides significant valuation support for the stock market. However, the counterargument is rates are low because growth is subpar, and low expected growth should result in lower valuations, all else being equal.

Regardless, our mission, as always, is to figure out how to operate in the given environment. We know that historically the lower the valuation when making an initial investment, the better the returns over the long run. That bit of historical wisdom has been turned on its head over the past five years or so. But over very long time periods, valuation is like gravity. Eventually it's going to have an impact. The connection between starting valuation, and subsequent return, is amply demonstrated below:

The chart on the preceding page requires explanation. The black line traces the price to book value ratio of the S&P 500. Book value is like net worth. Right now, the ratio is saying investors are willing to pay around 3.5 times the net worth of corporate America. Expensive. When investors are despondent, such as 2008-09, investors pushed down stock prices, and the ratio dropped to about 1.5 times net worth. Cheaper. Conversely, in giddy times such as the late 1990's, investors were willing to pay 4.5-5 times net worth. Ridiculously expensive. Unsustainably expensive, it would prove to be. Today we're closer to giddy than despondent, at least in stock market valuations. Bargains are few and far between.

The blue line demonstrates subsequent 10-year stock market returns, based upon the starting valuation. That's the blue numbers on the right side of the chart. Note that the numbers are inverted—negative numbers at the very top, getting larger as you descend. The lower the valuation, as shown on the left side of the chart, the higher the subsequent return, as shown by the right side of the chart. Makes sense to me.

At the stock market's bottom in 2009, the outlook for the next 10 years was around 15% per year, close to actual experience. If we look at the late 1990's dot-com bubble extreme, the projected returns for the next 10 years were around "***negative three percent per year.*** Again, pretty close to the actual outcome. Today, it's not quite so dire. According to this methodology, we're in for positive, but subdued 4%-5% annual stock market returns over the next 10 years. Not great, not horrible. But below the long-term 10% historical stock market average.

So again, our big question is, what do we do, given today's environment? Do we join the momentum crowd and buy Amazon, Netflix, Google, Facebook, Apple, Alibaba, Beyond Meat, Twitter, Uber, Peloton, Carvana, Lyft, Snap, Tesla, Workday, Tilray, on and on and on? There's lots of fast-growing, sexy stuff out there to invest in.

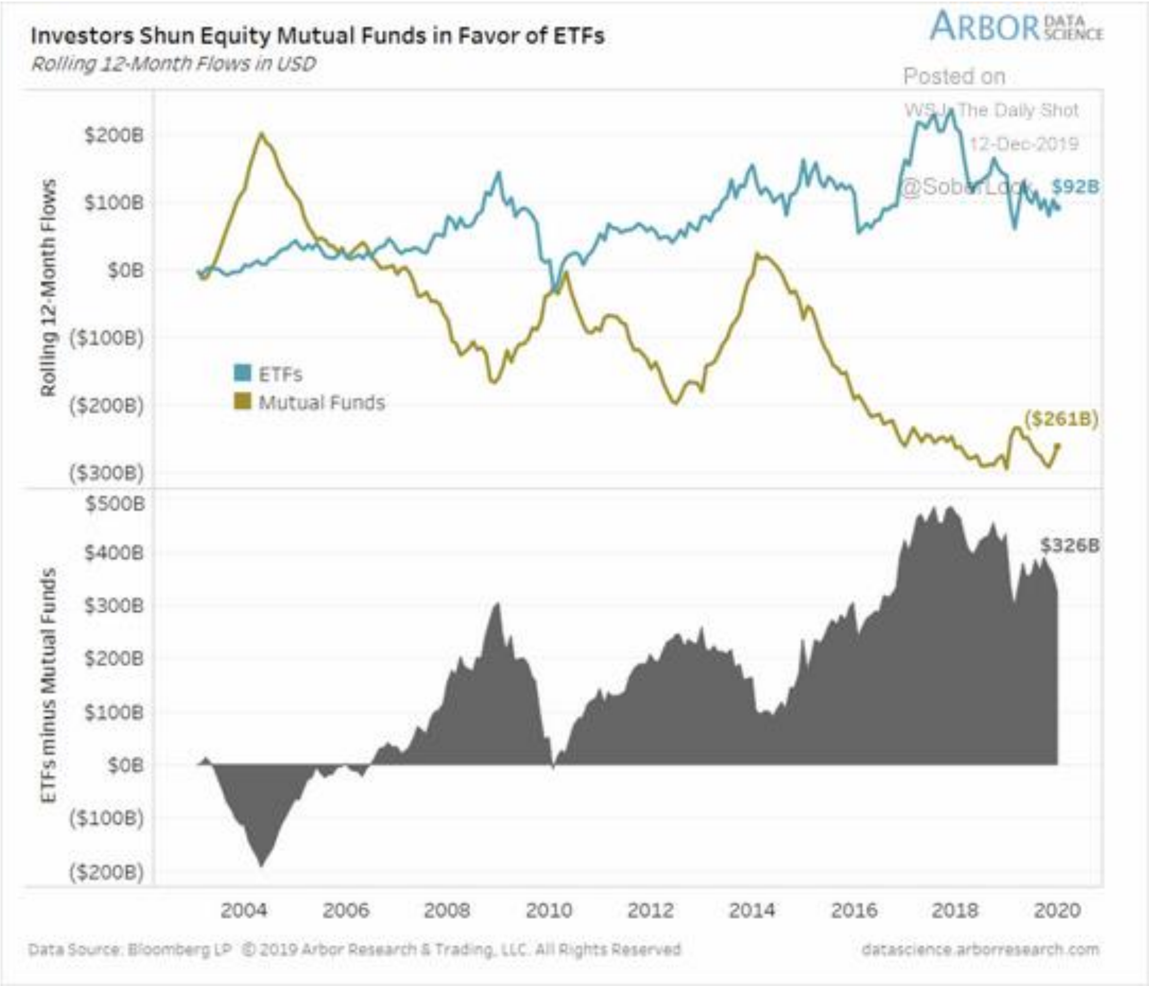
Our problem is twofold. First, in some cases we're not sure about the long-term prospects for some of these businesses. We'd put Beyond Meat, Carvana, Tilray, and many others, in this camp. Second, for established businesses we understand and admire, such as Google and Amazon, we can't quite justify the valuations right now. Some people might call it the "*old fuddy-duddy*" problem. We could be accused of not adapting fast enough to this new world. Perhaps so. We think about that often. It can be tempting to respond to the siren song calling us to another shore. Despite the almost straight-up market advance of the past ten years, we still believe markets are cyclical, and we'll get another opportunity to invest in great businesses during the next general market downturn.

As the chart on page 4 demonstrates, we believe there remains a strong connection between what you pay for an investment and resulting investment returns. We further believe that we own a collection of businesses with very modest valuations. That modest valuation doesn't guarantee anything, but if history offers guidance, we could have very respectable returns over the next 10 years, despite what we believe is today's below average return potential of the broader stock market.

One of the defining features of today's stock market is the bifurcation— a big word that means separating into two parts—between certain market segments and others. I've already mentioned the large technology companies. They're a subset of what's known as "***Momentum***" stocks. Many investors invest in stocks after they've gone up. No further analysis needed. It's gone up? Buy me some! Even large investment management organizations and many hedge funds behave this way. Many momentum stocks are known as "hedge fund hotels" because so many hedge funds are simultaneously invested in these stocks.

Crowding into momentum stocks is somewhat of a zero-sum game. If a large number of stock market investors choose this approach, guess what? The funds usually have to come from somewhere else. And anti-momentum is where the source of momentum money often comes from. What's anti-momentum? Generally, any company not growing rapidly is a potential source of funds to feed the momentum habit.

What's added more kerosene to the momentum game bonfire is the rise of passive investing, via index mutual funds, and especially passive Exchange Traded Funds, also known as ETFs. The key difference is ETFs, unlike mutual funds, are traded on the stock exchanges all day long, just like stocks. And boy, do these funds get traded. Combine the ability to invest in a large pool of stocks quickly—and cheaply now that commission rates are at zero—and you've got the makings of a bona-fide bonfire. It'll work, until it doesn't work. The chart below shows the inflows into ETFs funded in some part by redemptions of mutual funds:



Passive index funds or ETFs are just what the name implies. Passive. Just buy 500, 1,000 or 3,000 stocks and put them in a vehicle called an ETF, and you can trade this bunch of companies all day long. You don't need to know a thing about these businesses. What could be simpler?

The strange thing about this momentum investing is, the better it performs, the more money that gets thrown at it. Remember, momentum investing feeds off of momentum. If there is lots of stock market upward momentum, momentum investors will invest even more. Regardless of valuations. That additional investment usually leads to further stock price increases. Which then leads to more money being poured into momentum stocks.

Does that sound like an inflating bubble, that might burst one day? Yes, it does. Has that bubble burst? No, it hasn't. Will it burst? Probably. When will it burst? That's the big question. We've seen this movie before, and it's usually been a very sad ending.

We have nothing against growth companies. Or even companies displaying good price momentum. We like both. We just don't want the high valuations that often accompany these investments. We want growth, but we want growth available at reasonable valuations. Our holdings sell at reasonable valuations, and therefore get labeled as "value" stocks. Which almost seems to be a dirty word these days. Value stocks have played second fiddle to growth stocks for much of the past ten years, as this chart demonstrates:

Despite the challenging investment environment that we've been dealing with, and the subpar future prospects we see for the broader stock market, we're optimistic about the long-term prospects for many of our holdings. We do have a few underperformers that we get asked about, and we're monitoring their progress. Or lack of progress. We don't have infinite patience, despite history demonstrating that sticking with underperformers can at times result in good long-term performance. The trick is to know when it's time for more patience, and when it's time to move on.

## Company Commentaries/Spotlight

Each quarter we highlight a few of our current holdings to help clients understand our reasons for investing in companies. We generally prefer understandable businesses with high market shares, capable owner-operator managers with large stock ownership, available at sensible valuations.

## Borg Warner

Borg Warner is in the business of propulsion, specifically transmissions, clutches, torque converters and turbochargers for cars, trucks, buses, etc. BW customers include all the major car manufacturers, including Ford, Volkswagen, General Motors, etc. Increasing demands for safer, more fuel-efficient, lower-emissions vehicles promises to turbocharge demand for BW's products over the next 3-5 years. BW products are premium, branded components with a long history of quality, innovation and reliability. The company is already transitioning its products to serve the growing market for hybrid and fully electric vehicles. In addition, demands for better fuel efficiency and lower emissions from internal combustion engines means higher demand for more sophisticated BW products. Global expansion of car and truck sales also provides further growth opportunities.

BW provides a complete package of propulsion components to demanding, highly sophisticated customers. Once approved by car manufacturers, the company typically enjoys multiple years of production revenues from these customers. Competition is fairly limited, as the expertise, reputation and manufacturing commitment are significant barriers to competitive entry. BW has significant visibility into revenues over the next 3-5 years as its customers are now designing future models utilizing BW components. We appreciate the internal focus on cost efficiency and high returns on capital. We anticipate higher sales and earnings over our 3-5 year time horizon. Shares currently sell at a meaningful discount to an expensive market.

## Brookfield Properties REIT

Brookfield is a real estate investment trust—REIT for short—that invests primarily in commercial office buildings, retail shopping malls, and other real estate. The company is a bit unusual in being a hybrid with roughly 40% of operating income from office properties and 40% from retail, with the balance from other real estate. Nevertheless, the focus is on owning high demand, quality assets in growing space-constrained locations. BPR excels at buying properties with an eye toward improvements through redevelopment and operating enhancements. Once a property is fully optimized BPR will often sell portions or all of an investment at higher valuations, recycling the funds into new, higher return opportunities.

The shares have been depressed given investor fixation on current retail industry bankruptcies and challenges brought on by online shopping. BPR believes, as do we, that quality retail shops in desirable locations have a bright future. Management has underscored its confidence in the business and investment attractiveness by repurchasing $500 million of shares in 2019. With a high and sustainable 7% dividend yield, strong owner-operator management and significant development opportunities over the next 3-5 years, we're very comfortable holding these shares over the long run.

What both of these companies have in common is this: they are among the ***leaders*** in their industries.  We like to invest in businesses where the companies control their destiny by virtue of their significant market share.  In addition, we like ***management teams that own a personally 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
January 14, 2020

***"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 September 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.

| % | **4Q19** | **YTD** | **1 Year** | **3 Year** | **5 Year** | **Inception*** |
|---|---|---|---|---|---|---|
| **Concentrated All-Cap Equity Composite** | 8.09 | 22.52 | 22.52 | 1.01 | (2.15) | 5.12 |
| **S&P 500 Index** | 9.07 | 31.49 | 31.49 | 15.32 | 11.72 | 9.85 |

As of December 31, 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. All indices are unmanaged and may not be invested into directly.