Songbird Capital Research

2018 Yearend and Q1 2019 Letter and Market Commentary

Songbird Performance Review

2018 was a tough and unusual year for investors. It was the year when US corporations had record earnings, yet the market had spiked on volatilities and nose dive to bear market territory in the 4th quarter as the uncertainties appeared. Both US – China trade talks and Fed policy shook market confidence. It took patience and discipline for Songbird to stay on course and focus on the driving factors that could influence market in near and medium terms. Songbird held on to its core positions, while buying into several investments at deep discount at yearend.

Global financial market rebounded strongly in the 1st quarter of 2019. Songbird took the opportunity to rebalance its clients' portfolios by reducing US equity exposure during the rally and diversifying into other asset classes. Songbird delivered a strong performance so far in 2019 despite reducing equity risk by 25% on average across portfolios.

Portfolio and Market Review

In 2018 almost all asset classes except money market funds and private real estate investments had negative returns. Songbird clients' portfolios held up well in the first 9 months, up 3.6% and were positive in the mid November 2018. In the fourth quarter, US equities started tumbling as US-China trade talks created uncertainties for the world economy. Rising costs due to barriers of trade eventually would impact profitability of US companies as 50% S&P 500 companies' revenue come from overseas. US markets reacted and started pricing in the risk that the US tough stance on trade could backfire and lead world economy into unchartered territory with unintended consequences.

At the end of December 2018, Songbird took a contrarian approach and bought into investments that we believe were oversold with clear catalysts on the upside or were sectors that had solid fundamentals but were undervalued in the past few years. Following the global events closely during my research trips in the US and to Asia in the fourth quarter, I found that the cross currents of global events and economic policies were causing confusion, uneasiness and even panic among global investors. Songbird believes that in the near term there are three key factors influencing investors' confidence and sentiments, however, these in turn affect the market: **1) Trade talk; 2) US Fed policy; and 3) US corporate earnings.**

Trade has long term implications on the global cost structure, but trade deals usually take years to negotiate so to have any meaningful near-term results is a long shot. In the short term, its damaging effect can be felt by certain sectors and potentially economy at a large due to uncertainties. China has been undergoing structural reform by implementing tougher regulations and tighter credit policy since 2017, and these factors have already had a slowing impact on Chinese growth. Together with the trade war and they impeded on Chinese growth. The 4th quarter, China adjusted its policy and initiated fiscal stimulus to halt the slowdown. Several China experts expect that the new policy will take several months to have any effect, but we might see China's growth bottoming by the end of 1st quarter of 2019.

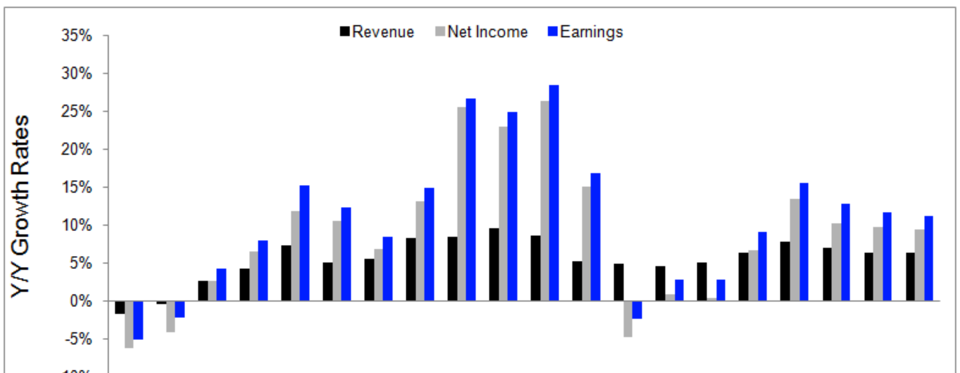
The interest rate policy as dictated by the Fed has been the "guiding hand" for global markets since the financial crisis. Fed's unconventional approach during the crisis averted further deepening of the crisis at the time and propelled US economy forward thereafter. In December of 2018, the Fed's strong stance and language on interest rate hikes and quantitative tightening rattled the market. The already fragile confidence of investors finally caved in, propelling further drop in US equities in the last two weeks of December. Since then, the Fed has changed its tone and kept the interest rate unchanged. In the short term, the Fed can be a stabilizer for the market. The current low interest rate could reduce the effectiveness of rate cut from the Fed, however, as a tool for handling the future crisis.

US corporate earnings: US corporations had record earnings in 2018 fueled by the tax cut. Although earnings are a positive factor in the short term, but also indicate that the future earnings will be on the declining path. Certain segments of markets will overheat because of low interest rates and the growth in private lending to small companies could trigger the next crisis. All these forces can create headwinds for US equities and overall economy.

The recent bear market is unusual, and ironically occurred during the record earnings reported by the US companies. Historically non-recession related bear markets usually recover within 6 months. Fortunately, US equity market almost bounced back to the September high in the past three and a half months. Investors could face a more difficult time in the next down turn because the recovery road could be long and winding.

<u>The fourth quarter of 2018 was a wake-up call to think about adjust asset allocation, not just about measuring risk but pricing risk properly within an asset allocation framework for the coming years.</u>

S&P 500 Revenue, Net Income and Earnings Growth



	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	8.6%	5.1%	4.9%	4.6%	5.0%	6.4%	7.8%	7.0%	6.4%	6.3%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	26.3%	15.0%	-4.8%	0.9%	0.4%	6.6%	13.4%	10.3%	9.8%	9.3%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	28.4%	16.9%	-2.3%	2.8%	2.7%	9.0%	15.6%	12.7%	11.7%	11.1%

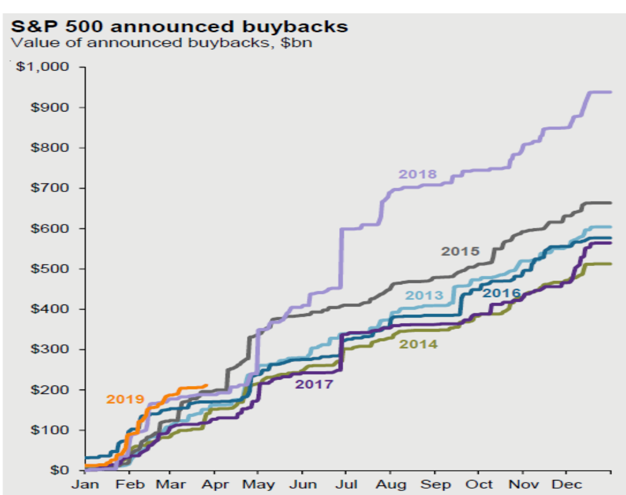
Sources: I/B/E/S data from Refinitiv

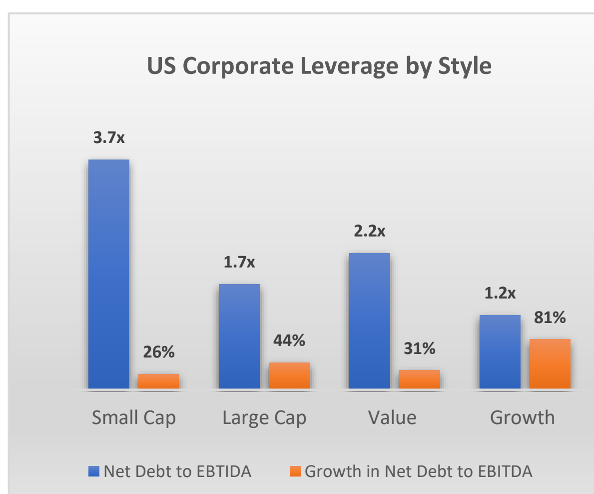
Record Stock Buybacks and Corporate Leverage

US corporations experienced record earnings in 2018 fueled by the tax cut. Instead of increasing capital spending, S&P 500 companies relentlessly bought back $1 trillion worth of their own stocks in 2018, which totaled 70% more than in 2017. This tells us that the tax cut for US corporations did not lead to greater spending and investments by companies as the tax cut was designed to accomplish. You can't simply blame these corporations. With all the cash on hand, they didn't see long-term investments other than their own stocks in the low growth, late in cycle and an environment with geopolitical uncertainties. Several warning signs of late stage of cycle with tight labor market and inverted yield curve call corporate executives to be cautious on their long-term investments. This collective thinking by the business community can generate a self-fulfilling prophecy and further slow economic growth.

Low interest rates and stricter bank lending rules after the financial crisis have created two distinct forces in the financial market. On one hand US large corporations with large cash reserve have been consistently buying back their own company shares, which provide a floor for their companies' stocks. On the other hand, bank lending has been constrained after financial crisis. It is harder for smaller companies and businesses get loans from banks, so they turn to private lending sources. A lot of the private debt is nonrated. Overall, the triple-B debt has become 50% of all investment-grade debt in the US. It has grown from $715 billion a few years ago to current $3.2 trillion, and the credit quality continues to deteriorate.

Will the rising in private lending and high yield loan market be the next harbingers of a downturn of the US market? We need to keep a close eye on it.

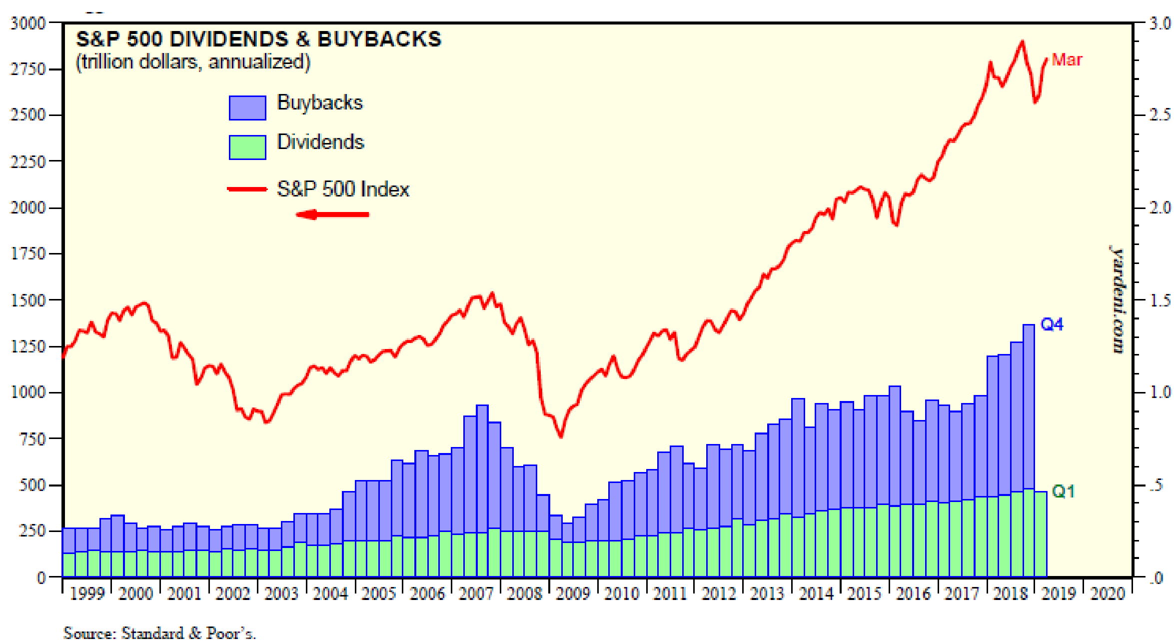




Sources: Bloomberg, Compustat, FactSet, Standard & Poor's, JPM Asset Management

The consistent buybacks and dividends do have impact on the performance of US equity market in the past decade. Both share buybacks and higher dividend yields in US stocks relatively to US bonds have steered investors to US equities. See the chart below for the evidence of high correlation of share buybacks and dividends and S&P 500 returns since 2009.

S&P 500 Returns follow Buybacks and Dividends



Market Outlook:

Yes, US Equity Indices could have hit the top range in September 2018 for the coming years

In the past 10 years, strong US equities, particularly growth equities have greatly outperformed all other assets propelled by low interest rate across globe, allowing them to move upward without major interruptions since they bottomed in March 2009.

Since March 1st of 2009, Nasdaq 100 had 610% accumulative returns in the following decade, followed by FTSE Nareit All REITs gained 436%, S&P 500 and MSCI World ex USA up 367% and 170% respectively. The divergence of the returns is evident. US growth stocks had 3.5x greater return than world outside of the US and 1.7x greater than S&P 500. The lowest bottom three asset classes were Bloomberg Commodity down 19.9%, Gold Spot up 39.64% and Morningstar Broad Hedge Fund TR returning 75% cumulatively in 10-year period. (See 10-year returns of various asset classes below)

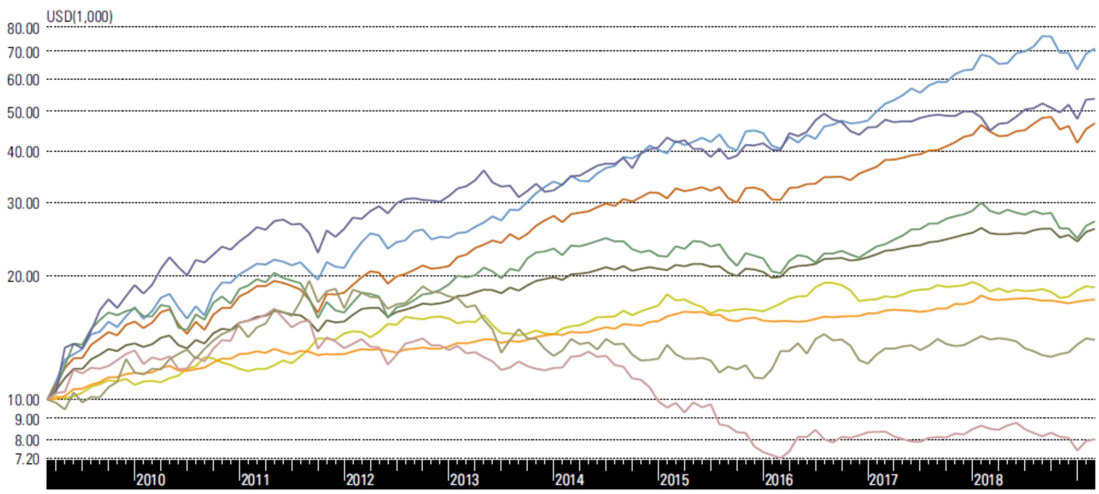
Just like tax and death are certain in our life, reversion to the mean is unavoidable in the financial market. It will eventually come and usually at the unexpected and inconvenient time. The impact of reverting to the mean on downside trajectory could be exacerbated if it coincides with recession. Managing risks in each portfolio becomes paramount when markets are volatile.

Investment Growth

Item(s) from 3/1/2009 to 2/28/2019

Currency
USD

Name	Security Type	Cumulative Return %	Annualized Return %	Max Front Load %	Max Back Load %	Expense Ratio %	Amount at End of Period
NASDAQ 100 TR USD	IDX	610.01	21.66	NA	NA	NA	71,000.64
S&P 500 TR (1989)	IDX	367.39	16.67	NA	NA	NA	46,738.74
BBgBarc US Aggregate 10+ Yr TR USD	IDX	87.11	6.47	NA	NA	NA	18,710.97
Morningstar Mod Tgt Risk TR USD	IDX	159.40	10.00	NA	NA	NA	25,939.64
MSCI World ex USA All Cap GR USD	IDX	170.48	10.46	NA	NA	NA	27,047.58
FTSE Nareit All REITs TR	IDX	436.34	18.29	NA	NA	NA	53,634.14
Morningstar Broad Hedge Fund TR USD	IDX	74.83	5.75	NA	NA	NA	17,482.89
Bloomberg Commodity TR USD	IDX	-19.90	-2.20	NA	NA	NA	8,009.77
S&P GSCI Gold Spot	IDX	39.64	3.40	NA	NA	NA	13,963.93



Source: Morningstar and Songbird Capital

It is time to embrace risk management

“Bull markets do not die of old age, they die of excess such as accelerating and above-trend economic growth, rising inflation, and interest rate hikes from hostile Federal Reserve. Those excesses are simply not with us today, nor do I expect their arrival anytime soon.” - Leon Cooperman

The quotation above is from Leon Cooperman back in August 2007, just four months after Bear Stearns’ Structured Credit Hedge Fund went insolvent and later brought down Bear Stearns along with it, and one year before the failure of Lehman Brothers that rattled the market and led to the deepest recession in the US history. Mr. Cooperman is an intelligent and well-respected fund manager, and I don’t intend to discredit him. My point is that our ability to forecast future disastrous events is limited. Beside our confidence in our investment philosophies, we need to rely on different tools to manage risks.

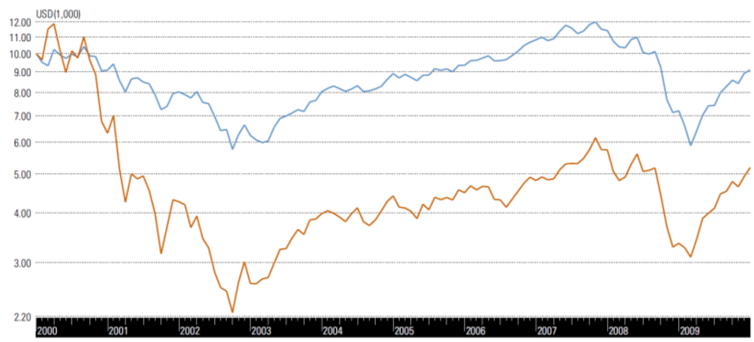
The current bull markets and historical low level of volatility have left investors an impression that whatever has gone down will soon bounce back. However, if we look back in the period of 2000 to 2010, the lost decade of the US equity markets, it is certainly not the case. After late 90's bull market, S&P 500 was flat between 2000 and 2010, while Nasdaq 100 lost over 48% for the decade. Now it is time to think about how we should safeguard our hard-earned returns from the past decade.

Investment Growth

Item(s) from 1/1/2000 to 12/31/2009

Currency
USD

Name	Security Type	Cumulative Return %	Annualized Return %	Max Front Load %	Max Back Load %	Expense Ratio %	Amount at End of Period
S&P 500 TR (1989)	IDX	-9.10	-0.95	NA	NA	NA	9,090.23
NASDAQ 100 TR USD	IDX	-48.16	-6.36	NA	NA	NA	5,184.40



Source: Morningstar and Songbird Capital

Please feel free to reach out to Songbird if you have any questions or concerns.

Songbird Capital has institutional experience in portfolio and risk management and is specialized in asset allocation across multiple asset classes and strategies. We provide valuable services for investors by capturing investment opportunities while navigating risks and staying invested. ***Songbird's competitive fees in the industry always helps our clients to keep more along the way. (See Songbird fees against industry average and "Savings from fees compounded over 20 years" on our website) .***

Sincerely Yours,

Jie Hayes / Principal of Songbird Capital

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