Investment Update

Meritage PORTFOLIO MANAGEMENT

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The stock market pulled back sharply in the fourth calendar quarter. Earlier-year gains were erased as declines breached bear-market territory for most broad-based indices. A year that began with high expectations and optimism around a resurgent economy finished the year in the opposite camp.

The abruptness of this shift was remarkable and equally notable in that there seemed to be no single catalyst to explain the decline. As much as anything, an erosion of confidence looks to be the common factor across multiple concerns.

The Fed's plan for multiple rate hikes and an escalating risk around trade policy were both disconcerting, but not entirely new issues to the market. Doubts around the third quarter earnings cycle did take on a different level of scrutiny and a deteriorating economic picture outside the U.S. added to the market's angst. Additionally, the structure of the market that is increasingly driven by automated trading strategies has been credited for exacerbating the level of market volatility and impairing investor confidence.

We'll take a close look at the impact of each of these issues and observe how this positions the market as we head into the New Year.

KEY STORYLINES FOR THE FOURTH QUARTER

Slowing Growth

There is a lot that falls under this category that is at the heart of the fourth quarter decline. The U.S. economy showed strong growth through the first half of the year, but more recent measures reveal a mixed picture. Moderating sales of new homes and autos, and fears of a full blown trade war with China weighed on the market and have led some forecasters to move forward the timeframe of the next recession. Other traditional economic measures, including consumer spending, show an economy that is still growing, albeit at a slower rate.

Outside the U.S., the picture gets cloudier. Europe appears weaker and in disarray. The Brexit deadline is approaching, there is social unrest in France, and Italy remains in a budgetary impasse. Economic growth has missed targets in China, Japan, and Germany. These international strains place more pressure on the U.S. to drive global growth.

Coinciding with economic worries has been an unexpected sell-off in oil prices, falling 38% this quarter. As investors learned in 2014, cheaper gas at the pump is no offset to the impact of reduced activity in the industrial sector. Lower oil prices are also seen as a proxy for reduced global demand, adding to the angst around a global slowdown.

Fed Policy Mistake

Recent commentary from Fed Chair Jerome Powell left little doubt that he is not as sensitive to the role the stock market plays in affecting the economy as his predecessors. Supporting the market is clearly not a part of the Fed's mandate to control inflation

and promote employment, but it is a departure from what investors had become used to.
Undeterred, Powell has taken a more aggressive tone to future rate hikes, and his remarks in the midst of the recent stock slide were not deemed conciliatory enough. Skeptics that see the Fed leading the economy into a hard landing have history on their side, as the Fed's track record of forestalling a recession is not particularly good. The recent decline in bond yields shows that bond investors are in agreement.

Complicating the Fed's job is the simultaneous unwinding of the quantitative easing program. Remember, this experiment was an unconventional way for the Fed to stimulate the economy and add liquidity to the financial system. Since most believed this policy supported higher stock prices, it should not surprise that its removal might have the opposite effect, however gradual the process. Critics of Powell have said that it is irresponsible to undertake both the normalization of interest rates and the unprecedented tightening of liquidity at the same time. With the balance of the economic cycle at stake, they have a strong argument.

A Crack in the Earnings Firewall

The core support to the latter stages of this bull market has been the resumption of strong earnings growth. The acceleration of the economy, top-line revenue growth, record margins, easy comparisons (against depressed earnings from the 2015 oil collapse), and tax cuts created an enviable environment for companies to show growing profits.

This bottom-line strength enabled investors to overlook a multitude of macro and geopolitical issues that otherwise might have been more disruptive over the past year. While third quarter earnings were generally good, there was more cautionary language from management about higher costs from tariff activity, raw materials, and wage pressures. As a result of reduced expectations, future earnings growth estimates have now been cut from levels of three months ago. The protective cover of earnings growth has diminished.

Another hit to investor confidence has been the decisive leadership shift away from the large-cap tech sector. The small group of favored tech companies that led the market higher have suffered disproportionately on the way down. Investors have since tempered their instinct to buy the dips in these holdings after a series of lower lows. It is too soon to know if these tech companies regain their luster or whether another sector emerges to fill this void in leadership. History suggests it will be the latter.

Market Structure

The influence of automated trading on the market decline is the most intriguing. While these tools have been around in some form for a while, they have become more sophisticated and have become a larger part of daily trading volume. Automated strategies execute trades by a pre-programmed set of rules and conditions that can adjust as market conditions change. They operate at extraordinary speeds and can make it difficult for traditional traders and market makers to provide important liquidity to markets to function efficiently.

The key concern is that automated trading acts as an amplifier, exacerbating a trend, potentially turning a routine decline into a rout. Since many algorithms key off similar factors (like momentum), when a signal is given, a herd effect can result. This phenomenon provides a cogent explanation for some of the outsized daily swings that the market has recently experienced.

If these programs do not initiate a decline or change the ultimate value of what a company is worth, then their effect on the market can be seen as just a temporary overshoot or undershoot of a more rational path. That may be too generous a take, especially if these programs cause traditional investors to lose faith in the system and create spillover effects from the market that back up into the real economy. These risks have prompted a growing outcry from market participants and politicians to consider restricting the use of automated trading. While the intent here seems constructive, history tells us these issues are highly complex and those with a vested interest to maintain the status quo will not go away easily.

Outlook

So where does all this leave us, other than trying to connect the dots to what happened last quarter? We'll summarize with a few general conclusions:

- It is too trite to say a bear market was overdue, but it is unusual to experience this magnitude of decline without more confirmation of a faltering economy. This serves as a reminder that markets and the economy are distinct entities, albeit highly correlated. In fact, a short-term disconnect between markets and their underlying fundamentals is what creates investment opportunities. At an extreme, though, the proliferation of advanced trading tools with shifts in investor psychology may make these short-term dislocations more severe and more frequent.

- Investors reached an inflection point in their faith that this late-stage economic recovery would continue to power forward amidst a growing list of uncertainties. High volatility remains a risk and will keep pressure on investor confidence that's already wounded. We can't discount the possibility of another leg down for stocks and it is typical to see subsequent rallies questioned, even in the face of positive developments (i.e. reaching a trade agreement with China). But we also know from experience that by the time there is visible evidence that confidence is rebuilding, stocks will already be well off their lows.

- Absent further signs of economic deterioration, a return to the more moderate level of economic growth that has characterized most of the current economic cycle should prevail. Recession concerns won't go away, but given the current sell-off, the risk to investors should be skewed more positively going forward. If the economy does come to a surprising halt, this will confirm the pullback and very likely put more pressure on stocks. The median decline for a bear market is approximately 25%. We are a good part of way there already.

Data as of December 31, 2018

Meritage Value Equity Fund

Top 10 Holdings	% of assets		% of assets
Utilities Select Sector SPDR	5.8%	Vanguard REIT ETF	3.1%
AutoZone Inc.	3.4%	CDW Corp.	3.1%
Cigna Corp.	3.3%	Emergent BioSolutions Inc.	2.9%
Energy Corp.	3.3%	Torchmark Corp.	2.9%
Royal Dutch Shell PLC-ADR A	3.1%	Koninklijke Ahold Delhaize ADR	2.8%

Meritage Growth Equity Fund

Top 10 Holdings	% of assets		% of assets
Apple Inc.	6.0%	Intuitive Surgical Inc.	4.3%
Microsoft Corp.	5.6%	Vanguard Growth ETF	4.2%
Amazon Inc.	5.2%	Home Depot Inc.	4.1%
Alphabet Inc. CL A	4.5%	MasterCard, Inc.	3.8%
Zebra Technologies Corp.	4.4%	Fortinet Inc.	3.1%

Meritage Yield-Focus Equity Fund

Top 10 Holdings	% of assets		% of assets
Merck & Co Inc.	3.1%	CenterPoint Energy Inc.	2.4%
Verizon Communications	2.5%	Stanley Black & Decker Inc. 5.375% Conv PFD	2.3%
PPL Corp.	2.5%	Entergy Corp.	2.2%
Public Service Enterprise Group	2.5%	Pfizer Inc.	2.2%
National Health Investors	2.4%	Piedmont Office Realty Trust Inc.	2.2%

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