Commentary October 11, 2018

Summary Overview

- We believe the cause of this week's market sell-off (other than stretched valuations in many companies) is due to the concern over rising interest rates, which the Fed is raising in an effort to head off the potential of higher inflation.
- From everything we can see today, we believe the U.S. economy is doing well. Even after the recent market volatility and pullback, we are encouraged by the fact that a majority of our indicators are showing no signs of a recession for the foreseeable future.
- We do not believe that this is the beginning of a major bear market. Instead, we believe this is a correction within a major bull market.
- We believe there is a rotation into value stocks from growth stocks and that our basket of stocks at Century Management continue to represent very good values.

Is This The Beginning of the Next Bear Market or Recession?

Because of the volatility in the market these first few days of October, coupled with the large sell-off in this week's trading sessions, some clients have asked if this is the beginning of a recession and a major bear market (i.e. a sustained downturn for stocks and bonds), or is this a normal and overdue correction in a major bull market?

In the past 50 years, **we have never had a major bear market without a recession**. However, it is important to point out that we have had market pullbacks without a recession. Some of these market corrections have been in the neighborhood of 5% to 15%. The differences between your average bull market correction and a full-blown bear market are both the size of the decline and the duration of the decline. Bear markets being more extreme in both areas. In this case, the most important thing we have to consider is whether or not this is the beginning of a recession.

We monitor a comprehensive list of several key indicators we believe give us insights into the overall health of the economy, markets, and various industries. **Everything we see today indicates that the U.S. economy is doing well. Even after the recent market volatility and pullback, we are encouraged by the fact that the majority of our indicators are not showing any signs of a recession for the foreseeable future**.

For example, the chart below is from the Conference Board. It shows the year-over-year change, on a monthly basis, of the ten leading economic variables that tend to move before changes in the overall economy occur. On the chart, the pink bars represent recessionary periods. According to the Conference Board, the leading indicator index must decline more than 3.5% at the same time the diffusion index is below 50% for six months, before there is the danger of a recession. It is currently at 80%. (*Note, the diffusion index measures the proportion of the components that are rising*).

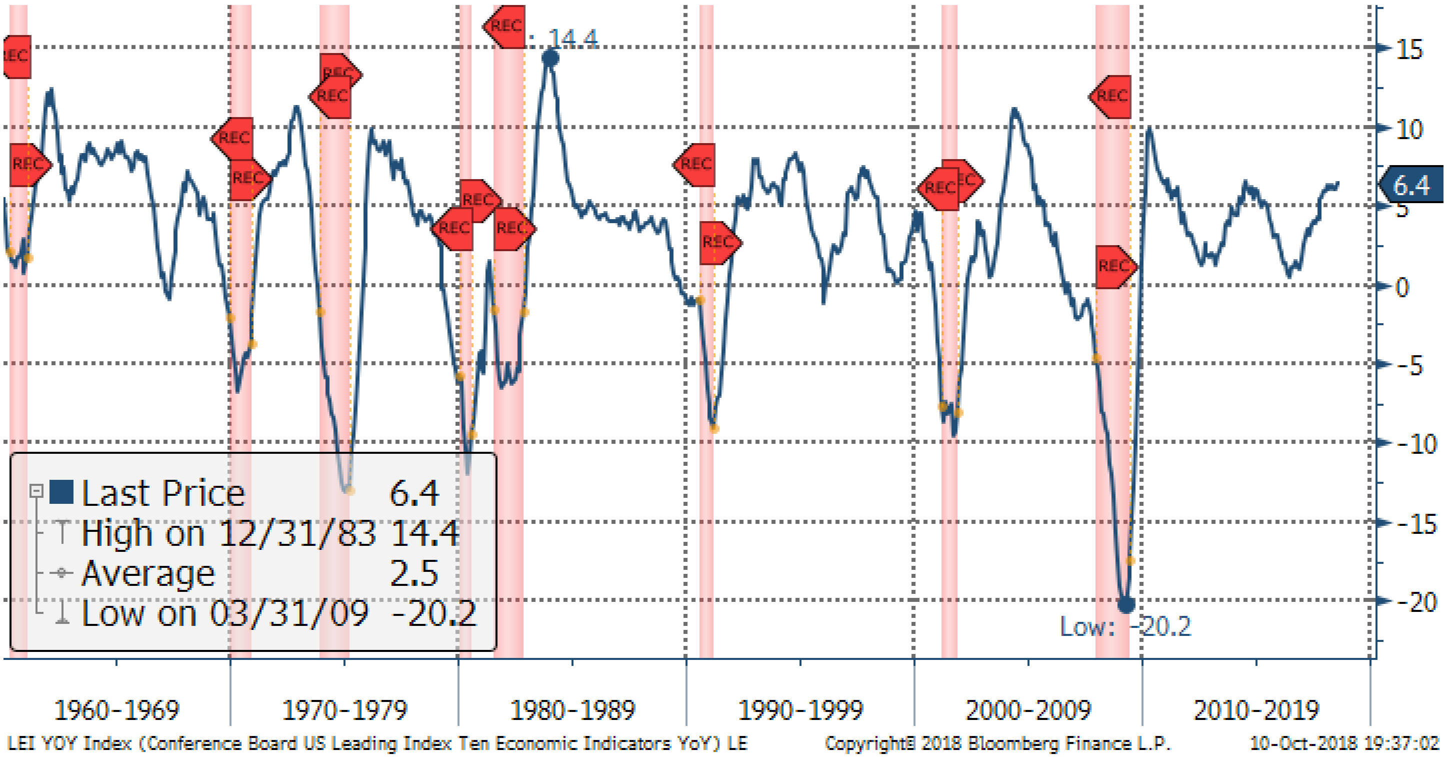
Dating back to 1960, the average year-over-year change has been 2.5%. As of September 20, 2018, the Conference Board's latest report, (which covers the period ending August 31), shows a 6.4% year-over-year positive change, the last six months showed a positive 2.5% increase (which if annualized is on pace for a positive 5%). August alone recorded a positive 0.4%. These are all strong readings, though we will note that the most recent six-month

805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888

growth rate has moderated in recent months.

The Leading Economic Indicators - Year-Over-Year Percent Change chart below illustrates that we should continue to see economic expansion. This in turn should be supportive of a positive outlook, coupled with a low probability of recession for the foreseeable future. However, we will continue to diligently monitor these indicators for any signs of potentially destabilizing risks.

Leading Economic Indicators - Year-Over-Year Percent Change
January 1, 1960 to Present (Monthly)



This Week's Market Sell-Off

We believe the cause of this week's market sell-off, other than stretched valuations in many companies, is the concern over rising interest rates, due to the underlying problem of higher inflation. **Remember, as inflation goes up, interest rates rise, resulting in stock multiples, like a price-to-earnings (P/E) ratio, going down**. When this happens, unless a company can offset the decline in its multiple with higher earnings, its stock price will likely decline. We have discussed this in many of our client communications. As we have said in the past and continue to firmly believe, **there are only three things that matter over the long run when it comes to investing in a company: inflation, interest rates, and the fundamentals of the business**.

We believe one of the catalysts for this week's overall price decline was the U.S. Department of Labor's release of its September Producer Price Index (PPI) report. The PPI, which highlights the wholesale and other selling prices of businesses, is less prominent in investors' minds than the Consumer Price Index. However, it does illustrate how changes in input costs are feeding into inflation. This report showed that U.S. producer prices rose for the first time in three months amid an increase in measurements such as airfare and rail-transportation costs. On a year-over-year basis ending September 30, the PPI index for final demand was up 2.6%, while the index for final

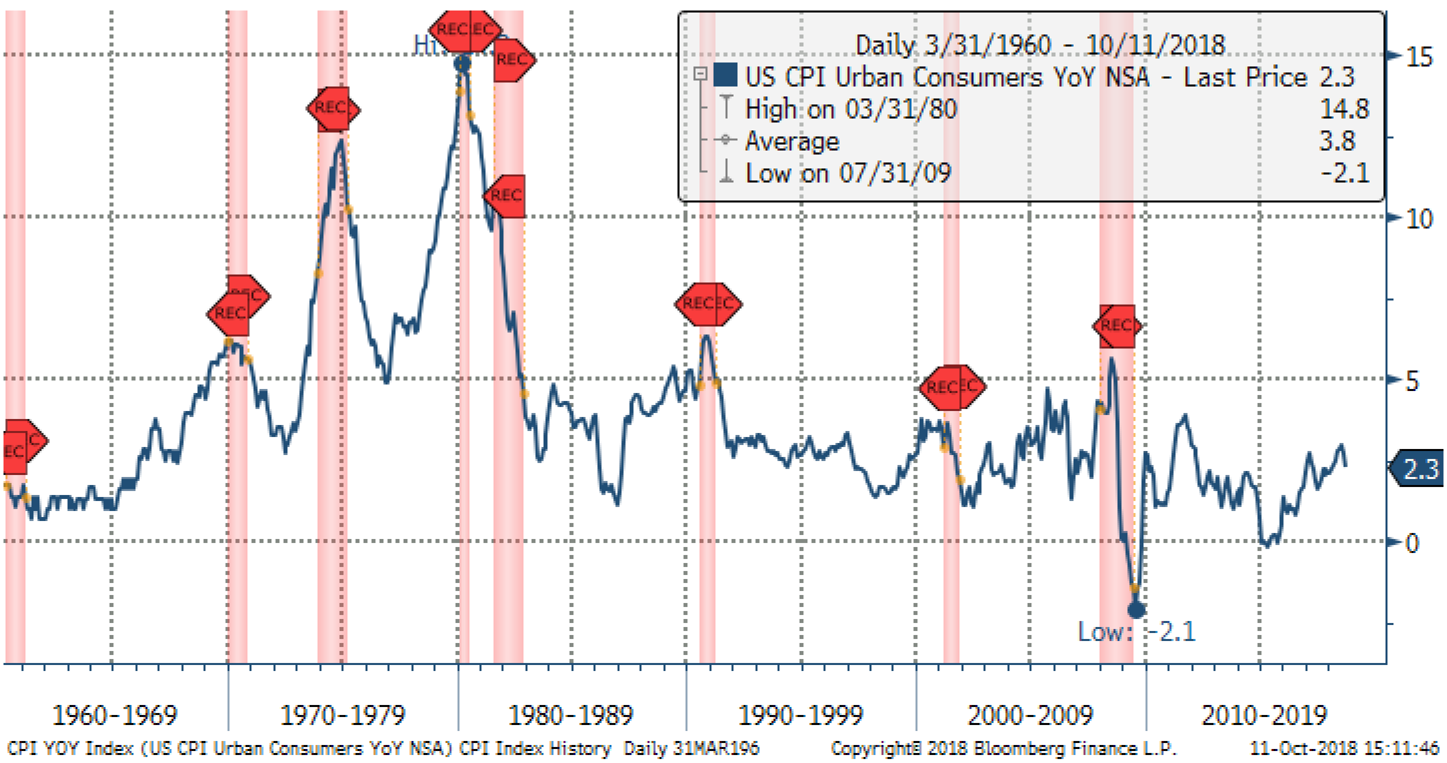
805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888

demand, less the more volatile food, energy, and trade service, was up 2.9%. We believe these inflationary signs are behind this week's market sell-off. **The point here is that producer prices climbed in September and as a result, there is nothing in the report to suggest the Fed is likely to deviate from another rate hike at its December FOMC meeting as the economy continues to grow at a solid pace**.

Inflation

Below is a historical chart of the Consumer Price Index (CPI). While this measure is far from perfect when it comes to measuring the true inflation rate, it remains one of the headline statistics used when quoting the inflation rate. Over the past 58 years, you can see the average inflation rate, as measured by CPI, has been 3.8%. You can also see that back in March of 1980, inflation reached a month ending peak of 14.8%.

Today, Thursday, October 11, the Department of Labor released its September update. It showed that for the 12 months ending September, the CPI increased at the rate of 2.3%. At this point, we are not worried about repeating the inflation of the 1970's or 80's. However, inflation is up from its July 31, 2009 low of -2.1%, and its second quarter 2015 reading of 0%. **The bottom line is that inflation is heading above the Fed's target of 2% inflation, which will cause interest rates to move higher. We believe this concern is what is impacting the market**.



805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888

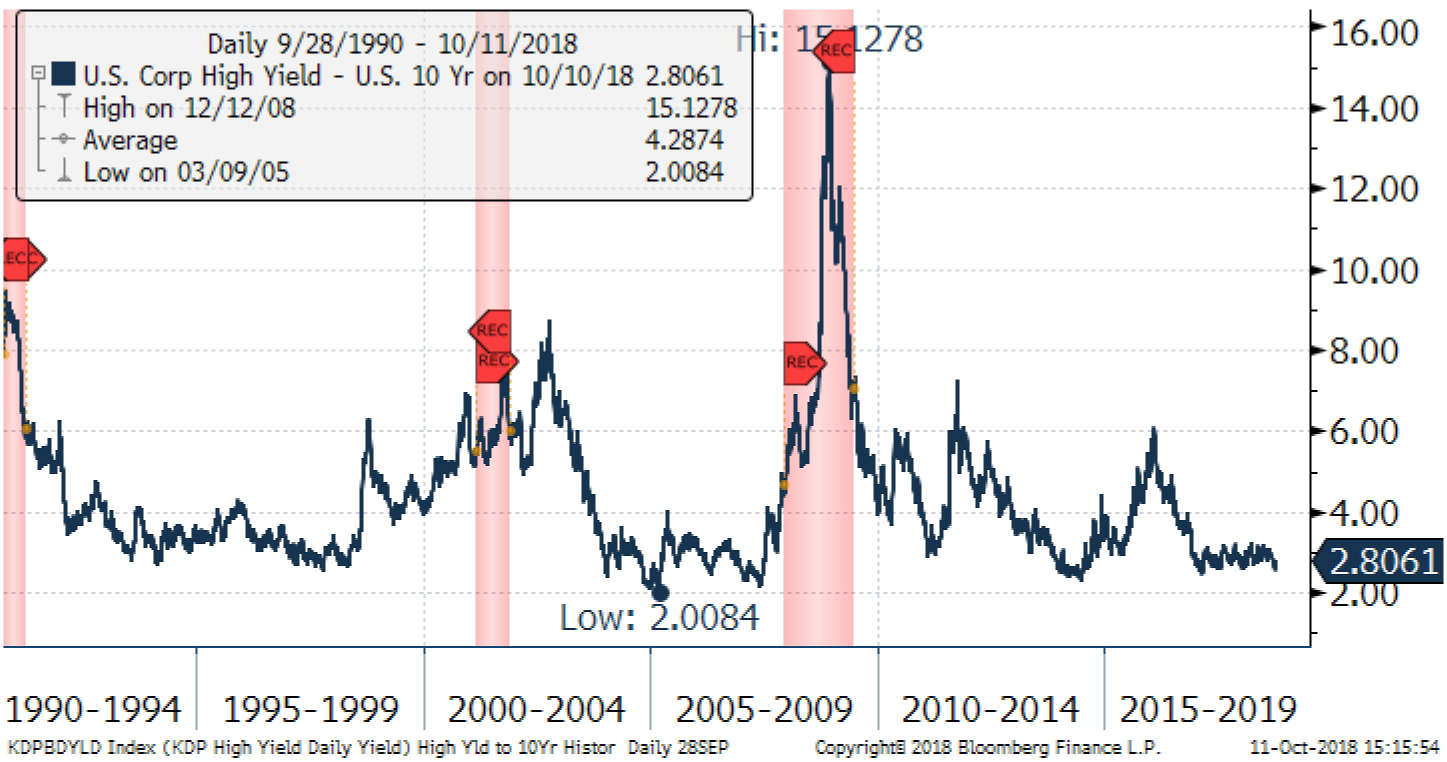
The takeaway here is that while we do not have runaway inflation concerns, inflation nevertheless is up per CPI at the annualized rate of 2.3% as of September 2018. We believe the danger point for the stock market will be when inflation, on a sustainable basis, rises above 3.5%. Historically, at this level of inflation, P/E multiples and stock prices fall precipitously. We believe this is what the Fed is working to prevent.

The Bond Market is a Good Way to Monitor the Health of the Economy

We believe one of the best ways to monitor economic trouble and market risks is to monitor the bond market. Unlike the stock market that is looking for future growth in sales and earnings, the bond market is focused on balance sheets, cash flow, and the company's ability to repay its debt. **Therefore, when the bond market is optimistic about the economy, there is a small spread between high quality bonds and lower quality bonds (i.e. junk bonds).**

Should the bond market sense an economic slowdown, regardless of the reason (i.e. higher interest rates, inflation, tariffs, fear of recession, etc.), investors generally sell their higher risk bonds for lower risk bonds, thus causing the spread between quality bonds and lower quality bonds to widen. As shown on the chart below, the spread widens dramatically before and during recessions, as the bond market is indicating that something is amiss in the economy.

The Spread Between High Yield Bonds and 10-Year U.S. Treasury Bonds



805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888

Despite all of the news about tariffs and trade, the federal debt, and overall excessive debt accumulation, the spread between high yield junk bonds and 10-year treasuries on Thursday, October 11, 2018, was 2.8. This spread is within the bottom 17 percentile of the narrowest spreads that have occurred over the past 10 years, and more than 34% below the 30-year average spread. **In other words, the bond market is suggesting that the U.S. economy is in good shape, and a recession is not a concern at this time.**

As a side note, albeit an important one, the reason we believe the focus on junk bonds is so important is that the amount of bonds issued to lower creditworthy companies today is at extreme highs. Many of the junk bond underwriters have even eliminated the requirement for any loan covenants. Those that do still require loan covenants, which historically have been put in place for the lenders' protection, require a significantly scaled down number of covenants. In the industry, these are referred to as "covenant light" loans.

Once the economy does begin to slow, we expect there will be major defaults in the junk bond market and therefore believe it is the riskiest asset class in the market today. Moreover, should this occur, we believe it could worsen the recession once it eventually happens.

Unfortunately, many investors who have been looking for a higher yield have ventured into this asset class, most likely unaware of the risks of owning such low quality bonds. If you happen to own any junk bonds, we suggest that now might be a good time to review them in great detail to make sure you are aware of the potential risks. If you have any reservations about the risk, it is probably a good time sell these bonds

Stocks in the CM Value I Composite

Overall, we continue to believe that the stocks represented in our various investment strategies are doing well on a fundamental basis and we believe this will be reflected in their stock price as we head towards year-end and into 2019. The chart below illustrates some of the portfolio characteristics relative to the S&P 500, as well as the Russell 3000 Value Index. Lower numbers on this table suggest better values.

Our largest exposure to equities by sector is energy. Though this group of stocks tends to have more volatility than other areas of the portfolio, we firmly believe we are in a bull market in energy and that this will continue well into 2019, if not longer. Sentiment around energy, while slow to change, has been changing nevertheless. It wasn't that long ago that the mantra surrounding oil was "lower for longer" and at the end of 2017 the major banks and brokerage firms were projecting $40 to $50 oil. That bearish sentiment has certainly moderated. Instead, we now read that the International Energy Agency (IEA) is telling OPEC it is important to increase production due to the low level of spare capacity around the globe today and President Trump is sending tweets for higher oil production.

805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888

Row	Ratios	CM Value I Composite	S&P 500 Index	Russell 3000 Value Index
1	P/E (trailing 12 months)	21.58	19.90	17.12
2	P/E (estimated next 12 months)	14.03	15.93	13.88
3	Price to Sales	0.84	2.15	1.52
4	Enterprise Value to Sales	1.13	2.42	1.81
5	Price to Cash Flow	10.12	12.82	9.96
6	Price to Free Cash Flow	13.60	18.23	14.61
7	Price to Book Value	1.31	3.20	1.98
8	Weighted Market Cap	$7,560 Billion	$115,149 Billion	$59,025 Billion

Source: Century Management and Bloomberg. Data as of October 10, 2018. Using harmonic averages for ratios. Lower ratios imply better values.

Though the price of West Texas Intermediate Crude (WTI) is up roughly 170% from its February 2016 low, many of the energy stocks in our portfolio, while up, have not yet appreciated at the same rate as the commodity itself. We believe this disconnect between the price of oil and energy-related stocks will soon converge, with the energy stocks continuing to rise and better reflect the price movement of the underlying commodity.

Conclusion

While the markets have become more volatile as of late, and the recent market selloff can be a bit unnerving, we feel confident that the U.S. economy is currently doing well and we believe it is likely to continue its solid growth for the remainder of the year and well into 2019. As for the stock market, generally speaking, we believe this environment should start to favor value stocks over growth stocks.

Overall, we think this bodes well for our portfolios over the coming months. More specifically, we believe there remains considerable value and upside in the energy sector, as well as the other sectors in our portfolios.

In conclusion, we are currently positive on the overall economy and do not see a recession in the near future. However, at some point down the road, we believe issues such as increasing inflation and rising interest rates and their impact on extremely high debt levels will become a headwind for the market.

As for our portfolios, over the past few months we have already started to make adjustments and are prepared to make more when the time comes. As always, we continue to monitor the economy, the market, and your portfolios on an ongoing basis.

Century Management

805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888

Disclosures

Century Management reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that the sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable. Forward-looking statements are not guaranteed.

Past performance is not indicative of future results. The discussions, outlook and viewpoints featured are not intended to be investment advice and do not take into account specific client investment objectives. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness.

Positions held within each individual account may not be the same from one account to the next. Individual securities may be traded at different times as well as receive different execution prices. In addition, individual accounts may be pursuing similar objectives but may have different investment restrictions.

The Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values. The S&P 500 Index measures the performance of the 500 leading companies in leading industries of the U.S. economy, capturing 75% of U.S. equities.

Century Management is an independent registered investment adviser. Registration does not imply a certain level of skill or training. Century Management is also registered as a Portfolio Manager in the Province of Ontario. More information about the advisor, including its investment strategies and objectives, can be obtained by visiting www.centman.com. A copy of CM's disclosure statement (Form ADV Part 2) is available without charge upon request. Our Form ADV contains information regarding our Firm's business practices and the backgrounds of our key personnel. Please contact Century Management at 512-329-0050 if you would like to receive this information.

805 Las Cimas Pkwy, Suite 430 • Austin, TX • 78746 • www.centman.com • phone: 512.329.0050 • fax: 512.329.0816 • toll free: 800.664.4888