MARCH 15, 2018

Julio C. Quinteros, Jr.
Portfolio Manager

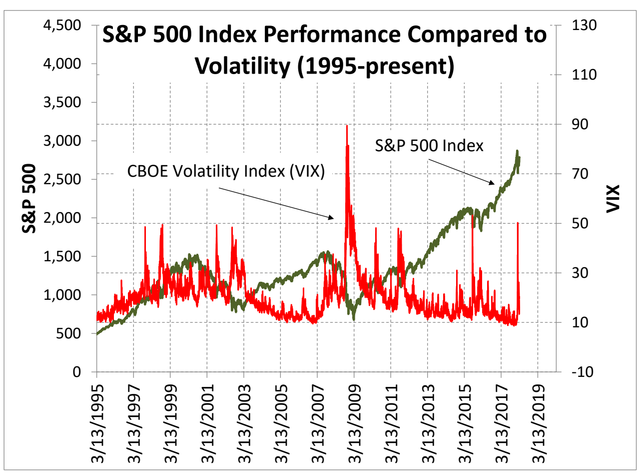
Embrace Volatility: Market Dislocations Create Investment Opportunities

Through the first half of March it is now clear that increased volatility in financial markets is a constant to take into account and balance as part of our investment considerations. While we fully acknowledge that risk factors are higher, short-term volatility on its own does not give us pause.

Our constructive stance is based on our fundamentally driven approach which remains grounded on two key pillars including corporate competitive differentiation and sustainable cash flow growth. Considering the recent era of low volatility, we embrace a rise in market volatility, as we believe that market driven price dislocations create long-term investment opportunities, especially when stocks get below our estimates of intrinsic value.

Definition Of and Recent Volatility Results

As a single measure, increased volatility is not a predictor of a looming market decline. For a recent historical look, the chart below (dating to 1995) maps the often-discussed CBOE VIX against the S&P 500.



Source: Bloomberg data.

Consider the standard definition of financial volatility provided by the Chicago Board Options Exchange (CBOE) which defines it "as a measure of the fluctuation in the market price of the underlying security. Mathematically, volatility is the annualized standard deviation of returns."[1]

It is important to remember that during volatile times daily price changes will often reflect market risk, amplified by the relative beta of a stock (i.e., its volatility in relation to the market) and not always a change in fundamentals, which we believe to be the long-term driver of a stock's return potential.

Volatility Whipsaws Markets in Early 2018

Looking at the performance of the S&P 500 in early 2018 there are many descriptors that come to mind. Our Senior Portfolio Manager, Julie Bryan, CFA, described recent market activity as a "lightning strike" in last month's Investment Update.

The whipsawed nature of recent market activity was captured well by J.P.Morgan Asset Management in a recent market update. They noted that in January, the S&P 500 reached its recent high and then sold off by 10% over a two-week period, only to recover most of its losses by the end of February. Accordingly, February "saw the third-highest realized daily volatility of S&P 500 returns in a single month since the global financial crisis, behind only August 2011 (during the U.S. debt downgrade and Euro-area sovereign debt crisis) and May 2010 when the "flash crash" occurred."[2]

Cutting Through the Market's Volatility, Acknowledging the Elephants in the Room

At the macro level, our constructive stance remains grounded on a confluence of factors including sustained global economic growth, earnings momentum and subdued inflation.

Against this positive backdrop, however, we fully acknowledge the proverbial elephants in the room, including concerns around inflation, rising interest rates in the U.S., increased deficit spending, and geo-political tensions. It is the specter of these increasingly influential risk elements that are expected to keep the era of low volatility behind us.

Focused on Long-Term Intrinsic Value

Despite expected higher volatility and resulting ebb and flow of financial markets, we remain grounded in our investment approach which emphasizes competitive differentiation and sustainable cash flow growth. Accordingly, we look for long-term intrinsic value to rise to the fore over time. As active managers our emphasis remains on individual fixed income and stock selection.

---

[1] CBOE, Options Dictionary, www.cboe.com.

[2] J.P.Morgan Asset Management, Multi-Asset Solutions Weekly Strategy Report, March 5, 2018.