investment styles ebb and flow . . . fundamentals never go out of favor

Storms Amid the Calm

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To observe broadly monitored measures of anticipated market volatility, one could reasonably conclude all was calm, a serenity ushered in by stable and synchronized economic activity (the IMF earlier this month raised its global growth forecast), hospitable credit market conditions, and a certain geopolitical nirvana…a kumbaya moment among world leaders. NOT!

Today marks the 30 year anniversary of the October 1987 crash – a synchronized onslaught that saw the Dow decline over 20% in one day, leading a stampede for the exits within markets in all corners of the world. At the time, I was a young analyst at Shearson Lehman (Google it), and as my co-workers stood aghast staring at the communal Quotron (ditto above) that stood in the middle of the research floor, I wondered what it all meant – not an idle consideration with a two-year old at home and a newborn on the way. In the end, all turned out fine. The lessons learned, however, were of the most enduring value. The realization that markets can abruptly vacillate between greed and fear somewhat inexplicably; the importance to focus on the task at hand, as clients were looking to us for solutions; and the imperative to resist complacency at all times. Lessons that are as applicable today as they were three decades ago.

For all the promise and peril socio/political and economic forces have invited of late, asset classes of many varieties have behaved in a remarkably benign and consistent manner – a bull rush of often uncorrelated asset classes has generally ensued. The lead story in a recent edition of the Wall Street Journal entitled *Markets Rise in Lockstep, Raising Worries of Reversal*, opens with, "Stocks, bonds, gold and bitcoin – assets that rarely move in unison – have all been surging…an everything rally that leaves investors confounded about how to play the plodding U.S. expansion and vulnerable to sharp reversals in fortune." The Economist, in its October 7th edition, similarly acknowledged the unsettled pattern of correlated asset class performance, noting "Yet rarely have so many asset classes—from stocks to bonds to property to bitcoins—exhibited such a sense of invulnerability...Add to this the craze for exotica, such as cryptocurrencies, and the world is in the throes of a bull market in everything."

As shown in Chart **I**, all appears sunny from a market perspective, with but one down quarter in nearly five years accompanied by subdued volatility. My partners and I have experienced too many market cycles to accept the absence of market instability as the "new normal," and if anything, think such silence begs the question as to when (not whether) cloud formations return. Indeed, one could argue the void of any meaningful setback for such an extended duration will translate to a harsher decline than might otherwise

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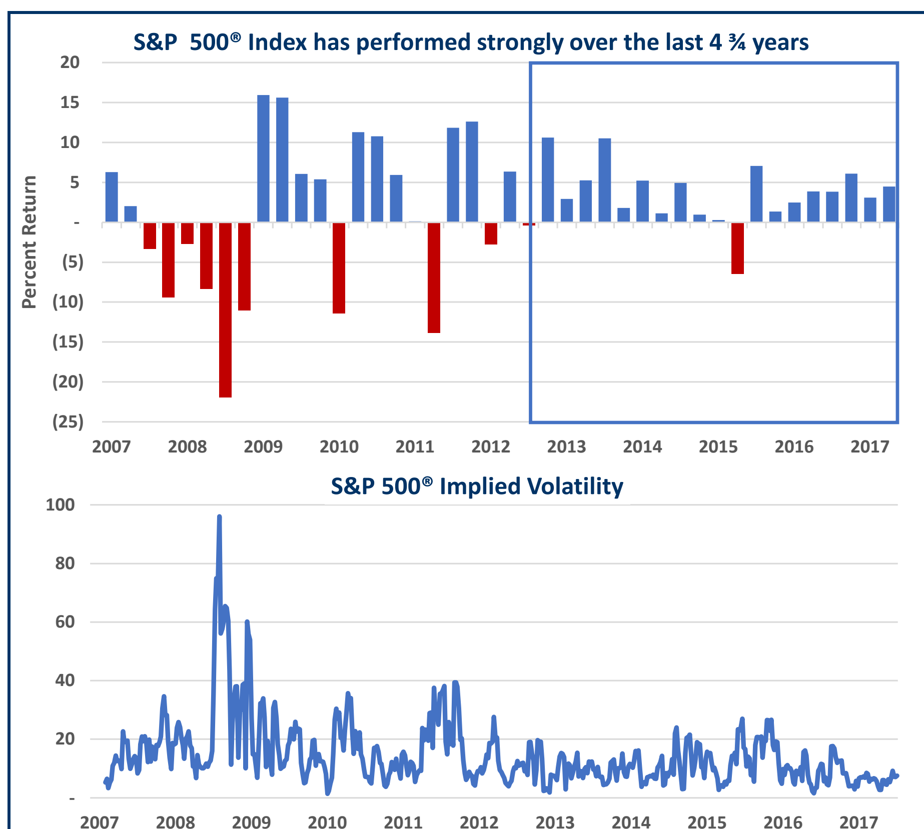
have been the case had the market self-corrected along the way. We do not believe the laws of human frailty in investment decision making processes have been repealed; indeed, the awarding of the Nobel Prize to Richard Thaler for his pioneering work on investors acting more irrationally than economists had otherwise acknowledged or applied to econometric models is prescient. Given this backdrop, we believe our emphasis on good businesses, growing the earnings/cash flow stream of client portfolios and maintaining a discipline with regard to valuation have become arguably more relevant as volatility has ebbed. For as we see it, there are plenty of *Storms Amid the Calm.*

I.



Note: These charts show, respectively, quarterly returns for the Russell 1000® Growth from 2Q07 through 3Q17, and the Cboe Volatility Index® (VIX® Index®) from 2007 to date.

Silencing the Noise

We were asked at a client meeting not long ago about our perspective as to how the various policy initiatives prescribed by the current administration, the influence of other geopolitical events (North Korea, Iran, Brexit, the Macron tenure in France, Catalonia's quest for independence from the Spanish state, et al.), the arc of economic activity – in short, the daily heartbeat that makes the markets as intriguing as they are humbling – affect our investment process.

Notwithstanding the considerable noise from a digitally crazed, omnipotent 24/7 news cycle, we try to maintain emotional clarity and balance while focusing on what matters.

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This sentiment was well articulated in a piece authored by J.P. Morgan strategists in a recent edition of *Eye on the Market: The Loneliness of the Long-Distance Runner*, “Investing can be a solitary and single-minded pursuit, best performed with blinders on in order to block out the stuff that doesn’t really matter.” What matters from our perspective – our focus at HSMP – is on earnings and valuation.

Continuity of Approach

One of the hallmarks of our approach is the set of principles we employ to turn down the volume: identify good businesses that satisfy our qualitative criteria; assemble such businesses into a concentrated portfolio of 20-25 securities with the objective of growing the earnings/cash flow stream in a consistent/visible fashion over time; and apply a proven set of tools so as to attach client capital to anticipated growth in earnings/cash flows at a reasonable valuation.

The qualitative criteria we apply when considering security selection for client portfolios centers on the attractiveness of the business model, and whether we’d be comfortable owning the franchise with the existing management team at the helm assuming we did not enjoy the luxury of equity market liquidity. When viewed through that lens, our gaze turns to businesses operated by seasoned, sensible and ethical management teams; possessive of leading market positions in large and growing categories; serving a diversified customer base; with an ability to play in developed and developing markets; engaged in the sale of generally affordable items and services such that a certain recurring revenue stream is potentially realizable; capital light, wherein the business routinely generates advancing levels of free cash flow on a fully exhausted basis; and large and increasingly formidable barriers to entry derived from the above criteria coupled with meaningful scale advantages.

Central to our investment philosophy is the imperative to grow the earnings and cash flow profile of the overall portfolio at an above average rate. We are very much bottom-up in our approach, and have found that the businesses that have historically allowed us to satisfy our principled objective tend to reside within the consumer (discretionary and staples), media, information technology (consumer and/or enterprise facing in nature), fee-based financials and select specialty industrial sectors. We are mindful that business profiles and industry structures can and do change, and that such change can invite opportunity; we are proactive in our thinking and try to guard against complacency with an open mindedness to new business models, the removal of legacy barriers to existing models, and an appreciation that the world is subject to more rapid disruption and dislocation than at any time in our 30+ year investment careers. The multi-dimensional process with which we assemble client portfolios - embracing companies across the growth continuum from established to more rapid growers, a willingness to go up and down the cap scale, and an appreciation for non-U.S. domiciled businesses - affords us flexibility in managing client assets.

Ultimately, we strive to deliver positive absolute investment returns over the course of a market cycle, and to have such returns eclipse those of respective industry benchmarks against which our Concentrated Quality Growth Portfolio is cast. Portfolio performance is comprised of two components: the cash flows of the underlying businesses, and the capitalization rate or valuation that investors are willing to pay for a given cash flow stream. The former is very much influenced by the quality of the business and the inherent predictability and anticipated rate of growth in cash flows; the latter is influenced by a number of variables including the level of interest rates as an alternative for investor capital, general market sentiment and the pace and stage of global economic growth, among other considerations. We believe our approach affords us

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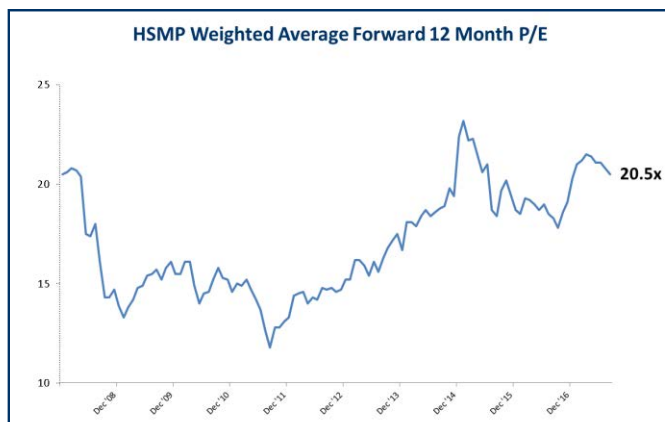
some discretion over the cash flow/earnings component through security selection, while Mr. Market invariably reshapes the valuation contour.

II.

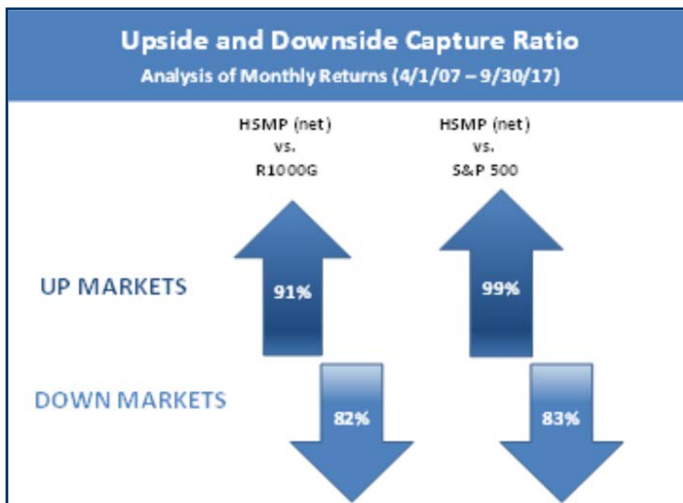


Note: Based on HS Management Partners, LLC estimates as of 9/30/17.

The chart above illustrates these points. HSMP's long term, since inception annualized net of fee composite performance (~11%) through 9/30/17 has been realized in largely hospitable markets notwithstanding terribly inhospitable beginnings (2008). As shown in Chart **II,** the forward twelve month P/E of the HSMP Concentrated Quality Growth Portfolio has rebounded meaningfully from the low point reached in the 3Q '11; noteworthy is the fact that, point to point, the valuation of the portfolio today is nearly identical to that which existed at the start of our now ten year plus performance track record. Given that performance is occasioned by cash flows/earnings and valuation, and the latter has been relatively static point to point, it stands to reason that portfolio performance over the long term has been largely influenced by our ability to grow the earnings stream (albeit at different intervals, changes to valuation have too had a meaningful impact). We also believe that, while portfolio valuation remains reasonable, the likelihood of any material P/E expansion from the absolute levels that now exist is not high, placing more emphasis on security selection/earnings growth prospectively.

Notwithstanding a market that has been less valuation centric in recent quarters/years, maintaining such a construct is important over the course of market cycles, as our long-term performance record and upside/downside capture ratio demonstrates (see Chart **III**). The utilization of such metrics has served clients well over the course of our investment careers, and we've no reason to believe prudence applied to owning good businesses and being attentive to valuation has been legislated away.

III.



Note: Performance results are presented net-of-fees and include the reinvestment of dividends and other earnings. See page 8 for the calculation methodology of the upside/downside rations. Past performance is not indicative of future results.

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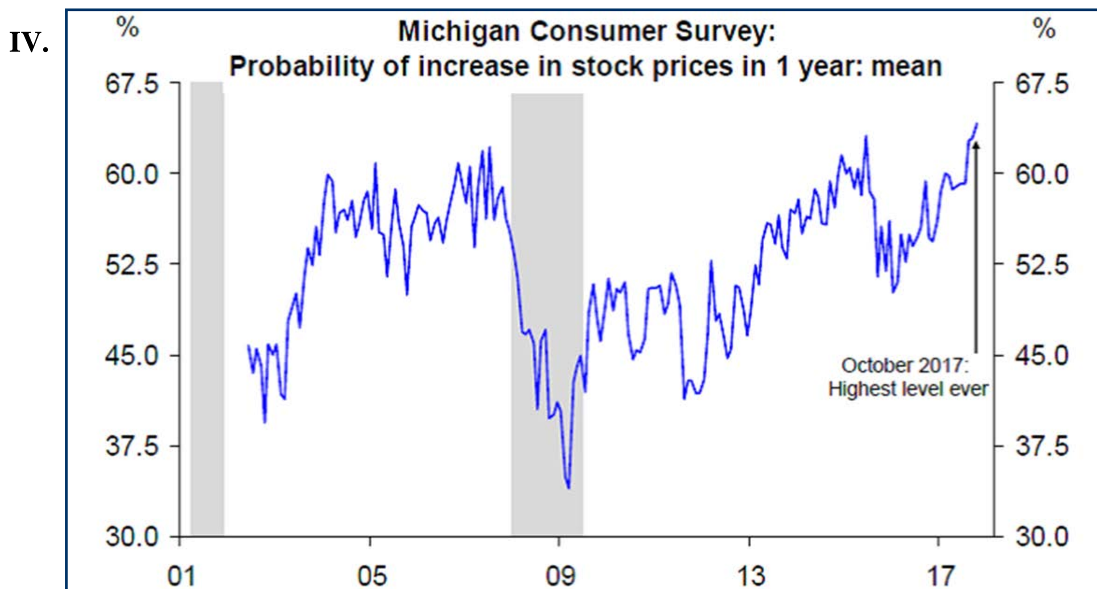
Ten Years On, the Song Remains the Same…

U.S. financial equity markets are at or near all-time highs, as are others around the globe; a certain giddiness exists among the throngs who've managed to partake in what has been a plentiful punch bowl. For some, today's 30-year anniversary of the October 1987 crash and the pain of September 2008 are distant memories, anomalies that cast a pall on an otherwise *cause de célébration*. As Nobel laureate Richard Thaler has noted, investors don't always behave rationally. Indeed, market participants often become ebullient when prudence and logic would suggest a more defensive caution should prevail ('06, '07, arguably today) and exhibit fearful tendencies when offense should be the order of the day ('01-'02, 4Q '08, 1Q '09). The accompanying Chart **IV** is illustrative.

IV.



Source: University of Michigan; Haver Analytics; DB Global Markets Research

The assumption and ascension of risk in financial assets has established links to the low level of nominal and real interest rates, the latter serving as a foundational valuation tailwind yielding to the former across geographies. Coincident with risk appetites becoming more satiated, the price transparency and attendant deflation digitization has afforded for everything from airline tickets to a jar of peanut butter has migrated to the financial services industry, such that prices - fees - have also become more transparent. Among the more pronounced examples of this phenomenon is the race to the bottom seen in exchange traded funds (ETFs), where the ability to mimic the performance of broad (S&P 500®, MSCI All-World) and/or increasingly narrow (reflation trade, sector/country ETFs) indices is readily and inexpensively accessible from one's phone. High correlations among disparate asset classes, and within asset classes, coupled with low cost substitute instruments, has proven a boon for passive flows (see Chart **V**).

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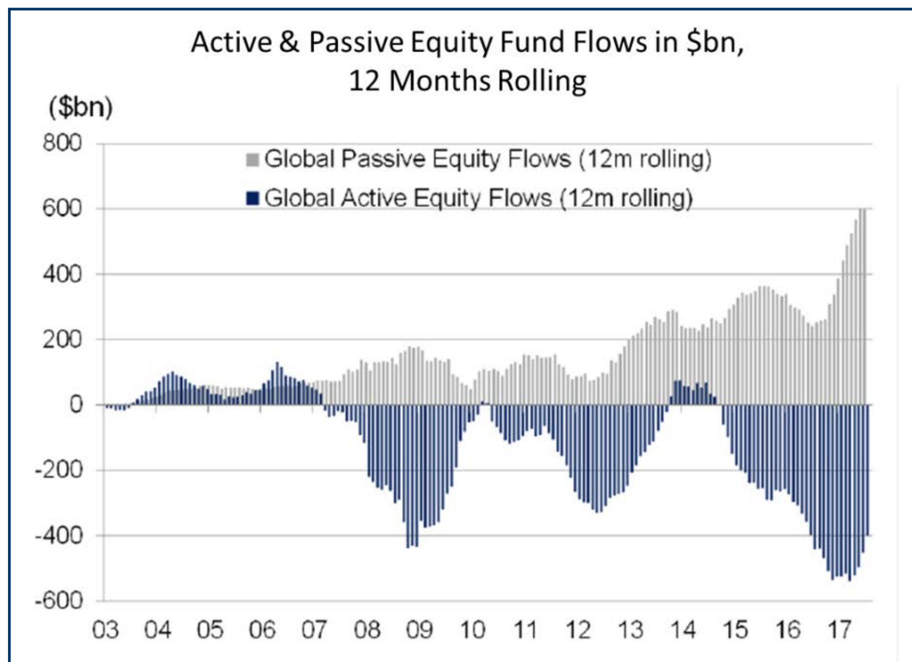
V.



Source: Citibank

This phenomenon has been supported by the low volatility highlighted throughout, and more capital chasing fewer names; a mid-September Bloomberg article suggested the number of U.S. publicly traded firms has dropped from approximately 8,000 in 1996 to roughly 4,400 at present. Such conditions have created a challenging climate for active managers, and there exists ample evidence that the strength in passive flows has continued unabated. The Wall Street Journal recently reported Vanguard experienced nearly $300 billion in flows through the first nine months of 2017, nearly equal to the level of flows the Firm witnessed in all of calendar year 2016.

And yet, perhaps a minor shift is afoot. A recent analysis from Credit Suisse's equity derivatives strategy team suggested the one month implied correlation for the 50 largest U.S. stocks has dropped to an all-time low, an environment that could bolster the climate for fundamentally grounded active managers. And what is arguably not well appreciated is that while index funds capture 100% of the upside, they too capture 100% of the downside; historically, our emphasis on sound business models and proven valuation tools has enabled us to preserve capital better than market averages in down markets, and that dimension - lost in the sea of green the markets have bathed in - will become relevant again, in our judgement.

...and the melody is one with which we are familiar

When the Firm was founded, and among many objectives and strategies/tactics employed to achieve our goals, we maintained that two overriding principles were critical to Client success and hence, Firm success: the ability to deliver positive absolute and relative investment returns over time; and the ability to run the Firm effectively by seamlessly integrating the three core disciplines vital to a successful asset management practice - investments, client service and operations - into the fabric of the client experience. The attainment of our 10-year performance track record at the end of March 2017 represents manifestation that those principles have been at least partially realized. And we thank our clients again for the trust and confidence you've bestowed in us; ten years on, our appreciation for your commitment runs as deep as the day we opened our doors.

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The nature of the reciprocal agreement with our clients is such that we do what we say we'll do, as perfectly imperfect as our abilities allow. Malcolm Gladwell, the gifted author, spoke at a conference I attended recently, and his comments addressed the concept of strong links and weak links to describe events and organizations. Through it all, the links that bind HSMP to our clients are represented by the consistent application of our process – ever more important as we ponder *Storms Amid the Calm*.

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When we use "HSMP" or "HS Management Partners" or "Firm" or "we" or "us" or "our" in this document, we are referring to HS Management Partners, LLC. When we use "Composite" or refer to the HSMP composite performance in this document, we are referring to our HS Management Partners Concentrated Quality Growth Composite.

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Please note that during certain transitional periods of selling or buying a security or due to some corporate actions such as spinoffs, or due to some other factors, the Portfolio may hold more or less than 20 to 25 securities.

The upside [downside] capture ratios shown in this letter were computed by dividing the cumulative annualized return of the HSMP Composite (net-of-fee) in months of positive [negative] benchmark index returns by the cumulative annualized return of each corresponding benchmark index for those same months.

The Cboe Volatility Index® (VIX® Index®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

HSMP's since inception (4/1/07) annualized net-of-fee Composite performance through 9/30/17 was 11.42%, versus 7.90% for the S&P 500® Index and 9.75% for the Russell 1000® Growth Index, for the same period. Please refer to our website [www.hsmanage.com] for additional performance information, including our Composite 3Q 2017 performance.

For benchmark purposes, the Composite is compared to the S&P 500® and Russell 1000® Growth indices, however, the Composite may contain securities not represented in either or both indices. The S&P 500® Index is an unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The Russell 1000® Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The performance comparisons in this document are provided for market context only, and there are meaningful differences between the Composite and the S&P 500® and Russell 1000® Growth indices (such as in terms of composition, concentration and volatility) that should be considered when comparing performance. Moreover, client account performance may vary from that of the Composite or from that of other client accounts for reasons such as account size, timing of transactions and market conditions at the time of investment.

The performance data contained in this piece should not be taken as an indication of how the performance of the Composite or of a client account will be in the future. Past performance is not indicative of and does not guarantee future results. While we believe that our investment strategy will produce desired returns, there can be no assurance that HSMP will achieve its investment objective or will be successful in implementing its investment strategy. Investment in securities involves significant risks that clients should be prepared to bear, including the risk of loss of the original amount invested. We encourage you to refer to our Firm Brochure (which is available on our website [www.hsmanage.com] or upon request at 212.888.0060) for some material risks applicable to our investment strategy and additional information regarding our Firm.

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