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TAG Stone CAPITAL INC

Second Quarter 2017

SECOND QUARTER MARKET OVERVIEW

Stocks around the world surged upward during Second Quarter 2017, continuing the trend that began at the end of 2016. For the quarter, the S&P 500 index of large, U.S. stocks gained 3.09%, while the Russell 2000 index of small, U.S. stocks gained 2.46%.

International stocks fared even better than U.S. stocks during the quarter, with the MSCI EAFE index of large, foreign stocks gaining 6.12% and the MSCI EAFE small cap index gaining 8.10%.

Alternative asset classes were a mixed bag during the quarter. The MSCI Emerging Markets index gained 6.27%, but the Dow Jones US REIT (real estate) index gained only 1.64%, while the Dow Jones Global REIT index gained 1.41%.

Bonds also posted modest gains for the quarter. The Barclays US Govt/Credit intermediate-term bond index gained 0.94%, while the Barclays Municipal Bond index gained 1.96%.

There is considerable handwringing in the media these days that the market is overbought and due for a downturn.

Investors who heeded the advice to move money out of stocks and into bonds and cash have missed out on those gains, and now face the dilemma of trying to decide whether to move their money back into stocks with the market at historical highs.

Stock Investing at All-Time Highs:

As stock markets, once again, continue to hit all-time highs, investors take this news not with celebration, but with trepidation.

Modern stock markets have been worrying investors with new highs since they were created several centuries ago. For example, in 1955, Benjamin Graham, the great teacher of Warren Buffett, was called before Congress to testify about the level of the stock market—and answer the question: “is the market too high.” At the time, the Dow was up 56% from September 1953 to March 1955 and had just returned to its 1929 peak. The Senate committee wanted to ensure abusive actions were not going to create another meltdown—or as the chairman put it, “a final orgy of buying.”

To give a sense of the discussion, below is an excerpt of the statement from Mr. Graham:

WISE COUNSEL
In 1955, Graham (right) and Sears Roebuck chairman Robert E. Wood testify before the U.S. Senate inquiry on investing

“The true measure of common stock values, of course, is not found by reference to price movement alone, but by price in relation to earnings, dividends, future prospects, and to a small extent, asset values.

EQUITY INDICES

	Jun. ‘17	2nd Qtr.	YTD
S&P 500 Total Return (Large-Cap Stocks)	0.62%	3.09%	9.34%
Russell 2000 Total Return (Small-Cap Stocks)	3.46%	2.46%	4.99%
MSCI EAFE (Developed International Stocks)	-0.18%	6.12%	13.81%
MSCI Emerging Markets (International Emerging Stocks)	1.01%	6.27%	18.43%

FIXED INCOME INDICES

	Jun. ‘17	2nd Qtr.	YTD
Barclays U.S. Aggregate (Broad Domestic Bonds)	-0.10%	1.45%	2.27%
Barclays 1-5 Yr. Credit (Short-Term Domestic Bonds)	0.50%	0.85%	2.26%
Barclays 5-10 Yr. Credit (Intermediate-Term Domestic Bonds)	0.93%	2.13%	3.66%
Barclays U.S. TIPS (Treasury Inflation Protected Securities)	-0.95%	-0.40%	0.85%
Citi World Gov’t 1-5 Yr. Hedged (Short-Term Global Bonds)	-0.14%	0.36%	0.65%

The Dow Jones industrials are now at a lower ratio to their average earnings in the past than they were at their highs in 1929, 1937, and 1946…. It should be pointed out also that high-grade interest rates are now definitely lower than in previous bull markets except for 1946. Lower basic interest rates presumably justify a higher value for each dollar of dividends or earnings.

Such a figure, if reliable would have to be regarded as rather reassuring. It would indicate that the market in terms of value is no higher now than it was in early 1926, or in early 1936, or late 1946.

It is fair to say the market is not too high today if we really managed to lick the business cycle. Although such a development would involve a revolutionary break with the past, I am not prepared to deny its possibility.

In my view, the fundamental reason for the rise [in the market since September 1953] *was the swing from doubt to confidence—from emphasis on the risks in common stocks to the emphasis on the opportunities in common stocks.*

My studies have led to the conclusion that sentiment alone, not supported by any visible change in value, will produce a swing on the order of 100 to 250 or 100 to 300 in price."

An interesting point to note is that the level of the stock market that the senators were so concerned with was the Dow reaching 381. As we know today, the Dow crossed 22,000 for the first time on August 2, 2017.

Five Thoughts on the Stock Market:

In the context of today's all-time market highs, Mr. Graham's 1955 testimony brings several things to mind about the stock market:

1. Maintain an Asset Allocation that Can Withstand a Market Downturn:

As Mr. Graham stated, the stock market moves in cycles. The common anxiety investors face when investing in a historically high market is the fear of buying at the top, just in time to catch a downturn. And, as you can see in the chart below, the average bear market return, from peak-to-trough has been -45%.

A major investment risk individuals encounter during these periods is the risk that the investor sells his or her stock positions during a downturn, turns "paper losses" into real losses, and misses the ensuing bull market. This is why we recommend that you maintain an allocation to stocks and bonds that you can stick with through a market downturn.

In addition, it is important to allocate stock investments across several asset classes, such as small

Characteristics of bull and bear markets

Market Corrections	Bull markets			Bear markets		
	Bull begin date	Bull return	Duration (months)	Market peak	Bear return*	Duration (months)*
1 Crash of 1929 - Excessive leverage, irrational exuberance	Jul 1926	152%	37	Sep 1929	-86%	32
2 1937 Fed Tightening - Premature policy tightening	Mar 1935	129%	23	Mar 1937	-60%	61
3 Post WWII Crash - Post-war demobilization, recession fears	Apr 1942	158%	49	May 1946	-30%	36
4 Flash Crash of 1962 - Flash crash, Cuban Missile Crisis	Oct 1960	39%	13	Dec 1961	-28%	6
5 Tech Crash of 1970 - Economic overheating, civil unrest	Oct 1962	103%	73	Nov 1968	-36%	17
6 Stagflation - OPEC oil embargo	May 1970	74%	31	Jan 1973	-48%	20
7 Volcker Tightening - Whip Inflation Now	Mar 1978	62%	32	Nov 1980	-27%	20
8 1987 Crash - Program trading, overheating markets	Aug 1982	229%	60	Aug 1987	-34%	3
9 Tech Bubble - Extreme valuations, .com boom/bust	Oct 1990	417%	113	Mar 2000	-49%	30
10 Global Financial Crisis - Leverage/housing, Lehman collapse	Oct 2002	101%	60	Oct 2007	-57%	17
Current Cycle	Mar 2009	258%	99			
Averages	-	**156%**	**54**	-	**-45%**	**24**

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
*A bear market is defined as a 20% or more decline from the previous market high. The bear return is the peak to trough return over the cycle. Periods of "Recession" are defined using NBER business cycle dates. "Commodity spikes" are defined as significant rapid upward moves in oil prices. Periods of "Extreme valuations" are those where S&P 500 last 12 months' P/E levels were approximately two standard deviations above long-run averages, or time periods where equity market valuations appeared expensive given the broader macroeconomic environment. "Aggressive Fed Tightening" is defined as Federal Reserve monetary tightening that was unexpected and/or significant in magnitude. Bear and Bull returns are price returns.
Guide to the Markets – U.S. Data are as of June 30, 2017.

foreign stocks, international and U.S. REIT stocks, and emerging markets stocks. This asset class diversification greatly reduces the risk of being concentrated in a single asset class (such as large U.S. stocks) that endures a decades-long downturn and increases the opportunity to invest in some asset classes that may have lower valuations and produce positive returns.

2. **Stock Prices Follow Investor Expectations in the Short Run:**

As Mr. Graham concluded, investor sentiment alone can create large swings in the stock price regardless of any change in real economic value. At any given time, investors can become overly optimistic about stocks or overly pessimistic about stocks.

Mr. Graham's student, Warren Buffett, might have said it best: *"In the short run, the stock market is a voting machine; in the long run, it is a weighing machine."*

3. **Stock Valuations, in the Long Run, are Related to Corporate Earnings and Cash Flows:**

As Buffett's quote states, stock valuations, in the long run, are related to corporate earnings and cash flows.

At the present time, the S&P 500 is highly valued by most metrics, but as shown in the table below from Goldman Sachs, the free cash flow yield on the S&P 500 is about 4.2%, almost directly on par with its long-term average of 4.0%, showing that the S&P 500 is fairly valued from this measure.

4. **When stocks go down, investors become *less* inclined to invest, *not more* inclined:**

There is a misguided belief among many investors that they will happily jump back into the stock market once a significant downturn has occurred. "Once we get a 20% downturn, I'll invest," goes the thinking.

But during such downturns, fear has usually gripped the market and news headlines are obsessed with how far the market has fallen and how much farther it will go.

Instead of feeling encouraged that stocks are a good buy, investors usually become more cautious, fearing they will put money into stocks only to see the market continue to fall. Instead investors usually continue to sit on the sidelines, waiting until things "calm down."

S&P 500 aggregate index and median stock both highly valued on most metrics
as of August 1, 2017

	Aggregate Index			Median Stock		
Metric (Aggregate index)	**Current**	**Long-term average**	**Historical %ile**	**Current**	**Long-term average**	**Historical %ile**
EV / Sales	2.3 x	1.3 x	**95 %**	2.8 x	1.4 x	**99 %**
EV / EBITDA	11.6 x	8.2 x	**88**	12.0 x	8.1 x	**99**
Forward P/E	18.0 x	12.8 x	**89**	18.1 x	13.1 x	**96**
Cyclically adjusted P/E (CAPE)	26.0 x	18.7 x	**87**	NA	NA	**NA**
P/E to growth (PEG)	1.4 x	1.1 x	**89**	1.9 x	1.2 x	**100**
Cash flow yield (CFO)	7.4 %	9.4 %	**87**	7.2 %	9.0 %	**96**
Price / Book	3.2 x	2.5 x	**85**	3.4 x	2.2 x	**99**
Free cash flow yield (FCF)	**4.2 %**	**4.0 %**	**52**	**4.3 %**	**4.1 %**	**47**
Median			**88 %**			**99 %**

Note: Data since 1990 for CFO and FCF, 1981 for PEG, and 1976 for all others.
Cash flow from operations yield and free cash flow yield exclude Financials and Real Estate.

5. Investing Near All-Time Highs is Part of Stock Investing:

Investing near all-time highs is part of stock investing. As shown in the graph to the right, the stock market, from January 1926 to December 2016, has closed at new month-end highs almost 30% of the time.

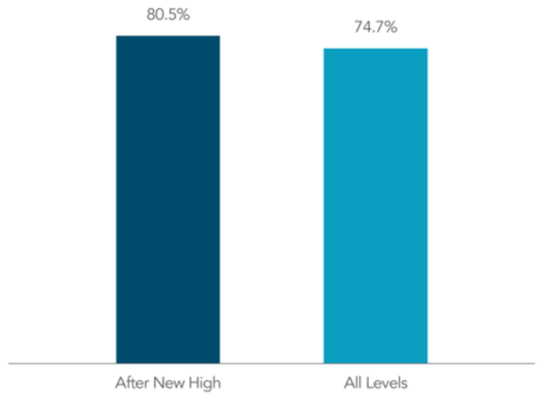
Historically, however, new highs have not been useful predictors of future returns. As the graph indicates, the chances of positive monthly returns over any 12-month period is about the same, whether the market is hitting a new high or not.

Bottom Line:

The bottom line is that making subjective decisions about when to invest in stocks is difficult. In a fully-valued market like today, investors should be prepared for a market downturn, even though a fully-valued market does not mean that a downturn is imminent. Instead, a market drawdown can occur at any time or any level of the market.

Instead of trying to time the market, TAGStone Capital recommends choosing a prudent investment strategy that you can stick with through any market conditions. Studies have shown that the average investor times the market poorly, getting in at the top and getting out at the bottom, and achieves below available returns.

Exhibit 1. **S&P Total Return Index Highs: 1926–2016**
Percent of Months With Positive Return Over Next 12-Month Period



From January 1926–December 2016, 319 months, or approximately 29% of monthly observations, were new closing highs.

Note: 1,081 monthly observations.

The S&P data is provided by Standard & Poor's Index Services Group. For illustrative purposes only. Index is not available for direct investment. Past performance is no guarantee of future results.

When asked by the Senate chairman how he deals with market levels in his business, Mr. Graham responded insightfully:

"I have never specialized in economic forecasting or market forecasting either. My own business has been largely based on the principle that if you can make your results independent of any views as to the future you are that much better off.

I think our success is due to our having established sound principles of purchase and sale of securities and having followed them consistently through all kinds of markets."

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

Data sources for returns and standard statistical data are provided by the sources referenced and are based on data obtained from recognized statistical services or other sources we believe to be reliable. However, some or all information has not been verified prior to the analysis, and we do not make any representations as to its accuracy or completeness. Any analysis nonfactual in nature constitutes only current opinions, which are subject to change. Benchmarks or indices are included for information purposes only to reflect the current market environment; no index is a directly tradable investment. There may be instances when consultant opinions regarding any fundamental or quantitative analysis do not agree.

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