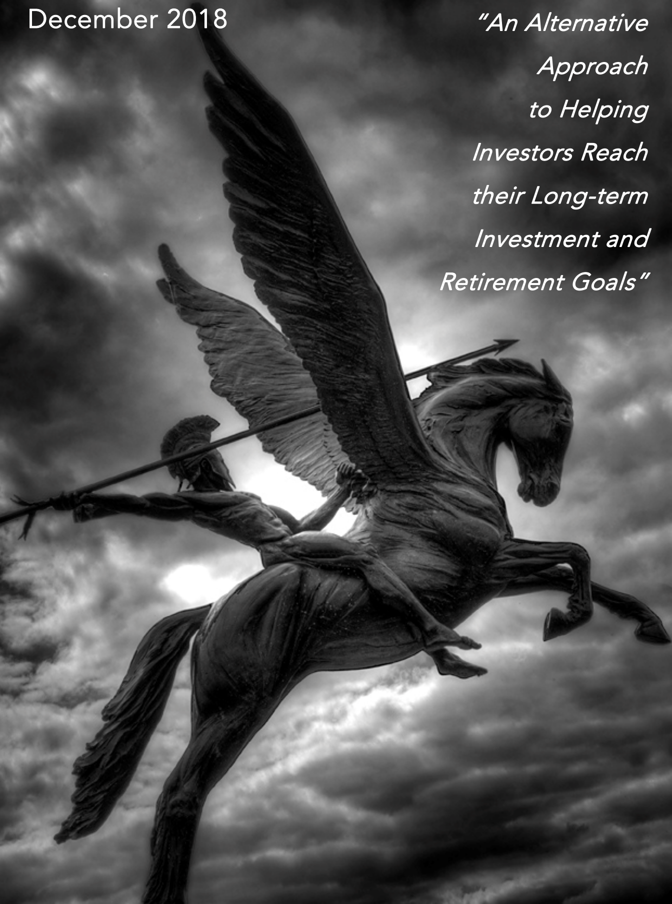
December 2018

"An Alternative Approach to Helping Investors Reach their Long-term Investment and Retirement Goals"



The Passionate Investor

4Q2018 Market Review and Commentary

We are truly humbled to be able to present you this quarter's newsletter. Our experience has been exciting to say the least, given that this is our first full quarter of existence as a new firm. Before we start, we would like to thank our friends and family who were very helpful and supportive of us. We hope to return the favor by helping as many people as possible reach their goals and dreams. We hope to excel in our job of offering a service that seems to be disappearing quickly: active investment management. Given the severity of the recent bout of stock market volatility, many friends and/or acquaintances have consoled us about the timing of our firm's debut. As the owner of an investment management business, I often get the comment about how tough it must be to start out in such a volatile climate. But I can honestly say that I would not have it any other way. That is because I truly believe that in such a market, my firm's investment strategy can make a difference and contribute towards helping investors reach their goals. It is in such a market that we find the best opportunities and can really separate ourselves from our peers.

Belleros Capital Management challenges conventional wisdom when we believe it necessary. We believe most investors or households are behind on their retirement goals because they fundamentally underestimate their life expectancy. They therefore also underestimate their financial needs in retirement and their need for growth assets (like stocks) in the here and now. Investors also rely too much on common investment concepts such as market efficiency, volatility, and diversification; treating them as fact when they are but theories. After ten strong years of stock market performance, many investors have chosen a passive indexing strategy because costs are low and presumably because they believe the stock market is efficient. The events of last quarter were evidence that the market is not efficient and that it doesn't just go up. Volatility is a symptom of this market inefficiency. Although it is a risk, we don't think it is the greatest threat for most investors. Volatility is less of a threat for investors who have long-term time horizons. It is also diversifiable (with bonds and cash) at a portfolio level for investors that must protect an income stream or plan for a liquidity event. Preoccupation with volatility can also lead to poor and emotional market timing decisions meant to lessen its impact.

Most investors don't understand that the gains and losses caused by volatility in their investment portfolios are only on paper (i.e. they are unrealized). Paper gains and losses aren't real or "realized" until investments are sold. (continued on the next page)

Inside this issue

Market Review……………………………..3
Market Commentary……...…………….…4
Closing Comments on 2018…………….5
Investment Strategy and Biography...….6
Code of Ethics and Privacy Policy……....7
Addendum……………………………….....8

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Opening Comments Cont'd.

Investors that are tempted by fear of volatility into selling their investments at losses may experience a real and permanent loss of capital; a greater worry in our opinion. Investors that have long-term time horizons (and most of us do) should focus less on short-term price swings (volatility) produced by market inefficiency and concentrate on the bigger prize: their long-term investment and retirement goals. Like a permanent loss of capital, outliving one's wealth or failing to reach your long-term investment and retirement goals because you focused too much on volatility and "risk" avoidance, should be your greatest concerns.

Belleros Capital Management has a comprehensive plan to benefit from market inefficiency and avoid permanent losses of capital. We treat volatility (especially periods of excess volatility) as an opportunity to exploit and avoid making investment decisions based on emotions. We can do this by following the most basic investment principle of buying low and selling high. We can further protect ourselves from permanent losses of capital by being selective in the investments we choose. Buying the stocks of high-quality companies with durable competitive advantages and strong balance sheets help to avoid companies that may not be around in the near future. We are also selective about price and will only buy them if they sell at a comfortable discount to their intrinsic values. And, we hold the positions long-enough for markets to normalize such that their prices return to intrinsic value. Lastly, we can avoid mediocrity by concentrating our positions and limiting investments to a select few, as determined by the opportunities available in the market. Diversification can be imagined as a scale where too few stocks equates to placing all of your eggs in one basket; too many stocks and portfolio performance begins to resemble the market (even worse after fees are considered). Therefore, we would rather seek a portfolio of stocks that is differentiated (having little in common with the index), and not necessarily concentrated or diversified.

We would combine our investment philosophy and strategy with our own value propositions that seeks to minimize investors' costs and helps them avoid short-term emotional decisions that could ultimately prove detrimental towards their investment goals. As such, we are trying to prevent ourselves and our clients from being an extra set of obstacles that stand in the way of their goals. We believe this is the best strategy to maximize your wealth generation potential. Investing in stocks is a necessity for most people. However, it need not be traumatic. Having a strong and well-defined investment strategy that includes active investment management helps. Indeed, it may be integral to-wards your reaching your long-term investment and retirement goals.

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Investing involves risk including the potential loss of principle. No investment strategy can guarantee a profit or protection against loss in periods of declining value. Past performance does not guarantee future results. Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments."
— Seth Klarman

Company Description

Belleros Capital Management is an independently owned investment management and advisory firm serving investors who have a desire to embark on an investment strategy that will help them reach their long-term investment and retirement goals. The firm actively manages investment accounts on a fully discretionary basis for our clients. Our primary purpose is to help investors reach their financial goals through a plan to minimize the "all-in" investment-related fees they pay, increase the value-add they receive from their investments, and by working with them to develop a strong level of investment discipline that will help them maximize their wealth generation potential.

Belleros Capital Management

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."
— Benjamin Graham

Investment Philosophy

Market Inefficiency

Equity or "stocks" are inherently volatile assets due to the sheer number of participants involved, the diversity of their motives, and the wide range of emotions they employ. Stocks are frequently prone to excessive volatility when emotions particularly run hot. We believe this excessive volatility is a sign of short-term stock market inefficiency. However, we believe the stock market is more efficient over the long-term as rational investment behavior reasserts itself. Similarly, excessive volatility causes the market prices of stocks to deviate from their intrinsic values. As time progresses, the market prices of stocks generally return to their intrinsic values. We believe that stock market inefficiency as represented by excess volatility is exploitable and represents an opportunity for profit. In our experience, excessive volatility can and does extend to all manner of companies and stocks. Even the best companies and their stock can be affected by stock market inefficiencies and come to exhibit excess volatility, creating exploitable investment opportunity for the astute investor.

Market Review *

- Equity markets generally underperformed fixed-income markets with the S&P 500 falling -13.52% (including dividends; -4.38% YTD) and the Barclay's Capital U.S. Aggregate Bond index increasing +1.64% (+0.01% YTD).
- Small caps underperformed large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned -20.20% (-11.01% YTD).
- Growth outperformed value during the quarter and YTD (as determined by the S&P 1500 broad market index which includes large, mid, and small capitalization stocks).
- Non-U.S. equity markets generally outperformed U.S. markets in both US dollar and local currency terms (MSCI EAFE**: -12.50% in USD; -12.16% in local currency; -13.36% and -10.54% YTD, respectively).
- Emerging markets outperformed both U.S. and non-U.S. developed markets (MSCI EAFE**) in both USD and local currency as the MSCI Emerging Markets Index fell 7.40% in USD and -7.36% in local currency (-14.25% and -9.73% YTD, respectively).
- Brazil (+13.56%; -0.15% YTD) was notable based on its strong performance during the quarter (all quoted in USD). Canada (-15.11%; -16.56% YTD), England (-14.96%; -11.90% YTD), Japan (-14.20%; -12.58% YTD), France (-11.77%; -14.10% YTD), and China (-10.73%; -18.75% YTD), were notable based on their weakness during the quarter.
- Most U.S. market sectors were negative during the quarter. Utilities was the only U.S. economic sector to post a positive return during the quarter (+1.36%; +4.11% YTD). Energy (-23.78%; -18.10% YTD), Information Technology (-17.34%; -0.29% YTD), Industrial (-17.29%; -13.29% YTD), and Consumer Discretionary (-16.42%; +0.83% YTD) stocks were most distinguishable given their weakness. Healthcare stocks were notable in that they lodged the best performance for the full year (+6.47%; -8.72% QTD).
- High yield bonds fell 3.49% during the quarter (-4.06% YTD). The U.S. corporate bond sector climbed 0.27% during the quarter (-2.50% YTD). 10-Year U.S. Treasury yields fell from 3.06% at the beginning of the quarter to 2.69% currently (2.41% at the beginning of the year).
- The U.S. dollar rose versus the British Pound (+2.34%; +5.85% YTD) and the Euro (+1.58%; +4.80% YTD) during the quarter and full year period. The Yen climbed versus the U.S. dollar during the quarter and year (+3.41%; +2.61% YTD).

** Unless otherwise noted, performances stated above reflect data provided by Standard and Poor's, Russell Investments, MSCI, and Barclay's Capital.*

*** The MSCI EAFE Index is a large capitalization, developed market benchmark that tracks non-U.S. or foreign equity markets.*

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Market Commentary

2018 need only be viewed through the lens of its last two quarters. Third quarter results were so good (+7.71% including dividends; +10.56% YTD through quarter end) that investors would be forgiven if they believed that ***the most widely accepted proxy*** of the U.S. stock market had wrapped up its record tenth consecutive year of positive S&P 500 performance. By the end of October however (down approximately 7%), many of us also probably began to suspect (I know I did) that that possibility was quickly slipping away. By year end, the third quarter's achievement was replaced by a starkly contrasting fourth quarter loss. For the first time ever, the S&P 500 index would end the year with a loss (-13.52% for the quarter and -4.38% for the full year) after recording gains through its first three quarters. For the first time in ten years, the S&P 500 would fail to offer a positive return for the full year.

The stock market's weakness extended beyond the S&P 500. All major broad market indices in the U.S. (some of which are included in the table below) fell into at least correction territory (defined as having a peak-to-trough decline of at least 10%). More focused indices like the NASDAQ (technology and growth stocks) or Russell 2000 (small caps) had the inglorious distinction of reaching bear market status (defined as having a peak-to-trough decline of at least 20%). The Russell 3000 and Wilshire 5000 indices, ***the broadest and perhaps best proxies*** of the U.S. stock market also achieved bear market status during the quarter.

International and emerging market stocks which were already struggling in terms of performance through the third quarter, swooned further with the dollar offering no respite for weary US-based investors. The U.S. currency continued to reflect a stronger domestic economy, outpacing every currency not named the Japanese yen. The Barclays Capital U.S. Aggregate Bond index offered traditional safe haven performance, returning +1.64% during the quarter. Fixed-income markets experienced a modest level of panic in early December as a narrow segment of the U.S. Treasury yield curve inverted briefly, causing many stock and bond market participants to fear the worse for the U.S. economy (please read the Addendum discussion for the reason behind this worry and for answers to questions you may have regarding yield curves and what it means for them to invert).

Peak-to-Trough Market Performance*			
Index	**Time Period**	**Return**	**Note**
S&P 500	9/20 to 12/24	-19.36%	Correction
DJIA	10/3 to 12/24	-18.77%	Correction
NASDAQ	8/29 to 12/24	-23.36%	Bear Market
Russell 2000	8/31 to 12/24	-26.89%	Bear Market
Russell 3000	9/20 to 12/24	-20.56%	Bear Market
Wilshire 5000	9/20 to 12/24	-20.72%	Bear Market

Source: FactSet

** Total return; using closing or end of day prices*

"We steer clear of the foolhardy academic definition of risk and volatility, recognizing, instead, that volatility is a welcome creator of opportunity"
— Seth Klarman

Investment Philosophy

The Main Source of Risk to Long-term Investors

Belleros Capital Management believes that the investment industry's definition of risk as volatility is inappropriate and generally does not apply to all participants. Although the effects of volatility can be particularly disastrous to investors that have near-term income or liquidity requirements, long-term investors can and should be less constrained by it. As opposed to gambling or speculation, we believe that investing is by definition a long-term strategy. We believe that stock market volatility is a source of investment opportunity for long-term investors, especially when it is excessive. Investors with a strategy to benefit and exploit stock market inefficiencies and excessive volatility should therefore concern themselves with (and try to avoid) greater risks such as a permanent loss of capital, the risk of outliving one's wealth, or the failure to meet their long-term investment and retirement goals.

Closing Comments on 2018

Despite the yield curve discussion in the Addendum, we don't believe our readers really need a lesson on yield curves to understand the bigger picture. We discussed in last quarter's newsletter that stock valuations appeared stretched and that the dearth of new opportunities available for investment suggested the same. It has been our experience that when stock valuations become stretched or far detached from reality or fundamentals, and their market prices rise well above (or below) their intrinsic values, they can become more susceptible to both the emotions of market participants and macro-economic events alike. The slightest event can cause an inordinate amount of volatility. When one or more negatively perceived macro-economic event mixes in a combustible soup of human emotions: conflagration. The environment becomes so charged that any macro-economic event like a China/U.S. trade war, Brexit, slowing global economies, fading relief from tax cuts domestically, lower inflation expectations, and newly dovish Fed sentiment (to name just a few), can provide the spark to start a fire.

The events of the fourth quarter are evidence of the market inefficiency we often speak of; occurring with greater frequency than most observers would care to admit. And "emotional" is a good word to describe the quarter because it clearly suggests that the stock market is far from efficient; a human characteristic for a volatile market with human participants. Those who would invest passively in an indexing scheme (or buy and hold strategy) have no choice but to accept the volatility and performance of the market; they must own it. Yet, this is still a far better choice than market timing which truly throws caution to the wind. But that volatility (especially when it is in excess) may be an opportunity for those who would treat it as such.

We will end this newsletter with a suggested New Year resolution for our readers and a quote by someone you've probably heard of. First, the New Year resolution: ignore the "noise" and pay attention to fundamentals. Much of what we've discussed above (and in the Addendum) is "noise" that really, only serves to exhaust your emotions and tempt you into making ill-advised short-term decisions that may lead you astray from your long-term goals. Focusing less on noise and more on fundamentals can benefit your mental health. If you are an investor in a stock and by investor I really mean "long-term" investor (I think the two terms together is redundant), it would serve you well to focus on the company's fundamentals. Fundamentals are things like competitive advantage, earning power, or intrinsic value which if durable are long-term characteristics that will not be permanently impaired by short-term "noise" that contribute to stock price volatility, and is the key to your investment's success. We wish everyone success in all manner of things in 2019. Lastly, the quote:

> *"Owners of stocks, however, too often let the capricious and often irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments." – Warren Buffett*

> *"Wide diversification is only required when investors do not understand what they are doing."*
> *— Warren Buffett*

Investment Philosophy

Diversification

Belleros Capital Management believes that the idea of portfolio diversification is counter-intuitive and works against our active management goals. The idea of diversification is meant to limit the impact of stock market volatility. We believe stock market volatility represents an investment opportunity that is exploitable. Therefore, limiting the opportunities we seek to exploit would seem rather perverse. Diversification is a scale. Too little and you risk putting all your eggs in too few baskets; too much and your portfolio and expected return mimics the broader stock market (index). We believe excessive diversification (in addition to high investment-related fees) is a main contributor to poor active management performance relative to passive/index investing. We believe investors who seek excess returns above and beyond what one could expect to receive from the broader stock market should choose an investment manager that minimizes fees and concentrates their investment portfolio to ward of the indexing-like characteristic of diversification.

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Investment Strategy

We seek to exploit stock market volatility in the short-term through a **long-term**, active investment management strategy that purchases higher **quality** stocks with sustainable competitive advantages and economic moats, and at prices below our calculation of intrinsic value (otherwise known as "**value** investing"). These characteristics help us defend against what we believe is the biggest risk in investing: a permanent loss of capital. In addition, we intend to show our discipline and conviction in our investments by employing a concentrated portfolio mandate that is differentiated and allows us to focus on only the best investment candidates available. Further, we seek to show our conviction through our portfolio weighting scheme which skews exposure to the best investment candidate.

- Active investment management
- Long-term investing
- Seek higher quality opportunities
- Value investing
- Avoid permanent losses of capital
- High conviction
- Invest with confidence
- Disciplined approach
- Volatility is an opportunity
- Concentrated stock portfolio
- Differentiated from the index

"Risk is not inherent in an investment; it is always relative to the price paid. Uncertainty is not the same as risk. Indeed, when great uncertainty – such as in the fall of 2008 – drives securities prices to especially low levels, they often become less risky investments." — Seth Klarman

"We don't have to be smarter than the rest. We have to be more disciplined than the rest." — Warren Buffett

Biography

Tim Hai, CFA®, CAIA®

Chief Investment Officer and Senior Portfolio Manager

- 22 years of experience in the investment industry
- 6 years experience overseeing public equity and fixed-income assets for a $10 billion multi-employer pension plan
- 8 years of equity portfolio management experience
- 8 years exp. manager research and due diligence
- M.B.A. - Loyola College of Maryland, 2000
- B.S. Finance – University of Maryland, College Park, 1996

Tim has 22 years of diversified investment experience that includes the research and direct investment management of stocks and bonds for high net worth and small business clients. Additionally, Tim has experience in manager research and due diligence, having helped oversee and manage a $10 billion institutional pension fund. Tim had direct oversight of the pension fund's equity and fixed-income investment portfolios that were managed by outside investment managers. Tim had specific oversight over the pension fund's $1.2 billion concentrated managers program that sought to extract value add from some of the country's best investment managers through a mandate that required high conviction and a limited number of stock positions.

Tim received his B.S. in Finance from the University of Maryland, College Park and his MBA from Loyola College of Maryland. More recently, he also completed coursework in international investing and currency management with the Oxford International Investment Programme at the Said Business School at the University of Oxford, United Kingdom. Tim holds the Chartered Financial Analyst ("CFA") and Chartered Alternative Investment Analyst ("CAIA") designations. He is a member of the CFA Institute and the CFA Society Washington, DC. He is also a member of the Washington, DC Chapter of the CAIA Association.

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Code of Ethics and Privacy Policy

Belleros Capital Management is a fiduciary; we will act in the utmost good faith, performing in a manner believed to be in the best interest of our clients. We believe that our business methodologies, ethics rules, and adopted policies are designed to eliminate or at least minimize material conflicts of interest, and to appropriately manage any material conflicts of interest that may remain. It is important to point out that no set of rules can anticipate or relieve all material conflicts of interest. Our firm will disclose to its advisory clients any material conflict of interest relating to the firm, its representatives, or any of its employees which could reasonably be expected to impair the rendering of unbiased and objective advice.

Code of Ethics

We have adopted a Code of Ethics that establishes policies for ethical conduct for our personnel. Our firm accepts the obligation not only to comply with all applicable laws and regulations but also to act in an ethical and professionally responsible manner in all professional services and activities. Firm policies include prohibitions against insider trading, circulation of industry rumors, and certain political contributions, among others. We periodically review and amend our Code of Ethics to ensure that they remain current, and we require firm personnel to annually attest to their understanding of and adherence to the firm's Code of Ethics. A copy of the firm's Code of Ethics is made available to any client or prospective client upon request.

Privacy Policy Statement

We respect the privacy of all clients and prospective clients (collectively termed "customers" per federal guidelines), both past and present. It is recognized that clients have entrusted our firm with non-public personal information and it is important that both access persons and customers are aware of firm policy concerning what may be done with that information.

The firm collects personal information about customers from the following sources:

- Information provided to us to complete their plan or investment recommendation;
- Information provided via engagement agreements and other documents completed in connection with
- the opening and maintenance of an account;
- Information customers provide verbally; and
- Information received from service providers, such as custodians, about client transactions.

The firm does not disclose non-public personal information about our customers to anyone, except in the following circumstances:

- When required to provide services our customers have requested;
- When our customers have specifically authorized us to do so;
- When required during the course of a firm assessment (i.e., independent audit); or
- When permitted or required by law (i.e., periodic regulatory examination).

To ensure security and confidentiality, the firm maintains physical, electronic, and procedural safeguards to protect the privacy of customer information. Within the firm, access to customer information is restricted to personnel that need to know that information. All access persons and service providers understand that everything handled in firm offices is confidential and they are instructed not to discuss customer information with someone else that may request information about an account unless they are specifically authorized in writing by the customer to do so. This includes providing information about a family member's account.

The firm will provide customers with its privacy policy on an annual basis and at any time, in advance, if firm privacy policies are expected to change.

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ADDENDUM

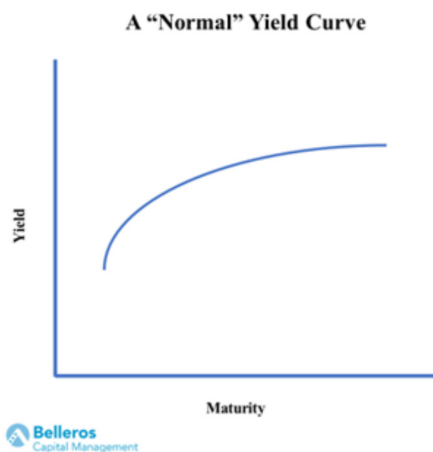
to the Passionate Investor Newsletter

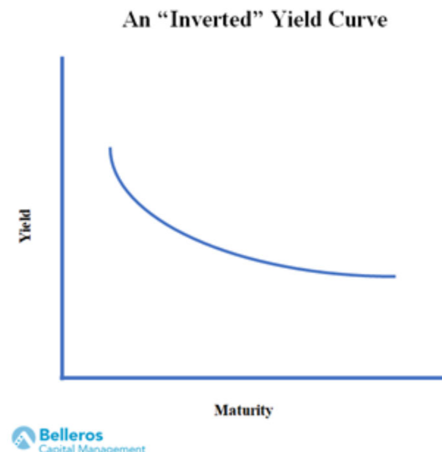
4Q2018 Market Review and Commentary

Ignore the Noise

The Yield Curve

The yield curve is a graphical representation of maturities and interest rates (yields) offered on bond or fixed-income contracts. In college it was often referred to as the term structure of interest rates. A common yield curve example exists on the information board posted inside most commercial banks. A typical board might publish the "APRs", or annual percentage rates of several certificate of deposits (i.e. CDs) alongside their maturities. While there are many bond market variations of the yield curve, investors have traditionally paid most attention to the U.S. Treasury yield curve with particular focus on bonds with maturities between two and ten years. The yield curve is "normally" upward sloping (see graph to the left below), signifying that bond investors typically require or demand greater interest rates over greater investment time periods. A "normal" yield curve is also said to reflect a good or stable economy.





The Inverted Yield Curve

Interest rates on shorter dated bonds can sometimes rise above those with longer maturities. In such a case, the yield curve is said to be "inverted" as depicted in the chart above (and to the right).

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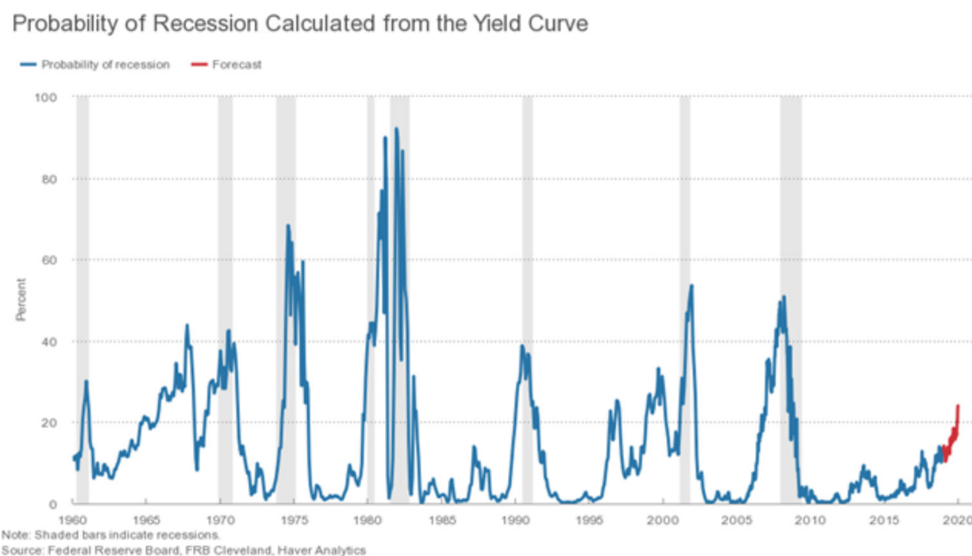
Ignore the Noise (Cont.)

Economists and professional investors alike pay close attention for signs of a potential yield curve inversion as they are reputed to have the ability to predict recessions. A full inversion in the U.S. Treasury bond yield curve (i.e. with maturities from two through ten years) has "predicted" each of the past seven recessions in the U.S., going back as far as 1970 and including the Great Recession of 2007. The chart below shows the probabilities of recession (as calculated from the yield curve) and their actual occurrences since 1960.



Full Year 2018

Economists and investors were on alert over the past year as the "normal" yield curve flattened into a transitory or "limbo" phase they worried could end in a state of inversion. They were also concerned that what was thought to be a major reason behind the year's flattening yield curve paralleled the inversion experienced prior to the Great Recession: Federal Reserve "tightening" (i.e. interest rate increases). The Federal Reserve (the "Fed") has been lifting its benchmark federal funds rate (the rate most other interest rates are based off in the U.S.) since December 2015 in an attempt to quell excessive inflationary pressure resulting from the strengthening U.S. economy. Bond yields are positively correlated to Fed Funds interest rate changes (i.e. they tend to rise and fall in unison) with the greatest impact felt by bonds with shorter maturities. Bond yields may also reflect supply/demand and any number of macro-economic news or events.

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Ignore the Noise (Cont.)

December 2018

In early December, a segment of the U.S. Treasury yield curve “inverted” as interest rates for three-year U.S. Treasury bonds climbed slightly above those offered at five-years. This inversion lasted until December 14 when it normalized. This partial inversion of the yield curve may have precipitated a strong increase in stock market volatility and a major decline in the stock market (as represented by the Chicago Board of Options Exchange’s Market Volatility Index and S&P 500 in the charts below, respectively). The S&P 500 index declined -15.5% between December 3, 2018 and December 24, 2018.

CBOE VIX 4Q2018 Performance

Source: FactSet

S&P 500 4Q2018 Performance

Source: FactSet