Belleros
Capital Management

The Passionate Investor

3Q2018 Market Review and Commentary

*Market Review **

- Equity markets generally ***outperformed*** fixed-income markets with the S&P 500 climbing 7.71% (including dividends; +10.56% YTD) and the Barclay's Capital U.S. Aggregate Bond index increasing +0.02% (-1.60% YTD).
- Small caps ***underperformed*** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned +3.58% (+11.51% 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 ***underperformed*** U.S. markets in both local currency and US dollar terms (MSCI EAFE**: +1.42% in USD; +2.42% in local currency; -0.98% and +1.84% YTD, respectively).
- Emerging markets ***underperformed*** both U.S. and non-U.S. Developed markets (MSCI EAFE**) in both local currency and USD as the MSCI Emerging Markets Index fell 0.95% in USD but rose a slight 0.11% in local currency (-7.39% and -2.56% YTD, respectively).
- Russia (+6.60%; +9.84% YTD), Brazil (+6.17%; -12.07% YTD), Japan (+3.81%; +1.89% YTD), and England (+2.87%; +3.60% YTD), were notable based on their strong performances during the quarter (all quoted in USD). China and India were notable based on their weakness during the quarter (-7.42%; -8.98% YTD and -2.25%; -9.60% YTD, respectively).
- All U.S. market sectors were positive during the quarter. Health Care (+14.53%; +16.63% YTD), Information Technology (+8.80%; +20.62% YTD), and Consumer Discretionary (+8.18%; +20.64% YTD) stocks were most distinguishable given their strength. Material stocks were noticeably weak (+0.36%; -2.73% YTD).
- High yield bonds rose 1.98% during the quarter (-0.59% YTD). The U.S. corporate bond sector climbed 0.72% during the quarter (-2.76% YTD). 10-Year U.S. Treasury yields climbed from 2.85% at the beginning of the quarter to 3.06% currently (2.41% at the beginning of the year).
- The U.S. dollar rose versus the British Pound (+1.23%; +3.60% YTD) and the Euro (+0.52%; +3.27% YTD) during the quarter and full year period. The Yen declined versus the U.S. dollar during the quarter and year (-2.55%; -0.83% 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.*

Inside this issue

Tim Hai, CFA®, CAIA®
CIO and Sr. Portfolio Manager

"Low U.S. un-employment and job-less claims in addition to rising consumer confidence and strong corporate earnings growth all have helped to create a soothing environment for stocks… "

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.

Market Commentary

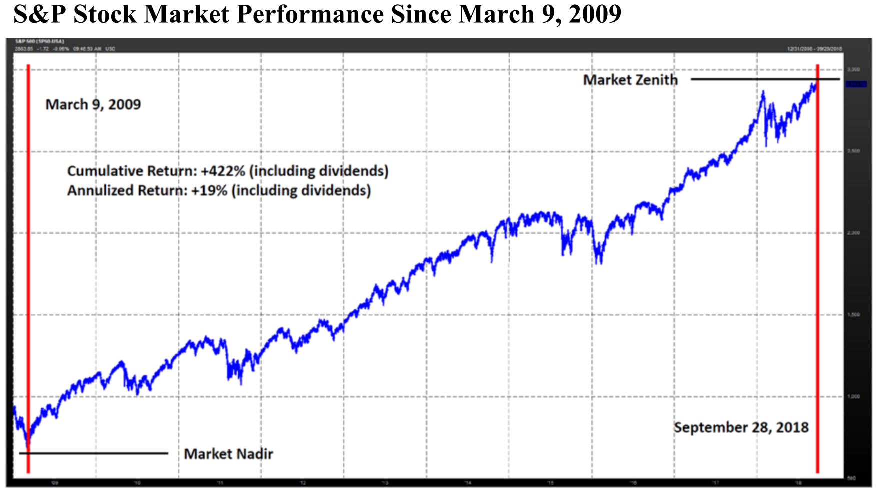
U.S. stocks and large caps particularly, dominated most other investment options this quarter. Second quarter corporate earnings growth of 25% (announced during the third quarter) and strong economic data regarding low un-employment and jobless claims undoubtedly helped the S&P 500's 7.71% return. This enabled U.S. stocks to easily outperform bonds which were themselves challenged by rising interest rates. Large cap stocks also outperformed their smaller cap cousins which also had a good quarter (though not as good) due to their perceived shielding from international pressures. International stocks underperformed because of the cloud of U.S. trade reform and due to the general strengthening of the U.S. dollar. Emerging market stocks also underperformed in part due to rising U.S. interest rates which increases lending costs.

Whether you believe the performance was fated after a slow start to the decade or if you believe deregulation and recent tax cuts are the main contributing factors, the result seems crystal clear: low U.S. un-employment and jobless claims in addition to rising consumer confidence and strong corporate earnings growth all have helped to create a soothing environment for stocks despite weak international markets, rising labor costs, rising oil prices, a strong U.S. dollar, and a back drop of rising interest rates. To be sure, inflation remains a risk as the U.S. Federal Reserve balances accommodation and monetary tightness. China-related tariffs may also become a threat to the economy should they persist or grow.

The Longest Bull market of All-Time?

You may have heard recently that the current bull market in U.S. stocks has claimed the "longest ever" title. There has been some wrangling over the claim based on one's choice of start dates, but no one can argue the fact that we **are** experiencing ***one of*** the longest bull markets ever. Given its current length, we are not surprised that many market prognosticators have become more vocal in their calls for an end to the party. Although we don't make such predictions, we can understand their basis given the cyclicality of the stock market and U.S. economy. Although we don't take them too seriously, we always preach against complacency and for continued vigilance.

S&P Stock Market Performance Since March 9, 2009



Source: FactSet

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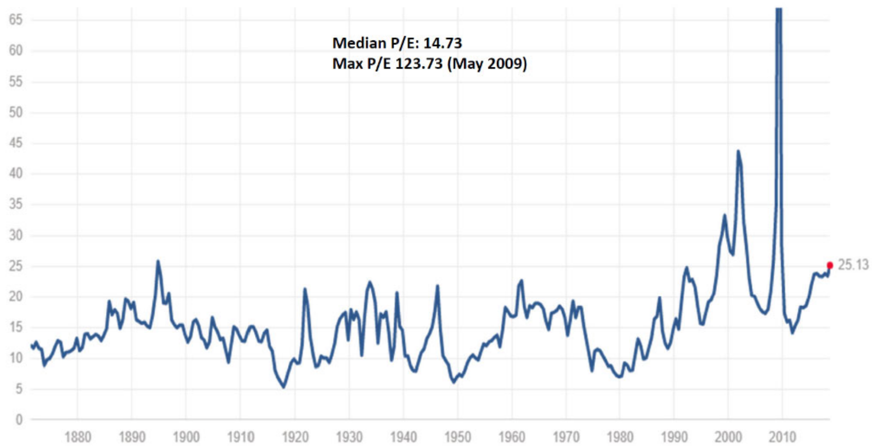
The Longest Bull market of All-Time? (Cont.)

Current S&P 500 PE Ratio (TTM earnings) (As of October 4, 2018)

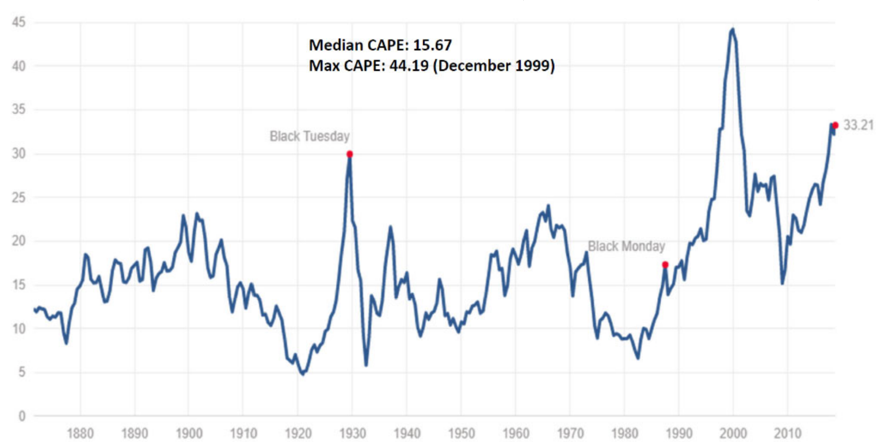


Source: http://www.multpl.com/

Our own unique perspective as a bottom-up manager of stock portfolios tells us that although investment opportunities exists, they are proving harder to find. This anecdotal evidence along with market valuations (some of which are flashing warning signals) may suggest that some sort of inflection point is close at hand. The S&P 500 index's price-to-earnings ratio ("P/E") is elevated historically, but not exactly near its highest ever levels (May 2009).

Another measurement, the Cyclically Adjusted P/E or "CAPE" ratio adjusts the aforementioned S&P 500 P/E ratio by using average inflation-adjusted earnings from the previous 10 years. This ratio attempts to "smooth" out the business cycle and other macro-economic events that may distort singular data. The CAPE ratio also suggests stocks are overvalued historically, though not at its highs in the late 1990s (the dot-com bubble of yesteryear).

Current CAPE or Shiller PE Ratio (As of October 4, 2018)



Source: http://www.multpl.com/

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

Investment Philosophy

Market Efficiency (or 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.

"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

We believe 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.

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The Longest Bull market of All-Time? (Cont.)

Despite the above signals, we are not in the business of predictions, forecasting, and market timing. Our investment philosophy is rooted in bottom-up, fundamental analysis. We only buy stocks that we believe sell at a compelling discount to our calculation of intrinsic value. We generally sell or pare back on them once they reach full valuation (though we may continue to own a smaller weighting in them if we believe the underlying earnings power of the company is growing and may lead to a re-valuation upwards in intrinsic value). This keeps our portfolio (in aggregate) from being overvalued. The stock market in general has no such culling process of removing expensive stocks from its herd, and so it is prone to extreme volatility from time-to-time. So, when one talks of market overvaluation, we would not confuse that with our portfolios. If the market re-prices because its bubble has been pricked, that is not necessarily fundamental or warranted bad news for your portfolio specifically. It may fall to a degree with the market, but its lower valuations should help support it and position it to benefit as we actively add high quality stocks at very attractive prices.

As such, our clients' portfolios ***generally***[1] have an relative valuation below that of the market. Because of this, we pay very little attention to talking heads on television or in print media that discuss such things. In this way, we are not pro-active or speculative when it comes to the market and stocks. We are very re-active and take what market opportunities come our way. We are like baseball players that wait for ***their*** pitch and will not swing at bad ones. We may have an indication of the next pitch based on the strike count, but we don't commit to swinging before the ball leaves the pitcher's hand.

This newsletter may seem rather long for some people due to the subject matter and number of topics. However, some readers may also find that it reads faster given the large charts. Please visit our website for more information regarding our investment philosophy and strategy (www.belleroscm.com). Never hesitate to shoot us an email or call with any questions you may have. One last point to mention before I let you all go: although I mentioned that we pay little heed to market noise (data, forecasts, etc.), we are cognizant of them if only to keep us from getting complacent. We also evaluate and reevaluate ourselves constantly to stay honest. As mentioned earlier, ongoing vigilance is required. Best wishes to everyone in this last but usually most eventful (in terms of holidays) quarter of the year.

[1] This characteristic may reverse in an upside-down market where stock prices have fallen dramatically, but falling corporate earnings (and projections) have fallen by much more. This situation causes relative valuation tools like a P/E ratio to signal an expensive market or stock when in fact it may no longer be. In such markets, we will be buying quality stocks at highly

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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 seeks to purchase 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

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

Investment Philosophy

Diversification (or Not)

We believe 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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Biography

Tim Hai, CFA®, CAIA®

Chief Investment Officer and Senior Portfolio Manager

- 22 years of experience in the investment industry
- 8 years of equity portfolio management experience
- 8 years exp. manager research and due diligence
- 6 years experience overseeing public equity and fixed-income assets for a $10 billion multi-employer pension plan
- 6 years experience overseeing a $1.2 billion program of investment managers utilizing a concentrated stock mandate
- Completed coursework in international investing and currency management with the Oxford International Investment Programme at the University of Oxford, United Kingdom, 2010
- M.B.A. - Loyola College of Maryland, 2000
- B.S. Finance – University of Maryland, College Park, 1996
- Achieved Chartered Financial Analyst designation in 2003
- Achieved Chartered Alternative Investment Analyst designation in 2011

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.