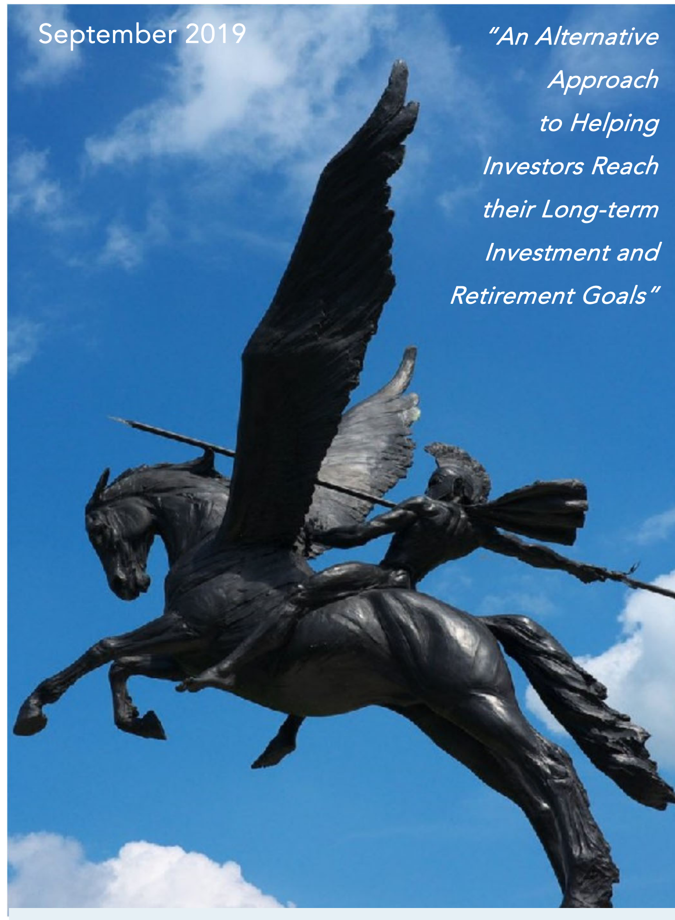
Belleros Capital Management

The Passionate Investor

3Q2019 Market Review and Commentary



*Market Review **

- Equity markets generally ***underperformed*** fixed-income markets with the S&P 500 rising 1.70% (including dividends; +20.55% YTD) and the Barclay's Capital U.S. Aggregate Bond index increasing 2.27% (+8.52% YTD).
- Small caps ***underperformed*** large cap stocks (S&P 500) as the Russell 2000 small cap stock index returned -2.40% (+14.18% YTD).
- Growth ***underperformed*** value as determined by the S&P 500.
- Non-U.S. equity markets ***underperformed*** U.S. markets in U.S. dollar terms (MSCI EAFE**: -1.00% and +13.35% YTD), but outperformed U.S. markets in local currency terms (+1.83% and +16.23% YTD).
- Emerging markets ***underperformed*** both U.S. and non-U.S. developed markets as the MSCI Emerging Markets Index fell 4.11% in USD and -1.93% in local currency (+6.22% and +8.10% YTD, respectively).
- Japan (+3.29%; +11.52% YTD) was notable based on its strong performance (quoted in USD). India (-5.15%; +2.14% YTD), China (-4.67%; +7.80% YTD), and Brazil (-4.54%; +10.76% YTD) were notable based on their weakness (quoted in USD).
- Defensive market sectors were generally ***positive***. Utilities (+9.33%; +25.40% YTD) and Consumer Staples (+6.11%; +23.28% YTD) stocks were most distinguishable given their strength. The Energy sector was notable given its weakness (-6.30%; +6.00% YTD).
- High yield bonds fell 0.67% (+8.76% YTD). The U.S. corporate bond sector rose 2.93% (+12.27% YTD). 10-Year U.S. Treasury yields fell from 2.00% at the beginning of the quarter to 1.68% currently (2.69% at the beginning of the year).
- The U.S. dollar rose versus the British Pound (+3.17%; +3.24% YTD), Euro (+4.27%; +4.63% YTD), and Yen (+0.31%; -1.49% 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 international equity markets.*

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

"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.

Market Commentary

Much of the third quarter (through August) was characterized by a risk-off trade that forced many investors to seek safety in havens such as the U.S. Treasury bond market. Investors fretted about trade wars, weak economic growth prospects globally, inverting yield curves[1] (read more about yield curves here), and ritual suspense regarding the U.S. Federal Reserve's (the "Fed") interest rate policy. The Fed lowered its benchmark interest rate by 25 bps in late July, its first decrease in over ten years and its first since the Great Recession in 2008 (the Fed would follow this up with another 25 bps decrease in September). U.S. stocks continued to swing wildly throughout the quarter despite the Fed's accommodation.

The Barclays Capital U.S. Aggregate Bond index (+2.27%) outperformed the S&P 500 index of large cap stocks during the quarter (+1.70% including dividends). The Russell 2000 index of small cap stocks fared poorly (-2.40%) as the prospects for a domestic recession increased. International stocks as represented by the MSCI EAFE index (-1.00% in USD) and emerging market stocks in particular (-4.11% in USD) continued to underperform relative to U.S. stocks. The quarter also experienced a newfound interest in value stocks (relative to their growth cousins) that typically offer higher dividend yields and/or sell below their intrinsic value or at lower valuations relative to their peers. Traditional safety stocks in the Consumer Staples and higher yielding Utilities sectors also outperformed. The U.S. dollar was particularly strong as it outperformed the Yen, Euro, and Pound as a safe haven currency.

[1] The yield curve is a graphical representation of maturities and interest rates offered on bond or fixed-income contracts. A normal yield curve is upward sloping with longer-term bonds offering higher yields. An "inverted" yield curve is downward sloping with short-term bonds offering higher yields. An "inverted" yield curve is believed by many capital market participants to be a sign of a looming recession. Please click HERE to read a previously issued article on yield curves.

A Drive in the Park

I recently took my family to Skyline Drive in Shenandoah National Park, Virginia. For those not familiar with the park, it is a wonderful escape from the congestion of Baltimore, MD and Washington, DC. A great place generally to drive, hike, bike, explore, and watch leaves change into their Fall colors. The park is nestled in the Blue Ridge mountains in western Virginia, itself a part of the greater Appalachian mountain system that stretches up and down the east coast. Skyline Drive is the park's lone road, stretching north-to-south along the spine of the Blue Ridge for the park's entire 105-mile length.

The trip reminded me of the stock market over the past several years. The initial stage of the journey offered a long climb into the mountains. We could not see the top because the trees imited our view as we drove up. Fortunately, there were several cut-outs or overlooks available to us. The clear and sunny weather allowed us to peer down into the valley below or across to other mountains to gauge our altitude. This reminded me of the period leading up to last year's fourth quarter when stocks were rising towards their longest bull market ever and nearly ten-straight years of uninterrupted annual performance gains in the S&P 500. Both experiences offered clues as to a potential peak or market top; but nothing definitive. We used similar tools in perspective or relative value analysis to help gauge our elevation and the stock market's valuation.

Crossing the first mountain peak corresponds to last October's stock market highs. Our descent seemed quite steep and remarkable if only because it was the first of our trip. The stock market decline that began last October was quite precipitous as most major stock market indices fell during the quarter into or nearly into bear market territory[1].

[1] A "bear market" is typically defined as a peak-to-trough fall of over 20%

"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.

"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.

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A Drive in the Park (Cont.)

S&P 500 Year-to-Date 2019 Performance

Source: FactSet

Both declines, in stock market and our journey, would eventually level out. In the case of our trip, the rising slope of the next mountain would prevent us from falling further (remember that Sky-line Drive traverses the spine of several mountains in the chain). The stock market would require assurances from the Fed that help was on the way. Stocks have displayed a similar level of volatility year-to-date ("YTD"), paralleling our own successive climbs and descents. And although performance since the end of last year has been quite rewarding as stocks rebounded off their lows (see chart above), it masks the greater struggle the stock market has endured over the longer, trailing one-year period that includes last year's major correction[2] (see chart on the next page).

My family ended our journey safely as we drove down what was to be the last mountain in our trip. We didn't drive the entire 105-mile length because of time constraints (our time horizon didn't match the park's). However, we thoroughly enjoyed the parts of the park we did see.

[2] A "correction" is typically defined as a peak-to-trough fall between 10% and 20%

"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

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A Drive in the Park (Cont.)

S&P 500 Trailing Year Performance through September 2019

Source: FactSet

Importantly, the experience left us with great memories. This is perhaps where our story deviates from the stock market's own experience over the past year. For many investors, that ride continues. The journey has been dizzying as investors have been treated to a barrage of headline news that has helped fuel stock market volatility (please refer to the laundry list of factors included in the Market Commentary section). That these issues still linger on suggests possibly more volatility in the future.

But we would caution investors from ending their ride too soon if it is based solely on a fear of volatility. Many investors require the high rate of return stocks offer to help them reach their long-term investment goals. They should understand that while equity investing is inherently volatile, it is integral to their plans. Investors should not try to circumvent or stop it. Doing so may delay the journey or even worse, irrevocably impair their ability to reach their goals. Understand that volatility is a necessary part of the experience. It's a big reason for the higher return many investors expect to receive relative to their bond holdings. Vacationers wouldn't want Skyline Drive to be a straight and level ride as that may detract from their fun and experience. Investors also shouldn't want their stock investing experience to be boring and dull because the reward might not be acceptable or enough to satisfy their required rate of return.

"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.

"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

Please contact us for a complimentary review of your investment advisory fees, your current investment portfolio, and to discover how we can help you maximize your wealth generation potential.

Belleros Capital Management

Closing Remarks

We wrote in our inaugural newsletter from a year ago that many stock market observers had been prognosticating a tough investing environment over the next decade to offset the previous ten years' generous returns. We're not sure if any of them called for an immediate correction coinciding with the past year, but kudos to those who did. We may never know if they are truly prescient or just lucky. For now, we will just allow them time to celebrate their good fortune. We do not speculate on matters related to investing or the economy. The probabilities from such an exercise is very low in our estimation. Our investment strategy involves exploiting opportunities that are tangible and not based on speculation (i.e. guess work). We believe this strategy offers a greater probability of success. But enough shop talk. We encourage everyone to get outside and enjoy the Autumn season while they can. The weather in our area has been superb and is still on the warmer side. Like the current hesitation in the stock market and economy, it won't last forever. Take advantage of it while you can. All the best!

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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.