ARS INVESTMENT PARTNERS

THE OUTLOOK

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The Market Pullback, the Mid-term Elections and Your Money

The sharp pullback in U.S. equity prices has created many compelling opportunities for companies we currently own and companies we are considering for inclusion in client portfolios. As our regular readers are aware, historically the months prior to a mid-term election have tended to be volatile and generally negative for stock markets, and the current correction was no exception. However, the period following an election has typically provided strong returns into the end of the year for investors. As we wrote in our September Outlook, stocks trade in an auction market where buyers exchange dollars for shares of businesses. In the recent market pullback, there has been a temporary absence of buyers that has created significant opportunity for long-term investors. Following such periods, premier companies can provide significant returns for investors when buyers return to the market. Given the sudden and sharp move in stock prices, we felt it appropriate to share with you our thoughts on three key questions:

- What drove the market pullback?
- What are we doing as a result?
- What are our highest conviction opportunities going forward?

The structure of the market has changed with more short-term trading done by computers and algorithms focused primarily on price movements, and not fundamentals

What drove the market pullback?

As we wrote in our last Outlook, today's stock market is more short-term oriented than ever before as ETF, algorithmic and high-frequency trading have come to dominate daily trade volumes. The structure of the market has changed with more short-term trading done by computers and algorithms focused primarily on price movements, and not fundamentals. The computer-driven trading trends that drive prices up or down are leading other market participants to react to the price movements exacerbating the price action. Recently, headlines highlighted that the global economy has been slowing somewhat and conditions have become somewhat less favorable due to concerns about companies lowering guidance, trade conflicts, geopolitics (Saudi Arabia, Brazil and Germany), recent comments by Federal Reserve Chairman Powell on future rate hikes, debt, deficits and the China economic slowdown. What is lost in the frenzy of the recent trading activity is the fact that fundamentals remain relatively strong for the U.S. economy and for the businesses at the core of our secular trends – tech, defense, healthcare and select consumer companies as well as small capitalization companies.

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The market is transitioning from a liquidity-driven market to a more fundamentally-driven one, which is positive for active management

Strong balance sheets and free cash flows should matter more than in recent years. It is worth noting that we are experiencing a transition from a liquidity-driven market to a more fundamentally-driven one, which is positive for active management and the many companies we favor whose earnings and free cash flows are expected to grow again in 2019.

What are we doing as a result?

While more and more market participants are making decisions based primarily on price and popularity, our decisions continue to be business-driven based on our judgment of the outlook for cash flows and earnings growth

We are making some adjustments to the portfolios, looking for opportunities to reduce taxes by realizing capital losses, and by taking advantage of the opportunities created by the recent pullback by adding to selected positions. Importantly, our secular views remain intact and we are putting cash to work in a measured way. We are focused on positive fundamentals of the businesses we own and other companies whose valuations have become particularly compelling. While the economic headwinds have increased, we maintain our strong conviction in the secular forces that we have identified and the fundamental value of the companies in our portfolios. Howard Marks, a legendary investor, has said that, *"Investment success requires sticking with positions made uncomfortable by their variance from popular opinion."* We share his viewpoint, and believe that the short-term price movements do not reflect either the business realities or the fundamental valuations that are inherent in our portfolio holdings, despite the recent sharp declines in stock prices. Doing right in investing often involves doing what is initially unpopular. While more and more market participants are making decisions based primarily on price and popularity, our decisions continue to be business-driven based on our judgment of the outlook for cash flows and earnings growth. In the past two years, we have generally held higher cash levels to take advantage of price dislocations due to the realities of today's market structure. We are currently redeploying some of that cash by buying companies we believe are on sale.

What are our highest conviction opportunities going forward?

We continue to focus on the secular trends favoring technology (including cloud, memory, storage, the internet of things), health care, energy, and defense companies

Those companies that are benefitting from the secular trends we have identified for several years should continue to generate higher cash flows and earnings allowing them to continue to invest to increase their competitive positions, raise dividends and repurchase shares. To this end, we continue to focus on the secular trends favoring technology (including cloud, memory, storage, the internet of things), health care, energy, and defense companies among others. Smaller capitalization companies should continue to be attractive given their more domestically-oriented businesses in light of the growing challenges of investing in foreign markets. We believe that many positive factors for U.S. corporations and the U.S. economy continue to be underestimated. By implementing the tax cuts and increased deficit spending in advance of the introduction of tariffs, the Administration has, at least in the near term, offset some of the negative consequences of the changing terms of trade. Moreover the devaluations that are occurring in the emerging

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market economies have the effect of augmenting the attractiveness of the United States economy and its markets. Notwithstanding the changes to the structure of the market, investors should not underestimate the impact of the powerful technological advances coming over the next 36-48 months that will affect every industry.

If you have any thoughts or questions about our views or your portfolio, please feel free to call us.

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