AURORA
INVESTMENT COUNSEL

3rd Qtr. 2018 Investment Counsel Report

Market Summary

The wall of worry that markets continually climb added some new heights, and displayed some new cracks in its base. Stocks were able to report persistent, if uneven, gains, against a backdrop of growing macro concerns. For the three months ended September 30th, 2018, the S&P 500 Index rose 7.7% beating out many other benchmarks for the quarter. Smaller stocks of the Russell 2000 Index gained 3.6%, and international stocks of the EAFE Index rose only 1.4%. For the Year To Date, the tallies were S&P500 +10.5%, Russell 2000 +11.5%, and EAFE down at -1.0%.

As things stand presently, stocks have achieved double digit returns in 2018, with 3 more months remaining. Earnings Per Share for S&P 500 companies have been delivered at +24% in Q1, +26% in Q2, and Q3 progress is expected at +21%. It is estimated that roughly 10% of this nominal growth is due to the change in corporate tax rates- which can arguably not be relied on for continued support. Even without the tax support, sales growth of 10% and record high operating margins show that the strong American economy can still deliver 12% EPS growth (presently the expected forecast).

We believe, and often preach, that stock prices follow earnings. And against the above backdrop, there is room for optimism about not only the corporate health and earnings of the companies we invest in, but in the stock universe at large. So where do our concerns lay, and what might we do about them?

Our Outlook

Today more than ever, a cacophony of "news" bombards us, with each report foretold to be material to us as investors. From politics (Trump tweets, elections, etc.), to economics (employment trends, consumer spending, etc.) to government policy (deficits, Federal Reserve, etc.)- all these activities do require some observation. To the extent that these "macro" issues eventually influence the drivers of corporate earnings and valuations of stock prices, we do pay attention. Each of these concerns have been around for a lot longer than our investment horizons, and we are sure that 25, 50, and 100 years from now, they will still be the subjects of scrutiny and debate.

The issues that we find most likely to be relevant to stock investors presently can be placed into two categories- 1) Areas where too much debt has been accumulated and 2) Normal cyclical swings that cause temporary fear and pullbacks from investors.

Without dropping into too much of an economics lesson, there are observable areas where accumulated debts have become a concern. Chief among them in our eyes is the US federal government. In the vacuum created by the 2008 financial crisis, the government has stepped into the role of leading lender to some important economic sectors- primarily financing mortgages and student loans, for example. The government now holds an estimated 60-75% of all mortgage financing risk in the US- a historic percentage. The government also is the creditor for $1.3 Trillion

Aurora Investment Counsel, Inc.
3350 Riverwood Parkway
Suite 2205
Atlanta, GA 30339
Ph: (770) 226-5323 Fx: (678) 202-0484
www.aurora-invest.com

of student loans- which are showing increasing signs of repayment difficulty (9.6% are in 90 day default as of 2017). Areas of corporate lending like leveraged loans have also seen dramatic increases, with worrisome credit trends.

Add to this the Federal Reserve's stated policy change of direction, after which the Discount Rate and other market rates have risen lately, and the cost of servicing these debts may well be on the rise. To the extent this may auger for even higher future interest rates, this could ultimately impact the borrowing costs and margins of the companies we invest with. Which is why we are favoring companies that have a lower level of indebtedness, and a higher ratio of income to interest payments.

Drifting away from "bubble" talk, the potential for investor emotions to run from currently hot to cold is always a possibility. While stocks are not overtly overvalued, a change in psychology can create unnerving days for stock investors. When the news blares concerns over isolated events, which leads to negative stock price movements, followed up by media post-op reports, the seeming endless loop can lead to the temporary downturns in market averages that we used to expect regularly. Eg:, China tariffs slow growth, interest rates must rise, stocks drop, rinse, lather, and repeat…

Aurora Approach

Aurora portfolio strategy of late has been to is to reduce some of the more successful (and higher priced) holdings, and to re-invest the proceeds into some of the cheaper valuation areas of the market. While not in any way a guarantee of avoiding a market selloff, we are trying to invest with less risk and lower exposure to such a cyclical turn in psychology. Specifically avoiding the most "popular" names (Facebook, Amazon, Netflix, Google, etc), and seeking out established and conservatively financed businesses has tended to involve less volatility.

In sum, we take comfort in the earnings progress of the companies we are investing in. Our holdings, and many in the general market are delivering earnings growth that can fuel higher prices over time. The valuations of the stocks that we hold likewise are within historical norms and seem commensurate with the profits being delivered. There are pockets of excess in valuation that are visible, but so long as profit engines keep churning higher, the market's long term ascension can be maintained.

David J. Yucius, Jr., CFA

Aurora Investment Counsel, Inc.
3350 Riverwood Parkway
Suite 2205
Atlanta, GA 30339
Ph: (770) 226-5323 Fx: (678) 202-0484
www.aurora-invest.com