4th Qtr. 2018 Investment Counsel Report

Market Summary

After many speedbumps, US stocks finally took a full header in the fourth quarter. Smaller stocks of the Russell 2000 Index fell most sharply, dropping -20.2%, and ending calendar 2018 at -11.0%. The larger S&P 500 Index stocks lost 13.5% in the fourth quarter, and closed the year -4.4%. Illustrating the global nature of stock market pain, international stocks of the EAFE Index fell -12.5% in the last quarter, and were negative -13.3% for the full year. While large red numbers to close out this year are uncomfortable, we should not forget the overwhelmingly positive run of uninterrupted gains stocks have delivered over the past 10 years. Giving back some of these gains is not pleasant, but is historically consistent with the normal pattern for long time equity investors.

There has been a steady wall of worry over geopolitical tensions (Brexit, US political strife, trade wars, etc.) that has made for an uneasy investor psyche over the past few months. While nothing new, added to these ever-present concerns were a reversal of Federal Reserve policy, concerns over 2019 earnings growth slowdown, and some valuation questions on certain crowded trades (FAANG stocks, increased retail ETF presence, high yield bonds, etc.). In our view, the universal drop in equity prices of all sizes, flavors and geographies indicates a psychological/emotional bloodletting, more than any observable fundamental change. More directly, the companies we own are still on very solid footing- reporting acceptable sales/earnings growth, reasonable valuations and reasonably low balance sheet stress.

Our Outlook

We assess the climate for investors in 2019 as that of anticipating very solid growth conditions, but simply not at the accelerated (and non-sustainable) rate of 2018. In essence, the conditions of an accommodating Fed, one-time tax breaks, and outsized labor gains were a near perfect rose garden for companies to report earnings growth- which they did. S&P 500 Earnings Per Share growth in 2018 came in at close to 19%*- versus a long term average rate of approximately 7%* from 2001-2018. Estimates for S&P 500 EPS in 2019 are averaging 9.8%*, still above historic norms, and valuations have gone from reasonable to cheap. In broad terms, a healthy US climate and reasonable priced stocks should provide disciplined investors favorable opportunities to select candidates.

The places we see outsized risks and hence we seek to avoid are "crowded" and overly "popular" trades.

There is a self-fulfilling prophesy that is created when throngs of careless investors crowd into small investment nooks. We can relate the stories of the "Nifty Fifty" stocks of the 1960's, the Internet Bubble of 2000, the Bitcoin Mania of 2017, and several other abject lessons of the past. Without identifying with the extreme conditions present in these specific examples, the nature of these booms/busts has some things in common with each other, and with some of the trends evident in markets today.

One of the downsides of passive investing is that the investor loses control and sometimes visibility into where risks can grow. There are many times when investment trends swing too wide and lead to disproportionate interest and exposures, and many times these risks do not "pass the smell test".

Reviewing the five FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) through June of 2018, just those stocks accounted for 80% of the total S&P 500 Index's YTD gains. It is very obvious (certainly in hindsight) to see that the rest of the stock market was experiencing less success than these lucky few stocks for much of the year. And because many popular indices (and their ETF products) are market weighted, the proportion of an index exposed to these stocks when they rise only increases.

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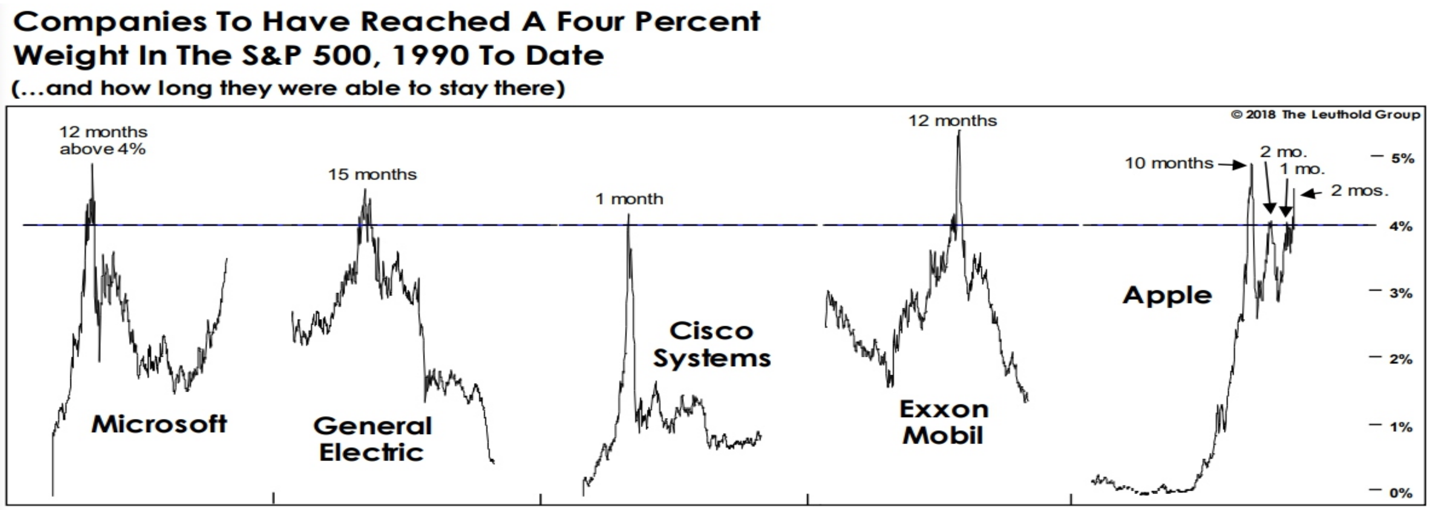
The chart below indicates the difficulty that can also come when individual "must own" stocks have grown in weighting and importance in the S&P 500.



In many of the examples cited above, good stocks and good ideas careened past prudence and into elevated levels of risk. If we look at the self-fulfilling trends, from today's FAANG stocks, Momentum investing, to Growth vs. Value, to passive vs. active, the air going into these balloons is easy to measure. It is the point of undue risk, even unforeseen risk, which gives us concern for retail customers in ETF vehicles and other crowded trades should they unwind.

Aurora Approach

Aurora's Growth At a Reasonable Price (GARP) discipline is geared towards prudent wealth accumulation over full market cycles. While there are times that we miss various up trends and seem out of step with parts of a cycle, we remain focused on managing our client assets in a disciplined and diversified manner. We did not invest over 30% of our portfolio in technology during the Internet Bubble, instead insisting the companies we invested in have tangible earnings. We did not have 30% of our portfolio in financial stocks coming into 2007, wary of rising credit risks. We did not allocate any assets into Bitcoin or other digital currencies in 2017, as we didn't (and don't) understand the allure. And at present, we don't have our portfolios dominated with expensive FAANG momentum stocks with valuations that seem expensive relative to their growth.

Aurora's portfolio holdings do today remain consistent with the fundamental traits that we have invested into for over 20 years. The average stock in our portfolio has lower Debt as a % of Capital, has grown Earnings Per Share in the past 5 years greater than average, and has higher Return on Equity than popular market averages*. Likewise, we have taken care to not unduly weight our portfolios beyond common sense levels of diversification, in an effort to reduce risk. We believe that these "common sense" tactics are helpful in avoiding too much of a good thing, if occasionally eluding certain fads and trends.

***Source: Bloomberg**

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