INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 3RD QUARTER 2018

The ACM Journal

Barn Cats

It is an unfortunate fact of farm life that if you have chickens, you have rats. A few years ago, our rats were getting a little out of control. We tried conventional methods such as poisons and traps, but nothing really worked. So, we decided that the only true solution was to go all natural and get some barn cats.

Of course, the kids and I are all allergic to cats, so we never really considered them as pets. However, it seemed that having them outside couldn't hurt, so I investigated options at our local Humane Society. A few forms and $25 later, I came home with a particularly nasty little feral cat that my son Omar named Yoyo.

We were told that you have to keep barn cats confined for two weeks, otherwise they'll run off immediately. So, we put Yoyo in a room in our barn to keep her in place. We subsequently learned the room was quite porous, and there was a quick end to the Yoyo experiment.

It turned out though, that the Humane Society was so eager to find homes for their barn cats that once you paid your $25, you could come back for as many free barn cats as you would like. Sort of a barn cat warranty. So, I went back and got a couple more.

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Portfolio review

The third quarter of 2018 was a mixed bag for investors. Stocks, at least domestic stocks, performed admirably. The S&P 500 rose 7.7% in the quarter and is now up 10.6% year-to-date. Small-cap stocks have performed even better so far this year, rising 14.5%.

However, that is where the good news ends. International stock returns have been disappointing, as have REIT returns. Bonds have been flat to negative, and alternative investment returns have been anemic.

While there are some meaningful differences, the current environment is feeling more and more like the late 1990s. During that period, the largest stocks with the greatest growth prospects, mostly technology and internet stocks, drove the performance of the overall market. Stocks rose to historically high levels, and the rally lasted much longer than anyone thought.

Today, we see a similar dynamic. Growth stocks, primarily large-cap technology stocks, have been responsible for the lion's share of the stock market's gains. In fact, other market segments, such as value stocks and low volatility stocks have lagged significantly behind the overall stock market for the better part of the last ten years.

This is an unusual dynamic, as value stocks historically have performed better than growth stocks, likely because of their higher risk profile. The same thing happened back in the 1990s. The market environment changed radically in the early 2000s, unfortunately with a nasty bear market. However, that doesn't mean we're due for another downturn now. Back in the 1990s, many technology stocks had negative earnings, and some companies even went public without any revenue. The highflying technology companies today are mostly real companies with positive earnings, solid business models, and tangible assets.

Consequently, we don't expect another dire market downturn. However, a change in market leadership seems overdue. The market can stay irrational longer than most of us expect, but it appears that the largest growth stocks are close to the limits of how far they can appreciate.

Apple now has a market capitalization of over $1 trillion. Alphabet, the parent company of Google, is worth $800 billion. Amazon is worth over $900 billion. Apple was the first company to achieve a market value of over $1 trillion, which makes you wonder how much further it can grow. Certainly, moderate appreciation in the stock, as earnings grow, is possible and reasonable. Nevertheless, expecting Apple, Alphabet, Amazon, or any of the most valuable tech companies to double or more from here seems extreme.

However, there is ample room for other market segments to grow. Valuations, as we have written previously, are not out of line for most of the stock market. Combined with

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Portfolio Review

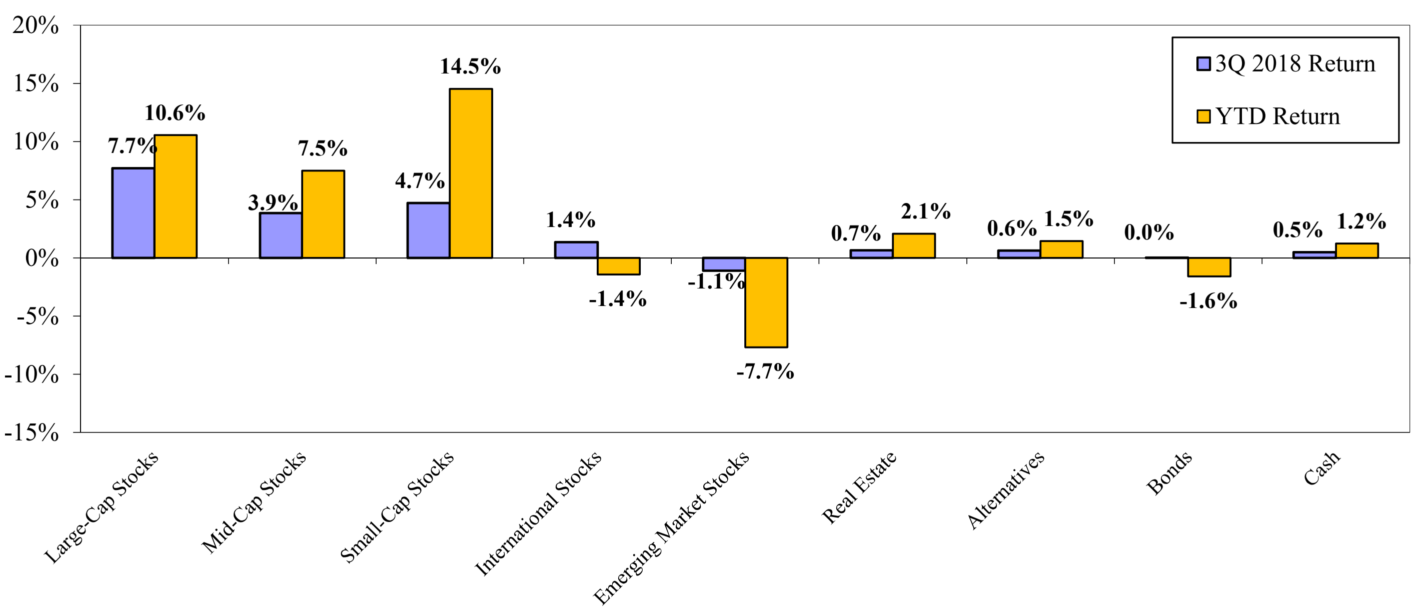
strong economic growth, stocks could continue to move higher from here, but we expect the stocks driving the next leg of market growth to shift. Value stocks and international stocks, in particular, should be the darlings of the next decade.

There are certainly risks to the stock market. Rising interest rates is a big one. The yield on the ten-year Treasury note has increased to almost 3.25% from around 2.25% a year ago. The Federal Reserve raising short-term interest rates has certainly contributed to this move higher, but the strong economy and inflation expectations are also to blame. Rising interest rates have weighed on bond market returns, which are down 1.6% year-to-date. We reduced the duration (and thus the interest rate risk) of our bond portfolios a couple years ago in anticipation of rising interest rates. We were too early, but that shorter duration is now protecting returns as rates move higher in earnest.

If stocks do falter as interest rates rise, political concerns become more acute, inflation increases unexpectedly, or trade disputes spin out of control, the unloved alternative investments we hold should finally have their day in the sun. It is not so much that falling stock prices result in better alternative investment returns, although in some cases that is true. Rather, the performance of our alternatives should improve as part of their natural cycle. Several of these strategies have struggled the past two to three years. Every investment has ups and downs, and unfortunately, we've just lived through a lot of the downs. These strategies all have solid long-term return profiles, and we expect those to start to shine through.

Diversification is one of the main tenets of investing, but lately it has worked against us. It is irrational to build a portfolio of only U.S.-based stocks, but such a strategy would have generated the best performance recently. In a truly diversified portfolio, there will always be good and bad performers, over just about any period. However, yesterday's losers often become tomorrow's winners, and vice versa. The key to long-term investing success is hanging in there through the downcycles of solid long-term assets.

Third Quarter 2018 Asset Class Returns



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Alternatives are represented by the HFRI Fund Weighted Composite index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

Mid-Term Elections and the Market

The mid-term elections are right around the corner. That means that the phone is ringing with questions about how the elections could impact the stock market. Generally, we prefer to keep politics and investing separate, but we grudgingly accept that they can influence one another in the short run.

By way of background, we have a number of conservative clients who were very upset when Barack Obama was first elected back in 2008. After all, they reasoned, his policies were socialistic, he had no economic experience, and he was antagonistic to business interests. Under his watch, the stock market did nothing but go up.

On the other hand, we have more than a few liberal clients who were beside themselves when Donald Trump was elected two years ago. After all, they argued, he's going to get us into a war, he's antagonistic to large parts of the population, and he's just plain nuts. So far, under his watch, the stock market has done nothing but go up.

Economic cycles may be exacerbated or mitigated by political policies, but the business cycle is largely going to play out regardless of who is in office. That said, markets can certainly react to political events, and the mid-term elections could be a short-term driver of markets.

There have been many studies showing how the market performed under various political regimes. For example, the Democrats have long boasted that the stock market has performed best when their candidate is in the Oval Office. That is indeed true. Since 1926, the stock market has averaged returns of 14.9% under Democratic presidents versus 8.9% under Republican presidents.

However, the results shift when you look at government as a whole. The best-case scenario, over the full period we studied, was for a Republican president and a Republican Congress. The annualized returns were 16.1%. This was just slightly better than the 15.9% earned on average with a Democratic president and Republican Congress (see table below).

AVERAGE STOCK MARKET RETURNS

President / Congress	Since 1926	Since 1950	Since 1980
Rep / Dem	11.0%	11.0%	14.8%
Dem / Rep	15.9%	18.5%	18.5%
Rep / Rep	16.1%	19.1%	16.4%
Dem / Dem	14.5%	14.3%	17.1%

Of course, the dirty little secret that articles in the financial media tend to ignore is that these numbers mean nothing. The relationships are not statistically significant, which means they could just be a random coincidence. Indeed, looking at subperiods, the results are not consistent.

So, with nothing to back us up other than a bit of common sense (which you could quibble with) and too much self-assurance, here is what we think could happen to the market in November.

Scenario A: The Republicans keep the House and Senate

While this outcome seems unlikely, it probably is the best-case scenario for the stock market. Love him or hate him, The Donald's economic policies have been popular with investors. The trade spat (not really a trade war yet) could get out of control, but otherwise lower corporate taxes and less regulation have proven strong fuel to keep the market cooking. If the Republicans remain in power, expect more economically-focused and business-friendly policies, including an extension of the tax cuts.

Scenario B: The Republicans keep the Senate but lose the House

Since this is the consensus outcome at this point, there likely isn't much impact to the market. There could be a short-term, knee-jerk reaction down, but don't expect any lasting effect. There will be a lot of talk of impeachment, and Trump could actually be impeached. However, it is unlikely that he would be removed from office, and we find it hard to image he would resign. The uncertainty of that process could cause further short-term market ups and downs. The President's agenda will probably still move forward through executive order under this scenario. These will mostly be challenged in court, resulting in very little getting accomplished, which historically has been good for stocks.

Scenario C: The Democrats take control of both the House and Senate

This scenario could be bad for the market, first because it is unexpected. Secondly, because it creates uncertainty around the economic policies that have recently been put in place. Emboldened Democrats could try to roll back the new lower corporate tax rates, and propose new legislation with tighter regulations. There would undoubtedly be gridlock with a split government, but the Democrats would have enough influence to try to enact some of their own policies, possibly by tying future debt ceiling increases to policy concessions.

There is, of course, a social agenda that accompanies either party, and we've intentionally limited this discussion to only economic issues. From an economic perspective, there is much to be optimistic about. As noted in a nearby article, the current economic expansion could still have a long way to run. The economy is strong and there aren't too many signs of a slowdown. Regardless of what happens in November, and the market's knee-jerk reaction to it, the markets could keep marching higher for some time.

Eight More Years of Economic Expansion?

A version of this article previously appeared at the CFA Institute's Enterprising Investor blog.

Where is the US economy headed?

Recent news coverage about an inverted yield curve, potential trade wars, and troubles in emerging markets have created some unease. Moreover, the current US economic recovery is now 111 months old, according to the National Bureau of Economic Research (NBER), making it the second longest on record after the 120-month expansion that ended with the bursting of the dot-com bubble in 2001. Could the present bull run simply die of old age?

Since 1854, economic expansions have lasted less than 40 months on average, making the two mentioned above all the more impressive.

Though economic cycles have lengthened since the end of the Great Depression, perhaps due to the ascendance of the US Federal Reserve or a general maturing of the US economy, the current period appears anomalous, and its extended duration begs the question of when the next downturn will occur.

No one has been able to consistently predict the length and magnitude of business cycles, but there is a strong case to be made for significant further growth. Many have noted that the current expansion has been weaker than historical recoveries. Indeed, despite its august age, the present expansion lags behind the mean.

The graph below compares the current recovery to the average post-1960 as well as the strongest recovery over that time, the one that ran from February 1961 to December 1969.

There have been eight NBER recessions in the last 58 years. We compared the four measures of economic growth — industrial production, personal consumption, and nominal and real GDP — to determine the strength of each recovery, focusing on the raw data rather than the growth rates to determine the dollar value of each measure created in aggregate from each recession's end to the outset of the next one.

For example, the 1990 oil price shock resulting from Iraq's invasion of Kuwait and the subsequent Gulf War helped push the economy into recession. Prior to the downturn, real GDP hit a pre-recession high of $9.4 trillion (in 2012 dollars) and a low of $9.3 trillion during the recession. It then expanded to a new high of $13.3 trillion just before the outset of the dot-com recession in March 2001. Thus, the US economy expanded 43% from the trough of the 1990 recession to its 2001 peak.

During the current recovery, however, real GDP sits just 23% above its nadir during the Great Recession of 2008 and 2009. What's more, the recession of the early 1990s was mild by historical standards, but the recovery was much more robust than the current one by every measure we studied.

This is not usually the case. In the past, deep recessions have generally been followed by steep recoveries. Why has this recovery, which followed the worst recession since the Great Depression, diverged from the historical pattern? Some have theorized that the housing market has not rebounded as quickly as in past recoveries or that policy uncertainty is to blame. Certainly, the regulatory environment shifted in the wake of the last recession. Large financial penalties were levied against those deemed to be at fault and has impacted corporations' willingness to spend and invest.

But things are turning around.

During those early recovery years, policy uncertainty hit record highs. Currently, however, it is below its long-term average, according to the baseline policy uncertainty index created by Scott R. Baker, Nick Bloom, and Steven J. Davis. This may be because of the recent regulatory rollbacks under the current administration.

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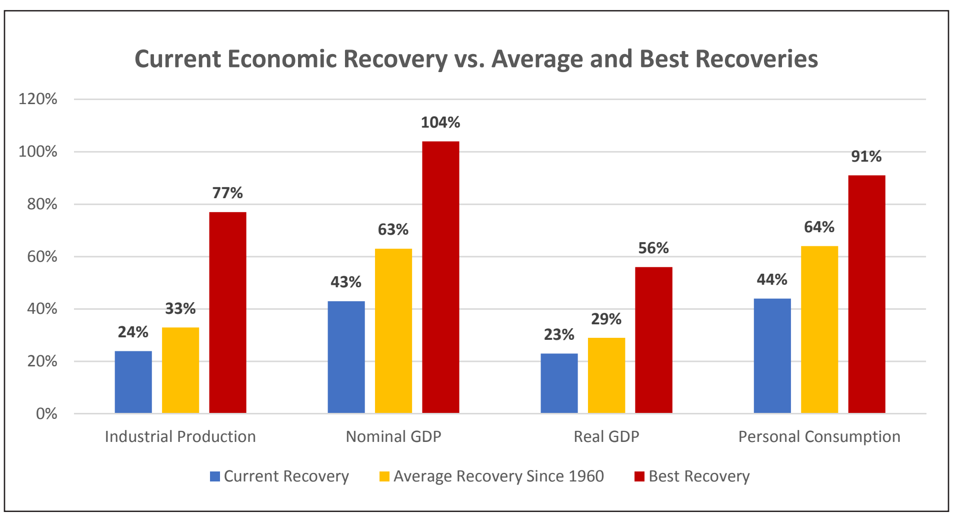

Source: Federal Reserve Bank of St. Louis, Armbruster Capital Management, Inc.

Eight More Years... *continued*

New residential construction has also trended up since 2011, according to US Census Bureau data.

This suggests that the present expansion, while long in the tooth, still has room to run. In fact, our research indicates that further growth at the average long-term rate for each of the indicators we studied could mean another three years of economic expansion. This assumes only average levels of economic recovery are achieved during this business cycle. If the US economy experiences an expansion like the more robust recovery of the 1960s, it could grow for an additional 8.8 years.

There are fundamental reasons for optimism. Policy uncertainty is low. Monetary policy is accommodative. While short-term interest rates are rising, they are still well below the levels that create economic distortion. Longer-term fiscal policy is also stimulative. The corporate tax cuts, like low policy uncertainty, could spur further capital spending, which could drive a virtuous circle of corporate activity that creates further economic growth. Finally, the United States may be taking growth from other nations through its new trade and tax policies.

The United States may not be able to stand alone forever while other nations lag behind, but there is cause for bullishness.

After all, even former Fed chair Janet Yellen once stated, “I think it’s a myth that expansions die of old age . . . So the fact that this has been quite a long expansion doesn’t lead me to believe that . . . its days are numbered.”

Firm News

October 1st was our ten-year anniversary. It is true that Armbruster Capital was incorporated a little over nine years ago. However, Mark started working at our predecessor firm, and building what would become Armbruster Capital, a decade ago.

It didn’t seem possible at the time, but over the years we have grown to become a firm with seven team members and around $425 million in client assets. We hope to continue building the firm in the future, and we have invested heavily to do so. We have written previously about the industry-leading software we implemented a couple years ago. We also have a full-time technology specialist on staff to help ensure the integrity and security of our data. That is unusual with firms our size, but having a robust infrastructure upon which to grow is essential.

Our team continues to grow as well. We recently added Colby Feane, CFA to help with business development and client service. Colby worked most recently at Manning & Napier, a very large, local investment firm. He also previously worked for ten years in New York City at JP Morgan’s investment bank.

Carlton Chin, CFA is our new Chief Investment Officer. This was a difficult hire for Mark, as he has been Chief Investment Officer at every firm he has been involved with for the past 18 years. However, it became clear that we needed additional resources on our investment team, and Carlton certainly brings a new skill set. He has extremely strong quantitative skills that he learned as both an undergraduate and graduate student at MIT. He then worked as an actuary, but found his way into investing while working at a firm that was ultimately acquired by Price Waterhouse Coopers. Carlton subsequently became the head of research for a firm focused on commodity futures trading, and worked in the commodity markets in different capacities for many years. He has also taught math at the college level.

We believe our firm has the most intellectual horsepower per employee of any investment firm in the region. We have three employees with CFA designations, one CPA, and one with the CRISC IT security designation. We have an important mission watching over our clients’ assets, and we try to hire the best to make sure we live up to that standard. Stop in sometime to meet Colby and Carlton.

What is ACM?

Armbruster Capital Management, Inc. (ACM) is a boutique wealth management firm serving high-net-worth individual and institutional clients. The firm’s innovative “Passive Quant” investment approach incorporates cutting edge financial research to help control risk and pursue superior returns. ACM uses index funds, exchange-traded funds (ETFs), and other investment vehicles to build portfolios designed to reduce investment-related costs and taxes in order to maximize net returns.

Located in Pittsford, New York, ACM is employee owned, independent, and minimizes conflicts of interest. Acting as a fiduciary, the firm creates truly customized investment portfolios tailored to each client’s unique objectives.

Barn Cats *continued from page 1*

These cats were much nicer, and hung around for several months. The problem was, unlike Yoyo, they wanted to be around humans and wanted to be in the house. Our dog at the time, Sierra, was a very large lab/shepherd mix that harbored a particular disdain for cats. She would go berserk when she saw one in the yard or out on the street. Inevitably, she came into contact with the new cats, and started viciously barking and charging at the smallest of our new barn cats. But, the cat didn't react. She just sat there, and Sierra didn't know how to respond. Within a few minutes, the cat was rubbing up against her, and Sierra completely lost her mojo. She never barked at another cat again. In fact, after that, she learned how to open our front door with her nose, and we would often find her snuggled up with the barn cat in our family room.

Many years later, another interesting barn cat adventure entailed a 3-hour round-trip voyage to a far-away Humane Society. I saw on Facebook that they were giving away barn cats for free, and I'm never one to pass up a bargain. So, I set off with two of the kids in tow. Unlike our local Humane Society, which is a virtual palace for animals, the more rural Humane Society was not what the kids were picturing. It was a rundown facility with a particularly strong odor of cats and dogs. The kids wouldn't even go in.

Eventually, we left with 4 new barn cats. We put a couple in a cage in the back of our truck, but had to keep the others separate because the staff told us they were mean and would fight with one another. Therefore, a couple of the meanest cats ended up in cardboard boxes inside the truck. As we were driving back on the highway, one of the cats started to escape. I was driving 70 miles per hour, and had visions of some wild beast whirling around the truck and scratching us all to shreds. I was trying to drive with one hand and keep the cat contained with the other, but she ultimately prevailed. As it turned out, she was as nice as could be. She walked around the truck like she owned the place, and the kids had fun petting her most of the way home. Though the petting stopped when the cat defecated on my daughter's sweatshirt and the truck started to smell like the Humane Society.

We noticed through our many experiences with cats, that there was a cycle to owning them. Once the weather turned cold, the cats tended to disappear. We suspect they found a house where someone would let them in, but we never really knew for sure where they went. Fortunately, there was no evidence that foxes or other critters were getting them. They always just disappeared under mysterious circumstances. It was as if our house was a Bermuda Triangle for barn cats.

So, we largely gave up on them for a while, but recent circumstances resulted in us adopting a new one. This one showed up at our friend's house around Halloween a few years ago, so she named the cat Kitty Boo. Our friend moved south and left the cat with us. The first thing we had to do was change the cat's name. I guess I'm just not that confident in my masculinity, because I couldn't see myself saying the words Kitty Boo out loud. The kids now refer to her as Kitty Bob.

Currently she is in the two week quarantine period. The kids are thrilled, my wife is wondering why we would do this again, and I'm feeding and cleaning up after yet another critter. We'll see how long she lasts, but at least our chickens will be rodent free for a while.

Armbruster

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