INVESTOR NEWSLETTER Armbruster Capital Management, Inc. 2ND QUARTER 2019

The ACM Journal

One of The Cool Kids

The time to sell a stock is when it hits its peak. It is difficult to know exactly when that occurs, but there are signs sometimes. For example, the time to sell social media stocks would be when everyone has already signed up and there are no new users to drive growth higher. It may be that time.

I thought I was doing fairly well with my 500 or so Facebook friends and 700 or so LinkedIn connections. It turns out, I'm just old and out of touch. Apparently, none of "the kids" are really using these social media sites, except to keep in touch with their grandparents or to appease their bosses. I was recently introduced to the new realm, and I suspect I'm among the last of the holdouts.

My oldest, Omar, set up an Instagram account with one of his friends that revolves around Nordic skiing at his high school in Honeoye Falls. They create funny pictures and post memes, many with inside jokes that only true Nordic skiers would understand. I miss the point of many of them. Despite this, skiers throughout the state have caught on, and Omar and his friend have become "the meme boys from HFL". They have been mentioned in statewide ski publications and

continued on page 4

IN THIS ISSUE

Portfolio Review

The second quarter was another strong period for stocks, and surprisingly strong for bonds. Large-cap stocks, as represented by the S&P 500, led the way with a gain of 4.3%. Mid-cap, small-cap, and international stocks all generated respectable returns, but lagged the S&P 500.

Stocks: Ripe for a Change?

This has been a theme for many years now. Similar to the late 1990s, stock market performance has been dominated by the largest stocks, particularly those in the high-growth technology sector.

Just a handful of stocks—Apple, Amazon, Google (parent company Alphabet), Microsoft, and Facebook—have accounted for the lion's share of the stock market's current advance. It seems unlikely that will continue. Microsoft's total market value is over $1 trillion. Apple, Amazon, and Google are all close to $1 trillion, and Facebook is over half a trillion. Additionally, these companies face the prospect of additional government regulation, if not break up, which could slow their growth rates. We read recently that the combined value of these five companies is greater than the GDP of every nation in the world except the U.S., China, and Japan. Even without government speed bumps, strong and sustainable market gains from these valuations is a stretch.

The impressive gains of the large-cap growth segment over the past 10 years makes you wonder if it even makes sense to invest outside of the S&P 500. After all, index funds are cheap and tax efficient. Why waste your time with international stocks that always seem to be struggling with economic malaise, smaller-cap stocks that don't account for much of the market anyway, or value stocks that seem to perpetually underperform?

The answer, which is hard to see since it has been obscured by years of being wrong, is that diversification does work. While the stock market has risen well over 300% since its low point in 2009, the picture hasn't always been so rosy. Since the top of the market in 2000, the S&P has gained only 4% on average. Between 2000 and 2011 the S&P gained zero. Between 1968 and 1982 the S&P also essentially stagnated.

During these periods, you would have been glad to have broader diversification, as small-cap, value, and international stocks all would have helped to boost returns. This sort of diversification will likely be valuable in the future as well. We have written before about how market leadership has to change. Market segments beyond the largest technology shares, particularly beleaguered value stocks, trade at more reasonable levels and have room to move higher, despite their disappointing recent performance.

Bonds Surprisingly Strong

Bonds are up more than 6% so far this year. That seemed a highly improbably outcome with interest rates

continued on page 2

Portfolio Review

continued from page 1

at only 2.6%, as measured by the ten-year Treasury yield at the beginning of the year. Nevertheless, signs of slowing economic growth have led to speculation the Fed could cut interest rates before long. Rates across the yield curve have rallied, and the ten-year Treasury ended the second quarter with a yield of 2.0%. Because prices move inversely to yields, the lower yields boosted bond prices significantly. This also seems unlikely to continue, but an economic downturn could lead to further gains for high quality bonds. We discuss our thoughts on the economy in a nearby article.

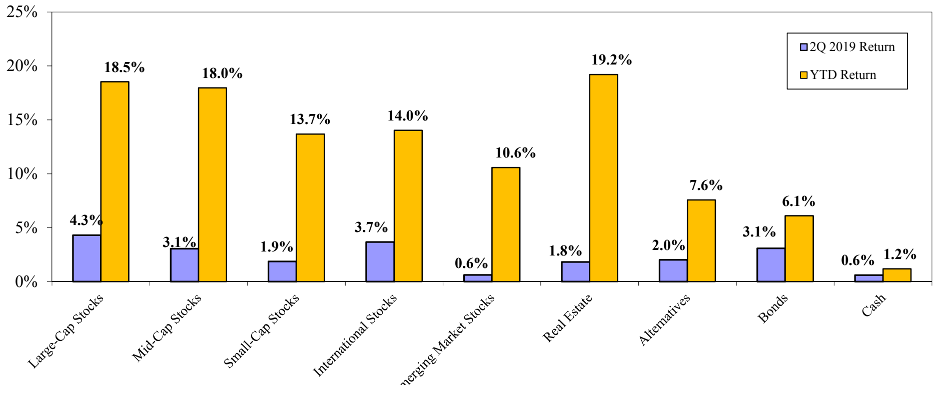
Alternatives Tick Up

Alternative investments have been mediocre, as seen in the nearby chart, with returns similar to bonds. However, the funds we use do not mirror this index. Our funds have been more of a mixed bag. Private real estate funds have generated attractive returns. Funds like reinsurance, risk premia, and style premia have lagged. However, there are some encouraging signs. Managed futures are starting to post positive returns, and alternative lending continues to chug along. Overall, we still want to see stronger returns from our alternative funds, but they have been an important diversifier.

A Solid First Half

The second quarter was generally very positive for investors. Indeed, the first half of the year was the best for stocks since 1987. This shows the power of staying the course after what was a very trying fourth quarter in 2018 when stocks dropped double digits. However, the dynamics within the markets are starting to shift, and signs of stress are apparent. It would not be surprising to see changes in market leadership before too long.

Second Quarter 2019 Asset Class Returns



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

Challenging Times Ahead

A year and a half ago, we wrote articles on how the economy could continue to grow for three more years and the stock market could increase 30% from March 2018. We based our stock market forecast on valuations, despite the fact that many thought stocks were already overvalued. The economic forecast was based on the anemic growth we've experienced during this business cycle, and suggested that the cycle wouldn't end until the magnitude of growth at least reached the historical average. You can read these articles at the CFA Institute's "Enterprising Investor" blog.

The stock market is halfway to our predicted target, and the economy has set a new record for the longest expansion so far. We continue to believe these trends will power ahead, but we're also starting to think about what comes next.

We're not economists nor market timers, but you don't need a crystal ball to know that the good times can't last forever. It also isn't exactly controversial to say that a recession will likely hit within the next two years. What will that mean for investors?

In the near-term, it could mean significant incremental stock market gains. We've written in the past about how this market cycle feels an awful lot like what happened during the technology boom of the 1990s. The last few years of that cycle provided some of the best returns. Also, while we generally don't give Presidents too much credit or blame for economic cycles, the current administration has a strong incentive to keep the good times rolling—at least until the next election.

Accordingly, it would not be surprising to see the Fed cave to pressure and lower short-term interest rates. Speculation of the Fed's next move has whipsawed markets recently, indicating we could see further gains if the Fed ultimately eases policy. A trade deal with China would also likely move stocks higher.

A recent theory from a noted economist posited that President Donald Trump would work to force down interest rates through verbal pressure and by weakening the economy with incremental tariffs. This would cause the Fed to lower interest rates, and then just before the election the President would eliminate all tariffs. There is no way to know if this is the actual plan, but it certainly could keep the economy and stock markets moving higher for a while.

Even if that were to occur, such moves likely won't make for a lasting expansion. We need to recognize that a downturn is looming, even if it is a couple years out.

There are signs already. Growth in capital spending by corporations is slowing down; corporate earnings estimates are being drastically cut; credit card interest rates have risen to their highest levels in at least a couple decades, which could pressure consumer spending; and while the headline jobs figures still look robust, deeper in the report are signs that large corporations are cutting back on hiring. The situation is worse overseas, with flattish economic growth and negative interest rates in some countries. The New York Fed maintains a recession-probability model that has been rising and is now at levels seen just before past recessions. The indicator has only once been this high without a recession occurring within two years.

Keep in mind that recessions do not mean the sky is falling. There are mild recessions, like the one around the Gulf War in 1991, and there are deep recessions like the one that started in 2008. Other than the Great Depression, which lasted three and a half years, the longest recession since 1926 lasted eighteen months. So, recessions tend to be fairly short lived, and our economy is strong and flexible enough that it has always rebounded and gone on the reach new peaks.

The stock market drawdown during recessions has often been quite modest, with dips of 15% or less in many cases. However, there are also the more memorable declines of 50% or so such as in 2008, during the technology bust of the early 2000s, and previously in the early 1970s.

No one knows for sure what the next recession will hold in store, but we suspect the impact to the stock market will be more severe than the milder cases, after all, the stock market dropped almost 15% in the last quarter of 2018 alone with no significant economic event. That doesn't mean that we'll see another crisis like in 2008, just that a higher level of volatility is likely coming.

We have all lived through these periods before, and they are not a reason to disrupt long-term investment and financial plans. There are actually some benefits. They can offer an opportunity to avoid taxes through disciplined loss harvesting that can be carried into the future. And they can allow us to reposition portfolios that may need adjustments that we've been putting off to avoid tax problems.

For those still saving money, market downturns offer an opportunity to buy stocks on the cheap. For those not saving, we will be rebalancing from bonds to stocks as stocks drop in price. This creates greater leverage when stocks ultimately recover.

That is not say that we're looking forward to the next recession or bear market. It is merely an acceptance that downcycles are part of investing. We'll live through it as we have in the past.

Firm News

It has been many years since we were active on the speaking circuit, but we got sucked back in again recently.

Chris gave a presentation on ETFs to the finance department of SUNY Geneseo this spring. Mark participated in a webinar with Standard & Poor's, spoke at an ETF conference in Boston, and presented to Vanguard at their headquarters outside of Philadelphia.

Most of these events revolved around factor-based investing. We have been using this investment approach since the inception of Armbruster Capital, but it seems to be catching on in a more significant way lately.

The most interesting event, at least to us, was the invitation to address Vanguard's global sales force at a conference a couple weeks ago. Vanguard recently launched a suite of factor-based investment funds, and asked us to educate them on how advisors think about, analyze, and use these funds. Vanguard's founder, Jack Bogle, was our hero and inspiration, so it was a real honor to visit his old stomping grounds. We acted like tourists to get

continued on page 4

One of The Cool Kids

continued from page 1

are regularly cited at races in Northern New York. Parents of skiers also follow them on Instagram. Not being "in the know," I started to feel a little left out.

My wife has also become a bit of a social media maven. She started a fashion blog focusing on the transition of her high fashion career in urban centers to more practical fashion for the rural/suburban mom; sort of a couture to country vibe. She has been taking pictures of hand bags, jewelry, and such around our farm. It is pretty well done. You can check her out at www.fashionipa.com. To support her blog, she has become an active poster on Instagram as well.

So, I finally caved to the family pressure and decided to open an Instagram account. Except, that I wasn't able to do it. There were a number of password and log-in issues that stymied and annoyed me for several weeks. Omar tried to help, but there was some problem with my Apple ID. Several more weeks later, I eventually figured out the ID, but Instagram still wouldn't accept my account. After a little research, Omar said it looked like a white supremacist with the same name as me had been banned from Instagram, and he guessed that was why I was declined. In any event, I was ready to give up in despair.

Omar found a work around though. He set up my account using a different name, Mark Farmrooster, which surprisingly enough wasn't already taken. Omar did this very casually on his phone while we were sitting at a table waiting at the local ice cream parlor. He snapped a quick photo of me with the camera on his phone, and set the whole thing up in a few minutes. It would have taken me hours if I could have done it at all.

Now I'm live, and bungling my way through the Instagram interface. Nipa and I have a mostly friendly competition to see who can get the most followers. She has a big head start, but I'm posting actively now and expect to "go viral" at any moment. Interestingly though, most of my followers are high schoolers. My kids' friends have been following me, and because of that, all the follower suggestions Instagram provides are also high schoolers. At least someone thinks I'm young.

If you're on Instagram, and a fan of this column, follow Mark Farmrooster. For more refinement, you can follow Fashionipa, also on Instagram. You won't find much investment news in our posts, but you can also connect with Armbruster Capital or me personally on LinkedIn to keep up on our more professional publications and events.

Firm News

continued from page 3

a picture of Mark and Chris with the statue of Jack in the courtyard.

We also had the opportunity recently to present some of our latest research, on factor-based investing, at a seminar we hosted for nonprofit organizations in Rochester. A number of nonprofit CEOs, CFOs, and board members came to hear about our strategies for boosting returns, particularly if the stock market doesn't continue to provide the strong returns of the past.

Our latest research, which we've been discussing at all these events, is a variation of a recent paper by professors Eugene Fama and Ken French. Using their methodologies, we've been able to show that a multi-factor portfolio can significantly outgrow the overall stock market, and can also reduce the odds of protracted underperformance. We're still testing and exploring funds that might fit into this sort of approach, but we expect some of our findings to make their way into our portfolios before too long. If you have an interest in learning more, just give us a call. We're always happy to chat about research and investment philosophy.

Armbruster CAPITAL MANAGEMENT, INC.

Armbruster Capital Management, Inc.
(585) 381-4180
info@armbrustercapital.com
www.armbrustercapital.com