July 15, 2019

Dear Investor,

On average investor accounts performed somewhat better than our risk weighted benchmarks (70% S&P 500, 30% Barclays Aggregate Index). Note that your actual account performance is detailed in your statement and personalized letter. Year to date the S&P 500 rose 18.3% and the Barclays Aggregate Bond Index rose 5.8%. In the first half of the year many of our stockholdings had strong gains while our fixed income holdings rose modestly.

Markets continue to be buoyed by a combination of low interest rates and slowing but still positive economic growth. Comments by the Federal reserve suggesting an end to rate hikes have helped sustain investor optimism, as has a temporary truce in the trade dispute with China.

<u>Notes on specific holdings</u>

It's been a tough few months for Alphabet (Google's parent company), one of our largest holdings. In the first part of this year the company's largest business, the sale of advertising space on the Google search page, slowed considerably. This business is now so large it's unlikely to sustain its earlier growth rates.

Despite the likelihood of slower growth, search advertising is an exceptionally good business for Alphabet. The Google search page is often the starting point for a consumer looking to purchase food, travel, services or merchandise. That makes the website critical to merchants seeking to display business information. As a result, the company has enormous market power as it sells placements on its search page and on related websites, such as the Google hotels and local business pages.

It's possible those businesses will eventually be weakened by regulation. In early June the Wall Street Journal reported that the Department of Justice planned to investigate whether Alphabet had violated antitrust laws. There are areas where the company may have done so, including prioritizing its own content on its websites over that of competitors. However, it's debatable whether the company is a monopoly, and whether its policies harm consumers. Proving both points has historically been a prerequisite to successful US antitrust actions.

If the DOJ does proceed with an antitrust action against Alphabet and prevails, the severity of the remedies will be important. Historically regulators have tried to break up monopolies. However, most of Alphabet's businesses, such as Google Search, You Tube, and Google Cloud, would be just as powerful as independent companies as they are today, so breaking up the company would likely be ineffective. A more effective alternative might be establishing and enforcing rules around the company's management of its search page and the results it provides.

DSW Investment, LLC
878 Lawrenceville Rd, Princeton NJ 08540
P:(609) 430-8407 F:(866) 202-2204
www.dswinvestment.com

My guess is that even with regulation, Alphabet will remain dominant in the marketplace. Furthermore, the investigation of Alphabet's monopoly status and subsequent litigation will likely take years. The DOJ's anti-trust investigation of Microsoft, together with subsequent litigation, spanned more than two decades. By the time there's a resolution to the Alphabet investigation, other Alphabet businesses like You Tube and Google Cloud will almost surely be larger and more significant contributors to the corporation's earnings. Given that timeline, and my continued admiration for the quality and prospects of Alphabet's businesses, I am maintaining our holding of Alphabet shares.

In recent years I have spread our stock investments between high growth businesses, many of them in technology, and more mature businesses that sell for much more attractive prices relative to their earnings. The faster growing businesses have performed better, on average, to such an extent that they now trade at unusually high premiums relative to the more mature businesses. Given those wide differentials in valuation, it now strikes me as a reasonably good time to invest more in these slower growth, but attractively valued businesses.

An example would be Delta, an inexpensively valued stock that has lagged the broader stock market in recent years, even as the company has modernized its fleet, reduced the cyclicality of its business, and grown its earnings. Although those earnings will almost certainly decline in the next recession, that decline should be less pronounced than in prior recessions.

That's partly because an increasing proportion of Delta's earnings come from the sale of loyalty miles through a partnership with American Express. Delta sells a fraction of its airline seats to the credit card company; those seats are later granted as rewards to cardholders for their expenditures. Because the seat sales are linked to overall consumer spending, they tend to be more predictable than direct expenditures on air travel. By 2021, Delta's Amex partnership is expected to represent roughly a quarter of the company's earnings.

Another reason to expect greater earnings stability for the airline is that in prior recessions there were seven or more major airlines and many smaller competitors. Today, after several large mergers, there are only four major US airlines and a handful of regional and discount competitors with limited routes. As a result, in the next recession there may be less pressure on airlines to discount prices in order to fill seats.

As always, please contact me with any questions.

Doug