October 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. The year-to-date performance reflects strong gains for many of our stockholdings as well as more modest gains for our fixed income holdings.

The US stock market has been supported by the Federal Reserve's lowering of interest rates. Stock prices have also been supported by optimism that there may be a truce in the US-China trade war.

At the same time, recent economic data isn't all that encouraging. A widely followed survey of manufacturing purchasing managers (the PMI Index) recently indicated that the US manufacturing sector is contracting. Automotive sales, an important part of the manufacturing economy, are lower than a year ago. The US service sector, which represents the largest share of the economy, still appears to be growing, but at a slower rate than a year ago. And long-term interest rates, which tend to reflect investors' expectations for future economic growth, remain at historically low levels.

Given those economic worries, I continue to gradually shift our exposure towards more defensive businesses and have reduced our exposure to cyclical businesses like banking. However, I have not reduced our investments in airlines (Delta and Air Canada) despite those businesses having been susceptible to business cycles in the past. That's because I believe that the airlines will perform better in the next recession as a result of consolidation, lower fuel prices, and a shift in their mix of revenue away from ticket sales and towards more predictable loyalty mile programs.

I continue to look for higher yielding bonds and preferred stocks as well as companies pending acquisition at fixed prices, all of which could provide positive returns in a declining market. Although the returns offered by these securities have fallen alongside interest rates, from time to time there are buying opportunities.

<u>Notes on specific holdings</u>
Earlier this year three of our largest technology holdings, Amazon, Facebook, and Alphabet (Google) were named as targets of federal anti-trust investigations. In early September attorney generals from forty-eight states initiated their own investigations of the tech giants. Despite those investigations, I see the tech giants as fundamentally well positioned.

In the case of Amazon, regulators have expressed concern that the company uses the data it gathers on third party merchants to merchandise Amazon branded products. For example, Amazon has unique insight into pricing and customers in the global battery market because major brands like Duracell and Eveready sell on the Amazon website. In theory Amazon can use that information to promote its own products. Regulators will likely try to eliminate this capability. I don't see this as a long-term risk to Amazon's business however, because I believe the company's future success will depend on its ability to provide high quality services to other businesses, as distinct from marketing its own products.

Facebook's business is vulnerable to privacy regulation, because the company uses information about its users to target advertising. For the moment at least, there is nothing to suggest this is the primary area of regulatory scrutiny. Instead, regulators appear to be focused on anti-trust violations, an area where Facebook has a relatively clean slate. It is true that by purchasing Instagram the company merged an important competitor into its own ecosystem, but it's hardly Facebook's fault that the merger was approved. Regulators could try to reverse the merger, although it's unclear on what grounds. It's also not clear that the two platforms would be worth substantially less if they were separated.

Aspects of Google's search engine appear specifically designed to weaken competitors. Those practices may ultimately prompt fines and regulation. However, as I wrote last quarter, regulating Google will be a long process, and in the interim I would expect the company's high growth businesses like YouTube and Cloud Services to continue to grow. Furthermore, the key to Alphabet's advantage in search advertising is the sheer volume of users on its website, and that's unlikely to change.

<u>Some notes on hedging</u>
I've discussed with some clients the use of protective puts on the S&P 500 index. Those puts allow for the future sale of shares linked to the S&P 500 index based on the current price. That option acts as insurance against a significant market decline.

Insurance comes at a cost. As of this writing puts that allow the holder to sell the S&P at its current price over the next four months cost about three percent of the S&P value. If the S&P remains where it is or goes higher the puts will expire worthless. However, if the S&P declines substantially the puts become valuable. The value of the described put would double with a six percent decline in the index and triple with a nine percent decline.

Puts will typically result in a better outcome than other hedges (such as cash) if the market falls sharply after their purchase but before their expiration, and a worse outcome if it does not. Put prices fluctuate and are the least expensive when investors are the most optimistic about markets. I am monitoring those prices to determine whether a purchase could make sense at some point.

As always, please contact me with any questions.

Doug

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