Bluestone
CAPITAL MANAGEMENT

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Dear Client,

Thank you for your continued trust in us. This has been one of the most challenging market declines we have seen in the history of the Bluestone Elite strategy, and it unfortunately coincides with the holiday season, which has added tremendous stress to all of our lives at a time when all we want to do is enjoy spending time with family and loved ones. One of the most frequent questions we have been asked in recent weeks is whether or not we anticipate going to cash and what would trigger a move of that magnitude. We want to address that question head on while we walk you through what we are seeing, how we are following our process and maintaining discipline to navigate this environment, and what we have been doing to position the portfolio in an effort to manage through this downturn.

The magnitude and velocity of the move lower in markets has many wondering if we are on the precipice of the downturn or even the next financial crisis. It has already compelled a number of managers to go substantially into cash, despite a brunt of the pain already being inflicted on net asset values. **We think about the Cash Trigger decision every moment of every day, especially during this recent correction. It is not something we take lightly. We regard the shift to cash as requiring the highest level of conviction of anything that we do.** The reason is that that decision is binary, and we have to be right on both *getting out* of the market as well as when to *get back in*. Going to cash after a correction, even ones less substantial than this, has often led to whipsawing that can destroy portfolio value and impair our ability to deliver to our clients the best risk-adjusted returns over a full market cycle. That being said, there are circumstances where going to cash is absolutely warranted. In short, the Cash Trigger decision demands a level of conviction that requires market Fundamentals to corroborate our Technical signals. Simply put, that has not occurred during this correction. From the data we see and what our indicators suggest, the pullback since October has likely been a technically- and sentiment-driven correction within an ongoing bull market as investors look to take profits and normalize positioning amidst a hazy

SPX Index | 96) Actions | 97) Settings | Consensus Overview
S&P 500 Index
Periodicity A | Flavor F12 | View Growth | Currency USD

Measure	Actual	F12 Est	Growth	Y+1 Est	Growth	Y+2 Est	Growth
1) Earnings Per Share	146.67	169.00	15.22%	176.28	4.31%	195.29	10.78%
2) EPS Positive	147.66	169.11	14.53%	176.35	4.28%	195.38	10.79%
3) Cash Flow Per Share	222.50	235.33	5.77%	247.51	5.18%	272.43	10.07%
4) Dividends Per Share	53.73	57.38	6.80%	58.59	2.10%	62.61	6.87%
5) Book Value Per Share	834.64	868.55	4.06%	938.78	8.09%	1021.42	8.80%
6) Sales Per Share	1318.11	1397.10	5.99%	1416.92	1.42%	1485.31	4.83%
7) EBITDA Per Share	249.59	293.62	17.64%	300.99	2.51%	324.92	7.95%
8) Long Term Growth	0.00	25.62	0.00%	0.00	0.00%	0.00	0.00%
9) Net Debt Per Share	372.43	509.65	36.84%	479.81	-5.85%	434.25	-9.50%
10) Enterprise Value Per Share	2899.59	3038.90	4.80%	3010.65	-0.93%	2966.47	-1.47%

Valuation Measure	Actual	F12 Est	Y+1 Est	Y+2 Est
11) Price/EPS	16.48	14.30	13.71	12.37
12) Price/EPS Positive	16.37	14.29	13.70	12.37
13) Price/Cash Flow	10.86	10.27	9.76	8.87
14) Dividend Yield	2.22	2.37	2.42	2.59
15) Price/Book	2.90	2.78	2.57	2.37
16) Price/Sales	1.83	1.73	1.71	1.63
17) Price/EBITDA	9.68	8.23	8.03	7.44
18) EV/EBITDA	11.62	9.88	9.63	8.92
19) Net Debt/EBITDA	1.49	1.27	1.24	1.15

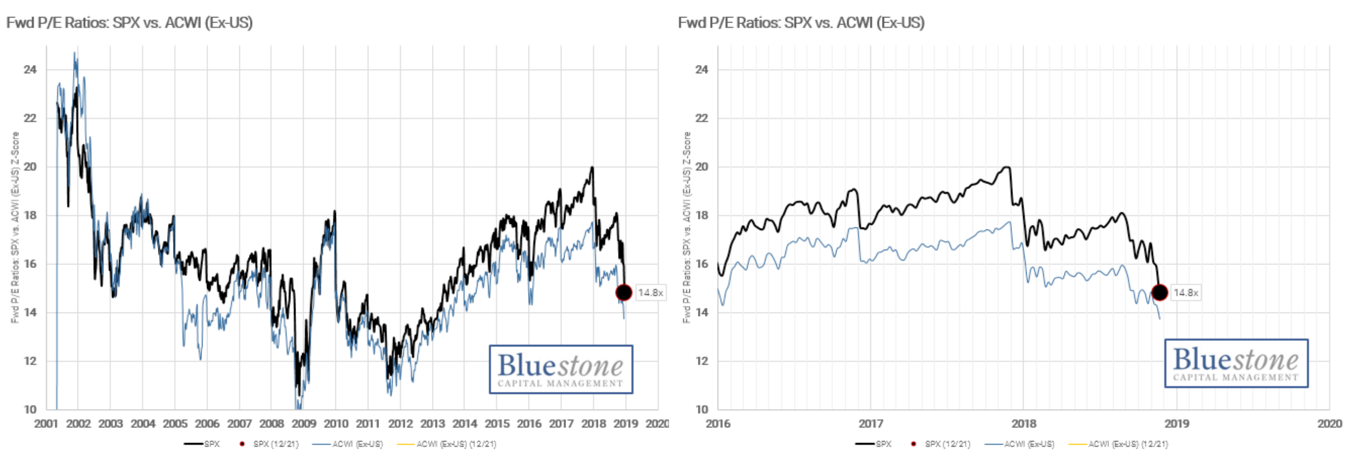
Figure 1: Micro Fundamentals – Earnings expectations are still positive and encouraging. (Source: Bloomberg)

outlook for geopolitics, monetary policy, growing skepticism of the durability of economic growth, and looming tail risks around solvency.

First, on **Fundamentals**. We think about Fundamentals in terms of both the Market and the Macro. First and foremost, starting with **Market Fundamentals**, the picture here still looks particularly healthy. Earnings are expected to grow at double digits over the course of next year (see Figure 1), and so long as the cycle remains intact that should be attainable.

Furthermore, market valuations have become quite compelling, both outright and relative to fixed income. For example, the S&P 500 trades at a sub-15x forward P/E (see Figure 2), which means stocks are now offering an earnings yield *in excess* of US treasuries of nearly 400bps (that is not even including the dividend pickup or benefit of share buybacks). Simply put, we are just not seeing signs that the business cycle has rolled over into a recession and market fundamentals remain healthy and at some of the most compelling valuation levels we have seen in a number of years. As mentioned, in order to go to cash, we need to see a corroboration between both the Fundamentals and Technicals. That simply has not occurred, whilst the technicals are painting a substantially more draconian picture that we believe is unsustainable.

Figure 2: Forward P/E Multiples - Market valuations have become compelling. The S&P 500 trades at a sub-15x forward P/E. (Source: Bloomberg, Bluestone)



Underpinning the Market Fundamentals are the Macro Fundamentals, which still appear healthy and supportive of the market. We think about the macro both the level and rate of change in growth as well as the composition of underlying growth drivers, spanning consumption, investment, government, and trade. When we talk about the level and rate of change in growth, we focus heavily on leading measure of economic activity. If we use this framework to look at historical market tops (i.e., 1972, 1976, 1980, 1990, 2000, and 2007), a common observation is that the economy is doing well but leading indicators (LEIs) rollover

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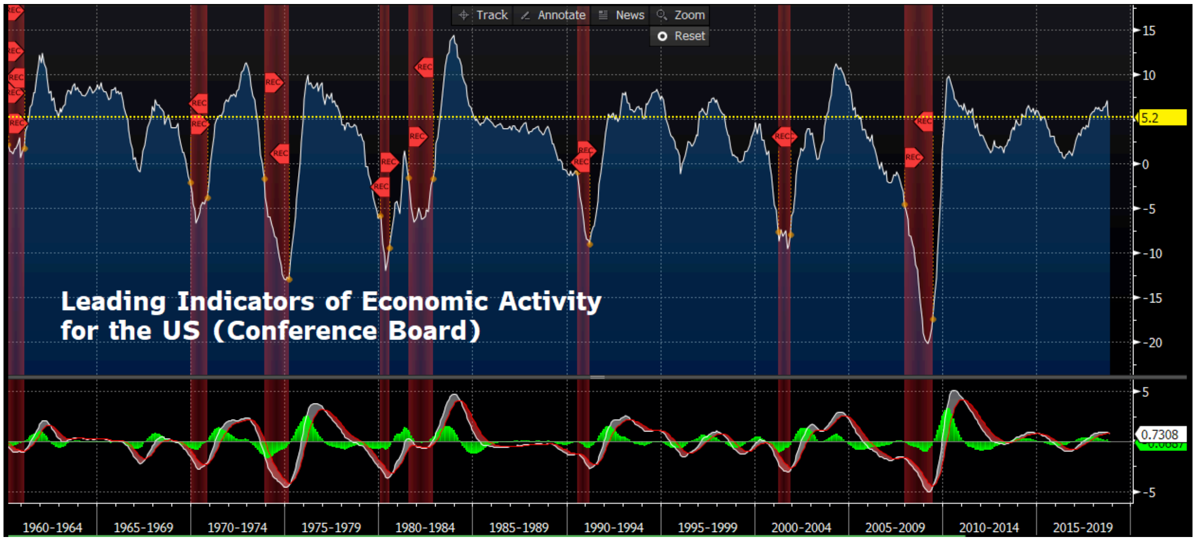
and turn negative. If you look at Figure 3, you will see that the LEIs have been growing at some of the healthiest levels all cycle.

Figure 3: Leading Indicators of Economic Activity for the US – LEI's have been growing at some of the healthiest levels of all cycle. We are watching these closely for signs of rolling over, as they can turn quickly. (Source: Bloomberg)



We are watching these leading indicators closely for signs of rolling over. It is possible we could be getting closer to that point, however, we do not appear there just yet, as the US Consumer is still quite healthy. Figure 4 illustrates that consumer sentiment is at some of the healthiest levels of all time and spending is nearly as healthy as it has been all cycle.

Figure 4: Macro Fundamentals – the US Consumer is Still Strong. Consumer sentiment is near some of the highest levels on record, and consumer spending (PCE) is about as healthy as it has been all cycle. (Source: Bloomberg)

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We do acknowledge, however, that there is a reflexive feedback loop between markets and consumer psychology, and that these dynamics can change quickly, so it bears watching how this recent correction may impact consumer sentiment and spending behavior in the time ahead. Shifting away from consumption-led growth to export-led growth, there is much consternation that an all-out trade war is on the verge of erupting and that this may catalyze a rollover into recession. Make no mistake, trade is an important issue. However, at the moment that may be more of a red herring than not as it relates to the durability of the business cycle's expansion. These indicators can change quickly, so we will maintain vigilant watch on the data.

Shifting to **Technicals**, our framework incorporates a composite of technical indicators that help us to quantify buying and selling exhaustion amongst other things. These indicators have provided a reliable read on periods of investor capitulation in the past. Our proprietary signals incorporate measures of market breadth and momentum as well as signals from the volatility and credit markets and measures of cross-asset behavior. Many of these measures are flagging extreme levels of capitulation that have in the past presaged a rebound in market risk appetite. For example, if you look at Figure 5, which is one of our gauges of market capitulation, the market has become as oversold as it was during the Fall of 2015 (China devaluation), 2011 (US debt ceiling crisis) and of course, the Great Financial Crisis (GFC).

Simply put, the macro data does not support an imminent recession, let alone the economy being on the precipice of the next GFC. Importantly, for investors that are looking to improve their risk-adjusted returns over a full market cycle, these periods of extreme capitulation have rewarded steady hands and afforded compelling opportunities to those remaining invested.

Figure 5: Capitulation Indicators Peaking – The market is as oversold as it was during the Fall of 2015 (China devaluation), 2011 (US Debt Ceiling crisis) and the Great Financial Crisis. (Source: Bloomberg, Bluestone)

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While we have not seen the conditions necessary to activate the Cash Trigger, we have been actively managing the portfolio through this drawdown to pivot it in a more defensive posture. We took these actions in an effort to try and protect clients' portfolios. Had we made these allocation shifts under more normalized circumstances, our decisions would arguably have been perceived as dramatic in nature. For example, earlier in the month, we took our overweight position in Mid-cap Banks and eliminated it entirely. At the same time, we dramatically reduced our exposure to Financials in general and some of the most aggressive Technology names. Instead of keeping the proceeds in cash, we allocated to more defensive sectors, which our research indicated had been participating significantly less in the downdrafts but still had asymmetric upside potential. These sectors included Utilities, Real Estate, and Healthcare (more specifically Medical Devices).

Clearly these have not been normalized circumstances. While this more defensive posturing has provided some protection from the worst drawdowns of the market, admittedly it has not been enough to over-compensate for what has been a correction of historic proportions. Just to put the price action of the past three weeks in context, the S&P 500 has declined nearly 14% in approximately 15 trading days. If we go back to the 1950's, there have only been a handful of periods that were as bad as this or worse (i.e., 1987 Crash, 1998 Russian Default, 2001 when markets opened after 9/11, and the GFC in particular). Said another way, what we've been experiencing has been a rare and epic *correction* in the market, but based on the Fundamentals, we believe this is unlikely to have been the start of an even more painful and protracted *reversal*.

So where do we go from here? The importance of every decision we make at this time is escalated in significance, so we are doing everything in our power to get this decision right. Our Core View is that on a multi-month basis, the longer-term up-trend in risk assets appears intact, so long as the cycle's expansion remains intact. We acknowledge markets have grown more vulnerable and we cannot dismiss a longer-term topping process very well may be underway, although the Fundamentals do not suggest that that should be our base case at this time. We are watching the fundamental data closely. Based on the extent of the correction and through the lenses of our Technical and Sentiment indicators, the market appears poised for a near-term relief bounce, and we are actively focused on how the portfolio and our clients can most prudently participate in that. On the other side, should the Fundamentals show signs of breaking down and corroborate the Technicals, then we will unequivocally activate the Cash Trigger.

We are happy to talk through this in greater detail and answer any more questions you might have. We are here to support you in any way that we can. We understand that you are having

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some uncomfortable conversations with your clients right now, and we feel very badly that is the case. Throughout all of this, we will continue to stick to our process, guide our decisions with data, and maintain a disciplined approach to try and offer you and our clients what we have always tried to deliver: improved risk-adjusted returns over a full market cycle. We will do everything in our power to try and navigate this market successfully with you and for our clients.

Thank you for your trust in us,
The Bluestone Capital Management Team

KEY POINTS:

(1) **The Cash Trigger decision is the most critical decision to get right, and therefore requires the highest levels of conviction of anything that we do.** Specifically, in order to shift the portfolio to cash, our framework and process requires a corroboration from both "Fundamentals" and "Technicals."

(2) **Simply put, that has not happened: Technicals appear oversold and inconsistent with Fundamentals, which continue to be positive.** Valuations have come down to some of the most compelling levels that we have seen in years, and the macro climate is still healthy and provides a positive underpinning to the market. We acknowledge that this can change quickly, and as such we will remain vigilant in monitoring the data.

(3) **We have been positioning the portfolio in a more defensive manner during this drawdown, however, that has not yet been enough to compensate for what has been a historic market decline.** Our framework suggests this correction has become overdone, and we stand ready to act and adapt should circumstances change, in either direction.

IF YOU WOULD LIKE TO JOIN OUR MAILING LIST AND RECEIVE MORE FREQUENT UPDATES FROM THE TEAM, PLEASE EMAIL US AT info@bluestonecm.com

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