EPIC INVESTMENT MANAGEMENT

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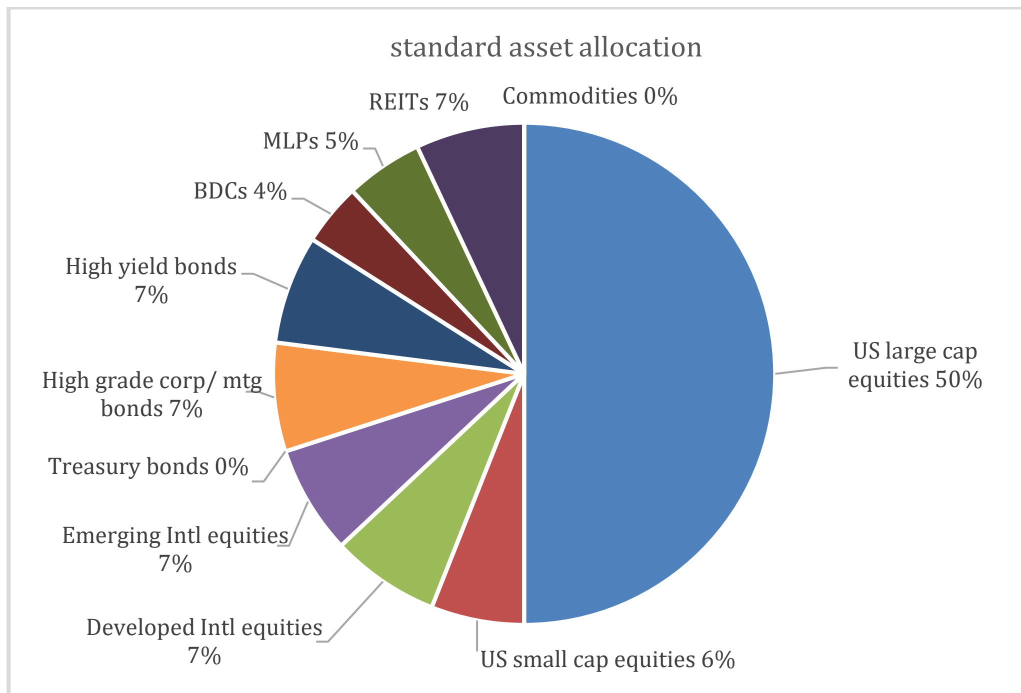
Portfolio Update

The chart below offers a visual representation of our standard asset allocation in client portfolios. 'Standard' assumes all asset classes are in a state of equilibrium, wherein their pricing, quality, and projected growth rates are near what might be described as average or normal levels. Considering that 11 asset classes are represented, and that financial markets are always in a state of flux, 'standard' is a condition rarely, if ever, seen.

Nevertheless, portfolio construction must begin somewhere. For Epic, it starts with a focus on equities, particularly US-based large-cap equities. As we have long noted, equities have historically provided investment returns well above those of other asset classes, including bonds, bills and commodities. Thus the equity focus. Alternative assets are included to provide diversification, current income, reduced volatility, and to selectively participate in attractive opportunities as they arise.



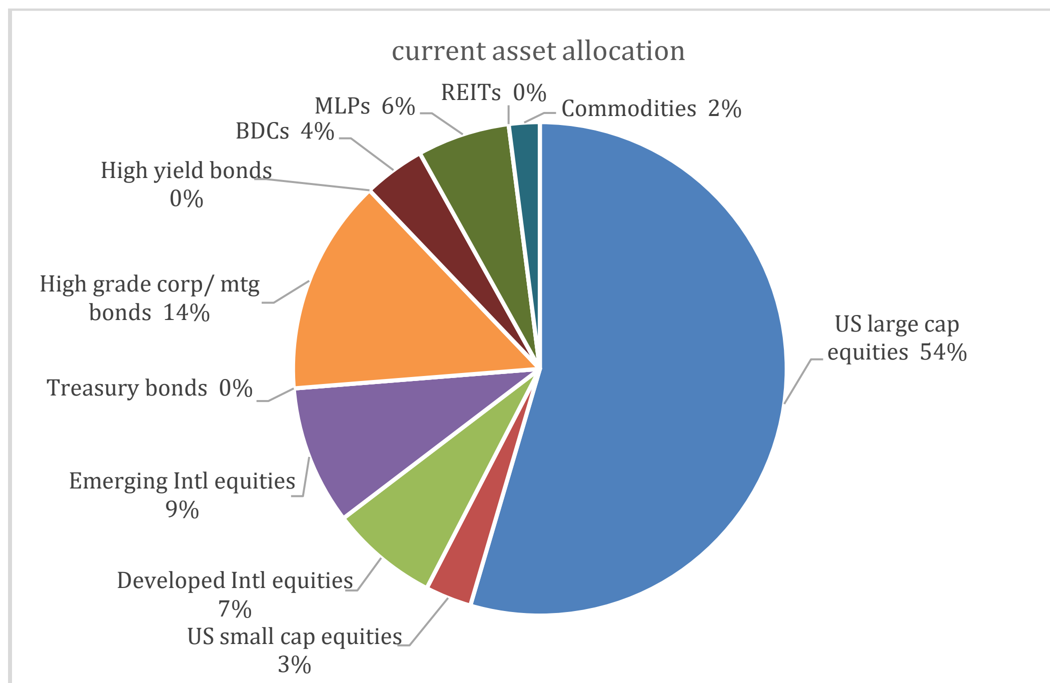
For clarification...
BDC stands for Business Development Company
MLP stands for Master Limited Partnership, in our case with a focus on energy infrastructure
REIT stands for Real Estate Investment Trust

All three serve as income/ yield alternatives, with tax-advantaged structures at the corporate level, high current-income streams paid to shareholders, and daily trading liquidity.

Note that Treasury bonds carry a standard allocation of zero. In most market environments, we prefer the higher yields of investment-grade corporate debt, mortgage debt, and high-yield bonds. While these carry more risk than government bonds, they typically reward investors with higher returns. And in almost every scenario, they are all less risky than equities.

Our usual exposure to commodities is also zero. Pure-play commodities -- including gold, silver, oil, industrial metals and agricultural products -- rank among the least rewarding investments over a long-term horizon. To overly simplify, they sell at zero yields and infinite price-earnings multiples. They also serve as a reminder that the term 'commoditized' is an investment pejorative.

Below is our current portfolio positioning, give or take a few percentage points of variation from one client account to another, and temporary cash holdings.



Our overall equity position is slightly above the standard allocation, reflecting our belief that equities are still more attractively priced compared to bonds and other assets. It's a relative value game, as opposed to a table-pounding endorsement. As has been the case for several years, there are few cheap assets in today's financial markets.

We hold no high yield bonds or REITs, viewing both as poor risk-reward trade-offs given current conditions. The allocation from these assets has been shifted to high grade and mortgage bonds, in the form of exchange-traded funds and mutual funds; and to a small commodity exposure which, atypical for the asset class, offers a significant yield, and will benefit from higher energy prices.

Cash is not listed as an asset class. Certainly, account cash levels will rise and fall as we sell some holdings and re-invest in others. But this is a short-term, transitional condition. Over a market cycle, investment returns suffer from accounts holding excessive cash, and with 11 assets classes from which to choose, we should generally find something we want to own.

This general rule is flipped on its head in severe market downturns, where cash becomes a safe haven. If we have the foresight to anticipate such a downturn, we will become hoarders of cash. The problem is one of timing, and our crystal ball is typically no clearer than anyone else's.

Our accounts are currently positioned to reflect these expectations and observations:

Interest rates will increase at a measured pace. The Federal Reserve has raised rates six times since late-2015, in 25 basis point increments, and is on schedule for two or three more rate hikes this year. The yield on the benchmark 10-year Treasury note has already pierced through three percent, up from 2.41 percent at the start of the year, and 1.36 percent at 2016 cycle lows. The three percent yield threshold was viewed as an important psychological barrier, but will more likely reaffirm our "rule of round numbers" -- they don't matter. So long as yields rise gradually from here, markets should be unfazed. Equally important are credit spreads, and bond yields in global markets, which should limit the upside in US yields.

The US Dollar will continue to weaken against major currencies, albeit at a slower rate. The Dollar's five-and-a half-year advance reversed in 2017, and currencies typically move in multi-year cycles. Overall, a weaker Dollar sets a favorable investment backdrop, so long as the greenback does not collapse.

Real Estate, in the form of Real Estate Investment Trusts (REITs), has lost its luster. This asset class ranks among the best investments over the past three decades, benefitting from tax-advantaged status, while providing an appealing blend of current income and capital appreciation. Nevertheless, a new theme is emerging across the US: our commercial real estate market is over-built, and future returns will be disappointing. Rising interest rates only magnify the problem. In an odd turn of events, a single-family housing shortage has developed, naturally through a paucity of development.

Among the biggest dichotomies in today's market is the tepid response of energy assets to the rising price of oil. Crude oil prices have nearly tripled from their early-2016 bottom; yet energy stocks represent only six percent of the S&P 500 index, a level approaching three-decade lows and usually associated with an oil market collapse. This condition is unsustainable, and should resolve to the benefit of energy equity investors.

While we expect stocks to recover from their recent sell-off, we also acknowledge that the bull market has advanced to its later stages, equities are far from cheap, and a correction could accelerate into a bear market. Market commentary often points to our strong economy as providing ongoing support, yet history says we can suffer bear markets within economic expansions. Most infamously, this occurred in the crash of 1987, and again in 1998 and 2000. Indeed, over the past five decades, roughly half of all bear market setbacks were unrelated to the broad economy.

The extraordinary period of low volatility, accentuated by 2017's quiescent market action, is over. Stocks typically advance "two steps forward, one step back", and downturns can vary from mild to gut-wrenching. Expect both. As equity investors, it is part of the bargain.

Markets always throw investors a curve ball. No matter how well reasoned our expectations, some of them will prove incorrect.

On the following page we provide our markets returns matrix, a visual summary we have maintained and updated for years, but never disseminated. As the image is confusing at first, a bit of guidance is warranted.

Focus on the far-right column, which ranks 10 asset classes by total returns since 1990, expressed as compound annual growth rates. The top-ranked asset is US REITs, with a compound annual return of 10.7 percent. Ranking second, below REITs, are US large cap equities, as represented by the S&P 500; followed by US small cap stocks (Russell 2000 index), high yield bonds, and emerging market equities.

The middle group of returns is comprised of US corporate bonds, Treasury notes, and international developed market equities, as represented by the MSCI EAFE index.

Gold and Treasury bills rank at the bottom, generating modest gains over the past 28 years.

We find this matrix informative on many levels. First, it reinforces our overall commitment to equities as the best means of growing capital over the long term. It also reminds us that cash equivalents and commodities, in this case gold, typically impose drag on a portfolio's performance. Of further note, gold has outperformed broader measures of commodity prices, yet still ranks as the penultimate asset in our matrix. Commodities as a broad category have been a lousy long-term investment, and we see little reason for this to change.

The next message is about variability of returns. Scan the top row, the best returns in each year, and note that eight different asset classes have been top performers at least once. Of particular interest, emerging markets have generated top returns eight of the 28 years, but have also been the worst performer (bottom row) in six years. It's a high risk/ high return asset class, yet its long-term performance and favorable outlook justify its place in a diversified portfolio.

A third takeaway is less obvious. Many of the returns generated over the past 28 years will be unachievable in the coming decade. A current-day Treasury note yielding three percent cannot return the historical six percent of the past 28 years. Likewise for other fixed income assets. Moreover, the outlook for equities is less sanguine compared to past returns. The reason is two-fold: lower future growth rates, and higher initial valuations. And as mentioned earlier, we expect REITs to produce middling returns over the next few years.

The message should be clear: investment returns over the next decade will be subdued compared to historical averages. Part of our job is to inform you of this; the other part is to make the most of it, to the best of our ability.

returns matrix 1990-2017

EPIC Investment Management

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
top returns	Treasury bills 7.6	Emerging Markets 58.0	Russell 2000 17.4	Emerging Markets 73.3	MSCI EAFE 9.2	S&P 500 37.6	US REITs 37.8	S&P 500 33.4	S&P 500 28.6	Emerging Markets 65.7	US REITs 28.8	US REITs 12.8	Gold 24.8	Emerging Markets 54.6
	US Bonds Corporate 7.1	Russell 2000 44.7	High Yield bonds 16.7	MSCI EAFE 33.5	Treasury bills 4.0	Russell 2000 27.4	S&P 500 22.9	Russell 2000 22.1	MSCI EAFE 21.5	MSCI EAFE 28.3	Treasury notes 16.7	US Bonds Corporate 10.3	Treasury notes 15.1	Russell 2000 46.9
	Treasury notes 6.2	High Yield bonds 43.7	US REITs 13.7	High Yield bonds 18.9	US REITs 1.6	Treasury notes 23.5	Russell 2000 16.4	US REITs 21.2	Treasury notes 14.9	Russell 2000 21.1	US Bonds Corporate 9.1	High Yield bonds 5.8	US Bonds Corporate 10.1	MSCI EAFE 39.3
	S&P 500 -3.1	US REITs 32.7	Emerging Markets 11.0	Russell 2000 18.0	S&P 500 1.3	US Bonds Corporate 22.3	High Yield bonds 12.4	High Yield bonds 12.6	US Bonds Corporate 8.6	S&P 500 21.0	Treasury bills 5.8	Treasury notes 5.6	High Yield bonds 3.1	US REITs 36.7
	Gold -4.6	S&P 500 30.5	Treasury notes 9.4	Gold 16.8	High Yield bonds -1.0	High Yield bonds 17.4	MSCI EAFE 7.4	US Bonds Corporate 10.2	Treasury bills 4.7	Treasury bills 4.5	Russell 2000 -2.9	Treasury bills 3.7	Treasury bills 1.7	S&P 500 28.7
	High Yield bonds -6.4	US Bonds Corporate 18.5	US Bonds Corporate 8.7	Treasury notes 14.2	Gold -1.9	MSCI EAFE 12.4	Emerging Markets 5.9	Treasury notes 9.9	High Yield bonds 0.6	High Yield bonds 3.3	High Yield bonds -5.2	Russell 2000 2.5	US REITs 1.4	High Yield bonds 27.9
	Emerging Markets -11.8	Treasury notes 15.0	S&P 500 7.6	US REITs 13.1	Russell 2000 -2.2	US REITs 11.1	Treasury bills 5.0	Treasury bills 5.0	Gold -0.3	Gold -0.1	Gold -5.5	Gold 2.5	Emerging Markets -5.0	Gold 19.4
	Russell 2000 -20.5	MSCI EAFE 13.2	Treasury bills 3.4	US Bonds Corporate 12.2	US Bonds Corporate -3.9	Treasury bills 5.5	US Bonds Corporate 3.3	MSCI EAFE 3.2	Russell 2000 -2.2	US Bonds Corporate -2.0	S&P 500 -9.1	Emerging Markets -2.9	MSCI EAFE -14.8	US Bonds Corporate 8.2
	MSCI EAFE -21.7	Treasury bills 5.6	Gold -5.3	S&P 500 10.1	Emerging Markets -6.7	Gold 1.0	Treasury notes 1.4	Emerging Markets -11.4	US REITs -16.1	US REITs -4.1	MSCI EAFE -12.2	S&P 500 -11.9	Russell 2000 -20.3	Treasury bills 1.0
bottom returns	US REITs -23.7	Gold -7.7	MSCI EAFE -10.9	Treasury bills 3.0	Treasury notes -8.0	Emerging Markets -4.9	Gold -5.0	Gold -21.4	Emerging Markets -25.5	Treasury notes -8.3	Emerging Markets -29.8	MSCI EAFE -19.6	S&P 500 -22.1	Treasury notes 0.4
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	1990-2017 cagr	
top returns	US REITs 32.2	Emerging Markets 33.4	US REITs 33.9	Emerging Markets 39.5	Treasury notes 20.1	Emerging Markets 78.6	Gold 29.5	Treasury notes 16.0	US REITs 18.6	Russell 2000 38.8	US REITs 29.1	US REITs 3.2	Russell 2000 21.3	Emerging Markets 37.5	US REITs 10.7	top returns
	Emerging Markets 24.7	Gold 17.9	Emerging Markets 32.2	Gold 31.0	Gold 5.8	High Yield bonds 54.2	US REITs 29.5	Gold 10.1	Emerging Markets 18.5	S&P 500 32.4	S&P 500 13.7	S&P 500 1.4	High Yield bonds 18.4	MSCI EAFE 25.7	S&P 500 9.8	
	MSCI EAFE 20.8	MSCI EAFE 14.1	MSCI EAFE 27.0	MSCI EAFE 11.8	Treasury bills 1.6	MSCI EAFE 32.4	Russell 2000 26.9	US Bonds Corporate 8.2	MSCI EAFE 17.9	MSCI EAFE 23.6	Treasury notes 10.8	Treasury notes 1.3	S&P 500 12.0	S&P 500 21.8	Russell 2000 9.6	
	Russell 2000 18.3	US REITs 11.6	Gold 23.2	Treasury notes 10.2	US Bonds Corporate -4.9	US REITs 29.2	Emerging Markets 19.0	US REITs 8.1	Russell 2000 16.4	High Yield bonds 7.0	US Bonds Corporate 7.5	Treasury bills 0.2	Emerging Markets 11.3	Russell 2000 14.6	High Yield bonds 8.7	
	High Yield bonds 12.0	S&P 500 4.9	Russell 2000 18.4	S&P 500 5.6	High Yield bonds -26.2	Russell 2000 27.2	S&P 500 15.1	High Yield bonds 5.5	S&P 500 16.0	US REITs 2.4	Russell 2000 4.9	MSCI EAFE -0.2	US REITs 9.0	Gold 13.1	Emerging Markets 8.6	
	S&P 500 10.9	Russell 2000 4.6	S&P 500 15.8	Treasury bills 4.6	Russell 2000 -33.8	S&P 500 26.5	High Yield bonds 14.4	S&P 500 2.1	High Yield bonds 14.7	Treasury bills 0.1	High Yield bonds 1.4	US Bonds Corporate -0.7	Gold 8.6	US REITs 9.0	US Bonds Corporate 6.9	
	Gold 5.5	Treasury bills 3.0	High Yield bonds 11.9	US Bonds Corporate 4.6	S&P 500 -37.0	Gold 24.4	US Bonds Corporate 9.0	Treasury bills 0.0	US Bonds Corporate 9.8	US Bonds Corporate -1.5	Treasury bills 0.1	Russell 2000 -4.4	US Bonds Corporate 6.1	High Yield bonds 7.0	Treasury notes 6.0	
	US Bonds Corporate 5.4	Treasury notes 2.9	Treasury bills 4.7	High Yield bonds 2.6	US REITs -37.9	US Bonds Corporate 18.7	Treasury notes 8.5	Russell 2000 -4.2	Gold 7.1	Emerging Markets -2.4	Gold -1.7	High Yield bonds -4.9	MSCI EAFE 1.6	US Bonds Corporate 6.4	MSCI EAFE 5.7	
	Treasury notes 4.5	High Yield bonds 2.3	US Bonds Corporate 4.3	Russell 2000 -1.6	MSCI EAFE -43.0	Treasury bills 0.1	MSCI EAFE 8.4	MSCI EAFE -11.7	Treasury notes 3.0	Treasury notes -9.1	Emerging Markets -2.0	Gold -10.4	Treasury notes 0.7	Treasury notes 2.8	Gold 4.3	
bottom returns	Treasury bills 1.2	US Bonds Corporate 1.7	Treasury notes 2.0	US REITs -17.9	Emerging Markets -53.2	Treasury notes -11.1	Treasury bills 0.1	Emerging Markets -18.4	Treasury bills 0.1	Gold -28.0	MSCI EAFE -4.3	Emerging Markets -14.8	Treasury bills 0.5	Treasury bills 1.4	Treasury bills 2.8	bottom returns
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	1990-2017	

notes:
total returns % when available

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data source: Bloomberg; Aswath Damodaran, NYU

The Real Dope On Tax Reform

When is a tax cut not a tax cut? When viewed through the critical eye of House Minority Leader Nancy Pelosi.

"Eighty-six million middle-class families will see a tax increase while they advertise it as a middle-class bill."

As reported by The Washington Post, Ms Pelosi has been spewing this line for months, apparently to receptive crowds who await her every word with eager anticipation. Pity the less fortunate.

Still citing The Washington Post, explaining Ms Pelosi's confusion:

> "The nonpartisan Tax Policy Center found that more than 80 percent of taxpayers would get a tax cut, with less than 5 percent getting a tax increase.
>
> But, without saying so, Pelosi focuses on the last year of the tax cut: 2027. Then, the numbers will have flipped, with only 25 percent of taxpayers getting a tax cut and more than 50 percent getting a tax increase. An even greater percentage of tax increases is in the bottom 80 percent of taxpayers: what Pelosi calls the middle class. That's where she gets her 86 million figure.
>
> What happened? The individual tax cuts expire over the course of the decade. Republicans did this to keep the whole tax cut -- especially the corporate tax cut -- in a budget box that allowed only for a $1.5 trillion increase in the federal deficit over 10 years."

In other words, almost every taxpayer, in every income bracket, will receive a tax cut, or no change in taxes, for most of the coming decade. As the tax bill winds down in 2027, taxes will begin to rise. But there is no payback of taxes saved in the prior years.

To Ms Pelosi's reasoning, no tax cut at all would be a better idea, even if it leaves most Americans with less of their own money. And more to the point, if she wants to protect middle-class Americans from the 2027 tax hike, Ms Pelosi could simply vote to make the tax cuts permanent. We're waiting.

More Government, Please

A poll conducted by The Wall Street Journal and NBC shows that a majority of Americans favor greater government involvement in their lives.

According to the poll, 58 percent support more government to 38 percent desiring less. This is the highest percentage of Americans favoring more government involvement since the poll was first conducted in 1995. Back in 1995, the split was 32 percent favoring more and 62 percent wanting less government.

A warning to American citizens: be careful what you wish for.

Tidbits..

Federal Reserve raises its target interest rate by 25 basis points, sixth rate hike in this cycle, sees balanced risks in economy.

US government blocks proposed mega-merger of chip-makers Broadcom and Qualcomm, citing national security concerns.

Trump Administration imposes trade tariffs on China, threatens more, provokes tit-for-tat response.
White House moves to lower Obama-era automotive fuel economy standards, always a pipe dream.

US crude oil exports hit record levels, over two million barrels per day.
US gasoline reaches highest price since 2015, crude oil rises to 2014 levels.

Coca Cola's Japan unit readies to infuse its sugar drinks with alcohol.
Doubling down on unhealthy beverage.

Walmart accelerates grocery delivery rollout, hopes to reach 40 percent of US households this year.
Amazon develops plan to leave packages in trunk of customers' cars.
Shopping mall vacancy rates, at 8.4 percent, reach highest level in six years.
Traditional retail in need of miracle turnaround.

Toys "R" Us, in bankruptcy, plans to close all US stores unless outsider buys them.
iHeartMedia, largest US radio broadcaster, to restructure under bankruptcy.
Remington Outdoor, America's oldest gunmaker, files bankruptcy.
Hollywood's Weinstein Company, crippled by sexual assault allegations, files bankruptcy.
Good riddance.

Uber suspends autonomous vehicle testing in cities after fatal crash.

Facebook under scrutiny from Federal Trade Commission, Congress, European regulators over protection of users' personal data.
Free service is never really free; users' privacy is never really private.

OECD study suggests 'only' 14 percent of its member nations' jobs are highly automatable, refuting earlier studies estimating nearly half of all jobs are vulnerable to robots, automation.

Wireless carriers T-Mobile and Sprint announce merger agreement, third attempt to combine firms.
CBS and Viacom, once independent, then merged, independent again, now consider reuniting.
Make up your mind.

Credit rating agency Moody's reaffirms United States' Aaa credit rating, says outlook is stable.
Sure, and there is an Easter bunny as well.

Source:
Bloomberg
Patriot Post
Tax Policy Center
The Wall Street Journal
The Washington Post