LESA
SROUFE&CO INC.
VALUE ADVISORS

January 5, 2018

2017 Update and Outlook

While the Standard & Poor's 500 Index (weighted towards large capitalization growth stocks) didn't take the crown for the fifth straight year of world asset class returns, incredibly it almost did; only to be slightly beaten by some foreign markets. We don't know if the U.S. will enter a recession in 2018, but we do believe that inflation will show up in most broad pricing indices. Already in the fourth quarter of 2017, commodity and industrial related stocks began to head higher, ending the year on a strong note and benefitting the LSC portfolios. Perhaps the biggest sector surprise of 2017 was the late rally in consumer retailer stocks. Many investors had given up much of this sector for dead only to be whipsawed by a broad recovery in these stocks in the fourth quarter of 2017. While the usual growth stocks got all of the attention in the fourth quarter, patience paid off for contrarian investors (like us) that focus on inexpensive and out of favor stocks.

Short term U.S. interest rates rose dramatically in 2017, albeit starting from historically low levels. Longer term rates didn't follow suit, resulting in a flatter yield curve to end the year. Flat yield curves often signal economic recession is around the corner. (How can this be with a big U.S. corporate tax rate coming in 2018?) It does sound overreaching to broach the possibility of an economic downturn given the current level of investor complacency, even giddiness, characterizing the general markets (especially in the U.S.). Nevertheless, current high valuations, low cash levels, high margin debt in U.S. investor accounts reflect expectations of further stock market appreciation in 2018.

Our thesis for investing has always been to be prepared for the unexpected, given that most investors tend to invest according to past entrenched trends. Thus, it would be surprising to most (but not us) if the S&P 500, as an asset class was in the bottom half of all returns in 2018. This might imply any number of scenarios including its heavily weighted Information Technology sector finally exhausts itself or that investors become enamored with foreign stock markets over U.S. markets (the recent decline in the U.S. dollar may be signaling exactly that). Also a possibility: investors become risk averse after years of handsome returns in many asset classes including real estate, stocks and collectibles. 2017 may be best remembered as the defining year that a newly found Da Vinci painting sold for $450 million and investors in bitcoin made fourteen times on their money. Going unnoticed, after several years of zero returns, investors are actually earning a return on their short term debt investments. This could mark the beginning of an era where investors' views of risk and return changes.

The Opportunistic Value Equity Strategy's significant cash reserves will cushion an inevitable market decline whenever it arrives. Over the past year, LSC has further raised its weighting in non-U.S. based companies to almost half of the portfolio. Their value proposition remains attractive.

During the fourth quarter, we purchased Fluor Corporation in the model portfolio. Fluor is a U.S. based engineering, procurement, fabrication and construction company. Its worldwide projects range from infrastructure (bridges and highways) to power plants and a broad range of energy-related construction projects. Current notable projects include the restoration of Puerto Rico's power network following

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Hurricane Maria and several highway and bridge construction projects around the U.S. We expect a pickup in infrastructure projects in the U.S. and energy (both renewable and carbon based) projects around the world after a multiyear slowdown.

Growth stocks dominated value stocks in 2017. We expect that trend to reverse in 2018. The U.S. dollar posted its largest decline in a decade in 2017, surprising many and just as U.S. monetary policy began to tighten. We think investors are looking beyond the U.S. Federal Reserve's actions and are focused on shifts in international power. Prices on a broad group of commodities ended the year strong and we expect that trend to continue. The coming year will likely see some pullback or more, in the equity markets. We're invested accordingly.