MAST
Investment
Advisors LLC
Making the Important Decisions

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Mast Investment Letter ***Making the Important Decisions***
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Amazoned
Retailer Amazon creative destruction coined a new phrase, Amazoned. As we have learned, this refers to disintermediation of brick and mortar retailers between consumers and product manufacturers. Similar technological enhancements streamline all transactions, most notably in the commoditized, fungible, and digital financial markets. The dilemma for the financial service product sales industry, like Ernest Hemingway's bankruptcy,is the decline of their product sales business model occurred slowly at first, then fast. The inefficiencies and sales personnel have been squeezed out of the cumbersome financial product sales business model, along with the expected returns. That these happened at the same time is no coincidence.

Fixed income expected returns leave no wiggle room for go-go 1980s style trading spreads and sales commissions. Gone are trading desks, their telemarketing sales representatives and financial sales firm trade earnings. Compared to the 1982 15% yield, the thirty year bond now yields 2.80% and the 30-year TIPs yield (the long term, risk free benchmark return) is a skinny 0.94%. In 1984 broker salespeople could load a 4% commission into a 12% ten year Treasury or CD and no one would notice, especially as rates continued a downward drift for 34 years, until July of last year. The Aggregate Bond Index current yield to maturity is 2.48% for a 5.69 year duration. You cannot hide a 1% "investment" management fee in a 2.48% yield, as the client net return gets a haircut down to 1.48%, hardly worth the wealth manager's guidance. Expected return is very specific and accurate measurement from current market values of fixed-income and equity returns: Long term risk free 2.80% and 6 year aggregate bond index 2.48%. Buy it; hold it and you know your return. How does an investment product salesperson assist investors with that decision and at what cost?

Equities (like the economy) have a whole lot of 2% going on. Here are equity expected returns from our calculation last month: real capital appreciation 1.94%, dividend yield 1.98%, expected rate of inflation 1.86%. Add up all those twos and, tah-dah, total nominal expected equity return 5.77%. Just like fixed-income, you can set it and forget it in an equity index. That 5.77%, in our experience and past calculation, is about 10 basis points up or down from the total equity market return that investors will receive in the next 3-5 years. Is that the return that investors want to receive, forecast they will receive, and feel they will receive? No, investors forecast, believe, demand and are sold the annual equity returns from the past, about 10%. And that magic feeling comes from assets which have recently experienced better than 10% returns, such as technology, Amazon, FANG, nifty fifty, internet IPOs or booming house prices. The actual knowledge of current expected return is a valuable investment tool, but not useful for investment dreamers or the wealth managers who peddle products into their portfolios.

Wealth Management Business Model Dilemma
These are the bad old days for the financial product sales industry. Investors know the difference. They know that indexes perform better for a fraction of wealth management product fees. They know that wealth managers are not expert investment advisors, selling investment expertise paid for by over-sold and emotionally risk-impaired financial products. They also know that the financial planning, hand holding,

concierge, coaching, therapeutic wealth management services are product-sales marketing strategies and not strategically beneficial. This leaves wealth management clients at the fringe of the investment universe, emotionally sold and accelerated into momentous stories, leveraged and illiquid. Every bear market and cyclical downturn comes from a surprise source. Not coincidently, wealth management financial products are the most severely impacted by such surprises. It is difficult to identify the financial assets which will adjust and when. Looking back, however, wealth management products (internet stocks, residential real estate) are always over-weighted and leveraged in the emotionally-attached momentum assets which suffer the greatest decline. It is systemic failure, part of their product marketing business model. If wealth managers are heavily invested in the S&P 500 Index, that can bring it down regardless of great earnings, average equity risk premium, moderate economic growth, great employment and low inflation. The emotional weight of investor need and sales product fulfillment distort prices and relationships, no less than the Fed interest rate repression.

Building the Financial Product Pile
While expected returns in public equity markets declined, though still relatively attractive, investors went to specialized, private-market and story-enhanced products. First stop was hedge funds over the past ten years until their recent five-year poor performance. Also popular several years ago, until their collapse, were special index structured-notes with derivative and futures-traded formulas. All those damaged investment funds seek the newest financial product appeal. Replacing those storied-funds are, as always, new ones.

"Giant venture-capital funds are piling up in Silicon Valley, a sign that pension funds and endowments are still willing to rush money into the risky startup sector despite lingering concerns about overheated valuations. Last year, U.S. venture capital raised 30 funds totaling at least $500 million each. That is up from 17 in 2015 and by far the most in a year since 2000, when there were 54. The influx of money from limited partners – the foundations, pension funds, endowments and other big money managers that invest in venture capital – suggests investors hope the startup frenzy of recent years will march on. Investment returns in recent years have been notably strong amid a low-interest rate environment, thanks to startup valuations soaring to new heights. As of July, 100 U.S. startups were valued at $1 billion or more, about triple the number from three years ago. Those returns, however, are mostly on paper because so few startups are holding initial public offerings, the main vehicle for venture firms to reap big profits." (WSJ 7/26/17)

"Apollo Global Management LLC, raised $23.l5 billion for the world's largest-ever buyout fund, the latest demonstration of a surge in investor appetite for leveraged buyout funds, extending a run of records in recent months. The fund adds to the mound of uninvested capital that private-equity firms are sitting on, accumulating a record $1.5 trillion of dry powder. Faced with increasing competition for assets from sovereign-wealth and pension funds, buyout houses have slowed the rate at which they have deployed capital." (WSJ 6/28/17) "For years, markets upward drift has buoyed buyout firms' portfolios and offered them ample opportunity to take profits when selling prior investments. But the rally, in turn, translates into higher prices for new investments, reducing buyout firms' margin for error. Adding to the pressure, pensions' and large investors' increased demand for private-equity funds and other so-called alternative investment products are fueling a fundraising boom, boosting competition for deals." (WSJ 7/28/17) There is no alternative. Repressed yields reduced the required and expected returns on other investments, first public equities and then private investment funds and deals. Leveraged and illiquid, these private deals will be difficult to dispose, especially if acquired at low required returns and high prices.

Changing Indexes To Products
Funding other services with investment product fees relegated investment advice to a low priority. "Automation is threatening personal financial advice. Over the past decade, financial advisers in brokerage houses and independent firms have amassed trillions in assets helping individuals shape investment portfolios and hammer out financial plans. They earn around 1% of these assets in annual fees, a cost advisers say is deserved because they understand clients' particular situations and can provide assurance when markets fall. In the latest test of the reach of technology, a new breed of competitors – including Betterment LLC and Wealthfront Inc. but also initiatives from established firms such as Vanguard – is contending even the most personal financial advice can be delivered online, over the phone or by

videoconferencing, with fees as low as zero. The shift has big implications for financial firms that count on advice as a source of stable profits, as well as for rivals trying to build new businesses at lower prices. The number of advisory firms grew to almost 3900 in 2017, up from fewer than 750 in 2002. Such firms collectively had $5.5 trillion in assets on which they made investment decisions. Independent robo advisers that target younger customers – with fees as low as zero for the smallest accounts – have enjoyed hefty growth. Morgan Stanley, UBS Group AG, Wells Fargo & Co. and Bank of America Corp.'s Merrill Lynch, known for providing full-frills service at top rates, are testing or have already launched automated-advice ventures that charge less than their standard fees." (WSJ 7/27/17) Making indexes into financial products is not investment research and advice. Wealth management sales firms, and their clients, have emotional transaction connection, not investment analysis and process. Investors conditioned to the product sales model as investment management do not care about calculated reason for their investment placements as long as they see stories with recent success in their accounts. This preference becomes widely shared and concentrated among all investors within wealth management account products. This is the illiquidity risk of the engineered leverage which wealth managers sell every economic and market cycle.

Leveraging the Leveraged Products

After the products are leveraged, hedged, optioned, derivative imbued, they are leveraged again by the wealth management business model. "Well Street brokerages have been selling billions of dollars in loans backed by stocks and bonds, a trend that yields lucrative fees for the firms but poses risks for borrowers. While banks don't always report these loans in the same way, these securities-backed loans total at least $100 billion for the biggest brokerages – up exponentially since the financial crisis – with several billions of dollars of additional debt held at smaller brokerages. Executives at Morgan Stanley earlier this month highlighted these loans to individuals as a big growth area and revenue driver, saying the loans helped expand the bank's overall wealth lending by about $3.5 billion, or 6%, in the second quarter. The loans work a lot like margin loans. Brokerages lend against the value of an investor's portfolio. But unlike margin lending, customers don't use the debt to buy more securities. The clients can get cash without shifting their investments, are also able to borrow money at relatively interest rates because the loans are secured.

Critics worry that the surging market has made investors numb to the risks of borrowing against their investments – a scenario that has played out before. In the run-up to the Great Depression, the dot.com bubble of 2000 and the financial crisis, investors binged on margin debt that proved perilous when stocks tumbled. Investors using these loans now could face a similar fate if markets tank and the value of their collateral shrinks, prompting the bank to demand repayment. If the margin call isn't met, the securities backing the loans are sold and the borrower is responsible for any remaining balance. For brokerages, these loans have become a reliable source of revenue in the years since the financial crisis, as firms have begun moving from a business model of charging commissions for trading to a system of fees based on assets under management. The loans themselves help brokers retain these assets because customers don't have to sell stocks and other securities when they need cash. These loans have also become a big factor in brokers' compensation.

Merrill brokers receive continuing payments for getting clients to tap credit lines, and those loan balances contribute to year-end bonus calculations. Morgan Stanley's customers had $30 billion in these loans, more than double from 2013. The bank expects more clients to take out loans ahead. 'That's been a real key driver of our wealth business.' Merrill opened more than 121,000 such loan accounts with more than $85 billion in total credit extended." (WSJ 7/27/17) Investor need for beneficial stories, backed by positive recent performance news, combined with the wealth management business model developed solely for leveraged product attractiveness always, repeat always, results in veg-o-matic concentration of investments declining simultaneously and quickly.

Investors' biggest risks are not the economy, employment, inflation, valuation, momentum or myriad daily news stories and events. The biggest risk is manufactured, created, leveraged and injected into wealth management products themselves. Combine this with the herding of investors out of taxpayer-government protected accounts and into unprotected wealth management product sales accounts, investors' losses will not be covered, simply incurred by the reserve and savings fund clients. Follow Mast research, do your own research, use investment decision criteria and protect your investment assets away from wealth managers very soon. Investors can decide if equity expected returns, credit spreads, duration are worth the risk for their investments. First, they have to know what those conditions are, now and compared to the past and for what reasons. Investors should show some respect for their own intelligence. So should the financial industry ostensibly servicing their investment funds.

Respectfully,

Jim Henderson
Mast Investment Advisors LLC

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Firm Description:

- Mast Investment Advisors LLC is Registered Investment Advisor (RIA) in the state of Illinois.
- Mast Investment provides active index money management services for its clients.
- To minimize trading expenses and to preclude conflicts of interest, Mast Investment manages its clients' assets on a discretionary basis at independent discount brokerage firms.
- Mast Investment receives fees only from its investment clients for this service, and receives no compensation or consideration from any other provider of financial services or products.

Investment Thesis:

- Active money managers (portfolio and mutual fund managers), generally under perform passive equity and fixed income indexes, and create much higher costs and expenses.
- The overwhelming portion of investment return is determined by strategic allocation to asset classes, and not by picking individual securities or funds.
- Over extended periods of time, different asset classes, and different components of those asset classes, perform better than others.
- Investors will, generally, be better served by utilizing index investments, and specifically, those index investments which may perform better than others. Index exchange traded funds provide broad diversification and direct replication of specific index performance.

Investment Methodology:

- Using models previously used over a ten year period for individual stock selection, Mast Investment created models to identify and to monitor superior index performance.
- Mast Investment changes asset allocations among asset classes, and within asset classes, based upon risk adjusted fundamental and technical analysis.
- Each client has a specific, neutral asset allocation provided, preferably, by an investment policy statement from a plan provided by a Mast Investment approved independent financial planner.

Investment Team:

- James D. Henderson, with 25 years of investment management experience, Kellogg MBA, Duke BA, is manager of Mast Investment in its Northfield, IL office.
- Research and decision criteria are in consultation with John R. Tilton, CFA and his investment research models.

Management Fees:

- Fees (generally 1% per year) and other important disclosure information are contained in the firm ADV, filed with the state securities department, and provided to all clients and prospects by Mast Investment.

Investor Communications:

- Clients receive monthly statements from their broker, quarterly statements, performance reports and billing statements from Mast Investment, and monthly investment letters.
- Current, and all previous, investment letters are posted at the firm website under the communications section.
- With client approval, Mast Investment will work with the client's other professional advisors and planners, striving to integrate investment management with other financial needs and goals.