Mast Investment Advisors LLC

1723 A Northfield Square
Northfield, IL 60093
847-501-3148
jhenderson@mastinvestment.com
www.mastinvestment.com

Mast Investment Letter

Making the Important Decisions

September 2017

Investment Ecosystem Participation

Mast research calculates, monitors and responds to expected returns, risks and spreads among major asset classes, fixed-income categories and factors, and 1650 stocks. All these moving parts over time behave both absolutely to their own conditions and relatively to all other asset classes and similar securities. The return, risk, spread and price factors which determine value and projected price/yield change every day, so it is beneficial to monitor them together, not in isolation, to discern the efficacy, or not, of a financial asset investment. This multivariate perspective opposes the human emotional attraction, and dysfunction, of financial product feelings and stories.

The **behavioral food chain starts at the bottom of economic/market cycles**. When fear is exhausted, investment assets disgorged, expected returns and risk premiums are very attractive. This is precisely because the most recent price performance (momentum) has been terrible. When financial assets are broadly owned and concentrated with leverage and illiquidity, expected returns and risk premiums are below average. **In the ninth year of this cycle, investors are full of, and dissatisfied with, broad equity and fixed-income indexes (asset classes)**. Economic, monetary and financial price conditions have reduced performance metrics to a boring 2%.

That is not enough. At the same time, this low expected return is not enough to pay the traditionally high fees and costs of wealth management product sales firms. In order to succeed, wealth managers must take advantage of the final emotional (momentum) moment of investment decision. That entails **products with stories which confirm investor bias for particular investments, stories, factors recently successful**. It is not a calculation or a position within the living/adapting investment eco-system. It is a feeling conveyed to sell the product(s). Generally, each cycle, investors change wealth managers once. This occurs after recovery from the failed products of the previous cycle and dissatisfaction with subsequent returns related to storied alternatives. Wealth management is primarily, 95%, superior marketing and sales. The other 5% is administrative support. **Investment research and management is layers below the marketing accumulation of feelings, news stories and product affinity with those feelings**.

The real problem for the financial product distributors is turning 2% expected returns into something more, to cover sales charges/fees of 3% and, perhaps, a net return of, say 5%. To squeeze a total return of 8% to net 5% requires **superior short term trading, leverage, illiquidity** or all of the above. When paying a wealth manager high fees, **investors expect them to do something**. In the real investment world, our data **often recommends doing nothing**, holding an investment allocation. Wealth management trading, product activity is not investment management; it is **marketing cover for higher risk assumption in order to pay high and unnecessary fees**. Four years ago, just in time for this market/economic cycle, early cycle products failed. We covered them in these letters: non-traded REITs, hedge funds, traditional mutual funds, annuities, energy partnerships. **Wealth management firms swapped clients** as investors were attracted to better, newer stories: big data trading, factors, option hedging, alternative investments, liquid alternatives, tactical rotation, robo investing, and index asset allocation. In the later stage of this cycle, investors are now positioned, as always, in the products and stories which are concentrated, leveraged and illiquid. These letters cover these products as encouragement to readers/investors to make investment decisions based on the real investment ecosystem. Do not let the **centrifugal forces of momentum feeling and product attraction** put you at the periphery of the system, herded with all the other feeling people. We believe that independent research, unassociated with product sales, is a necessary input for a successful investment portfolio, cycle after cycle.

Financial Product Contagion

Due to technology improvements and regulatory quarantine, **financial product sales firms (brokers, banks and wealth managers) increase earnings from wealth management product fees while traditional trading and underwriting earnings decrease**. This is a worldwide phenomenon, as U.S. wealth managers expand product sales and operations internationally, particularly in Asia. Those markets have lower penetration of financial products, thus the superior revenue opportunity. The U.S. market is saturated, with clients increasingly averse to financial product risks, costs and poor performance.

Demand is particularly acute in China as growing amounts of capital are churning both inside and outside of China, depending on Chinese state manipulation of capital, currency and investment flows. The Chinese asset-management industry has growth to $9 trillion (almost half the size of U.S. GDP). "The problem for Beijing isn't just the industry's sheer size. The evolving relationships between the key players and ever-changing nature of the products they sell have made it nearly impossible to regulate. Even if the authorities manage to stamp out one area of egregious behavior, another quickly emerges. Much of the problem stems from China's **banks, which have issued almost 30 trillion Yuan of wealth management products in the recent past, offering them as short-term investment opportunities to household and corporate customers**. **By the end of the first quarter, some 44,000 of such products were outstanding**. These products usually recorded off the banks' balance sheets, ripple through the financial system in various ways that complicate regulators' efforts. Banks can also **package some of their loans and sell them to nonbank financial institutions like mutual funds and trusts**. These then parcel the loans into so-called asset-management products and plans, which they can sell back to the original banks. Then a bank's loan book has suddenly become part of the bank's investment portfolio. Banks have unloaded another $1.9 trillion of loans this way. As banks find ways to **channel these products, the network has come to include big insurers and brokerages**. The short-term nature of the products, when set against the long-term nature of the assets in which they often invest, creates the risk of asset-liability mismatches that could potentially destabilize Chinese markets if funding is squeezed." (WSJ 8/7/17) U.S. and foreign financial sales firms can take advantage of wealth management demand catch-up but the financial products, as in the U.S., often kill their hosts.

Demographic Retirement Fund Liability Bubble

Major economic and demographic trends concentrated liabilities into popular assets, internet stocks and residential housing. This economic and market cycle features **retiring baby boomers liabilities and underfunded reserves**. Leverage and illiquidity conclude economic and market cycles. This cycle leverage is unfunded liabilities for public employment and government entitlement retirement benefits. The **collective public pension plan shortfall is estimated at $4 trillion. That is up there with the other trillion dollar debt clubs; auto loans, student loans and credit card debt**. The illiquidity is large drawdown of over-priced financial assets to meet these accelerating obligations against inadequate reserve funds. "The public pensions' predicament is the result of decades of low government contributions, overly optimistic investment assumptions, over-promises on benefits and two recessions that left many retirement systems with deep funding holes. Demographics are also a factor: Liabilities are rising as waves of baby boomers retire, leaving fewer active workers left to contribute to pension plans. For many pensions, funding problems worsened in the years following the 2008 financial crisis as interest rates hit – and remained at – rock bottom**. Many funds tried to address the issue by ramping up their ownership of equities in the hopes of benefiting from an eight-year bull market**. But that level of exposure to stocks means public pensions will experience even more funding stress if a bear market returns. Even if returns remain elevated, large pensions won't be able to reverse their shortfall in coming years, according to Moodys Investors Service. Large public plans currently **have just 70% of what they need** to pay future benefits to their retirees. Funding levels won't improve significantly unless cities and states ramp up their yearly pension contributions." (WSJ 8/9/17) Large public pensions do not have funding levels which reach benefit goals without extremely unusual forecasted return assumptions. **Illinois now has just 35% of what it needs to pay all future obligations, California 68% and Connecticut 35%.**

Needy Investors Demand More Risk, Accept Lower Return
Private real estate owners and **investors who picked up foreclosed properties in the great recession sold off the properties into public markets** after substantial price rebound while retaining the steady real estate management business. This has been a successful strategy for several economic cycles over the past fifty years. Real estate ownership risk is assumed by public market stocks and wealth management products. During low expected public market returns, investors demand less safety for less return. "Two of the country's largest rental-home owners have agreed to merge, one of the clearest signs that Wall Street is betting homeownership rates will remain low and that a growing number of U.S. families will rent. The all-stock deal between the **publicly traded real-estate investment trusts is the biggest yet in the rapidly consolidating institutional rental-home business, which sprouted from the foreclosure crisis when big investors raced to buy homes at steep discounts**. Their near-term wager is that bad credit, a lack of savings and tight lending will keep many people renting. Longer-term, they are wagering that homeownership will no longer be an essential component of the American dream and that more people will chose to rent. The homeownership rate is hovering around 50-year lows and home prices are rising. That has driven rents higher in the markets where the companies operate. Invitation says its average monthly rent is \$1683, while Starwood says its is \$1629. The challenge will be to pace rent increases so as to not turn their tenants into house hunters who would compete with them for properties." (WSJ 8/11/17)

Dissatisfied public market investors also find their way into venture-capital funds which, in turn, discover over-valuation price distortion in private deals. "The IPO market remains anemic for technology companies, and the M&A market isn't faring that much better. Yet **investors continue to pour money into technology startups – even the sol-called unicorns valued at more than \$1 billion. That means a reckoning is still on the horizon**. Fat private valuations need to be cashed out eventually, but public investors have their limits. The bottleneck on exits hasn't stemmed the money flowing into the startups yet. Private companies based in the U.S. **raised \$17.4 billion in venture funding in the second quarter, up 13%** from the previous quarter and a fractional gain year over year. And the well isn't running dry for venture capitalists either. U.S.-based **funds raised \$12.8 billion in the second quarter – up 58%** from the first quarter and up 9% year over year. That means a reckoning is still likely, especially as the unicorn herd keeps growing." (WSJ 8/19/17)

After substantial real estate price declines following the financial crisis debt defaults, investors with cash purchased real estate assets, on their own or through funds. Monetary stimulus, cheap interest rates and bank regulatory allowances revived, slowly then quickly, real estate prices. The price recovery attracted more investors, assuming that price increases would continue further long-term. **Over-invested categories which are experiencing distress are commercial-retail and multi-family**. "Retail sales and occupancy rates are falling in many parts of the U.S., partly because of **oversupply of stores** and competition with online retailers. That has meant **lower property values**. Cushman and Wakefield estimates that the number of store closures this year will reach at least 8,000. That would be up from more than 4,000 in 2016. More retail **landlords are defaulting on securitized loans** than owners of other property types. In the first seven months of 2017, the loan balances of these **defaulted mortgages increased roughly 20%** to \$1.34 billion, according to data from Trepp Inc." (WSJ 8/30/17) Many of the defaulted loans are contained by **already-failed non-traded REIT products and other collateralized debt products featured in wealth management accounts.**

On the flip side of the second leveraged real estate price decline in a decade, new investors scavenge currently collapsing deal and bond investments. "Investors are raising funds to take advantage of **busted condominium projects and other distressed property as weak sales and falling cash flow** in parts of the U.S. real estate industry show signs of spreading. They have money available to take advantage of condo developments falling short of sales projections, shopping centers struggling with competition, delinquent debt and other problems surfacing in several markets. Some analysts point out that **commercial property typically runs in cycles, and it is one of the longest-running bull markets in recent memory**. Lately, the pace of sales volume has slowed, which often is a sign that the market is at or near its top. At the same time, values have started falling. The rate of **owners falling behind on loan payments** also has increased this year." (WSJ 8/30/17)

"**Private equity has a $600 billion problem. That is the record amount of uninvested cash** that buyout funds are on after a bout of fundraising that included the biggest buyout fund ever: Apollo Global Management's $23.5 billion vehicle wrapped up in June. The **problem is how to spend it**. Although loan markets are flooded with cheap money and loose terms, company valuations are very high. The big risk for private-equity investors is that their deal makers might do something dumb. The last cycle peaked with KKR's $45 billion buyout of Texas energy group, TXU, which went bankrupt in 2014 and only now is being sold off in pieces. Very large deals have been scarce recently. **Alongside the glut of funds in private equity's hands, more competition is coming from traditional asset managers and pension funds hunting for better returns**. They will have to balance discipline with the desire to put money to work." (WSJ 8/28/17)

Famously worldwide, Americans are consumers, regardless of economic conditions. It is what they do. With interest rates so low, and house prices recovered, the home piggybank returns. "Rising home prices are making **borrowers comfortable again with the idea of tapping their homes for cash**. Home-equity lines of credit and cash-out mortgage refinances, two products that let consumers spend the windfall of home ownership, are back in vogue. The main engine driving demand: rising home prices. The median sale price of an existing home rose to $263,800 in June, the highest on record, up 40% from $187,900 at the start of 2014. A home-equity line is similar to a credit card, where a borrower can spend as much or as little of the available credit as they wish – but with the **house as collateral**." (WSJ 8/28/17) While consumers increase residential borrowing, their increased risk is packaged and off-loaded into wealth management products.

Bank regulation reform reduced bank balance sheet risks to protect taxpayers from financial security/product losses. The **banks find ready buyers for risky securities among the clients of their subsidiary wealth management divisions**. Not only can they dispose of the products, they can receive compensation from the purchasers. At the core of the 2008 financial crisis, Fannie Mae and Freddie Mac mortgage products are **shifting risk from taxpayers to investors**. "Investors are snapping up securities sold by Fannie Mae and Freddie Mac that shift mortgage default risk away from taxpayers, powering a quiet transformation of the housing giants after almost a decade of government control. Fannie and Freddie have sold roughly $48 billion of the securities since 2013, **transferring a large measure of risk on roughly one-third of the single-family mortgages they guarantee**. The sales mark an early step toward reducing the government's role in the $14.4 trillion U.S. mortgage market. The amount of mortgage debt funneled through Fannie and Freddie and other taxpayer-backed entities roughly doubled after the financial crisis, to around 70%. They **buy them from lenders and bundle them into securities**, typically carrying a guarantee that Fannie and Freddie will pay investors if the underlying mortgages default, leaving investors with only the risk that the bonds will lose value if interest rates rise. The credit-risk transfers don't carry that guarantee. Nevertheless they have **proved popular with investors, who have concluded that the yields they offer are worth the added risk**. How much risk Fannie and Freddie have shed depends in part on the severity of defaults. In a normal economic expansion, investors would likely shoulder around 20% of the losses in the mortgages underlying the securities. But that number would jump to around 60% to 70% if there were another severe recession comparable to the last one – enough, if the firms were private, to possibly avoid a federal bailout." (WSJ 8/15/17) There is a gravitational pull for investors into riskier investments which assume returns higher than public-market indexes and securities. The attraction accelerates as expected returns and risk premiums reach lower levels. Best practice is to scale out of financial products and wealth management distributors. One purpose of the distribution of our research reports is to assist readers with the ongoing position of their investments in the real investment universe.

Respectfully,

Jim Henderson
Mast Investment Advisors LLC

Investment Letter Distribution

- This letter is distributed by subscriber permission only.
- E-mail addresses are kept entirely confidential, not used for any other purpose or communication, and are removed immediately upon request.
- Your contact with us for elaboration or explanation is welcome, but we will not otherwise contact readers referred to us.
- This letter is intended as a service and an opportunity for us to disseminate some of the results of our investment work.
- Thank you for subscribing and for referring others.

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.