CAZ Investments
Quarterly Letter

A Quiet Summer

The 2nd quarter could be called "boring" by some and a delightful respite by others. Markets were choppy and mixed for the quarter, with very few significant winners or losers. The big news of the quarter related to trade wars and tariffs. Those issues are very significant, so we are not minimizing their potential impact, but when we look at what actually happened with asset prices, not much really changed.

That said, we view this sideways action as very constructive and actually like flat markets right now. Trading ranges are healthy, in that they have a way of eliminating euphoria and bringing the focus of market participants back to what really matters which is earnings and economic growth. Both of those inputs are performing well and that means the longer that asset prices go sideways the better valuations become. Simply stated, if a company's stock price doesn't go up or down but earnings are increasing the stock actually gets less and less expensive. That is encouraging to us and we would love to see stocks stay in this trading range for several more quarters, which would allow rising profits to catch up with stock valuations that are clearly still quite expensive. Getting better, but still very expensive.

When we talk about the economy we try to look past the noise of the political news cycle and focus on the fundamental data that is important to us. Nearly every economic indicator continues to point to a continued expansion, with inflation not a problem…yet. There are several ways inflation begins to assert itself in the data but the one we are most focused on right now is wages. As an example, Jobless Claims are at the lowest level that we have seen since 1962. Think about that for a minute. Less people are filing for unemployment right now than any other time in the last 56 years. That is a very healthy sign for the economy and it also can lead to "wage-push" inflation. We won't dive into an economics class here but, suffice it to say, if wages go up rapidly the costs of goods will either have to also go up, or companies profit margins will suffer. Stocks don't mind the former, as a general rule, but they definitely don't like the latter… As we talked about last quarter, if the market has a "kryptonite," it is profit margin compression from wage and cost inflation. We are not overly concerned yet, but we are definitely not complacent.

Long term interest rates were on a tear higher earlier this year and then ran into a wall of fears about economic growth slowing as a result of a trade war. The Federal Reserve has been consistent with their previously forecasted rate hikes and are likely to raise rates twice more this calendar year. That is putting us on a precarious path towards a potentially inverted yield curve. For those not familiar with the term, the yield curve becomes inverted when short-term interest rates are actually higher than long-term interest rates. That, of course, is counter intuitive as most people would demand a higher interest rate on a longer loan. The exception is created if market participants believe the economy is going to slow down, causing long-term interest rates to drop, and wish to lock in a decent rate for a long time on their loans before that happens. This inverted yield curve phenomenon has been an uncanny indicator of pending economic slowdowns/recessions. There is no "magic" formula that says if we see an inverted yield curve that we will have a recession within a year or two, but history has given us plenty of data to support becoming exceedingly concerned if we see an inversion occur. As of this writing the 10-year U.S. Treasury yield is approximately 2.8% and the spread between 2-year and 10-year rates is razor thin. Something is going to have to give and we basically have only three possible scenarios:

1. Long-term interest rates are going to go up significantly in the next six months
2. The Federal Reserve changes course and decides to not raise rates twice more this year
3. Long-term rates remain in this area and the Federal Reserve does what they said they were going to do and we will have an inverted yield curve.

When we look at each of the possibilities, none of them are particularly good for asset prices other than scenario 1. If long-term rates go up sharply because the market believes that the economy is about to kick it into another gear higher that could be very positive. Now, rates will begin to become a significant competitor to stock prices, but the general expectation is that the rapidly growing economy would provide significant earnings growth and offset any competition from the higher rates available from bonds. This is what we would paint as our optimistic scenario as we look at the remainder of the year. It is still easier for us to build scenarios that are less optimistic, so we remain cautious.

Action for Investors

Occasionally, especially after a very flat market, it makes sense to reiterate what was already stated recently. What we articulated last quarter bears repeating because when investors see flat prices, they have a tendency to not take much in the way of action. One of the most common statements we make that is quoted by others is, "Sell when you can, not when you have to." This is so true today. Complacency is dangerous and frequently precedes rash decisions. Be assertive and make sure that you are comfortable with your portfolio design. Here is what we said last quarter:

We continue to believe that the long-term return outlook for stocks and bonds is quite tepid. Unless we see a significant decline in stock prices, it is hard to model out a scenario where investors are going to be able to count on a traditional portfolio to meet their actuarial/return assumptions. Quite frankly, if an allocator of capital simply does what they have always done, they are likely to be severely disappointed with how their returns will fare over the next decade. If someone is a professional allocator, they risk losing their job…We believe that investors are going to need to look where they have not looked before and be open to unique, idiosyncratic, opportunities in order to generate returns of the magnitude they have grown accustomed to. To put it bluntly, the next decade is going to reveal which investors are really capable of creating alpha (similar to the old saying about how when the tide goes out we all see who was not wearing a bathing suit!). If an investor is not willing to work for alpha for the next decade, and just wants to count on beta to give them the returns they need, they are in for a rude awakening.

For this reason, we remain **a "1" on the CAZ Scale**, which is our most cautious position. Valuations are getting better because stock prices have generally gone sideways since January, and if company cash flows continue to increase while stock prices stay in this general level, our outlook will improve. We will continue to monitor the long-term outlook for asset prices and will adjust our rating if the risk/reward becomes more favorable.

Because of the strong possibility of rising long-term interest rates, please do not have outsized exposure to long duration fixed income and be wary of investment areas where valuations are excessive. We continue to favor international stocks over domestic, because they are simply much less expensive. Be focused on investments that are creating value and are not just using financial engineering or large levels of debt to generate returns. As we have been quoted in several places recently, there continues to be significant pockets of overvaluation and we want to avoid those areas.

The year is now more than half over and we have made a few investments, but the landscape continues to be challenging to find truly compelling opportunities. Know that when we contact you about something that we are doing with our personal capital, it has surpassed an extremely high hurdle before it was approved and, thereby, we have been convinced from our diligence that it offers a strong risk/reward.

There has been a tremendous amount going on behind the scenes this year. We have added significantly to our team in the last few months and we look forward to you meeting them in the very near future. Our vastly improved website is now live. Please go to www.cazinvestments.com and let us know what you think! If you have not already spent time watching the new 3 to 5-minute fund update videos that we rolled out in April, please do so. The feedback has been excellent, and we would love to hear any suggestions that you may have.

Finally, our leadership team recently updated our Firm's Vision and Purpose as well as created what we call our Guiding Principles and CAZ Promises. You will find those documents on the subsequent pages and we hope you will take a few minutes to read them. We view those who co-invest with us as Partners and consider you an extended member of our family. As such, we want to be sure you know what the Principles we are committed to and the Promises that we expect each member of our Team to live up to, to the very best of their ability.

All our very best and we look forward to seeing you soon.

The team at CAZ Investments

CAZ INVESTMENTS

Access to Innovative Investing

WHO WE ARE

- Partners First
    - We place the needs of our Partners above our own.
- Alignment
    - We align our interests with our Partners.
- Raving Fans
    - We create Raving Fans of our Partners, Shareholders and our Team.

HOW WE THINK

- Challenge the Conventional
    - We think outside the box.
- Find What Matters
    - We see the forest not the trees.
- Think Forward
    - We invest with the wind at our backs.
- Understand the Risks
    - We know if we can live with the worst case, the upside takes care of itself.

WHAT WE DO

- Do With Excellence
    - We give our best to be the best.
- Place Team Above Self
    - We are a family, not just a business.
- Emphasize Independent Thought
    - We respect and encourage individual thinking.
- Serve Our Community
    - We are servant leaders for our causes and our community.

CAZ INVESTMENTS
Access to Innovative Investing

<u>The CAZ Promise</u>

I will make ravings fans of our partners and team

I will always put the interests of our partners first

I will elevate my teammates and help them grow

I will partner with the team to ensure the group is stronger than the individual

I will commit to win and lose as a team

I will embrace and promote a culture of healthy conflict

I will go to the source and avoid gossip

I will sharpen the saw to be the best I can be

I will think like an entrepreneur

I will welcome intellectual challenges and new ideas

I will think for myself and encourage others to think for themselves

I will challenge norms and think outside the box

I will find what matters and see the forest not the trees

I will do with excellence

I will demonstrate a higher standard of work ethic

I will honor the process and do the right thing at the right time in the right way

I will be above reproach in all aspects of my life

I will own my mistakes and grow from them

I will embrace my strengths and design around my weaknesses

I will strive to be better and for better

I will find a way

I will celebrate the journey as much as the victory

<u>I am a member of the CAZ family</u>