2020 Vision

What do you see?

ABOUT THE AUTHOR

Michael J. Merlin
MMerlin@rockco.com | (404) 942-3060
Michael Merlin is the founder of Merlin Wealth Management at The Rockefeller Global Family Office. He and his team formulate wealth strategies to help clients achieve their specific objectives and provide advisory services including cash flow planning, retirement and estate planning, and philanthropic consulting.

The 1972 Miami Dolphins, under the expert leadership of legendary coach Don Shula, remain to this day the only team in NFL history to ever enjoy a perfect season with no defeats and no ties. What was probably most remarkable about this epic season was that it was not expected by *anyone*- the Dolphins were considered major underdogs going into the 1972 season, yet by some measure they were able to grind their way to this unbelievable result.

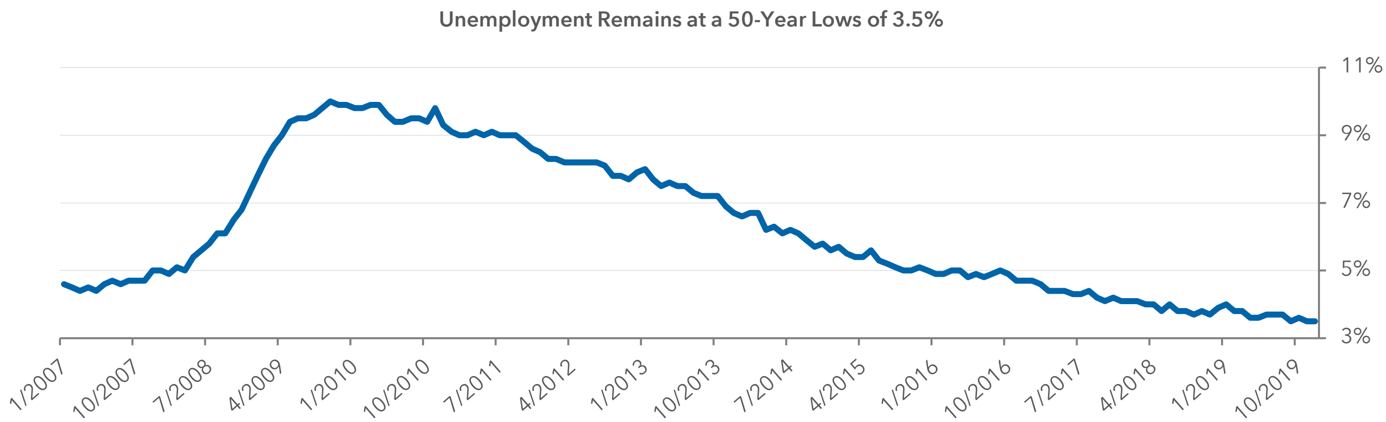
I think many would say that the 2019 stock market displayed equally unexpected, but epic results! The S&P 500 Index increased +29% last year. Almost every major stock average was up double digits, and bonds also delivered 8%+ returns as measured by the Barclays Aggregate Bond Index. Yet, while the market was delivering historic returns, investors remained skeptical. Fund flow data in 2019 continued to show the same trend it has for most of the last decade, with more money fleeing equity funds than being added; and more of that money going into bond funds. This past year, then, just adds to our assertion that this is the most unloved bull market in history. Yet, to us, this friction from the investment community has actually helped prolong the market expansion. It would be more concerning if we saw signs that the investment community was capitulating, beginning to put money to work unconsciously and seeing markets soar into a "melt up" that is typical of market tops and recession beginnings.

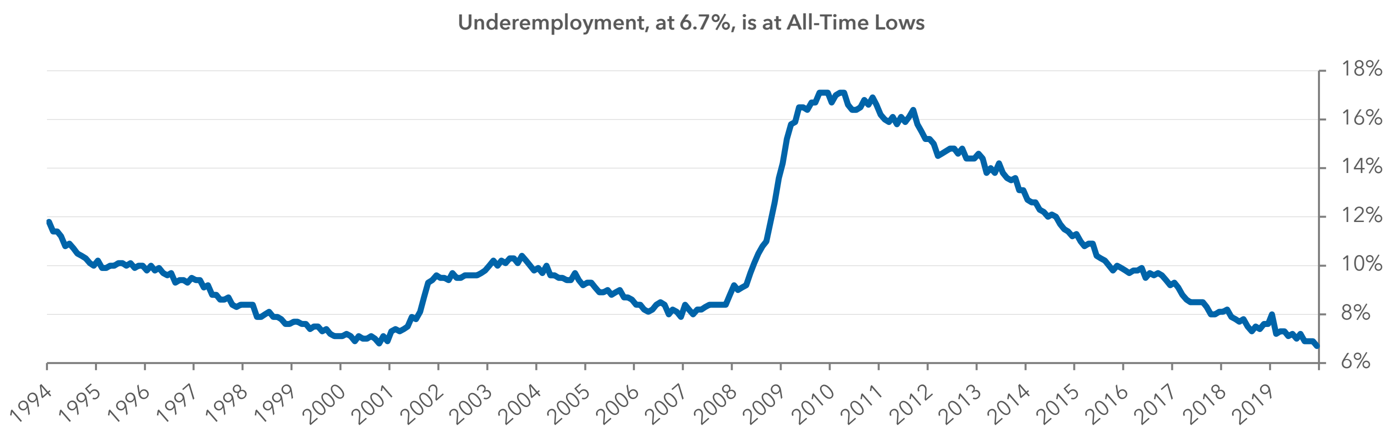
As 2020 is now upon us, many are singing the same tune, saying the markets will most certainly fall under the weight of these ever growing gains; that politics, geopolitics or valuation alone will lead us to a prolonged correction that has been inevitable since the 2010 recovery from the Financial Crisis.

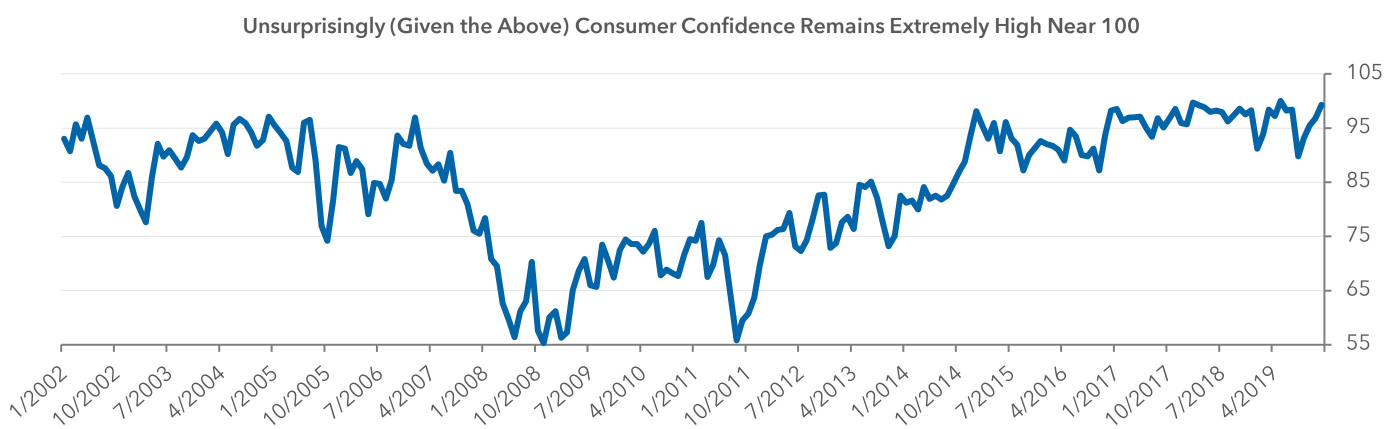
Yet, there are still reasons to believe the market has room to continue its steady increase. Following the six times in the past the S&P increased by +29% or more, the index increased +19% on average the next year. GDP accelerated +1.7% on average [1]. Additionally, consensus surveys are becoming more optimistic, potentially a sign of capitulation and the beginning of the "melt up" we expect to see before we potentially enter a recession risk. Investors surveyed by ISI on January 6th are now expecting an average of +2.6% GDP growth in 2020, which is significantly faster than previous surveys of 1.8%. They are also expecting S&P earnings to increase +7%, which is also much higher than prior consensus of +2%-+3%. Meanwhile the Global Economy seems to be improving as measured by Global EDI, Global Composite PMI and ISI Surveys. Finally, at the end of previous expansions, bond yields have been much higher than they are today. From this perspective, bond yields pulling back to 1.79% last week is encouraging. Of course, if the yield curve turns negative, that's another matter (which we've addressed in previous letters).

[1] Source: ISI, Morning Economic Report. As of Jan 7, 2020.

There are also continued signs of strength in the U.S. Economy[2]:

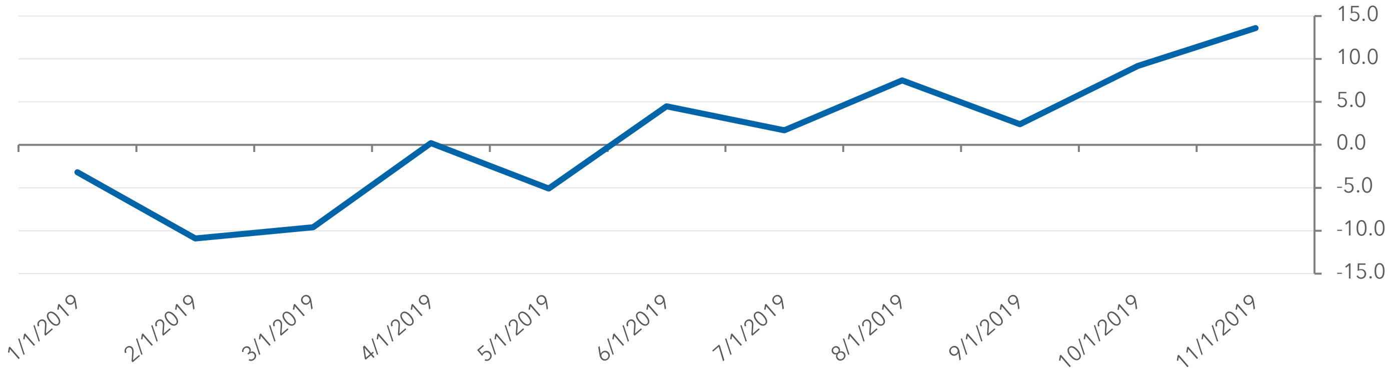




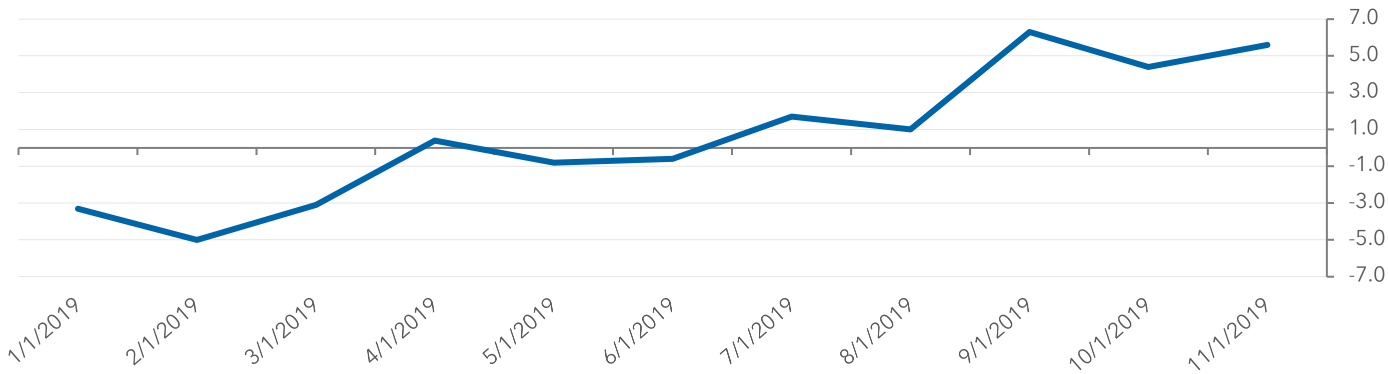


[2] Source for charts on pages 2 – 3: Bloomberg.

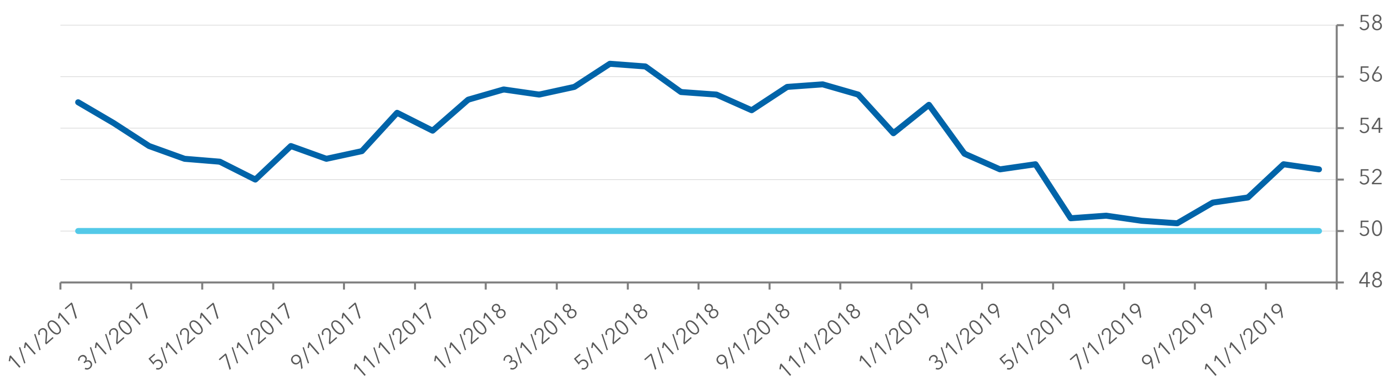
Housing Starts Accelerated Through 2019 on Low Rates, and High Consumer Confidence



As Did Pending Home Sales (New & Existing Units)



The Markit US Manufacturing PMI Measure has Inflected From 50, Even Before a US/China Trade Deal



With all that said, here are our key themes for the coming year:

1. Don't Fight the Fed
2. Core Inflation remains muted
3. Stock markets typically peak just before recessions
4. An acceleration in consumer net worth lifts GDP growth 6 months ahead
5. Be fearful when others are greedy and greedy when others are fearful

Now that we are in 2020, we are asked often about our views on this year's U.S. presidential election and other geopolitical issues affecting markets, most recently the U.S. conflict with Iran, but also continuing China-U.S. trade conflicts, impeachment proceedings and the like. While we do not try to predict the outcome of these inherently unknowable events, we certainly evaluate potential damage to individual businesses caused by proposed legislation or geopolitical events. Over our entire history, though, rarely have we had to make significant portfolio changes based on macroeconomic issues; and, at this point, we do not expect to make meaningful changes to our portfolio holdings solely based on the winner of the upcoming U.S. presidential election, the progression of the Iranian conflict, the next phase of the U.S.-China trade talks, or other economic factors.

At the end of the day, "factor rotations" that either weigh on our portfolios, like the latest geopolitical conflict or valuation fears we experienced in 3rd Quarter 2019, or benefit the portfolios, like prior "rotations" into high quality factors, are all simply short-term noise. In prior commentaries, we have discussed how the market's daily trading volumes are increasingly driven by "non-thinkers" such as passive and quant strategies and how this trend may cause share prices and business fundamentals to disconnect over shorter periods of time. But, shorter-term market drivers are neither of consequence to us nor controllable by us (or any other investment manager for that matter). What we believe drives share prices and returns over the long-term and what is within our ability to understand is the long-term earnings power of businesses. We believe the long-term earnings power of our portfolio holdings remains top notch, and this is where we will continue to focus our time. We will not make tactical shifts into lower quality companies based on non-fundamental market moves. Now or ever. Hopefully, for us, these types of market reactions present opportunities to buy great businesses that may have been temporarily caught up in short-term gyrations unrelated to underlying company fundamentals.

That does not mean that we do not remain vigilant in evaluating risks to our investments, including macroeconomic risks. These risks, however, very rarely change our investment thesis in a company. The companies we seek to own typically have value propositions, competitive advantages and growth opportunities that we believe are too strong and durable to have short-term economic headwinds derail their long-term earnings potential. Although their path may not be linear and may have bumps along the way, we continue to expect our companies to produce robust earnings growth well into the future.

We are often asked about our idea generation process and where our ideas come from. Our investment ideas come from many sources. Before discussing the sources we do use, it is important to point out two important industry sources we do NOT use: indexes and quantitative screens.

1. **In-house Research.** The most important source of ideas for us is our in-house research staff. There are currently 5 of us that are developing ideas based on the knowledge of various industries that we've developed over many years. There is a constant give and take between us, the substance of which forms the basis of our debate. We then hold regular discussions where the ideas are tested and vetted collaboratively.
2. **Existing Investments.** We often find new ideas from existing investments. If we find a business model that we particularly like, we will look for other investment opportunities with comparable business models, although the end market may be different. Company executives (or former company executives), are also a source of investment ideas. When we find mangers/business owners we think are exceptional, we often follow them if they move to other

companies. We ask them about their opinions on other companies as well. We also find out which companies they think are their best vendors, suppliers, or distributors. We ask them who they admire, and who they fear.

3. **Capital Markets.** Historically the capital markets have been a consistent source of investment ideas for us. Typically, this involves following a company before it is public, and then deciding to make an investment in the company on its IPO (initial public offering) or sometime thereafter. Typically, by the time of the IPO, we have already done a considerable amount of research on a stock to give us the confidence we need to invest. We typically take a small position in the company and continue to do more extensive research once their public filings are released. If we like what we see, as we build conviction, we add to the position. Examples of stocks we've purchased in this fashion include Facebook (2012) and Alibaba (2014).

4. **Industry specific events.** We also find ideas by attending (virtually or in person) industry events and through ongoing contacts with industry specialists and analysts. At these events, we learn about industry trends and new product launches, hear company presentations, and speak with industry experts. For example, a few years ago we attended a tech conference where we first became acquainted with ServiceNow, Inc. The company provides enterprise cloud computing solutions to businesses worldwide, a theme that has been of particular interest to us. After learning about the company, we did additional research, spoke with management, an analyst that covers the company, and became convinced that the business had the characteristics and potential to become a successful investment over time. So, we waited for the valuation to meet our desired buy range, and we purchased the stock in our New Era portfolio in 2018.

5. **Professional contacts.** Over two decades of a managing money, we've come into contact with other investment managers that we admire and respect. In maintaining close contact with these peers, we sometimes hear about a company more than once, at which point we start to pay attention. We may bring the idea up in our weekly investment meeting and decide if it warrants a deeper look at its fundamentals.

6. **Reading.** We spend a significant amount of time reading industry-specific publications, sell-side research reports, trade magazines, newspapers and other online new sources. To be able to identify a potential investment opportunity requires that we are knowledgeable about an industry and about the broad economic environment in which that industry operates. Reading educates us about regulatory changes, political implications, and economic trends, and it allows us to identify areas of potential interest. We are constantly sharing articles among ourselves, asking questions about the conclusions and wondering whether there is action we should be considering.

The general principles of Merlin Wealth Management's investment approach are the single most significant idea filter that we use. Looking for long-term growth naturally refines our investment universe. More specifically, our focus is on the duration of the growth opportunity. We think not only about how long a business will grow but also how long it is going to grow fast. In our view, most investors often miss or misprice great investment opportunities because of their focus on short-term outcomes.

While ideas are the lead in our investment process, much work has to be done before ideas become investments. After we source an investment idea that looks interesting, the next step is to do extensive research. Our research is bottom-up and fundamental. We pull apart the pieces of a company to understand it completely. We develop an investment thesis, test it, and keep testing it throughout the life of our investment. We also think it is critical to talk to management because it enables us to learn about their vision and goals for their business and how they plan to realize those goals; to understand business practices, management style, priorities, character and values; and to assess the managers' abilities to execute their plan. We think our multiple interactions with management over may years of an investment allows us to understand the long-term prospects of the business, and to understand when an earnings miss or dip in the stock price might be an opportunity to add to our position.

Before investing, we look at the fundamentals of each company, in search of certain characteristics that we deem critical in order for us to invest. Among these characteristics we look for are sustainable competitive advantages, recurring revenue, a unique product or service, strong management, scale, market leadership, and global growth opportunities.

Valuation is our final cut. Using our proprietary valuation models, we substantiate that our qualitative assessment of leadership and a company's strategic plan can be translated into measurable and sustainable performance. We want to invest in what we believe are great businesses at good valuations; we never want to invest in a bad business just because it is cheap.

Our seasoned stock picking process and our ability to generate successful investment ideas have contributed to our strong long-term outperformance. While past performance is no guarantee of future results, we believe that being consistent with our investment approach will continue to add value in the future.

20 ideas that will shape the 2020s[3]

We thought it would be fun to summarize our favorite 10 of the 20 big ideas Fortune Magazine uncovered when it interviewed 20 of the sharpest minds in the world to weigh in on the epic, disruptive, thrilling, terrifying, and fascinating ideas that will shape the next decade:

1. Business and government will- GASP!- work together again- *Mariana Mazzucato (University College London Institute for Innovation and Public Purpose)*
2. A 'Gold Standard' of Digital Currencies will emerge- *Klaus Schwab (Founder and Executive Chairman, World Economic Forum)*
3. Capitalism will save the planet- *Andrew McAfee (Co-Founder and Co-Director, MIT Initiative on the Digital Economy at the MIT Sloan School of Management)*
4. Genomics will rewrite medicine- and prevention- *Jennifer Doudna (professor of chemistry and molecular biology at UC-Berkeley, and Executive Director of the Innovative Genomics Institute)*
5. The future of the world is skills- that doesn't mean you have to have a college degree- *Jamie Dimon (Chairman and CEO, JP Morgan Chase)*
6. The 4-day work week will make companies more productive- *Andrew Barnes (Entrepreneur and Philanthropist)*
7. Women will alter the workforce- dramatically- *Melinda Gates (Bill and Melinda Gates Foundation)*
8. The line between human and bot will disappear- and we'll be fine with it- *Geoff Colvin (Author, Humans are Underrated)*
9. The 2020s will connect rural America- or lose it- *Beth Ford (President and CEO Land O' Lakes)*
10. We will witness the end of the internal combustion engine era- *Christiana Figueres (Executive Secretary, United Nations Framework Convention on Climate Change, 2010-2016)*

[3] Source: 20 Ideas That Will Shape The 2020s, Fortune Magazine, January, 2020 pgs 41-63.

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