PERSPECTA TRUST®

September 30, 2015

Thank You

First and foremost, thank you to the ~800 readers of the inaugural edition of this investor letter. We appreciate your many and varied feedback.

Say's Law

While it's been more years than I care to admit since I finished the CFA program, I don't recall "Say's Law" standing out as focal point of any given study session. The theory reads as follows: *a product is no sooner created, than it, from that instant, affords a market for other product to the full extent of its own value…as each of us can only purchase the productions of other with his own productions…the more men can produce, the more they will purchase.*[1] Effectively, supply creates its own demand, as gainfully employed workers producing supply turn around and spend their earned income on goods and services.

Ignoring for a moment some of the obvious shortcomings of the theory, it implies, at its very core, a cause-and-effect: because someone is producing and being compensated for the production, then he or she will demand products and services. Supply leads and creates demand. If Say were around today, he would see a bizarre version of his theory wherein *supply has contracted to meet demand instead of demand expanding to meet supply*.[2] How could this happen?

The Demand-light Recovery

As you likely know, US GDP is made up of four components – Consumption (68%), Government Spending (18%), Investment ex-housing (13%), and Housing (3%).[3] Putting aside government expenditure (which has been roughly flat since 2011) for the time being, the main drivers of growth are personal consumption and business investment. In the aggregate and all else being equal, one would assume that over a period during which the S&P 500 appreciated by ~65% (more than 14% annually), the drivers of both consumption and investment would reflect such market jubilance.

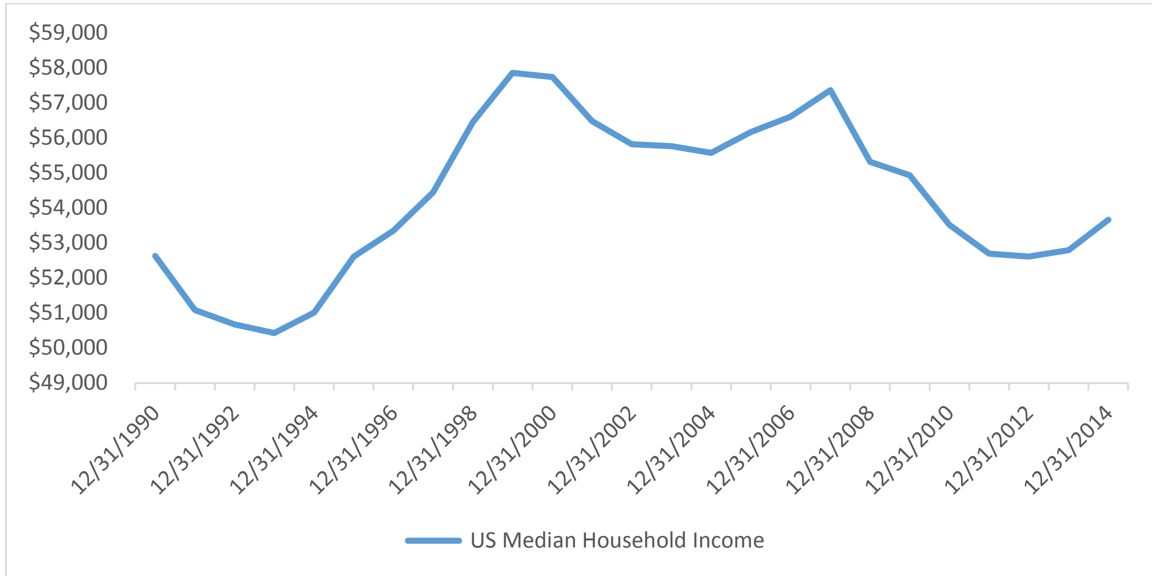
As it relates to the consumer, one's desire to purchase goods and services is generally driven by three attributes: wage income, current net worth (includes real estate and investment income), and how wage income and net worth compare to history. I'd further argue that as the average consumer ages and approaches retirement, the pendulum shifts from current income to net worth (as defined above) as the primary driver of sentiment and spending decisions. In inflation-adjusted dollars, median household income in the US is roughly flat since 2009 and at the same level as the mid 1990's:[4]

[1] Say, Jean-Baptiste. A Treatise on Political Economy.

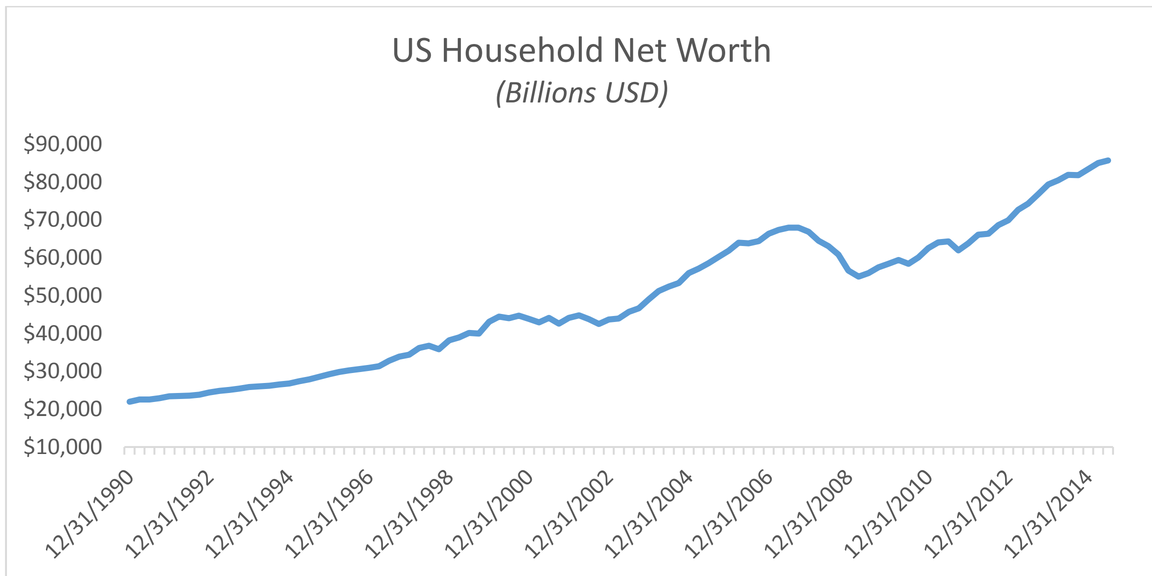
[2] BCA Research. Global Investment Strategy. Fourth Quarter 2015

[3] JPMorgan Asset Management. Guide to the Markets. U.S. Fourth Quarter 2015 as of 9/30/15

[4] Bloomberg; US house median income is in real chained 2011 dollars



Despite the roughly flat household income numbers over the last five years, aggregate household net worth has increased significantly:[5]



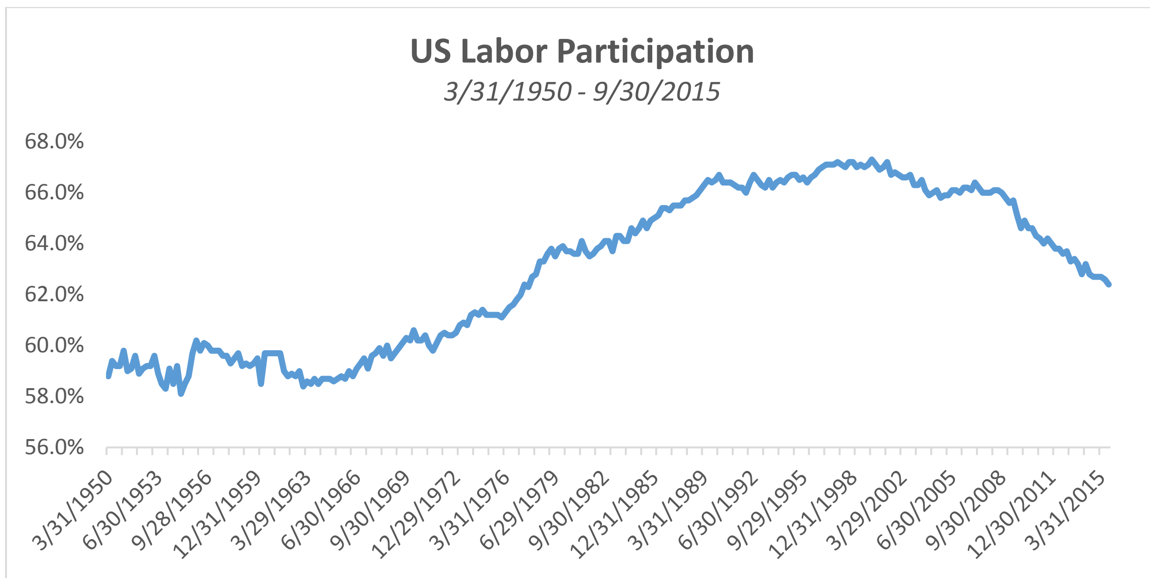
Retirement funds and other financial assets likely make up the bulk of the increase in household net worth over the 2Q07 – 3Q15 period, as equity and bond markets have both been strong (S&P 500 and Barclays Aggregate Bond indices are up 52.7% and 48.5% respectively over the referenced period). On the other hand, aggregate home prices are still *down* ~9% since the end of 2Q07 as reflected by the Case-Shiller

[5] Bloomberg; not seasonally adjusted; nominal US dollars

Index.[6] Further, of the roughly 24% increase in household net worth since 2Q07, more than half of that increase is due to inflation – CPI suggests asset values have increased ~15% over the subject period.

As my former boss would often ask after I rattled off a slew of seemingly unconnected numbers, "so what does that mean?" At a high level, what that means is, as far as sentiment goes, consumers are looking at flat income but marginally higher net worth due to capital market appreciation. The euphoric effect of the marginally higher net worth is likely at least partially offset by home values that are flat to down over the past eight years. Generously assuming that these two factors cancel each other out (hence roughly flat sentiment and anticipated consumption), the driver of future consumption and likely US GDP surprises would be *relative job status* – how productive I feel, how my income today compares to recent history, and what my prospects are for the future.

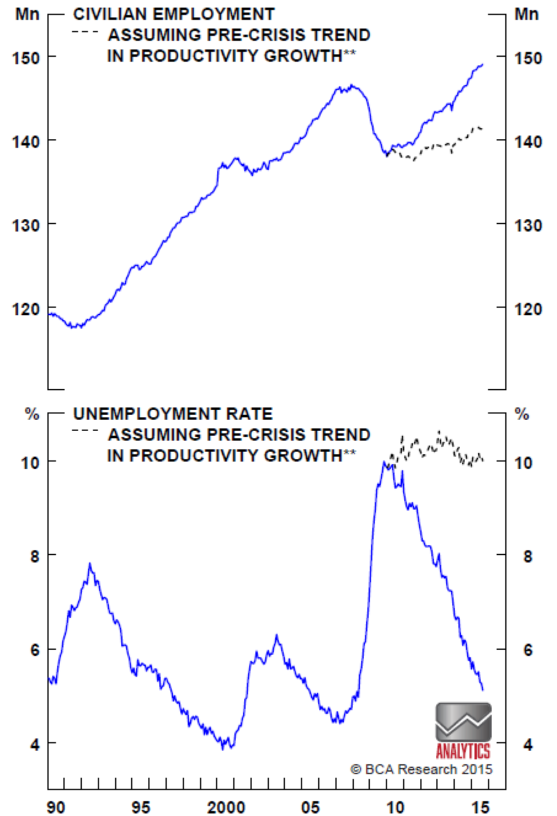
US unemployment is hovering at around 5.2%, its lowest since March 2008. That's great. However, what it masks is the redeployment of labor that's taken place since the recession hit. Below is a chart that shows the well documented phenomenon of decreasing US labor force participation.[7]



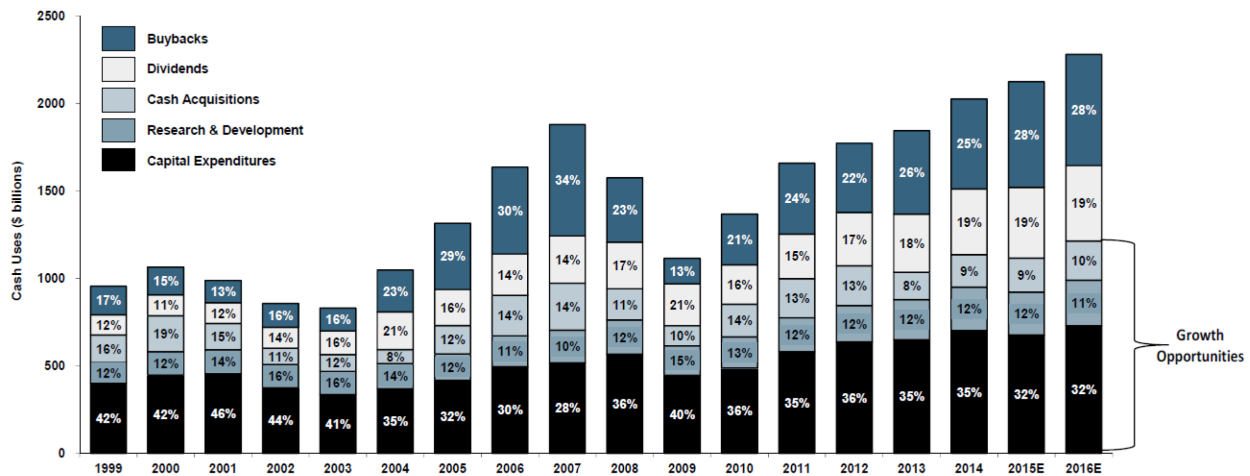
The rate has declined from a peak of around 67% at the turn of the century to 62% currently (roughly the level it last hit in 1977). In addition to decrease participation, the *productivity* of labor has also declined significantly. Since October 2009 when unemployment was around 10%, US GDP growth has averaged around 2% annually. Per BCA Research, 2% growth would typically garner job gains of roughly 50k per

[6] Bloomberg
[7] Bloomberg; seasonally adjusted

month; however, this recovery's 2% growth has created triple that.[8] The missing variable is productivity. To the right are two charts that show what historical 2% GDP growth would mean for employment in past recoveries. Per BCA and as the charts show, if the relationship between growth and unemployment was consistent in this recovery with past recoveries, the unemployment rate today would still be around 10%.



On the corporate side, data supports the same conclusion while taking a slightly different form. Per JPMorgan, earnings for S&P 500 constituents are at or near all-time highs. The same holds true for profit margins, corporate cash as a percentage of current assets, and total cash returned to shareholders. Below is a chart from Goldman Sachs that shows aggregate capital use by companies in the S&P 500 since 1999. The data is broken down broadly into four categories – buybacks, dividends, cash acquisitions, R&D, and capex. Note that 2014 surpassed 2007 as the highest total cash used by companies in the S&P.



However, the *type of deployment* has changed meaningfully over the 15-year period. Growth capital (R&D, capex, and M&A) ranges as a percentage of total capital deployed from a high of 75% to a low of 52%. Growth capital represented 55% and 56% of total capital deployed in years 2013 and 2014 respectively, both in the bottom third of observations over the 15-year period, and is expected to drop to 53% in 2015.

[8] BCA Research. Global Investment Strategy. Fourth Quarter 2015

Readings this low were last seen in 2007. Despite good operating results and cash flow generation, companies are struggling to find profitable investments to make, hence returning cash to shareholders.

Our conclusion: seemingly good economic data masks certain weaknesses in the US economy. The weaknesses center on consumer demand and corporate investment. Assuming a fragile situation at best in both, any marginal disruption to the laissez-faire environment of the last five years could have material consequences for US GDP growth, corporate results, and global equity markets. If I'm the Fed, there is no reason to begin a rate increase until you have signs of inflation, which is currently tracking well below long-term targets. Further, the volatile situations in China and Russia / Syria and in global energy markets could pressure the fragile economic situation both here and abroad. Crude oil prices have ranged from $40 to $90 over the last year with a *weekly* standard deviation of around $12 per barrel. Hardly the environment to throw fuel on the volatility engine and upset a fragile and incomplete recovery.

High Yield

Given recent headlines, you may be wondering what's in store for the U.S. high-yield market through the remainder of 2015. After posting a total return of +2.2% during the first six months of 2015, our U.S. high-yield benchmark[9] declined -4.9% during 3Q. As has been the case for most of the year, the U.S. high-yield market behaved almost as a combination of two distinct markets in the quarter: energy and everything else. The high-yield energy sector registered its worst quarterly performance in at least ten years, losing -19% during 3Q, as oil prices traded down to levels that had not been seen since the worst days of the financial crisis in early 2009.[10] Meanwhile, the volatility that swept global financial markets caused the rest of the high-yield market to decline -2.2% during 3Q as the sell-off in global equities and uncertainty over U.S. interest rate policy caused investors to reduce exposure to risky assets. Case in point: the yield on the U.S. 10-year declined to 2.0% at the end of the quarter after rising as high as 2.5% in early July.

Perspecta's high-yield strategy[11] was not immune from the broader dynamics impacting the U.S. high-yield market. Despite outperforming our benchmark by nearly +300 basis points during the first six months of 2015, we underperformed the benchmark by nearly -350 basis points during 3Q. Results were largely driven by our energy holdings, which came under pressure during the quarter as oil prices declined by about -25% from the end of June. While the commodity price environment remains challenging, we believe that the high-yield energy sector currently presents an attractive investment opportunity based on its risk-reward profile. Moreover, we believe our energy holdings are backed by fundamentally strong companies with excellent management teams that will safely guide their businesses through the current down-cycle. Following are brief summaries on two of our current energy positions:

- Seventy Seven Energy, the oilfield services business spun-out of Chesapeake Energy in 2014, has made significant progress this year on its two long-term strategic objectives: diversifying its customer base and upgrading its drilling fleet. We believe that success on both fronts should allow the company to expand its market share during the down-cycle, which should eventually translate to higher cash flows as the industry recovers.

- Linn Energy, an independent oil and gas producer, is expected to generate strong cash flows over the next two years as a large portfolio of hedges it built prior to the downturn will allow it to sell the oil and natural gas it produces at prices substantially above current market prices. In the

[9] BofA Merrill Lynch 1-5 Year U.S. High Yield Index
[10] Bloomberg Intelligence
[11] Please contact us directly for a full description and disclaimers regarding Perspecta's high yield strategy

meantime, management has cut operating costs, swapped out some of its higher coupon debt, and established JV's with Blackstone/GSO and Quantum Energy Partners to develop new projects.

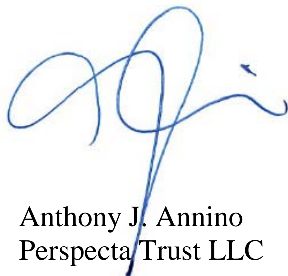
We generally avoid making short-term predictions about the direction of market returns, commodity prices, GDP growth rates, Fed policy, geopolitical events, and the like. These things have historically been difficult to forecast accurately, and worse yet, they are not necessarily predictive of long-term investment results. However, we would be remiss in failing to recognize that the relative attractiveness of asset classes changes over time as a result of the aforementioned market and economic indicators. Today, our benchmark offers a yield to maturity of 8.6%, about +160 basis points above its 5-year average and a level that hasn't been reached since late 2011. Better yet, Perspecta's high-yield strategy offers a yield-to-maturity of over 10% despite featuring a similar credit quality and shorter duration profile than the broader market. This compares to domestic and global equity markets trading well above trailing 5-year valuation multiples. Relative attractiveness seems to favor credit at least for the time being.

Firm Update

Our company and team continues to grow. Perspecta's fiduciary assets are just under $8 billion, and the number of inquiries we receive seems to grow by the day. We recently made two additions to the team – Steve Tall and Miles Cobb. Steve joins from Acadia Trust, where he served as president and CEO. Steve will serve in the Chief Operating Officer role here at Perspecta. Miles joined us from F-Squared Investments where he oversaw the performance measurement and reporting process for portfolio composites. Prior to that Miles worked at GMO LLC as an investment analyst. We continue to seek qualified people for both investment and planning roles at all levels of the organization, so please mention us to any qualified candidates that you think appropriate.

The leaves are turning up here in the Granite State. If you happen to be in the Boston area, it's a great time of year for a short 45-minute jaunt up the coast to New Hampshire. We would welcome the opportunity to host you here at Liberty Lane.

Please let us know if you have questions, and thanks as always for your continued support.



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