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Berwyn Strategies Current Outlook and Investment Strategy

"Knowledge speaks, but wisdom listens" - Jimi Hendrix, American rock guitarist.

Summary

- The economy is estimated to have grown by 4.1 percent in the second quarter. This is a solid number that, if sustained, will be supportive of higher corporate earnings.
- Rising corporate earnings are resulting in lower and less speculative valuations for many companies.
- The ongoing trade negotiations may result in more volatility in the months to come. The end result should be a net positive to U.S. industry and the domestic economy.
- Our IMAs outperformed their benchmarks in the second quarter as small-cap value stocks outperformed the major indices. The outlook for the stock market remains positive in our opinion.

Background

The domestic economy, as measured by the gross domestic product (GDP), is estimated to have grown 4.1 percent in 2018's second quarter. The growth was a continuation of the rebound that has been occurring since the fourth quarter of 2015 when the economy grew at an annualized rate of only 0.5 percent. The sharp increase in second quarter GDP growth was predicted by most economists, however, the effect of this expansion upon the health of our Nation should not be minimized. If economic growth can be improved from the disappointing results of the recent past, there are many positive consequences, including full employment, higher tax revenues and a continuation of the bull market.

GDP growth is critical to both an increase in corporate earnings and government tax collections. Given the reluctance of politicians to reduce spending, GDP growth seems to be the only possible way to mitigate the worrisome rise of the federal debt.

Since the end of the Great Recession in early 2009, GDP growth has averaged 1.7 percent annually and after adjusting for population growth, it has expanded at an annual rate of approximately one-percent per capita. This lackluster rate of growth proved to be incapable of lowering the unemployment rate below four percent, or reducing the unfunded liabilities that have been a major part of the Nation's mounting federal debt. Table 1 illustrates what is hopefully a developing trend in GDP growth to a level that will promote rising corporate earnings and higher tax revenues.

QUARTERLY PERCENTAGE GROWTH IN GDP
2016-2018

Calendar Quarter	2016	2017	2018
March	1.5	1.8	2.2
June	2.3	3.0	4.1
September	1.9	2.8	0.0
December	1.8	2.3	0.0

Table 1: REAL GDP GROWTH HAS BEEN IMPROVING SINCE 2016
Source: Bloomberg

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U.S. TRADE BALANCE OF GOODS & SERVICES
12/31/1999-06/30/2018

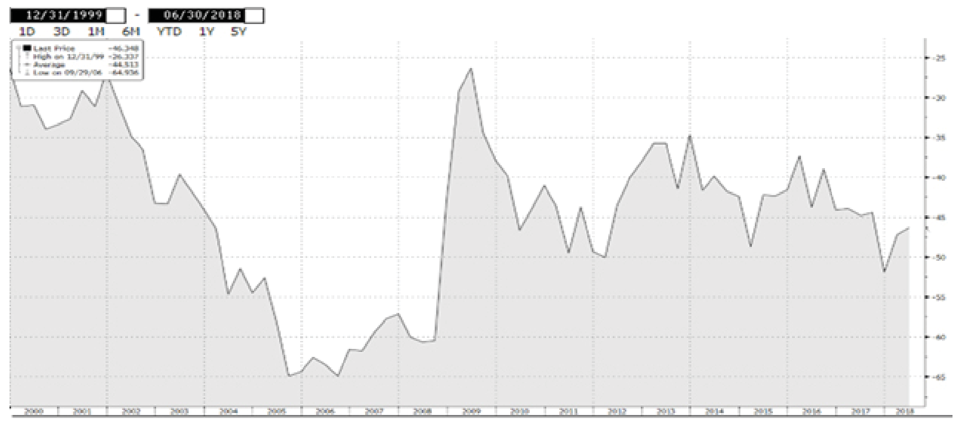

Figure 1: The U.S. Balance of Trade has been negative for decades and generally worsens when our economy is imporving
Source: Bloomberg

Corporate earnings are the most important element in determining the long-term direction of the stock market and the slowly improving GDP numbers are having their anticipated effect in this regard. Using the companies in the S&P 500 as a reference point, corporate earnings have been growing at an annual rate of about 8.1 percent annually since the end of 2015. Due to the disappointing GDP growth, however, corporate revenues have grown at a much lower rate, and the improvement in earnings has come from cost cutting, expansion into overseas markets, stock buybacks and acquisitions.

Now, with the impressive second quarter economic growth, the outlook for corporate revenues as well as earnings has been raised substantially. In fact, according to Bloomberg financial services, annualized earnings for the S&P 500 companies is predicted to be $160.30 for the quarter ending June 30, 2019, as compared to $133.17 for this year's comparable quarter, a rise of 20.3 percent!

If the corporate earnings growth cited above can be achieved, the valuation of the S&P 500 Index becomes much more normal from an historical perspective. Based upon trailing twelve-month (TTM) earnings, the Index is now selling at approximately 21 times earnings, which is relatively high. So, a 20 percent increase in earnings would lower the forward price-to-earnings ratio to 17.6, which is reasonable in the present low interest rate environment.

Besides the Nation's economic growth rate, U.S. foreign trade policy was another important issue during the second quarter. It is no secret that for many years the U.S. has had a negative balance of trade with its global competitors. The trade deficit has been responsible for the closing of domestic businesses, fewer job opportunities, lower tax collections and a weaker currency. Figure 1 illustrates the monthly trade deficit extending back to the beginning of this millennium; since the numbers are negative, the lower the line on the graph, the higher the deficit. For example, during the 2006 through 2008 period, the monthly trade deficit was over $60 bn. and in 2001 and briefly in 2009, it shrunk to approximately $30 bn. per month. In recent years, the deficit has ranged between $40 bn. and $50 bn.

Earlier this year, the Trump Administration began to implement a plan intended to change present trade agreements with the rest of the world. So far, this plan has been more difficult to execute than first thought. The result has been a volatile stock market, particularly for stocks of companies whose businesses are directly affected by imports and exports. Most observers agree that the United States is treated unfairly by its trading partners; however, there is widespread disagreement on how these inequities should be addressed. The entire subject is complex and the solution goes beyond the simplicity of imposing tariffs. The reality of military alliances, cyber security threats, and global

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political considerations are likely to make a quick and easy solution to our international trading problems impossible. Nevertheless, this thorny problem creates uncertainty, thus hindering the bull market. Any progress in these negotiations has the potential to reinforce the economic growth that our Nation is currently experiencing.

Interestingly, the financial markets seem to have already determined the "winner" from this international competition. As of this writing, August 3rd, the S&P 500 Index is up 6.92 percent for the year, while the Shanghai Shenzhen CSI 300 Index is down 16.22 percent.

Current Strategy

Despite the controversy about trade agreements and the threat of tariffs, various sectors of the stock market performed well in 2018's second quarter. The Dow Jones Industrial Average (DJIA) and S&P 500 Index managed to advance modestly, 1.26 percent and 3.43 percent, respectively. However, the NASDAQ Index, which consists of high technology companies, and the Russell 2000, an index of two thousand small-cap companies, rose 6.61 percent and 7.75 percent, respectively.

Our individually managed accounts (IMAs) performed well in this period. The Chartwell Berwyn Growth Strategy (CBGS)* portfolio advanced 7.99 percent and outperformed the major stock market indices; the Chartwell Berwyn Balanced Strategy (CBBS)** rose 5.59 percent, while outperforming its reference index, which rose 4.02 percent. All performance figures cited are "total returns" that include dividends and are net of expenses and advisory fees.

For the six-month period, ending June 30, 2018, the DJIA lost 0.73 percent. However, the S&P 500, NASDAQ and Russell 2000 rose 2.65 percent, 9.38 percent and 7.66 percent respectively. Due to their underperformance in the first quarter, for the six-month period the CBGS and CBBS rose 3.14 percent and 2.77 percent, respectively. The benchmark for the CBBS rose 4.13 percent in this period.

We believe that our improved relative performance in the second quarter is due to two factors: a significant repositioning of our portfolios which was made in the first quarter and secondly, a shift in market sentiment, which placed greater emphasis upon the undervalued sectors of the marketplace. In our opinion, we have only begun to realize the benefits of the position changes that have been made and we are working hard to carry our progress into the third quarter. In particular, the performance of small-cap value stocks in the second quarter is encouraging and assuming a continuation in the economy's strength through the third quarter, the momentum in small-cap stocks may endure.

After the DJIA bottomed at 6,469 on March 6, 2009, during the Great Recession, this venerable index has risen, nearly uninterruptedly, to 25,451. Both the magnitude and duration of this advance are legitimate reasons for questioning the longevity of this powerful bull market. In fact, comparisons have been made between the present advance and the dot-com bull market as it peaked in January 2000 and also, the real-estate-based financial collapse that began in the autumn of 2007.

In reality, the present bull market is very different from either of these past two periods. During the dot-com bubble, there was a speculative fever that permeated our culture. People invested in companies that had no revenues, much less earnings, and valuations made little sense. The excesses in the market were dramatic and widespread. For example, Cisco, a high-quality manufacturer of computer network equipment, traded at a price-to-earnings ratio (p/e) of 179. As of this writing, priced at $42 per share, Cisco has never reached the price of $66 that it attained in March 2000 and trades at the modest p/e of 14.2.

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The market collapse of 2008 – 2009 was rooted in financial instruments, collateralized by residential homes, that were valued at unrealistic prices. Most often, the owners of these houses, the mortgagees, received their loans from unscrupulous mortgage bankers and were not financially qualified to repay their loans. To complete the circle of deceit, these mortgages were sold to investment bankers, who securitized them and sold them to unsuspecting investors. The extent of this crisis tore at the foundation of our financial system and another meltdown of this magnitude is unlikely to be repeated soon due to fundamental changes in the regulations that now safeguard the mortgage banking system.

The present bull market is not perfect – none of them are perfect. As mentioned above, criticism can be aimed at the valuation of the S&P 500, which is now trading at approximately 21 times TTM earnings, which is historically high. Most value-oriented investors would feel more comfortable if the S&P 500 was trading at 15 times earnings, however, interest rates and inflation remain below historical norms and as noted in earlier paragraphs, the new tax bill provides an added impetus for higher corporate earnings and a lower forward valuation.

Normally, companies are valued at different multiples of earnings depending upon investors' viewpoints of their prospects. Price-to-earnings ratios in the ten to twenty range are typical, although some popular stocks might trade at twenty-five, or even thirty times earnings. In the present market; we have extremes at both ends of the spectrum. For example, Ally Financial, General Motors and Western Digital are trading at 6.8, 5.5 and 10.0 times trailing TTM earnings, while Amazon and Netflix are trading at 185 and 156 times TTM earnings. Alphabet, formerly Google, is trading at 31 times forward twelve-month earnings. So, although there are some popular stocks whose prices are vulnerable to disappointing news, there are also many stocks that are trading at valuations that discount a significant business slowdown. Consequently, if the uncertainty surrounding international trade can be resolved favorably to the United States, in our opinion, there remains significant upside potential to the stock prices of many companies.

The three best performing stocks in the second quarter were Myriad Genetics (MYGN) (1.3%), up 50.65 percent, Quality Systems (QSII) (1.7%), up 40.71 percent and Arbor Realty (ABR) (1.8%), up 33.70 percent. MYGN's latest earnings report has shown an increase in revenues as more of their genetically-based diagnostic and therapeutic procedures have been accepted by medical insurance companies. QSII finished their 2018 fiscal year with a strong quarter as revenues grew and earnings met expectations. ABR reported a stunning 162 percent increase in their first quarter earnings and a subsequent increase in their quarterly dividend.

The three worst performing stocks during the second quarter were Spartan Motors (SPAR) (1.8%), down 8.31 percent, China Automotive Systems (CAAS) (0.7%), down 7.85 percent and McDermott International (MDR) (1.6%), down 4.27 percent. SPAR is a long-term winner for our portfolios and has been consolidating its gains since October 2017. The company has a large backlog of business, which should result in solid future earnings gains. CAAS has been a disappointment and we are currently selling our position at a modest loss. On the other hand, MDR, a leader in offshore construction for the oil industry, is in the process of making a large acquisition, Chicago Bridge & Iron (CBI). CBI is a leading constructor of storage vessels, chemical process facilities and is engaged in LNG (the emerging liquefied natural gas industry).

**The numbers in parentheses following each company mentioned reflect the percentage of the portfolio's net assets comprised of such securities as of 06/30/18. Holdings are subject to change. A full listing of portfolio holdings is available upon request.

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Top 3 Contributors
As of 06.30.2018

Holding	Return	Change
Myriad Genetics	1.3%	up 51%
Quality Systems	1.7%	up 41%
Arbor Realty	1.8%	up 34%

Source: Chartwell Investment Partners

Top 3 Detractors
As of 06.30.2018

Holding	Return	Change
Spartan Motors	1.8%	down 8.31%
China Automotive	0.7%	down 7.85%
McDermott Internation	1.6%	down 4.27%

Source: Chartwell Investment Partners

Chartwell News

There is no major organizational news this quarter. The employees at Chartwell hope that everyone is enjoying the summer weather and finding some time for a vacation.

If you have any questions regarding your account, or want to discuss changes in your investment objective, please don't hesitate to call Mike Magee (484-324-6835), or Bob Killen (484-324-6332).

Past performance is no guarantee of future performance. Investment involves a risk of loss.

This commentary is for informational purposes only. It is not an offer to buy or sell any security and should not be construed as investment advice.

*The Berwyn Growth Strategy Composite includes all fully discretionary, fee-paying equity accounts with a growth objective whose asset size is $300,000 or greater at the beginning of the measurement period.

**The Berwyn Balanced Strategy Composite includes all fully discretionary, fee-paying accounts with a balance between growth and income as a principal objective whose asset size is $300,000 or greater at the beginning of the measurement period.

The composites do not include accounts where total cash flows exceed 10% of the account's value during any quarterly period or accounts holding securities purchased by anyone other than the Advisor. No accounts using leverage or short positions are included in the composites. An individual client's account may have performed better or worse than the composites' returns presented above.

The composites contain taxable and non-taxable accounts. The returns are before taxes and net of all advisory fees and commission charges. The net performance results for each composite are presented after deducting the actual fee charged to each account in the composite based on the management fee schedule in the Firm's Brochure or the fee negotiated between the account holder and Chartwell. Returns include the reinvestment of dividends and interest (total return). Returns for other Chartwell composites are available upon request.

As of 06/30/2018, Chartwell managed $9.5 billion in assets, $8.8 billion as advisor and $0.7 billion as sub-advisor. During the most recent quarter, the Chartwell Berwyn Growth Strategy Composite consisted of 20 accounts which represented 18.6% of total Berwyn Strategy Individually Managed Accounts and 0.3% of total Chartwell assets. During the most recent quarter, the Chartwell Berwyn Balanced Strategy Composite consisted of 28 accounts which represented 38.8% of total Berwyn Strategy Individually Managed Accounts and 0.6% of total Chartwell assets.

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Chartwell Investment Partners LLC, is an investment management firm dedicated solely to the investment advisory business. Chartwell's philosophy is to rely on proprietary, bottom-up research to find high-quality investments across its various product offerings.

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