INVESTMENT STRATEGY UPDATE

June 30, 2017

MILLENNIALS: WHAT GOES AROUND…

"This generation of Americans has a rendezvous with destiny." – F.D.R.

More than eighty years ago President Roosevelt used these words to describe the young men and women coming into adulthood between the later years of the Great Depression and the beginning of WWII. The profound changes that occurred during the years of this "Greatest Generation" included winning WWII and the subsequent rebuilding of much of the world's infrastructure, and would by anyone's definition be considered monumental. Yet, we believe immense changes are in the works today, too. Millennials, the oft-derided cohort of young people, are, whether we like it or not, shaping both the economy and societal norms in profound ways. In this quarterly update we point out some of the ways they are doing so, and note how we as investors may be able to take advantage of the changes.

Roughly fifty years ago, a leading publication of the day made reference to what was coined the "generation gap," or the difference of opinions and outlooks between members of different generations. Using adjectives similar to those ascribed to the millennials of today, LIFE Magazine described the baby boomers who were back then entering their 20s and 30s as "privileged, lazy, entitled, selfish, and shallow" as well as "unambitious shoe-gazers." It seems fair to say that regardless of the generation to which they belong, as members enter adulthood and begin making a name for themselves, they are ridiculed by the current establishment.

The term *millennial* has a loose definition, but we take it to refer to those born between the years of 1980 and 2001 (currently aged 16 to 37). In 2016 this generation became the United States' largest demographic group totaling over 75 million men and women – now larger than the baby boom generation. These individuals are humorously known for such activities as changing jobs frequently, delaying marriage, and living in their parents' basements.

The Sharing Economy

On what seems like a daily basis, new technologies and business models are being introduced that attempt to challenge the old paradigms of commerce. Many of these new ideas incorporate the sharing of existing and future resources, such as ride-sharing or real-estate sharing. While technology, automation, and globalization are concepts that have been

with us for as long as we can remember, advances in these areas are now rapidly assimilated into our day-to-day lives. In contrast, when the automobile was introduced, only the elite few could afford to own a car. It would take years before Henry Ford brought the auto into the mainstream. Fast forward and now anyone with a smartphone can press a button and an Uber or Lyft car will appear, usually driven by a millennial as a part-time gig. What's more, the payment for this service is pre-calculated and electronically billed with no cash exchanging hands. Through similar sharing technology, prices for many other goods and services continue to decline.

Behind the scenes, big data has emerged as a driving force behind advertising and business decision-making. Cloud computing, data mining, and the easy ability to retrieve information about purchases are shaping consumers' behavior, allowing them to become smarter. It is not a surprise, then, that four of the ten largest companies in the S&P 500 are technology stocks. Also interesting is that millennials account for the vast majority of employees at these companies; the average age at Amazon, for example, is 29.

Customs and practices of millennials diverge from the traditions of past generations. The ways in which they spend their money are a key difference and the implications reverberate outside the confines of technology. Many of this generation graduated from high school or college in the years immediately following the Great Recession. As employment was scarce, many decided to opt for additional and/or advanced degrees to better their chances of finding a good job. It has been calculated that the average millennial consequently has upwards of $30,000 in outstanding debt. On top of that, for the past eight years there has been relatively lackluster wage growth. Is it any wonder that a consumer has emerged who looks unfavorably at large outlays of capital, and who is willing to embrace technology to lower costs? This mentality helped shape the sharing economy, the gig economy, and the value millennials place on experiences over material possessions.

Is it Cool to Buy a Home?

First-time home buying in the U.S.--once a rite of passage into adulthood--has seen a lull due to the factors mentioned above as well as stricter lending practices and rapidly rising housing prices. One of the biggest impediments to the millennial who *is* ready to make a first-time home purchase is the down payment. Until recently, millennials really had no choice other than to rent or move back in with parents.

The tide is beginning to turn. A recent article in the *Wall Street Journal* points out that the share of first-time home buyers fell to 32% of home sales in 2015. This was the lowest level in nearly three decades and down from a historical average of around 40%, according to the National Association of Realtors. By 2016 it had ticked up to 35%, as millennials began forming households at a faster pace. We believe that as the economy continues to grow and wages increase we will witness reciprocal growth in the housing market.

Secular Trends in Retail

In the meantime, for those still saving for a down payment, sharing a flat in an urban area with myriad apps catering to anything from transportation to dating to food delivery has made the millennial a completely different breed of shopper.

One only needs to look at what is happening to traditional brick-and-mortar retail. The dawn of online retail has even given us a new verb: to be "Amazon'd." The online behemoth has put many mom and pop retailers out of business and transformed forever how we buy and sell certain items. Shopping malls and retail spaces are starting to be recast as data centers, schools, and multifamily housing complexes. Amazon has even begun to threaten bellwethers UPS and FedEx as it develops new methods of delivery, including drones.

Omni-channel retail is shaping up to be the new face of consumerism. Customer engagement has become blended between online and in-store where the customer begins the process online and finishes the transaction in-store, or vice-versa; more often than not facilitated by a tablet or smartphone.

Amazon recently announced it will acquire Whole Foods Markets, representing the omni-channel theme we see unfolding. Experiential shopping will have a meaningful impact on how people conduct retail transactions. With the dawn of the millennial and their preference for an asset-light lifestyle in favor of one based on experiences, there will continue to be dramatic changes in how and where money is spent.

Investment Implications

Change is never easy. Today we have a generation, 75 million strong, profoundly reshaping the economy. From buying a home to having a package delivered to your door, millennials and their way of consumerism are influencing the ways in which things are bought and sold and experiences are had. Understanding the idiosyncrasies of this cohort will be important to successful investing.

Investing in the millennial theme offers a changing set of choices. We believe traditional retailing will continue to see disruption as technology companies further their push into areas such as brick-and-mortar grocery outlets. Such companies are less likely to thrive going forward and we would avoid investments here and in the associated real estate.

One only needs to look at the fierce battle behind the scenes in retail to see the effect technology is having on everything from supply chain management to customer acquisition. Cloud computing giants are locked in heated competition to provide their versions of cloud computing software to retail vendors. We see continued growth as data accumulation and interpretation become more prevalent in successful organizations. Investment exposure to some of the more established technology companies with diversified business models could be warranted.

Furthermore, as this generation emerges from the cohabitating years of their lives toward household formation, we believe there will be sustained growth in home construction. The need for multi-family and single-family housing, as well as the ancillary services associated with them, will provide investment opportunities ranging from apartment REITs to home improvement retailers. We also see opportunity in the raw materials and land necessary to meet an increased demand for residential real estate.

Finally, the sharing economy and the value millennials place on experiences over material possessions will drive young people to continue to spend in areas that cater to interactive entertainment, including traditional retail as it adapts to this trend. Discretionary spending for the millennial shopper seems to blur the line between products considered consumer staples and those seen as luxury items. Sipping cold brew coffee on a weekend getaway in an Airbnb with friends, booked on a smartphone, has become as commonplace as prior generations' family vacations to Disneyland. Companies that provide these services, such as high-end coffee shops or online travel agencies, are worth consideration.

Market Update

World financial markets have continued to move higher and volatility remains benign, with the exception of energy markets where increasing U.S. production has put significant downward pressure on oil prices of late. Over the past few months, President Trump's legislative itinerary has foundered in the Washington swamp. His initial timeline is being pushed back, which has impacted stocks of the perceived beneficiaries of his infrastructure build out, tax reform, and regulatory rollback, including the industrial and financial sectors. Meanwhile, the beneficiaries of a more moderate economic growth scenario, including technology and health care stocks, have lately exhibited the most relative strength.

In the bond market, short-term interest rates are up as a result of recent Federal Reserve rate hikes, while longer-term interest rates have declined modestly this year. It is too early to say if this flattening "yield curve" is a harbinger of slowing U.S. economic growth, or the residual outcome of foreign money flowing into our bond market. We expect possibly one more increase in the Federal funds rate before year-end.

Economic indicators point to a continued sustainable pace of growth in employment and income, consumer spending and capital investment, with inflation running at an annual pace of just below 2%. While a number of geopolitical risks remain areas of concern, they are difficult to quantify and disaster does not seem imminent. Continued corporate earnings growth could propel equities modestly higher over the remainder of the year, although with the possibility of some increased volatility. As equity valuations are currently a bit on the high side, we are being deliberate when allocating new money into the market at this time.

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