

Value Trust

By Jeff Otto, CFA

Last month, I had the good fortune of attending an investor conference featuring some of the world's most renowned technology companies. A few of the marquee speakers included Facebook COO Sheryl Sandberg, Microsoft CEO Satya Nadella and Alphabet (Google) CFO Ruth Porat. Not surprisingly, there was almost universal optimism from every management team regarding their future growth prospects. As several CEO's noted, every industry in the world is being impacted by the digital revolution. This digital transformation is leading to strong secular demand for hardware, software and semi-conductors that power things like cloud data centers, autonomous vehicles and smartphones.

Hard Questions

One of the more interesting presentations I heard was from Microsoft CEO Satya Nadella explaining the advantage he sees Microsoft having versus technology competitors. Nadella said, "The question that every customer – whether it's a financial services company, whether it's a retailer, whether it's a manufacturer – is going to ask is, whom do I trust?" For technology companies in particular,

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they are entrusted with large amounts of data generated by their customers. In some

cases, technology companies are in competition with these customers, which can lead to a lack of trust. "So, therefore, I fully expect them (CEO's) to be asking the hard questions of which technology partners can they really trust...whose long-term interests are aligned with their long-term interests," he said.

At the same time that Microsoft is benefitting from their status as a trusted business partner, Facebook is reeling from the news that they broke the trust of their users. As you may have read, Facebook allowed massive amounts of personal user data to be accessed by third parties for targeted marketing purposes. Like Microsoft nearly two decades ago, Facebook is suddenly the subject of increased regulatory scrutiny given the size of their user base and dominant market share of online advertising. In our opinion, Facebook should take a page from Microsoft's playbook and evolve their mindset to prioritize user privacy above all else.

Core Values

As one of the core values of FCI Advisors, trust is the bedrock of our firm and our client relationships. The trust we have in our investment process has allowed us to position portfolios to weather the ups and downs of market cycles. This investment discipline, combined with open and honest communication, allows us to build trust with our clients. Just as we invest with companies whose incentives are aligned with shareholders, we align our investment strategies with the long-term interests of our clients.

When choosing long-term investments, often times making the right decision is not always the most popular decision. An excellent example of this is determining the proper allocation to stocks and bonds within a portfolio. When stock markets exhibit high returns, like the 21.8% gain in the S&P 500 in 2017, any allocation to bonds within a portfolio will have a diluting effect on overall returns. Our investment process, which has stood the test of time, believes that managing downside risk through rebalancing and ownership of bonds is a winning long-term strategy. In years of extreme stress, such as in the 2008-2009 financial crisis, high quality bonds increased

in value as investors sought safe haven assets. Having a

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diversified portfolio inclusive of both stocks and bonds can help to smooth out volatility and

cushion portfolios during difficult years.

New Leadership

All one has to do is look at the top weighted stocks in the S&P 500 to see the daily impact the biggest technology companies have on the stock market. Apple, Microsoft, Google and Facebook represent almost 12% of the S&P 500, and if you count Amazon as a technology company that weight increases to over 14% for the top five stocks. In total, technology represents the largest sector in the S&P 500 at 26%. Since the market low in 2009, technology has been the single best performing sector with 22.2% annualized returns compared to the S&P 500's 16.8%.

As we move into the second quarter the S&P 500 is now down 0.8% for the year-to-date period after surging 5.7% in January. Some of this weakness is related to pressure from large technology companies while some amount is related to normal market volatility. We have just experienced the first 10% correction in the stock market since 2016, and normally these corrections happen once every year. Ultimately, we believe this is just a correction because economic and corporate fundamentals continue to show strength. S&P 500 earnings are expected to grow 19.1% in 2018, unemployment remains historically low and consumer and business sentiment remains high.

However, we are keenly focused on signs there will be new leadership in the market during the next uptrend. In the weeks following Facebook's data scandal, investors have shaved off nearly \$100 billion from the company's market value causing a ripple effect across the entire technology sector and the stock market as a whole. Also, for the first time in several years many sectors outside of technology are exhibiting strength as the economic expansion accelerates. These forces could dictate changes in portfolios such as overweighting value or yield oriented equity styles at the expense of growth styles, which heavily favor technology companies.

Conclusion

Technology stocks are at the epicenter of the digital revolution, and the trends driving that growth are here to stay. Long-term investors should certainly have a place for these stocks in their portfolios. In a more volatile environment, continuing to own a diversified portfolio of stocks with trusted business models can help investors achieve their long-term goals.

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