The Essex Exchange

ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

Winter 2018

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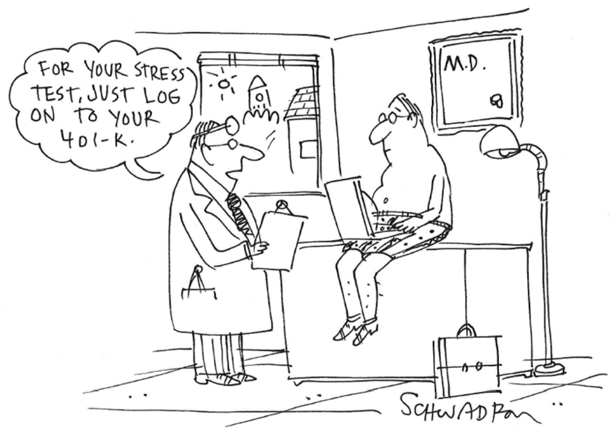
Please see our website www.essexinvest.com for updated insights from our portfolio management and research team.

Is This Time Different?

By: Stephen D. Cutler, President & Senior Portfolio Manager

I thought this was (unfortunately) appropriate particularly given how volatile the stock market has been.



Source: Leuthold, November 2018

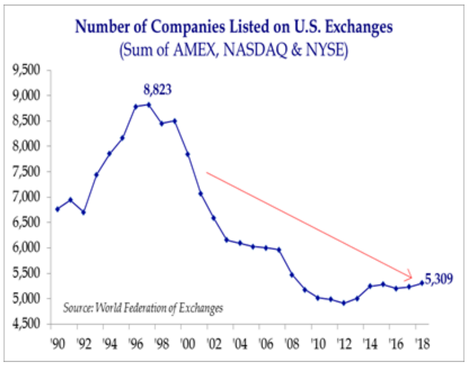
In trying to put together the outlook for the next few years there are plenty of concerns, which could be called a Wall of Worry, that have contributed to the turbulence in the stock market. The bricks in the wall include:

- The trade/tariff dispute
- The steady increase in interest rates by the Fed
- Loss of confidence in our Government
- A slower rate of earnings growth now that the benefit of the tax rate cut has been realized
- The growing Federal deficit and how it will be funded
- The Rising Dollar
- The Mueller investigation /possible impeachment
- An Immigration solution
- The Brexit turmoil
- The age of the recent bull market
- And of course, ongoing geopolitical problems including Iran, North Korea, Russia, China and the Middle East in general

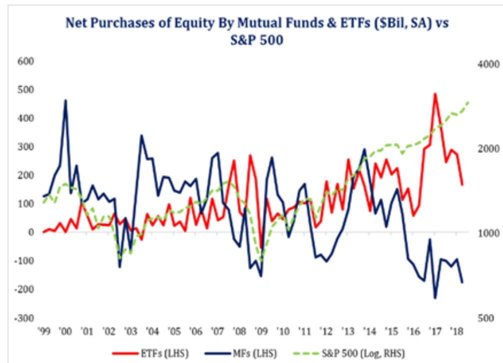
All of which lead to uncertainty for both corporations (and their spending plans) and investors.

Is This Time Different? *By: Stephen D. Cutler*

Although we have talked in the past about the changing nature of the stock market structure, the recent volatility has provided more evidence of this change. Ten years ago, passive ownership of ETF's was practically nonexistent but today they hold more than 30% of the shares in the S&P 500.



Source: Strategas, September 2018

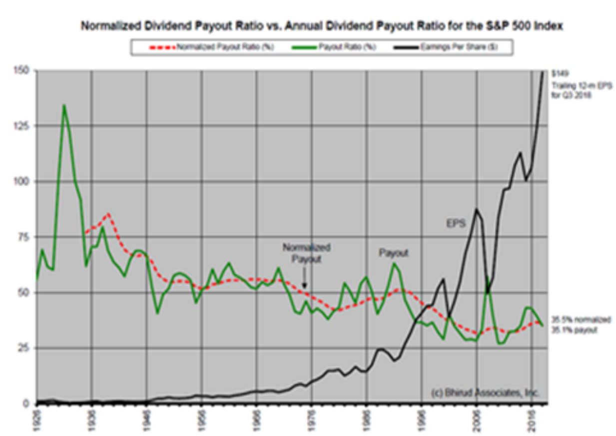


Source: Strategas, September 2018

The impact from algorithm traders is also significant. Some estimate that algorithm traders account for 90% of order flow on the major electronic exchanges and as the new Goldman Sachs CEO said, "there's no question when you look at the recent market selloff, some of the selling is the result of programmatic selling because as volatility goes up, some of these algorithms force people to sell." Also, JP Morgan says, "this is something worth noting at this late stage of a cycle given that passive investing seems to be trend following, with inflows pushing equities higher during bull markets, and outflows likely to magnify their fall during corrections." ETF volume on down days represent 35% of total volume compared to 18% historically. If less sophisticated investors, fearful of a serious decline, redeem their passive investments in ETF's and Index Funds in a panic, and if the algorithm traders who provide liquidity in the new market structure decide to sell, the result could be similar to the "flash crash" event in October 1987 which was driven by quantitative machine based strategies. Since less fundamental research is done, stocks of solid companies would be liquidated, eventually creating great opportunities as seen in the long term chart on the following page.

But all of this negativity is tempered by a steady economic outlook in the U.S. As you can see consumer confidence remains high and the growth in earnings remains strong enough to provide growing dividends especially in view of the low payout ratio.

Source: Bhirud, October 2018



Source: Bhirud, November 2018

Is This Time Different?

By: Stephen D. Cutler

Recently Jerome Powell, head of the Federal Reserve Board, said "the FOMC will continue to monitor global economic and financial developments and assess their implications for the economic outlook and we will let data form the outlook." The good news is that there is at least modest growth in the economy, but if there is any more evidence of a slowdown, Powell will moderate the pace of rate increases which would be positive for stocks.

S&P 500 Historical and Current Valuation

	March 2000	March 2009	Current	20-Yr Avg	Current Rel Avg
Trailing P/E (S&P)	29.6	13.7	18.1	19.5	0.93

Source: Strategas, October 2018

As you can see valuations indicate the stock market is not overvalued as it was after the prior long bull run. Also the low (relative to the past) interest rates allow the price paid for earning to remain reasonable. And in view of the recent stock market decline it is well to remember that stock market declines do not necessarily cause or predict a recession.

Major S&P Declines Without a Recession
1945 to Present

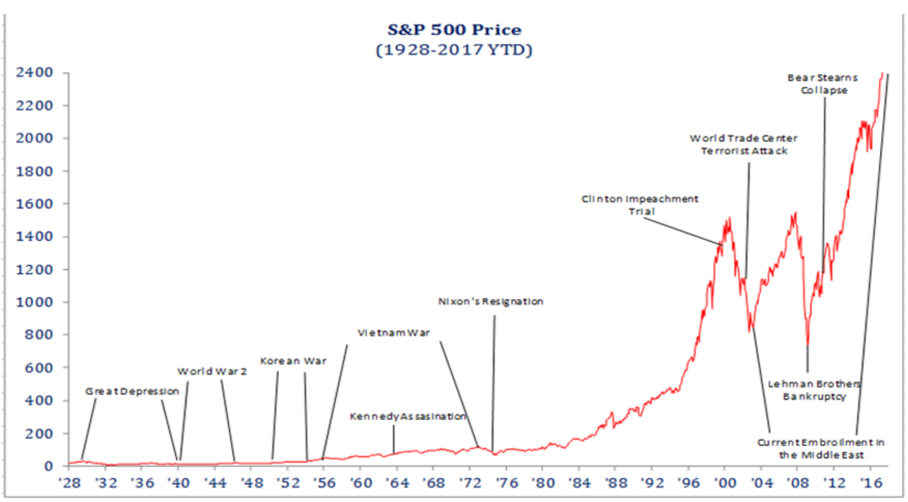
Start Date	End Date	% Decline	Recession?
5/20/2015	2/11/2016	-15.2%	*No*
5/2/2011	10/4/2011	-21.6%	*No*
7/20/1998	10/8/1998	-22.5%	*No*
8/25/1987	10/20/1987	-35.9%	*No*
9/21/1976	3/6/1978	-19.4%	*No*
2/9/1966	10/7/1966	-22.2%	*No*
12/12/1961	6/26/1962	-28.0%	*No*
5/29/1946	5/19/1947	-28.5%	*No*

Source: Strategas, December 2018

The question that concerns us, is this time different? We are looking at the next few years because we always like to take a longer term view when analyzing the stock market and selecting stocks of companies with accelerating earnings growth and selling at reasonable prices relative to their growth rates.

In thinking of the next few years, and I hate to remind you but there is another election coming in 2020! To feel confident, there has to be some evidence that the Administration and Congress (with a Democratic majority in the House of Representatives) can work together to solve some of the concerns. The fact is that many politicians act as if their job is to get reelected in the next election. The hope is that they want to have some legislative successes to reach that goal. Given that, stocks may see more of the volatility with more lackluster returns in 2019 (since most of the tax reduction impact was realized in 2018) until some of the concerns I mentioned are resolved.

However, looking back historically the U.S. and our markets have had plenty of reason to despair as seen in the following chart. But, the U.S. has always been able to survive and grow despite these problems.



Source: Strategas, Essex, December 2017

ESSEX

Essex Strategies

The Essex Micro Cap Growth, Small Growth and SMID Cap Growth strategies each share a common investment philosophy and process. Our team in Evanston is focused exclusively on managing long-only small growth strategies and has worked together for more than 15 years.

Micro Cap Growth: We look for under-followed, under-owned, under-appreciated companies & industries in early stages of acceleration.

Small Growth: The process focuses on identifying companies in an inefficient sector of the market at an inflection point where their growth rate is improving.

Small/Mid (SMID) Cap Growth: Our approach is to execute a systematic, fundamental process to find companies whose future growth prospects are not fully reflected in the price of the stock.

Global Environmental Opportunities Strategy (GEOS) operates at the nexus of environment and finance, investing in companies that enable greater natural resource and energy efficiency. GEOS is a listed-equity, global, all-cap strategy investing across nine environmental technology themes in long-only fashion with about 40 holdings. GEOS is clean technology and energy infrastructure-focused, with companies that exhibit generally-high growth rates.

Essex Research Strategy is co-managed by a team of investment professionals seeking growth equity opportunities across an all-cap universe. By employing fundamental top down economic and sector analysis with bottom-up stock picking skills, the strategy provides the investment team a wide framework in which to identify growth candidates regardless of market capitalization restraint. Individual client portfolios are offered in two profiles: aggressive growth or growth and income.

Essex Evolution Long Only is an aggressive all-cap strategy which primarily aims to uncover small and mid-sized companies that exhibit the potential for meaningful growth over time. Seeks to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. The Strategy is concentrated within 40-70 names and is sector agnostic.

Essex Evolution Long/Short strategy is an aggressive All-Cap equity strategy that aims to maximize returns by utilizing both fundamental and technical analysis with an emphasis on thematic investing and tactical market positioning. Specifically, we aim to understand key themes within dynamic sectors to capture the growth in those trends and utilize short positions to both hedge portfolio risk and exploit specific stock mispricing's.

Essex Global Life Sciences seeks capital appreciation by investing in both long and short positions of medical and life science companies. These companies are focused in the areas of drug discovery and distribution, the production of devices and instrumentation, delivery of health care services, and the development and implementation of medical information technology. Essex Global Life Sciences seeks to isolate the early signs of improving/deteriorating financial estimates and business conditions through a combination of fundamental research and overall industry expertise.

Growth Equity is an All-Cap strategy designed to provide investors with exposure to growth companies in a market capitalization range of $100 million and up. The strategy is a concentrated portfolio of 50-70 companies diversified across domestic industry sectors that show accelerating earnings and sustainable revenue growth. Individual client portfolios are offered in two profiles: aggressive growth or growth and income.

Please refer to our firm's website at www.essexinvest.com for more information about Essex and the strategies we manage.

ESSEX INVESTMENT MANAGEMENT COMPANY, LLC

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