SILVERCREST
ASSET MANAGEMENT GROUP

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Operator: Hello and welcome to the September 2019 Silvercrest Market Commentary call.

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And now, I'd like to introduce your host for today's program, Rob Teeter. Please go ahead, sir.

Robert Teeter: Thank you and welcome, everyone. Today, we're going to be discussing a number of topics from our summer [Insight] publication. If you haven't seen this publication yet, it is posted on our website, probably you have received a copy as well.

We're going to be having a very fast-paced conversation speaking with the authors of each piece, getting at the essence of each piece. We will, however, at the end take any and all questions that any of the folks that have dialed in have and we also encourage any direct follow-up with Silvercrest portfolio managers or with any of us directly to talk about these topics in more depth.

So, to start off, within the space of about 30 minutes or so we can better inform you on the importance of due diligence, about why you should be selective in private equity, why you should consider international investing, help you to better understand volatility, help you understand and be well-informed on best practices in corporate governance, take a glimpse at some of the factors that are influencing inflation today and how to avoid being a collector of investments.

So, it's a tall agenda but we got a great roster of speakers who are all going to go through the topics quickly welcome questions at the end as I said.

So with that, I'm going to turn it over to our first set of speakers, Joe Agnello and Lilly Capatori, who will be talking to us about why do smart people continuously fall for financial products.

Lilianna Capatori: Thank you, Rob. Good afternoon and thank you for joining us on this call. First off, I want to mention that our due diligence team at Silvercrest is comprised of seasoned due diligence professionals with over a decade of investment or operational due diligence experience and collectively, we have looked at hundreds of managers in every asset class out there.

When we approach a new manager, we don't assume that it's a fraud. However, we do go in with what we deem to be professional objectivity. Our motto is trust but verify. We're aware of human biases and emotional rather than rational responses that may cause us to reach an incorrect assessment and conclusion. As an example, a common element in frauds is secrecy or lack of transparency which to us is a huge red flag.

All the frauds we mentioned in the piece made of Theranos, Enron, 1MDB and so on all lack transparency. Madoff used the common strategy to prevent investors from asking detailed questions, that is the exclusivity and rationing of the investment opportunity. Investors were conditioned psychologically to be grateful to get in, they would not risk their ability to get in or stay in by asking too many impertinent questions.

Theranos had a secret technology. Enron had extreme structural and transactional complexity and 1MDB was repeatedly unable to provide its auditors with support for investments it claimed to have.

Our team has no incentive to approve or not to approve an investment, hence, getting in at any cost bias is removed as a starting point. We also have a documented process that we go through methodically and it involves numerous steps, including verification of service providers such as custodians, administrators, auditors among others. Also, we verify the nature and amounts of underlying assets as a prerequisite to most of our approvals.

My colleague, Joe, will provide you additional color on the process we have built and that we firmly have in place at Silvercrest. Joe?

Joseph Agnello: Thank you, Lilly.

A key aspect of our due diligence process here at Silvercrest is the operational on-site due diligence meeting with any manager we are evaluating. We feel that this meeting gives us an enhanced perspective on the manger and his operational team. The on-site visit can reveal flaws in a manager that appear operational strong on paper, establishing a relationship and meeting with the people that are operationally responsible for our clients' investments allows us to make more informed decisions on a manager.

We also review a manager's due diligence questionnaire, offering materials, audited financial statements and any regulatory documentation we receive from the manager in order to compare these to the information we learned during our on-site visit. Once our operational due diligence work is complete, we meet to discuss the findings with our internal manager selection group.

Another key aspect to our process is vetting out any potential business risks associated with the managers we recommend. It's important to know that the operational due diligence team at Silvercrest has veto power over the investment team. This circles back to what Lilly just mentioned about seeing through a manager's perceived greatness and their special sauce. If there are operational flaws in a manager, we will not invest.

Utilizing these standards of operational due diligence helps us avoid some of the well-known frauds such as Madoff, Theranos and 1MDB.

Robert Teeter: Great. Thank you, Joe. I appreciate the overview.

The next piece that we'll be talking about is what to make of private equity and this is Robert Teeter, I wrote this piece. All it takes is looking at news headlines or Google Trends and looking in any of our inboxes and you'll very quickly know that private equity is certainly a topic du jour.

This piece was really designed for people who are hearing about PE maybe for the first time and are not quite sure what to make of it. So, the first thing that we do is we walk through the very broad range of investment opportunities that are encompassed by private equity or more broadly, private investment.

We note that it is comparable to talking about a term like mutual funds, which means a lot of different things to a lot of different people. A similar situation exists here so, we produced just roughly the overall categories within private equity, everything from venture and growth, investing to buyout special situations, et cetera. It's fairly very easy to get excited about a lot of the opportunities in the private investing marketplace today. The past results have been very, very compelling.

But we think it's important to step back to the first job of good portfolio management whenever it comes to selecting an investment, which is does it fit the portfolio goals. And it's here where we think it's important to take a nuance approach. Each investor has different preferences with regards to things like liquidity or time horizon, the comfort level with complexity and dealing with paperwork, different appetite for returns and then there's certainly the issue of strategy fit relative to what the rest of an investor's portfolio looks like.

We don't take a one size fits all approach here and we recognize investors have different preferences with each of those characteristics. And so, what we do is we set a hurdle rate and try to adjust returns back to public market benchmarks or otherwise reflective of those additional risk factors and complexities.

So, the most important thing again is portfolio fit and being very selective. We use a data vendor called [Pitchfork] which notes that there are over 9,000 open and upcoming funds in the private funds marketplace today. So, there is a lot of opportunity. But as we conclude in the piece, while it's interesting and perhaps relevant to buy or invest in private equity, we also think it's very important for you to beware and make sure that this exists.

So with that overview, I'm now going to turn it over to our colleague, Chris Richey, who's going to talk to us about the five good reasons to invest internationally.

Christopher Richey: Thank you, Rob, appreciate the opportunity and opportunity is what international investing is all about. I want to walk through the five good reasons, let me preview those—it's the scale of the opportunity set, is compelling, particularly has grown over the last four to five decades, the exposure to growth during actual investing is important, the quality and scale of those opportunities out there are equally compelling in terms of the types of companies, the products we use and their stability.

The fourth reason is really the cyclicality of performance. International equity investing adds to an asset allocation an element of counter-cyclicality that we experience in U.S. stock markets as far as ups and downs, they will countervail those. And lastly, we're value investors here in the international equity team, so the valuations are compelling.

And let me walk through each of these five in greater, a little greater depth.

The opportunity set out there globally is $70 trillion worth of public companies of which $40 trillion, obviously more than half, are non-U.S. We can attribute this really if we go back and look at the '70s to the 20 to 30 years of market liberalization that we experienced over those decades. Back in 1970, 70%, almost three quarters of the investable opportunities and equities, were all in the U.S. That's obviously flipped now and 55% of the opportunities are outside the U.S.

Back then, there were 20 investable markets. Now, there are nearly 80 investable markets. Back in the '70s, there were 17,000 publicly listed equities globally. Now, there are 46,000. So, that era of liberalization grew global capital markets now to the point where, frankly, it should be largely unavoidable.

But that opportunity set, if it's not attractive in other ways, should be compelling, and those are first and foremost the growth. Growth outside the U.S. is generally higher. It runs in the 3% to 4% range. We run in the 2% to 3% GDP growth range.

The quality and scale, back in the 1970s, '60s and even into the '80s, most of the largest best companies were located in the U.S. Now, we find when we look at sectors, half or more than half of the largest and highest quality companies in any given sector are non-U.S. companies. So, you shut yourself off to some very high-quality, high-liquidity companies if you aren't investing internationally.

Fourth reason, the cyclicality of performance. It has been a tremendous 10-year run for U.S. equities. They are up three times or more in that period coming off the 2008–2009 cycle. Overseas, they've only doubled. They're only up 100% over that time period. So, non-U.S. equities have underperformed U.S. equities although they've done quite well.

Conversely, however, from the 2001 to 2009 era, non-U.S. equities outperformed U.S. equities 200% to 100% on return basis. So, the counter cyclicality there of investing overseas comes through.

And then lastly, we're a little biased here, we're the value equity team, the valuations are really compelling overseas. Right now, S&P 500 trades at 16 times earnings versus 13 times earnings on overseas companies. Domestic dividend yield is about 2%. Overseas dividend yield is about 3.6%. We think it's worth considering even despite headlines or what you see on the news owning non-U.S. companies as part of a truly diversified long term allocated portfolio. Thank you.

Robert Teeter: Thanks, Chris, a lot of great information in there and certainly worthwhile to be paying attention to.

Mark Morris is going to speak next and he's going to be talking to us about his piece called "It wasn't that volatile, was it?"

Mark Morris: Thanks, Rob. In the piece, I tried to highlight that common concepts can be worth revisiting since the details are often easy to forget and because seemingly simple questions can yield important insights. In this case, the concept we wanted to cover was volatility, a word that is used in the investment world all the time, but can easily be misused.

We had talked about writing something on volatility because it was topical and timely. Many headlines in late 2018 mentioned volatility in some way. As we talked however, we noted that answering the question in the title of piece was not that easy except in the trivial sense, the volatility in the fourth quarter was higher than it had been earlier in 2018.

As I began writing, I was reminded that volatility is one of those terms that gets used very casually and that's generally harmless, but it can be very helpful to know or, for those of us that have forgotten, be reminded that there's also potentially hurtful things if you don't remember the specifics of what it means. And then a formal definition and sort of quite practical and powerful uses can be handy.

It's seemed useful then to provide that definition and use the market moves late in 2018 as illustrations. It also gave us a chance to talk briefly about volatility in a more general context, highlighting it as one of the manifestations of risk and noting that understanding it and putting it in its proper context can turn what is a common pitfall, namely selling into a volatile market downturn into an opportunity and perhaps add exposure when markets fall. Thanks.

Robert Teeter: Thank you, Mark, appreciate the overview of a concept that can be quite confusing at times.

Next up is Seán O'Dowd. He's going to be discussing the importance of independent directors and good corporate governance for family businesses.

Seán O'Dowd: Thanks, Rob.

Key takeaways regarding corporate governance. One, what constitutes good corporate governance? Any CEO could have a board made of individuals who are [related] to them, and would, therefore, be unwilling to challenge major decisions. These boards are known and in the long run they prove unhelpful to the CEO and the company, and will lead at best to financial stagnation.

What is critical for good corporate governance is to have independent board members who are not family members or prior employees. Ideally, independent board members will bring up different points of view based on their professional experiences which empower other board members to follow suit.

Another key takeaway why a family-owned business would require a board; one, to provide another level of support in oversight for senior management. Management should be held accountable for their work and a board provides this. Some people see boards as a hurdle or an impediment for management to deal with. However, a board that is organized with a great deal of thought and insight will in fact prove to be very helpful to senior management as a sounding board and provide confidence to investors and family members that management is doing a great job and making appropriate decisions.

Another reason is to gain access to areas of specific expertise. Every business or industry is unique and requires different types of expertise and a board should reflect this. For instance, in an industry that's undergoing a great deal of consolidation through M&A, it would be important for the board to have a director with an M&A/investment banking background. This person would have important M&A contacts and could also provide guidance to management on how to acquire a business, including what type of financing may be required.

Another takeaway is does board membership or composition change over time? The answer is yes. It is important to point out that the composition of a board should change over time along with the changing dynamics of the family business. For instance, early stage companies would usually have board members with access to firms with capital and who understand what a company needs to survive to the next stage of finance.

As this company matures and becomes more stable, other areas of expertise from the board will be required to address operational and strategic issues such as technology, M&A, and capital budgeting.

The final key takeaway: are there specific formulas for boards, for family members' board of directors? No. There are no family businesses that are the same. This applies to family boards as well. Boards should reflect the unity, culture and nature of family business. Thank you.

Robert Teeter: Great. Thank you, Seán, some great advice for family business owners.

Next up is Patrick Chovanec who'll be talking to us about Fed policy and inflation.

Patrick Chovanec: Most of you know that I weigh in on various topics on at least a quarterly basis, often more frequently, and in this piece, I was asked to focus on the outlook for Fed policy, a topic that's been much in the news and particularly the role that inflation plays in feeding into what Fed policy will be.

One of the most remarkable things over the past six months or so has been the degree to which inflation has slowed. If you go back at the beginning of the year, there was a strong belief and a great deal of concern in the market that inflation was picking up as it logically would do at the end of a business cycle or at least deep into a business cycle. Various constraints usually come into play. Typically in the United States, these are a tight labor market and also higher energy prices.

But there was a concern that the Fed in response would be raising rates and that that could help push the U.S. into a recession. We're in a very different environment now. First of all, inflation really cooled off, went almost to a crawl in the first quarter, has rebounded slightly since then, but is well below the Fed's 2% target.

And this has given the Fed a lot of room to deal with the growing concerns about the outlook for growth. Typically, the Fed, even if growth was faltering at this stage of the business cycle, was facing much harder choices than it does. But the fact that inflation remains so moderate, one might even say tame, gives the Fed a lot of room.

Now, to some degree, the reason why inflation has fallen off, whether it be in energy markets or more broadly, is because of faltering growth abroad; the weakness in growth abroad has pushed down inflation. So, the Fed then has greater room to anticipate and respond to that than it typically would. But it's important to remember—and that's a good thing, that's a good thing for our economic outlook, because the Fed has more flexibility to anticipate, perhaps preempt a recession.

But it's important to remember what Chairman Powell said, that many of the tools of monetary policy, if they operate alone may not be enough to counter some of the things that have been slowing both global and U.S. growth. So, for instance, he particularly mentioned trade wars, anxiety over trade wars, the erosion of business confidence, that by lowering rates, the Fed could give some boost to the economy, some boost to certain aspects, but that it couldn't necessarily offset all of the things, all the more substantive issues that might be weighing down on economic growth.

So, you'll hear a lot about the Fed in the news about—the president even talks about what the Fed should do, but this is some context to why the Fed is looking at cutting rates but also why the Fed more importantly has some room to cut rates at this stage of the business cycle and what the impact is on our economic outlook.

Robert Teeter: Great. Thanks, Patrick. That was a great overview of the complex and not all too clear kind of topic.

Next up is Martin Loeser and Elinor Ouyang. They're going to be talking about manager selection and why it's important to follow the asset allocation.

Martin Loeser: Thank you. So, in this article, Elinor and I attempted to summarize our team's approach to manager selection. I'm going to start off with some of the common mistakes investors make in typical manager selection processes and then Elinor will describe how our process addresses some of these problems.

Some of the things you might hear are we're looking for high returns while avoiding frauds or blowups, looking for interesting and differentiated strategies, looking for managers that outperform their peers or some other variant of searching for uncorrelated and strong risk adjusted returns.

These are all valid criteria to seek, but if one isn't careful, they can quickly fall down a slippery slope of either having a bloated and complex portfolio or having a portfolio that is not structured to deliver the investor's ultimate goals, and in many cases portfolios has both of these problems. Why do I say that? The bloated or complex portfolio typically results from the type of investor that is constantly looking for something new or interesting.

The typical justification to invest may be that the manager is playing in an uncrowded space or that they will provide diversification benefits. But this ultimately leads to what we call collecting managers and owning a portfolio of fads.

The second problem I highlighted was ending up with a portfolio that is not built to meet an investor's specific goals. This often results from the focus on finding the manager that has the best performance relative to peers or what is sometimes negatively referred to as return chasing.

In our quantitative analysis, we have found that the top performers in an investment category by which I mean, for example, large cap growth or small cap value, we have found that these outperformers have typically invested in something outside of their mandate which is exactly what drove their strong relative results.

By investing in these types of outperformers, an investor will not ultimately be getting the types of exposures that they had counted on. It is essential to know how the past returns were generated and whether the current positioning of the manager remains consistent with their stated style. Without this knowledge, how can the manager be counted on to meet a specific goal.

Now, I'll pass it on to Elinor to describe how our process addresses some of these mistakes.

Elinor Ouyang: Thank you, Martin.

So, at Silvercrest, we view that our approach combats these two types of problems Martin just mentioned head on because we're always speaking about asset allocation. And asset allocation is constructed to meet a specific client goal and then that allocation directs the selection of what type of managers we want to include.

We can then find managers [in] each of the asset allocation categories. We have created proprietary sector models to make sure that each manager has generated their return in a manner consistent with their stated strategy and making sure the outperformance we're seeing is actually coming from what we call profit-driven alpha, not from some kind of like (inaudible).

In fact, we typically eliminate the best and worst performers in each asset class for this reason. And the quantitative analysis we conducted supports our view that our chance of beating a benchmark actually improved by eliminating those outliers.

I will finish with saying that with a well-constructed asset allocation, differentiated or exciting strategies can still fit perfectly in a client portfolio. We work closely with clients to first develop an asset allocation that meets their goals, and only then does it make sense to start selecting managers.

Robert Teeter: Great. Thank you, Martin and Elinor. And thanks, everyone, for your patience.

Well, this is certainly a fascinating world, and this is a very fascinating format for this call. So, hopefully that was enjoyable for everyone. Just before we transition into the Q&A, I just wanted to remind everyone that the [Insights] publication that we were talking about today is available on our website and all of us as well as everyone here at Silvercrest welcome further and deeper dialogue on any of these topics whether it be today during the Q&A or any time that you reach out to us.

So with that, I'd just like to say thank you again and turn it over to the moderator for questions.

Operator: Certainly. Our first question comes from Caller 1, private investor. Your question please.

Caller 1: Yes. Great call and we're still with you after the interruption there. But I had a concern about international exposure and wondered if the moderator might pose to our excellent team of commentators. Are we more or less interested in international exposure now than, say, earlier this year?

Robert Teeter: Sure. Thanks Caller 1 for dialing in. This is Rob. I'll take a crack at that and let Chris Richey speak to is as well from an individual company perspective.

From an asset allocation point of view, the first thing that's important is thinking about the investor or the client's domicile and where their future spending needs might be and what their return objectives are and, again, sort of their comfort with a lot of the things that we talked about throughout the call.

I would say in general we think that there are a lot of interesting opportunities in international with regard to our exposure. Our clients do have exposure to international investments, both developed and emerging markets albeit at levels that we think are relatively modest that allow us to get some benefits from diversification as well as—and this is where I'll transition over to Chris—assets. Some of the wonderful companies that reside outside the U.S. but have a lot of benefits in terms of asset evaluation, gaps and different things like that.

I think Patrick might have some things to say as well.

Patrick Chovanec: Yes. I'll just add that I think part of this is the context to the current moment, right, in which we see some global weakness. And I think one of the main reasons for international risk is diversification and not just an issue of whether you think international is going to do better than the U.S. products vice versa.

And a key thing there is finding risks that are not correlated. There are some international risks that are correlated too, say, U.S. recession risk or [interest you at] what to Fed does, things like that. But there are a lot of risks out there that aren't and even if they appear risky, it actually reduces portfolio risk to be exposed to different kinds of risk that won't necessarily all happen at the same time. So, if there is a U.S. recession on one hand, you're buoyed up by other things that haven't happened, could happen but haven't happened in the other parts of your portfolio.

So, I think it's important to think about risk in that way that it's not just is international riskier than domestic but what are the kinds of risks you encounter and how that comes together in the portfolio.

Robert Teeter: Great. And then, Chris, I'll turn it over to you. We've got a lot of great investment managers located all around the world and Chris Richey here is based in California and manages international equities for Silvercrest.

And, Chris, one of the questions pose to you as a kind of a follow-up is one of the things we see a lot of is a bad valuation disparity for very comparable companies around the world based on where they happen to be located and sort of have nothing to do with where their business takes place. I wonder if that's maybe a phenomenon that you could speak to.

Christopher Richey: Yes, absolutely. I mean, I think if 2008 told us anything, it was that the world has been globalized, capital markets are global. What started off as some potentially foolish lending into the housing market in the U.S. ultimately ended up dragging almost everybody else in.

And I think the same is true vice versa. You could have a purely domestic portfolio growth value in equities whatever you want, and U.S. companies are going to be exposed to overseas risk in the revenue stream, in their liabilities, in all sort of things. There really is no retreating back to the coastline here and avoiding the world. This is where we've ended up and, frankly, in the three decades I've been managing money, it's generally been the same concerns over and over. We've had wars. We've had recessions, et cetera.

We've tended to see people make money through with a long-term perspective and an asset allocation that they think of. I was watching a Navy Seal last night talk about crisis management and what's involved in it and he said really what crisis management is making as many decisions ahead of time as you can so that in the moment whether it's financial crisis or any other kind of crisis, you have a plan.

Our plan is to make sure our clients are allocated internationally to quality companies at reasonable prices with good balance sheets and that are prudent, large and of high quality. And over time, that has worked out very well even with currency movements here and there and increasing our clients and other investors' wealth.

So, in reaction to what you're seeing internationally, I'd say play on.

Robert Teeter: Great. Thanks, Chris, very well said.

And thanks for your question, Caller 1. We certainly look forward to seeing you soon.

Caller 1: Thank you.

Robert Teeter: Back to you, moderator, if there are other questions.

Operator: Thank you. As a reminder, ladies and gentlemen, if you have a question at this time, please press star, then 1. And I'm not showing any further questions in the queue at this time.

Robert Teeter: Okay. Great. Well, thank you, moderator.

I think even if we took up a little extra time with the confusion around the conference line, we'll end the call here even though I had a few questions that I was looking forward to asking everyone. But we're at around the time limit that we try to keep doing. Again, we encourage everyone to reach out with follow-up questions. We're happy to talk about these topics in more depth. Thanks for dialing in today, everyone.

Operator: Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.