CROSSMARK GLOBAL INVESTMENTS

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# MONTHLY COMMENTARIES

## Market Commentaries Overview

Lessons of an Unsuccessful Sports Card Trader / Speculator / "Investor"

As a Houston based investment management firm, you probably could have guessed we'd be *leading off* this month's Commentary Overview with a shout-out to the 2017 World Series Champions, the Houston Astros. It cannot be overstated what this World Series journey has meant to the City of Houston, still in the early stages of rebuilding after Hurricane Harvey. There's almost nothing more nostalgic than the memories of a hometown championship, so the fact that Houston's first World Series titles came less than two months after Hurricane Harvey helps make otherwise *bitter* memories a little more *sweet* for Houstonians. As such, with baseball and (as always) the markets currently top of mind for all of us at Crossmark Global Investments, we thought combining some thoughts on the two a befitting way to headline our monthly portfolio commentaries.

Rather than juxtapose today's increasingly "quant"-driven markets to the statistical data-driven framework employed by the Oakland A's in Michael Lewis' *Moneyball* or to the Astros' transformational combination of quantitative analytics and traditional scouting that catalyzed a 100-loss team into a 100+ win World Series champion in under 4 years (see Sports Illustrated's 2014 [1] and 2017 [2] articles) – we thought we'd take a less traveled and perhaps equally topical route. So below, you'll find the takeaways that one Crossmark Global Investments research analyst gleaned at a young age trading one of the more obsessively popular and often forgotten market bubbles: sports trading cards in the 1990's.

An Expensive Lesson in Getting Hustled

I remember the day in the early 1990's that, for me, card collecting went from a fun hobby to what I realize now was probably a mix between: 1) a long term buy-and-hold value / growth at a reasonable price (GARP) strategy 2) with a long term long call option overlay strategy…and 3) gambling. This transition occurred sometime in 1993 – I pulled out a shimmering gold Chicago White Sox Frank Thomas, '92 Donruss Elite card from a $1 or $2 pack of baseball cards that I bought with my hard earned money doing chores around the house (most of the cards back then were pretty plain looking cardboard). Knowing that my older brother's favorite team was the Chicago White Sox (his Little League team that year), I knew I was in an advantageous position to leverage this card into 10, maybe 20 of his cards that I needed to complete a set for my favorite team, the Houston Astros (my Tee Ball team that year). To my surprise, I got an entire shoebox of cards out of the deal. At the local card shop that weekend (a booming business back then), my brother asked the owner what his new Frank Thomas card was worth, "around $450 to $500, I'll give you $450 cash for it". I don't think I've ever cried harder or longer than I did in that store on that day.

Evolution of the Sports Card Market in the early 1990's

Sports card values and card manufacturer revenues tend not only to be at the mercy of shorter term, short-lived trends and erratic popularity but also at the mercy of American's disposable incomes and, therefore, the overall U.S. business cycle. In the 80's and 90's, the market had also become increasingly competitive for card manufacturers across all sports as collectors became more interested in collecting.

[1] https://www.si.com/vault/2014/06/30/106479598/astromatic-baseball-houstons-grand-experiment

[2] https://www.si.com/mlb/2017/10/24/houston-astros-sports-illustrated-world-series-prediction

Everyone knew the Honus Wagner 1906 American Tobacco Company card was going for 6 figures; everyone knew the 1952 Mickey Mantle Topps Rookie Card was going for 5 figures. So collectors in the '80s and '90s were content trading, maintaining, and holding on to new production cards, essentially as a relatively cheap (and fun) long term call option in the hopes that they'd dust off their collection and make a small fortune in 30/40/50 years.

However, the unrealized problem for collectors at the time was: 1) cards were being produced on a much larger scale relative to the 1950's and 2) every collector had also put on that same long term call option beginning in the early '80s. My parents, on the other hand, traded for the Mickey Mantle's and Joe DiMaggio's and the like, but clipped their cards to the spokes of their bikes like every other kid in America and never saved any. As such, for most card collections accumulated in the '80s and '90s, an overwhelming majority of our call options (with a few lucky exceptions) are either out-of-the money currently, or considerably less in-the-money.

The problem for card manufacturers, which they realized at the time, was that they'd never see a penny of that long-term secondary market price appreciation. How could they grow revenue without having to rely mainly on kids' allowances or the relatively few older sports nostalgia collectors? In response (and around the time of the Frank Thomas story above), card manufacturers' business models changed from one primarily catered toward kids' allowances to one targeted to older sports fans and enthusiasts with larger wallets looking to strike the more immediate cardboard gold.

This meant that the old look and feel of sports cards was in for a dramatic make-over. Soon, new production card packs and boxes previously only containing plain-looking cardboard cards with relatively immaterial current market values, turned into packs and boxes of new production cards with randomly inserted, limited production "Insert Cards" with a perceived immediate scarcity value premium. For an increasing number of card manufacturers (about 4-6 companies at the time), you could no longer buy a complete box set of cards as you could previously and expect to get every card produced that year, adding to the perceived scarcity of these cards. Furthermore, these new "Insert Cards" sported shiny gloss, metallic-like material (i.e., the Frank Thomas card), holograms, autographs, or (beginning in the late '90s) pieces of athletes' game worn jerseys (see: *Card Company Slices up Ruth Jersey* [3]), increasing market values even more. Thus, the per pack price of cards would soon rise as much as 4-5x with production volumes skyrocketing to meet the increased demand from this new target market.

Regulation to the Rescue

However, regulators eventually caught on. Given the gambling and/or lottery-esque look and feel to the way kids and adults were now beginning to collect "Insert Cards", regulators mandated that sports card packaging would have to state the per pack odds that each would contain a highly sought after "Insert" (i.e., 1-in-10 packs, 1-in-50, 1-in-200, etc.). At the same time, sport card price guides containing rough estimates of a card's recent market value (essentially surveys of card shops, major collectors, and industry experts) began picking up in popularity and eventually became an essential tool for every card collector, trader, or speculator in the archaic pre-internet, pre-eBay trading era.

The Unintended Consequences of Regulation

Despite consumers now having the 3 tools needed to calculate the probability weighted expected return of a pack of cards (the price guide, the odds of getting an "Insert Card", and the cost per pack), few either made that calculation or those that did still couldn't help themselves. FOMO (the Fear of Missing Out) was alive and well in this bubble. I'd bet none of the probability weighted expected returns for any pack was positive (though at the time I wouldn't have had the slightest idea how to connect those dots, nonetheless do that math). In fact, placing the odds of getting an "Insert Card" more than likely boosted sales even more. For me, my friends, and everyone else I ever saw open a pack of cards, we only looked at the odds (in fine print on the back of the pack) after we opened a pack with an "Insert" – it gave us immediate feedback on the potential value of the card. A "1-in-3 packs" card would be nothing special; a "1-in-300" card meant you better buy a plastic protective case from the card shop immediately.

This was the evolution of the market in the 1980's and 1990's, one that transformed the sports card collecting hobby into a sports card bubble. And this was the primary market in which one Crossmark Global Investments analyst predominately traded in the 1990's. Of course, this analyst's focus has shifted now to much more sophisticated markets and strategies, to which we will now turn.

[3] http://www.espn.com/sportsbusiness/news/2003/1020/1642358.html

## Large Cap Core Growth Commentary

It sounds like a broken record, but, once again, the stock market continued its post-election surge with the S&P 500 gaining 2.33% in October. The index has not suffered a negative month since the election (with dividends included). The Russell 1000 Growth Index, our benchmark, continued its seemingly steroid-enhanced performance, gaining 3.88% for the month. It has posted one negative month since the election but has gained impressive 25.40% this year with help from its heavy weighting of "FANG" stocks (Facebook, Amazon, Netflix, and Alphabet/Google). In October, once again, our Large Cap Core Growth model split the difference by outperforming the S&P 500 while underperforming the Russell index.

Our LCCG models best performing sectors for the month of October were Technology, up 6.46%, and Industrials, which rose 4.56%. Conversely, lagging sectors were Healthcare, down 4.19%, and Telecom, which fell 2.10%.

Top performing stocks included Microsoft, which jumped 11.67% on tech sector strength followed by a stellar earnings report and Apple, which rose 9.68% on "buzz" surrounding the new iPhone release and anticipation of good earnings. On the other side of the ledger, losing stocks included Schlumberger, which fell 8.26% on a disappointing earnings report, and Celgene, which plunged 30.76% after a drug trial for Crohn's Disease was halted followed by a disappointing earnings call.

Adjustments to the LCCG model for October included the sale of Dr. Pepper Snapple after weak results as well as the purchase of Polaris Industries and adding to our Ecolabs position.

## Taxable Fixed Commentary

Don't you just love that event where you anxiously await for the day to get here so you can enjoy all the wonders it brings? For some of us, it's waiting for November 1st so we can begin to play Christmas music without the rest of the family groaning and reminding us to wait for Thanksgiving. For investors, the final days of October and the first days of November were definitely those events. Besides the earnings reporting season, we had the announcement of a new Federal Reserve chairperson, the Federal Open Market Committee meeting and the introduction of the proposed tax plan from Congress. So what do we do with all of this information and how does that affect investors?

For the immediate future, investors should continue on their current path with business as usual. The recommendation from President Trump of Jerome Powell as the new Fed chairperson will most likely result in a continued measured rising of the Fed Funds rate towards the neutral rate of about 2%. As the remainder of the vacant seats on the committee are filled, we could see a shift in the tone of the FOMC over time, but for the rest of this year and into 2018, the intentions of the FOMC have been well telegraphed. And due to this previously laid out plan, there was no expectation of a rate hike at the November 1st meeting and that is exactly what happened. The language was slightly altered to show stronger growth in the economy over the last month, but no shifts in the presumption of one more hike this year at the December meeting which futures are currently giving about 85% chance of happening.

Although the new Fed chair announcement and the November meeting did not shake up the market very much, we have seen movement from both earnings and the proposed tax plan. For the majority of companies that have reported so far, earnings were strong this quarter and the tax plan gives additional information for corporations and individuals to digest in what their tax expense looks like going forward. With continued uncertainty in the market regarding earnings and policies out of Washington, Crossmark Global Investments will continue with our business as usual of maintaining a conservative strategy in regards to taxable fixed income investments. We accomplish this by reducing a portfolio's sensitivity to interest rate movements as it appears rates will move higher over the coming quarters and couple that with higher levels of income to buffer any volatility in market values. When we see the US 10yr Treasury rates break above the higher-end of the current trading range towards the recent highs of around 2.60%, we will have the opportunity to adjust our strategy, move further out the yield curve, and benefit from differing market dynamics.

## Municipal Fixed Income Commentary

Puerto Rico remains in flux with nearly 65 percent of the island still without electricity. In the wake of Hurricane Maria, Puerto Rico's federal oversight board granted the island about seven weeks to revise its financial recovery plan to account for damage suffered in the storm, raising the possibility the territory may attempt to impose deeper losses on bondholders. Revenue collections have been nearly impossible while payments pending are not going away.

Not surprisingly, an index of Puerto Rico securities is having the worst performance since 2000 as the commonwealth struggles to recover from the recent natural disaster. Through October 31, an index of Puerto Rico debt has lost 17 percent year to date, a steep decline since 2000. In comparison to the overall municipal bond market, S&P Dow Jones Indices show an improvement of 4.41 percent over the same time period. The trading volume for Puerto Rico securities reached its highest level in at least three years during October. With volume of trades considerably higher, one can reason with those that are liquidating but the buy side is speculating on a recovery to levels above the entry-level price. Insurance companies that provide insurance on specific issues have a financial interest to own additional bonds at lower prices, as they will essentially cover the difference on what they paid for the discounted bond in exchange for what they insure through insurance. The actuarial departments are working extra hours to determine the mathematical breakeven point between the current bond price and the insured levels. Insurance companies taking a business risk is one thing but individuals speculating the island will recover to levels greater than current pricing is an extreme risk as any solution may be years in the making and bondholders may be severely disadvantaged in the future price offering.

We have consistently advised our clients of the potential risks associated with Puerto Rico bonds. Although we wish the very best for the people and island, it remains an avoid investment situation.

Pension funds are witnessing robust investment gains for plans during their current fiscal year, most of which end in June or July of each year. An example includes New York City's five public pensions that now show assets sufficient enough to cover 71.2 percent of promised benefits, an increase of 5.6 percentage points greater than the year prior. NYC pension funds have reported a 13 percent return net of fees compared to a meager 1.5 percent the year prior. The current year returns improved pension standings but the funding ratios remain below what is considered healthy levels. Some pension funds are reducing return expectations as this requires government entities and pension participants to increase contributions to make up differences in funding levels, helping to shore up under-funded retirement systems. One such entity is the Ohio Police and Fire Pension Fund that recently reduced the assumed rate of return on its investments from 8.25 percent to 8.00 percent. The current fiscal year return of 10.9 percent improved the funding ratio to 69.8 percent. The lower target return of 8.00 percent for Ohio Police and Fire Pension may still appear high when compared to the 100 largest public pensions as roughly two-thirds of the plans now have assumptions of 7.5 percent or below. There is still a lot of work to be done on the pension front in terms of reducing return expectations as well as refurbishing how to add contributions to existing plans. There may be a trend in the near future to freeze current plans, as new participants will be offered more traditional contribution plans. Pension liability will remain a hot topic for an extended period of time.

Congress has yet to roll out final details for projected Tax Reform legislation with current talk centered on individual and corporate rates. There are some early discussions that include terminating private activity municipal bonds, repealing the use of advance refunding municipal bonds and tax-credit municipal bonds and prohibiting the sale of tax-exempts for professional sports stadiums. The biggest roar from the lions in the trading and public finance departments is that these early proposals would eliminate roughly 25 to 30 percent of current new issues being brought to the market. This would be revenue negative initially for public finance firms and could push rates higher, prices lower, if enacted as municipalities could rush new issues to the market prior to the December 31, 2017 deadline. The supply/demand theory could produce short-term volatility in price and inventory for several quarters as Tax Reform legislation is battled out on Capitol Hill. Crossmark Global Investments has limited participation in the sectors involved in Tax Reform so the portfolios would be neutral affected.

## Covered Call Income Commentary

The markets continued to set new record highs in October along with investor sentiment measures showing widespread optimism. Third quarter earnings season has been solid so far and economic growth has continued to surge forward. That being said, we did experience four straight days in October where the VIX closed above 11 as equities dipped ever so slightly as a few high profile negative earnings surprises hit the street. However, as has been the case almost all year long, even the slightest of pullbacks are met swiftly with investors eager to buy on the dip. From a technical standpoint the buy the dip strategy will likely continue as long as it keeps working.

Covered Call Income continued its strong year as the strategy returned another positive performance month and outperformed both the S&P 500 covered call index and the BXM. The markets were led again by the technology sector as that sector was up 6.51% for October. The Covered Call Income strategy has an equal weight in the technology sector and benefitted from owning Intel (INTC), PayPal (PYPL) and Microsoft (MSFT) as those names returned 19.46%, 13.32% and 11.66% respectively on positive earnings announcements. The financial sector followed up a solid month of September with a nice October up 2.86%. The Covered Call Income strategy has a slight overweight to the financial sector. Two names owned in the financial sector that had positive performance returns for October were American Intl Group (AIG) and Morgan Stanley (MS) which were up 5.24% and 4.31%. On the flip side, two names that performed poorly for the month of October were Cerner (CERN) which was off -5.32% due to a bad earnings announcement and Gilead Sciences (GILD) which was down -7.47%. Even with historical low volatility, the Covered Call Income team was still able to generate attractive premiums from the sale of covered calls over the month of October as opportunities presented themselves.

**About Crossmark's 30 Year History**

Crossmark Global Investments is an innovative investment management firm. The firm provides a full suite of investment management solutions to institutional investors, financial advisors and the clients they serve. We have a multi-decade legacy of specializing in responsible investment strategies for clients. Founded in 1987, the firm is headquartered in Houston, Texas. Additionally, Crossmark is the exclusive manager of the Crossmark Steward Funds, which is a fund family that applies an overarching values-based screening methodology to its suite of equity and fixed income funds, including its award-winning Steward Global Equity Income Fund - named Lipper's "Best Global Equity Income Fund" for the last three consecutive years.

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