

Madison Perspectives

Second Quarter 2018

Against a backdrop of decelerating global growth, the United States economy, buoyed by recent fiscal stimulus, stood out by essentially holding firm. For the second quarter, financial markets responded accordingly with U.S. stocks (S&P 500®) advancing 3.4% versus a 2.6% decline in foreign stocks (MSCI ACWI-ex US®); meanwhile, U.S. bonds (Barclays Aggregate) fell 0.2%.

For a variety of reasons, many major global economies have softened. For example, China's growth rate is declining as it continues with its long-term transformation away from an investment-led economy. China President Xi Jinping has clearly articulated that China will no longer perpetuate a "growth at any cost" mindset. Rather, a focus on quality of life issues, particularly environmental concerns, will now take precedence.

Perspectives

"He who knows only his own side of the case knows little of that." - John Stuart Mill

"A watch is the most essential part of a lecture." - Willa Cather

Whether acknowledged or not, every investor makes an inferred daily decision to either buy, sell or hold. This is true for every security in their portfolio. Since most investors are not inclined to trade every day, the "hold" decision is clearly the most likely and repeated occurrence. To combat against being harmed by an overly stale investment portfolio, it is essential to promulgate a healthy dose of "status quo" skepticism. In short, each security in the portfolio must be continually scrutinized. If a position no longer warrants inclusion it should be eliminated and replaced. This perpetual "pruning and planting" process is vital to maintaining a healthy portfolio.

We have found that a "devil's advocate" approach to security assessment can be an effective tool for scrutinizing a portfolio's holdings. Accordingly, we whole-heartedly embrace a healthy dose of skepticism when it comes to investment management. Our goal is to never get too comfortable. The world is changing too quickly to metaphorically sit back and passively watch any portfolio. Disruption happens. Values change. Geopolitical events unfold. We can't afford to be overly ponderous. Ever watchful, an efficient and effective portfolio manager must be decisive and act accordingly. Acting in this manner is our goal.

Outlook/Positioning

Netflix has clearly been a "popular" stock for investors. It is the "N" in the now often-cited FAANG acronym (which includes Facebook, Apple, Amazon and Google). U.S. stocks are commonly assigned price targets. A price target is the projected price level of a financial security as determined by an investment analyst. Netflix currently trades at approximately \$400 per share. Here is where things get interesting: Netflix now has price targets that range from \$90 to \$500 per share! The \$500 per share target shouldn't be surprising, given that Netflix already trades at \$400. However, the \$90 price, at 77.5% below its current price, is rather eye-opening!

In theory, the intrinsic value of an investment security, such as a stock, is equal to the discounted stream of its future long-term cash flows. In an efficient market, the price of a stock should match its intrinsic value but sometimes markets aren't efficient. This was clearly the case in the late 1990's when rampant speculation pushed tech and telecom stocks to unprecedented heights, creating the now infamous NASDAQ stock market bubble which ultimately "popped" in 2000. At the market peak, virtually every stock in the NASDAQ was trading well above its intrinsic value. Valuation levels were clearly unsustainable and unjustified. A little over two years later, by early 2003, the NASDAQ completed a painful correction, after plummeting a full 80% from its 2000 highs.

In our view, the \$90 to \$500 range of price targets for Netflix is very telling. If nothing else, this dispersion should inform investors that the future profitability outlook for Netflix is highly uncertain. Relative to cash flows and earnings, Netflix is one of the most highly priced (and storied) stocks in the S&P 500. Current shareholders are hoping and believing that Netflix will be able to grow at a very high rate for many years to come. Maybe it will.

Therein lies the irony. A great (so far) company such as Netflix, like all companies, still faces its own share of uncertainty and risks. However, in our view, the price of Netflix does not appear to compensate current investors for this uncertainty. With extremely high expectations for growth, even mild disappointments could be costly for shareholders. More broadly and importantly, the current

valuation of Netflix does, in part, reflect the complacency that has more than crept its way into today's financial markets. We think the healthiest markets are those that focus on both story and price. Sometimes the best stories don't have a happy ending.

Investor complacency remains unusually elevated. Accordingly, most risk-based asset classes provide little margin of safety. We are increasingly focused on quality. Globally, corporate debt is a growing concern. Credit quality is deteriorating due to heavy issuance and increasingly excessive leverage. Finally, the growing prospect of trade wars is particularly threatening to manufacturing margins and global supply chains.

From an equity perspective, we are emphasizing healthy balance sheets and less trade dependent regions. We are also shifting our fixed income portfolios to higher grade credits and Treasuries. In short, we are paring risk exposure.

Summary

We are confident our Multi-Asset portfolios remain well-positioned for a growth-challenged global economy. We also understand and embrace our ongoing responsibility to insightfully differentiate between attractive and less attractive asset classes as we strive to deliver superior risk-adjusted returns. As always, we truly appreciate your confidence and your support.

David Hottmann, CFA



Patrick Ryan, CFA



Nothing contained herein is intended to be a recommendation to buy or sell any security nor is it intended to represent the performance of any Madison Fund or product. Madison Asset Management, LLC. © July 11, 2018 - All Rights Reserved.

Additional Information:

The Russell 3000 Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 23 Emerging Markets (EM) countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

Bloomberg Barclays Capital Aggregate (U.S.) Bond Index is an unmanaged index of U.S. fixed income securities. The U.S. Aggregate Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The index includes bonds from the Treasury, Government-Related, Corporate, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS sectors.

Russell Investment Group is the source and owner of the trademarks, service marks and copyrights related to the Russell Indexes. Russell® is a trademark of Russell Investment Group.

This material is informational only and should not be taken as investment recommendation or advice of any kind whatsoever (whether impartial or otherwise).

Although the information in this report has been obtained from sources that the firm believes to be reliable, we do not guarantee its accuracy, and any such information may be incomplete or condensed. All opinions included in the report constitute the authors' judgment as of the date of this report and are subject to change without notice. This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.