JANIAN
INVESTMENT ADVISERS, LLC

February 20, 2018

Janian's now five years old.

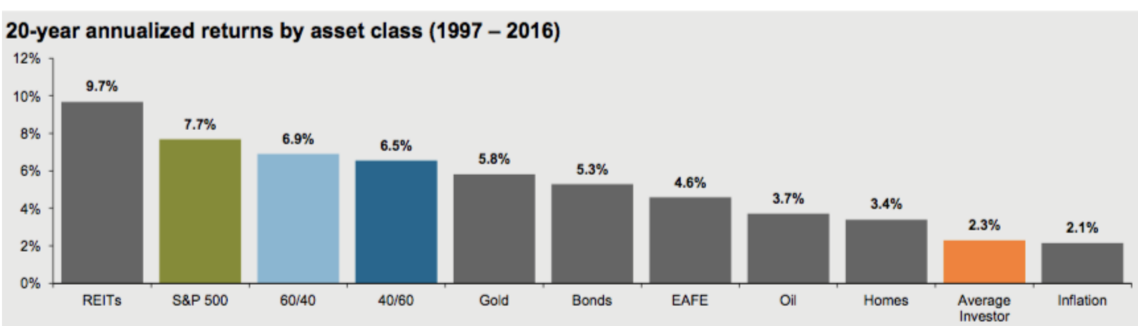
Our service model remains unusual in the investment advice industry:

- Combine financial planning and direct security selection
  (by cutting out the second step in the traditional distribution of investment advice from 'fund portfolio manager' to 'broker / advisor' to client, thereby removing cost and increasing information to the client)

- Be a low-cost provider
  (by emphasizing performance compensation as Janian's big economic upside and simultaneously offering low management fees versus competitors)

- Stress personal relationships
  (by taking only individuals as clients, emphasizing the uniqueness of the planning for each client, and focusing on client retention not new sales)

Our overarching goal remains to help clients to capture more of the opportunity to build a better future than the average investor does[1].



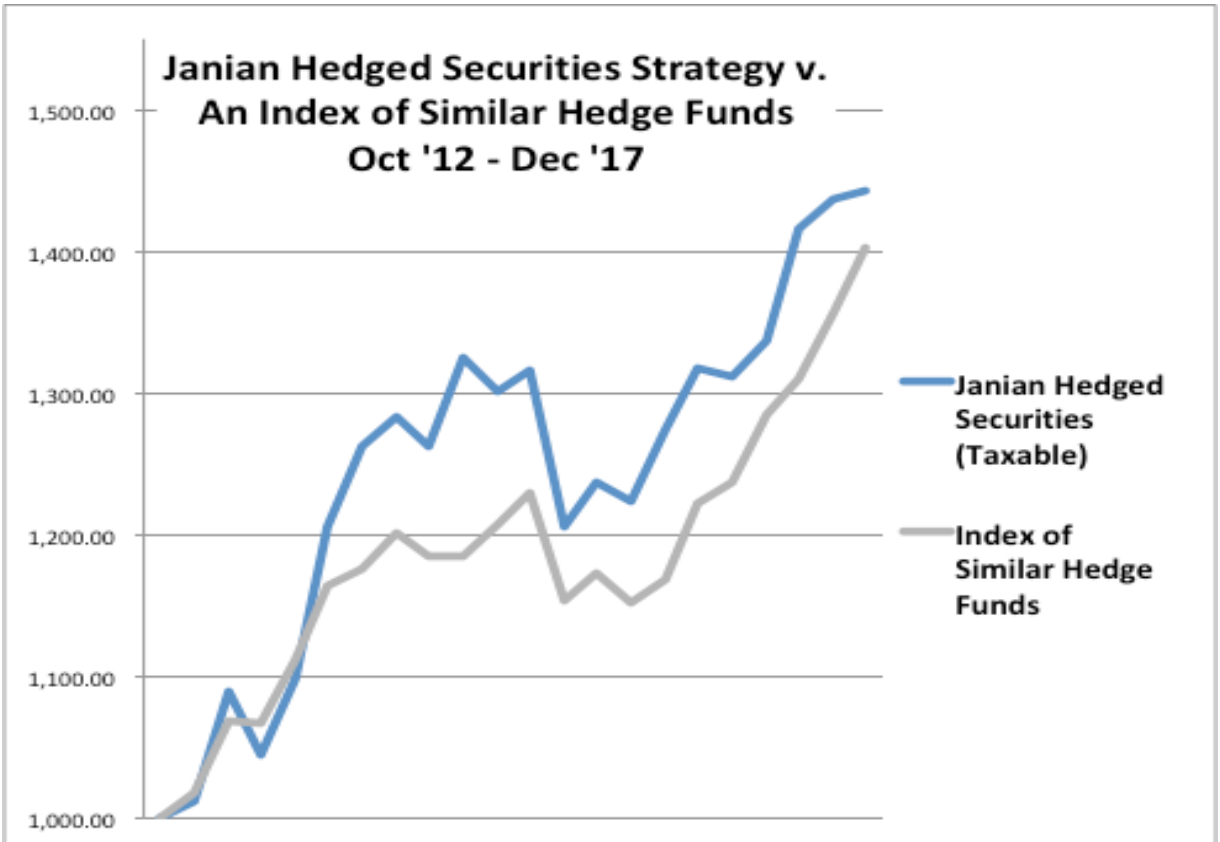
We have over $20 Million under advisement, solid investment track records, and >95% client retention since inception. We hope to grow the first, improve the second, and maintain the third in the next five years.

[1] Thanks to J.P. Morgan Asset Management for the chart. Please call us if you'd like to know the data sources that it cites for any of its charts that we use in this letter.

2017 INVESTMENT REVIEW

Hedged Securities

Taxable accounts in this strategy were up, on average, 10% for the year net of all fees. Over the last five years we have delivered higher returns than the average similar strategy[2].



Long Securities

A client recently requested that we launch an unhedged (i.e., just the long positions) version of our Hedged Securities strategy. We intend to run this portfolio 100% invested in bullish environments. Since the Hedged Securities has typically been 70-80% gross long, we accomplished 100% invested for Long Securities by investing the majority of the strategy's cash in a long stock market ETF. The strategy does NOT have a mandate to be 100% long at all times; Janian could sell the ETF or any of the long positions at any moment. There will not be any hedging in the strategy.

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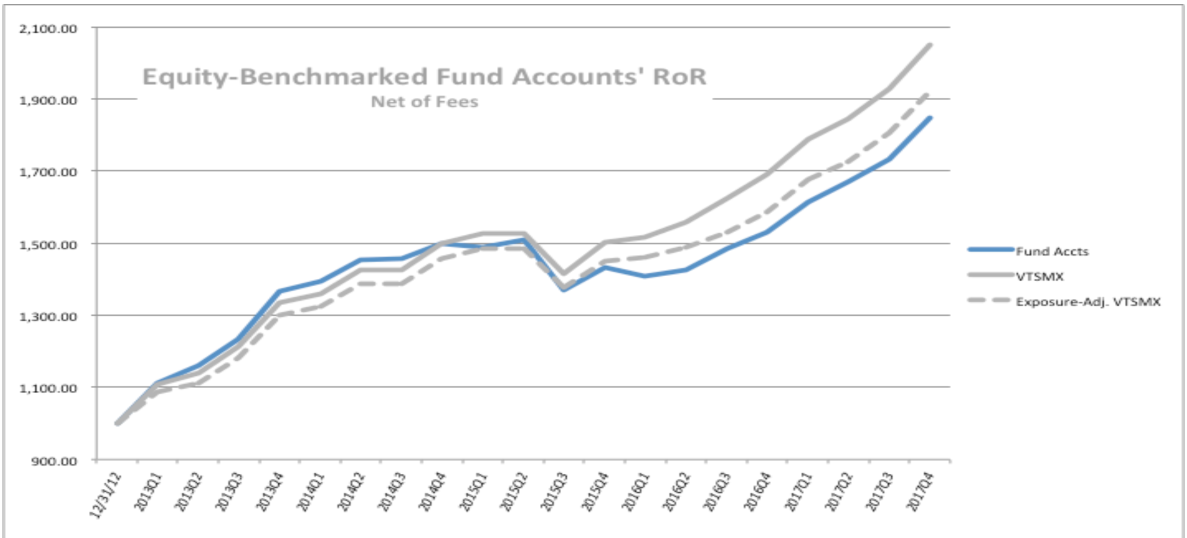
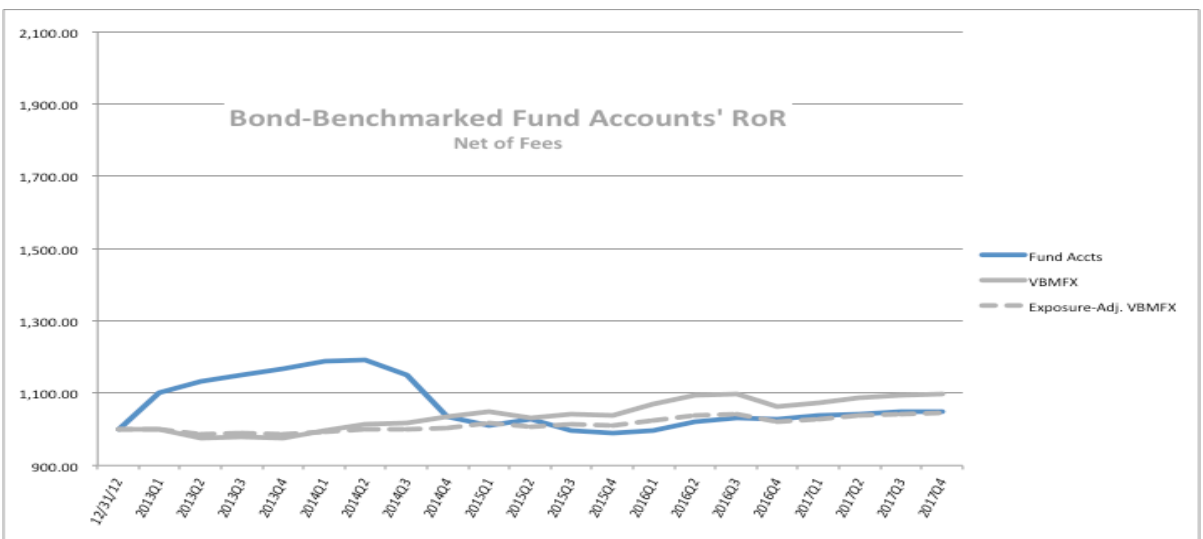
[2] A critical additional point is that the average hedge fund has much more gross leverage, and thus more risk, than Janian. We have produced better relative risk-adjusted results than shown here. A second important point is that our tax costs have been lower than the average hedge fund's.

Funds – Equities



This strategy, which aims to match the stock market over time, performed as intended in 2017[3].

Funds – Bonds



This strategy, which aims to match or beat the bond market over time, matched it in 2017[4].

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[3] Over the last five years It trails the stock market by ~10%, because it did not invest in growth funds in 2015 and cautiously held too much cash in 2016.

[4] Over the last five years it trails the bond market by ~4%, as it slowly claws back from a relatively weak 2014-2015.

FIVE-YEAR INVESTMENT REVIEW

Janian is focused on the long term for each and every one of our clients. Five years is, then, a reasonably long amount of time over which to review our results. The keys facts as we see them[5]:

- **<u>Long stock selection has been solid</u>**
  The return on capital invested long in stocks over the last five years has, after our management fee, approximately matched that of the stock market. We've overcome the slight headwind against valuation-sensitive investors like us[6].

- **<u>Short stock selection has been successful</u>**
  The Hedged Securities' outperformance versus the average hedge fund has been due to the shorts' impact[7].

- **<u>After-tax results have been attractive</u>**
  After-tax results in Hedged Securities have been higher than pre-tax results in three of five years if we make our usual assumptions. Taxes incurred have been relatively low in our other strategies too.

- **<u>Funds – Equity has been solid</u>**
  We've been too cautious, but have still done fine.

- **<u>Funds – Income has been solid</u>**

- **<u>Risk management has been consistent</u>**
  It's been five years of a bull market, so our loss avoidance tools have not had a chance to shine. None the less, we have not wavered in our commitment to managing risk and attempting to generate attractive <u>risk-adjusted</u> returns.

JANIAN RUMINATIONS

Risk management is not just numbers and calculations. Among other things, it's also identifying background issues and how they shape the investment risks that we face. We'd like to share our thinking about three background issues in order to help illuminate our current thinking about managing investment risk.

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[5] Please call us if you'd like to see the data that supports the statements in this section.

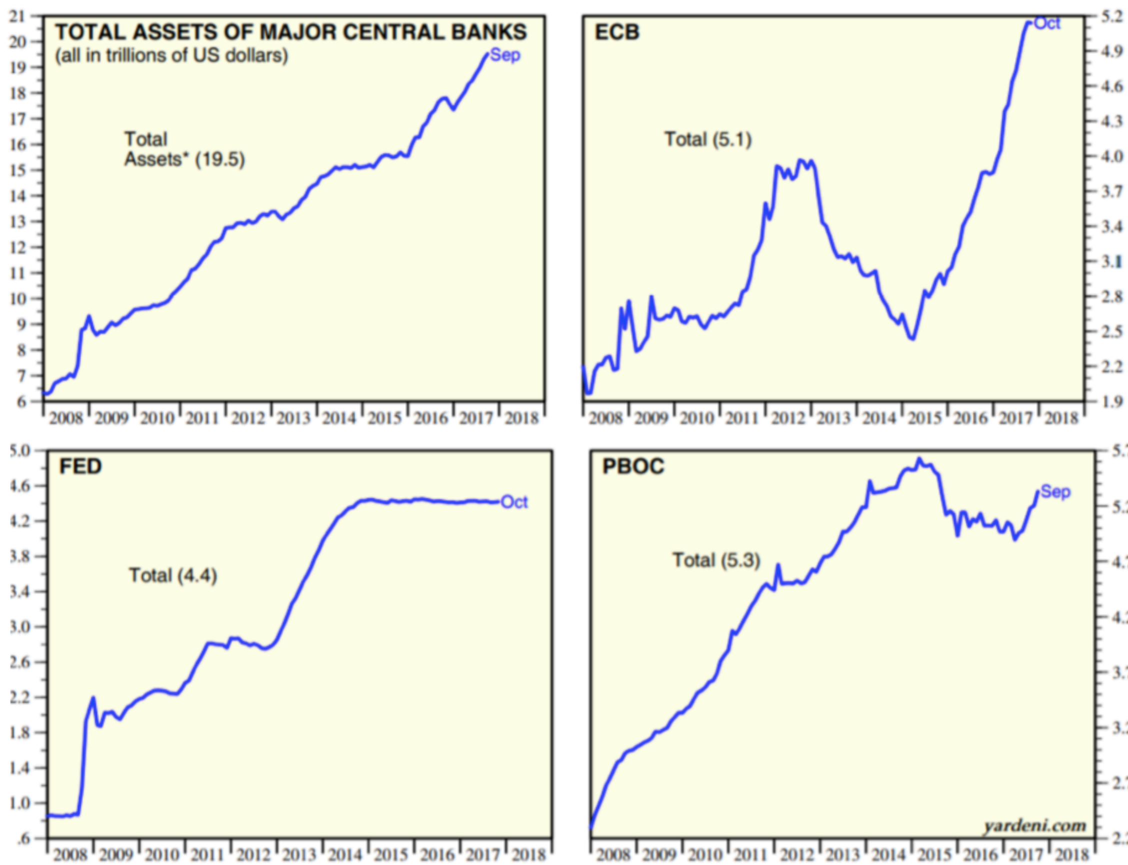
[6] The Vanguard Growth ETF outperformed the Vanguard Value ETF by 3% 2013-2017.

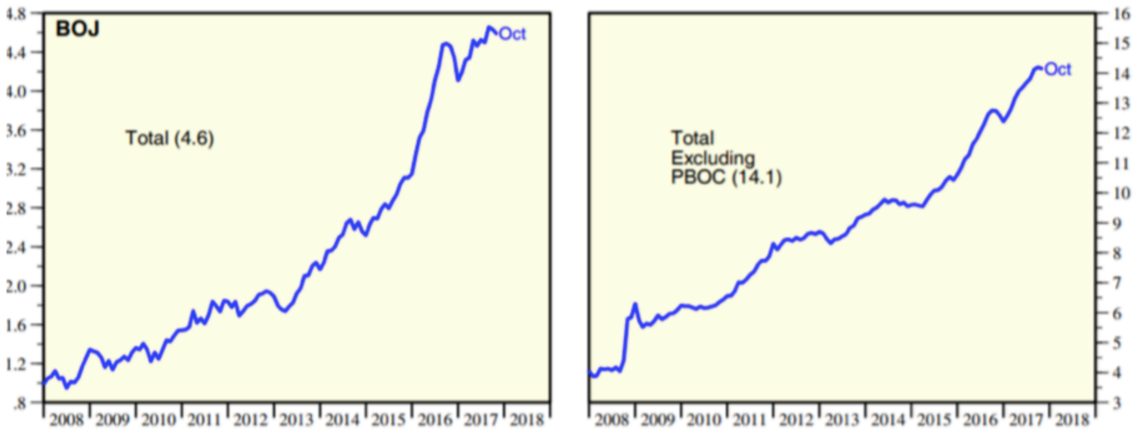
[7] In my fifteen years in the hedge fund industry, I learned that most hedged investors are not successful short-sellers; Janian's short-selling has been a source of relative strength.

Central Banks

We believe that the impact of the European, Japanese, and Chinese central banks on 2017's investment environment has not been widely discussed in the U.S. However, our friend Robert L. Burch IV of A.W. Jones Advisors did discuss this:

> As has been the case since the Great Financial Crisis, monetary policy has been a major driver of the investing environment. After an 8-year period when the world's major central banks were in either an easing or neutral mode, the environment began to shift two years ago. At the end of 2015, the US Federal Reserve implemented the first quarter-point interest rate hike, ending its zero-interest rate policy, having phased out quantitative easing (QE) a year earlier. This hike marked the Fed's shift to a tightening monetary policy, and also meant that the Fed was the first major bank to tighten in this cycle. The rest of the world's major central banks have not only not raised rates, they have continued printing money – in particular, the European Central Bank (ECB) and Bank of Japan (BOJ) have continued easing on a large scale, and they were joined in 2017 with a resumption of QE from the People's Bank of China (PBOC).
>
> The result is that Yardeni Research now puts the balance sheet of the PBOC at $5.3 trillion, the ECB at $5.2 trillion, the BOJ at $4.6 trillion and, the Fed trailing the pack at $4.4 trillion. Given the Fed's balance sheet combined with its interest rate increases over the last two years, it is understandable why many US investors think that the monetary environment is tightening. In fact, we are on track this year for the largest amount of global QE since the financial crisis, as the Yardeni Research charts show below.





We think it's possible that money created by Europe, Japan and China[8] helped fuel the stock market's 2017 rise. Such a fuel boost would probably not be concerned with the particulars of any given security's valuation, and could instead be distortive to discovering the 'fundamental' price of any given asset. If central banks decrease the amount of money creation in 2018, perhaps individual security selection will become more meaningful.

The Tax Cuts and Jobs Act of 2017

The U.S. Department of Commerce's Bureau of Economic Analysis ("BEA") says that U.S. Gross Domestic Product ("GDP") is $19.739 Trillion[9]. It also says that the U.S. Federal Government has annual receipts of $1.617 Trillion from "Personal current taxes" (8.2% of GDP) and $0.408 Trillion from "Taxes on corporate income" (2.1% of GDP)[10].

The Executive Office of the President of the U.S.' Office of Management and Budget ("OMB") says that the Tax Cuts and Jobs Act ("TCA") "provides $5.5 Trillion in tax cuts" and "will raise $4 Trillion … by closing the door on dozens of corporate accounting tricks[11]."

Let's ignore the timing of the above (and any fill-the-gap-borrowing-costs that such timing might entail) and assume that it all settles to a static point. Let's also assume that OMB used a ten-year horizon in calculating the $5.5 & $4 Trillion numbers. Then, let's assume that OMB engaged in some political spin by overestimating the number of corporate accounting tricks that will have doors shut on them, and we'll haircut the $4 Trillion raised to $3 Trillion. Thus, our assumptions imply that all else being held constant, the TCA increases the U.S. Federal budget deficit by $2.50 Trillion / 10 = $250 Billion per year (1.3% of GDP) and will lower the all-in "Personal current taxes" and "corporate income"

[8] We think that https://mises.org/wire/why-we-should-worry-about-china is an interesting viewpoint about Chinese debt.

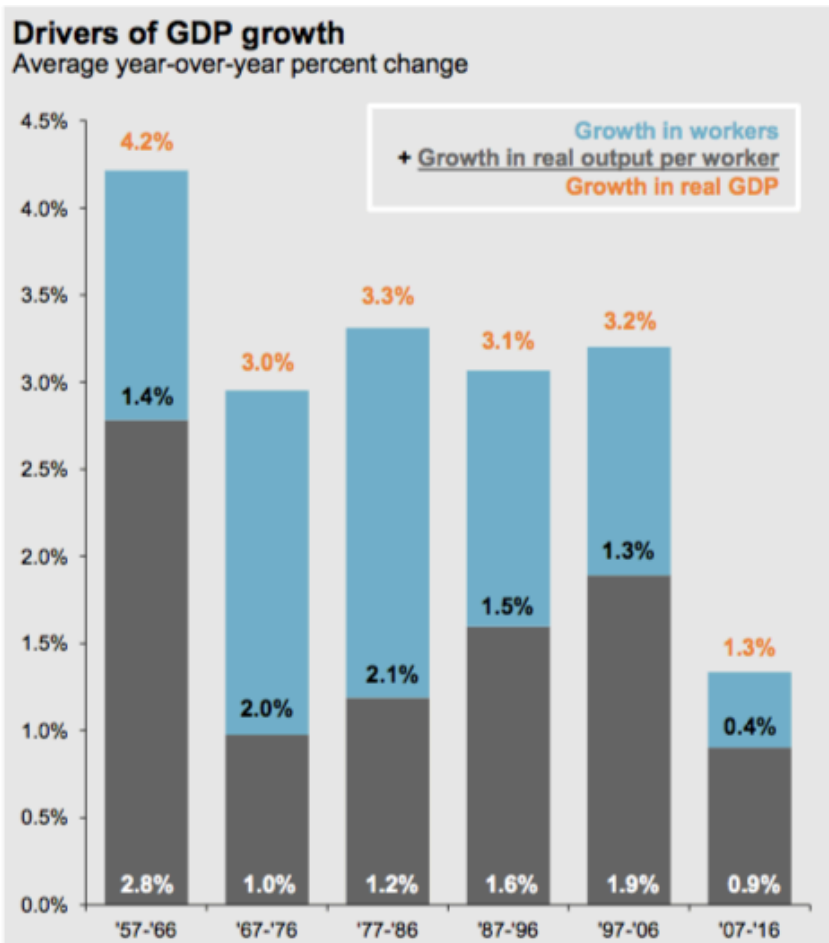
[9] https://bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=3&isuri=1&1921=survey&1903=5

[10] https://bea.gov/iTable/iTable.cfm?reqid=19&step=2#reqid=19&step=3&isuri=1&1921=survey&1903=87

[11] https://www.whitehouse.gov/articles/tax-cuts-making-america-great/

rate from 10.3% to 9.0% of held-constant GDP (i.e., a tax cut of ~13% of income tax receipts system-wide).

Then, holding all else constant (which is to say people and corporations produce just as much domestic product EXCEPT for the impact of the TCA), for the TCA to be break-even to our collective net worth (and, after all the U.S. Federal Government represents US[12]), annual GDP has to grow by $250 Billion / 9.0% = $2.778 Trillion, or ~14% in size[13]. The U.S. Department of Labor's Bureau of Labor Statistics preliminarily says that as of December 2017 there were 146 Million private sector workers in the U.S.[14], so that means that GDP per current number of private sector workers would rise by $19,027 – at a time when the structural drivers to GDP growth have been weakening for a while[15]:



12 Although we have our ambitions otherwise, at present all Janian clients are U.S. citizens.

13 According to BEA, GDP grew ~2.8% per year from the early '70s to 2007, and has grown ~2.2% since 2009. Adding 14% HOLDING ALL ELSE EQUAL will not be easy, and if it happens is likely to take a long time to unfold.

14 https://www.bls.gov/cps/cpsaat18b.pdf

15 Thanks to J.P. Morgan Asset Management for the chart.

There's one more element to the income part of the picture. The U.S. Federal Government had, according to BEA, 2016 Total Receipts less Contributions for government social insurance of $2.335 Trillion[16] and Total Expenditures of $4.394 Trillion, i.e. it ran a $2.059 Trillion deficit (10.4% of GDP).

Turning to the balance sheet side of the story, according to the U.S. Department of the Treasury the Total Public Debt Outstanding of the United States as of January 2018 was $20.494 Trillion[17].

Whoa!

$20 bleeping Trillion. 104% of GDP.

The stock market has, so far, not cared. Not in the slightest[18]. To the contrary, it celebrated the TCA. Which is quite rational[19] in the short term. And the stock market as a whole, despite claims to the contrary from some practitioners (such as Janian) that some specific members act differently, barely cares about anything other than the short term.

The stock market's celebration is, at least in part, based on recent positive economic data. Capital equipment purchases have already risen in the U.S., and average small business confidence is at all-times[20, 21]. Animal spirits are clearly high[22]. But will the TCA eventually lead to a >14% bigger GDP (all else being held equal)? The simple assumptions above – which probably miss some pieces of the puzzle – lead us to believe that if it doesn't, the long-term health of the collective U.S. economy (which supposedly the stock market as a whole is somewhat reflective of) will be worse off[23].

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16 Personal & corporate taxes are the bulk, but not the totality, of receipts. See Footnote 6 for the data source.

17 https://treasurydirect.gov/govt/reports/pd/mspd/2018/opds012018.pdf

18 Janian Year-End Letters discussing the national debt: 4/5. Quarters since Janian's inception where the stock market was down: 1/20.

19 Implied in the assumptions above is that U.S. corporations' profits from domestic operations will go up after-tax.

20 https://www.nfib.com/surveys/small-business-economic-trends/

21 Not ALL small businesses' confidence. See https://techcrunch.com/2017/11/30/theres-an-implosion-of-early-stage-vc-funding-and-no-ones-talking-about-it/ for another take.

22 The fundamental justification argument: lower taxes will led to greater business investment, fueled in part by repatriated cash formerly held outside the U.S.; greater investment will give more tools to the workforce, leading to higher productivity; higher productivity will lead to greater profits, leading to more confidence and capital flows into the U.S. from foreigners; and so a virtuous cycle will be kicked off.

23 https://www.thecapitalideas.com/articles/tax-reform-6-key-takeaways and https://www.newyorkfed.org/newsevents/speeches/2018/dud180111 give a sense of consensus expectations about the size and direction of the TCA's impact on GDP.

As we have said before in earlier Year-End Letters, Janian believes that there is a possibility of a disruptive re-set in the market's concern about U.S. debt, and we further believe that the TCA has increased the chances of that possibility occurring[24].

Crypto-Currency Mania

Every bull stampede has at least one kooky popular mania[25]. We're lookin' at you, crypto.

We think that this mania has been, in part, fed by the two topics discussed above. The place of the powerful idea of blockchain in the innovators : imitators : idiots construct probably has been important as well.

To date, we have gotten one client inquiry if we can help get exposure to a crypto currency[26]. In the interest of saving the rest of our clients' future time: No.

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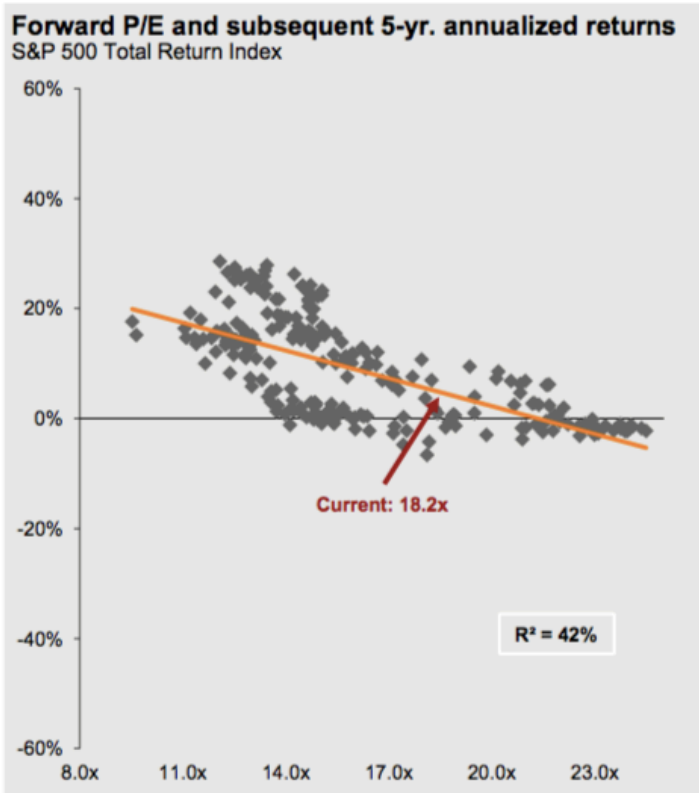
[24] For those of you who learn best through cartoons, https://www.youtube.com/watch?v=xnYZwxzxd9Y presents a different framework that gets to a similar suggestion.

[25] Were the '90s truly more sweet than the 'teens? https://nypost.com/2015/02/22/how-the-beanie-baby-craze-was-concocted-then-crashed/

[26] For those of us who think that *People*'s got nothing on *The Wall Street Journal*, the best Bitcoin dish so far is at https://www.marketpsych.com/newsletter/68/bitcoin-cryptocurrency-and-the-greatest.

Looking forward, we are as of today in the midst of a resumed market melt-up. We don't know how long it will last, or what will happen when it ends. History suggests that stocks' returns over the next five years will be low[27].



However, we acknowledged that there's no guarantee that that happens[28].

Meanwhile, we are largely or fully invested but mindful of where the exit is in all of our strategies, and we continue to have a meaningful hedge in our Hedged Securities strategy.

This positioning and ability to act on it is, of course, at the heart of Janian's differentiation and value to our clients: we combine sophisticated risk-controlled security selection with individualized total portfolio construction and financial planning. Most investment advisors focused on individuals don't have the experience or tools that we do to manage risk, and appear to Janian to struggle to incorporate risk management into their overall portfolio or planning advice. Plus, we are tax-conscious, priced below our competitors, and built for retention not sales. We're proud of what we've done for our clients the last five years, and very excited about what we can do in the next five – and beyond!

[27] Thanks to J.P. Morgan Asset Management for the chart.

[28] Careful readers no doubt remember that we included a similar chart and made a similar point in the 2013 Year-End Letter … and the Vanguard Total Stock Market Index Fund was up 54% four years later.

Sincerely,

James W. Hague

James W. Hague
Founder
Janian Investment Advisors, LLC

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