February 4, 2020

Dear Clients and Friends:

2019 INVESTMENT REVIEW

STRATEGY	2019 Rate of Return*	Comparable Index Return
Unhedged Securities (Taxable)	28.8%	30.8%
Unhedged Securities After Tax (Estimated)	*28.3%*	
Fund Selection - Equity Benchmarked	27.6%	30.8%
Hedged Securities (Taxable)	20.8%	10.7%
Hedged Securities After Tax (Estimated)	*19.7%*	
Fund Selection - Bond Benchmarked	8.1%	8.8%

* Average Client Account, Net of Fees[1]

The stock market had a great year. So did Janian's strategies.

Your account, which employs strategies X & Y, returned Z%. Tables displaying your account's composition of returns for the 4th quarter, track record since inception, and non-cash exposure at year-end are attached after the Appendix.

We'll briefly discuss each particular strategy's 2019 on the next few pages.

[1] Please contact us if you'd like an explanation of how we calculate these returns.

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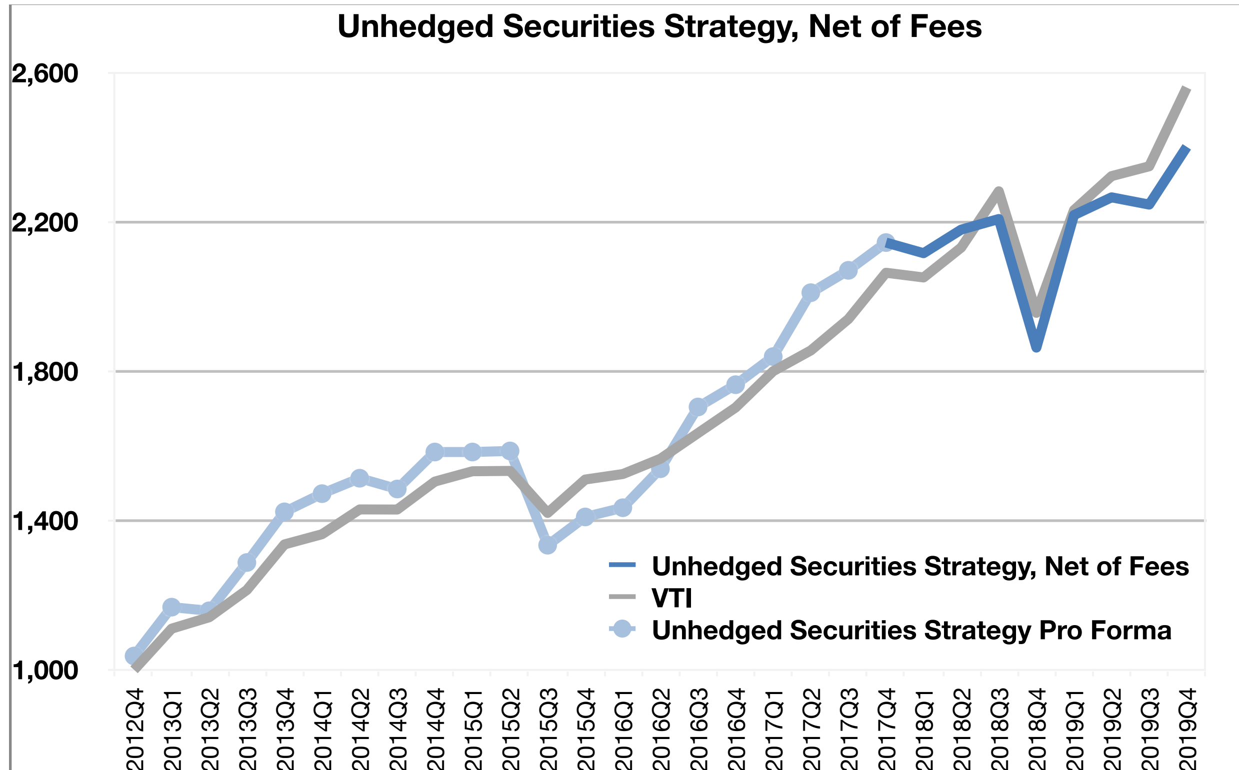
Unhedged Securities



	% Change	
	Unhedged Securities Strategy, Net of Fees	**VTI**
2013	37.12	33.49
2014	11.24	12.57
2015	(10.96)	0.36
2016	25.08	12.74
2017	21.54	21.17
2018	(13.10)	(5.20)
2019	28.81	30.80
Annualized	14.43	15.56

The Unhedged Securities strategy[2] matched the stock market.

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[2] The Pro Forma results are calculated as the actual gross Return on Invested Capital of the long portfolio of the Hedged Securities strategy, adjusted for a 1% Management Fee, for October 2012 - December 2017. VTI = Vanguard Total Stock Market ETF.

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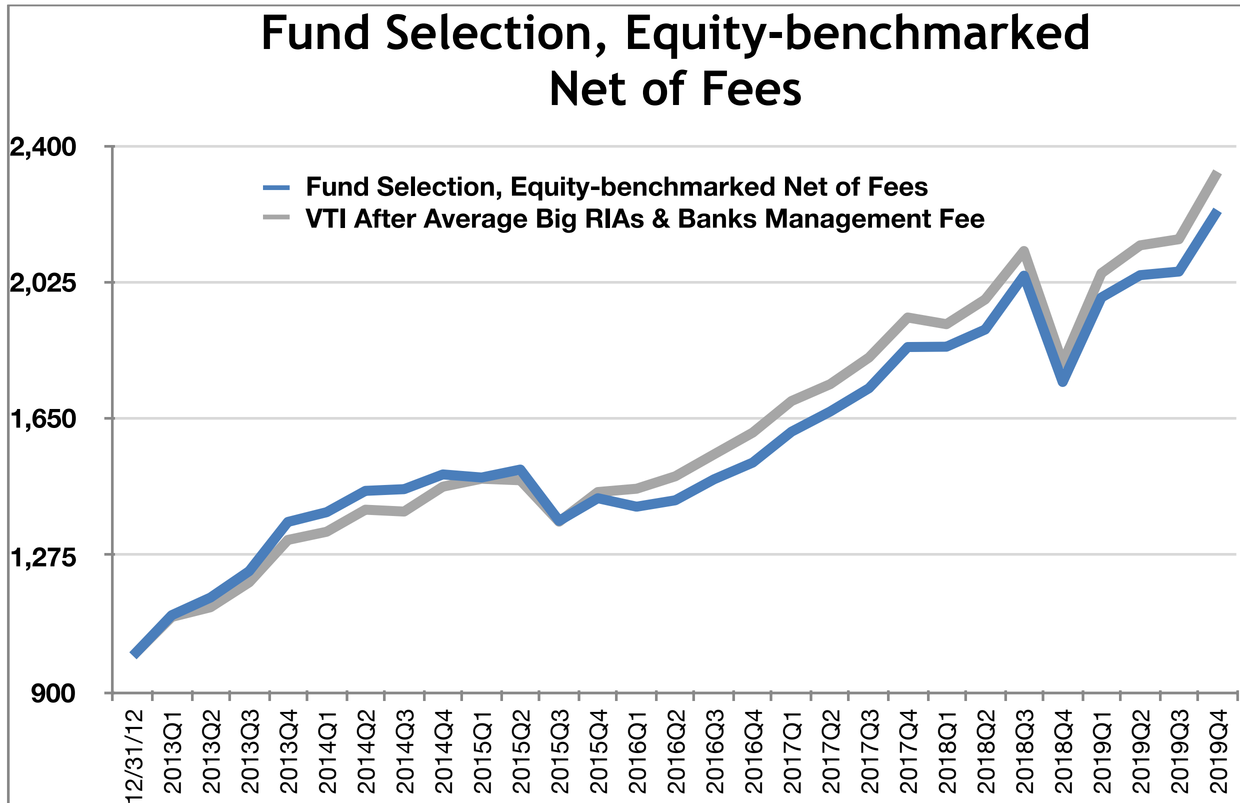
The positions held by the taxable Unhedged Securities strategy continue to match those held in the long portfolio of the taxable Hedged Securities strategy, which currently is long 17 stocks, plus (often) an index to more fully invest this strategy. One of the positions, Innophos, is subject to a signed leveraged buyout and will leave the portfolio early this year at a high-teens long-term annualized return.

Given the long bull market and the high valuations touched on below, bargains in stocks are hard to find. Some of our positions have exceeded our estimates of fair value, although for the most part we have continued to let the winners run. We do so while keeping a close eye on trailing price stops[3], i.e. are constantly trying to stand near the exit door in case the party turns sour. Even with this cautious stance, we have continued to have some success finding longs, and we still build new long positions from time to time.

Funds – Equities



This strategy, which aims to match the stock market over time, performed as intended in 2019.

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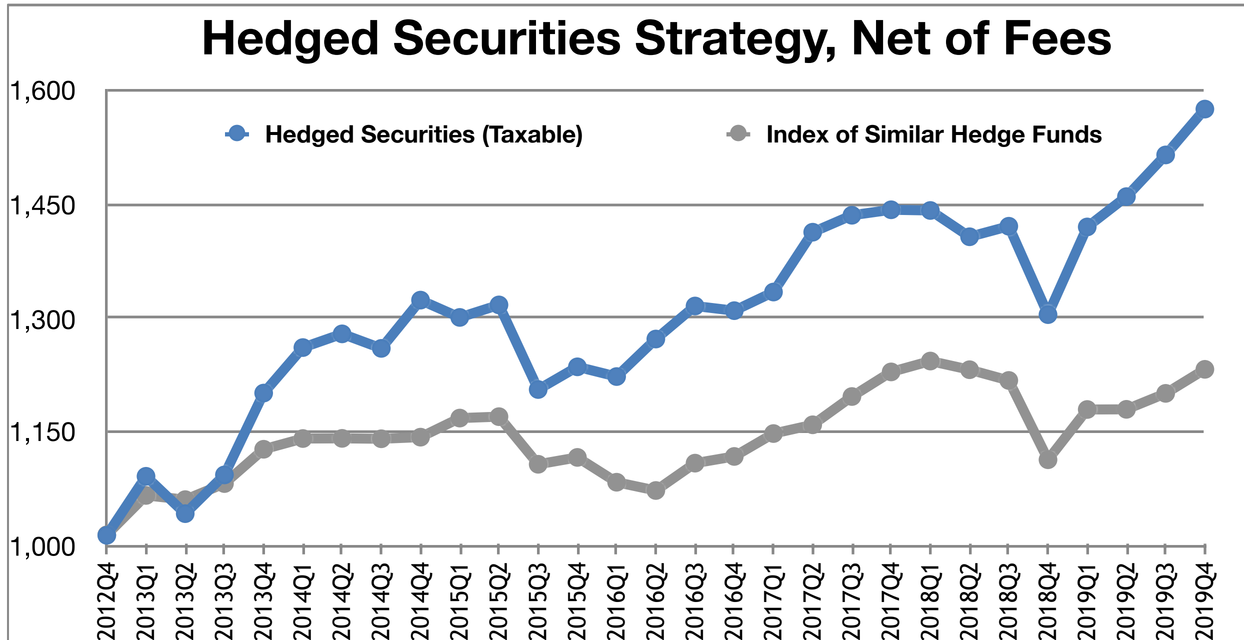
[3] In the taxable Hedged Securities strategy we are also increasingly setting up 'option boxes' around some of the long positions. Please call if you'd like a more detailed explanation of this.

Hedged Securities



Over the last seven years we have delivered higher returns in taxable accounts than the average similar strategy[4]. The returns in non-taxable accounts have been very slightly lower than the taxable accounts'.

For the year, longs contributed ~+23%, which is a 33% return on average quarter-end gross long exposure of 70%. Nine long positions contributed >1%; there were zero losers that cost >1%. Turnover was low.

Shorts cost ~-2%, which is a -6% return on average quarter-end gross short exposure of 31%. We're very pleased with this result, given that a short of the stock market would have returned -31% on the exposure. Our short basket of cannabis-related stocks was the biggest contributor at +3%. We covered this basket entirely in 2019. We even made money on our Tesla short, despite the huge rally in the stock (which is ongoing) in the second half of the year. We currently have no position in it. We did lose -1.0% in a short of Tactile Systems stock (which we covered), and -1.3% in an index hedge.

The Hedged Securities portfolio is currently long ~57% of capital. Barring an obvious arrival of a bear market, we expect to increase the % of capital invested in longs during 2020.

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[4] 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.

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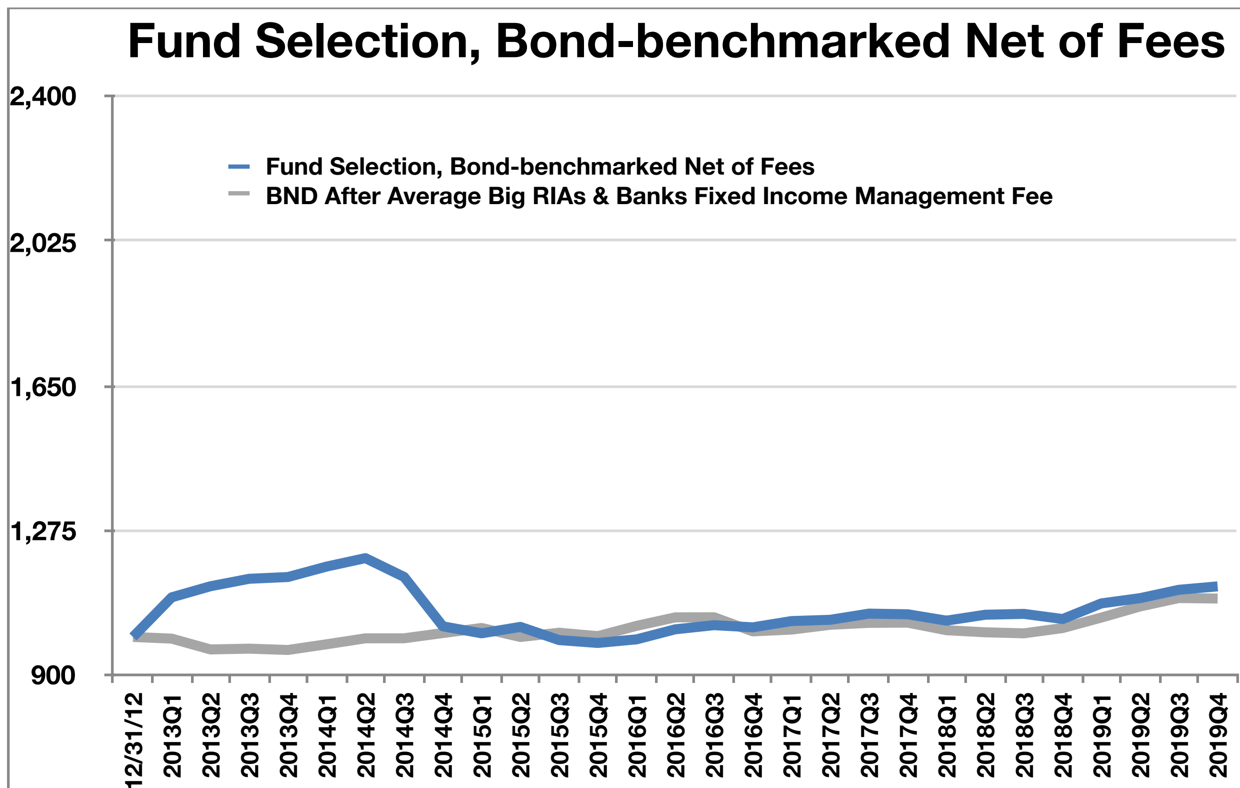
The non-U.S. portion of the taxable Hedged Securities long portfolio currently includes four companies representing ~8% of capital. We are in the process of increasing three of these positions. Two of these positions do not have ADRs and so do not appear in non-taxable accounts; the net long exposure of the pertinent Hedged Securities accounts remains roughly the same as the taxable accounts', though, by accordingly adjusting the size of the index hedge used in the non-taxable accounts.

The taxable accounts' short portfolio currently has 31 positions with ~37% of capital. It's a diverse set of underlying companies, ranging from a small N.Y.-based food packager to a large provider of television equipment. The long-running bull market continues to grind down valuation discipline among investors, and the number of stocks trading at irrational prices held aloft by storytelling continues to grow. As we understand that they say at Mavericks: dude, there is some crazy stuff out there. We expect to keep the % of capital invested in shorts such that the Hedged Securities' net exposure remains relatively low.

Funds – Bonds



This strategy[5], which aims to match or beat the bond market over time, performed as intended in 2019.

[5] BND = Vanguard Total Bond Market ETF.

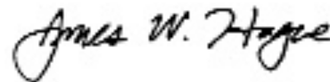
JANIAN UPDATES

A housekeeping note: we have changed the reporting benchmark for our equity-focused strategies from the Vanguard Total Stock Market Index Fund ("VTSMX") to the Vanguard Total Stock Market ETF ("VTI"), and for our bond-focused strategy from the Vanguard Total Bond Market Index Fund ("VBMFX") to the Vanguard Total Bond Market ETF ("BND"). Since the respective funds and ETFs are invested essentially identically but the fees for the ETFS are lower, this has the effect of raising the benchmarks' return. We also changed the strategy-comparable reporting benchmark for our Hedged Securities strategy from a hedge fund index that is uninvestable (meaning no one has actually ever gotten those returns) to one that is investable (meaning you can easily fire Janian and hire it instead). The investable index's return has been lower than the uninvestable's during Janian's existence.

We have been working on strengthening our already excellent financial planning processes. As we described in several earlier Letters, planning is a very important part of our service, and we're proud of the quality of what we deliver to our clients. Ask us about it.

Best wishes for a happy and healthy 2020 to you and your family.

Sincerely,



James W. Hague
Founder
Janian Investment Advisers, LLC

APPENDIX

Janian's Macroeconomic Outlook

The Federal Reserve ("the Fed") cut interest rates three times last year and expanded its balance sheet at the fastest pace since the Financial Crisis. This liquidity injection, along with the prospect of the Phase 1 trade agreement with China, fueled last year's stock market boom. Corporate profit growth was very anemic and provided little help. The Fed has taken a very dovish[6] stance and indicated that interest rate increases, which would eventually be negative for equities, are currently off the table.

With the 2020 election less than 10 months away, U.S. politics will be a mainstay in the news this year, and how the polling data trends will impact financial markets' returns. President Trump will do what he can this year to keep the economy growing, which would then give him a better chance at re-election. The Fed traditionally holds interest rates steady in an election year. Economists' consensus is for the U.S. economy to grow slightly less than the slightly-lower-than-historical-average level of 2019[7].

Current levels in credit markets, current sentiment[8], valuations, the election cycle, and other factors in aggregate suggest positive but below average returns for U.S. equities in 2020. To be more positive investors should need to see more rapid corporate profit growth, even lower interest rates, more election certainty, or a Phase 2 trade deal with China. We have to keep in mind that we are in the eleventh year of an economic expansion, the longest recorded in U.S. history[9], and that U.S. unemployment is at 3.5%, which is a very low level. There remains a possibility of a recession, though the odds of that were lowered by the Fed's current stance on interest rates. Importantly, equity valuations are now at the high end of their traditional range and forward returns from this valuation point in the past have usually been low[10].

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[6] Some economists would not use the word "dovish:"
https://review.chicagobooth.edu/economics/2019/article/fed-can-t-fight-trade-war?source=ic-em-20200128&mkt_tok=eyJpIjoiTkdWaFpEWXpaVGMyTkRSaiIsInQiOiJ3NDlBRFlRRGtaNXJBbWhBR2htOEVqQjU2RVF0UXJySVdaMHo1YTJqRVNCUkpaRGpXbGgzeHdWNW5qZnYzMzZOVEc3TGl2N3c3NTRzQVFVcDFzXC80aFE5ZFI3Q3IyTkZaaktOWjBuNWVja3d2b0VCUU9nV0JRbitHMFZkV2I1MmoifQ%3D%3D

[7] https://www.chicagofed.org/publications/chicago-fed-letter/2020/429

[8] For example, https://www.conference-board.org/us/ has several sentiment-related data sets that indicate this.

[9] https://www.nber.org/cycles/cyclesmain.html

[10] https://am.jpmorgan.com/blob-gim/1383407651970/83456/MI-GTM_1Q20.pdf

Quantitative Investing

We wrote in our 2016 Letter about “an admittedly cloudy concern regarding the increasing prominence of quantitative investing” and cast Citadel[11] as a villain[12], illustrating with a fine that the SEC assessed against Citadel’s market-making business. We’d like to walk that characterization back a bit. In December 2019 Bloomberg published an article[13] suggesting that the large profits (“$2.2 billion of” EBITDA in 2018) generated in this business are in part a result of offering a better deal[14] for other investors. We believe that this is, at least in some sense, true. Relative to the value that they received, other investors were wildly overpaying for liquidity before Citadel; now, the wildness of that overpayment has probably been somewhat reduced.

A quick aside: Janian takes pains to access liquidity in a manner that does not force us to pay Citadel, or any other liquidity provider, what we consider to be exorbitant or poorly disclosed rates.

As to our larger concern that quantitative investing might be an “eventual disaster:” we believe that our understanding of quantitative investing’s impact upon financial markets has deepened since 2016. Although we continue to believe that these investment tools may strengthen or accelerate the eventual turn to a bear market, this “cloudy” concern is currently not impacting the execution of Janian’s investment strategies[15].

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[11] https://www.citadel.com.

[12] It appears that the powers that be would disagree with this casting: https://www.chicagotribune.com/politics/ct-trump-calls-out-ken-griffin-20200116-irdz2xo2jffwrli5wlxrkedc4e-story.html?utm_source=dlvr.it&utm_medium=twitter. Some follow-up is at https://www.chicagobusiness.com/finance-banking/citadel-securities-agrees-97-million-settlement-china?utm_source=morning-10&utm_medium=email&utm_campaign=20200121&utm_content=article9-readmore.

[13] https://www.bloomberg.com/news/articles/2019-12-11/ken-griffin-has-another-money-machine-to-rival-his-hedge-fund

[14] From the article: “Griffin [the CEO and ~75% owner of Citadel] hasn’t shown much sympathy for the competition’s woes. “The disruptive innovation that has taken place within the equities market has created winners and losers,” he said in written testimony for a 2014 hearing of the Senate Banking Committee. It shouldn’t be a surprise that legacy participants “publicly yearn for the old days when they extracted disproportionate rents from investors on the basis of anti-competitive business practices,” Griffin added. The regulatory overhaul that followed the financial crisis created a more level playing field, said Ahmed, the Citadel spokesman. “This transformation of the markets has resulted in more liquidity, better pricing and lower transaction costs for end investors,” he said.”

[15] That said, https://www.bloomberg.com/news/features/2020-01-09/the-hidden-dangers-of-the-great-index-fund-takeover raises a different sort of concern: how index funds may abet wealth disparity and declining social mobility in the U.S.

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The Tax Cuts and Jobs Act of 2017

In our 2017 Letter we wrote about our skepticism that this will work out to be a net positive for the overall U.S. In our 2018 Letter we couldn't resist two follow-ups. This year, *The Wall Street Journal* asked "Did the U.S. Tax Overhaul Do What It Promised?[16]" and answered "The bottom line: It seems clear the tax cuts contributed to economic growth—but not enough to pay for themselves, as many backers promised."

As we wrote in 2017: "The stock market has, so far, not cared. Not in the slightest."

We are clearly hanging out at the weird kids' lunch table, where Cassandra and Peter sit. Still, we don't get it. We believe that the effort that will eventually be necessary to fix this mess will cost investors dearly, and that that cost compounds on itself ever more rapidly. How can it be that the stock market doesn't care in the slightest about that? Surely it should price in some chance of that happening. If any of our diligent readers can help educate us, please call.

The SECURE Act

This important change to the U.S. financial planning landscape got signed into law recently. Below are the key items that you should be aware of:

1. Required Minimum Distribution starting age changes from 70 ½ to 72.

   What does this mean for you?

   Before the law change, you were required to take distributions from your IRAs in the year that you turned 70 ½. Under the new law, some people will have an extra year and others will have an extra two years before they are forced to make withdrawals. This only applies to those who turn 70 ½ in 2020 or later.

   Why is this important?

   When you take distributions from your retirement accounts, you must pay federal and possibly state income tax (although retirement plan distributions are exempt from state income tax in Illinois and several other states). With tax deferral pushed out another 18 months, the value of your IRA accounts will rise, all else being equal, which adds to the impetus to (1) stuff them with as much money as possible, and (2) delay withdrawals for as long as possible.

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[16] https://www.wsj.com/articles/did-the-u-s-tax-overhaul-do-what-it-promised-11578114001?mod=mw_quote_news. It's now behind a paywall. A more antagonistic take is at https://www.newyorker.com/news/our-columnists/new-reports-show-that-trumps-economic-promises-were-empty.

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2. The age cap on traditional IRA contributions was eliminated.

What does this mean for you?

Before the law change, you could not make contributions to a traditional IRA in any year you in which you turned 70 ½ or older by the end of the year. Now, there is no age limit.

Why is this important?

If you are still working, you may be able to get a tax deduction for making an IRA contribution past the age of 70 ½. Plus, you can defer more taxes for longer (see 1. above).

3. Inherited IRA withdrawal requirements have changed significantly.

What does this mean for you?

If you inherited money in 2020 or later, you will no longer be able to withdraw the money over your projected lifespan. Under the new law, most beneficiaries will be required to take the money out of the inherited IRA within 10 years. This only applies to non-spousal beneficiaries.

Why is this important?

This accelerates the payment of tax upon inheriting an IRA from anyone other than your spouse All else being equal, the lifetime value of your mom's IRA that she will bequeath to you has now dropped for you.

Here's an article that describes these changes and several others in more detail:

https://www.wipfli.com/insights/articles/hcm-secure-act-becomes-law-retirement-savings

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