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of Compounding  
Across Full Cycles*

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## listening in

# Participate And Protect

*Stralem's Long-Standing, "Simple" Formula For Beating The Market*

*Let me be straight about it. Adam Abelson, the CIO of private institutional and wealth manager Stralem & Co., a Wall Street fixture for over 50 years, had a leg up in getting my attention, simply by virtue of his last name. But Adam, who graciously sat for this week's WOWS investment interview, was also quite up front. He is not some long-lost relative of my famous mentor, Alan Abelson. Indeed, even though his father, Stralem's chairman is one of Alan's contemporaries in the relatively small world of Wall Street, they evidently never even met.*

*So I got to make the discovery of Stralem's participation with protection approach to growth investing, and its long-term record of compounding market gains while avoiding the worst draw-downs of bear markets, through reliance on an investment strategy the firm traces back to before the really great financial crisis — the one that started in 1929.*

*With the current market environment giving off vibes*



Adam Abelson

*that feel increasingly end-of-cycle, Adam's pragmatic investment approach seems particularly germane. Listen in.*  
KMW

**Welcome, Adam. I imagine you're as**

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**transfixed as most everybody is lately, by the sudden return of volatility to the markets, threats of trade wars and such.**

**ADAM ABELSON:** I'm actually enjoying it, partly just because it comes on the tail end of so many years of sameness and a lack of originality. So it's interesting to see complacency get shaken up again. If you think back to late-1999 or mid-2007, it was the same type of complacency. I just feel like we're there.

**That's ominous. Yet when I've brought up complacency lately, I've gotten a lot of push back.**

Well, bull cases are more appealing, right?

**By definition, sure.**

Yes. Today, I suspect it's less about the sheer appeal of the bull argument about how good times are than it is the fact that the institutional memory of what I'd characterize as just the normal ebb and flow of volatility seems to have been lost — until quite recently. Investors seemed to have forgotten about what "reversion to the mean" entails. What percentage of the time do markets go up, what percentage of the time do they go down?

**What, it's not a one-way up ramp? I'm so old I have to keep reminding myself that few investors remember the bear markets of the 1970s — or even 1987.**

Oh, absolutely. It's very hard to compare periods — particularly this period to the late-1970s' inflation but —

**There were a bunch of bears in that decade. But we've had the mirror image "runaway inflation" more recently.**

I was just writing my quarterly letter to clients and mentioning that it's probably one of the two top questions I get — "where for art thou inflation?" But it's everywhere other than in the things that they measure, of course.

**So be careful what you wish for.**

Exactly. That opens a whole other can of worms that I don't think anyone would really like to have to manage through right now.

**No, they wouldn't. My friend Louise Yamada has been writing about "inflation in all the wrong places" for quite a while. But the official numbers have stayed incredibly low.**

I think that has bred some of the complacency and confusion. You are convinced that what you're being told by the Fed about inflation in general isn't matching up with the actual hard data that you're experiencing. I think also that's where erosion of confidence begins to a certain degree. Either that, or you're just absolutely comfortable with that mismatch between declarations about economic strength and not seeing the actual data reflecting that.

**The times we're living in seem to get more interesting by the day — for good or ill. But that actually plays to your strength at Stralem,**

**doesn't it?**

Yes, in that our strategy feeds off of that normal ebb and flow in the markets that complacent investors seemed to have forgotten about until recently.

**Cycles? That sounds almost quaint.**

This has certainly been an interesting period of time in the markets, if you think about the characteristics of active money managers, right? You need stock picking —

**But it's passé.**

Well, the massive flow into passive has certainly been a game changer for active management in the last almost decade now — and the only question is does that abate? Does stock picking come back? Do you get rewarded for all the hard work that your top-down and bottom-up processes involve? Will the out-

***"We have been asking this question for over a year now but of late it's certainly gotten — just say it now has a little bit more resonance. It's a very simple question: Do you think, in terms of investing, that the next five years will be like the last five?"***

put of all that work — are you going to get rewarded for it in the market? In the last bunch of years, the answer has been no — in the relative sense.

**Implying, however, that it remains rewarding in the absolute?**

Yes. The irony of our business is that we are measured against benchmark constructs. So suddenly doing 15%, 16%, 17% — whatever your compounded return is over the last couple years — gets lost — that extraordinary return gets lost because in comparison with that benchmark it might be trailing by 150 or 200 basis points — and that's an interesting conundrum.

**True, though you can't actually invest in an index — despite the plethora of products pitched as tracking them. Slippage is inevitable.**

There is that. Then too, just look what happened in February, when an esoteric — relatively small, at the margin — volatility product had that outsized deleterious effect on the indexes. I mean, nine-and-a-half out of 10 people have no access to that product to begin with, right? It's a real institutional picking up pennies in front of the steam roller type of product. But there's your modern day financial markets in a nutshell.

**That tail definitely wagged the dog. And gee, leverage was involved.**

Oh gee, I'm not surprised. Why pick up one penny when you can pick up two? It's just a stark reminder of all the linkages, across trading instruments and across markets, that exist. They've been forgotten again, though they were so obvious in 2007, '08, '09.

**Which is fairly astounding given how horrible the financial crisis was —**

Yes, it's astounding but it's not without historical precedents.

**We never learn —**

True enough. If you think about human behavior, and think about market cycles — the beginning of a bull market, what is that? It's what comes after a bear market. And in a bear market, people's confidence is lost, capital is obviously lost and multiples are pushed down. So in the first couple of years



Facebook, David Fitzsimmons, The Arizona Star, Tucson, AZ

after that experience, history tells us that most investors are going to be looking in the rearview mirror, right? It takes a couple of years for their confidence to be repaired. Then, once that happens, multiples expand and more people start to participate. Then investors' attention is suddenly focused on looking out over the dashboard, instead of on the rearview mirror. And I think that cycle has a long history.

**True, it does. And it fits, understandably enough, with human nature, when you're talking about "ordinary" cycles — run of the mill bull and bear markets. I had just thought a crisis like 2007-2008, literally tottering on the edge of the abyss, might have exhibited more lasting impact.**

Except that the Fed conjured the ghost of John Maynard Keynes and stepped into the breach and suddenly the velocity of money took off again. And it all happened so quickly you almost didn't have time to ponder it.

**If you took any time, the bull left you behind. But don't you think some of the scars from that experience — and even the popping of the internet bubble — have added fuel to the passive investing "fire"?**

It probably has, to a certain degree, but I think more of it has had to do with the old cost issue — it's just so cheap to participate passively. And again, there has been no volatility, and the Fed has had investors' backs. The Bernanke put — the Greenspan put — the Yellen put —

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**It was handed down. But is it the Powell put now? The was the assumption, but –**  
He didn't seem to get a clean hand off of the baton.

**Nothing is going very smoothly these days in Washington, to state the obvious.**  
It's tough. We have been asking this question for over a year now but of late it's certainly gotten — just say it now has a little bit more resonance. It's a very simple question: Do you think, in terms of investing, that the next five years will be like the last five years?

**Do you have to ask?**  
It's not a fair question because the answer is relatively obvious, if you think about policy or geopolitics — the big broad brushstroke issues. Just think about macroeconomic risks, political risks, policy risks, market risks — the ones you'd list today did not even exist five years ago. We would never have been happy with the intellectual property demands that China makes. But if any multinational, China is where the marginal growth is in the world — and where it has been for the last 15 years. If you look at the really unbelievable numbers of people moving in to the middle class, just in China alone, and at the purchasing power they bring and at their disposable income, it's hard to get your head around the dimensions of that incremental growth. That population is larger than that of the U.S. and Europe combined.

**Makes my baby boom generation look like nothing in terms of its pig in the python economic effects.**  
I do think it's going to be disruptive and that is just the first step in a larger problem, in terms of their China 2025 industrial policy. That's certainly going to be a challenge for a lot of U.S. and European companies. You've got to be out there, participating and learning the nuances of managing your businesses successfully so far from home. To try to block China's growth, through tariffs or anything else, is I think, pretty much like shooting yourself in the foot.

**Sort of the trade equivalent of trying to defend the Alamo?**  
That's a good analogy. I travel to China regularly and am so impressed by the managements that I've met there.

**We'll go there. But first, let's back up and get some background on Stralem – you – to put some of this in context.**

Let me start at the beginning with Donald Stralem and Hirschel Abelson. Full disclosure: I'm the youngest of Hirschel's sons. Stralem & Co., a client-focused private boutique investment advisor, was founded in 1966 by Donald, who was very well-known on Wall Street, because he believed a young independent firm with more capital could better serve modern clients' needs. Donald had been a partner at a prestigious, old-line firm, Hallgarten & Co., where he'd worked since the 1930s. Soon after founding Stralem, Donald was introduced to Hirschel, who had come to Wall Street in 1955 and was a partner at Ladenburg Thalmann & Co. — he actually had worked in research there with Marty Whitman and Lionel Pincus — two others who became well-known names on the Street. Hirschel brought into Stralem with him, Philippe Baumann, who had been at A.L. Stamm & Co. and Coleman & Co. In the early years, Donald and Philippe would introduce private clients to the firm and Hirschel handled the portfolio management duties. Donald passed away in the early 1970s, but Philippe and Hirschel managed the business for over 40 years — until Philippe's passing just a couple of years ago. Hirschel is still here, as chairman. We celebrated Stralem & Co.'s 50th anniversary last year — we think because we've done one thing, and done it quite well for all those years.

**Kept the business in the families?**  
Well, yes, but that wasn't my point. What we've done very well is consistently apply a singular, time-tested wealth-building strategy we call “participation with protection,” which Hirschel learned from his mentor. The strategy is based on a solid set of wealth-building principles whose origins go back to before the Great Depression and were devised by Hirschel's mentor, Harry B. Lake — who got his start on Wall Street in 1911. Hirschel had become Mr. Lake's associate in 1960 and learned the ins and outs of his strategy. His “participation with protection” is still the basis of investment management at Stralem today — the foundation of our Large Cap Equity Strategy™ (LCES), which has a long history of outperforming the S&P gross of fees.

**So I'm guessing it has nothing to do with Artificial Intelligence –**  
Right, this process goes way back. I mean, 1911. That's pre-Great Depression, pre-the S&P, pre-the VIX.

**Before passive portfolios, modern portfolio theory – even Graham and Dodd.**

Yes, it predates all of that. Our investment philosophy is elegant and it's simple. It's based on the idea that — especially wealthy private clients and institutions like endowments, universities — people who have money — *aren't* looking to double down. People with assets are typically looking to protect those assets. They'd obviously like them to grow, too — especially if they have grandchildren's trusts or whatever else that they want to be able to fund. So ultimately you're looking for a little growth. But you're first and foremost looking to protect their capital, and you're also looking for income to live off of. That's where this philosophy — participation with protection — comes from. And that is what we still follow for clients — now, through separately managed accounts, a U.S. mutual fund (the Stralem Equity Fund, STEFX), a Luxemburg-based UCITS for European clients, and also some accounts customized for socially responsible investing. But the strategy really hasn't changed that much. It's all about balancing growth with preservation of capital. And it has paid off dramatically across, historically, very different market conditions for our clients — who understand that participating in market advances but protecting capital when markets decline is one of the most effective ways to build long-term wealth.

### Because it should harness the magic of compounding?

Exactly. So LCES has a long history of outperforming the S&P 500, gross of fees, through its combination of strong participation in rising markets and protecting capital when they go south. Statistically, from the beginning of 1992 through the end last year, Stralem's LCES had 91% upside capture and 62% downside capture, generating alpha of 3.3%, a 2.1% premium over the S&P 500. What's more, its standard deviation, at 12.43, was lower than the index's 13.95.

### Can you delve a bit more into how it works?

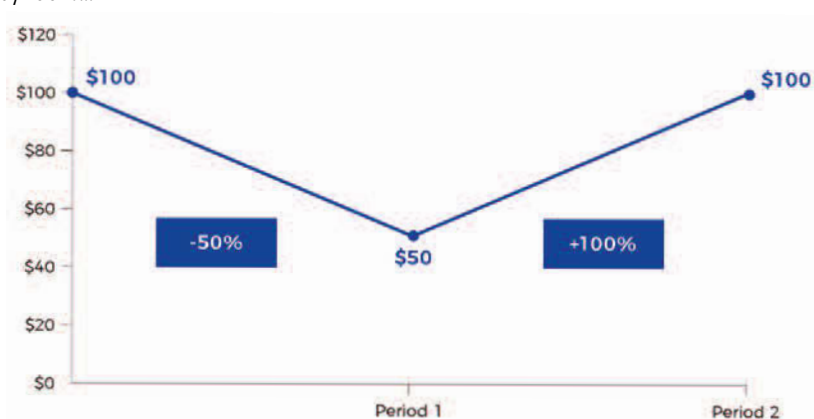
Put simply, participation with protection is based on the understanding that the impact of preserving capital in falling markets far outweighs the importance of outperforming the market in rising ones, if the goal is building wealth over time. Our approach lets investors participate when the market goes up without taking undue risk and outperform *over time*.

### Because of the protection part?

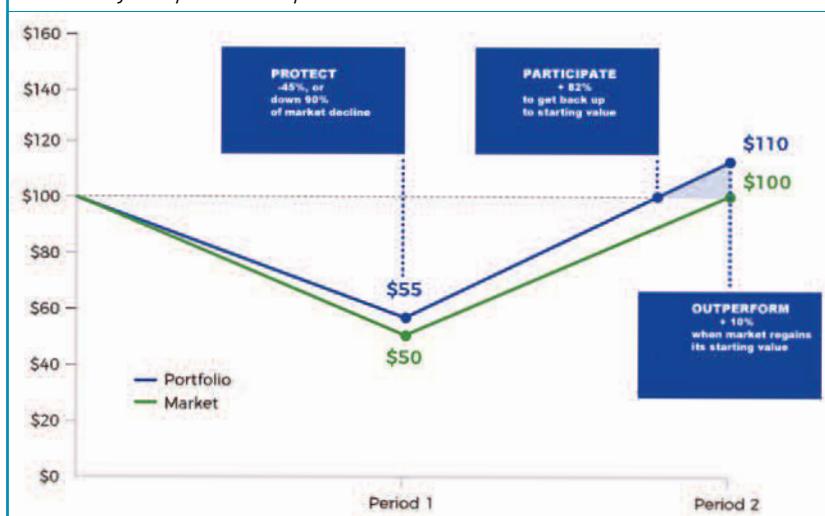
Yes, by going down less when the market declines, a portfolio grows from a higher base when the market starts to advance again — providing a significant opportunity to outperform over the full cycle. and begin outperforming the market sooner. Some

### How Participation + Protection Works

Most investors recognize that to make up for a 50% loss, a portfolio has to rebound by 100%...



But few realize how powerful minimizing the initial loss can be in rebuilding or exceeding their original investment. For example, if you were able to reduce your loss by just 5 percentage points - making your decline 45% instead of 50% - your portfolio would need to go up only 82% instead of 100% to get back to where it started. In other words, protecting your capital so that you were able to cut your loss to just 90% of the market decline would put you back to where you started after your portfolio advanced 82% instead of 100%. If the portfolio advanced by 100% - to where the market regained its starting value - it would have surpassed where it started and grown your wealth by 10%!



Source: Stralem & Co.

charts from our website [this page and next] help paint the picture. The bottom line is, an investor does not need to continuously seek to outperform the market to build wealth as long as the portfolio is adequately protected during declines. While tempting, a singular focus on outperforming the market can lead to taking on unnecessary risk that may prove costly in the long run.

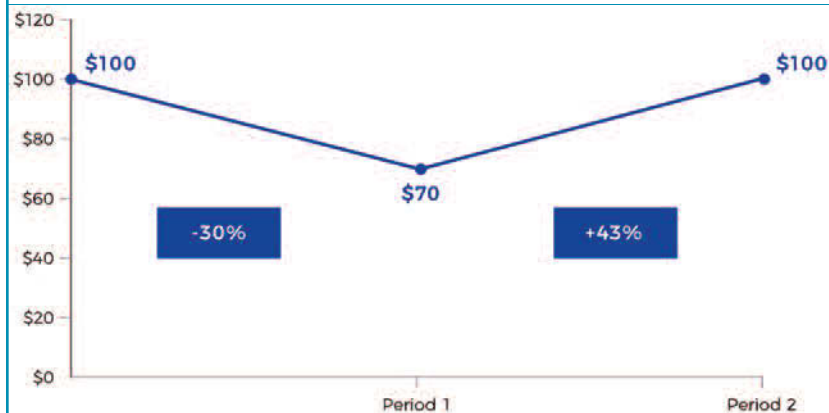
### And you are managing how much in your various portfolios?

We had \$707 million in AUM at the end of 2017.

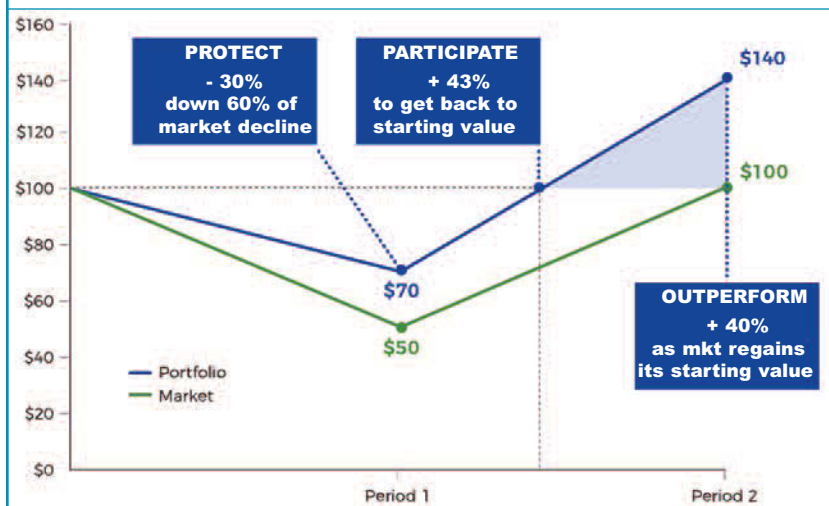
### I would have guessed more, considering your long-term record.

Remember, we stress long-term wealth building.

Now, imagine if you were able to reduce your loss to 30% instead of 50%. The portfolio would need to go up by only 43% instead of 82% to get back to where it started. In other words, protecting your capital so that you were able to cut your loss to 60% of the market decline would put you back to where you started after your portfolio advanced 43% instead of 100%.



Any advance beyond 43% would mean that you were growing your wealth. And if your portfolio had advanced until the market regained its starting value, you would have grown your capital by 40%. Protecting your portfolio against decline is among the most effective ways of building long-term wealth because it takes less of a market advance to get you back to your starting value and you begin growing your wealth beyond that starting value much quicker.



Source: Stralem & Co.

### In other words, you manage the antithesis of hot money?

Well, interestingly enough, but maybe not surprising to students of human nature, the level of interest we see in the “protection” side of our strategy very much ebbs and flows. It really only comes to the fore in the aftermath of the market taking a hit. Think of the period after the tech bubble burst, or right after the financial crisis. Or maybe, increasingly, a bit today. It’s only after people take losses that they realize the power of going down *less* than the market, combined with the power of compounding. After all, if the market plunges but your portfolio drops less, and then the market turns around, you’re going to start growing again from a higher base. It’s such a simple philosophy but, again, it gets lost because of the cycles in this business.

### Are you saying that while LCES might lag in strong bull phases, you more than make that up during the down parts of the cycle?

Yes and no. The second part of that, absolutely. But it’s not that we can’t fully participate in up markets — we outperformed the benchmark in 1997, 1998, 1999, 2000, et cetera, even without holding any dot.coms. LCES is less about just absolute stock picking and portfolio construction (though they are important) than, it is again, about feeding off the characteristics that make an active manager successful. And those three legs under the stool are volatility, correlation and dispersion — for lack of better terms.

You need to have volatility so that stock picking — in terms of both the offensive and defensive sides of the portfolio — is working. And you need to have that lower correlation so that, again, the stock picking actually stands out from the overall bench. And dispersion doesn’t hurt either.

### Those three market characteristics have been AWOL until quite recently –

The insidious nature of quantitative easing put all three of those out to pasture. Historically, you could go through periods where one or two of those characteristics wasn’t prevalent, but never before did we see all three characteristics fade like they did from the start, basically, of QE2 — I’d say from the end of 2011, when they announced QE2 at the Jackson Hole Summit, all the way through until now. There have been lots of moving parts obviously going on underneath that but for the most part — until this period arose in which you’re starting to have policy question marks — and particularly macroeconomic and geopolitical waves — you hadn’t seen those three characteristics. But yes, you’re starting to see that now.

### Implying there’s more to come?

It doesn’t all come back at once. The market characteristics/fundamentals really haven’t changed that much over the years. They don’t just go away overnight; it takes a little while for these things to gain traction. So if you want to play both sides of the market, you have to realize that the cycle is not going to change all at once. So you have to try to participate on both sides.

### You’re saying you overweight growth stocks in bull markets and defensives on the downside?

Absolutely — but we’re not a market-timing portfolio. We *don’t know* when the market’s going to turn. We might have our own qualitative and quantita-

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tive metrics that would suggest when it might, but again, we don't know. We didn't foresee Mexico defaulting in the late-'90s, we didn't know about Long-Term Capital's woes or Russia's, or the Asian currency crisis in advance. The list is fairly long, just covering the last 20 years here. You don't see those volatility events coming until they happen.

But investors *should* have seen the tech bubble building, should have seen the financial crisis — that stuff was all there for everybody to see. It was just a question of whether you wanted to acknowledge it or not.

But the things that add more natural volatility to the markets are the things that you can't plan for. So you need to have really good upside capture — 90% or more — which means you really need to hold good growth stories so that the other positions you're carrying — those down market stocks — what we call comfort food — that protection side of the portfolio — isn't too much of a drag. You naturally want to talk about the sexy stuff at a cocktail party, and not the comfort food. But the comfort food is the secret sauce in a lot of ways.

**Still, there's a price to pay for protection.**

Yes, and you can go through periods where those comfort stocks are not needed. They might go up but they're going to go up less than the bench, so you're not going to pick up 100% of an up market.

**Which can tend to frustrate clients –**

Only if they're not focused on the full cycle. Again, you can go through these longer extended periods where holding the comfort food in the portfolio can really be a drag on relative performance. But then you have this moment in February where, wow, what a great thing it is to have. We'd been told all along, "No, you've got to own these bull market type cyclical stocks versus the boring stuff you own." And they'd been right — until they weren't right. You had those several days in February where boy, did it pay to have some downside protection — and certainly in the last couple of weeks here it has also paid. Not that you shouldn't have seen a trade spat coming — Trump ran on it, getting tough on trade, especially with China, was a big part of his campaign. The fact that he hadn't gotten around to addressing trade policy in his first year was just because of the pecking order of things that were important to him. The fact is it was hardly something that came out of the blue.

**But the market sure acted like it came out of the blue –**

And in that instance, again, it really pays to hold

onto that protective side of the portfolio. I mean, clearly, defensive stocks have not done well in the last couple of years — there's been no volatility. In fact, February was the first month in 16 months that the market was down on a monthly basis.

And even though the market hardly qualified as a bear market in the first quarter, it was down a percentage point or two, depending your bench. The surprise at year-end had been that there was only one down quarter in five years. If you think about that, it amounted to what? Spending 5% of the last five years in a down market. So now it's 10% of the last 5 years in down markets —

**You're implying the placid and pleasant markets of these past few years have been a real outlier in terms of history?**

Right. If you speak about what is the mean — the mean is two-thirds/one-third. In other words, 66% of the time, market indexes climb up, 33% of the time, they are falling down. But recently the split has been like 95/5, or now say 90/10. That, to me, is a more pressing topic for conversation than are stocks cheap or are they expensive? That's almost irrelevant in way.

**What way?**

The fact is that there has been less participation, in the up moves, in terms of the number of stocks that are going up. Of course, with the cap weighting of the indexes as it is, just a couple of names can really take the indexes a lot higher.

I think the FANG stocks last year accounted for, what was it, 20% of the returns in the index?

**They had a huge impact.**

No question. That, to me, is why if you're an investor you've got to think ahead of these things. You can't wait for the decline to come; can't wait for something that we don't foresee occurring to happen before you make a move to try to protect yourself. Because then that's just too late.

**But how do you balance aggressive growth with caution?**

The way we think about portfolio management and think about the clients that we have is that for most private clients — and for most small institutions — we're part of multi-manager platforms. So we're just one cog in their overall asset allocation. But we definitely try to be the manager that doesn't keep them up at night.

**Okay, but tell me how –**

A little bit more background on Stralem should

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help. Our decision-making is centralized in our investment committee, so that all of our clients receive our best thinking. And one of the characteristics of the firm that we are proud of is that all of our employees are invested in the fund, so we eat our own cooking, if you will. It's putting my kids through college and probably putting all of our kids through college and probably some through graduate school. We're an all-weather manager that at the end of the day provides a concentrated, high-conviction, high active share, low-turnover, tax-efficient portfolio. We have 33 names in the portfolio today — and 3-to-5 year holding periods, on average. Again, we obviously try to participate in the market's rise. But we also know that going down less, over time, is the secret sauce to long-term wealth growth in wealth management — even though that, from time to time, goes out of favor. After all, when there is no downside, why pay for the downside protection side of the portfolio?

**To which your answer is, stuff happens?**

That's why you buy insurance, right? So ours is a lower-risk strategy. But LCES necessitates not just buying your best ideas but also buying stocks in a collective sort of framework — again, because you're trying to play both sides of the equation, in terms of stocks for both an up and a down market.

**In a collective framework? You're implying that portfolio construction is a key to what you do?**

Exactly. Because our strategy predates the S&P 500, we use unique groupings to structure the portfolio incorporating the up-market participation and down-market protection we've been discussing.

**Go on —**

If you think about the last couple of years, for example, there has been very, very high correlation — and not just in the overall market — we look at how the stocks in our portfolio are correlated. And even there, it's been very difficult to break free of that very high correlation. We've made some adjustments over time and they've certainly paid off. But thinking about the portfolio in total, you definitely want to have a separation between what's driving stocks up and what's preserving capital when stocks aren't going up. In that way, the construction of the portfolio is probably as important as the stocks within it — in terms of how you allocate to them, how you think about them, what their role is.

**But how do you pick stocks?**

Our stock selection, driven by our participation and protection philosophy, is fundamental, bottom-

up research driven, long-term focused and based on our belief that earnings growth ultimately drives long-term stock performance. Stock ideas originate mostly from fundamental analysis that we do in house, sometimes driven by top-down themes we've identified, or from valuation metrics. What we look for are companies with competitive advantages to deliver growth for the participation part of the portfolio and cash-rich companies to protect capital and reduce volatility. The research team advances the attractive ideas that meet our investment criteria to our investment committee —

**I'd guess that's not a cast of thousands.**

Hardly. Our investment committee consists of our portfolio managers, headed by Hirschel, and including me, Andrea Baumann Lustig, Edward Cooper, Philippe Labaune, and Michael Alpert. What we do is use a multi-layered risk management model and debate the ideas for their fit with our portfolio structure, stock valuation criteria and our buy/sell discipline. And the decisions we come to about buying and selling have to be unanimous.

As I'm sure you can tell, these are not traditional ways of deciding, "Oh, I want to buy XYZ stock." It's always about the why for us. What is it, besides the fact that it might be a good story? How does it fit in with the overall construct that you're trying to have? I think that distinguishes us in terms of most managers that we know. Their portfolios tend to reflect either growth or value. Rarely do you have this sort of blend that we have — it's almost like a long-only hedge fund without the fees.

**Can you be more specific about your stock selection criteria?**

For upside participation, we select growth companies with a focus on their long-term outlook, given our long holding periods. We want companies whose relative growth opportunities exceed the market's. These generally fall into three categories: new industries, new products, and dominant companies. In the first category, we look at market innovators, leaders in the current cycle, technological shifts, and companies exhibiting stronger growth. In the second category, new products, we'll look at more mature growth companies, ones with an intense focus on R&D, ones with more predictable growth, or horizontal growth. The dominant companies in our third category tend to be thematic investments, companies with increasing market share, leading global brands, or boasting world-class managements.

**And when you're looking for protection?**

**WOWS 2018  
 Issue Dates**

January 19  
 February 16  
 March 9  
 March 23  
 April 13  
 April 27  
 May 11  
 May 25  
 June 8  
 June 22  
 July 20  
 August 10  
 September 7  
 September 28  
 October 26  
 November 9  
 November 30  
 December 14



Which, you understand, is all the time — to some degree — we want to combine those growth stocks in the portfolio with stocks that should provide downside protection and capital preservation when markets fall. In other words, cash-rich companies which tend to provide smoother return profiles. Those tend to fall into two groups: One with high, sustainable dividend yields and the other with low prices, relative to cash flow. In the first case, that's companies with dividend yields higher than the market average, ones raising their dividends faster than inflation, or ones with secure dividend payments evidenced by low payout ratios. The cash flow group consists of companies with high, sustainable levels of cash flow, companies whose cash flow is fundamentally and financially secure, and also cash flow-rich companies that we can opportunistically purchase at a discount to the market.

That's the portfolio combination, we believe, that tends to outperform over full market cycles, though it may lag during strong bull phases, because it protects during declines. And that's what, of course, allows wealth compounding to begin from a higher base when growth resumes. This combination strategy for all markets also dampens portfolio volatility, helping us — and clients — sleep at night.

### **Can you point to a time when that has worked, in practice?**

The most persuasive case we been able to make in recent years has been by pointing to how our U.S. Large Cap Equity Strategy (LCES) portfolio minimized the impact of downside volatility — and outperformed — during the financial crisis that began in 2007. LCES was down 38.5% peak to trough —

### **Ouch.**

It wasn't fun. Except on a relative basis, because the market skidded 50.2% in that stretch. So we captured only 77% of the decline. Again, not fun. But the point is that it took LCES only 23 months and a 65% market rise to recover to its pre-crisis level — compared to 37 months and 104.5% for the S&P 500. By the time the S&P retraced all the ground it had lost, our strategy was up 91.8% from the trough, generating a total return of 118% — and outperforming the S&P's paltry 1.9% return by 16.1 percentage points.

### **But your focus is more on riding long-term secular market waves than on catching every little blip?**

We're much more into the secular camp. From a top-down perspective, most of the trends we see

have good secular wings to them. That's where we can see, for our longer-term holding period, a nice up ramp — that's certainly what drives our thought process.

### **So you don't spend a lot of time fussing over the next quarter's earnings?**

No, exactly. But on occasion — especially where the M&A world intersects when you are trying to buy growth — disappointing earnings might shorten your relationship with a company.

### **Because?**

Suppose, okay, they've made their cost savings target, but then there are still just all these hanging threads around the merger that they haven't been able to wrap up, so it doesn't make a compelling story any longer. Getting the initial cost savings is always the easiest part of a merger. But actually merging two companies' cultures or software, their distribution, or whatever it might be — typically, that's a much harder thing to achieve.

We see that — unfortunately — more than we'd like. A deal looks great on paper and the banker has got to get paid, right? So all these deals get done but they're not always as well-executed as they are imagined.

### **I'd venture that's the case more often than not.**

And we've definitely entered the late stage now of this market and economic cycle, where disappointments are typical. So we try to think independently about what we want to achieve.

### **Is looking for prospective M&A candidates another part of your process?**

Not typically, no. We're sometimes cognizant that a company might ultimately be a target. But that's not what drives our research, because frequently you get disappointed. Look at — what is the worst performer in the market this year? It's probably Kraft.

### **Or GE.**

Right, but why is Kraft (KHC) doing badly? Because they did all these deals, they got everybody excited and then they just left the investors hanging for the last three years, while margins declined and revenue declined. They clearly are in need of an injection of growth. So if you bought Kraft expecting — or if you bought Mondelēz (MDLZ) expecting them to re-merge, you've been thoroughly disappointed. That's a tough one. Or at least, M&A is not our strength.

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**Both have been subjected to all manner of financial engineering alchemy for years—making bankers and others rich – but both still are essentially mature businesses, great cash machines, that just aren't going to grow faster than demographics. Unless they improbably manage to hook the Chinese on Oreos and ketchup.**

Their international packaging is good. I tend to wander through grocery stores when I'm in Shanghai, for example. It's interesting to see familiar brands being sold with a slightly different look to them.

**Chinese characters on the box.**

The characters, the photos — they usually trick them out with a green tea flavor which probably doesn't sell big in Pittsburgh.

**But may intrigue someone in Chengdu.**

And there's some room for that in the market. But it's still definitely a foreign food, not something that's part of the culture. So while it may look good on paper, I think a lot of the consumer companies, at least, are realizing that to succeed in China they need to be on the ground, producing for local tastes, instead of trying to convert the world to U.S. tastes. That's not enough.

When it comes to the growth side of the equation, if you want to have long-term holdings, you need to find good secular trends. Something like the growth of social media —

**Even that's been rather painful lately.**

Yes, but at the end of day, while poor old Facebook (FB) and Google, or Alphabet, now, (GOOGL) have certainly been under the microscope in terms of privacy issues and enabling malicious activities — or anything else the European regulators can think up — they still hover up three-quarters of all the advertising that's online. And who knows how much more, in traditional media. Those are big stories. They are growing their top lines over 20% and their bottom lines at 40%-plus. That growth has been pretty steady and they have a lot of things they haven't even monetized yet.

Those stories don't go away, in terms of growth. But what we prefer to do is ask questions like, "How does all that advertising get onto the web? What are the mechanisms and what are the software programs that enable all of this content to be created?" In other words, we look at the same growth stories as everyone else, but try to find that extra hook. A different angle of approach.

**For instance?**

It could be a stock like Adobe (ADBE), for example. It has a big growth story because its business has a very high barrier to entry. They are, de facto, *the tool* used today to create online content and advertising. That's the kind of good up-market-type growth story that you certainly want exposure to.

**It's something on the order of a modern twist on Levi Strauss selling jeans or pick axes to the Forty-Niners?**

Basically. Software as a service, or SaaS, for example, is a very big deal. The cloud is everything. The numbers that the big tech guys are racking up in cloud services growth are gaudy. You can't participate in the up-market if you don't have that.

But the caveat is that you need to manage your active exposure to the cloud, knowing that if markets turn down, those kinds of stocks are going to be the first to drop, just because they've gone up the most. That's just how that works. So if you're going to have a big tech exposure, you also definitely have to think about what is the other side of that position? That's, again, how we construct the portfolio.

**So what is on the other side? Traditional defensive stocks like utilities?**

Utilities historically have always been the comfort food. A regulated utility has — you can think of it as pricing power — but what they really have is rate-based growth. If they are investing in their infrastructure, they're able to pass that growth through to the end users and today that could be upwards of 6.5% per annum, which is very, very strong for a business where actual electricity consumption has been flat for a decade. They have to pass through their rate growth to either feed more investment or, more importantly, to increase dividends annually at a rate higher than inflation growth. Which means you're maintaining the purchasing power of the dividends you're being paid.

It's not something, again, you're going to talk about at a cocktail party but it has tremendous value when you least expect it, in terms of a market drop.

**Do you have some examples?**

Well, we're at the end of a long cycle here so it's not just utilities. Some of the mega-pharmaceutical companies with decent pipelines but just enormous cash flow — AbbVie (ABBV) and Pfizer (PFE) come to mind — are good down-market stocks. They still have pipelines and there's still certain expectations of those pipelines, so there's going to





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already occurred. So we were sort of quantitatively forced sellers of techs at the beginning of 1999. While Wall Street analysts were still selling you then on the notion there'd be a "new normal" of tech shipments, it just wasn't reflected in the actual shipments going out. Clients weren't happy about us selling for the first six or nine months, but they certainly were happy about it afterwards.

### **Funny how that works. What's your participation/protection distribution today?**

We're around 65% up and 35% down — because we counter-cyclically were buying when everyone was rushing for the exits in 2008 and '09. And we would have continued to buy, but when they threw sand in the gears of the clearing process in March '09, we just stayed with this distribution, instead of chasing that multiple expansion.

In this business, really you just need a good idea every half-decade or so, to really power you for the next couple of years. So if you have the ability to come up with one, and to draw up some contingency plans — that's how we think about it and try to execute our strategy.

### **Okay, what's your big secular idea here?**

This one isn't even new anymore. It emerged a couple of years ago. But if you think about it, demographics are driving just about everything on a global scale. First and foremost is in healthcare. Not only is disease identification made quicker, it's available to more people. As the wealth affect of emerging middle classes starts to take off, some of the first dollar spends, after an entertainment splurge to Disney World or whatever, typically is in healthcare. That's why we're seeing growth in U.S. — and European, to a lesser extent — pharma companies in Asia.

It's lost here in the U.S., as we argue over the Affordable Care Act and the cost of insurance and healthcare in general. But that is the biggest, without question, macro trend out there. Just peeling back that onion one level, you're investing in the life sciences, because the discovery process can only go as far as the tools in the lab can take us. So I see life sciences as the most interesting place to be on a secular scale for the next bunch of years.

### **Even a growth investor has to be challenged to buy them at today's nosebleed levels, though.**

If you just look at the multiples, yes. That's problematic. But we have a proprietary tool that we look at valuations through. It basically tries to look at the ramp up — where earnings have come from

versus where they're expected to go.

### **You don't just take a pair of binoculars and look through the wrong end?**

Ha! That's a good description. Typically — here we are in 2018, so the way we calculate things — we look at GAAP earnings for 2016, '17, plus the mean estimates for this year — a three-year earnings stream. Then we take a simple average of those years and divide it by the Street's mean estimate for next year, which frequently needs adjustment, because all too frequently the analysts all drink from the same batch of Kool-Aid —

### **No? Really?**

What that exercise produces is a growth rate. Then you look at the P/E on that three-year growth rate and use that in what we call our relative growth valuation model. The result is that we can actually buy something that's selling at 35 times current earnings — if the projections for the forward estimates over the next year or two are supportive or are growing that much more rapidly than the trailing three-year average. We also use the model's output for controlling risk in our portfolio construction process. [table, next page]

### **No wonder you're so interested in investor psychology. That sort of valuation depends heavily on shifting human perceptions.**

Absolutely right. And we stress tested the estimates. We're not calculating our own estimates — there are more than enough people doing that in the U.S. large cap space, on our behalf. But we certainly stress test the estimates we use to see if they're just straight out wrong. They can be.

### **No kidding. You mentioned life sciences. How about pharma or the biotechs?**

They're the other side of that coin. Those companies spend billions of dollars either investing in their own molecules or doing a joint venture or buying someone else's molecules. But if you get that wrong — whew — and that's happening today. We're seeing more misses in the pipelines than we did previously. That's probably just a reflection of the scale and scope of modern pharmaceutical companies. But that means you have to lower your estimates and your expectations, which impacts their growth valuations, even if the multiples drop.

### **You're saying it's a mine field?**

Well, here's the danger. You might think, "Okay, it's a cheap stock. It's been re-priced." But it's probably only been re-priced relative to where its prior earning stream was. It might not have been re-priced enough, relative to getting the overall cal-

ulation to work for you.

Again, we look through a slightly different prism. I don't know if stocks are expensive or not today.

### Seriously?

I have a sense they are. You are paying \$18, \$20, \$22, \$24 — whatever the trailing estimate is — for a dollar of earnings. That doesn't seem reasonable in overall market structure. But at an individual stock level, we try to separate that out from the overall benchmark. Because otherwise, you're just going to sit in cash and not make anyone any money. You do want to participate so you just need to find your comfort zone —

### Yet I see you do hold cash on occasion.

We have frictional cash, on average, of about 4% of the portfolio. That's partly for tax efficiency. You don't want to be forced to recognize a capital gain every time you want to add something. If you do get a resetting of prices, you can maybe buy down without actually having to create a capital gain. But we don't hold cash for tactical purposes.

### Your strategy invests just in U.S.-listed companies, but you've mentioned traveling the globe frequently — even to China?

We invest only in S&P 500 listed companies so we're certainly America-centric in terms of the pond that we fish in. But with that said —

### A lot of S&P companies are international in their reach?

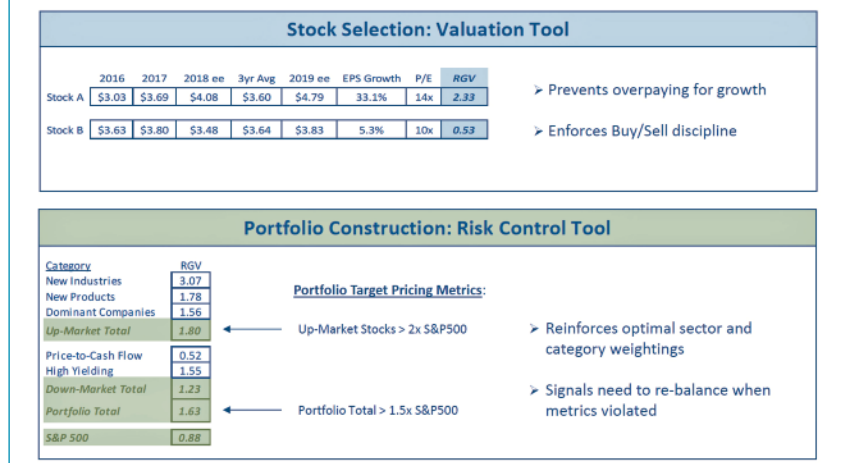
Yes, about 65% of revenues of portfolio companies comes from outside the U.S. That has been by design. And keep in mind that we have oil companies, so sometimes that metric isn't as straightforward as it sounds. But we really like the way companies we're invested in are taking it to the emerging markets.

Not as much, obviously, in reporting periods impacted by a strong dollar. But lately the dollar has been weak, which helps our companies. They are doing business in local currencies, they're reinvesting in the local businesses in those local currencies. So we try not to worry too much about the quarterly distractions of dollar accounting.

### Do you have favorite EM here?

We love Asia, we like Europe. We have companies in the portfolio that have been growing double-digits over the last couple of years — when European GDP was effectively flat. We have companies doing double-digits in Brazil, while that nation's economy

## Relative Growth Valuation Model (RGV)



Source: Stralem & Co.

is contracting. That's what we're looking for. It's not just that we have this top-down thematic exposure. We do the bottom-up research to find the companies able to execute, regardless of what's going on in the region.

### And that's the purpose of your travel?

Yes, very much so. We go out to meet not just with the managers on the ground in the companies we invest in, but other companies, economists, academics — just about anyone who's willing to sit down and help us to a much better understanding of the backdrop. That is always changing and you can't just sit here and read about. Then you're consuming information that's already stale. You have to be there.

I've been so impressed over the years with the management teams we meet overseas. I happened to be in China during the 2016 presidential election. Partly by design — I find China particularly to be a wonderful vantage point for watching democracy at work. They didn't block CNN in the Western hotels, so I could watch what turned out to be just a crazy moment in time.

I then met with a couple multinationals whose regional headquarters are in Shanghai, and asked what Trump's platform of protectionism and trade wars was going to mean to them. "How am I suppose to think about this? How are you thinking about this?" What amazed me was that they already had a game plan. They'd already gone through their logistics and their global footprint and figured out how to operate, in a hostile trade environment.

"We're getting something from a plant in Texas, so we're going to now resource it from Thailand or from Saudi Arabia," or whatever. They'd already figured out how to minimize any disruptions of

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their supply chains. Because they're doing business in China for China, or for the greater region. They are not making things to re-import to the U.S., contrary to claims. I was just terrifically impressed that they'd already anticipated all that, which to me is a hallmark of a great local management team.

### **So all the verbal fire and fury over tariffs isn't overly worrying in terms of your portfolio companies' international exposures?**

No, we've gone out and looked and assessed the risks. It remains to be seen how they execute, of course, but our companies have actually been preparing for years. We're comfortable because they're ahead of the curve. Not just reacting to yesterday's headlines. Clearly, it ultimately depends on where it ends. Historically, trade wars, sort of have one round. But with our current president, you just don't know. It might all just be bluster. I mean, NAFTA is still NAFTA, right?

### **Bluster is his favorite negotiating tactic, it seems.**

The thing is, what's often overlooked is that bluster doesn't translate well. These are proud cultures he's targeting, and that's problematic. His game theory is single round, but this is multi-round and it's much harder to foresee where it ends. Mexico's is also a proud culture. There's only so much bullying they'll take before digging in their heels.

The big question for Trump is how far he and his administration are willing to take it. China is pragmatic, they know where to hit him — they're going to hit him in his face — hitting America's strength, unfortunately, which is primarily agriculture. And Trump's base. Meanwhile, the Chinese are used to suffering, while we haven't suffered, as a nation, for a long time.

China will find ways to replace U.S. soybeans. They'll grow more, source more from Brazil. Whatever. But we get 100% of our Christmas lights, 100% of our American flags and who knows how many other things — socks, brassieres — from China. We don't have that capacity here.

### **Well, depending on what day it is, the market seems a mite concerned.**

It creates an interesting backdrop for investing, regardless of the outcome. You try to avoid it as best you can, but the overall market inevitably reflects this anxiety — which is probably healthy. Again, relative to how we've gotten to where we are in the market, and the impact of the central bank in inflating assets. Now the real world seems to be

intruding to a degree. Which is something that we find interesting and attractive both in terms of what we do and how we do it.

### **Participating and protecting, again. So I'm guessing you're not loading up on leveraged derivatives?**

Not at all. This current administration is going to keep everyone on their toes. They're moving around quite frantically from one thing to the next. And I suspect this is just the beginning. Like I started out saying, after so many years of a becalmed market, we're kind of enjoying watching the market react with more volatility. With a portfolio structured for both up and down markets, we're just hopeful that this creates opportunities for us to gain exposure to our short list investments we'd love to own, at the right prices.

### **How about sharing some of the ideas on your wish list?**

Well, we have all the noise of politics and geopolitics and just an acrimonious environment. Let me just observe that the way cyclical ran up hard based on some policy decisions — especially the tax cuts — we found somewhat amusing. Because what was ramped up — particularly the industrials — were too expensive to begin with.

Industrials are a funny sector. If you look at the administration's policy on infrastructure, it's one thing to do tax cuts, bring back foreign assets — the obvious things. You want to own a lot of the big tech companies to get the big repatriated cash, or the big pharmaceutical companies. That makes sense. Deregulation is going to work well for energy, maybe utilities — certainly financials.

But the investment case for industrials generally isn't so straightforward. There are five border states, each with its own municipalities and regional issues. There is no one overarching winner there. And with global growth slowing a little bit, the industrials are the tip of the sphere, and that slowing is starting to be visible.

### **Which leaves you, where?**

It brings us back to demographics, which has had the biggest impact overall, in recent years. Again, we like the life sciences, where Thermo-Fisher Scientific (TMO) has been our big horse for the last five years or so. They're doing 20%-plus growth in China every quarter, like clockwork. And they should continue to do well — of course, we don't know what impact a trade war would have, but they produce domestically in China, so it might not



be as much as would be presumed.

TMO sells the big ticket analytical gear, like mass spectrometers and DNA sequencers — all that super fancy stuff that drives discoveries. They're in all the right places at the right time. The second largest spender in life sciences, after the U.S., is China. With their demographics growing the way it is — and just their sheer numbers — you have to be there. Plus, the Chinese are doing the largest DNA sequencing projects in the world right now. So TMO is a very attractive, very high-growth company that we certainly want exposure to.

### **What's another?**

Danaher Corp. (DHR) is another attractive life sciences companies. It is just so steady year in and year out. They don't make noise, they execute, a phenomenal management team. For us, if you're only going to have two companies in life sciences — which is a fact of our life, running a concentrated portfolio — it's certainly a way we want to get exposure to life sciences.

### **So those aren't positions you've been trimming as the market advanced?**

We're not slowly reducing it. Again, the way we manage, we have a slightly lower weighting in Danaher than in Thermo-Fisher Scientific, because it's growing much faster than Danaher; has a much more reasonable multiple. We're looking out over the valley a little bit and seeing TMO as having a greater growth opportunity set than Danaher.

### **You mentioned Adobe. Do you like other software purveyors?**

They really don't have any equal in the software as a service space, in terms of creating online content. Adobe is pretty much a perfect Stralem stock. Not only are you getting tech growth characteristics — 42% profit growth, 20%-plus top-line growth, extremely attractive margins, I think 86% — but what makes them a Stralem stock is that Adobe's transition to a software as a service model has led to 85% of their revenue is recurring. That's us. That's great stuff.

We like that visibility, that clarity in their growth, in terms of recurring sources. It's just very stable and should enable a continuously higher valuation. We like that a lot. We own a couple of companies like that.

### **For instance?**

One is the Intercontinental Exchange, (ICE). They own a couple of the stock exchanges, they're a major clearing house for global derivatives growth,

especially in interest rates and commodities. But since they own the exchanges they're able to sell “the exhaust” — as they call it — real time data — to hedge funds. So 50% of their revenue is recurring, from selling that “exhaust” from the exchanges. You could also own the CME Group (CME), which is the other company in that space, but they don't have that recurring revenue stream that we find quite comforting.

### **Selling trading data is big business, certainly. I just wonder if it's vulnerable to questions about who really owns the data.**

Well, unlike Facebook, the data they're selling is not personal.

### **Not in the same way, certainly. My trading data is laughable. Jim Simons', however — Anyway, what else?**

Healthcare is our biggest footprint, no question. We like the devices that Abbott Labs (ABT) sells. Abbott's former partner, AbbVie — I mentioned. Its Humira patent is just a phenomenal source of growth, cash flow. Then we have more esoteric, take-your-shots, positions. Celgene (CELG), we've owned for years. It's recently run up against some drug trial headwinds, but it's still a great growth story; has been an extremely good investment for a number of years.

### **Do you have a favorite in your protection basket?**

Dominion Energy (D) is a utility serving very attractive end users. They're in northern Virginia where you have the government corridor along the Potomac River and the Baltimore/Washington technology corridor — 70% of global internet traffic goes through Dominion's territory every single day. This is where you find the cloud computing networks of Amazon and Apple and others. But its large regulated customer base is also highly diversified. Its balance sheet is strong. Its dividend is over 4%, and growing at 8% per annum, with a 70% payout ratio. It's just very attractive in terms of the security and transparency of dividends — and that's what matters.

That's how we think. For much the same reasons we like Philip Morris (MO) on the protection side of our portfolio. They're obviously dominant in tobacco and they're moving the e-cigarettes —

### **Vaping and all that.**

Which is growing like hotcakes right now.

### **Another addictive product. is great until someone gets around to regulating it too.**

True. We run some SRI/ESG portfolios for clients

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and find alternatives for ones who have ethical objections to owning things like tobacco or fossil fuels — without diluting what we do. That's another part of how Stralem does business.

**The clients come first – always a good policy. Thanks, Adam for sharing some of your ideas – and atypical approach to what are increasingly atypical markets!**

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**Welling on Wall Street Interviewee disclosures:** Adam S. Abelson is Chief Investment Officer at Stralem & Co., chairs firm's Investment Committee and leads Stralem's research effort, overseeing the implementation of the U.S. Large Cap Equity Strategy. He co-authors the firm's quarterly "West of the Hudson" letter, which is the product of the team's research trips around the world. He serves as a director of Stralem's UCITS fund. Adam joined Stralem in 1998 after managing business units within the emerging technologies, consumer products and hotel/gaming industries. He's a graduate of Pitzer College, Claremont Colleges. Manhattan-based Stralem & Company is an independent, SEC registered investment adviser established in 1966 by Donald Stralem, who had been a long-time partner in Hallgarten & Co. He was soon joined by Hirschel Abelson, a former partner at Ladenburg Thalmann & Co. and Philippe E. Baumann of A.L. Stamm & Co. and Coleman & Co. Hirschel, a disciple of Wall Street pioneer Harry B. Lake, applied Lake's Great Depression-tested wealth building principles for the new firm's private clients and both the firm and the clients prospered. The Large Cap Equity Strategy™ Composite (LCES) consists of fully discretionary large capitalization equity accounts. The investment objective of the LCES is to deliver above market returns with less risk during both up and down markets. The investment philosophy of the Large Cap Equity Strategy is predicated on the belief that there are four types of market environments, two types of bull markets and two types of bear markets each characterized by momentum and valuation factors. Market environments affect portfolio structure so it is critical to identify and prepare for changing market environments. The Large Cap Equity Strategy adds value by purchasing a set of fundamentally solid growth companies along with a set of companies that deliver strong cash flow and adjusting the balance between these two groups depending on where we are in the market cycle. Stralem defines the LCES as a conservative growth strategy that also focuses on preserving capital during down markets. For comparison purposes, the composite is measured against the S&P 500 index. The S&P 500 index is widely recognized as a leading indicator of the U.S. equity markets. Prior to 7/1/2014, the Russell 1000 growth index was presented in addition to the S&P 500 as an additional benchmark for the LCES composite. Stralem claims compliance with the Global Investment Performance Standards (GIPS®) and prepares its report in compliance with the GIPS standards. Stralem has been independently verified for the periods January 1, 1992 through September 30, 2017. The firm maintains a complete list and description of composites, which is available upon request. To receive a complete list and description of Stralem's composites contact Stralem at 212-888-8123. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Past performance is not indicative of future results. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. Legal Disclaimer: For further information, see [www.stralem.com](http://www.stralem.com). This interview does not constitute advice nor a recommendation to buy, sell or hold, nor an offer to sell or a solicitation to buy interests or shares in the Stralem Fund or other offerings, or in securities in the companies mentioned in it ("relevant securities"). It has not been prepared in accordance with legal requirements designed to promote the independence of investment research. Stralem, its affiliates, directors and employees are not subject to restrictions on dealing in relevant securities ahead of the dissemination of this interview.

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