Willamette University
Atkinson Graduate School of Management
December 12th, 2019

O'Neill Student Investment Fund Letter, Trailing Three Months,[1] 2019

Dear Board of Directors,

We would first like to take a moment to sincerely thank you for the opportunity to manage the O'Neill Student Investment Fund. This responsibility has been a wonderful learning experience and a unique privilege. As a class we were able to advance our education and experience growth as investors in ways that would not have been possible through simulation or a typical classroom setting. Using real money and facing real consequences provided our class with the opportunity to evaluate the challenges, risks, and stakes of fund management. This skill set will be an invaluable asset moving forward that we can apply to other aspects of our MBA education and future opportunities following graduation.

The following pages outline factors that went into our investment decisions and what we learned through this course. It will begin with an analysis of the macroeconomic outlook and trends, followed by a discussion of our individual investment decisions, our benchmark for assessing our performance, and the future outlook for the economy and the O'Neill Student Investment fund.

Macroeconomic Outlook and Trends

Over the course of the semester, our team analyzed market performance and investor responses to several macroeconomic factors. These factors have helped us to identify sectors in which investments would generate greater returns and those areas where we predicted investments by the fund would underperform. Below are the three main macro trends that we have been tracking and assessing:

- The Trade War
- Federal Reserve Activity
- Slowing Economic Expansion

Each of these trends has guided our discussions and our investment philosophy over the past three months. Below, we outline these factors and how they factored into our decisions in further detail.

[1] Months of September, October, and November of 2019

The Trade War

The current United States presidential administration has taken a hardline stance on trade with China. In 2018, the U.S. imported a record $539.5 billion in goods from China and sold the Chinese $120.3 billion in return. President Trump's first campaign platform focused on this trade deficit as well as the impact of Chinese steel and aluminum on American manufacturers. Following this campaign, President Trump spent 2019 levying tariffs on Chinese goods in an attempt to force the Chinese to make concessions on a trade deal. However, tariffs make imports more expensive. When a country levies a tariff against another country, producers respond by raising the price of the affected goods, and Americans (the final consumers) absorb the impact in the form of higher prices. China has retaliated by levying tariffs of similar magnitude on the United States (halting the purchase of a majority of U.S. agricultural products) and manipulating its currency to weaken the dollar.

The unrest between the U.S. and China, the two largest economies in the world, and the uncertainty of a trade deal made us wary of international investments for the fund. The current U.S. government views protecting American interests as the primary objective of trade policy. Based on these conditions, we rated the domestic market as a stronger candidate for consistent growth opportunities than international markets. The following page has a graph that demonstrates the returns over the last five years for the Shanghai Stock Exchange Composite Index in **black** and the Dow Jones Industrial Average in **orange**.

The Dow Jones Index over the last five years has returned just under 60%, while the Shanghai index has returned only 7.5%. President Trump has championed the performance of the economy as the main driver for his re-election. With an election year around the corner, we concluded that he would not change these policies soon.

Consumer confidence in the U.S. economy has also been steady. A recent Gallup poll shows that 55% of respondents rate the economic conditions as “good” or “excellent,” 35% as “only fair” and 9% as “poor.” The high consumer confidence suggests that people will continue to spend money without fear of a recession or economic downturn; this mentality will help businesses continue to prosper. We believe that President Trump will continue to put the United States into economically advantageous positions. With these beliefs in mind, we expect to see similar returns to the ones we have been enjoying over the last decade. The principles outlined above have served as the backbone for our investment strategy in international markets. We view domestic stocks and bonds as the strongest performers today and in the future, thus we have chosen to focus our resources on those securities. We further supported this decision through our analysis of the Federal Reserve activity.

Federal Reserve Activity

The Federal Reserve is the central authority on borrowing rates in the United States. These rates determine how expensive it is for banks to borrow money from one another. When rates are low, it allows money to be borrowed at a low cost, fueling economic expansion. However, inflation can become a concern, should the rates be too low for too long. To fuel the bull market since the recession, the Federal Reserve has consistently kept the Fed Funds Rate below 3%, with the President championing the low rates, even going so far as to suggest negative rates in October. As seen in the graph on the next page, when rates rose to just 2.4% in early 2018, it did not last, and over the last year and a half we have seen rates continue to fall, with three separate rate cuts happening in 2019 alone.

Rate cuts can be a good sign for investors who are heavily invested in equity markets as they spur investment and allow companies to expand. However, these cuts historically have brought on inflationary pressure that raises prices and stifles consumer spending habits. This has not been the case in the United States since the recession. Over the past ten years, inflation rates have hovered below the historical average of 3%. This relationship between low interest rates and low levels of inflation is unusual, and investors should be wary of the current trend being the exception and not the norm. As stated earlier, it is no secret that the current administration values a bull market, low inflation, and high consumer confidence. With the government looking to do whatever it takes to keep the economy riding high, we viewed the domestic market, at least in the short term, as a growth opportunity and as such, focused our capital there. Once we determined which markets we wanted to invest more heavily in, we set to work identifying sectors of interest and companies within those sectors.

Federal Funds Rate Historically

Slowing Expansion

While the United States economy has been in a bull market for the better part of a decade, there are signs that suggest that this record expansion is beginning to slow. Firstly, earnings in 2019 began to show weakness. There was a 2.2% decline in earnings for Q3 of this year and the blended year-over-year revenue growth for Q3 '19 was 3.1%, the lowest for the index (S&P) since Q3 2016.[2] These figures suggest that domestic firms may be experiencing difficulties in maintaining their revenue and earnings expectations set forth by investors. Expectations are as high as they have ever been given the extended bull run the market has been experiencing. These difficulties can also be seen in net profit margin growth from 2018 to 2019. Net profit margin is the percentage of revenue left after all expenses have been deducted from sales. The measurement reveals the amount of profit that a business can extract from its total sales. Earnings are expected to grow at a faster rate than revenue for FY2020. As a result of this trend, we believe that companies are likely going to have to cut costs or reduce the number of shares outstanding to increase earnings per share. Cutting costs could reduce a company's ability to expand, and further contribute to the economic slowdown that is on the horizon. Finally, we identified broad macroeconomic factors that reinforced our position that an economic slowdown may be coming in the next 12-18 months. Q3 '19 GDP grew at a 1.9% annual rate, business investment fell by 3%, and spending on factories and offices dropping by more than 15%.[3] These

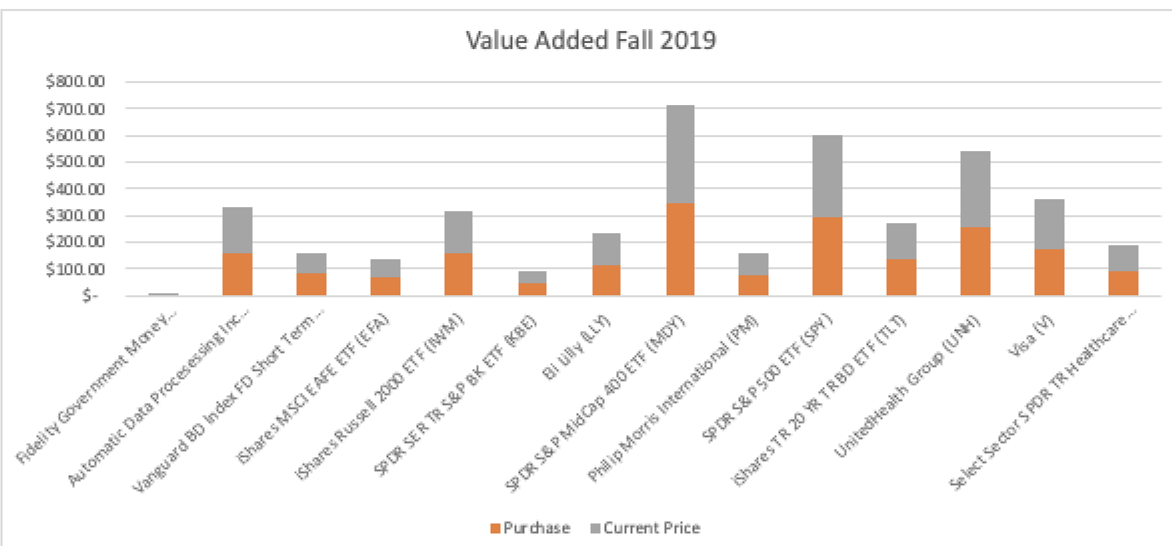
[2] https://www.factset.com/hubfs/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_112219.pdf

[3] https://www.nytimes.com/2019/10/30/business/economy/federal-reserve-interest-rates.html

statistics suggest that companies are preparing for an economic pullback. It is important to note that these are not signs of an economic collapse or even a serious recession, but given the success the economy has enjoyed it makes sense that companies would take precautions to prepare for a slowdown. These factors do not change our opinion that the current administration will continue to put companies and investors in advantageous positions, but to ignore them would be foolish and we will continue to be diligent in monitoring broader economic trends.

Portfolio Performance Fall 2019

	Cost Basis/Share		Total Gain/Loss	
Symbol	Purchase	Current Price	Dollar	Percent
Fidelity Government Money Market (SPAXX)	$ 1.00	$ 1.00	N/A	N/A
Automatic Data Processing Inc (ADP)	$ 160.03	$ 168.36	$ 366.50	5.20%
Vanguard BD Index FD Short Term Bond (BSV)	$ 79.92	$ 80.63	$ 450.57	0.89%
iShares MSCI EAFE ETF (EFA)	$ 67.00	$ 68.07	$ 420.85	1.60%
iShares Russell 2000 ETF (IWM)	$ 154.83	$ 160.94	$ 666.22	3.95%
SPDR SER TR S&P BK ETF (KBE)	$ 42.88	$ 46.05	$ 630.62	7.39%
Eli Lilly (LLY)	$ 112.27	$ 119.77	$ 540.36	6.69%
SPDR S&P MidCap 400 ETF (MDY)	$ 348.91	$ 365.61	$ 1,219.28	4.79%
Philip Morris International (PM)	$ 78.63	$ 82.38	$ 468.75	4.77%
SPDR S&P 500 ETF (SPY)	$ 290.12	$ 312.02	$ 11,060.27	7.55%
iShares TR 20 YR TR BD ETF (TLT)	$ 132.66	$ 139.12	$ 1,952.34	4.87%
UnitedHealth Group (UNH)	$ 256.11	$ 282.00	$ 802.59	10.11%
Visa (V)	$ 176.81	$ 181.89	$ 228.60	2.87%
Select Sector SPDR TR Healthcare Fund (XLV)	$ 91.30	$ 99.75	$ 3,220.96	9.26%



Based on the chart and graph above, our portfolio over the last three months has demonstrated overall positive returns. All securities in our portfolio have increased in value as of the end of November, thus increasing the total value of the portfolio.

Allocation Rationale

The majority of our portfolio is invested in equities rather than bonds. Our rationale behind this decision included multiple factors. Historically, equities have outperformed bonds, and given current market conditions we believed that this trend would continue. In addition, the Federal Funds rate cuts, which negatively impact the bonds market, led us to move away from the bond market. As of this writing, the Federal Reserve has cut rates three times, reaffirming our position that the equity markets are primed for a strong finish to the year.

Individual Investments

Over the last three months, the O'Neill Fund Team analyzed the positions that previous classes had invested in and determined that there were additional opportunities for growth. At the start of the semester, before we had the chance to dive deeper into individual stock research, we identified the S&P 500 Index ETF as an opportunity to provide the fund steady returns. As discussed earlier, the current presidential administration values the growth of the stock market and has been championing policies that keep investor confidence high. Progress on a potential trade deal with China and interest rate cuts by the Federal Reserve have given investors confidence to drive stock prices to an all-time high. As a result, we have seen $11,060.27 gains in our SPY position, and it has grown 7.55% this semester.

Healthcare Investing

Beyond the S&P Index, we attempted to identify additional companies that could provide the fund with value. The first area we identified was the healthcare industry.

According to the Population Reference Bureau, "the number of Americans ages 65 and older is projected to **nearly double** from 52 million in 2018 to 95 million by 2060, and the 65-and-older age group's share of the total population will rise from 16 percent to 23 percent."[4] Given these trends, we viewed healthcare companies as potential growth opportunities.

Eli Lilly is a pharmaceutical company that makes some of the most recognizable drugs on the market today, including the diabetes medication Trulicity and the antidepressant Prozac. Eli Lilly posted the fifteenth highest profit margin as of quarter three of 2019 and has seen consistent revenue growth over the last 4 years ($20 billion in 2015,[5] 21.22 billion in 2016,[6] 22.9 billion in

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[4] U.S. Census Bureau, Population Projections.
[5] Eli Lilly Q4 2015 Financial Summary
[6] Eli Lilly Q4 2016 Financial Summary

2017,[7] and 24.6 billion in 2018[8]). Given Eli Lilly's track record of producing highly effective, popular drugs, we viewed their growth opportunities as enticing for the fund.

We also invested money into UnitedHealthCare Group, an insurance provider who, as of 2018 was the largest health insurer in the country, covering over 49 million people and generating revenues over $200 million.[9] The company also reported strong numbers in Q3 of 2019 with revenue, enrollment, and earnings per share all up year over year.[10] UnitedHealthGroup is also an intriguing option due to its ownership of Optum, a company that specializes in the delivery of care to patients in urgent, outpatient, and pharmacy settings. Optum is an opportunity for UnitedHealthGroup to coordinate health insurance with care delivery. This minimizes transaction costs as well as the negotiating that usually takes place between providers and insurance companies. Having more control over all stages of care provision gives UnitedHealthGroup an interesting business proposition that, given their place in the market today, will provide revenue growth opportunities in the future. Having a high-quality care provider like Optum also protects UnitedHealthGroup from the threat of "single-payer" healthcare. Even if a single-payer system threatens the core business of UnitedHealthGroup, Optum could provide a steady revenue stream that keeps the company ahead of its peers.

Payment Processing

Outside of healthcare, we identified other sectors and companies that provide things that people need now and will continue to need in the future. One of those industries is payment processing. The majority of the market share is controlled by two companies, including Automatic Data Processing or ADP. We liked the prospects of ADP because of how steady their revenue streams are. We discussed in class that companies, no matter the stage of the market cycle will always need payment processors to pay their employees. This makes companies like ADP rather resistant to market turbulence in ways that entertainment or technology companies might not be (given their dependence on consumer spending). ADP's financials also showed that the company is taking advantage of current market conditions with a strong performance in their most recent year end reports. The company's core business, Employer Services, which provides different human resource and employment administration services, saw growth of 4% in revenue, and 6% growth in new business bookings.[11] These are not surprising figures given the strength of the economy in 2019 but we were excited about how a company that thrives on job growth and new business openings would fare in a market that encourages those activities.

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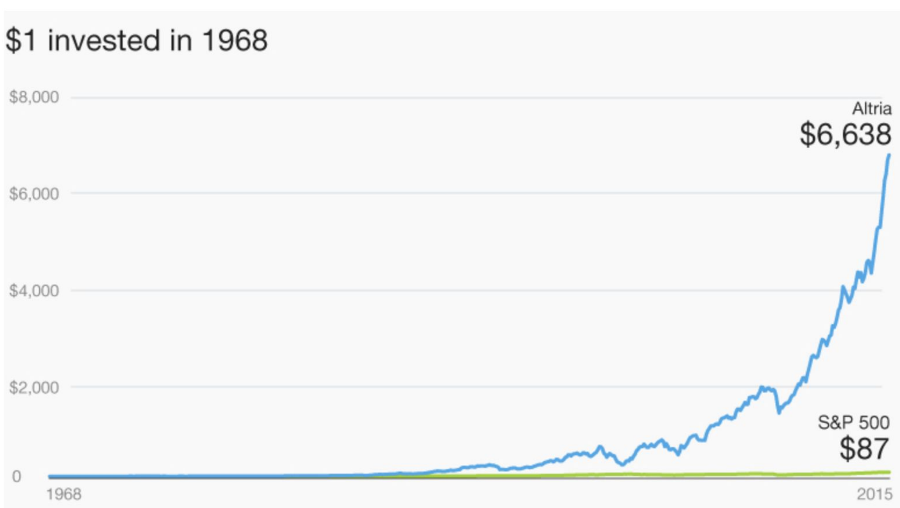
[7] Eli Lilly Q4 2017 Financial Summary
[8] Eli Lilly Q4 2018 Financial Summary
[9] https://www.beckershospitalreview.com/payer-issues/america-s-largest-health-insurers-in-2018.html
[10] https://finance.yahoo.com/news/unitedhealth-unh-7-since-last-143002259.html
[11] ADP Q1 Fiscal Year 2020

For many of these same reasons, the team also liked the prospects of Visa. Visa specializes in credit cards and payment processing. We were particularly interested in the increasing popularity of cashless transactions. As consumers, anything we want is available online and we revel in the convenience of being able to get what we need with the click of a button. Given Visa's standing as a market leader in payment processing, we felt the company was primed to see growth over the next 1 to 5 years. This is due to Visa having a pipeline that is robust and current expectations are high to sign significant renewals and deals in 2019. The company's financial information also demonstrated trends that were encouraging. Service revenues were up 9% year over year in Q4 2019 and data processing revenue was also up 14% in the same time period to over $10 billion.[12] Visa also saw increases in payment volume (9% year over year) and processed transactions (11% year over year) during Q4 2019.[13] These figures suggested to us that Visa was continuing to enjoy strong business prospects and, given the strong economy, would continue to see volumes increase as consumers spent the money they earned from a strong jobs market.

Investment in Vice

Our final investment this semester was Phillip Morris, a tobacco company that sells Marlboro and other branded cigarettes. The interest in Phillip Morris started during a casual conversation about how certain products have created demand through addiction. We researched the topic and were interested to find that $1 invested in the tobacco conglomerate Altria in 1968 would have returned investors $6,638 as of February 2015.[14] This got us thinking about whether or not that trend of returns could continue.



[12] Visa Q4 2019 Financial Summary
[13] Visa Q4 2019 Financial Summary
[14] https://money.cnn.com/2015/02/19/investing/americas-best-stock-ever/

During the semester, our team chose to purchase Philip Morris stock. We added Philip Morris in order to diversify our portfolio. Based on the fact that tobacco is generally an inelastic good, we believed the stock will show consistent returns, regardless of the current economic conditions.

Our team selected Philip Morris over Altria after extensive discussion. Altria has a large stake in Juul, leading us to move away from investing in their stock. With the current negative stigma of Juul and the problems it is facing (such as causing deaths), we decided the stock price would be negatively impacted, adding more risk to our portfolio than we wanted to incur. In addition, we chose not to pursue Altria because of their smaller international stake; smoking is generally more popular internationally. We wanted to diversify our portfolio without assuming the international risks, and the inelasticity of tobacco coupled with the popularity of smoking internationally offered an opportunity for this. Finally, after looking at the historical data, we identified that Altria stock demonstrated high volatility, especially compared to Philip Morris. Philip Morris's stability gave us reason to believe we wouldn't have as much risk for heavy losses.

Benchmark

During the semester, we learned the importance of asset allocation over security selection. Effective allocation reduces risk and adds value to the portfolio. We distributed our funds into multiple asset classes, including stocks and bonds. To measure our success, we compared our results to specific market benchmarks. We used different benchmarks for each sector of the market, U.S. equities, international equities, and the bond market. Each of these benchmarks allowed us to gauge our relative performance against the market. They included:

- The S&P 500, for our holdings in U.S. equities
- The MSCI EAFE, for our holdings in international equities
- The Barclays Capital U.S. Aggregate Bond Index (BarCap), for our holdings in bonds

At the end of November, the O'Neill portfolio had roughly 66% allocated in U.S. equities, 21% in bonds, 6% in international equities, and the remaining in cash. In our first month (September), the fund underperformed the benchmarks, due to our significant cash holdings at the beginning of the semester. In the following two months (October and November), the portfolio outperformed both the static and dynamic benchmarks, indicating we had both nominal and relative returns.

Future Outlook

The current economic climate is one filled with uncertainty. With a presidential election coming in 2020, a current president who has campaigned on and promised economic prosperity, and tension among two of the world’s top economic powers, there is little promised stability in the years to come. However, we view current conditions as favorable for investors, especially in domestic markets. Recent talks between the United States and China on a trade agreement have been stagnant, but on December 5th, Chinese officials offered reassurance to markets that trade talks remain on track.[15] These should be encouraging remarks, as the tension among the two nations remains one of the heaviest weights on investors’ minds as they look for opportunities to invest in 2020. As noted earlier, President Trump views the performance of the economy as the main success of his presidency. He has consistently sparred with his own Fed Chairman about interest rates and keeping them at levels that give consumers and businesses in the United States an advantage over their international peers. As a result, we see a future where economic conditions continue to be advantageous for businesses to invest, thus making the environment advantageous for investors.

We are confident that we have made investments into companies and industries that are not fads or flashes that will fade with time. Healthcare, payment processing, and tobacco are three industries that are, one way or another, staples in the American way of life. People will always get sick, people will always need to be paid, and people, for better or worse will always use tobacco. We do not see these trends changing in the future and are confident that our investments in these industries will provide lasting value to the fund.

Thank you again for the opportunity to manage the O’Neill Student Investment Fund. It has been an invaluable experience that has taught us the value of diligent research, spirited debate, and how putting the pieces of the economy together is a difficult but rewarding endeavor. We thank you for your confidence and appreciate your continued trust.

Sincerely,
The OSIF Fall 2019 Team

[15] https://www.wsj.com/articles/china-says-trade-negotiations-with-u-s-remain-on-track-11575533354