VAN HULZEN ASSET MANAGEMENT

For Investment Professionals Only

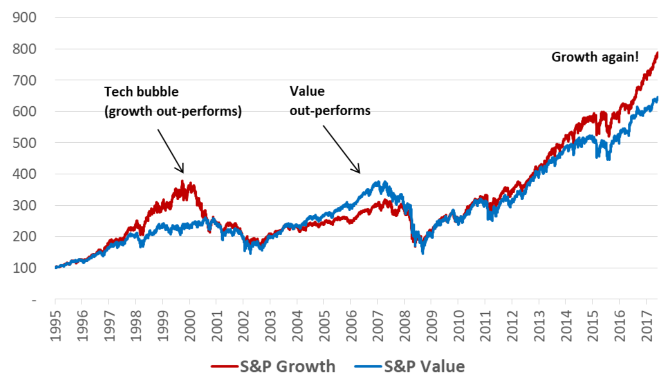
INVESTMENT COMMENTARY: Q4 2017

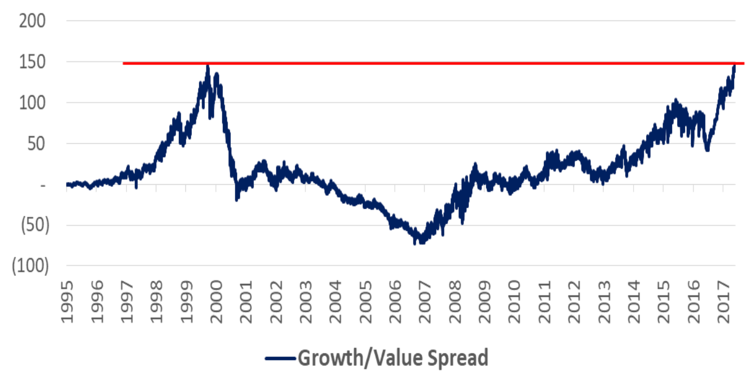
January | 2018

Unprecedented growth and the Volatility Paradox

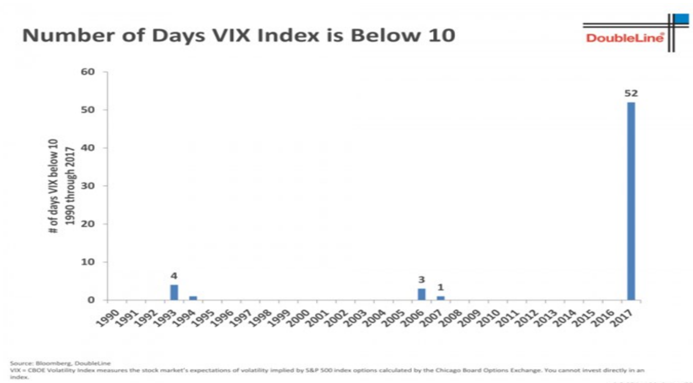
We have all watched in wonder as growth stocks have set new highs seemingly every week. We like to look at the long-term chart of growth stock versus value stocks to provide more context. Over the very long term, these two categories (S&P growth, ticker SGX, and S&P value, ticker SVX) have performed pretty much in-line with each other, with growth stocks providing capital appreciation while value stocks have provided both growth and income (in the form of dividends).

But there are noticeable periods of divergence between these two indices (see the graphic below). For example, growth out-performed value nearly 2-to-1 during the tech bubble. After the bubble burst, value stocks took a strong leadership role for the next 5-6 years. The two indices performed fairly consistently coming out of the 2008-09 crash but again began diverging in 2014. And over the past three years, the FANG stocks (among others) have once again driven the growth index to a premium spread above the value index.





This spread (growth minus value) is at the same level as during the technology bubble in 2000. The valuation, as measured by price to sales, is as high as during this period. This all is occurring during with an unprecedented low volatility environment, with a record number of trading days that the VIX traded below 10.



One could say that this all appears safe and sound; however, we came across the 2017 Financial Stability Report of the Office of Financial Research (OFR). The OFR Research and Analysis Center conducts research to support and improve the regulation of financial entities and markets, evaluate stress tests and other stability-related assessments of financial entities, and investigate disruptions and failures in the financial markets.

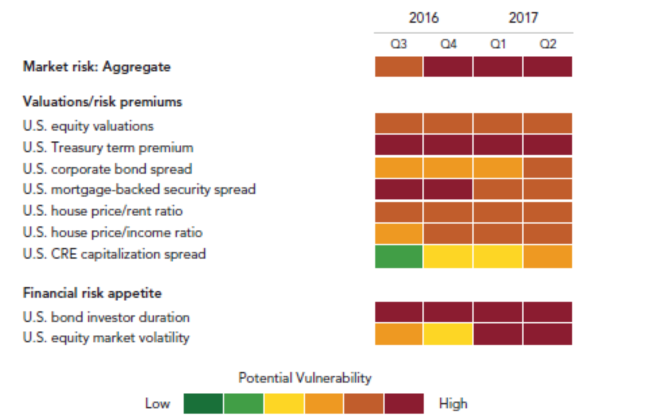
From the report: *"Market risks — risks to financial stability from movements in asset prices — remain high and continue to rise (see Figure 12). The OFR has highlighted in each of our annual reports the risk that low volatility and persistently low interest rates may promote excessive risk-taking and create vulnerabilities."*

One view they highlight is that low volatility may serve as a catalyst for market participants to take more risk. This low volatility would make the financial system more fragile.

There are a number of channels through which low volatility may contribute to greater leverage and risk-taking. Low volatility may increase risk-taking in other ways as well.

As we know, correlations of returns across markets tend to be muted when volatility is low and rise sharply when markets become more volatile. These low correlations could entice investors to accumulate risky exposures, believing that their portfolios are diversified. Prolonged periods of low volatility may further decrease correlations and encourage risk-taking. This phenomenon is known as **the volatility paradox.**

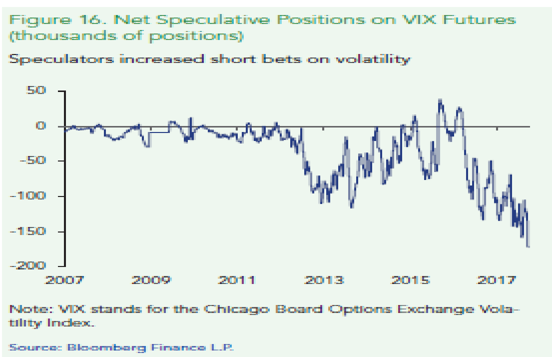
Figure 12. Financial System Vulnerabilities Monitor: Market Risk

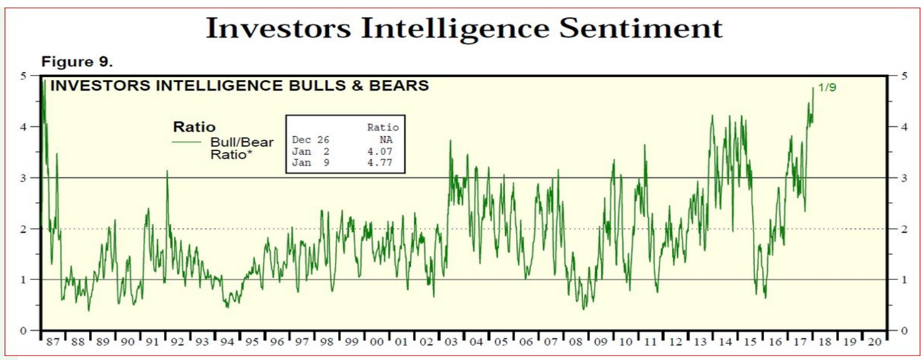


Note: CRE stands for commercial real estate. Figure is excerpted from the OFR Financial System Vulnerabilities Monitor. Technical information about the monitor is available at https://www.financialresearch.gov.

Sources: Bloomberg Finance L.P., Haver Analytics, OFR analysis

By studying figure 16, it appears that the paradox is present. According to the CBOE, we are at a record high with investors following the paradox. This (crowded) strategy will go well....until it doesn't.





Although markets appear to be calm (by measuring volatility) the underlying risks are rising (by the OFR study), hence the paradox. We believe in mean reversion, both for volatility and investor sentiment. We don’t pretend to know when markets will peak or trough, but we do believe that volatility will always normalize over the long term.

Van Hulzen Covered Call Strategy in Review and Outlook

Our strategy gained 2.5% in Q4 compared to 2.8% for the BXM and 6.6% for the S&P 500. This is the first time in the history the stock market that we did not have a down month on 12 sub sequential months. Therefor the BXM was able to ride the perfect wave by producing 13% return for the year. Our strategy produced 11%. The winners in Q4 were big tech and other big weighting index stocks like Boeing, 3M and Caterpillar.

Our investment process is focused on finding undervalued high quality stocks and selling call options to potentially enhance the total return and risk profile on each position. We believe that equity markets are likely to experience heightened volatility in the coming years. As covered call investors, we welcome back this higher volatility as it makes the total return performance less dependent on price appreciation.

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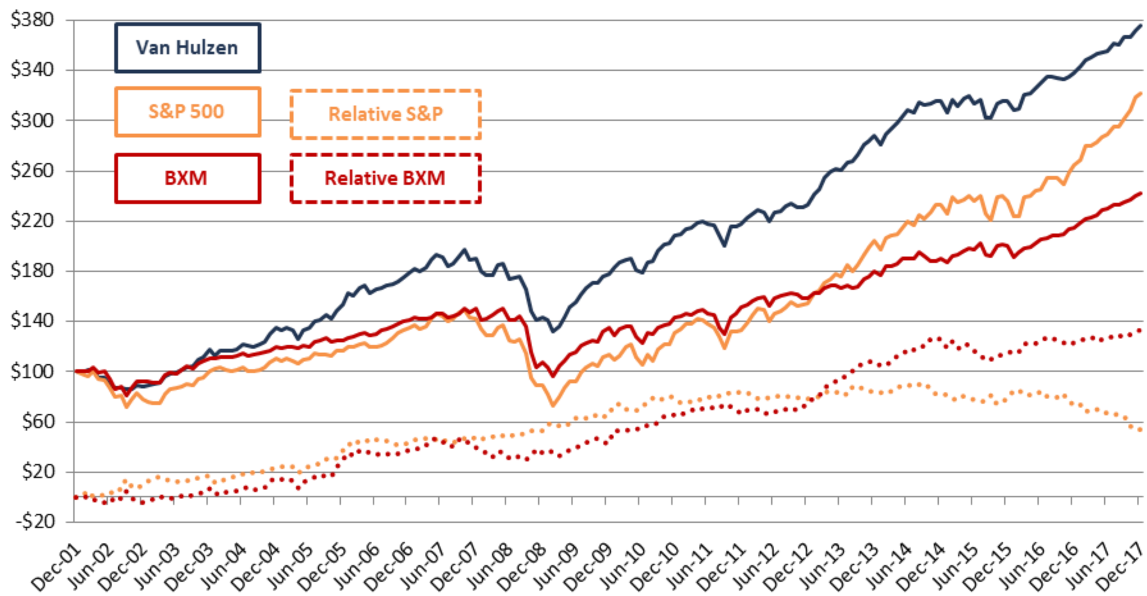
Covered Call Strategy Performance (gross as of 12/31/2017)



Returns (annualized)*	Dec 2017	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	0.9%	2.5%	5.6%	11.2%	11.2%	6.0%	10.0%	8.8%	7.1%	8.6%
Van Hulzen (Net)	0.9%	2.3%	5.2%	10.4%	10.4%	5.4%	9.3%	7.9%	6.1%	7.7%
BXM	0.7%	2.8%	5.4%	13.0%	13.0%	8.4%	8.8%	7.8%	4.9%	5.7%
Difference (Gross-BXM)	0.3%	-0.3%	0.2%	-1.8%	-1.8%	-2.4%	1.2%	0.9%	2.2%	2.9%

***Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts**

Note: There is no assurance that the Strategy will achieve its investment objectives. Writing call options can result in an option exercise and may cause shares to be "called away" and sold. The use of covered call strategies does not ensure profits or guarantee against losses. Past performance may not be indicative of future results.

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