PARAGON
CAPITAL MANAGEMENT

The End of a Key Market Cycle
July 2016

We have been monitoring a long term trend within the stock market that has reached an extreme. Therefore, we are beginning to make portfolio changes. The following will be discussed in this memo:

1. "Expensive" stocks have been outperforming "cheap" stocks for the past 9 years, reaching a historical extreme.
2. Valuations of expensive stocks relative to cheap stocks are also reaching an extreme.
3. Our "quality" stock portfolio has become expensive.
4. "Quality" stocks have seen a deterioration in quality, due to stagnant revenue growth and increasing debt to fund stock buybacks.
5. One of the quality stock indexes we own has changed its methodology to invest in more expensive, lower quality and less defensive stocks.

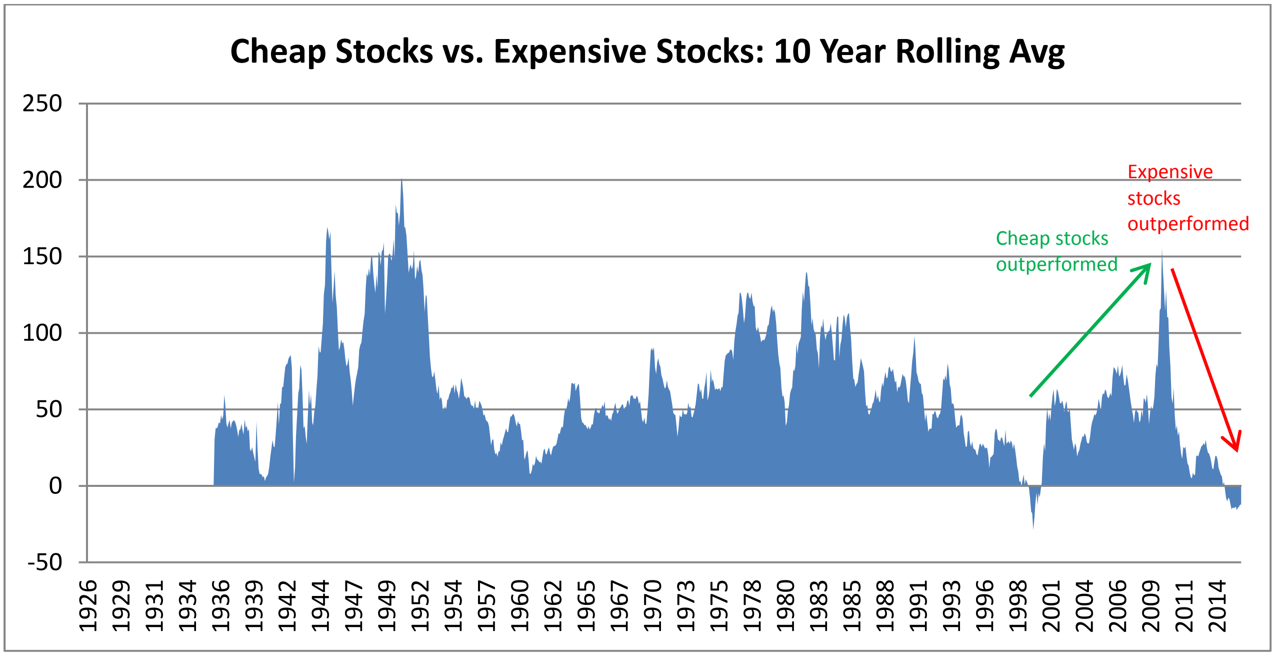
Background

Using data going back to 1926, we analyze the market in various ways, looking for trends and cycles. One such way is "cheap" vs "expensive" stocks (often referred to as "value" vs. "growth"). We're defining this by valuation, specifically the price-to-book-value ratio. Cheap stocks have the lowest price-to-book value ratios and expensive stocks have the highest.

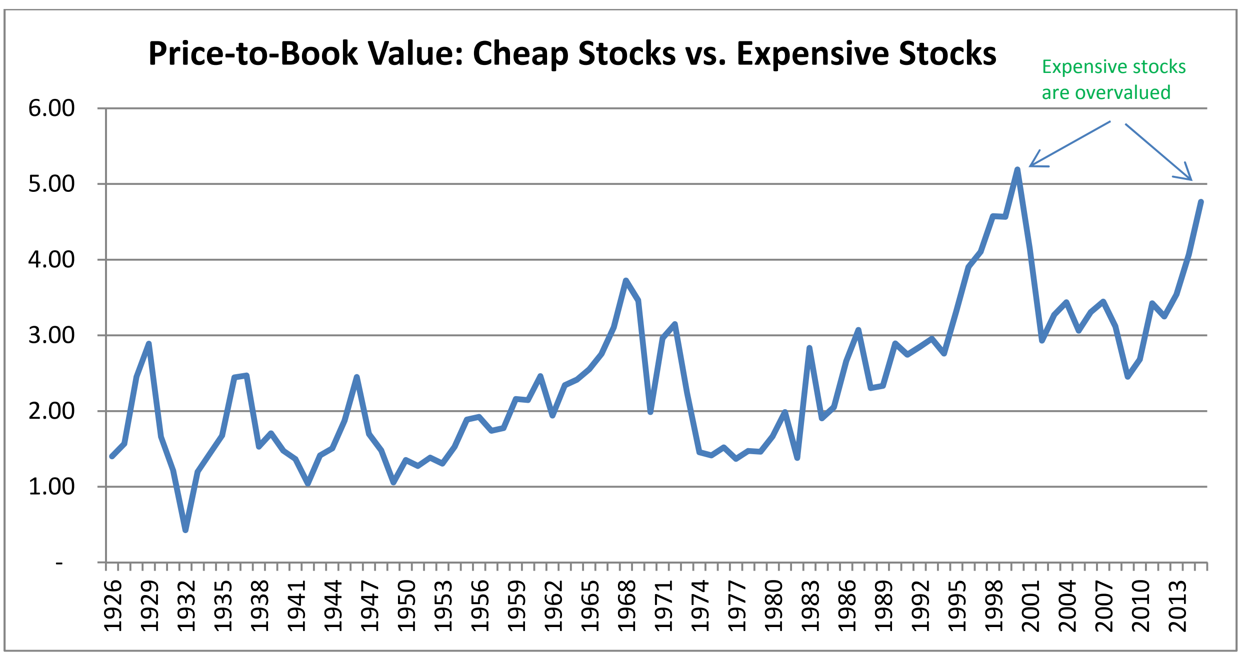
Over the long run (90 years), cheap stocks have tended to have an inherent advantage. They have outperformed expensive stocks by 4% per year over that time because investors chase performance, pouring money into sectors that have performed well, driving valuations to excessive levels. High valuations eventually lead to lower investment returns. Likewise, cheap stocks are unpopular and out of favor, but these low valuations ultimately lead to higher investment returns as they move back into favor over time. However, cheap and expensive stocks swing back and forth over long, multi-year cycles. Paragon leans toward value stock investments, but we recognize that trends can persist for long periods of time.

Current Cycle Status

Expensive stocks have been outperforming cheap stocks for much of the past nine years. The following chart shows a rolling 10-year average of returns of cheap stocks minus expensive stocks. On this basis, the cycle is near an all-time extreme last seen at the end of the dot-com boom in the late 1990s. In all other 10-year periods, cheap has outperformed expensive.



Besides looking at historical returns, we look at valuations. Specifically, we analyzed the difference in the price-to-book-value ratio between cheap and expensive stocks. As seen in the following chart, the valuation spread is also nearing a historic extreme. The average price-to-book-value ratio of expensive stocks is nearly five times higher than that of cheap stocks. This is double the ratio from 2009, as well as the long term average of 2.4.



Underlying Reasons

Most of the recent rise in relative valuations is due to a sharp increase in expensive stock valuations, not a decline in cheap stock valuations. In other words, cheap stocks are no cheaper than they've been historically, but expensive stocks are significantly overvalued relative to their 90-year history.

As we have highlighted in our quarterly updates, the stock market seems very highly valued and somewhat susceptible to a downturn. In the last large downturn, many expensive stocks held up better than cheap stocks. This certainly may happen again, but every downturn is different, and investors often are unfortunately positioned for a repeat of the most recent events. Analyzing 90 years of data hopefully helps us avoid this "recency bias".

Over the first half of 2016, cheap stocks have outperformed expensive stocks. It is never clear if the cycle has shifted or if it is just a short term trend within a longer cycle that will continue. However, given the extreme length and valuation disparity of the current cycle, we believe it is prudent to begin preparing for a longer term market shift into cheap stocks.

Portfolio Positioning

How will this shift affect our client portfolios? After all, we are heavily invested in "quality" stocks. We have dissected the holdings of our three primary quality stock funds, and found that they are overwhelmingly also classified as expensive stocks. Based on current holdings and weightings, these funds consist of 76% expensive stocks, 3% cheap stocks and 21% core stocks (for definitional purposes, cheap and expensive stocks consist of the bottom 30% and the top 30% valuations, while core stocks consist of the 40% in the middle). Thus, high quality stocks have become very expensive as they have outperformed in recent years. Also, due to recent market trading patterns, traditionally expensive and volatile stocks such as Facebook, Amazon and Google are starting to be considered in some high quality, low volatility, and defensive stock portfolios.

Deteriorating Quality

We've found that the rise in price-to-book-value ratios of quality stocks is due to more than price increases. Many of these companies have bought back stock at a record pace, which effectively reduces each company's book value, therefore increasing the price-to-book-value ratio. We have noticed with some large companies, such as Coke and P&G, that their revenue growth and cash flow has been flat over the past few years. With no growth, these companies have been borrowing money to buy back stock in an attempt to create shareholder value, resulting in large increases in debt. With interest rates so low, this may be a wise strategy. But ultimately, with flagging growth, increasing debt, and using cash for stock buybacks instead of investing in growth opportunities, these companies are sacrificing their quality status.

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Significant Shift in High Quality Index Fund

Another reason for rebalancing our portfolios is a shift in the PowerShares S&P High Quality Index fund, which has performed well in recent years, and has met several of the characteristics we are looking for in an investment. The fund now tracks the S&P Quality Index (as opposed to High Quality). We analyzed the new Quality index vs. the High Quality index, and we found that, despite the similarity in names, the Quality index owns much more expensive stocks, and is not nearly as defensive as the High Quality index has been. For example, when the market declined 10.3% in the first six weeks of this year, the High Quality index held up very well, with only a 4.9% decline. However, the Quality index declined 9.1%, nearly as much as the market. We have seen similar results in several recent market selloffs. The valuations of the stocks in the Quality index are much higher, and the factors used in the index result in less defensive stocks.

Implications

Since defensiveness is one of the key qualities we're looking for in our investments, we are selling the fund and redeploying the proceeds into funds that better reflect our strategy. With growth and quality factors expensive, we are shifting towards cheaper stocks and funds that have stronger defensive characteristics. For now, we have swapped into the S&P Dividend Aristocrats Index. We will give significant consideration to income taxes in determining the magnitude of client portfolio repositioning in favor of overweighting value managers.