



Investment Key Takeaways

For most of the second quarter, financial markets seemed to defy grim economic news, the continued spread of COVID-19, and worldwide protests against racial inequality. Global equities performed strongly for the quarter. The S&P 500 Index gained an incredible 21% and by quarter-end was down only 3% for the year, despite the huge drawdown in March. Developed international and emerging-market stocks gained 17% and 19%, respectively, and outperformed U.S. stocks in late May and June.

However, there is a distinct style (or factor) bifurcation beneath the surface: Growth stocks, as measured by the Russell 1000 Growth Index, outperformed value stocks (Russell 1000 Value index) by a stunning 26 percentage points so far this year. As seen in the United States, growth indexes are meaningfully outperforming value indexes overseas.

Enormous levels of money printing and government spending certainly helped the investor mood. Central banks around the world provided unprecedented support to markets and economies. On the fiscal side in the United States, trillions in direct payments and loans have been or are going to be delivered to impacted citizens and businesses. The level of stimulus globally already surpasses by far what was issued during the 2008 financial crisis.

Short-term interest rates are now near zero or negative in most of the developed world. The 10-year Treasury yield fell slightly this quarter but has revolved around 0.7% for some time. Also, investment-grade corporate bond spreads narrowed. Accordingly, core bonds gained another 3% during the quarter.

Non-core flexible bond funds and floating rate loan funds, which take on more risk than core bonds but have higher expected returns, rebounded strongly from their poor first quarter performance, meaningfully outpacing core bonds this quarter.

Our lower-risk, multi-strategy alternatives fund had a strong quarter gaining 8%, also after a disappointing first quarter. In contrast, trend-following managed futures funds gave back much of their strong positive returns from the first quarter, as many market trends have sharply reversed since March. The varied performance of these investments reflects their beneficial, diversifying roles in a portfolio.

While markets and the economy have rebounded, we should steel ourselves for a potential double-dip, even possibly back down to the late-March market lows, most likely caused by disappointing developments on the virus/medical front. There are also other uncertainties around the November election or the ongoing U.S.-China dispute that could disrupt financial markets. This is why we maintain a healthy allocation to core investment-grade bonds, despite very low yields. They are one of the few

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investment classes that should appreciate if the economic recovery stalls or faces a setback, along with a number of our alternative strategy investments.

Still, we see several ways for our portfolios to outperform over the next five to 10 years. If a more benign public health scenario plays out, there is a good chance we'll get a sustainable, albeit uneven, global economic recovery. Along with low interest rates and the monetary and fiscal policy response, this would support the view that equities and fixed-income credit sectors are relatively attractive compared to core bonds. Non-core, flexible, and actively managed bond funds should also do quite well in this event.

Overall, our current portfolio positioning is being implemented in a way that we believe best balances a variety of shorter-term risks against attractive medium- to longer-term return opportunities.

Commentary from Our Chief Investment Officer

Portfolio Performance & Key Performance Drivers

The incredible rebound in risk-asset markets—stocks, corporate bonds, and other credit markets—in the second quarter provided a strong tailwind for our portfolios.

As a reminder, in mid-March, as the S&P 500 plunged 25%, we added an increment (around 4%) back to U.S. stocks in our balanced portfolios, funded from lower-risk assets. As the market continued to drop, we were prepared to add another increment to U.S. stocks. But, (no) thanks to the Federal Reserve's massive "whatever it takes" monetary interventions, we didn't get the chance; the market reversed course about 10% above our trigger point.

We don't rule out the possibility U.S. stocks will revisit their March lows (2,237 on the S&P 500) and we are ready to act again when a compelling opportunity arises.

In the meantime, we like how our portfolios are positioned, balancing a variety of shorter-term risks against attractive medium- to longer-term return opportunities, across a range of macroeconomic scenarios and potential market outcomes.

In the second quarter, we closed out our tactical overweight to European stocks and reallocated the proceeds to a mix of diversified international and EM stock funds. As of quarter-end, our core balanced portfolios are slightly underweight to equities overall—comprising an underweight to U.S. stocks, a neutral allocation to developed international stocks, and an overweight to EM stocks. Our more conservative balanced portfolios have a smaller overweight to EM stocks.

As highlighted above, global equities performed strongly for the quarter. While the U.S. market was the best performer, foreign markets gained some momentum, outperforming the S&P 500 from late May to quarter-end. As we discuss later in this commentary, looking ahead, we expect superior returns from international and EM stocks over our five-year tactical time horizon.

Our portfolios' fixed-income exposure is well-diversified. It includes core investment-grade bond funds (providing recessionary/bear-market ballast to the portfolio) and flexible, actively managed credit- and income-oriented funds, including a tactical position in floating-rate loans. All these non-core fixed-income sectors meaningfully outperformed the core bond index, enhancing our portfolios' absolute and relative performance for the quarter.

Along with stocks and bonds, the third broad asset class grouping in the portfolio comprises lower-risk and diversifying alternative strategies. Our lower-risk, multi-strategy alternatives fund had a strong quarter gaining 8% after a disappointing first quarter. In contrast, our trend-following managed futures funds, gave back

some of their strong positive returns from the first quarter, as many market trends sharply reversed off the March 23 stock market bottom. The diverse performance of these investments reflects their beneficial portfolio role.

Finally, in aggregate (and with only a few exceptions), our active equity and fixed-income managers outperformed their respective benchmarks for the quarter—another reversal compared to their relative performance in the first quarter.

It's Been a Wild First Half ... Where Do We Go From Here?

The Economy

COVID-19 is the Most Important Near-Term Variable

As always, we see a range of potential economic and financial market outcomes looking ahead over the next six to 12 months and beyond. What's unique about the current environment is how dependent the outcomes are on the course of COVID-19. Significant uncertainty remains as to the virus's progression, even as economies around the globe start to reopen and relax social distancing standards. The timing, availability and effectiveness of treatments and vaccines are also highly uncertain but crucial variables for the economic outlook.

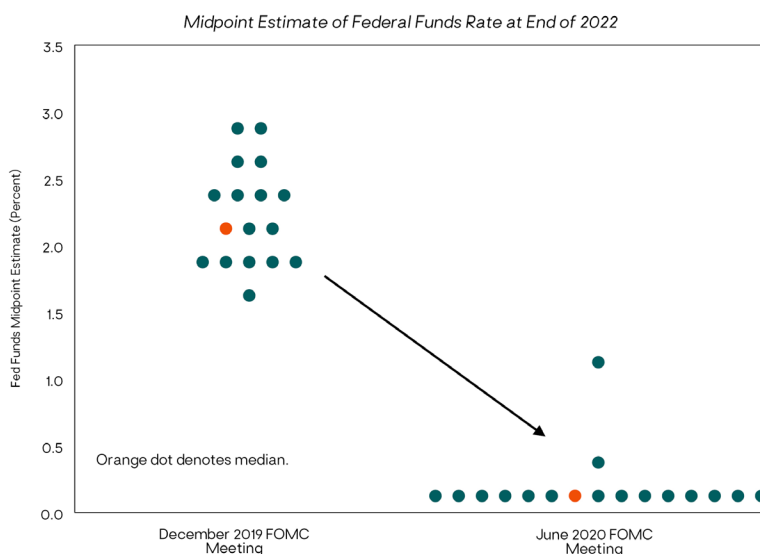
In our view, the key risk to the economy and financial markets is the potential for a widespread second wave of COVID-19 infections, hospitalizations, and deaths that force another large-scale economic shutdown. In that event, stocks could re-test their March lows. We are prepared for that dire scenario with our portfolio holdings in core bonds, Treasuries, and alternative strategies. But absent a severe second wave (or some other major exogenous shock), and even assuming there are smaller localized outbreaks, we think an uneven but steadfast economic recovery is the most likely scenario looking out over the next six to 12 months at least.

Monetary and Fiscal Policy Are Also Key

While we view the progression of COVID-19 as the most important driver of the near-term economic and market outlook, monetary and fiscal policy are second-most in importance. And, in the policy sphere, the Fed is key.

After the Federal Open Market Committee (FOMC) meeting in June, Fed chair Jerome Powell made it very clear the Fed intends to keep monetary policy extremely accommodative for the foreseeable future. Powell said, "We are strongly committed to use our tools to do whatever we can, and for as long as it takes, to provide some relief and stability, to ensure the recovery will be as strong as possible and to limit lasting damage to the economy. ... We are not thinking about raising rates. We are not even *thinking about* thinking about raising rates."

The Fed Doesn't Expect to Raise Rates Above Zero Before 2023



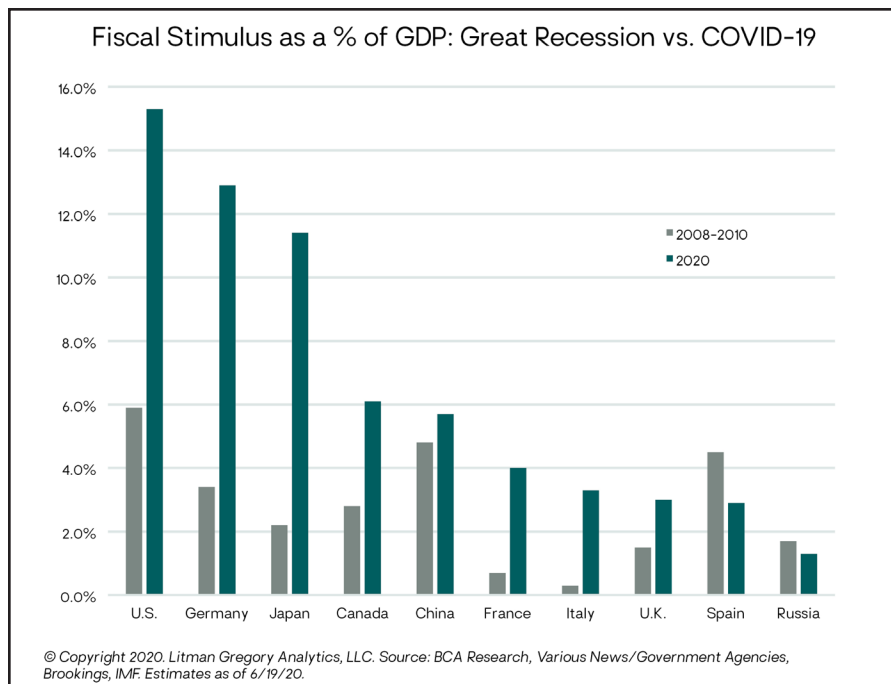
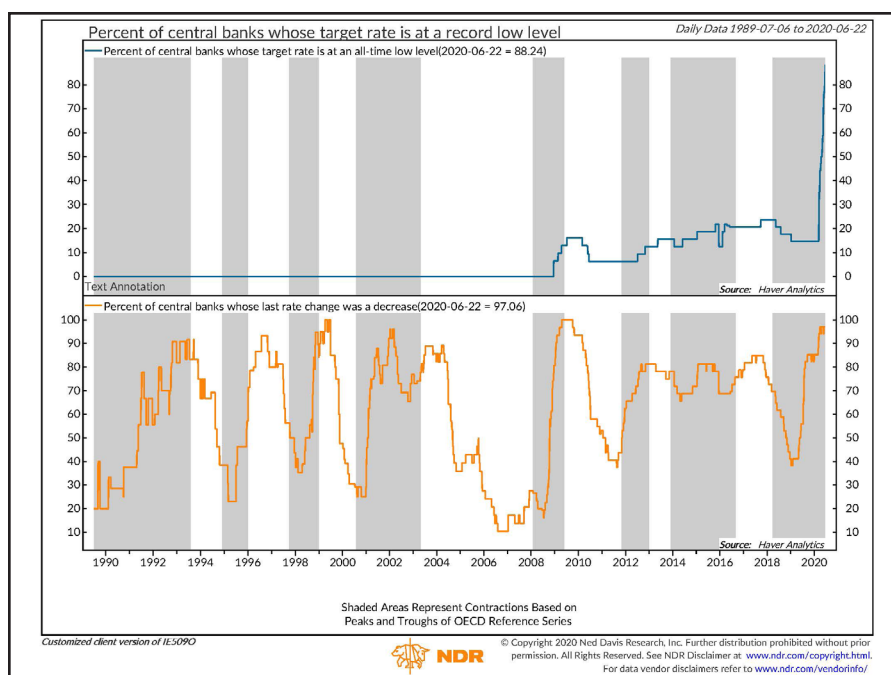
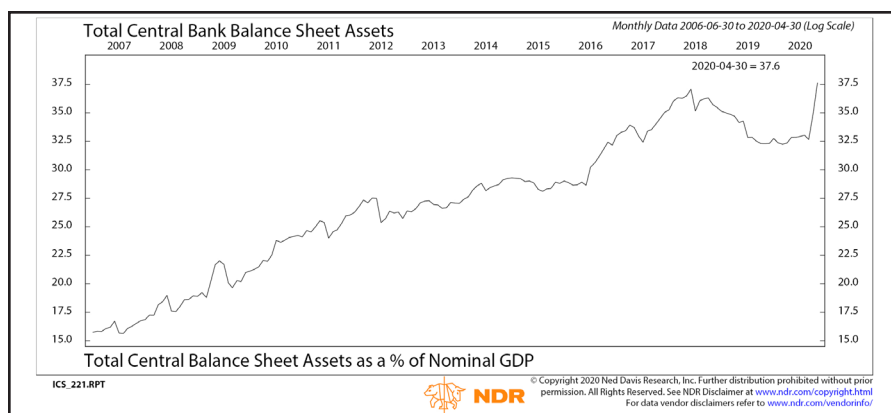
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To this end, 15 of 17 FOMC participants expect the federal funds policy rate to remain near-zero at least through the end of 2022. (See the dot-plot chart on the previous page.) Moreover, the Fed restarted large-scale quantitative easing (QE), committing to purchase \$120 billion per month of Treasury and agency mortgage-backed securities.

The Fed is leading the way for other global central banks to enact their own extremely loose monetary policies. According to Ned Davis Research, 97% of all central banks are now in an easing cycle (cutting rates), and 87% of central banks have their current target interest rate at a record low level.

On the QE front, global central bank balance sheets, in aggregate, have increased to a record 38% of global GDP. The Fed's balance sheet stands at a record 33% of U.S. GDP and climbing. Similarly, for the European Central Bank at 44% of GDP and the Bank of Japan's balance sheet at a whopping 118% of Japan's GDP.

On the fiscal policy side, global fiscal stimulus and support programs have also been unprecedented, much larger than during the financial crisis of 2008–09 for most countries. Another trillion-ish dollar fiscal stimulus package in the U.S. seems likely later this summer as both the White House and Democrats (if not yet congressional Republicans) favor additional government spending to support households and business get through the medical crisis.



This monetary and fiscal support helped prevent a depressionary spiral from taking hold as the pandemic crisis peaked in March/April. It now looks like the U.S. and global economies may have bottomed in April and are on the upswing, albeit from severe recessionary levels. Recent U.S. economic data have been much better than expected—most notably the surprisingly strong May payrolls (2.5 million jobs added) and retail sales reports.

But as Guggenheim Investments recently wrote (and we agree): “Ultimately, monetary and fiscal policy will take a backseat to public health policy. Progress in testing, treatment, non-pharmaceutical intervention and vaccine development will be the biggest determinants in the shape of the [economic] recovery.”

Given All This Stimulus, Is Inflation a Risk? Not Now, Maybe Later

We’re seeing a lot of discussion in the financial press about the risk of inflation in the United States given the massive stimulus from the Fed along with the multi-trillion-dollar debt-financed fiscal support programs.

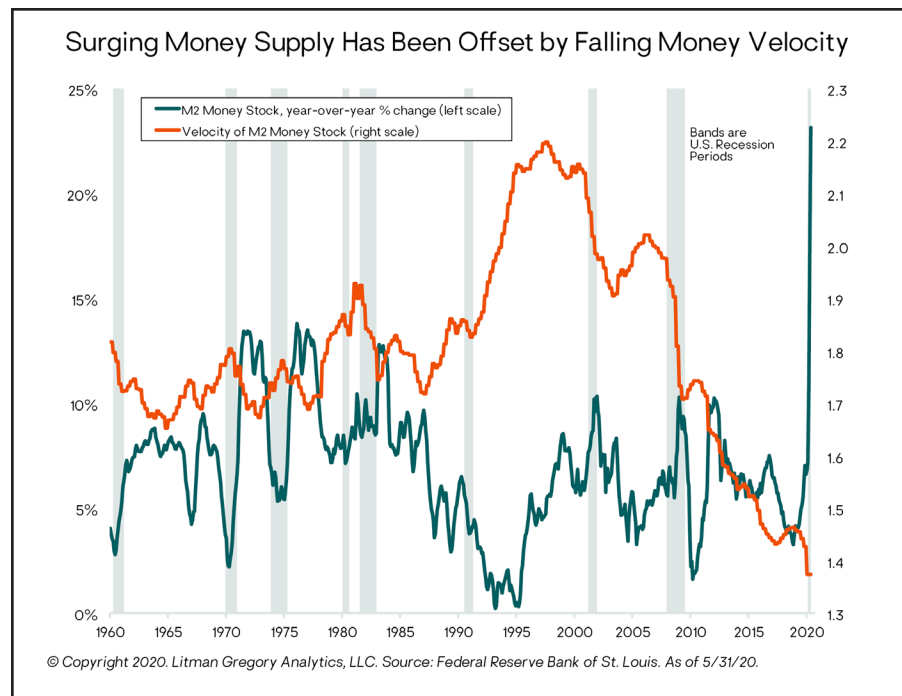
We don’t see inflation as a near-term risk given the strong disinflationary impact of the pandemic. But we can envision a scenario where the current reflationary policies set the stage for an inflationary environment a few years down the road.

We also don’t view inflation as a near-term risk because there is too much slack in the economy due to the hit from COVID-19, absent a major supply-side shock that more than offsets the demand shock. It will take a while—likely a few years at least—for the economy to get back to operating at full capacity and full employment. Until then, the slack should restrain consumer price inflation and wage inflation. It’s also worth remembering that even when the U.S. economy was at full employment in the months before COVID-19, core inflation was still below the Fed’s 2% target. Now, with the economy running below its potential, inflation is a lesser risk.

But isn’t inflation “always and everywhere a monetary phenomenon, in the sense that it is produced only by a more rapid increase in the quantity of money than in output,” as economist Milton Friedman famously said 50 years ago? It’s true that the Fed’s aggressive stimulus has caused the growth rate in the *money supply* (M2) to soar to an extraordinary 24% year over year rate. This is unprecedented. But it shouldn’t be immediately inflationary because the velocity of money (how often a dollar changes hands in economic transactions in a given period)—which Friedman ignored—has dropped to an all-time low. Falling money velocity offsets the surging money supply. As we learned in Macroeconomics 101:

$$MV = PQ$$

where M is the money supply, V is money velocity, P is the general price level and Q is the total quantity of goods and services produced (aka real GDP).



As we saw in the aftermath of the 2008 financial crisis, the Fed's liquidity largesse showed up in price appreciation for *financial assets*, rather than in price inflation in the real economy. We see this as likely to replay again. It already has to a meaningful extent given the huge rebounds in equity and credit market since late March.

However, there is a strong risk these policies will translate into inflation if they remain extremely loose after the economy reaches full capacity and full employment. The Fed is signaling it won't act preemptively to curb inflation in this cycle, unlike how it behaved in the good old days. The Fed is also apparently content to effectively monetize the debt created by government deficit spending. If the Fed continues these policies beyond the COVID-19 crisis, it runs the risk of falling behind the inflation curve. This could lead to an inflationary surprise and a sharp repricing of assets.

We will be watching closely for evidence of inflation as this cycle unfolds. In the meantime, should we get an inflation surprise, our portfolio positions in floating-rate loans, flexible fixed-income funds, EM stocks, and alternative strategies should all perform relatively well. Core bonds will be the big loser in an inflationary environment.

Other Risks

Besides a resurgence in the pandemic, there are several other macro risks to be aware of. We'll name the four at the top of our list:

1. An escalation in U.S.-China geopolitical tensions and/or a re-ignition of their trade war
2. The November elections and policy-related uncertainty (for example, a repeal of the Trump corporate tax cuts if the incumbent party loses)
3. Increasing social and political unrest
4. The potential for corporate earnings to disappoint the consensus later this year

Financial Markets

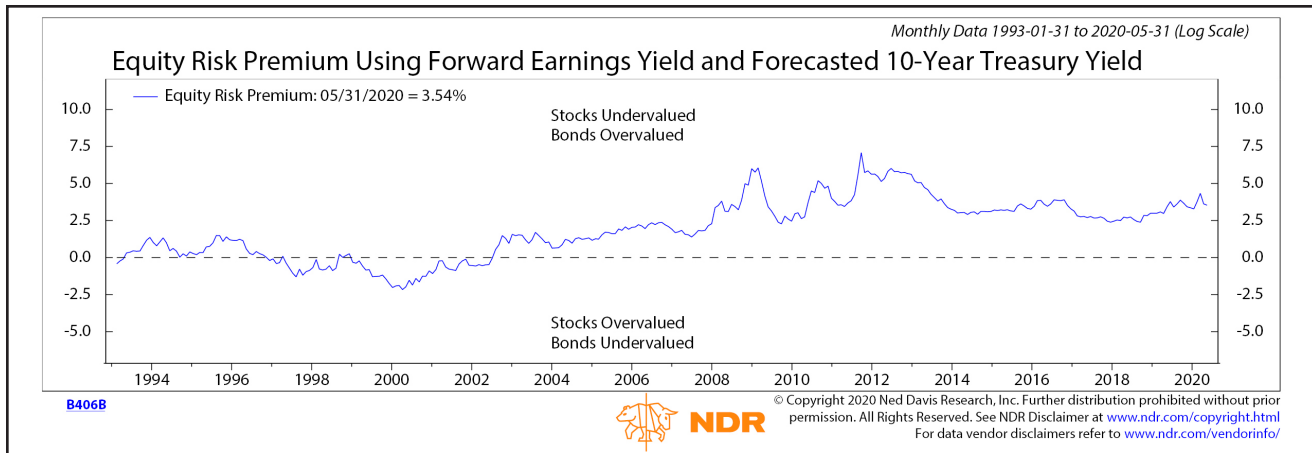
Given this economic backdrop, we see both risks and opportunities for financial assets. In addition to the list cited above, the primary market risk we see is *overvaluation*, which implies poor forward-looking returns for both core bonds and U.S. stocks.

Core Bonds

No matter how you slice it, the future returns from core bonds will be very low, and probably negative when adjusted for inflation, due to the very low starting yields. This is why roughly half the fixed-income allocation in our balanced portfolios is invested outside of core bonds, in flexible bond and floating-rate loan funds. These investments have expected returns several percentage points higher than core bonds, in our view. They have more short-term risk, but they are much less risky than stocks. We believe they have higher five-year return potential than even U.S. stocks at this point in the cycle.

Stocks

After rallying 40% from their March low, U.S. stocks again appear overvalued in absolute terms. However, many investors consider stock valuations relative to bonds or cash, typically referred to as the equity risk premium. On this measure stocks still look attractive. Our investment process focuses more on absolute valuation as it's been a better predictor of full-cycle returns. But we recognize and respect the fact that many investors use relative valuation measures, and relative measures can indeed drive returns in the short to intermediate term.



For us to overweight stocks from our current approximate neutral weighting, we need to see attractive *absolute* expected returns, which are not on offer today. At the same time, attractive relative valuations and a plausible bull-case scenario keep us from unwinding the U.S. stock positions we added during this year's bear market. There are sensible arguments that U.S. stocks *should* be priced higher today than they have been in the past, especially in light of extremely low interest rates that are expected to be in place for a long time.

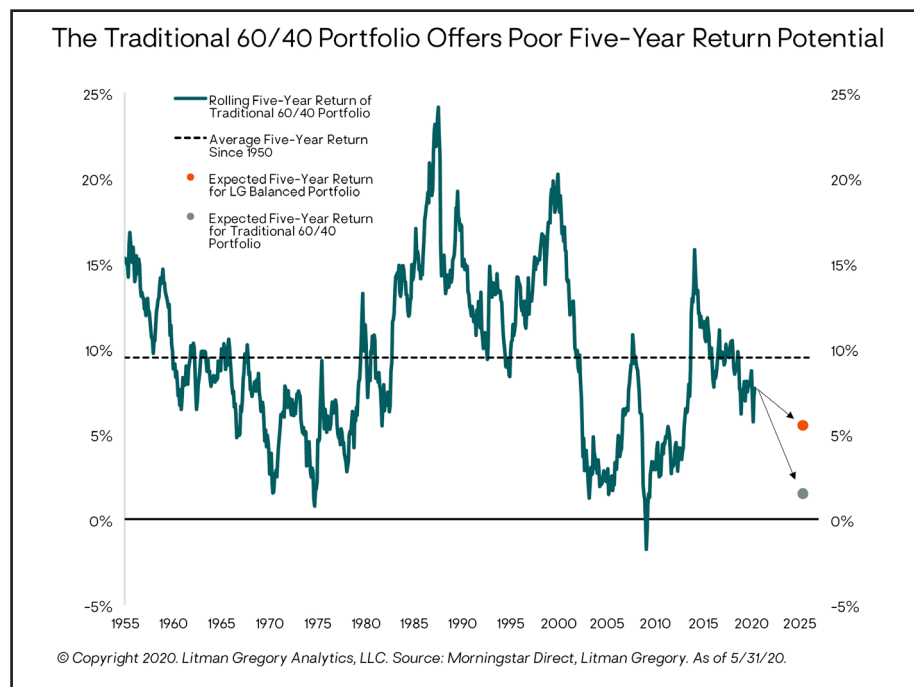
Now within equities, there are compelling opportunities in foreign stocks, especially in emerging markets. First of all, overseas stocks are more reasonably priced. For example, EM stocks' cyclically adjusted P/E ratio is near its lowest point in 35 years of data. Second, foreign economies and their markets are generally more sensitive to global growth, so as the world recovers from the pandemic, foreign stock prices should outperform U.S. stocks. Finally, in a sustainable recovery, we would expect the U.S. dollar to decline, as it is generally a safe-haven currency that depreciates in the face of strong global growth. A falling dollar would further enhance foreign stock returns for U.S.-dollar-based investors (as foreign earnings are translated into more dollars).

Putting It All Together: How Our Balanced Portfolio Compares to a Traditional 60/40 Portfolio

Our active portfolios are constructed and managed to balance risks and opportunities, over the short- (12 months), medium- (five to 10 years) and long-term (10-plus years), across a wide range of scenarios that may play out.

Comparing our Balanced portfolio with a traditional "60/40" portfolio composed of U.S. stocks and core bonds, reveals where we see the best opportunities and how much shorter-term downside risk we are willing to bear to achieve those medium- to longer-term returns.

Using our base-case expected



return assumptions for each of the asset classes in our portfolio, we estimate the traditional 60/40 portfolio will produce a five-year annualized return of roughly 1.5%. This is far below the nearly 10% average 60/40 portfolio return over the past 65 years and its 7.7% return over the past five years.

That is an unsatisfactory expected return, to say the least. We believe we can do better *without* taking on excessive short-term risk compared to the traditional 60/40 mix. Based on our current tactical active allocations, we estimate a roughly 5.5% annual return over the next five years. (This assumes we make no changes to the portfolio over that time to take advantage of new opportunities, which is unlikely.) That equates to an estimated 23% higher cumulative return than the traditional 60/40 portfolio over the next five years.

We also believe our portfolio is more balanced and resilient across a wider range of risks and scenarios than the traditional 60/40—particularly if we get into an environment where inflation and/or interest rates rise. We think there is a good chance of rising inflation and rising rates at some point within the next five years, once an economic recovery starts gaining some momentum and depending on the fiscal and monetary policy actions at that time as well. That could be a scenario where core bonds and U.S. stocks *both* perform poorly and where the broader diversification of our portfolios will pay off. In other words, the exact opposite of the past five to 10 years.

Closing Thoughts

So where does this leave us? We believe our portfolios are prepared for a resurgence in the coronavirus as economies start to reopen and also potentially due to seasonal factors later in the year. Of course, there are other uncertainties looming in the near distance that could disrupt financial markets as well, such as the November election and U.S.-China geopolitical frictions.

But we also hold a cautiously optimistic view that even with an inevitable uptick in COVID-19 cases in coming months, the overall social policy response won't need to be as draconian, and therefore the economic impact won't be as bad as during this first wave.

If the latter public health scenario plays out against a backdrop of extremely loose fiscal and monetary policy, there is a good chance we'll get a sustainable, albeit uneven, global economic recovery. It's unlikely to be a sharp V-shaped recovery, but something more gradual, with fits and starts along the way and some sectors and industries doing much better than others. If so, corporate earnings are likely to rebound as well. Measured against very low interest rates—and with fears of severe recession (or worse) off the table thanks to the policy response—this would support the view that equities and fixed-income credit sectors are relatively attractive compared to core bonds. Our meaningful portfolio exposures to non-core, flexible, and actively managed bond funds should do quite well in this event.

Furthermore, within the equity universe, a global economic recovery, likely accompanied by a declining dollar, should also be a tailwind for international and EM stock markets relative to the U.S. stock markets, for the reasons discussed earlier. Our globally diversified equity exposure should benefit from this, and our overweight to EM stocks should further boost portfolio returns.

In our actively managed equity portfolios, we would not be surprised to see value/cyclical stocks take the leadership reins from growth stocks, potentially marking a new cycle of relative performance in favor of value. Our portfolios would benefit from this change in leadership as well.

In sum, we see several ways for our portfolios to “win” looking out over the next five to 10 years. But we should also steel ourselves for a potential double-dip back down to the late-March market lows, most likely caused by disappointing developments on the virus/medical front. As always, it is so important to be invested in the right portfolio aligned with your risk tolerance and financial goals. This should enable you to keep a healthy long-term perspective and to remain disciplined and “stay the course” through the inevitable down-drafts when fear in the markets is palpable.

—Litman Gregory Investment Team (7/7/2020)

A Message from Litman Gregory's CEO

In June, I wrote a memo to the firm to make clear that Litman Gregory stands against racism and views inclusion as a core value. Our co-founders also shared a personal communication that underscored these beliefs in which they offered to extend our company's charitable matching program and bolster this year's impact by personally matching individual gifts to charitable organizations that support communities and causes working to achieve an equitable society for all. We believe it is also important that our clients and friends know where we stand so I am sharing excerpts from my internal communication below:

I am reaching out on behalf of our Executive Team to acknowledge the extraordinarily difficult period we've been experiencing and to consider this in the context of the values of our firm. Recent events have elevated the frustration and urgency around the destructive power of racism and the imperative for progress. We are also amidst a painful economic downturn and health crisis that is particularly hitting the most vulnerable members of our community. We know that many of us share feelings of sadness or anger and a strong desire to help.

In considering the events around us, we have had many individual conversations within the Litman Gregory community and feel it is important that you know where we stand. We believe diversity is a strength and that we and our clients benefit from a workforce that supports and draws on a range of backgrounds, viewpoints, experiences, and identities. We do not accept discrimination of any kind. We stand firmly in support of the daunting challenge to bring racial equity, and we recognize that racism exists overtly and in subtle persistent ways that break hearts and destroy lives.

We believe a society that provides equal and fair opportunities is not only our moral obligation but is also in our collective interest. Given our country's history, it may at times seem difficult to achieve the positive change that will move us closer to that goal. In support of what we strongly believe is a collective interest and responsibility for the community and broader world we all live in together, we must find ways to do so.

We are each individually stronger if everyone is stronger, and we join the effort to work toward a better, more just world and better times ahead.

—Steve Savage, CEO

Taking Action in a Time of Uncertainty

Although this journey through a global pandemic and economic slowdown is still unfolding, each day we know more and there are fewer unknowns. However, we are still facing a high level of uncertainty, and this can cause people to react in the extremes—either freezing up to complete inaction or making changes just to feel better that action is being taken.

In our role as wealth advisor to our clients, we take seriously our responsibility to help guide thoughtful decision making and wise action. Today more than ever, we want to focus not on what we can't control in this uncertain environment, but on what we can control.

There are a growing number of positive steps that we can take together during this difficult time. Many of the actions we highlighted in articles and personal communications earlier this year are still relevant:

- 1. Keep a long-term and opportunistic perspective.** The roller coaster that we've already experienced this year can quickly erase the memory of significant market gains just last year, and for many of the last 10 years. And the anxiety of potential additional catalysts for market declines in the near future can impede the ability to look for opportunities when the environment looks bleak. We know that responding in panic doesn't pay off, but we also know that preparing for potential downside is prudent. Keeping a long-term perspective will help drive better decisions today and better preparation to take advantage of buying opportunities or tax optimization through loss harvesting—both of which can be beneficial to your bottom line.
- 2. Confirm an appropriate “emergency fund.”** One of the best strategies to help you sleep at night, even during market volatility, is to ensure the funds you need for spending in the near future are not at the mercy of short-term market movements. We can work with you to make sure you have an appropriate amount of cash or low-volatility investments set aside to fund either spending needs or just as an emergency fund—keeping this money steady when the near future is unknown.
- 3. Revisit financial planning and/or cash flow projections.** By reviewing how your resources will support cash flow needs into the future, we can help you plan for your spending to be sustainable. And if making changes to expenses in the near term would be advantageous, that could be a positive step to take during a difficult time. Reviewing scenarios for how the future may play out can be very helpful in creating the appropriate context for making decisions today.
- 4. Take advantage of various provisions of the SECURE and CARES Acts.** For example, under the CARES Act, required minimum distributions can be waived this year, including those for clients with inherited IRAs. And if you've already taken a portion or all of your distribution, we may be able to help you use IRA rollover rules to return any unneeded portion to your account. Roth IRA conversions may also be an attractive tax strategy to consider given rule changes for 2020 and recent market volatility. Given that each individual, family, or organization's situation is unique, it is worthwhile to have a conversation so we can uncover other opportunities made possible by recent law changes (such as deferring tax or loan payments, applying for business loans, refinancing, reviewing beneficiaries, contributing to retirement plans, and more).
- 5. Update Charitable Giving Plans.** If you want to give more in this time of crisis, or even revise your giving to support new causes and organizations, we can help you update your plan. Keep in mind that the CARES Act also now allows you to deduct up to \$300 in cash contributions, whether or not you itemize deductions on your tax return.
- 6. Take proactive breaks from the 24/7 news cycle.** We encourage you to take time away from the news and daily COVID-19 updates. The constant news feed is focused on keeping consumer attention and primarily benefits advertisers. It can be overwhelming to the viewer, and that can lead to unnecessary stress and anxiety. It's important to stay both physically and mentally healthy so you

can make the best decisions for your overall benefit. We, at Litman Gregory, are practicing this ourselves and believe it puts us in a better position to support thoughtful decision making with our clients.

If you would like to review any of these or other actions that could benefit your financial situation, please connect with your Litman Gregory Wealth Advisor.

Gretchen Hollstein Named to Forbes Top Women Wealth Advisors List

We are pleased to share that Litman Gregory Senior Advisor and Principal Gretchen Hollstein, CFP® has been named to the 2020 Forbes Top Women Wealth Advisors list. This year's list spotlights 1,000 top advisors across the country who have demonstrated high levels of ethical standards, professionalism, and success in the wealth management business.

"I'm honored to be included on this prestigious list of advisors," said Gretchen. "The recognition is especially meaningful during this time of unprecedented instability affecting all of our lives. It's truly a privilege to be trusted by clients to help guide them towards financial peace of mind. I am also indebted to the integrity-driven people on the Litman Gregory team, all of whom are committed to our work together to make a positive difference in the lives of our clients."

Gretchen joined Litman Gregory in 2005 and became a principal in 2010. She has over 20 years of experience providing investment advisory services to individuals, family groups, and nonprofits. Her experience includes extensive work in personal financial analysis, asset allocation, retirement planning, and multi-generation family legacy planning.



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