

Portfolio Manager Commentary

Fourth Quarter 2019

Dear Client,

Well, that was fun. 2019 marked the best year for the S&P 500 since 2013. The year started with a bang as the market bounced sharply off of a steep bottom from the fourth quarter of 2018, had a period of tepid returns as it muddled through a couple of quarters in the middle when trade war and recession fears controlled the narrative, and finished with a bang in the fourth quarter as many of the prominent macro fears seemed to subside. Our Focused Growth portfolio generated strong results during 2019 with gross returns up ~38%. Our investment philosophy is predicated on stock prices following long-term earnings growth and while the earnings growth of our portfolio was not 38% in 2019, the earnings growth achieved by our portfolio companies since the launch of this strategy in fourth quarter of 2018 roughly matches the 19% return generated over that period. As we look towards 2020, we are sure that new macro issues will replace the old ones, but our focus remains on the underlying performance of our portfolio companies. On that front, the companies in the portfolio exit 2019 with strong business momentum and we believe that stability in global interest rates and trade creates an environment in which their natural competitive advantages will be able to shine.

The morning of December 13th was a moment of professional peace for me. The week of December 9-13 seemed to provide a sense of clarity on three of the largest macro-economic overhangs on the market. In the period of one week, the Federal Reserve announced that it was holding interest rates steady and had no expectation of a rate move in 2020, the British elections produced a clear outcome thereby reducing some of the uncertainty surrounding Brexit and the US and China announced that they had reached agreement on Phase 1 of a trade deal. Given the amount of time I had spent over the past year thinking and writing about these issues, the prospects for greater visibility around them produced a welcomed sense of calm. This lasted about halfway through my morning commute at which point I realized macro-economic uncertainties are like highway construction in Houston- projects begin and projects end, but there are always orange barrels around which we must navigate.

The biggest orange barrel looming over 2020 is the US Presidential Election and the dueling visions of the next four years that will be presented to the American people. As we have noted before, our approach to the election from a portfolio standpoint will be to filter out the apocalyptic rhetoric from both sides while, always keeping in the forefront of our mind, that our system of government is such that dramatic change in law in either direction is difficult to achieve. That said, once the Democratic challenger to President Trump emerges, we will be paying close

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attention to commentary surrounding intended executive orders and regulatory changes as these are areas that can see material changes based on which party controls the executive branch. Despite the current bliss of relative tranquility on the trade front, this will remain an issue that can add volatility and uncertainty to the markets on a moment's notice, with a moment being defined as the time it takes President Trump to grab his phone and send a tweet. This won't change in 2020, but we will note that it seems to be in both side's self-interest to make 2020 a less contentious year on the trade front. Our expectation is that the meatier portions of the trade dispute will be tabled until after the election, but we would point out that this is one issue where there is not a great deal of separation between the Democrats and Republicans and we believe that both parties will run on a tough on China platform.

Speaking of orange barrels, the new year was not yet a week old when the 40-year conflict between The United States and Iran looked as though it was on the cusp of turning into a full-fledged shooting war. After a US contractor was killed by an Iranian militia in Iraq, the US launched a missile attack against the group. Following this attack, Iranian proxies attempted to overtake the US embassy in Baghdad, which escalated the conflict. Things really reached a boiling point when the US was able to locate and kill General Soleimani, the leader of Iran's Quds Force and the architect of its policy of exporting terror and mayhem over the past 20 years. Iran responded by firing 15 missiles at US bases in Iraq, which thankfully resulted in no US casualties although tragically, it appears as though an errant missile downed a commercial aircraft resulting in 176 deaths. As it stands today, it seems as both sides have taken a step back from the brink of war to reassess strategy. It goes without saying that our hope is for a peaceful solution that advances global stability and protects every single one of our service men and women serving in the area. As for the impact on global markets, we marvel at the resiliency of the equity markets over the last six months during which Iran disrupted the flow of oil in the Strait of Hormuz, attacked an oil production facility in Saudi Arabia and came to the brink of war with The United States. Simply stated, the strategic importance of Middle Eastern oil has decreased dramatically with the invention of shale drilling and the resulting spike in US oil production. Further, the importance of oil shocks to our Focused Growth portfolio is minimal as we own no energy companies and our portfolio is comprised of businesses that are not energy intensive. Still, any escalation of this conflict will have an impact on global markets and as such, this is something we will monitor closely.

Behavioral finance is a fascinating topic and coming off a year in which the S&P was up 31%, it seems like a good idea discuss the concepts of recency bias, reference points and confirmation bias and how they interact to form investor opinions and guide actions. The current bull market has often been referred to as the most hated bull market in history as the extended rally in equities and period of economic expansion has been distrusted by many investors who have been

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waiting for a market collapse similar to the 2008/2009 financial crisis. This is understandable given how unsettling the financial crisis was. It is also a great example of recency bias, which is when greater emphasis is placed on recent events than on an entire body of evidence. The most recent economic downturn resulted in the sharpest decline in GDP since the Great Depression and the biggest one-year market downturn since 1931. However, consider that since World War II, the S&P has fallen by more than 20% in a single year only 3 times, and it gives the sense as to how rare 2008 was. Still, this period is fresh in the minds of many investors. Taking the pain of the last downturn together with the fact that over the last 11 years, the market has appreciated at a compound annual rate of 14.7%, and it is easy to see why so many investors are fearful of a substantial market decline. The 11-year market return cited is an example of a reference point, the point at which a period of measurement begins. When considering market performance, the reference point matters greatly. Highlight the 14.7% annual returns delivered over the last 11 years and the market sounds frothy. However, the 9.1% compound annual returns achieved over the last 12 years sounds more reasonable. The 20-year annual rate of increase of 6.1% seems anemic, while the 25-year compound annual return of 10.2% is more reasonable. It's all a matter of when the counting starts. Finally, we get to confirmation bias, which is the tendency to seek evidence that confirms existing beliefs. Let's see how they all work together. The last crash was terrible (recency), the next one is just around the corner because we've been on an 11-year run (reference), I knew it, we are doomed (confirmation). The good news is that this mindset will make a person sound much more intelligent at cocktail parties as only a wise man sees and understands the risks of the world while many a fool are content to party it up until the next crash. The bad news is that this is probably not a mindset geared towards building long-term wealth. As I've noted many times before, I have no clue as to the near-term direction of the market. For proof of that, look no further than the decision to launch the Focused Growth Strategy just in time for Q4-18, the worst market quarter in the last decade. That said, I do firmly believe that investing in a basket of growing businesses over a long period of time is the best way to protect and grow wealth when you sift through all of the noise. This is the essence of what we are trying to do.

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Fourth Quarter Portfolio Results:

Table 1 below shows the results of the Focused Growth Strategy in the fourth quarter, for 2019 and since inception (10-1-18) as compared to the S&P 500 and Russell 1000 Growth.

Table 1:

Portfolio / Index	4Q19 Return	2019 Return	Since Inception
Focused Growth Portfolio	12.2%	38.2%	19.3%
S&P 500 Total Return Index	9.1%	31.5%	13.7%
Russell 1000 Growth Index	10.6%	36.4%	14.7%

Returns are gross of fees

As discussed above, fourth quarter equity returns were very strong marking a nice bookend to an exceptional year. Our portfolio companies benefitted from a more stable macro environment and a continuation of strong underlying results. Third quarter earnings were announced in October and November and the weighted average revenue and EPS growth rate for the portfolio was 15% and 19% respectively for that period. As discussed above, the earnings growth since inception is very consistent with the 19% return since inception. This speaks well to the fundamental justification to the returns achieved to date. We expect continued strength in operating results and look forward to the report of fourth quarter results and the initial look at guidance for the coming year.

Tables 2 shows some notable performers during the fourth quarter in terms of both absolute performance as well as total contribution (% increase/decrease x weighting) to overall portfolio returns.

Table 2:

Notable Q4-19 Performers					
Positive Contributors			Negative Detractors		
	Performance	Contribution		Performance	Contribution
Alibaba	+26.8%	+1.34%	AB-Inbev	-15.8%	-0.47%
Nvidia	+35.2%	+1.41%	Comcast	-0.2%	-0.02%
United Health Group	+35.3%	+2.82%	Verisk	-5.6%	-0.14%

Returns are gross of fees

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Fourth quarter results were very strong on both an absolute and relative basis and almost half of the total return in the period was driven by the outstanding performances of Alibaba, Nvidia, and United Health Group. In prior editions of this letter, we have noted the fact that the trade dispute with China seemed to be adversely impacting the share performance of both JD.com and Alibaba despite the fact that, as Chinese e-commerce players, neither was directly impacted by the dispute. We used this dislocation between the fundamentals and share performance to increase our weighting in JD.com in Q3 and we did the same with Alibaba early in Q4. As the trade dispute moved from a period of escalation towards a period of truce with the two sides agreeing to a Phase One deal that at least halted further intensification of hostilities, shares of both JD.com (+25%) and Alibaba (+27%) enjoyed very strong fourth quarter performance. Given that both companies reported results well ahead of expectations throughout 2019, we believe that the positive re-rating achieved during the fourth quarter is more reflective of the underlying fundamentals and remain upbeat about the prospects for both stocks, particularly now that some of the noise surrounding the trade dispute has quieted.

United Health Group was another stock that we highlighted in our Q3-19 investor letter as being unfairly punished due to a political risk that we put very low odds on being realized. UNH shares fell 11% in Q3 as Medicare for All took center stage in the Democratic debates and Elizabeth Warren surged in the polls. We used this as an opportunity to add to our position and figured that at some point, the valuation overhang would subside, and the stock would catch up with the fundamentals of a company that continued to grow earnings at a 15% rate. This happened in the fourth quarter, which saw a sharp 35% rebound in UNH shares. As is the case with Alibaba and JD.com, we believe that the rebound in valuation is more consistent with the very strong underlying fundamentals of this company.

Shares of Nvidia (+35%) had an outstanding fourth quarter as improvement in datacenter chip demand indicated that the trough in the recent semiconductor cycle has already been reached. When we bought Nvidia in May of 2019, in the teeth of the recent downturn in the semiconductor market, we did so not because we believed we could time a semi cycle (this was confirmed by the fact that the stock went down every day for the first 15 days we owned it), but because we thought the pressure the shares were under offered a unique opportunity to initiate a position in the world's leading GPU provider with heavy exposure to very attractive end markets (gaming, data center, and artificial intelligence). As we enter 2020, we are excited to see the growth that Nvidia delivers as its end markets move from cyclical contraction back to growth.

As for the underperformers during the quarter, there are three different explanations, the first two of which not being overly problematic while the third of which explains why AB-Inbev is no longer part of the portfolio. Comcast is a stock that was discussed at length in the third quarter

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investor letter, so it is unnecessary to reiterate the tremendous value we see in the cable wires that provide broadband connectivity. In the fourth quarter, the market showed signs of agreeing with our assessment as shares of Charter, which is a pure play cable business, increased 18%. Shares of Comcast failed to keep pace, which we attribute to visibility concerns surrounding its NBC Universal and Sky divisions. Our view is that as visibility around the non-cable portions of Comcast improves (we expect this process to begin when the company lays out its streaming plans this month), the valuation gap that has opened up between Charter and Comcast will narrow by seeing Comcast's valuation expand.

Verisk is an example of a company that has continued to execute but whose stock may have gotten a little ahead of the fundamentals. Unless there is a massive disconnect between current valuation and long-term opportunity, we will not liquidate a position solely on a valuation call. Instead, as we have done with Verisk, we will trim a position into strength and reallocate into better opportunities should the current valuation become stretched. Verisk's business continues to perform as we had expected and as such, we are not overly alarmed about the soft patch that the stock hit in the fourth quarter.

Before it starts to look as though we make excuses for any holding that underperforms during a period, we present AB-Inbev. As a long-term investor, one of the biggest things we try to guard against is thesis creep. Simply stated, we want to own companies where the fundamentals validate our long-term thesis rather than being put in a situation where we must massage our long-term thesis to justify owning a company with deteriorating fundamentals. We owned Bud because we believed that the company's ability to penetrate new markets with its three global mega-brands (Budweiser, Corona, and Stella Artois) could overcome persistent weakness in its US and Brazil businesses. Third quarter results, which were released in late October, showed that the growth in these global brands slowed sequentially while weakness in the top two markets (US and Brazil) persisted and in the case of Brazil, worsened. For a company with a heavy debt burden and enormous foreign currency risk, this breakdown in the thesis was something we could not excuse. As is the case with many leading global consumer staples companies, Bud simply did not have a lot of margin for error as it relates to growth. The slowdown in the global brands coupled with continued weakness in the US and Brazil took profit growth from the mid-single-digit range to slightly negative. This delays the healing of the balance sheet, which pushes the period of increased cash return beyond a point that we were willing to tolerate. Hence, we liquidated our position in Bud.

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Fourth Quarter Portfolio Activity:

Table 3 shows the changes made to the portfolio during the fourth quarter. Third quarter results, which were mostly reported in October and early November, ranged from solid to outstanding across the board, except for AB-Inbev. As such, fourth quarter activity was minimal. As discussed above, deteriorating fundamentals forced us to sell our stake in Bud, which we reallocated to Alibaba and Intuitive Surgical. We touched our rationale for increasing Alibaba earlier. As for Intuitive, 2019 was a transition year for the stock as the company ramped up its spending which depressed earnings growth. Moving forward, we expect to get greater clarity as to the opportunities that drove the uptick in spending which we think will be beneficial to the shares. As such, we took the opportunity of the Bud sale to increase our weighting in Intuitive, which remains one of our favorite long-term ideas.

Table 3:

New Purchases / Additions		
Company	Beginning Weight	Ending Weight
Alibaba	5.0%	6.0%
Intuitive Surgical	6.0%	8.0%

Eliminations / Reductions		
Company	Beginning Weight	Ending Weight
AB-Inbev	3.0%	0.0%

2019 was a fantastic year and if we could, we'd order up a dozen more just like it. Unfortunately, markets don't quite work that way so we will have to be content with continuing to monitor the fundamental progress of the companies in our portfolio and counting on them to build value over time. As the pendulum of market emotions swing back and forth, we are committed to maintaining an even keel. We are grateful for the trust you have placed in us and enter the new year confident in the composition of the portfolio and excited for the release of Q4 earnings and the issuance of 2020 guidance. As always, please feel free to reach out if you have any questions.

Sincerely,



Ken Burke
Chief Investment Officer

Disclosure

The Burke Wealth Management Focused Growth Composite, created on October 1, 2018, contains fully discretionary large cap equity accounts that is measured against the S&P 500 Total Return Index and the Russell 1000 Growth indices. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The Burke Wealth Management Focused Growth Strategy invests exclusively in a portfolio of high-quality companies.

The S&P 500® Total Return Index is a widely recognized, unmanaged index of 500 common stocks which are generally representative of the U.S. stock market as a whole. Ordinary dividends are reinvested across the index and accounted for in the Total Return index calculations. The Russell 1000® Growth Index is an unmanaged index that measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000® Index companies with higher price-to-book ratios and higher forecasted growth values.

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