

### INVESTMENT OVERVIEW

#### NO STONE UNTURNED: SMALL CAPS OFFER VALUE IN 2020

The date of McShane Partners' annual portfolio manager panel event is fast approaching, with this year's exclusive event scheduled to take place on **Tuesday, February 25<sup>th</sup>** from **5:30-7:00 PM** at **Carmel Country Club**. Nearly half of the available seats have already been reserved, and we would encourage anyone who has not already done so to RSVP at your earliest convenience, as prior years' events have always been extremely popular and well-attended.

This year's panelists were carefully selected for their unique perspectives, respective areas of expertise, and years of experience researching, analyzing, and investing in small-cap equities. With small caps - in particular, small-cap value stocks - continuing to underperform their large-cap peers, combined with diminished analyst coverage of the small-cap equity universe, the Investment Team believes that the current set-up in small-cap equities represents an extremely attractive entry point in an out-of-favor, neglected asset class. Given the increase in informational asymmetries across small-cap equity markets and the outsized impact of formulaic trading by exchange-traded funds ("ETFs") on small caps, there is an opportunity for experienced, fundamental portfolio managers to exploit pricing inefficiencies and, eventually, benefit from relative multiple expansion and idiosyncratic outperformance as valuations exhibit mean reversion.

[Continued on next page](#)

### WEALTH ADVISORY OVERVIEW

#### NEW YEAR, NEW MARRIAGE? A PRE-NUPTIAL AGREEMENT IS A NO-BRAINER

The current Millennial trend of marrying later, coupled with the usual wave of 40 to 50-something second marriages inherently means that individuals with greater personal wealth (and potentially some financial scars) are getting married in 2020.

While pre-nuptial agreements of the past might invoke an image of a tense conversation between a "have" and a "have-not", today's conversations are more likely to be a discussion between two people who both want to preserve accumulated wealth for themselves or for their family members. Some family law attorneys have suggested that two-thirds of divorce cases could be avoided with pre-nuptial agreements because unfortunately, money is usually the sticking point when a couple parts ways even in an amicable situation. Without a pre-nuptial agreement, the court, not the couple, will decide what happens in the event of a separation and/or divorce.

#### WHY SHOULD YOU CONSIDER A PRE-NUPTIAL AGREEMENT?

There are definitely certain circumstances where a pre-nuptial agreement may make sense.

1. **Substantial Assets** You may have substantial wealth coming into a marriage, or the potential for substantial wealth due to pre-marital investments. A pre-nuptial agreement may provide clarity and a preservation of wealth attributable to activities that began before the marriage. How will the stock options you earned

[Continued on page 8](#)



### INVESTMENT TEAM

Daniele Donahoe, CFA  
Chief Investment Officer

Elliott Van Ness, CFA  
Director of Research | Portfolio Manager

Thomas Mack  
Research Analyst

### WEALTH ADVISORY TEAM

Sandy Carlson, CFP®, CPA, CDFATM  
President | Wealth Advisor

Rebecca Hoover, CPA, CDFATM  
Director of Tax | Wealth Advisor

Lorri Tomlin, FPQP™  
Wealth Advisor

Ryan Vaudrin, CFP®  
Wealth Advisor

Daniel Hudspeth  
Wealth Associate

Corey Meyer  
Wealth Associate

Lesley Burke  
Client Service Associate

### POINTS OF INTEREST

- [Monthly Index Review](#)
- [Portfolio Manager Particulars](#)
- [Around McShane Partners](#)

## INVESTMENT OVERVIEW

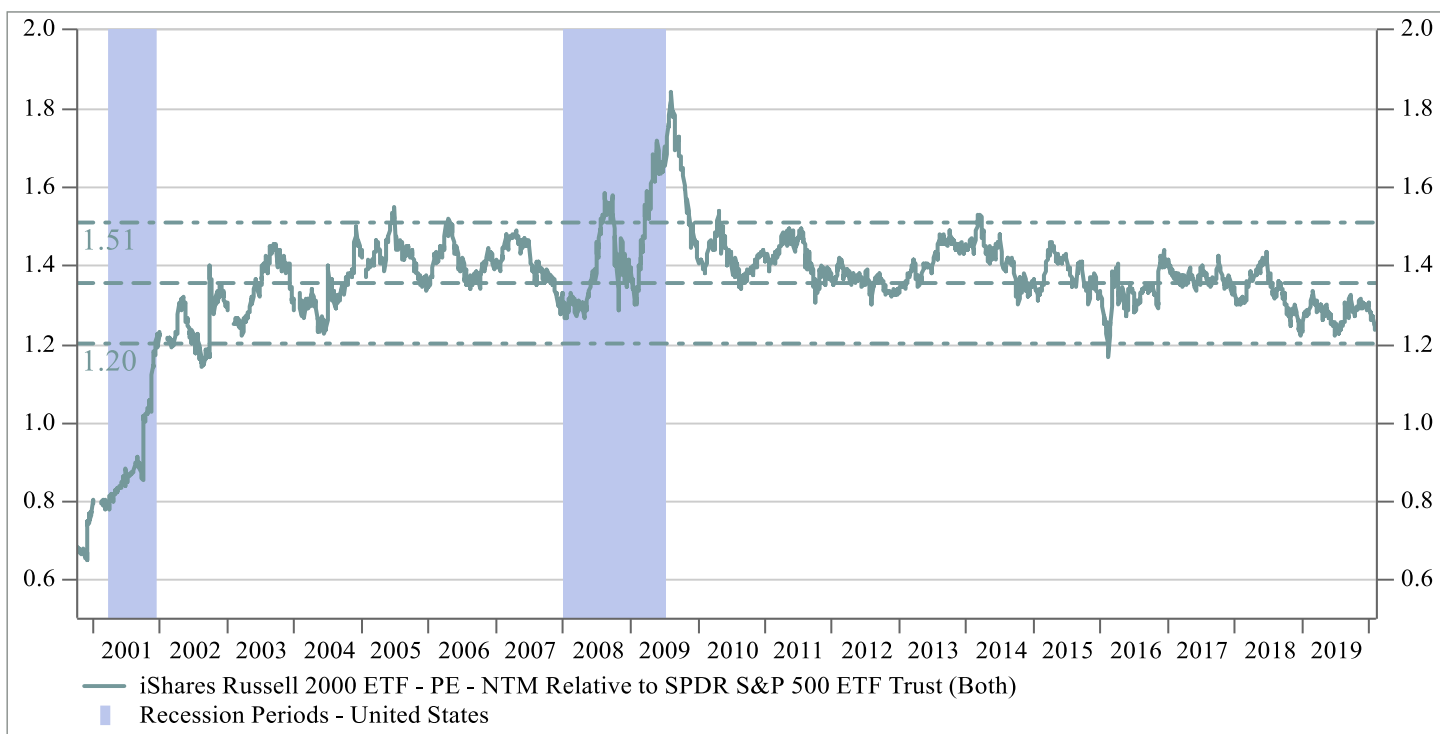
### NO STONE UNTURNED: SMALL CAPS OFFER VALUE IN 2020

#### SETTING THE SMALL CAP STAGE

Despite the highly publicized favorable fundamental backdrop for large-cap stocks, small-cap stocks are currently trading at a significant discount to large-cap stocks, which would indicate that much of the optimism and good news has already been priced into large-cap stocks. Furthermore, small-cap value appears extremely inexpensive after having underperformed small-cap growth for the third year in a row. Historically, small-cap stocks have traded at a sizable premium to large-cap stocks ( $\pm 35.0\%$ ), which has ebbed and flowed over time based on shifts in investor sentiment surrounding and enthusiasm for small-cap equities. Chart I, below, illustrates the historical relationship between the forward-looking price-to-earnings (“PE NTM”) multiple for the iShares Russell 2000 ETF (“IWM”) relative to that of the SPDR S&P 500® ETF (“SPY”) over the past  $\pm 19$  years. As previously indicated, small-cap stocks are trading below their long-term historical average relative multiple vs. large-cap stocks ( $\pm 1.35x$ ), reflective of

[Continued on next page](#)

**CHART I: SMALL CAP VS. LARGE CAP RELATIVE VALUATION ANALYSIS: PRICE-TO-EARNINGS NTM**



Source: McShane Partners - FactSet Research Systems, Inc.

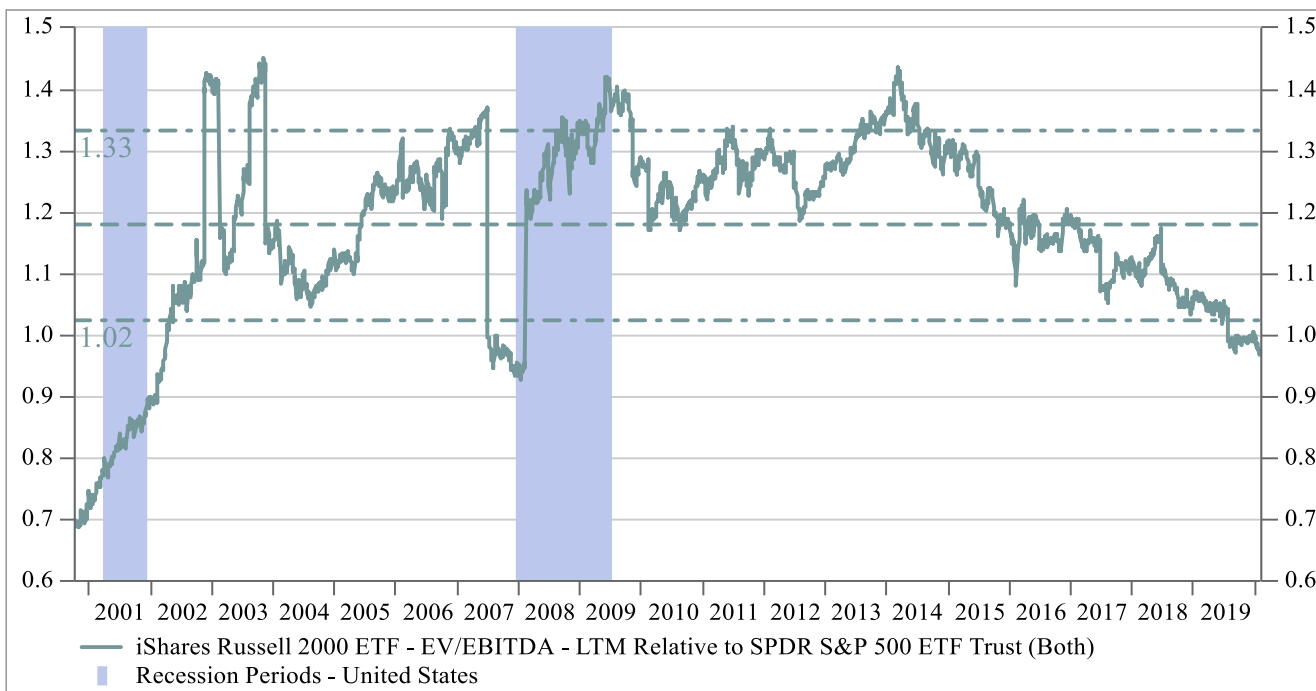
#### MONTHLY INDEX REVIEW USD TOTAL RETURN

DATA AS OF JANUARY 31 <sup>ST</sup> 2020	JANUARY 2020	2019	2018	2017
S&P 500®	-0.04%	+31.49%	-4.38%	+21.83%
Dow Jones Industrial Average	-0.89%	+25.34%	-3.48%	+28.11%
NASDAQ Composite	+2.03%	+36.69%	-2.84%	+29.64%
Russell 2000	-3.21%	+25.52%	-11.01%	+14.65%
MSCI Emerging Markets	-4.66%	+18.88%	-14.24%	+37.75%
MSCI EAFE	-2.08%	+22.66%	-13.36%	+25.62%
Bloomberg Barclays U.S. Aggregate Bond Index	+1.92%	+8.72%	+0.01%	+3.54%

## INVESTMENT OVERVIEW

### NO STONE UNTURNED: SMALL CAPS OFFER VALUE IN 2020

**CHART II: SMALL CAP VS. LARGE CAP RELATIVE VALUATION ANALYSIS: EV/EBITDA LTM**



Source: McShane Partners - FactSet Research Systems, Inc.

negative investor sentiment and waning enthusiasm for small caps given the significant outperformance of large caps. Prior instances of extreme discounts in relative PE NTM multiples for small caps have typically been followed by relative outperformance vs. large caps over the subsequent 12-month period: for example, after the IWM traded down to a relative multiple of **±1.23x** vs. the SPY in June 2004, the Russell 2000 returned **+15.12%** over the following year vs. a comparable return of **+8.93%** for the S&P 500® Index.

Chart II, above, further illustrates the discounted valuation and relative cheapness of small caps vs. large caps based on a comparison of trailing 12-month EV/EBITDA multiples: relative to large caps, small caps are currently trading more than one standard deviation *below* their long-term historical average multiple, which corresponds to a relative discount of **-18.0%**. As such, simply reverting to the mean and

[Continued on next page](#)

**TABLE I: U.S. EQUITY MARKET PERFORMANCE**  
USD TOTAL RETURN

SIZE & STYLE/FACTOR INDEX PERFORMANCE	JANUARY			
	2020	4Q19	1Q19 - 3Q19	2019
S&P 500®	-0.04%	+9.07%	<b>+20.55%</b>	<b>+31.49%</b>
S&P 500® Value	<b>-2.64%</b>	<b>+9.93%</b>	+20.01%	<b>+31.93%</b>
S&P 500® Growth	<b>+2.27%</b>	+8.32%	<b>+21.06%</b>	<b>+31.13%</b>
S&P 500® Equal-Weighted	-1.84%	+7.61%	<b>+20.10%</b>	+29.24%
S&P Mid-Cap 400®	-2.61%	+7.06%	+17.87%	+26.20%
S&P Mid-Cap 400® Value	<b>-4.13%</b>	+7.41%	+17.39%	+26.08%
S&P Mid-Cap 400® Growth	-1.21%	+6.73%	+18.32%	+26.29%
Russell 2000	-3.21%	<b>+9.94%</b>	+14.18%	+25.52%
Russell 2000 Value	<b>-5.39%</b>	+8.49%	+12.82%	+22.39%
Russell 2000 Growth	-1.10%	<b>+11.39%</b>	+15.34%	+28.48%

Source: McShane Partners - FactSet Research Systems, Inc.

## INVESTMENT OVERVIEW

### NO STONE UNTURNED: SMALL CAPS OFFER VALUE IN 2020

returning to a more normalized level through multiple expansion could offer as much as **+20.0%** relative outperformance for small caps vs. large caps based on current estimates. Another data point to recognize is the sharp drop off of the performance of the S&P 500® Value Index year-to-date (“YTD”) in 2020, as can be seen in Table I on [page 3](#). The sharp slowdown in equities, combined with the underperformance of value, seems counterintuitive to traditional theories of defensives behaving like a “safe haven” during a declining equity market, and we will seek insight from the panel of managers regarding this recent anomaly.

#### PORTFOLIO MANGER PARTICULARS

With valuations extremely inexpensive, the primary factor necessary for a small-cap value cycle is in place: the catalyst required to spark a rally in small-cap value, however, remains opaque and elusive. Our esteemed panel of experienced small-cap equity portfolio managers participating in this event will shed light on improved investor participation in small-cap equities, with an emphasis on small-cap value. The Investment Team has hand selected this year’s portfolio managers for their unique perspectives and investment philosophies.

Each portfolio manager has distinctive, but complementary, thoughts and opinions regarding the small-cap equity market, and we look forward to hearing how they are navigating the current investment landscape, how they are positioning their portfolios to prevail against passively managed alternatives, as well as which individual companies or investment strategies are ripe to deliver outsized risk-adjusted performance vs. the broader market.

Below is an overview of each portfolio manager, including a brief synopsis of their investment strategies, their portfolio management processes, and, where applicable, their best ideas for 2020 and beyond.

#### **DANIEL BRESLIN**                      **DIRECTOR | PORTFOLIO MANAGER**

LAZARD ASSET MANAGEMENT

LAZARD U.S. SMALL-MID CAP EQUITY FUND (“LZSCX”)

FUND AUM:                \$122.7 MIL.

EXPENSE RATIO:        0.87%

Mr. Breslin has an excellent pulse on small-cap equity markets, with a particularly keen understanding of sector and style rotation. He astutely highlighted how the froth in the market rally was susceptible to the anxiety surrounding China and how the emergence of the novel coronavirus could cause a necessary, but healthy, pullback. His thoughts about the transient nature of last years’ rotation into value and the sustainability of the Information Technology sector’s outperformance will be particularly interesting. Sector-specific commentary around cyclicals, commodities, and the irrelevance of the Energy sector in popular small-cap equity benchmarks could have meaningful investment implications and relevance for investors with particular industry exposure.

Mr. Breslin manages the Lazard U.S. Small-Mid Cap Equity Portfolio (“LZSCX”), which typically holds between 70-80 U.S. equities with a targeted market cap threshold of ≤\$10.0 billion. LZSCX returned **+30.00%** in 2019, outperforming the Russell 2000 Index by **+447** basis points (“bps”).

#### BEST IDEA FOR 2020

BRUNSWICK CORP. (“BC”)

MARKET CAP: \$5.13 BIL.

DESCRIPTION: Brunswick Corp. (“BC”) engages in the design, manufacture, and marketing of recreation products, including marine engines, boats, fitness equipment, and active recreation products.

THESIS: The recent sales trend towards larger engines is significant and Mr. Breslin predicts BC’s forward estimates are too low. In addition, Mr. Breslin believes that the company’s growing after-market business is making the business model less cyclical given stronger, more predictable recurring and consistent revenue streams. BC is also

[Continued on next page](#)

## INVESTMENT OVERVIEW

### NO STONE UNTURNED: SMALL CAPS OFFER VALUE IN 2020

shedding select assets (e.g., their fitness equipment segment), creating more efficiencies, a cleaner balance sheet, and a more precise market focus: this is allowing more flexibility in returning capital to shareholders.

VALUATION: BC trades at 11.0x consensus 2021 EPS estimates and an attractive 10.7x EV/EBITDA multiple based on consensus 2021 EBITDA estimates, which Breslin believes are very conservative.

*“There are two times in a man’s life when he should not speculate - when he can’t afford it, and when he can.”  
- Mark Twain*

#### MATTHEW REINER, CFA PRINCIPAL | PORTFOLIO MANAGER

ADIRONDACK FUNDS

ADIRONDACK SMALL CAP FUND (“ADKSX”)

FUND AUM: \$94.2 MIL.

EXPENSE RATIO: 1.24%

Mr. Reiner has strong beliefs about the impact of computerized trading on small-cap equities and sees increased opportunities given the plethora of mispriced value stocks due to trading pressures exacerbated by the lack of analyst coverage, which can be attributed to ongoing industry consolidation. Furthermore, Mr. Reiner sees the political landscape and the proliferation of passive, index-based investing pushing more small, boutique investment management firms to consolidate, which could have a negative impact on individual investors, small companies, industry competition, and critical, independent thinking.

Mr. Reiner manages the Adirondack Small Cap Fund (“ADKSX”), which has a portfolio of approximately ±60 U.S. micro- and small-cap companies using a “middle-down” approach. In 2019, ADKSX returned **+15.95%** vs. a return of **+25.52%** for the Russell 2000 Index, as the strategy’s “value” approach remained out-of-favor amongst investors.

#### BEST IDEA FOR 2020

OFFICE DEPOT, INC. (“ODP”)

MARKET CAP: \$1.21 BIL.

DESCRIPTION: Office Depot, Inc. (“ODP”) provides office products, supplies, business print and copy solutions, and information technology (“IT”) support services.

THESIS: A recent shift and diversification of ODP’s business lines, in response to the “Amazon-effect” and corresponding impact on traditional retail, has gone underappreciated by analysts. In 2017, ODP acquired CompuCom Systems, Inc. to make a play in the IT hardware, software, and services sphere. Concurrently, ODP has significantly decreased their retail footprint to adapt to the changing marketplace and become less dependent on this traditional revenue stream, yet it still offers a solid cash flow profile. Their business-to-business services segment has also grown rapidly, with over ±200K enterprise account relationships.

VALUATION: ODP trades at a PE NTM multiple of ±6.0x and an EV/EBITDA NTM multiple of just under ±4.0x, all while offering a dividend yield of ±4.0% and a free cash flow (“FCF”) yield over ±20.0%.

#### ROBERT CRESCI SENIOR FUND MANAGER

J O HAMBRO CAPITAL MANAGEMENT

JOHCM INTERNATIONAL SMALL CAP EQUITY FUND (“JOSMX”)

FUND AUM: \$229.8 MIL.

[Continued on next page](#)

## INVESTMENT OVERVIEW

### NO STONE UNTURNED: SMALL CAPS OFFER VALUE IN 2020

EXPENSE RATIO: 1.24%

Mr. Cresci is the only one of our panelist members with an explicit international equity investment mandate. Mr. Cresci opines on the effect of the “passive approach” of investing within small cap, similar to Mr. Reiner. He further expands upon this by explaining how this is exacerbated in international equity markets, along with the broader macro and geopolitical risk factors that are inherent when investing in less-developed markets. Mr. Cresci examines the infrastructure, communication, and liquidity issues that arise when smaller international firms attempt to attract interest from the general investing public. Mr. Cresci’s process emphasizes leadership, corporate governance, and stability, which have been tantamount to the sustained success of the strategy. The Investment Team applauds his mandate to visit each company periodically to routinely evaluate and analyze the underlying health of the business.

Mr. Cresci manages the JOHCM International Small Cap Equity Fund (“JOSMX”), which is comprised of ±70 individual stocks with approximately 20%, 19%, and 19% of the assets invested in Asia, Eurozone, and Japan, respectively. The strategy’s primary benchmark is the MSCI All Country World ex-U.S. Small Cap Index. In 2019, JOSMX returned **+20.91%**, underperforming the MSCI All Country World ex-U.S. Small Cap Index by **±202 bps**. Over the past five years, however, JOSMX boasts relative upside-downside capture ratios of **±94.0%** and **±83.0%**, respectively, vs. the benchmark, which is indicative of the strategy’s ability to deliver strong risk-adjusted performance during periods of heightened geopolitical risk and increasing volatility across international equity markets.

#### BEST IDEA FOR 2020

SCAPA GROUP PLC (“SCPA-GB”)

MARKET CAP: £390.44

DESCRIPTION: Scapa Group PLC (“SCPA-GB”) is a holding company, which engages in the manufacture and marketing of bonding products and adhesive components for applications in the healthcare and industrial markets. It operates through the Industrial and Healthcare segments.

THESIS: While shares of SCPA-GB may not be Mr. Cresci’s top recommendation for 2020, he did bring the stock to our attention during our initial due diligence call with him earlier this year as an example of how some companies have been able to pursue value-additive deals over the past 12-24 months, emphasizing the potential for mergers and acquisitions (“M&A”) activity to pick up through the end of the market cycle. In particular, through strategic acquisitions, SCPA-GB has been able to successfully expand its intellectual property (“IP”) portfolio, while also shifting procurement channels and diversifying product sourcing in order to improve supply chain management. While capital intensive, these investments should allow the company to better navigate potential disruptions in the near future in the event of rising geopolitical tensions.

VALUATION: Shares of SCPA-GB are currently trading at a PE NTM multiple of ±15.6x.

#### **ROBERT BRIDGES, CFA SENIOR MANAGING DIRECTOR**

STERLING CAPITAL MANAGEMENT

STERLING BEHAVIORAL SMALL CAP VALUE EQUITY FUND (“SPSCX”)

FUND AUM: \$117.2 MIL.

EXPENSE RATIO: 0.80%

Within the Sterling Behavioral Small Cap Value Equity Fund (“SPSCX”), Mr. Bridges incorporates specific quantitative factors in order to parse down the small-cap equity universe and build an optimal investment portfolio capable of delivering long-term outperformance. In particular, he and his team take a behavioral approach to arbitrage mispricing and momentum opportunities. Three flawed traits innate in human nature are fear, greed, and ego: if executed correctly and efficiently, these can be exploited to achieve outperformance. Fear creates a common misperception that a stock trading at a discounted valuation multiple is “cheap for a reason” and neglects the due respect to a firm’s true fundamentals. Greed manifests itself in investors’ tendency to exhibit herding behavior by passively [Continued on next page](#)

## INVESTMENT OVERVIEW

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following trends and price momentum. Ego is apparent in analysts' hubris of their original forecasts or estimates, which can be seen in the inability or unwillingness to adjust ratings and being inflexible to new information.

While SPSCX does utilize individual stock selection or incorporate bottom-up, fundamental analysis within its investment framework, the composition of the strategy's stock portfolio reflects active weightings across underlying positions that can deviate significantly from the strategy's primary benchmark. Moreover, Mr. Bridges and his team do not focus on creating thematic narratives to describe or contextualize the positioning of their strategy: as such, when asked for his best idea for 2020 and beyond, Mr. Bridges emphasized the importance of adhering to the strategy's investment objective and remaining disciplined across portfolio-level exposures to both "value" and "momentum" factors, as shifts in prevailing market trends are often quick, violent, and painful for investors who aren't positioned appropriately or who are trying to time the market.

#### CONCLUSION

As we mentioned in an earlier newsletter, many investors rotated aggressively out of equities as global equity markets rallied throughout 2019, with nearly ±\$75 billion coming out of equity funds during the first eleven months of 2019. As perplexing as this is, when trailing year fund flows have been this low over the past ten years, forward stock market performance has been positive (*Source: Furey Research Associates*). For this reason, the Investment Team feels compelled to maintain exposure to global equity markets, despite unsavory valuations and precarious macroeconomic backdrop of global debt levels.

Accordingly, the Investment Team believes that successful portfolio returns will result from leaving no stone unturned and identifying unique opportunities to make money in an increasingly competitive market landscape. This year's portfolio manager panel is designed to do just that: generate contrarian ideas to outperform in 2020.

#### FOURTH QUARTER 2019 ECONOMIC OVERVIEW WEBINAR

**DATE:** Tuesday, March 10<sup>th</sup>

**TIME:** 10:00 AM EST

#### REGISTRATION INFORMATION

Please use the following link or be sure to look for additional registration reminders, which will be sent out in the days leading up to the webinar.

To register for the webinar, please click [here](#).

A recording will be available on our website after March 13<sup>th</sup>.

## WEALTH ADVISORY OVERVIEW

### NEW YEAR, NEW MARRIAGE? A PRE-NUPTIAL AGREEMENT IS A NO-BRAINER

prior to the marriage, but exercise during the marriage, be treated? Individual assets may remain individual after you marry, but appreciation on those assets is generally considered marital property. The pre-nuptial agreement can lay out how future growth on those separate assets will be treated.

2. **Substantial Debt** A pre-nuptial agreement is equally important when a spouse brings significant debt into a marriage. This debt can take the form of a student loan or a personal bankruptcy that will absorb marital cash flow for years to come. The pre-nuptial agreement can lay out how future cash flows will be used to pay-off pre-marital debt.
3. **Children from Previous Marriages** Each party may have children from previous relationships. Pre-nuptial agreements can help you both think through how to provide for those children in the event of a divorce, death, or disability. Your pre-nuptial agreement can work in tandem with a trust and/or a will to ensure your wishes are respected.
4. **One Party will not be Employed Outside of the Home** One of the most contentious issues in divorces is how to value the time and contribution of a spouse that does not work outside of the home. A pre-nuptial agreement can help you have the conversation regarding how assets in this situation will be “shared”.

#### THINGS TO AVOID

For your agreement to be respected, it is generally better to act earlier rather than later. A pre-nuptial agreement that is signed in the church dressing room before the ceremony might be considered as signed under duress. As with any legal agreement, the parties signing should understand what they are signing, and should sign in good faith.

Both parties to the agreement should not try to hide assets, or intentionally under or over-estimate their worth. Pre-nuptial agreements cannot cover any illegal activities, and they will not help you retain the value of an extortion scheme.

In addition, pre-nuptial agreements cannot be used to determine certain things, like child custody or the maintenance of future children. They generally cannot be used for personal items, such as a way to require that Christmas be spent with one family versus the other, or that your spouse change their name.

The state where the couple lives during the marriage will determine the treatment of marital assets in a divorce, and you cannot always predict how your relationship will evolve over a long period of time, or how revelations about finances may impact your feelings about your spouse.

Pre-nuptial agreements can be scrutinized as providing a couple with an incentive to divorce. However, if you can identify with some of the circumstances in this article, it pays to have the conversation with your future spouse. In addition, you should work closely with a knowledgeable family law attorney rather than try to craft an agreement yourself. Equally important is incorporating a financial advisor to help you who has the expertise to value assets, income streams, and model the appreciation and potential impact in the future.



## AROUND McSHANE PARTNERS

### 2020 PORTFOLIO MANAGER PANEL: OPPORTUNITIES IN SMALL-CAP EQUITY INVESTING

You are invited to attend McShane Partners' exclusive portfolio manager panel featuring four tenured portfolio managers sharing unique insights on investing in the small-cap equities. You should walk away from this experience with a better understanding of how to navigate rising market volatility, changing economic growth, and elevated risk of recession. The panel will be moderated by our Managing Partner and Chief Investment Officer, Daniele Donahoe.

#### Event Details:

Tuesday, February 25<sup>th</sup> 2020  
5:30 PM - 7:30 PM  
Carmel Country Club

Please contact [Lesley Burke](mailto:lesley@mcshane.com) at [lburke@mcshane.com](mailto:lburke@mcshane.com) and RSVP at your earliest convenience if you are able to attend.

### CFA SOCIETY NC 2020 ANNUAL FORECAST DINNER

For the eighth year in a row, McShane Partners was proud to sponsor a table at the CFA Society of North Carolina's 20<sup>th</sup> Annual Forecast Dinner - *Trump, Trade, and the 2020 Election*. This is the premier networking event of the year, bringing together over 350 of North Carolina's leading investment professionals and key decision-makers.



### McSHANE PARTNERS

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

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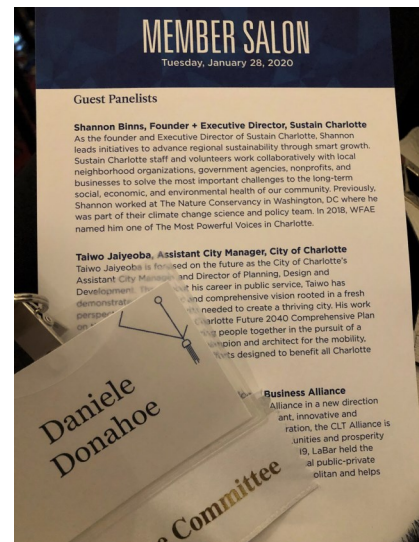
### THE LEARNING SOCIETY AT QUEENS UNIVERSITY IN CHARLOTTE

Daniele Donahoe is an executive committee member of the Learning Society and McShane Partners is a proud sponsor of the 2019-2020 Lecture Series.

Since 1988, the Learning Society has brought leading thinkers and doers to our doorsteps. Renowned authors, journalists, physicians, scientists, artists, economists, politicians, government leaders, scholars, historians, entrepreneurs, business executives, environmentalists and social activists—these and more have shared their knowledge and life experience with Queens students and the greater Charlotte community.

### FOURTH QUARTER 2019 ECONOMIC OVERVIEW

McShane Partners invites you to join us for our Fourth Quarter 2019 Economic Overview Webinar on **Tuesday, March 10<sup>th</sup> at 10:00 AM EST**. This is a dynamic and interactive opportunity for clients, colleagues, and friends to hear McShane Partners' CEO and Chief Investment Officer, Daniele Donahoe, discuss our thoughts on the significant financial, economic, and political developments throughout the quarter, as well as our perspective on current economic conditions and our outlook for global financial markets.



*Information provided in this newsletter should not be considered or interpreted as advice for your particular financial situation. Please consult a professional advisor for advice regarding your specific financial needs.*

*CIRCULAR 230 NOTICE: To comply with requirements imposed by the United States Treasury Department, any information regarding any U.S. federal tax matters contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, as advice for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.*

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