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MONEY MANAGER INTERVIEW

STEVEN ABERNATHY

The Abernathy Group II Family Office

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Using a Scientific Investment Approach and a Core Satellite Strategy

STEVEN ABERNATHY, THE ABERNATHY GROUP II FAMILY OFFICE

Steven Abernathy is the Founder and Chairman of The Abernathy Group II Family Office. Earlier, he was Senior Vice President of Portfolio Management at Shearson American Express, and a Special Limited Partner and Director of its Executive Services Division at Cowen & Co. While at Cowen, Mr. Abernathy developed The Abernathy Group, a group of investment professionals specializing in asset management for experts in health care and technology. This collaboration between investment professional and client-expert was called the Collaborative Investing style of portfolio management. The collaborative effort forged between Mr. Abernathy's financial knowledge and the technology and health care expertise of his clients has produced top-tier results. In 1996, Mr. Abernathy co-founded The Abernathy Technology Research Institute, formerly known as The Abernathy Leet Institute for Financial Research, a registered broker/dealer. Mr. Abernathy is a member of CFA Institute and the New York Society of Security Analysts. Mr. Abernathy earned a Bachelor of Science degree as a pre-med student from Fordham University. The Abernathy Group II and its predecessors have been ranked number one, 16 times by Nelson's World's Best Money Managers since 1991.

SECTOR — GENERAL INVESTING

(AHR522) TWST: Could you tell me about the firm?

Mr. Abernathy: Sure. We are a family office, and this means we work directly for the family that hires us. In most instances, this is important because it rids the relationship of conflicts of interest, which is one of the points I believe is most destructive in an advisory relationship. I have been a financial analyst since the early 1980s. I owned and ran a hedge fund for over 20 years, which was one of the earlier funds and was one of the very few funds that managed its assets for no management fee, just the percentage of profits, because this structure got rid of the conflicts of interest.

As Warren Buffett would tell you, we mandated that the portfolio manager and the analysts had to have at least 50% of their investable net worth in the fund. Meaning, we wanted everyone involved to eat their own cooking. In 2012, we opened up the fund to other families that were our co-investors in our family office.

Highlights

Steven Abernathy discusses The Abernathy Group II Family Office. The firm works directly for a family, which rids the conflicts of interest. In addition to removing the conflicts of interest, Mr. Abernathy says other benefits of this structure include cost savings and the fact that it's a deductible expense. Mr. Abernathy uses a scientific approach to investing and a core satellite strategy. The core of a portfolio is usually global and widely diversified, with customized weightings of equities and debt. When it comes to equities, Mr. Abernathy seeks more value than growth, smaller companies over larger and ones that are consistently profitable. The satellites of the portfolio are customized for each family; however, some of the themes Mr. Abernathy explores are shareholder activism, cybersecurity, the rollout of 5G, emerging markets, agriculture, China and distressed debt.

TWST: I would think that being a direct employee of the families is a little bit different approach. What are the benefits for high net worth individuals who can have that kind of relationship with their financial professionals?

Mr. Abernathy: Number one, it's a cost savings. We operate in most relationships at a fraction of 1% per year, whereas most advisory firms are higher — significantly higher — than that. Number two, it is a deductible expense, which has

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become incredibly helpful, when the 2018 laws changed. As most investors will know, the fees they pay legal, financial or investment advisory professionals are not deductible anymore. Moreover, when you hire a family office directly, they become an operating expense for the company. Therefore, those are the direct benefits.

"The satellites of the strategy are the unique investment that most family offices offer, which truly add a level of diversification for each family. It's a strategy focused on outperforming inflation and being able to sleep at night by investing in opportunities that are not correlated with the global capital markets, yet that will outperform inflation."

The indirect benefits include that we have no conflicts of interest. We are paid by one master and only one master. And we offer advice at the behest of that investor or that family.

Most people would think it is more expensive, yet it's actually less expensive. And I wanted to quote a passage from one of the better books written over the last 25 years. The book is called *Winning the Loser's Game*. You may have read it. It's written by Charley Ellis. He is an incredibly smart individual who really cared about the investing public. Our firm agrees with the vast majority of his thinking.

The quote is: "Investment management differs from many other professions in one of the most unfortunate ways. It's losing the struggle to put professional values and responsibilities first and business objectives second." And what he's referring to is the rampant conflicts of interest that are created by the commission structure or the kickback structure that incent the brokerage community to offer solutions that pay them the most to sell, instead of the solution, which is simply the best for the client.

I am hoping that the Vanguard approach toward investment management will continue to gain steam. The Vanguard structure supports hiring the best investment professionals we can hire, and we charge you what it costs to keep these people employed. We operate similarly to Vanguard.

TWST: Could you describe your investment philosophy?

Mr. Abernathy: We have a strictly scientific approach toward investing. It's called the core satellite strategy, and it delivers the benefits of that philosophy. The science of investing clearly demonstrates that when you invest in an incredibly well-diversified market, you are going to pay lower fees, you are going to pay lower taxes, and you are going to pay lower operating expenses. And the best part is that you save yourself five hours to 25 hours per week of research, which really must be done to remain educated enough to select active managers who are quite likely to deliver lower performance than passively managed index funds or ETFs.

The science of investing also clearly demonstrates that value investments tend to outperform growth investments by an average of over 3% per year. Small companies tend to outperform large companies by an average of over 3% per year as well. And companies that are profitable consistently outperform unprofitable companies. Each investor should tilt their portfolios so that they slightly overweight value over growth, small companies over large companies and consistently profitable companies over highly variable or negative-earning companies.

The core satellite strategy for most families is global, and it's widely diversified, in both equities and debt. It often encompasses thousands of different securities in the core of the portfolio. The weighting of equities versus the weighting of the debt is customized for each family being served — meaning science and academia say that all investors should use low-cost index vehicles that are highly diversified globally, with the lowest cost and lowest turnover so that we save families money with lower fees and lower taxes at the end of the year. In the equity portion of the portfolio, we factor the weighted indexes that are, again, more value than growth, more small than large and more profitable than unprofitable. So that is the core of the strategy.

The satellites of the strategy are the unique investment that most family offices offer, which truly add a level of diversification for each family. It's a strategy focused on outperforming inflation and being able to sleep at night by investing in opportunities that are not correlated with the global capital markets, yet that will outperform inflation.

The core of the strategy could be between 25% of a family's net worth and 75% of a family's net worth. The satellites make up the remainder. They are customized for every family.

TWST: And as we speak in August, what is on the minds now of a lot of high net worth individuals? There's certainly been some volatility some days in the market.

Mr. Abernathy: Yes. One of the most important family office offerings is education. And it's incredibly important for nonfinancial families to be well-educated so they know what to expect from their investment portfolio. So all investors are worried and should expect significantly more volatility during the next two years than they have experienced in the last 10 years. Interest rates have been suppressed since 2009 by the Federal Reserve. As global growth starts to slow and earnings become a bit more volatile, stock markets' movements — both higher and lower — are going to increase.

In 2019 and beyond, with the current pricing of the market, investors should expect returns going forward in the next 10 years of 4% to 6% with a 2% dividend, rather than the historic 7% to 9% with a 2% dividend. Inflation expectations should remain quite subdued for an indeterminate amount of time. A low and controlled inflationary environment is incredibly important and incredibly positive for investors.

TWST: And are some of the investors looking for defensive-type stocks right now?

Mr. Abernathy: Some are, but as I was saying earlier, it is important that financial analysts take the time to educate their clients and help them understand what they should be expecting. It is only when you are surprised that you tend to react emotionally. Think of a surprise birthday party. You might end up acting a little weird when they yell "Surprise!" versus if you knew you were walking into that room full of your friends.

The stock market is down 32% of the time, and it is up

68% of the time. Las Vegas makes billions of dollars a year, and they have odds that are 52% in Las Vegas' favor and 48% in the gambler's favor. To compare, in the stock market, you win 68% of the time and lose 32% of the time. Those are great odds.

"A very unpopular topic right now for an investment satellite is China. However, if you think about it, it is a difficult investment to refute. China will overtake the U.S. as the world GDP power over the next 10 years. This means that all portfolios should have a 5% to 10% subjection to China at least."

The stock market tends to be down between zero and 10% about 16% of the time, between 10% to 20% 9% of the time, between 20% and 30% 3.5% of the time and between 30% and higher 1.1% of the time. Said differently, the stock market is down 5% or more every 71 days. That is typical volatility, but we have not experienced it in the last 10 years.

So again, it just means that every three months to four months, every investor should realize the stock market is prone to a correction of between 5% to 10%. In addition, investors should be prepared and not surprised when the stock market is down up to 20% 1.5 times per year. So once every eight months or so, every investor should expect the stock market to have downturns of up to 20%.

TWST: Are there certain sectors that might be beneficial to look at now given what's going on with the market and the economy, or is it more of a micro-level kind of thing?

Mr. Abernathy: Yes, we think there are opportunities. And these are the themes we explore and invest in regarding the satellites. One theme we've discussed in our earlier interview with *The Wall Street Transcript* was shareholder activism. We think shareholder activism will continue to create value for intelligent investors.

The fundamentals of shareholder activism are that, first, these activists identify assets that are selling at a significant discount to their true value. They present a clear pathway to ensure investors can realize the true value of those undervalued assets. And there is often a high probability of success, meaning the activists have usually spoken with the vast majority of other shareholders to ensure they are in agreement with the changes that need to be made to fix the companies that are experiencing some temporary difficulty. Shareholder activism continues to be a viable and interesting satellite investment for us.

Some of the other satellites investors may find fairly interesting — I want to make sure that you know that all of these themes have positives and negatives, but in most instances, the positives outweigh the negatives significantly. The first theme I think is most interesting to highlight — yet very few investors embrace — is cybersecurity.

Cybersecurity is going to be a growth industry for as far as we can see. Wars may become less frequent, yet they will become electronic, not physical. The negative regarding cybersecurity is that finding companies early is always risky, meaning that these are largely private investments. Yet, there are some public companies we are involved with. We have built an ETF equivalent that embraces all of them because we don't know which one is going to find the secret sauce. The bottom line, cybersecurity is likely to be a very vigorous growth industry for as far as the eye can see.

Another theme we think is incredibly interesting would be the rollout of 5G. Remember that the iPhone didn't exist when we were in 3G. Since then, we've been in the 4G rollout for the last seven years or so. The 5G rollout is going to change everything. The structural communications upgrade may be as much of a change agent as the internet was for society because 5G will enable Big Data to become a reality. It will enable the internet of things to become a reality.

Autonomous driving — which is obviously still not here — is impossible without 5G's constant connectivity. We all have experienced instances where our connectivity is lost and we cannot hear each other. That cannot happen when vehicles are driving autonomously. You cannot have a dead patch. 5G will largely eradicate that.

The negative with 5G is that it is going to cost the communications companies significantly, and the service providers are going to spend large sums of money to roll the service out, thus their balance sheets may very well be damaged. However, 5G for us, the consumer, is going to be incredibly beneficial. It is also going to have an enormous impact on the emerging markets.

Emerging markets at some point in the next several years will become a very interesting place to invest. The emerging market sectors are more correlated with the global economy than most satellites, and the world economy is somewhat dependent on each constituent country. However, make no mistake, emerging markets are growing faster than the developed markets. In addition, they will grow faster for longer. Yet, there's more volatility.

Keep in mind that some 80% of all humans ages 30 or under live in the emerging markets. The bottom line is that emerging markets will be a fertile investment playground at some point. The negative is that the U.S. dollar strength could negate almost all of the assured gains in the near term. Also, there are political risks, if we start to embrace global nationalism.

Along that same line, agriculture is a very high-conviction theme here at our firm. It's a bit complicated to implement, but agriculture will become incredibly important. As the emerging markets mature and their citizenry becomes wealthier, history says wealthier populations eat better. And as you eat better, you eat more protein. And the facts are that you need much more agriculture to produce that protein. As the emerging markets become wealthier, they will consume more protein, and accordingly, the demand for food is expected to double over the next 30 years. Having that demographic tailwind helping you along, we think, is incredibly important.

A very unpopular topic right now for an investment satellite is China. However, if you think about it, it is a difficult investment to refute. China will overtake the U.S. as the world GDP power over the next 10 years. This means that all portfolios should have a 5% to 10% subjection to China at least.

The key is effective implementation. How do you buy it? It will be one of the most significant themes of our generation. China, with its "One Belt and Road" initiative, offers an incredible amount of infrastructure still left to build. And China will become an important investment in everyone's portfolio.

Here's the potential downside. History says that as nations emerge and challenge the dominant existing nation, the world power, conflicts arise. The global number-one power becomes the global number-two power. We are a little bit more advanced today, yet leadership certainly matters. And if we get consistently more caustic global leadership, conflicts could become more prevalent. There is also a political and nationalistic risk, both of which are uncontrollable, but I think if you use those instances of weaknesses as buying opportunities, you will be in great shape.

Another controversial satellite, which leverages the negative market aspects, is distressed debt. We have been studying this business vertical for some time. The U.S. is over 10 years into their current economic cycle, which was designed to encourage capital spending. You could get capital available for 3% or under for the last 10 years, which is a long time. Currently, 10-year bonds are only 1.5%.

So many businesses are almost zombie-like. They are existing on cheap debt, and they will not be able to exist when rates normalize. I know that rates tend to be decreasing versus increasing currently, but that will change over the course of the next year or two. And those companies that are overleveraged are going to be in significant trouble.

We believe that every portfolio should have access to some distressed debt. When the economic cycle turns down, distressed debt will be a significant moneymaker. And by the way, the negative for distressed debt — it's difficult for most investors to become enthusiastic about a company that's in bankruptcy or that's likely to enter bankruptcy, yet done correctly, it's an incredibly profitable value investment.

Yet, the need to diversify and to have top-notch portfolio management is incredibly valuable. It is not something that we do. We farm it out to very experienced managers. We believe the current economic cycle returns will be incredibly attractive for those interested in that satellite.

TWST: Is there anything we didn't talk about you care to bring up?

Mr. Abernathy: We think that China is not the current global challenge moving forward. We think Europe is going to usher in the next global problem moving forward. Europe is not fiscally linked, but they are monetarily linked. And we think that presents a problem. The countries need to be able to vary their own currency to get them in and out of economic downturns. In short, we think that Europe really is the smoking gun here and not China.

TWST: Thank you. (ES)

STEVEN ABERNATHY
Founder & Chairman
The Abernathy Group II Family Office
623 Fifth Ave.
28 Floor
New York, NY 10022
(212) 293-3499
(917) 398-1689 — FAX
www.abernathygroupfamilyoffice.com
email: info@abernathygroupfamilyoffice.com