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ASSET MANAGEMENT GROUP

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Corporate Speakers:

- Robert Teeter, Silvercrest Asset Management Group Inc., Managing Director and Chairman of Investment Policy and Strategy Group
- Patrick Chovanec, Silvercrest Asset Management Group Inc., Managing Director and Chief Strategist

Operator: Welcome to the Silvercrest Asset Management Group Market Commentary Call.

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I would now like to introduce your host for today's call, Patrick Chovanec, managing director and chief strategist; and Mr. Robert Teeter, managing director and chairman of investment policy and strategy group. Gentlemen, please begin.

Robert Teeter: Before we start looking ahead, I thought we'd take a very brief look back; certainly 2017 was a very strong year for equities globally, and specifically for the S&P 500, in the U.S. In fact, if you update the numbers through yesterday and today, stocks are up around 30% since January 1st of 2017.

I think among some commentators, the tendency to dismiss these gains is sort of related to FANG stocks or technology stocks, and I just wanted to go through a couple of statistics and then will get right in to our look ahead.

So, as we look back at last year, 2017 calendar year, we see that the top 25 stocks contributing to the S&P return contributed about 50% of the return for the year. However, they represent about a 28% weight and is comparable to other periods in history.

In fact, there are other names within the top 25 that non-tax stocks, like Boeing, were not quite bad. But rather than commenting on individual stocks, let's also just note that well over 400 of the 500 stocks in the S&P were up on the year.

As we look through the characteristics of the year and try to identify some of the key drivers from last year and how that might influence our thoughts going forward, one thing that really stood out was earnings growth.

And so, if you take a look at the Russell 3000 Index on the year last year, and segment it by earnings growth, you'll see that the top 60% or so of stocks had earnings growth greater than 8.5%.

The stocks return is somewhere between 20% and 30% as a basket. Whereas if you look at stocks with earnings growth lower than that, the bottom 40% earnings growth less than 8.5%, you'll see that the stocks return is somewhere between 10% and 15%, again as a basket, not individual names.

And so, as we try to discern what might happen going forward, certainly one of the key drivers of earnings that we're looking to for this year is the impact of the Tax Cut and Jobs Act. And so with that, I thought I'd turn it over to Patrick to get some thoughts and observations on the impact of the tax cut on corporations and their earnings potential going forward.

Patrick Chovanec: Sure, thanks. I just want to reiterate the fact that the markets—the market gains that we saw last year—were primarily driven by earnings. The S&P 500 was up just a little bit over 19%. Earnings were up just a little bit over 17%.

Now, a lot of that was due to the recovery in the energy sector because of the crash in oil prices from 100, 110, to down almost 30. It put a lot of the energy sector companies into negative earnings in 2015–2016. And what we saw was a stabilization of the oil price and recovery from that.

But really, while that may have been a leading factor, it was far from limited to that. We saw earnings growth less dramatic, but still positive, across the board in most of the sectors in the S&P 500. And so, if it was simply a question of that the S&P 500 was up 20% on the year out of euphoria or anticipation of growth that hadn't materialized, that would be one thing.

But in fact, what we've seen is earnings growth that has materialized and either put a floor under—support under the market—earlier market gains or has held valuations from rising further.

So, valuations right now are about P/E ratio looking backwards. The 12-month trailing P/E ratio is just a little bit above 21x. That is a—that's a pricey valuation. It's more reflective of a sort of a mature stage of the business cycle, the market cycle than the beginning stage.

So, I think it's important to realize that we are not talking about being at the beginning of a bull market. We are talking about being in a mature bull market. But at the same time, as long as those earnings continue to support price gains at the current valuation, then there should be support underneath this market.

One thing that has happened in the first month of this year is that stocks have risen—the S&P 500 has risen about 7.5%. And that's a pretty abrupt rise for a very short period, and either it's going to be supported by earnings—continued earnings growth, or it's—even if it is, we should be cautious about expecting that kind of trajectory going forward throughout the year.

I think some of it comes from—and this gets back to the point that Rob raised. Not only are economic numbers looking good, they are looking very good. Almost across the board, almost all economic numbers today see our positive and include forward-looking things like new orders, which should—which would imply that there's momentum that should continue for at least the next 3 to 6 months.

But in addition to that, there's also the fact that corporations are going to have a tax cut and the corporate tax rate has come down from 35% to 21%. Now, that's not going to affect all companies the same way because some were paying very different effective tax rates based upon different kinds of tax benefits that they could claim. So, it's going to affect different companies differently.

But overall, we're probably looking at more money even if just—same company making the same amount of money is going to end up with more on its bottom line after taxes as a result of that tax cut.

And so, we have factored that into our anticipated earnings for this year. We expect that earnings will grow about 5% earnings per share. The S&P 500 will grow about 5% organically and then another 5% on top of that due to the tax cut.

Now there's some that actually are much more aggressive, and the consensus actually says that there'll be about 20% gain in corporate earnings over the course of the year. It's possible that because of the tax cut that there might be more benefits to companies than we're factoring in right now.

But we feel good about being on the conservative side of that because we're still constructive, we're still positive, but I think that there are going to be aspects—so this is a tax bill that was passed in an unprecedented hurry. What normally would have taken two years took about two months.

And I suspect that there are going to be things in it that end up being a surprise; provisions that affect different companies in different industries in ways that are unanticipated, also just mistakes get put into legislation, even under normal circumstances. And normally, there are ways of dealing with that. There are bills that could be passed to make corrections.

But much like the Affordable Care Act, or better known as Obamacare, because it was passed on a pure party-line vote and because it was passed using certain procedures to get around the threat of filibuster, it is not going to be that easy to make corrections to this bill.

So it is possible, but we may be cooling our heels to find out what exactly, if there are corrections that need to be made, things that affect companies in unanticipated ways.

So this, right now, it's interesting that the sentiment about the tax bill has gone from, at the beginning of December, great skepticism about whether it would pass and what it would look like and whether it would be beneficial at all—including from businesses and industries that otherwise were supportive of a tax cut. You had a lot of pushback from a lot of different industry groups to now a very positive feeling both among companies and also in the market.

And I think it's probably going to find—the needle is going to find its way back to a middle ground where there's a recognition that "Yes, it's going to help the bottom line," but there may be some complications or maybe some unexpected outcomes from this bill as well, given the pace at which it was passed.

Robert Teeter: Great. I think one of the challenges with that strong economic background and backdrop and the strong performance of the stocks that we've seen is inviting complacency, and particularly when you've had a market that's experienced very little volatility.

In fact, when we look at the last year or so, we found that market ball for the S&P 500 has been about 25% that it has averaged historically. In other words, markets could be about four times more volatile and that would actually be normal.

So, one of the ways that we try to fight this complacency obviously is to think about what might happen and what are some of the events on the horizon that we want to keep an eye on. And so there I wanted to get your thoughts on geopolitical outlook and what things you're keeping a close eye on and what things you're maybe not as worried about.

Patrick Chovanec: So, I think one of the reasons why the—why volatility has been low over the course of the past year has been because the economic data has looked so positive.

And it has been hard to find, although we constantly are trying to think about what could be a catalyst for correction, what could go wrong, what is looming out there that's going to cause the end of this cycle?

Because like I say, we are in a mature phase of the cycle and this cycle will end. Share prices will not go up indefinitely. Something will happen that will cause them to come back down at least for a time.

So, although we scratch our heads and think about what that could be, the fact is that the economic data has been very supportive of the market. The earnings data has been very supportive of the market. The—and then you got—you mentioned geopolitical and that would include domestic political issues as well.

Robert Teeter: Sure.

Patrick Chovanec: It's been a tumultuous year, not just because of the controversies surrounding the Trump Administration, but also internationally. You've got Brexit. You've got North Korea. So, there's no lack of things that stir the pot, if you will, when it comes to headlines.

But one of the things that is an interesting lesson that we've taken away has been: we should not underestimate the prospect of disruptive events, but we should not—politically disruptive events, but we shouldn't overestimate their impact on the economic outlook in our markets, because there are ways, of course, that political decisions and political uncertainty can affect the economy.

But there are also ways in which the economy can just kind of chug along on its own in the face of those uncertainties and that's what has in fact been happening. And so, we don't want to be—we want to be cognizant, but not overly intimidated, by some of this uncertainty that's out there.

Specifically, we just came out of week where there was a government shutdown that took place. And as I said internally here, look, we've gone through previous government shutdowns. The fact is that government shutdowns—especially if they're temporary, anything that's temporary—say, a week or less, is not going to have an economic impact that is significant at all.

If we had something that went two or three weeks, we could start talking about that. But really, just because something generates a lot of headlines, creates a lot of drama, does not necessarily translate into it being an important economic event.

What, alternatively, do we think could be important economic events that could change this cycle? Inflation, which is something I discussed in my quarterly note. It's a logical time, which we might expect inflation to start appearing in the economy.

The addition of fiscal stimulus from the tax cuts would logically hasten the day when that might take place, but we still don't see it. It's logical to look for it, but we haven't really seen a sign of inflation that would send the alarm bells, and we will continue look for it.

Another thing would be trade. This morning, it was announced that the Trump administration was enacting tariffs on imports of washing machines and solar panels. Some people interpreted this as the president is going to Davos, and it's kind of a shot across the bow saying that maybe the administration would be tougher in delivering on its Trump tough trade rhetoric.

We have the prospect of continued NAFTA negotiations and the possibility that the United States could quit, or at least announce that it threatened that it's going to quit. Quitting NAFTA would be a serious economic event.

And it’s interesting, though, that throughout this year, there's been this gap between the president’s rhetoric, which has been fiery and continues to be fiery on trade.

It continues to disparage the idea that the U.S. benefits from any of these trade agreements and maybe it would be better off without them and maybe we should pull out of the South Korea Trade Agreement. And there are things that you—obviously you got to pay attention here, because those will be big deals if they happen.

And yet what this administration has actually done in the area of trade other than withdrawing from TPP at its very beginning, the Trans-Pacific Trade Partnership which we hadn’t— which hadn’t started yet. So, it wasn’t—we withdrew from a perspective agreement. Other than that, it’s all been pretty conventional stuff.

Even the tariffs that were announced today were fairly targeted, currently limited in nature. There was another tariff earlier this—earlier last year with soft lumber from Canada, which is part of a long-standing dispute. These kinds of things happen in any administration; under the Bush administration or the Obama administration, there were tariff actions.

So, we hadn’t seen an unconventional trade policy yet from the Trump Administration. We’ve heard a lot about it and it’s always possible that we could wake up tomorrow to it—something dramatic happening. And I would say that some of the things that have been talked about could be—have a significant impact.

They could have an impact on the market. They could have an impact on the economy. They could even take the economy into recession. But, we’ve got to cross that bridge when we come to it.

And one of the things that we tried to keep in mind throughout the year is that—just because something is said, doesn’t mean it’s actually going to happen. And actually, that’s guided us fairly well throughout the course of the year.

Another thing that I think about is China. China had a good year last year. It had a year where growth rebounded. A lot of people in the markets looking at it and said “Oh, we were worried about China before, obviously, we don't need to be worried.”

I think that the problems that exist in China continue to be there. China got a bounce because it let loose of the credit spigots in order to get a bounce during the Party Congress. So, every five years, there’s a Party Congress, a very important political event.

And China did get that bounce, but at the expense of digging the hole deeper, creating more bad debt, creating more overcapacity, not resolving the issues that needs to resolve.

And that continues to loom out there as something that, depending on how China deals with it, could send shockwaves throughout the rest of the economy and, at the very least, could surprise some people who have said, “Oh, well the problems with China are all gone.”

And of course, if they’re not all gone, there will be a recognition at some point that they're not, and that could rattle the cages of the market. So, these are some of the things that I watch I think that could have substantive impact on our economic outlook. It could have a substantive impact on the markets.

But we don’t want to get—one of things I said throughout the quarterly commentary, one of the main messages is “don’t get too far ahead of the story.” Because even though we can see storm clouds on the horizon, doesn't mean that it's raining. And for now, the economic data that we see is actually very positive.

Robert Teeter: Great. Thank you for that overview of a wide-ranging roster of topics. Just being mindful of the of the clock and the set time for the call, I did want to ask one question before we open the lines to the folks dialing in.

It’s a question that we’ve been hearing a lot about and it’s something that you addressed in your letter, which is Bitcoin. And I think at least I was particularly intrigued by the link you made between Bitcoin and that being a legacy of the financial crisis. And I'm just curious to have you give an overview for those who either didn't read the letter or want a little more color on your thoughts on Bitcoin.

Patrick Chovanec: Yes. I addressed Bitcoin, first of all, because I knew that it was something that people had a lot of questions about. And given the performance of Bitcoin, especially in November or December of last year, it shot up like a rocket. It made its way on to a lot of people's radar screens and a lot of people had a lot of questions.

So, I wanted to place it then within the context of our thinking about the economy, and I think it does. The fascination with Bitcoin is not just “Oh, it’s another—it’s money chasing another asset.”

I think it's a unique kind of asset that promises certain things, particularly protection from fiat currencies or the instability of currencies or worries about instabilities of currencies. And one of things I explored in the quarterly commentary was this idea that the Fed is in uncharted territory with the size of its balance sheet, the amount of excess reserves.

The question of can—if there is inflation, and there isn't so far—if there is inflation, can the Fed raise rates not just a couple of 25 basis points, 50 basis points, but could it raise to 5%, 6% or higher in a way that works in order to head off inflation.

And I think there are some open questions about that. Now then, the question is: Is Bitcoin really the answer? If you have concerns about inflation, if you have concerns about monetary policy, is Bitcoin the answer?

And I would argue that Bitcoin is—the Bitcoin and the technology that enables it, which is Blockchain—is real. It's a very intriguing technology. It offers certain advantages that are much talked about.

It all also presents some disadvantages that are maybe not so much talked about, including the amount of energy that it uses, including the ability to do things besides simple transactions within it and the need for intermediaries and how reliable those intermediaries are if you want to do anything more than that. The vulnerable—the reliance on a potentially vulnerable infrastructure.

Bitcoin is sometimes compared to gold, but gold is—the attraction of gold is physicality. The fact that you can bury it in the backyard and a nuclear blast could go off, and you could go dig it up and it's fine. Whereas Bitcoin actually relies on a very sophisticated communications and electronics infrastructure to function at all. And, if that is not working, then no Bitcoin.

So, what we did was just to explore some of this and try to put it into context. Not to brush aside the prospect of Bitcoin as an interesting technology and potentially an interesting asset, but also to recognize that if you are concerned about inflation, if you are concerned about monitoring stability or other sorts of things that might typify the end of this cycle, there are other more tried-and-true assets and forms of investing besides a new experimental currency where we can think about, and talk about, whether allocation make sense.

Robert Teeter: Great. Thank you, Patrick. I think with that, we'll turn it over to the moderator to open the line for questions.

QUESTIONS AND ANSWERS

Operator: (Operating Instructions) Caller 1, your line is now open.

Caller 1: Are we disagreeing that there's a disruptive technology as well as not enough educated workforce as some long-standing effect? How do you inject that into the projection and then making—in the long run, not short—not really short run but intermediate run?

Patrick Chovanec: When you're asking about a disruptive technology, are you talking about Bitcoin here? Or are you talking about other things?

Caller 1: This disruptive technology—I think Internet is one of the biggest disruptive technologies…

Patrick Chovanec: So more broadly, the question of disruptive technology.

Caller 1: Yes.

Patrick Chovanec: I think it's challenging. I think it presents some challenges, not just to our top-down thinking but also for bottom-up thinking. That—one of the things that we've seen is the lifecycle of companies becomes shorter.

Caller 1: Exactly.

Patrick Chovanec: I—when I was in China before joining Silvercrest, I taught a course in American Business History and we talked about the rise and fall of companies like RCA and Pan Am. And these sorts of things took place over the course of a generation or more, right?

Caller 1: Yes.

Patrick Chovanec: You fast-forward to something like Blockbuster Video, which was around for about a decade before Netflix came around and made it essentially obsolete. And I think there are a lot of companies where—one of the things that we think about when we value companies is "terminal value."

That is, after it's done growing and it just keeps making money, what is the value of that stream of income? And the question is what if you last for ten years and then your terminal value is zero?

So, it does post new challenges to valuation that can be dealt with. I mean we can think through those questions, with specific companies, and also the implication for the overall economy. But it is a very different environment and the world seems to be moving at a different pace when it comes to the lifecycle of business models.

So, I don't know what—I don't know if there's a magic answer to that except to say that it's something that we're very keenly aware of. And oh, and I should—I'll just mention also, I think you mentioned the workforce.

The challenge there of course is workforce participation, productivity and product. Once you reach full employment, productivity is key. And productivity comes from having a labor force that is able to meet the tasks at hand, and those tasks keep changing.

If you can't have a job for a lifetime because the skills are going to change three or four times in the course of your lifetime—that presents a challenge to human capital. It presents a challenge to labor as a factor of production in terms what kind of wages people are able to command in the economy.

And I think that we've seen that with the lower labor participation rate and we've seen that with fairly stagnant wages over the course of the past cycle that perhaps the mismatch in skills is a factor that is playing a role.

And so, what's the answer to that? Well I guess maybe rethinking the education system, maybe rethinking the lifelong process of education retraining, but again there are no easy answers. But it is critical to the question of continued future growth. But thank you—thank you for your question.

Operator: Thank you. Our next question comes from Caller 2. Your line is now open.

Patrick Chovanec: Hello?

Caller 2: Hello.

Patrick Chovanec: Yes, hello. Go ahead.

Caller 2: Hi. I have a question. Thank you for your comments on the Blockchain technology and Bitcoin. I'm sort of intrigued by some aspects of Bit—of Blockchain technology, but I don't know how you invest of it—invest in Blockchain, outside of Bitcoin and I guess I should talk to somebody else about that right?

Patrick Chovanec: Well, I mean I—OK, I can try to—I can—but go ahead with your second question and I can try to answer a little bit.

Caller 2: OK. But the other one which really intrigues me is AI, artificial intelligence. There's going to be real winners and losers in this. And how do we look at it from an investment standpoint? Where are the good investment vehicles and the bad investment vehicles, I guess, is the question.

Patrick Chovanec: OK. Well, thank you and these are very interesting questions that you pose. They're ones that I try to give a lot of thought to.

In fact, it's interesting; not only do I read articles about recent developments in companies, but I've also been doing a lot of reading of science fiction, to try to think about—which are often kind of near future science fiction, "What will the world be like in 30 or 40 years from now? What kind of technologies will we be living with?"

And it's always sort of a somewhat fanciful and often inaccurate process, but it's worth thinking through. The first thing I would say in response to both of your questions is that Silvercrest's approach is—I'm the top-down guy. I'm the guy who thinks about the world and what big things might affect us and what the economic indicators were looking like.

But the way we pick stocks, the way we actually pick investments, is bottom-up. And so, cognizant of these technology trends, cognizant of both the disruption that they cause and also the opportunity that they create, Roger and his team are looking at both from traditional industries and also emerging industries: what are the companies that they feel are doing interesting things and/or what companies are going to be potentially vulnerable? Or how are they preparing themselves to not be vulnerable to these sorts of traps?

So, I just say upfront that—while I can give a top-down view, really when you talk about investment vehicles, that's a bottom-up thing that they're thinking about from a complementary perspective. I wouldn't call it just a different perspective, it's a complementary perspective.

With Blockchain, there are a lot of people who were very interested in it. I was actually just reading an article today about—that France has granted permission about a month ago for the trading of unlisted securities using Blockchain technology. China is looking into using Blockchain in its—within its financial system.

A lot of companies—and there's a lot of VCs, venture capitalists, in Silicon Valley who are pouring a lot of money into Blockchain, so Blockchain technologies that are really about financial—things that we call fintech, financial technology, so banks using Blockchain for settlement among other banks, so things like that.

Caller 2: Well, there's some chain—there are some VC funds which are Blockchain-only investments.

Patrick Chovanec: Yes. And you know, with that…

Caller 2: Highly risky.

Patrick Chovanec: Well there's always a—I don't pretend to be an expert in VC, but there's always a tension between being an expert in your core area, right, which is a good thing, and being narrowly focused on the thing that seems to be the best thing to raise money for, which is not necessarily a good thing. So, you've got to balance those things out.

It's a hot thing. And when you ask people, "So what do you do in VC?" Nine times out of 10 now people will say, "Oh, I'm in Blockchain." And you kind of go, "Really? Aren't you sort of in fintech? Isn't that actually like…"—but no, Blockchain is a catchword. So, you've got to be wary of catchwords.

But no, it's a real technology. There are real issues having to do with energy usage and things like that. But it's a real technology. The other thing—what was the other thing that you asked about? You asked about…

Caller 2: Artificial intelligence.

Patrick Chovanec: Yes. I mean, well, OK. So, a huge area. There's all this talk about all the different jobs which people won't be doing in 20 or 30 years' time, including what we're doing right now.

But it's like the industrial revolution where skill sets that were highly valuable before the industrial revolution like being a—running a loom become valueless. And people either fall out of the economy or they learn to adapt.

There are new opportunities that are created, but they're not created for everyone automatically. And so, that's going to be one of the huge challenges going forward for not just the U.S. economy, but economies around the world. Thanks for your question. I think we're running short on time here.

Caller 2: OK. Thanks for your answer, I really appreciate it, Patrick. All right. Thanks guys.

Patrick Chovanec: So, are we going to take another question or are we going to—OK. Is the moderator there?

Operator: Yes. I do have another question here from Caller 3.

Patrick Chovanec: OK. Please go ahead.

Operator: Your line is now open.

Caller 3: Hi. Can you hear me?

Patrick Chovanec: Yes, I can hear you. Yes.

Caller 3: Hi. Yes. I just wanted you to talk a little bit about fixed-income returns this year, what you're expecting and if you think there'll be positive returns in the fixed-income portfolio.

Patrick Chovanec: Well, the challenge in fixed income throughout the last several years is the low interest rate environment and the fact that—one of things I talked about a lot has been the very large equity risk premium that's existed.

And the implication of that is that people were being relatively well rewarded for taking a great risk and the cost of going into things like fixed income—at least plain-vanilla fixed income that were seen as relatively safe or less risky, there was a very high cost to doing so be—not because they were negative, but because there was just—the opportunity cost is very high. That the return that was left on the table is very high.

And we've reflected that in our asset allocation. That doesn't mean that people should be in fixed income. It just means that they need to be conscious of the fact that it was expensive to be risk off instead of taking equity risk.

I think that the concern going forward is that with interest rates at all-time lows or near all-time lows that if you start getting a ramp up interest rates quickly, that obviously that means bond prices fall, right?

I mean it doesn't mean that if you hold, it's really an opportunity cost question. If you hold, fixed income is going to generate a positive return. The question just is what are you getting up and in exchange for that, right?

And so, it is possible especially, that's one of reasons why we're looking at inflation and if inflation picks up. Because if inflation picks up, then you're going to start to see Fed rates raise or try to raise rates faster.

And the open question that I asked in the quarterly commentary was "Can they raise rates?" or are they just going to reign in inflation or not. But it's funny because if you go back to almost three years ago now with the taper tantrum, when Bernanke first announced that they're going to taper QE, the 10-year treasury went up 3%.

And everybody thought it was going to go up from there, and instead it went down. And it went down to the lowest rates that we've ever seen. So, we've had—there's a history of everyone expecting higher rates and yet even though the economy grows, they don't materialize.

So that's why we're sort of keeping our powder dry when it comes to predictions about inflation or predictions about rate increases, because it's a logical time to start looking for it, but it doesn't mean it's necessarily going to happen.

And the implication would be that, you continue to see low returns—relatively low returns in fixed income, but not negative ones, and just the high opportunity cost.

Robert Teeter: I'll just very briefly add on Caller 3. Our official outlook has generally been towards earning yield in fixed income and not doing any better or worse than that. In the past few years as you know, folks have done quite a bit better as rates have trended down.

And if that stabilizes and reverses itself, as Patrick was saying, we're probably looking at returns a little lower than current yield or coupon. So, that's how we're positioning it at the moment.

Patrick Chovanec: Thanks for calling in.

Caller 3: OK.

Operator: Thank you. And I am showing no further questions in the queue.

Robert Teeter: Great. Well, thank you to everyone that dialed in and just as a reminder, there will be a replay of the call available as well as a transcript and information on both of those that can be found on our website as well as within the details provided within your invitations. So, thank you all for calling in this afternoon.

Operator: Ladies and gentlemen. Thank you for your participation in today's conference. This concludes the program. You may now disconnect. Everyone, have a great day.