STRAIGHT TALK

3rd Quarter 2018

Steven F. Mosshart AIF®, Chief Investment Strategist   Sonny Mehra, Director of Research

Market Returns

Domestic Large
S&P 500
10.56%

Domestic Small
Russell 2000
11.51%

Intl Developed
MSCI EAFE
-1.43%

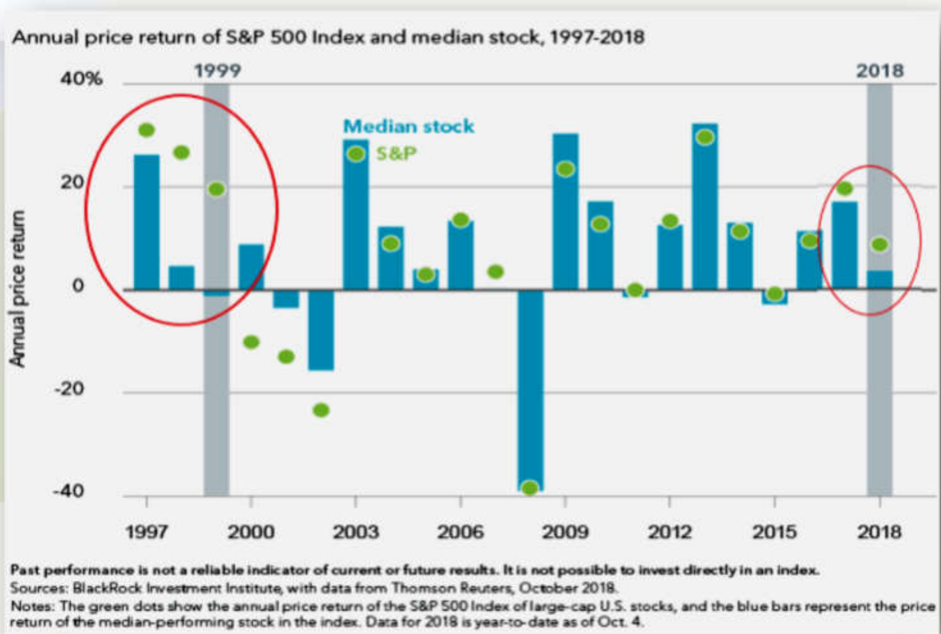
Emerging Markets
MSCI EM
-7.68%

Fixed Income
BBgBarc US
Aggregate Bond
-1.60%

**Market data is from Morningstar and is through 9/30/18. All returns are with dividends reinvested.*

It has been an up and down year for markets, with many external factors driving returns. Looking at the performance of the S&P 500 or Dow it's easy to assume that everything has been ok, but those indices represent a narrow subset of a much larger investment universe. When constructing portfolios we have to consider broader questions of style, market cap, geography, and asset class. While diversification is a prudent long-term strategy, it does work against investors at times. This year, for instance, we've seen abnormally high dispersions across styles (growth vs. value), geographies (domestic vs. international developed vs. emerging markets), and across asset classes (stocks vs. bonds). We'll go into this in more detail below, but it all boils down to the simple fact that a small group of stocks are generating high returns, while most other areas are either flat or down for the year. The muted returns across markets has delayed the need to make significant portfolio changes, but we do expect to trade accounts in the near future.

In US markets we've seen the ongoing trend of growth stocks outperforming value, as a small group of predominantly tech names post exceptional returns, while most others lag. We believe that domestic equities are in the latter part of this market cycle and are beginning to exhibit some of the same characteristics that we witnessed during the late 90's tech bubble. This should not cause panic, as we certainly don't see the same investor exuberance at this time. We aren't calling for an immediate bear market either, but we are increasingly aware that many of the same stocks that have been the biggest contributors to market gains over the last decade are now being bought blindly in index funds and by investors chasing returns. The chart below illustrates the weakening breadth in the market.



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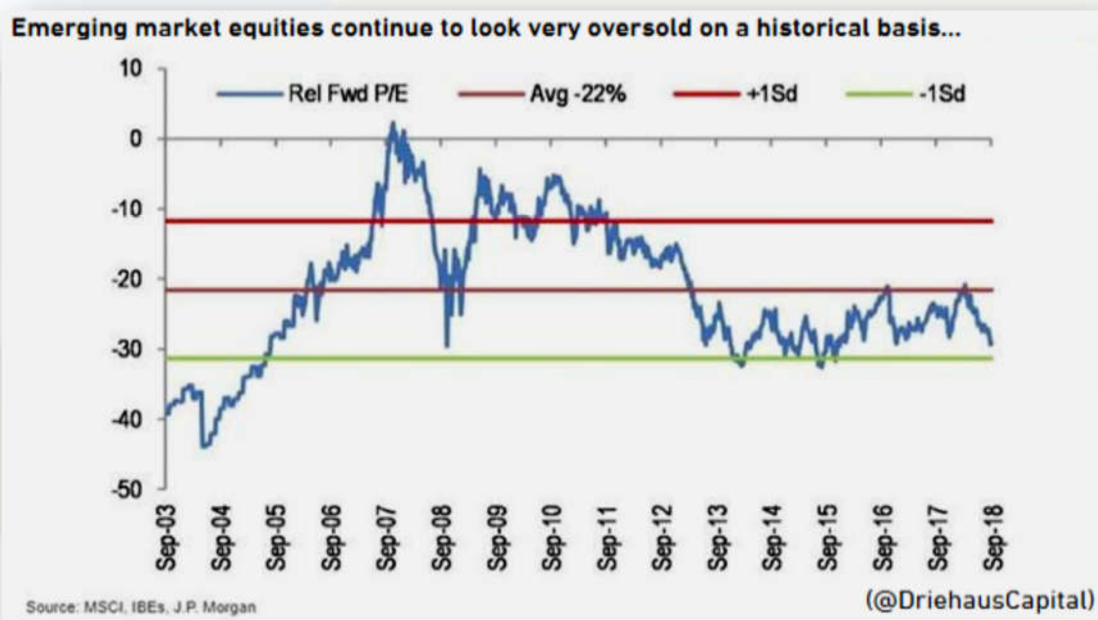
The likes of Apple, Netflix, Microsoft and Amazon, just to name a few, are all great companies which have revolutionized the spaces in which they operate, and their stock returns reflect the amazing growth that they've achieved in the last decade. However, while their stories are wonderful, we have to divorce ourselves from the emotions they elicit and determine whether these stocks can continue to generate returns 50%+ higher than the broad market, and if not, what implications does that have for markets as a whole. For example, in the S&P 500 weighting, the top three positions (Apple, Microsoft, and Amazon) make up nearly as much as the bottom 250 companies. Nothing lasts forever, and if these companies can't keep putting up the same returns going forward, or if they suffer a large drawdown, it's going to have an outsized impact on index returns. We have to look no further than this recent pullback, as each company declined more than the S&P 500 and exacerbated market losses. Now we have to ask ourselves going forward how much exposure do we want to have to these companies and if there might be better areas in which to invest.

The S&P Index remains a large weight in our equity holdings, however, we've been decreasing that allocation gradually and diversifying to other areas. We continue to favor international markets as better investments for the next phase of this cycle. Until recently it seemed that some of these markets had turned the corner, particularly as international stocks outperformed domestic markets last year and at the start of this year, but the focus on trade and recent currency fluctuations have derailed markets, temporarily in our estimation. As seen below, valuations in emerging markets are near cycle lows and are low by historical standards. Returns in international markets have been disappointing this year, but as Warren Buffet said "Be fearful when others are greedy, and greedy when others are fearful." We acknowledge that there are still some headwinds facing these markets, but international equities are among our highest conviction ideas looking ahead.



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International stocks haven't been the only source of pain in portfolios this year. The US bond index is also down for the year and so are most bond funds. This is due to the uptick in bond yields, which we've been expecting to some degree. The known factor in this move has been the Federal Reserve, which continues to steadily raise rates, while also halting the reinvestment of some maturing bonds that were acquired during the Quantitative Easing era. However, we believe that there have been additional factors which have magnified the selling in bond markets. Some governments have come under fiscal pressure and may have sold large chunks of their treasury holdings in or order to free up capital. Also, the new tax plan that was enacted last year may have had the unintended consequence of hurting demand for corporate bonds, which were a resting place for much of the cash that companies held overseas. We were expecting a somewhat challenging year for bonds, and have been increasing our exposure to short-term funds and cash. In our Schwab portfolios two of the four fixed income holdings have managed to generate positive returns, even in this tough environment. Bonds will continue to offer downside protection when equity markets selloff, and we believe they remain a better investment than pure cash over the next 12-36 months.

What we're seeing this year is reminiscent of what happened in 2013, when the taper tantrum led to losses and a -2.02% annual return in the bond index. At that point everyone thought that the Fed was set to reverse course and that bonds were dead money. However, the bond market rallied in the following year and ended 2014 with a 5.97% return. We aren't saying that bonds are going to be up anywhere near 6% next year, but when everyone thinks that one thing is going to happen the opposite is usually the outcome. This is the reality of fixed income investing for the foreseeable future. There are going to be periods where things get ugly, but over a longer time frame we expect core fixed income to produce mid to low single digit returns, with the potential for more when we see a significant stock market decline.

This current market pullback isn't entirely unexpected and highlights many of the points we wanted to make in this newsletter. Large cap growth stocks have been among the hardest hit, particularly as the proliferation of high frequency and algorithmic trading is intensifying the speed and magnitude of market movements. As such it's going to be imperative to be ahead of the curve when it comes to larger market shifts. In the near term it is our belief that markets may remain somewhat volatile until the elections, and regardless of the outcome, once we move past them one source of uncertainty will be removed. Additionally, with the US Mexico Canada trade agreement and possible US/China talks at the G20 meetings in late November, we expect to see more positive developments on the trade front, which should remove a key barrier to better returns in international markets.

It can be hard to digest the numerous events and factors that play into market movements and this year has been especially challenging on that front. This market is being driven by momentum in high growth, highly valued stocks. While things are good a lot of money can be made, then again a lot can be lost just as easily, and in a very short period of time when the momentum fades. We are not in the business of chasing returns without considering the risks. We've been entrusted to manage retirement funds for many of you, and while portfolio returns are generally flat this year, we do see better days ahead. Patience on the part of investors and money managers, and a focus on value will pay off. Thank you for your continued trust, please let us know if you have any questions.

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