Economic Review & Outlook

FIRST QUARTER 2019

Navigating the Behavioral Seasons of Investing

We often state that giving our clients financial clarity is our primary objective when managing their assets. At times, this is easier said than done. During periods of market volatility, underperformance, and overall market uncertainty, it's not unusual to feel stressed or even wonder if you are properly invested.

In this edition of the Economic Review & Outlook, we will discuss the concept of "behavioral seasons," how often they have occurred historically, and the psychological toll they take on most investors. We will also reveal which season we are in currently, as well as some tips on successfully navigating these market environments. Not everyone has the same investment goals or reactions to these seasons, so we seek to tailor your portfolio to your specific needs; we will cover how we approach this in our strategy section.

We will first cover the latest economic news and market performance.

Economic Review

Fed Again Raises Rates

On December 19, the Fed announced the fourth and final increase in 2018 to the fed funds rate to a target range of 2.25-2.50%. Even though this move was expected, some were skeptical as doubts around continued economic expansion began to creep in. However, although the rise in rates this year has negatively impacted fixed income returns, forward-looking yields have become more attractive, as seen in the following table.

2018 Change in Bond Yields
(1/1/2018 – 12/31/2018)

Type	1/1/18 Yield	12/31/18 Yield	Change
30-Day Treasury	1.3%	2.4%	1.2%
1-Year Treasury	1.8%	2.6%	0.9%
2-Year Treasury	1.9%	2.5%	0.6%
5-Year Treasury	2.2%	2.5%	0.3%
10-Year Treasury	2.4%	2.7%	0.3%
U.S. Bond Index	2.7%	3.3%	0.6%

Source: FactSet. U.S. Bond Index—Barclays Aggregate U.S. Bond Index

Trade War Continues

Tariffs continued to be a major theme this quarter. While further negotiations and some concessions by China were promising, things took a turn on December 1 when a Chinese executive, accused of violating Iranian sanctions by U.S. officials, was arrested in Canada. To this point, no final compromise on tariffs has been made, and we expect continued market volatility until a solution is reached.

Democrats Retake House

The U.S. midterm elections in November led to mixed results for both parties. While Republicans slightly increased their majority in the Senate, Democrats regained control of the House of Representatives, leading to a divided Congress. These results were largely expected, and while a divided Congress isn't necessarily bad for markets, there is speculation that it could lead to more intense investigations of President Trump, which could potentially increase market volatility.

Asset Class Performance

Q1	Q2	Q3	Q4	2018
Commodities 2.8%	Commodities 5.8%	U.S. Stocks 7.7%	Gold 7.2%	Diversified Bonds 0.0%
Emerging Markets Stocks 1.3%	U.S. Stocks 3.4%	Int'l Developed Stocks 1.4%	Diversified Bonds 1.6%	Gold -2.8%
Gold 1.0%	Diversified Bonds -0.2%	Commodities 0.4%	Emerging Markets Stocks -7.4%	U.S. Stocks -4.4%
U.S. Stocks -0.8%	Int'l Developed Stocks -0.8%	Diversified Bonds 0.0%	Int'l Developed Stocks -12.5%	Commodities -11.0%
Diversified Bonds -1.5%	Gold -5.5%	Emerging Markets Stocks -0.9%	U.S. Stocks -13.5%	Int'l Developed Stocks -13.4%
Int'l Developed Stocks -1.6%	Emerging Markets Stocks -7.7%	Gold -5.0%	Commodities -18.4%	Emerging Markets Stocks -14.2%

Indices used: Commodities—Credit Suisse Commodity Index, Diversified Bonds—Barclays Aggregate U.S. Bond Index, Gold—S&P GSCI Gold Index, U.S. Stocks—S&P 500 Index, Int'l Developed—MSCI EAFE Index, Emerging Markets—MSCI Emerging Markets Index. Indices do not reflect the deduction of advisory fees, transaction charges and other expenses. You cannot invest directly in an index. Past performance does not indicate future returns.

Volatility returned in a big way during the fourth quarter, as equity markets were down across the board. U.S. (-13.5%) and international developed (-12.5%) stocks were down the most, while emerging markets fell by nearly half as much (-7.4%). Commodities, which had a strong year up to this point, sold off strongly, losing -18.4%. Gold (+7.2%) and bonds (+1.6%), naturally defensive asset classes, had solid quarters, though corporate bonds did not fare as well as treasuries. Overall, 2018 was not a strong year for the markets. International equities and commodities were down double digits; gold and U.S. stocks were down as well. Even bonds, the highest returning asset class, earned essentially zero return for the year. While this was a difficult reversal of a very strong 2017, a diversified investor likely still saw respectable performance over the past two years combined.

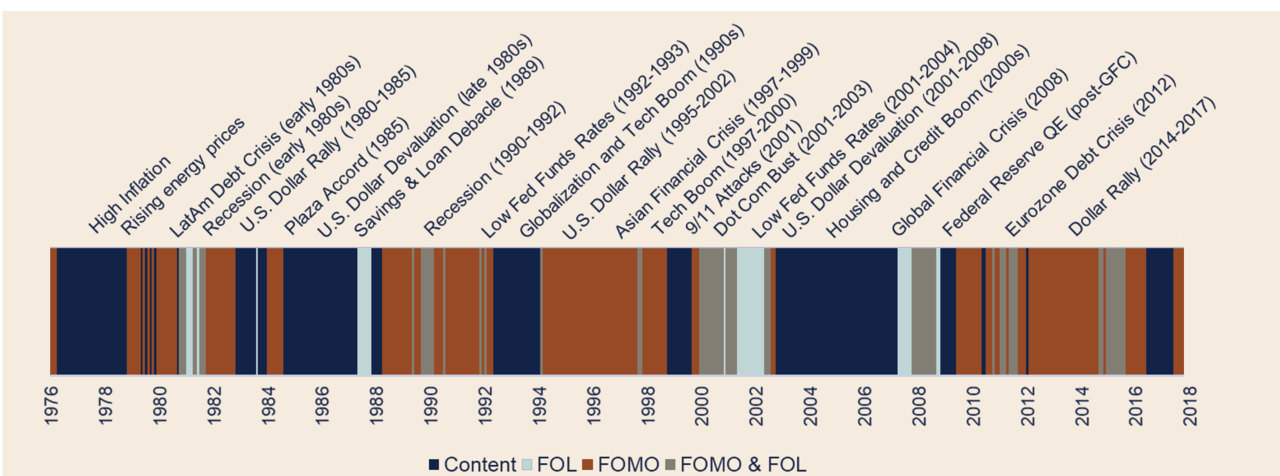
Our Perspective

Our human nature expects us to be content all the time. In reality, things are different. We experience setbacks and unmet expectations. When things aren't going well, our first instinct is to either avoid or fix the discomfort. This can be problematic with investing, as a long-term perspective is often the best way to achieve success. Still, we realize that completely removing emotion from investing is nearly impossible, but believe understanding that difficult market environments are normal – and to be expected – can help ease the discomfort and increase the probability of staying the course.

What are behavioral seasons?

There are times where we experience different emotions based on what's happening in the investment landscape; we call these environments "behavioral seasons."

In the following sections, we will observe when these periods have occurred historically and how long they lasted. Below are the overall results:



Source: FactSet. Seasons defined using one-year rolling monthly returns. It is assumed the investor owns the MSCI All Country World Index (ACWI) and the benchmark index is the S&P 500.

Season of Contentment

Investing doesn't always feel difficult, and extended periods of good performance can put our minds at ease. We can open our statement and feel pleased to see positive performance that is better than our expectations. For many clients, this occurs when a diversified portfolio is doing better than the U.S. markets. We classify this season as "Contentment." Some examples include the late 1970s before energy prices got out of control, the Reagan boom in the 1980s, and the 2000s post 9/11 leading up to the financial crisis.

It's important to note that these periods were not devoid of geopolitical uncertainty, volatility, or other concerns, as even a good year in the markets can have pockets of disappointing returns. We would urge investors to not get complacent when things are going well, because a change in seasons may be coming.

Fear of Missing Out (FOMO) Season

Sometimes we see good performance on a stand-alone basis, but it is disappointing because we fall short of U.S. markets. This triggers a frustration or concern that we're not keeping up with benchmarks or other strategies, which is what we call a Fear of Missing Out (FOMO) season. While achieving positive performance is sufficient for some, knowing that you theoretically could have done better can be difficult, especially if it goes on for a long time or the performance gap is particularly large. The tech bubble of the late 1990s is the most famous example of this. From 1995-1999, a global stock investor received a cumulative return of over 140% during that period. How could you not be happy with that? During the same period, a U.S.-only investor was up over 251%, and those who invested solely in tech stocks did even better. As people grew frustrated with not keeping up, more and more investors jumped into dotcom stocks just as the bubble was ready to burst.

Most of the post-2008 investment landscape has been dominated by the FOMO season, and it has been very frustrating for diversified investors as U.S. markets have hit all-time highs, while other asset classes have underwhelmed. While it hasn't gotten as bad as the late 1990s, the psychological toll has been similar and we should approach this environment with the same lessons in mind. First, periods like this have happened before and will happen again. Second, these periods don't last forever and often lead to sharp reversals in the other direction. Third, it is critical to not attempt to time these cycles, or you run the risk of an outcome much like those who started buying tech stocks in 2000. As difficult as it may be in the moment, staying diversified and trusting your process is generally the safest course of action.

Fear of Loss (FOL) Season

Alternatively, there are times when performance is bad, but not as bad as other markets, and investors are distressed about losing money. We call this season Fear of Loss (FOL). FOL seasons, while typically shorter than FOMO seasons, can be harmful enough to leave a permanent mark on an investor's psyche. These seasons can come out of specific events, such as 9/11 or the great recession, and be a blip in an otherwise strong bull market or mark the bursting of a bubble.

Some will be tempted to move their assets to cash at the first sign of trouble; however, timing the length and severity of a market decline is almost impossible, and some of the best market periods have followed large drawdowns. Going to cash can be dangerous, as you run the risk of participating in the downside but missing the upside. For example, investors who chose to sell their stock positions in 2009 as the market bottomed missed much (or all) of the current bull market. We believe that there are three strategies for weathering an FOL season: 1) keep adequate reserves in safer, liquid investments and give your longer-term, riskier assets time to withstand periods of loss; 2) pay attention to valuations because the largest losses are associated with the unwinding of overpriced, speculative markets; and 3) broadly diversify because it is rare for a sustained season of loss to hit every asset class with the same severity.

Fear of Loss (FOL) and Fear of Missing Out (FOMO) Combination Season

While not particularly common, it can be extremely difficult for investors who find themselves experiencing negative returns *and* doing worse than the benchmark. These periods can cause them to give up by switching strategies or leaving the market entirely. However, those who wait these periods out have been awarded eventually, as these periods often occur at market inflection points that lead to subsequent periods of satisfying performance.

On the following page are the summary statistics for behavioral seasons:

Season	% of Time	Median Length (Months)	Longest Period (Months)
Content Globally diversified portfolio has positive returns and is outperforming U.S. stock portfolio	39%	5.0	54
Fear of Loss (FOL) Globally diversified portfolio has negative returns but is outperforming U.S. stock portfolio	6%	2.5	12
Fear of Missing Out (FOMO) Globally diversified portfolio has positive returns but is trailing U.S. stock portfolio	41%	3.5	42
FOL & FOMO Globally diversified portfolio has negative returns and is trailing U.S. stock portfolio	14%	3.0	11

Source: FactSet.

As you can see, participating in markets means that the majority of time, you will be dealing with some type of discomfort. While it is perfectly normal to feel the emotions associated with these behavioral seasons, we find that understanding that these cycles are normal, remaining diversified, and sticking to your process can help put your mind at ease.

Our Investment Strategy

After seeing these behavioral season cycles, a natural response could be, "Shouldn't the investment team be able to predict these cycles and position my portfolio accordingly?" While tempting, these seasons are neither consistent nor predictable, and attempting to time the market goes against two of our core principles – that the world is uncertain and markets are inherently unstable. Rather than attempting to avoid these seasons, our goal is to position our portfolios in a way that will minimize the impact of these periods in the following ways.

Time-Based Approach

You can limit the damage from adverse behavioral seasons by giving your more volatile investments sufficient time to rebound. We accomplish this by understanding your financial plan and segregating your conservative and risky assets into shorter- and longer-term buckets. Bonds, particularly those that are high quality and liquid, tend to hold up well during times of heightened equity market volatility. This can help protect funds that will be withdrawn sooner and give you confidence that you will have time to recover from losses in your longer-term portfolio.

Diversification and Valuation

Another way to help navigate these cycles is to build portfolios that focus less on avoiding short-term volatility and more around protecting against permanent loss of capital. This can be accomplished by paying attention to the price you pay for an asset. Buying into an expensive, speculative market could mean a greater loss once things normalize. While fundamentally sound investments can be just as volatile in the short term, they have greater potential for long-term appreciation.

A robust portfolio is also well diversified. Putting all your eggs in one basket can lead to great short-term results if the conditions are right, but if the economic landscape shifts, you may see your entire portfolio go out of favor at once. If the shift is large enough, it could be difficult to ever fully recover.

Customized Solutions

We recognize that not all our clients have the same goals, risk tolerance, or comfort with financial markets; therefore, our goal is to put you in a solution that works best for your disposition. If you have long-term goals, but are concerned about loss, we will work with you on a portfolio that will help manage that risk. Likewise, if you struggle when U.S. equity markets are outperforming a diversified portfolio, we can tweak your exposure to be a little more domestic. We believe these steps can both accomplish your goals and help you feel more comfortable along the way.

In Conclusion

When performance is good, it's easy to be content and believe that investing is simple. Yet during difficult seasons, it can feel as though things will never get better. Investing will always have its challenges, but we believe that recognizing this on the front end and having the right perspective is imperative. Although there is not a one-size-fits-all solution for all investors, we believe working with your advisor to construct a portfolio that is adequately diversified, reasonably priced, and appropriate for both your financial plan and temperament can go a long way to help you weather challenging market environments.

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