Economic Review & Outlook

FIRST QUARTER 2018

Investing vs. Speculating

We often hear about what could be the next hot stock, collectible, or other "investment of a lifetime" and that we should act now, before it's too late. Maybe we know someone who made a fortune by buying stock in the early days of a successful corporation or someone who bought a piece of artwork at a garage sale that turned out to be worth thousands of dollars. It can be difficult to sit back with a sensible, diversified portfolio, experiencing single-digit returns year after year, while being bombarded with the prospect of annual returns of 10%, 20%, or even 100%.

In this quarter's Economic Review & Outlook, we will examine the difference between investing for your goals and speculating on the next "hot investment." The recent surge in investor interest in Bitcoin presents a timely case study. We will also provide an overview of 2017 market performance and important economic themes going into 2018.

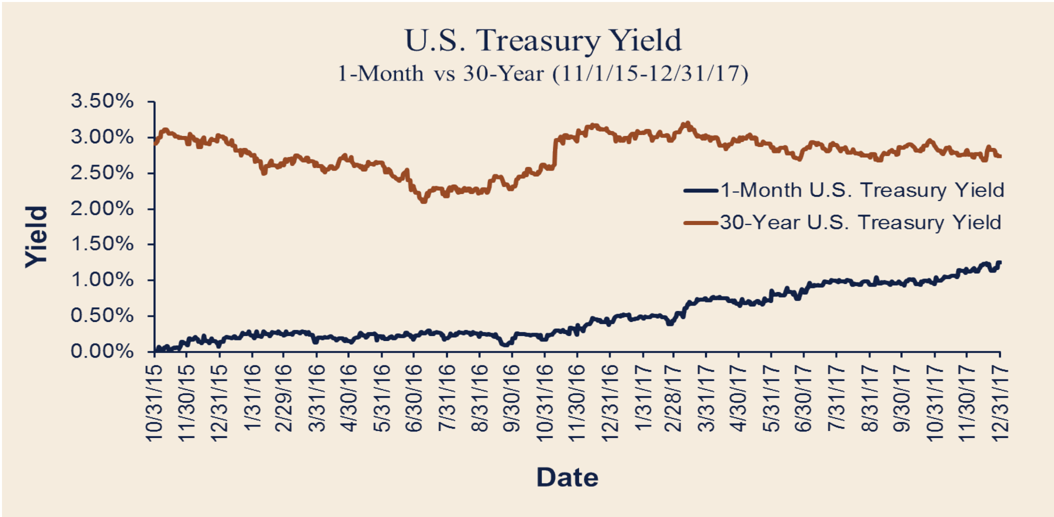
Key Economic News

Fed raises Rates and Releases 2018 Guidance

In December, the Fed raised its benchmark federal funds rate to a target range of 1.25%-1.50%, marking its third and final increase in 2017. The federal funds rate is the interest rate banks charge each other to lend reserve funds overnight. Fed Chairwoman Janet Yellen expressed continued confidence in U.S. and global economic growth, a signal that has successfully kept volatility muted. Yellen stated that continued gradual rate increases would be necessary in order to keep inflation in check without moving too fast, putting the current recovery at risk. The Fed is targeting three more rate increases in 2018 and two increases each in 2019 and 2020.

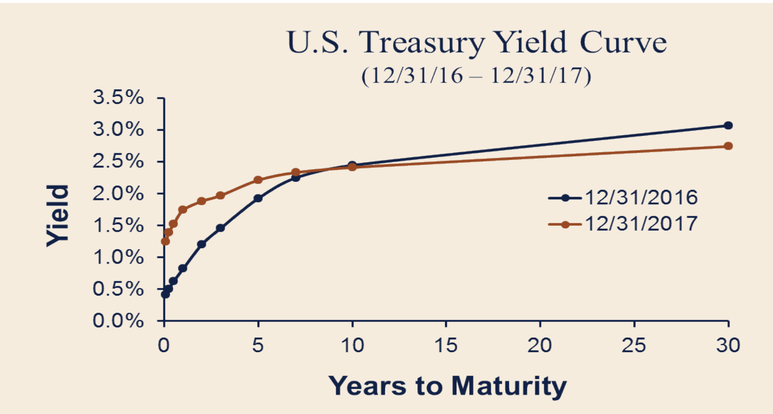
A Flatter Yield Curve

Typically, investors may assume that an increase in interest rates would be seen across all bond durations following a Fed interest rate hike. However, this has not been the case. While short-term rates receive the most direct impact from the Fed's policies, over the same period of time, yields on Treasuries with longer maturities have not risen to the same degree. In fact, 30-year Treasury rates have actually decreased since the Fed began raising the federal funds rate. The comparison can be seen below through plotting the yields of U.S. Treasuries over a period of time.



Source: FactSet

The net effect has been a yield curve (a plot of the yields of U.S. Treasuries with differing maturities) that has gone from very steep in the beginning of 2017 to relatively flat by the end of the year.



Source: FactSet

The shape of the yield curve is important because it is a metric used to gauge expectations of future interest rates, and by extension expectations on future economic growth. Over the past year, we believe that the flattening yield curve (when there is little difference between short- and long-term yields) could be due to a combination of several factors:

- The market is more pessimistic now than a year ago, possibly due to worries around central bank tightening, expensive valuations, and stagnant growth.
- The market is no more pessimistic, but the true shape of the yield curve was manipulated by artificially low short-term rates while longer-term rates were less susceptible to central bank policies.
- Although less susceptible, longer-term rates will also rise over time. Therefore, the flattened yield curve is temporary.

Historically, a flat or inverted yield curve has often been a precursor to an economic slowdown or recession, and is widely considered to be a bearish indicator for market returns. Many forecasters are predicting the yield curve to become inverted at some point next year.

U.S. Passes Major Tax Reform

The Tax Cuts and Jobs Act officially signed into law in December marks the first major tax overhaul since 1986. The main objectives of this legislation were to lower the tax rates for most individuals and corporations, and to simplify the tax code through fewer available deductions. We believe that reducing a country's tax burden and creating a more efficient tax code is positive for long-term economic growth. However, we remain concerned with the mounting debt profile of the U.S. and much of the globe. Critics are concerned that future spending cuts will be required in order to avoid a material increase in the U.S. deficit.

Asset Class Performance

Q1	Q2	Q3	Q4	2017
Emerging Mkts Stocks 11.5%	Emerging Mkts Stocks 6.4%	Emerging Mkts Stocks 8.0%	Commodities 9.4%	Emerging Mkts Stocks 37.8%
Gold 8.2%	Int'l Developed Stocks 6.4%	Commodities 7.7%	Emerging Mkts Stocks 7.5%	Int'l Developed Stocks 25.6%
Int'l Developed Stocks 7.4%	U.S. Stocks 3.1%	Int'l Developed Stocks 5.5%	U.S. Stocks 6.6%	U.S. Stocks 21.8%
U.S. Stocks 6.1%	Diversified Bonds 1.4%	U.S. Stocks 4.5%	Int'l Developed Stocks 4.3%	Gold 12.8%
Diversified Bonds 0.8%	Gold -0.8%	Gold 3.1%	Gold 1.9%	Commodities 7.7%
Commodities -3.3%	Commodities -5.5%	Diversified Bonds 0.8%	Diversified Bonds 0.4%	Diversified Bonds 3.5%

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. As of 12/31/17.

Equity markets finished the year on a strong note, particularly in emerging markets, which saw an increase of +7.5% for the quarter, ending the year up +37.8%. U.S. equities also had very positive returns for the quarter (+6.6%) and year (+21.8%). In terms of real assets, gold and commodities posted solid returns for the quarter and finished the year up +12.8% and +7.7%, respectively; bonds were up modestly for both the quarter (+0.4%) and year (+3.5%). After a year of high gains and low volatility, it is important to remember that markets will fluctuate over time, and these returns should not be the expectation going forward, especially given today's expensive valuations.

Our Perspective

How many of us have thought, “If only I had bought Amazon back in 2001…?” At that time, you could buy one share of its stock for as little as $5.51. That same share would be worth about $1,183 today, meaning that a simple $5,000 investment would now be worth more than $1 million. To be fair, no one could have predicted Amazon’s success at the time. Investors would not have been eager to own stock in a company that lost more than 95% of its value after the dot-com bubble. Many companies start out with highly promising futures only to go bankrupt due to accounting fraud, mismanagement, or just plain bad luck.

These scenarios aren’t limited to financial products. For a few years in the 90s, the entire country was caught up in “Beanie Baby mania” with more than 60% of U.S. households owning at least one Beanie Baby. Transactions of the plush toys accounted for 10% of eBay’s sales, and fortunes were made as prices soared. Many spent their entire savings on these “investments,” as their values were only expected to increase over time. However, almost overnight, prices tumbled, and the craze ended. Some people got out at the right time and made a lot of money, while many others bought in at the very top and were left with hundreds of very expensive toys.

It’s easy to laugh at historical craziness and think we should have known better. However, the temptation to be on the ground floor of something that could lead to overnight riches is often difficult to overcome. How can we discern the difference between a forward-thinking, insightful investment and pure speculation?

Bitcoin: World-Changing Currency or Digital Beanie Baby?

Cryptocurrencies have taken the financial world by storm. These digital versions of money have gained popularity as an alternative to traditional currency by using a new technology called “Blockchain” which houses a record of transactions on each participant’s computer. These currencies have fixed, pre-determined supplies, which has appealed to those worried about excessive money printing by central banks. While the technology behind these coins has many potential benefits, it is their skyrocketing prices that have attracted so much attention.

Bitcoin, the first digital currency to use this technology, has garnered most of the spotlight to this point. While it has existed since 2009, Bitcoin was not an overnight success. Actually, its share price did not surpass $1 until 2011. It started gaining mainstream attention when its price quadrupled in a month in 2013, only to fall by two-thirds in the ensuing week. Since then, its price surpassed $1,000 last January, only to double several times since. By early December, it passed $10,000 and briefly breached $20,000, ultimately finishing the year at $12,600.

Source: www.bitcoin.com

This rise was enough to capture the attention of the world, as seemingly everyone wanted to learn more about, or “invest” in Bitcoin. The number one question we received during the second half of 2017 was, “Is Bitcoin a good investment, or is it in a bubble?” While it’s true that equity markets also have uncertainty, instability, and the possibility of large losses, there is one big difference between equity investing and speculating on cryptocurrencies: cash flows. When you buy a stock, you are buying a real ownership stake in a real business, and the long-term success of that stock will be based on what kind of earnings it can generate over time. Since Bitcoin does not produce cash flows and there is no real way to fundamentally value cryptocurrencies, they will likely remain very volatile as their value is almost entirely driven by short-term sentiment and speculation.

For this same reason, we would also hesitate to make the claim that the price of Bitcoin is in a bubble. To declare a bubble means you have to be certain that the price is far above its intrinsic value. We simply don't have that conviction because we're unable to apply the same fundamental analysis that we do for other financial assets in which we'd normally invest.

Ultimately, the distinction between investing and speculating lies not within the asset itself, but the mindset of the purchaser. An investor seeks to grow capital over time with a patient, consistent, diversified approach that uses economic fundamentals to reach specific financial goals within a certain time frame. A speculator attempts to get rich quick through a few, concentrated bets, often abandoning trades during difficult times and using intuition over evidence.

We don't believe it is wrong to speculate, but we do think that those activities should be kept in a separate account from your main investment portfolio. These funds should be treated just like an entertainment budget, and this "speculative bucket" should not be tied to your financial plan in any way. If you find that these activities cause you undue stress, or there is a temptation to commingle these funds with your primary investment portfolio, it is probably best to avoid speculating altogether.

Our Investment Strategy

Typically, when returns are high and volatility is low, there is a tendency to let recent performance alter one's risk appetite. One of the benefits of a time-based approach is that asset allocation decisions are determined by the investment's ability to meet future cash flow needs, independent of the investor's risk appetite. An investor's risk tolerance is susceptible to mood swings dependent on the most recent market performance, which can fluctuate wildly. Some investors may develop lofty return expectations, while others may become overly cautious. We're not downplaying the need to assess your risk tolerance. On the contrary, it is very important. However, risk tolerance should be considered upfront in the portfolio selection process—before investing, in the context of investment trade-offs—not on the fly as market prices fluctuate. Strategy changes made as a result of recent performance can lead to poor results.

Investing may seem easy when returns are positive and volatility is low. However, investors must be emotionally prepared for future performance that may look very different than what we saw in 2017. Looking forward, valuations are high in both stocks and bonds, and long-term returns are expected to be lower than in times past. Volatility will eventually return and with it, investor anxiety. When markets correct or relative returns slip, investors will be tempted to abandon their strategy, most likely at the wrong time. We believe that the more investors try to understand the investment trade-offs and their strategies' investment approach, the better prepared they will be to weather the storm when it comes.

In Conclusion

There will always be the temptation to try to hit an investment "home run," by finding the next hidden gem. Unfortunately, these opportunities are difficult to identify ahead of time; for each success story, there tend to be many more failures. While logic tells us to avoid these traps, we often succumb to the Fear of Missing Out (FOMO) and invest anyway, for fear of being left behind. In contrast, a successful investor will have pre-defined goals, identify opportunities based on a consistent, reasonable process rather than emotion, and be appropriately diversified. Following those guidelines may not make you an overnight millionaire through investment returns, but it should help you achieve your financial goals.

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