Economic Review & Outlook

SECOND QUARTER 2018

Long-Term Investing in Expensive Markets

Investors with longer investment horizons are often told to “stay the course,” but this can be difficult because any long-term period is made up of several short-term periods. At present, equity valuations are estimated to be at extremely high levels; fixed income yields are coming off historic lows with expectations that they will continue to rise in the coming years, putting pressure on bond prices. Now, with fresh uncertainty around Fed leadership and the potential for a trade war, volatility has reappeared in what had recently been a historically docile market. Is the best course of action to attempt to avoid large downturns (losses), even if it means giving up some upside (gains) along the way?

In this quarter’s Economic Review & Outlook, we offer steps on how to approach investing for the long term, particularly during times of heightened fear or uncertainty. We will also outline how this approach plays into our current positioning. We begin with an overview of recent economic events and market performance.

Key Economic News

New ‘Sheriff in Town’ Begins Term with the Fed

On February 4, Jerome Powell succeeded Janet Yellen as Chair of the U.S. Federal Reserve. So far, Powell has continued along the current path of signaling a strengthening economy and the need to continue to gradually raise interest rates. On March 21, during his first meeting as Chairman, Powell announced an increase of 0.25% to the Fed funds rate with a target range of 1.50% to 1.75%. This announcement was widely expected, and most are forecasting two to three additional rate hikes in 2018.

A New Tariff in Town Too

During the quarter, President Trump announced plans to impose a 25% tariff on steel imports, 10% tariffs on aluminum imports, and 25% tariffs on certain Chinese imports, as a means to protect U.S. producers’ interests at home and abroad. Many U.S. trade partners, particularly China, threatened retaliatory actions, leading many to believe that this could ultimately lead to an all-out trade war. If this occurs, it could raise the threat of higher inflation and hurt global economic growth. However, others believe that this is a negotiation tactic and are hopeful that a mutually beneficial resolution will eventually be reached.

Volatility is Back for Another Round

After a relatively quiet start to the year, late January to early February brought an increase in market volatility. During this 10-day stretch, global stocks declined -5% to -10%, bond yields increased sharply, and the VIX (a measure of U.S. stock volatility) spiked to its highest levels since August 2015. After a brief rebound, the markets continued to go up and down for the rest of the quarter. While it is always difficult to assign a precise cause to market events, some potential drivers were fears around valuations, increasing interest rates, and trade wars stemming from tariffs. While volatility can be concerning, it is important to remember that it is a normal and common occurrence in financial markets and the stability of the last few years has been an exception.

Asset Class Performance

January	February	March	YTD
Emerging Market Stocks 8.3%	Diversified Bonds -0.9%	Commodities 2.0%	Commodities 2.8%
U.S. Stocks 5.7%	Gold -1.8%	Diversified Bonds 0.6%	Emerging Market Stocks 1.3%
Int'l Developed Stocks 5.0%	Commodities -2.4%	Gold 0.4%	Gold 1.0%
Commodities 3.2%	U.S. Stocks -3.7%	Int'l Developed Stocks -1.9%	U.S. Stocks -0.8%
Gold 2.3%	Int'l Developed Stocks -4.5%	Emerging Market Stocks -2.0%	Diversified Bonds -1.5%
Diversified Bonds -1.2%	Emerging Market Stocks -4.6%	U.S. Stocks -2.5%	Int'l Developed Stocks -1.6%

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.

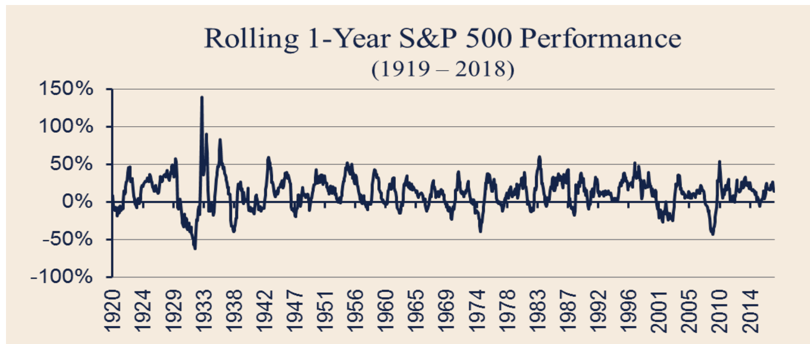
The end of January was a major inflection point for the quarter. During January, nearly every major asset class was strongly positive, while in February, everything was down. March was more of a mixed bag, where gold, bonds, and commodities were positive, while equities were in the red. For the quarter, commodities led the way with a +2.8% return. Emerging markets led all equity markets with a gain of +1.3%, while International Developed equities were the worst performing asset class, losing -1.6%. Rising rates, paired with increased inflation concerns, led to a decline in bonds (-1.5%) for the quarter.

Our Perspective

Long-term investors are grappling with whether to stay the course or temporarily alter it in the face of high valuations and recent stock market volatility. In response to this common question, we believe that investors should take the following three steps in order to gain confidence that staying the course is still the wisest decision, even when valuations are high. In fact, investors who bought into the U.S. stock market at its absolute peak in 2007 (immediately preceding the financial crisis) were subjected to a greater than 50% decline but still managed to earn approximately 7.3% annualized over the subsequent decade if they stayed invested.

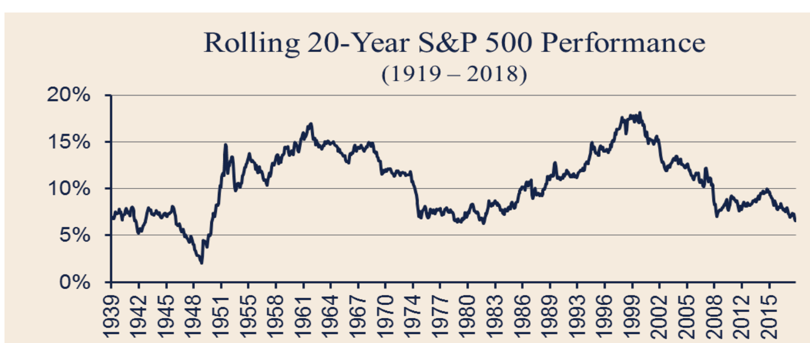
Step One: Determine when you will need to use the money.

We believe that understanding when you need to be able to use your money is the most important factor in determining how to invest. For example, stocks are not appropriate investments for money needed in the short term. The chart below shows that there are many large drawdowns over rolling one-year periods. Experiencing a large market decline, such as with the Great Depression or the 2008 Financial Crisis, could be devastating if you're counting on using that money in the near future.



Source: FactSet

However, for money needed 10 to 20 years in the future, it's important to expose a portfolio to growth through stocks. The chart below shows the rolling 20-year performance of stocks. Notice the scale has compressed dramatically. In fact, U.S. stocks have not experienced a negative 20-year period in modern history. With this in mind, the question is not *if* a long-term investor will earn a return; it's *how much* of a return they are likely to earn if they stay invested. This perspective can offer some assurance because volatility becomes virtually meaningless and valuations become less important than the compounding effect of earnings growth over time.



Source: FactSet

Another way to think about this is by looking at probabilities. The table below shows that in the short term, stocks are likely to outperform bonds, but given a longer time horizon, the outperformance of stocks approached 100%.

Percentage of the Time Stocks Outperform Bonds (1871 – 2012)	
1-Year	61.3%
5-Year	69.0%
10-Year	78.2%
20-Year	95.8%
30-Year	99.3%

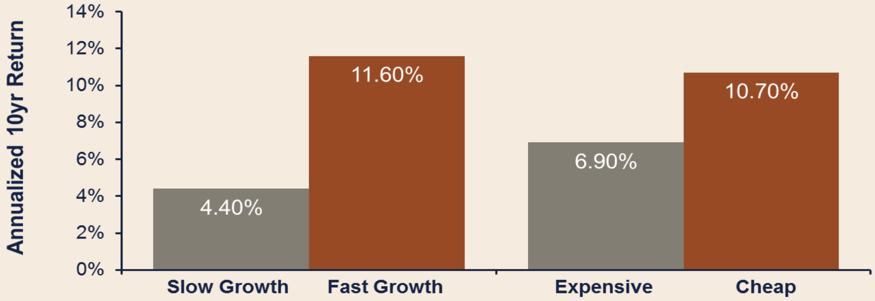
Source: Stocks for the Long Run

This is why the primary determinant of whether stocks are appropriate given today's valuations and volatility is time horizon, not speculation or prediction.

Step Two: Invest accordingly and integrate valuation and growth.

Given a long-term time horizon, the next step is to determine how to allocate investments globally. We believe that certain timeless principles guide how the economy works. A country's or region's productivity leads to better stock market returns and higher economic growth in those areas. At the same time, we believe that paying less for a given level of future growth is preferable. The chart below shows that the performance of faster-growing countries has, on average, more than doubled that of slower-growing countries. Also, when countries are sorted based on the aggregate stock market price relative to its growth (price-to-earnings), the less expensive countries dramatically outperformed the more expensive countries.

Average Country Stock Returns by Economic Growth and Valuation
(31 countries; 1996 – 2017)

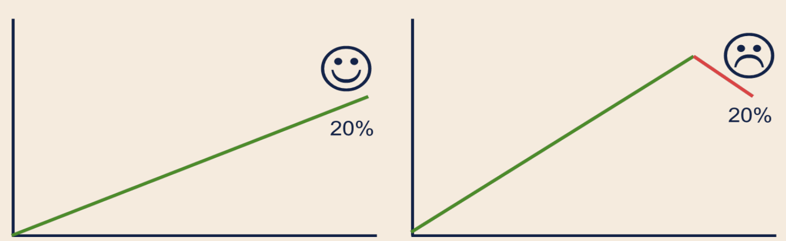


Source: FactSet. Past performance does not indicate future returns. P/E's are normalized five-year moving average. Returns are nominal, USD. GDP is real, local currency and was measured over 10-year rolling periods. As of 12/31/17.

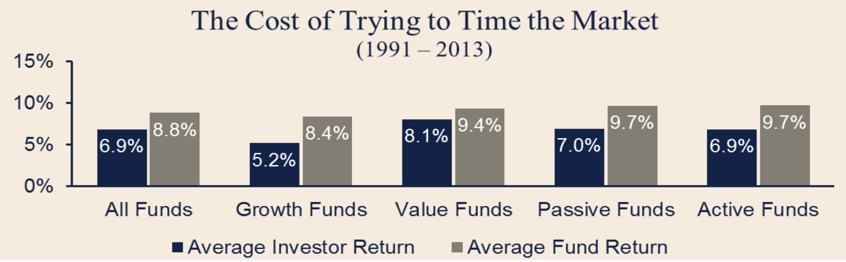
In both cases, for economic growth and valuation, time horizon is key. While economic growth and valuations aren't good predictors of next year's return, both do a good job of predicting returns over longer time horizons.

Step Three: Don't let fear or greed drive you away from the process.

Once the time horizon of the investment has been established and an investment selection process based on valuations and economic growth has been implemented, the final step is to ensure that the process is truly followed. Our emotions can wreak havoc on an investment portfolio if decisions are made based on them. The simple illustration below shows how two different investors can experience a 20% return over the same time horizon, and both feel content and comfortable during periods of gains. However, when a drawdown occurs immediately after, the second investor's outlook appears to sour although he earned the exact same return.



Who do you think is more likely to sell during the drawdown? In theory, all rational investors should react in the same way, but they seldom do. In fact, a study from 1991 to 2013 showed that the average investor lost out on an average of 2% returns per year by buying and selling funds at the wrong time (shown by the chart on the following page). This pattern was prevalent across all types of funds; even passive index fund investors fell behind.



Source: "Timing Poorly: A Guide to Generating Poor Returns While Investing in Successful Strategies." "Average Fund Return" represents the average annualized time-weighted return, which equals the return of an investment independent of contributions or withdrawals. "Average Investor Return" represents the average annualized dollar-weighted return, which equals the internal rate of return (IRR) of an investment, based on the net present value of its cash flows.

To put this into context, 2% per year over 20 years is the difference between a $1 million portfolio being worth $3.8 million instead of $5.4 million (6.9% versus 8.8% compounded). It is vital that investors who are investing for the long term protect themselves from making decisions based on recent performance, annual volatility concerns, news stories, or anything else focused on the short term.

Furthermore, it's important to distinguish between market timing and a dynamic asset allocation process that responds appropriately to valuations and economic conditions. Traditional market timing involves using short-term metrics and news as the primary driver of an allocation change. Market timers will buy an asset if they think it will go up soon, regardless of its long-term prospects. In contrast, dynamic asset allocation seeks to buy assets with strong long-term prospects, regardless of short-term fears or news reports. We believe that the latter approach, while difficult to stomach at times, will lead to the highest probability of a successful outcome.

Our Investment Strategy

It's always tempting to try to time markets, either because of a fear of suffering through downturns or wanting to squeeze out every last drop of return. While it's true that you would do much better if you could sell right before a correction and buy back in at the bottom, succeeding at this is very difficult. The vast majority of investors who try to time markets end up buying at the top and selling near the bottom. Those who focus on short-term news and volatility also lose sight of the things that really matter in the long run, such as valuations, growth rates, and diversification.

Volatility is, by nature, a short-term risk that affects all investors. However, it's exponentially more important for investors who will need their money soon. For those with a short time horizon (less than two years), we believe that minimizing volatility risk is the most important thing to accomplish, so we recommend a diversified portfolio of short-term, high-quality, liquid bonds.

Those with intermediate-term cash flow needs (3 to 9 years) can likely weather short-term volatility events, but they run the risk of hitting a major downturn without adequate time for recovery. For these investors, it is important to balance volatility control with the potential for purchasing power growth. Our current positioning involves a diversified mix of intermediate-term bonds, with greater emphasis on corporates, which offer higher yields. A small amount of equities and real assets (gold and commodities) may also be warranted to further increase diversification and growth potential.

Longer-term investors (10 to 15 years) generally don't have to worry about short-term volatility and should mostly use a mix of global equities. They must also pay attention to valuations and remain diversified against the possibility of adverse economic outcomes, which is why we currently recommend layering on a small exposure to real assets and corporate bonds. We believe those with more than 16 years to invest will do best by maximizing long-term growth potential through an all-equity portfolio, leaning into areas of the market with the greatest growth potential at reasonable valuations while remaining broadly diversified. Currently, this means an above-average allocation to emerging market stocks.

In Conclusion

It is human nature to seek protection from painful experiences, which often leads us to place greater emphasis on more recent events. While this desire to avoid pain can be beneficial in some aspects of our lives, it can be quite harmful in the investment space, where ignoring short-term noise, being contrarian, and taking a long-term approach tend to be rewarded over time. In investing, it's important to have a sound financial plan and work with your advisor to define your goals, preferences, and potential stumbling blocks ahead of time. Once you do that, we believe that incorporating the steps outlined above can put you on the path towards greater clarity and confidence about your finances.

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