Economic Review & Outlook

FOURTH QUARTER 2018

Decisions and Outcomes

In life, our behavioral patterns are often formed by our experiences with simple cause and effect. If we follow a cooking recipe correctly, we expect to get a nice meal. If we touch the stove, we know we'll get burned. However, it's a paradox that sometimes we do the right thing but receive a poor result. We also may manage to avoid negative consequences even when we may not have behaved in the wisest manner.

In this quarter's Economic Review & Outlook, we examine decisions and outcomes and how they may not always be correlated, especially in the short run. This can be especially true with investing, where even a sound process can lead to some periods of discomfort. We believe that investors who focus more on making wise decisions on the front end will more likely persevere during difficult market environments. We will also outline characteristics of wise investment decisions and how they are incorporated into our process.

We start with recent economic news and market commentary.

Economic Review

Fed Raises Rates as Expected

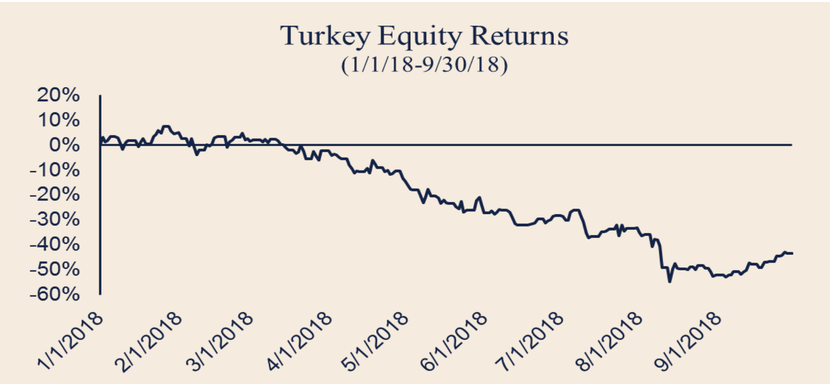
On September 26, Fed chairman Jerome Powell announced an increase in the federal funds rate to a range of 2.00 – 2.25%. This quarter-point increase was almost unanimously expected by forecasters and marks the third rate hike of this year. Another increase in December is largely expected. We view a rate hike as neither a positive or negative event – it simply reflects economic policy and where our economy stands at the moment.

China Trade Showdown Broadens

Much of this year's economic news has been dominated by concerns of a trade war between the U.S. and China. Things continued to escalate this quarter as the U.S. announced several additional tariffs on Chinese imports, while China in turn placed their own tariffs on various U.S. goods, including cars and agricultural products. While it's difficult to predict the short-term results of these negotiations, we do believe that in the long run, free trade is positive and that permanent trade restrictions could have a negative impact on global economic growth.

Turkey Continues its Currency-Driven Slide

While much of the news was centered on China, smaller, less resilient nations usually suffer the most from trade wars. Turkey is one example, as tariff talks and ensuing dollar strength have had an outsized impact on the country's financial markets and its currency, which has depreciated by nearly 40% against the dollar so far this year. This has contributed to Turkey's equity market decline, as seen below. Most of this has been driven by a weakening in Turkey's currency, the result of high inflation, over-indebtedness, and tariff concerns. It's



Source: FactSet.

important to note that large market swings are the norm for Turkish equities, and Turkey makes up a very small proportion of global equity markets. Therefore, it's unlikely that this will directly lead to more widespread issues.

Asset Class Performance

Q1	Q2	Q3	YTD
Commodities 2.8%	Commodities 5.8%	U.S. Stocks 7.7%	U.S. Stocks 10.6%
Emerging Markets Stocks 1.3%	U.S. Stocks 3.4%	Int'l Developed Stocks 1.4%	Commodities 9.1%
Gold 1.0%	Diversified Bonds -0.2%	Commodities 0.4%	Int'l Developed Stocks -1.0%
U.S. Stocks -0.8%	Int'l Developed Stocks -0.8%	Diversified Bonds 0.0%	Diversified Bonds -1.6%
Diversified Bonds -1.5%	Gold -5.5%	Emerging Markets Stocks -0.9%	Emerging Markets Stocks -7.4%
Int'l Developed Stocks -1.6%	Emerging Markets Stocks -7.7%	Gold -5.0%	Gold -9.4%

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.

Lingering concerns around trade wars and rising rates continued to take a toll on international equities, particularly emerging markets, which were down another -0.9% this quarter compared to a +7.7% gain for U.S. stocks. Gold also suffered during the period, losing -5.0%. Bond performance was flat, though yields continue to rise, which bodes well for future returns. So far this year, U.S. stocks continue to dominate all other asset classes (+10.6%), while emerging market stocks (last year's top performer by a wide margin) have struggled, losing -7.4%. Commodities have had a solid year (+9.1%), though gold has been the worst performer year-to-date, losing -9.4%. While it can be tempting to pile into the best performing area of the market, it's important to remember how quickly things can change, and that a better indicator of long-term success is more closely tied to paying attention to valuations and staying diversified rather than chasing recent winners.

Our Perspective

The world can be uncertain at times, and even good decisions do not guarantee desirable outcomes. Investments can also fit into this category, as outcomes can be deceiving and sometimes the right long-term decision for your portfolio may not produce desirable short-term results. How then should we evaluate the quality of our choices without relying on outcomes? To answer this, we will examine the relationship between four potential decision and outcome scenarios and how you may feel about them in the short term.

Good Decision/Good Outcome

It is only natural to expect good results when we make good decisions, and life usually works this way. For example, someone who follows a healthy diet and exercises regularly will almost certainly see positive results through increased overall health. However, they may experience plateaus or not see results overnight, so they must still maintain proper expectations and persevere when they are tempted to deviate from their plan.

In the same vein, a person who begins saving early in their career and regularly contributing to a diversified 401(k) will likely have the financial freedom to retire comfortably with a sizable nest egg. Of course, to do this, they must avoid overly extravagant spending along the way and stick to their process through multiple market cycles.

Good Decision/Bad Outcome

While good choices usually lead to good outcomes, there are exceptions. Take the above situation. What if the person is out jogging, trips on the sidewalk, and twists an ankle? Does this mean that making the decision to exercise was wrong? No; they made a wise choice but suffered a poor outcome.

With investments, prudent choices aren't always rewarded. Consider the tech bubble of the late 1990s.

Imagine an investor who is committed to remaining diversified yet his neighbor approaches him about liquidating his 401(k) to invest in a hot new tech startup. The diversified investor refuses and sticks to his plan, only to find out later that the neighbor became a multimillionaire by putting his life savings into that stock. While the neighbor was handsomely rewarded for taking that huge risk, would following suit really have been a wise decision? While it didn't lead to the best outcome in this case, staying diversified and sticking to a plan is indeed a good decision because he is still likely to reach his original, long-term goals.

Bad Decision/Bad Outcome

As much as we strive to make good choices, everyone makes mistakes sometimes. It's part of being human. Bad decisions often become painful, yet valuable life lessons. For example, taking money out of savings to gamble at a casino, then losing all of the money would certainly be a regrettable decision.

In terms of investing, employees often have the option to buy their employer's company stock as a benefit. This can be attractive, especially if the stock is offered at a discount to market value. However, we believe keeping a large percentage of your portfolio in your company's stock is unwise. If the company experiences a downturn, you risk losing both your job and your nest egg at the same time. Nobody thinks this will happen to them, but it is far more common than people realize.

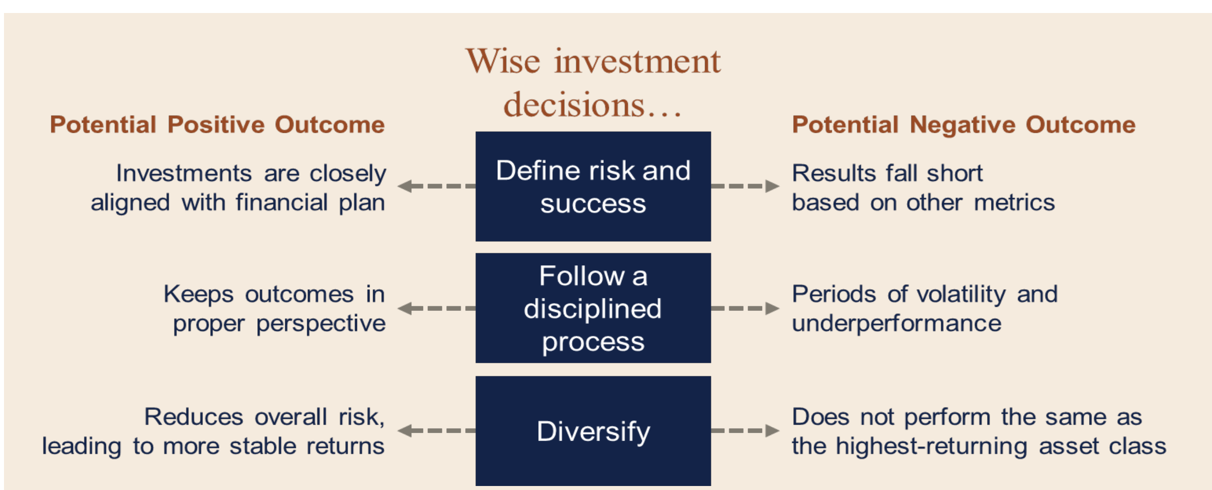
Bad Decision/Good Outcome

Imagine you are planning a cross-country road trip with your family. As part of your preparations, you realize your tires are bald and in desperate need of replacement; however, you are rushed for time and do not want to delay your schedule. You decide to proceed, and you make it there and back safely with no issues. While driving long distance on bald tires is a rather poor decision, nothing bad happened in this case. However, relying on this outcome happening again in the future wouldn't be prudent.

When it comes to financial matters, good outcomes can still result from risky, unwise decisions. For example, someone struggling with debt and living above their means should probably not try to get financing to buy the most expensive house with as little money down as possible. However, what if they happen to be in the right place at the right time and can flip their house in a few years for an enormous profit? The advisor who warned against this bad decision was not incorrect, but they somehow received a great outcome. The reality is that if they continue to make poor decisions, eventually a negative outcome becomes inevitable.

Our Investment Strategy

Exemplified through the scenarios we present above, outcomes are never guaranteed. While it is natural to react emotionally to recent outcomes, we believe that investors should instead focus on making wise investment decisions, rather than letting outcomes overly influence their decision-making process. Of course, with every decision, there is a potential for a positive outcome, as well as a negative one. Seen below are key characteristics of good investment decisions and potential outcomes, followed by a brief description of how these traits are incorporated into our investment strategy.



Define Risk and Success

Investment success cannot be simply defined as beating a specific index or achieving a certain return. Likewise, the best measure of risk may not always be short-term volatility. The correct definitions for you will depend on your financial goals, investment horizon, and behavioral temperament. This is why we aim to match your investment goals and risk management with your financial plan.

For short-term investors, our primary goal is to protect your principal, minimizing short-term volatility. Currently, this means short-duration, high-quality bonds. Intermediate-term investors need to protect their purchasing power (keep up with inflation). To do this, we recommend a portfolio mostly driven by broadly-diversified fixed income, leaning into sectors with more attractive yields, such as investment grade corporate bonds. Longer-term investors have more time to ride out volatility, so permanent loss of capital and inflation are the biggest risks to manage, and success should be defined through growing purchasing power over time. Here, equities are the primary driver of returns.

Additionally, we may tweak these goals for clients who are more prone to define success around certain market benchmarks, or who are more concerned with market downturns. This improves the odds of keeping you invested and increasing your peace of mind.

Follow a Disciplined Process

Outcomes are often inconsistent, but if your process is consistent, the chances of staying on course increase considerably. For us, seeking out faster-growing economies at attractive valuations is part of our process. Currently, this means overweighting emerging market stocks. We would not have reached this conclusion if we were solely focused on current outcomes, as emerging markets have lagged the rest of the world lately. However, it is often yesterday's underperformers that create tomorrow's opportunities.

Diversify

If there's one takeaway to this point, it's that even a good process can still lead to poor results, especially in the short run. We believe you can add some protection for yourself by always remaining diversified. Concentrating your investments in a single company, country, or asset class can be dangerous, even if your selection rationale is sound. For example, we may prefer emerging market stocks in this environment, given their faster growth and more attractive valuations, but we still own a healthy amount of U.S. and developed international equities. This has paid off over the last few years, as emerging markets have struggled. We would classify investing in emerging markets as a good decision with a temporarily bad outcome, and being diversified has helped lessen the damage.

In Conclusion

We cannot control outcomes; we can only control our process and decisions. For areas of our lives where short-term outcomes are more uncertain, like investing, we believe focusing on making high-quality decisions is the best way to ensure the highest probability of good future outcomes. If we only concern ourselves with outcomes without considering the quality of the decision, we run the risk of repeating an unwise behavior simply because it resulted in a lucky outcome. If we instead focus on making right decisions and sticking with them, realizing that short-term outcomes may not always be good, we can increase our chances of positive outcomes while limiting the damage from negative ones.

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