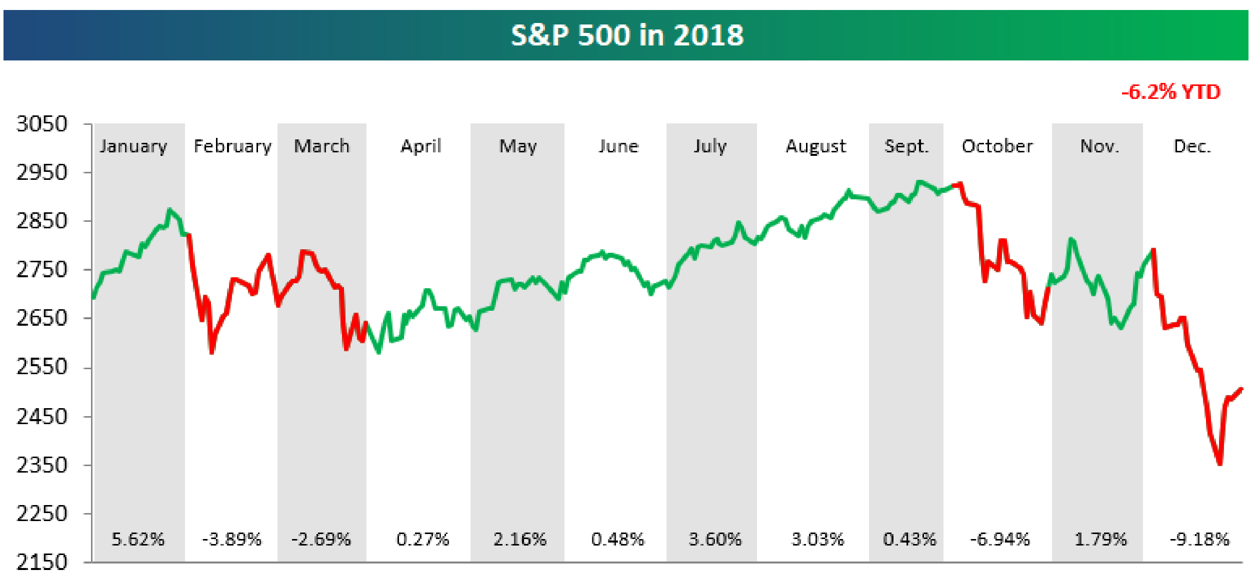
4th Quarter 2018

2018 was a year in which investor complacency turned to investor anxiety. There were many twists and turns throughout the year but the sharp selloff in the 4th quarter left the stock market with its largest annual loss in 10 years. The Dow Jones Industrial Average ended the year down 5.63% and was off by 11.8% in the 4th quarter. The S&P 500 Index declined 6.24% for the year and was off by 13.97% for the quarter. Small cap stocks fared even worse for year and the quarter with the Russell 2000 Index down 12% (full year) and 20% (4th quarter). There was no reprieve for international markets as the MSCI EAFE Developed Market Index and MSCI Emerging Market Index were lower by 16% and 17% respectively for the year.

The chart below courtesy of Bespoke Investment Group shows the price action for the S&P 500 in 2018 with the up months in green and down months in red. After recovering from the declines early in the year, stocks again suffered large declines in October and December.



Nearly all asset classes were lower in 2018, which contrasts with the strong performance across almost every asset class in the prior year. The notable exceptions for 2018 were short and intermediate term treasuries and the Barclays Aggregate Bond Index that ended the year with a return of 0.10%. According to data by Deutsche Bank, 90% of the 70 asset classes tracked delivered negative returns for 2018. In 2017, there was a similar phenomenon of asset classes moving in one direction, but in that year's case it was only 1% of asset classes delivering negative returns. So, in a sense it was this year's broad weakness giving back some of last year's broad strength.

The lack of volatility and sheer complacency that had permeated markets for so long started to give way to the looming challenges facing both a market and an economy in the latter phase of expansion. The U.S. economy is still growing, but the sequential rate of change is decelerating. Consumer spending has been strong, unemployment is very low and we're starting to see much needed wage growth in the economy. Interest rates while still low relative to historical levels, rose for most of the year and then reversed rather abruptly in December as stocks sold off and the flight to quality drove bond yields lower. Stock and bond markets are digesting a confluence of factors amid this deceleration in growth. U.S./China trade policy, higher deficits and a highly leveraged corporate sector, slowing global growth, rising rates and the unwind of the Federal Reserve's policies (quantitative tightening) are all weighing on markets at once.

While we certainly see the deceleration in economic growth, there is a big difference between lower growth and negative growth. Recall that this recovery has been very long but not particularly strong. Also, for much of the early phase of the recovery, many Americans were still feeling like they were in a recession (unemployment was still high and wage growth was stagnant), as there was somewhat of a dual economy dividing the "haves and have-nots" (remember the Occupy Wall Street protests in 2011) with asset price inflation playing a big role. The reason for pointing this out is twofold. Number one is, if the recovery has not been particularly strong, there are less excesses in the economy to "recess" in the next recession (which will happen sometime). Number two is, the market may begin to price in a recessionary scenario that may be too dire for the conditions at hand. This is especially relevant in this cycle given the erratic nature of the trade negotiations, for example, and how this weighs on sentiment. While we are conscious of this, we will take our cues from the data as it comes in and weigh the economic data against valuations. Many individual stocks have already dropped by levels typically associated with recessions. So, while we are aware of the late cycle dynamics and the rate of change deceleration, we are also keen on identifying long term opportunities that arise from market turbulence.

In terms of valuations, we have seen the multiple on earnings (PE ratio) come down for stocks broadly. The PE multiple on the S&P 500 had dropped by over 4 points going into year end. The median PE multiple on the 1700 Value Line stocks has fallen by even more (from 20 to 14). We were expecting multiple contraction in overvalued segments of the market to occur and it is happening in a rolling fashion across sectors. This has improved the valuation in some segments of the market. However, a lot of risk still exists in growth/momentum stocks that trade at premium multiples. When the market trades at 17 times trailing earnings and a stock is trading at over 30 times earnings or more, a lot of damage can be done to a stock price in just the re-rating of that high PE multiple regardless of what earnings do. It is very important to differentiate between high multiple stocks to begin with and stocks that were purchased at attractive multiples before this selloff took hold. The former is where the real risk to investment goals sits. Therefore, we favor a rifle approach (a select basket of quality businesses priced at attractive valuations) as opposed to a shotgun approach (passive benchmarks that ignore valuation) in our stock portfolios.

Company stock prices have moved much more than the value of their businesses have changed.
When a company we own is performing well as a business, but its stock price is getting marked down with the overall market declines, we do not view this as concerning in any way. If the business fundamentals have not changed, the price moves are just noise along the path of our holding period. We view that as simply a temporary, rather than permanent loss of capital.

The increase in market volatility that we have been expecting is starting to play out. It is never a good idea to try to time a market. While the S&P 500 is now about 14% below the recent high, it experienced a 6.8% rally from December 26 to December 31. Vital to our process is knowing what we own and why we own it – so as not to allow market volatility and indiscriminate selloffs to force us out of quality holdings. Today's market structure, where quantitative hedge funds, algorithmic high-frequency trading, and passive index products with no valuation filter, but primarily use momentum as their input can drive unusual volatility. The only way to filter the noise from such activity is to have a durable, disciplined process for valuation that weighs the risks and rewards in a non-emotional way.

As we enter the New Year, we fully expect volatility to remain high for all major asset classes. Bond yields and credit spreads have kept us focused on shorter duration and higher quality assets and we see this continuing in the near term. The flatter yield curve has resulted in a minimal difference in yields between short maturity and longer maturity bonds, favoring the short end. This also lends us to favor active bond managers that can construct their portfolios to look different from a benchmark and be flexible and opportunistic within bond sectors. We continue to like and seek out compelling alternative investments that can further diversify return streams and lower overall portfolio volatility. Diversification and portfolio construction in multiple asset classes while taking prudent risks – where we have high conviction that the return potential warrants doing so- are core priorities. While it's impossible to call an absolute bottom for the market, we do see the opportunity set improving selectively, both for adding to existing investments, as well as assessing new bargains as they emerge from the volatility.

Happy New Year to you all and thank you for your continued trust and confidence.

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