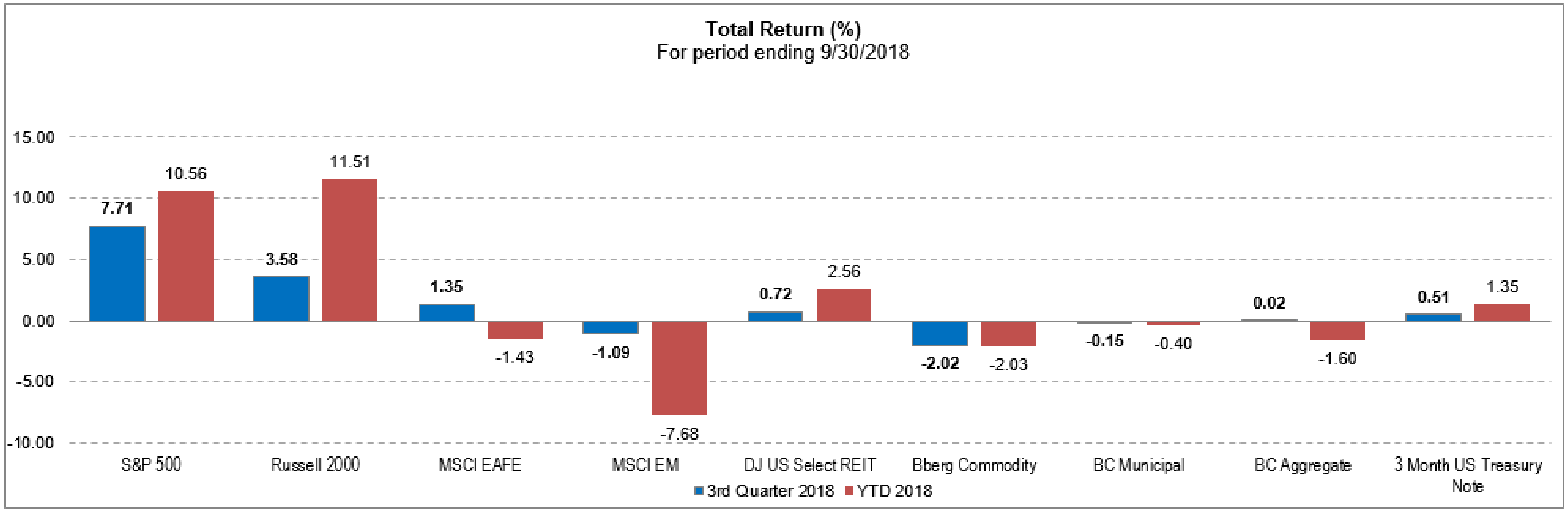
Portfolio Review

Prepared by Schneider Downs Wealth Management Advisors, L.P.
September 30, 2018

SCHNEIDER DOWNS
Wealth Management

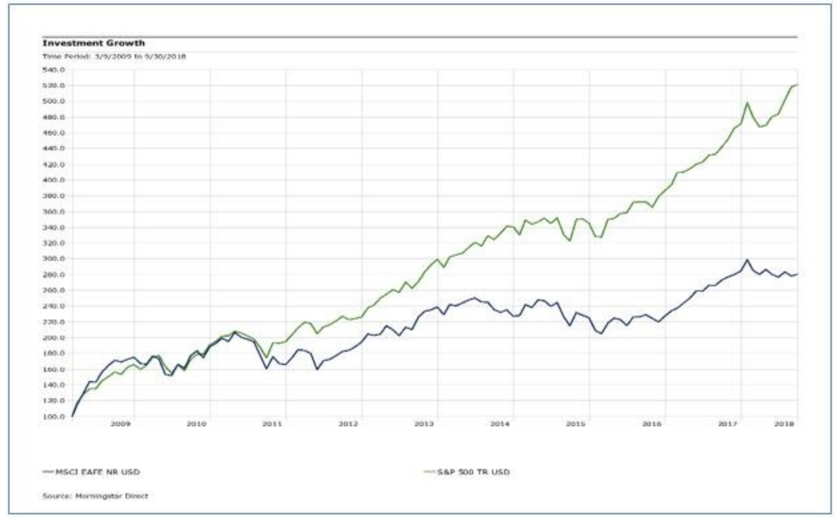


The third quarter of 2018 produced some great results (U.S. large cap equities), some good results (U.S. small cap equities), some fair results (International developed equities as measured by the MSCI EAFE and U.S. publicly traded real estate), some fairly benign results (U.S. municipal and high-quality taxable bonds), and some negative but not wholly disheartening results (International emerging market equities and commodities). To sum it up in two words, the broad capital markets return in the third quarter were a very “mixed bag.” The results give bulls and bears alike talking points to argue their respective cases as we enter the fourth quarter of 2018 with more questions than answers.

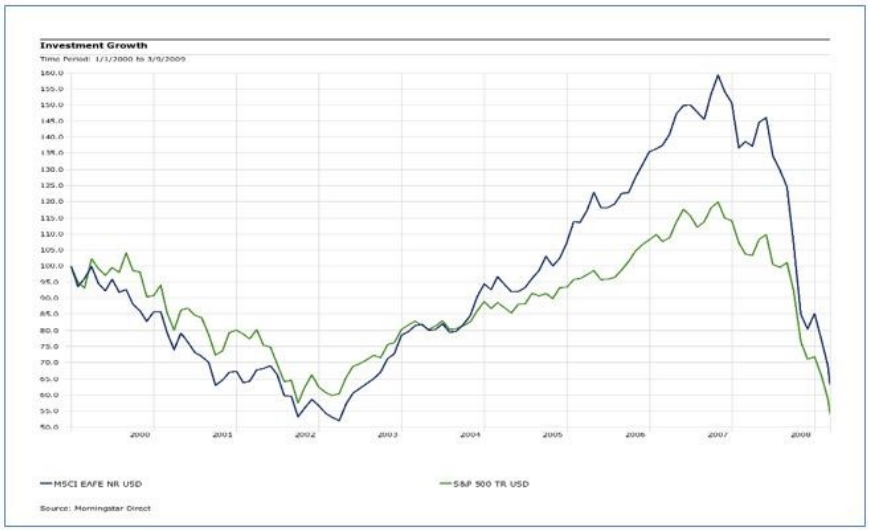
U.S. companies reported strong earnings that were largely anticipated given the forecasted effects of the newly-enacted corporate tax reform legislation hitting company bottom lines and earnings releases. However, questions remain about the sustainability of earnings growth in future quarters as companies settle into a new environment of higher interest rates (higher ongoing financing and operating costs) without the benefit of additional tax legislation to aid earnings. International developed equities were modestly higher while International emerging equities were modestly lower for the quarter. Neither of the asset classes provided investors solid data points to indicate that they were poised to breakout (in either direction). The increasing performance gap between U.S. equities and International equities post the Great Financial Crisis of 2008-2009 (GFC) is something that we will explore later in this letter.

Historically diversifying asset classes like U.S. publicly-traded real estate (REITs) and commodities produced a mixed result with REITs producing a modestly positive result for the quarter and commodities down a couple of percent. However, the trajectory of higher interest rates puts into question the future return prospects of REITs. In addition, confusing data around global growth and inflation have left commodities with a negative year-to-date return.

One of the largest questions for investors going forward is in reference to the two asset classes that delivered the most benign returns in the third quarter: municipal and U.S. high quality bonds (as measured by the Barclays Aggregate index). The U.S. Federal Reserve, led by Chairman Jerome Powell, raised the federal funds rate (very short term interest rates) again in the final week of September and signaled that behind the strength of the U.S. economy, they would likely continue to raise interest rates in the future. So, what does a continued rise in interest rates mean for the short to intermediate term (6-18 months) returns in fixed income? In addition, what are the longer term implications (18+ months) for equity returns as they incorporate higher operating costs from a starting point of historically elevated valuations?



While the third quarter was broadly positive, it has left market participants with more questions than answers. The chart to the right shows the performance of U.S. large cap equities, as measured by the S&P 500, and International developed equities (as measured by the MSCI EAFE) from the bottom of the great financial crisis (March 9, 2009) through the end of the third quarter in 2018. During this time period U.S. large cap equities have outperformed International developed equities by approximately 240%[1] on a cumulative total return basis. From an annualized perspective, U.S. large cap equities have outperformed their international developed counterparts by approximately 7.4% per annum and have higher returns in six of the eight full calendar years since the GFC[2]. In previous writings, we have explored and analyzed why U.S. equities have outperformed in the 9+ years since the GFC (stronger more coordinated and proactive response by the U.S. Federal Reserve and legislative bodies, scale and diversity of the U.S. economy, among others). However, many of the same mechanisms that fueled the rise in U.S. asset and equity prices are likely coming to an end. Specifically, the significant monetary support from the U.S. Federal Reserve is being systematically removed from the economy in an effort to "normalize" interest rates. As the cost of financing and operating a business becomes more expensive, those increased costs can, and have in the past, put pressure on operating margins and net income profits. The U.S. equity market is currently trading at an elevated valuation relative to its history (16.8x vs. 15.9x)[3]. With the prospects of high interest rates, it is reasonable to ask whether U.S. equities should continue to demand the significant return premium over international equities that they have commanded since the financial crisis. The chart to the left shows the time period from January 2000 through the bottom of the GFC, where international developed equities actually outperformed U.S. large cap. The oscillating nature of these returns suggests maintaining a diversified equity allocation is a prudent course for investors. It also suggests that a compression of the domestic versus international equity premium could be on the menu as we enter the fourth quarter of 2018 and begin to assess the backdrop for 2019.



[1] The S&P 500 has returned +421.11% from 3/9/2009 through 09/30/2018; the MSCI EAFE has returned +180.74% from 3/9/2009 through 09/30/2018. Returns were generated using Morningstar Direct. Total return is the price return of the index plus dividends that were automatically reinvested at the time of distribution.

[2] The S&P 500 has an annualized return of +18.84% from 3/9/2009 through 09/30/2018; the MSCI EAFE has an annualized return of +11.40% from 3/9/2009 through 09/30/2018. Returns were generated using Morningstar Direct.

[3] JP Morgan 4Q2018 Guide to the Markets

We also wanted to revisit and provide you an update on the major theme from last quarter's letter: the divergence between growth stocks versus value stocks. While growth continued to outperform value (the Russell 1000 Growth outperformed the Russell 1000 Value by ~3.5% for the quarter), there was a noticeable compression in the month of September, particularly in the last few weeks. Two of the mega cap FAANG[4] stocks began to show signs of weakening, which given their extraordinary appreciation in price, is understandable. Facebook and Netflix saw declines of 11.2% and 13.8%, respectively, in July before finishing the quarter down 15.4% and 4.4%[5]. Growth oriented stocks are carrying elevated multiples relative to their peers, some have argued they are "priced to perfection," and thus more susceptible to the uncertainty permeating in the markets. While growth stocks have shrugged off higher interest rates, eventually higher input and operating costs will effect margins. Combining the headwind of high interest rates with the potential slowdown in demand as a result of trade disputes dampening global growth prospects, it is reasonable to expect more volatility in stocks that are carrying higher valuations. The team was heartened by the performance of our value strategies in the third quarter and view them as a nice (and necessary) counter-balance to our growth strategies.

Heading into the fourth quarter, capital markets are dealing with the combination of elevated equity valuations and rising interest rates domestically. Uncertainty surrounding the Trump administration's pursuit of tariffs and its broader trade agenda, rising geopolitical tensions in the Middle East, and the current bull market, now the longest standing on record, are all data points that suggest to investors that we could be entering a more volatile time period for risky assets. Additionally, the synchronized global growth story that propelled equity returns in 2017 is now coming under significant pressure. Given the aforementioned uncertainty as a backdrop, our team feels that now is a prudent time to take measure of where we are, how far we have come since the GFC, and what changes need to be made to rebalance portfolios and reconfirm risk tolerances. A well constructed and diversified portfolio, consistent with a specific risk tolerance, gives investors the best chance to weather market volatility, remain invested, and achieve their goals and objectives. We look forward to speaking with you in the coming months and discussing our views on the market and how they may impact your portfolio. Thank you again for entrusting us with managing your wealth – it is a responsibility that we take very seriously. If you have any questions, please feel free to reach out to a member of our team.

[4]FAANG is short hand for Facebook, Amazon, Apple, Netflix and Google (now known as Alphabet, but trading under the symbol GOOGL)
[5]Facebook and Netflix stock returns were generated from Morningstar Direct.