Portfolio Review

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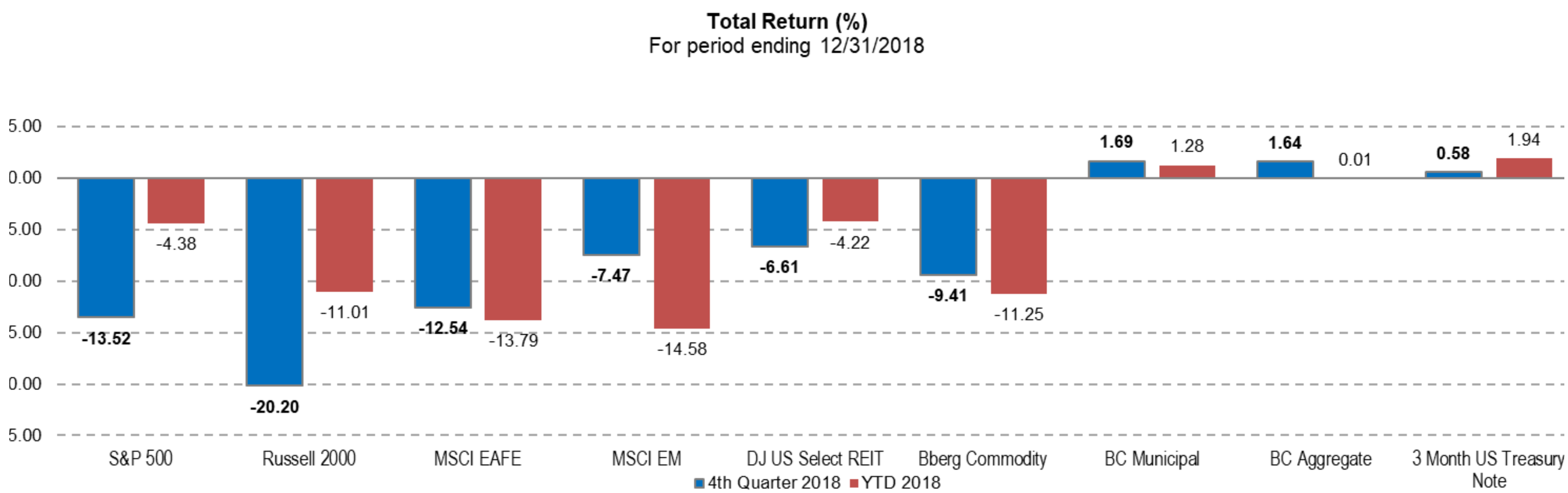
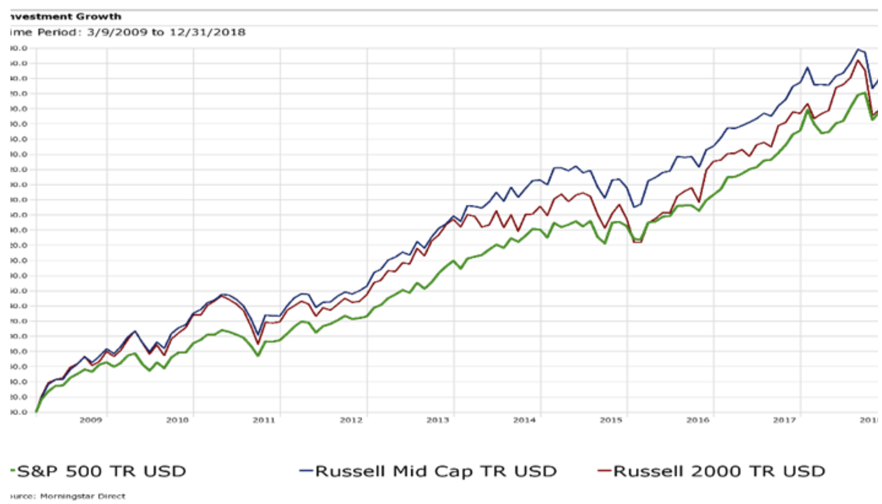
SCHNEIDER DOWNS
Wealth Management



The fourth quarter of 2018 served notice to investors, market participants, and prognosticators that the era of low volatility, marked by extraordinary measures of monetary accommodation, is effectively over. A combination of weak forward earnings guidance by previous market darlings (e.g. Apple, Facebook, and Google, to name a few), the effects of a global trade war beginning to surface, heightening tensions in the Middle East and the Korean Peninsula, and the U.S. Federal Reserve raising interest rates for the ninth time since December 2015 combined to create a perfect storm; roiling markets and shaking investor confidence and sentiment. If investors were to have read the headlines on CNBC or Bloomberg, it would be understandable for them to think that the market was experiencing an idiosyncratic event that no one had ever dealt with before. In reality, it was similar to what investors faced in the last four months of 2011 when capital markets seemed to be in a daily spiral downward as they digested a European sovereign debt crisis in the PIIGS (Portugal, Ireland, Italy, Greece, and Spain), an unprecedented intervention by the Swiss central bank to prevent further appreciation of the franc, the continued uprising in the Middle East now dubbed the "Arab Spring," China's growth slowing down from a decade of blockbuster growth, and the ending of the second round of quantitative easing by the U.S. Federal Reserve. Sound familiar? While the recent downturn in the markets might "feel different," in actuality they are not. As investors have gotten further away from events like the "Great Financial Crisis," months like September of 2011 fade into the recesses of our memory – it's human nature. In this letter we will spend some time reviewing what happened in the fourth quarter and how it affected the overall performance for the year; more importantly, we are going to look forward and discuss the ramifications of the 4th quarter and how they have manifested into opportunities and challenges for 2019.

U.S. equities, large, medium and small, suffered significant declines in the fourth quarter. While almost no equity sector or subsector was spared in the fourth quarter, US equities were most acutely effected. There is no doubt that quarters like this one can shake even the most seasoned and steely-eyed investor. However, when trying to understand and determine how to view asset classes like U.S. equities moving forward, especially after absorbing periods of heightened volatility and downward price trends, it is important to take a step back and remove ourselves "from the moment." Oftentimes taking this approach can be arduous, as our very nature as humans pulls us into the current moment. Forcing ourselves to take a longer-term view of the situation is the key to long-term investment success.

The chart on the right shows the growth of U.S. large cap stocks (S&P 500 in green), U.S. mid cap stocks (Russell Mid Cap in navy), and U.S. small cap stocks (Russell 2000 in red), from the bottom of the Great Financial Crisis on March 9, 2009 through December 31, 2018. While there were certainly bumps along the way, the upward appreciation is unmistakable. From 3/9/2009 through 12/31/2018, the S&P 500 had an annualized total return[1] of ~16.6% that equated to a ~351% cumulative return, the Russell Mid Cap had an annualized total return of ~17.5% that equated to a ~386% cumulative return[1], and the Russell 2000 had an annualized total return of ~16.3% that equated to a ~340% cumulative return[1]. Despite the large drawdown in the fourth quarter, the returns for U.S. equities have been outstanding over the last 9+ years, but investors were only able to experience these returns if they stayed invested amid bouts of volatility and uncertainty in capital markets. Looking forward, after almost a decade of significant outperformance, we expect more modest returns than are detailed above as U.S. equities readjust to a more normal interest rate policy and grapple with existing trade issues and geopolitical matters.



While international equities declined in the 4th quarter, they held up better on a relative basis than their U.S. counterparts. One of the potential opportunities in 2019 is investing in international equities, both developed and emerging, after a lackluster and disappointing 2018. Coming into 2018, despite a strong 2017, international equities continued to trade at a significant discount to their U.S. counterparts, a discount that widened during 2018. Currently, the MSCI ACWI ex US[2] is trading at a 20% discount to the S&P 500 while sporting a dividend yield of 3.8%, which is 65% more than the S&P 500 (2.3%)[3]. While there are certainly challenges facing international equities, namely trade disputes with the U.S. and disparate domestic growth stories for individual countries, we believe current valuations and yields outweigh these concerns. Despite a jagged return profile since the Great Financial Crisis, international equities represent an intriguing source of potential return as we move away from 2018 and look forward into the future.

Several clients have asked us over the past several years why we kept a dedicated allocation to high-quality fixed income which offered meager return prospects with even more paltry yields. The line of questioning was entirely reasonable given almost a decade of near zero-percent yields combined with a soaring equity market. Our response was that while we did not believe it is possible to forecast when the next drawdown in global equity markets would occur, we were sure that at some point one would happen. Our expectation, we relayed, was when the drawdown occurred, fixed income would serve as the ballast of the ship, guiding allocations through treacherous waters and into calmer seas. The fixed income allocation proved its mettle and value to portfolios by not only holding its value, but by also appreciating in the face of tremendous equity capital market volatility. Despite an uncertain interest rate environment, one with no clear direction on inflation and still historically low yields, fixed income will remain a critical part of client portfolios.

[1]Source: Morningstar Direct; total return is defined as price appreciation plus dividends that are reinvested into the index at time of distribution.
[2]MSCI ACWI ex USA index captures large and mid-cap representation across 22 of 23 developed market countries and 24 emerging market countries. The index covers approximately 85% of the global equity opportunities outside the US. Source: www.msci.com
[3]JP Morgan Asset Management Guide 1Q2019 Guide to the Markets

Closing out 2018, the fourth quarter reminded investors and advisors alike of the importance of asset allocation and diversification. In addition, and we would suggest even more importantly, is properly identifying/acknowledging investors' risk tolerance. While asset allocation and diversification are important, as was demonstrated by having high-quality fixed income allocations, the benefits aren't appropriately amplified if a client's risk tolerance is not reflected in the allocation. What we experienced in the fourth quarter, from a volatility standpoint, is not "abnormal," however it felt like it was after several years of below-average volatility in capital markets. It is important that we as advisors and investors not panic, but sensibly and soberly take advantage of this recent volatility to ask the question "were you able to handle the recent volatility?" The answer to the question is of critical importance. Having the appropriate asset allocation that is commensurate with a client's risk tolerance gives clients the best chance to remain invested in the most tempestuous of market environments. As the chart[4] here demonstrates, remaining invested is the key to investor long-term success.

Although not reflected in this chart, we have had two such drops in the last two weeks. On December 24th, the S&P 500 dropped -2.7% only to rally on the next trading day, December 26th, appreciating +4.96%. Had investors sold on the 24th, they not only would have permanently realized the losses incurred on that day, they would have not participated in the rally on 12/26/18. The second, and very similar event occurred on January 3rd of 2019 after Apple announced that it was cutting its 2019 profit estimate and the S&P 500 responded by declining -2.5%; the following day the market rallied following comments made by U.S. Federal Reserve Chairman, Jerome Powell, with the S&P 500 advancing +3.4% on the day. Investors that stayed the course and resisted the urge to sell were rewarded by gaining back all that was lost on Thursday and receiving almost a full 1% additional appreciation.

As we enter 2019, we will almost certainly face challenges as well as opportunities. We are excited about the chance to move on from last year and remain steadfast in guiding your portfolios into another year. The team at SDWMA wants to thank you for another year of partnership and are grateful for the trust you place in our team. If you have any questions or concerns, please reach out to your investment advisor or another member of the team.
Happy New Year!

[4] https://am.jpmorgan.com/us/en/asset-management/gim/adv/insights/market-insights/get-invested-stay-invested-navigating-volatile-markets