

To: Aequitas Client

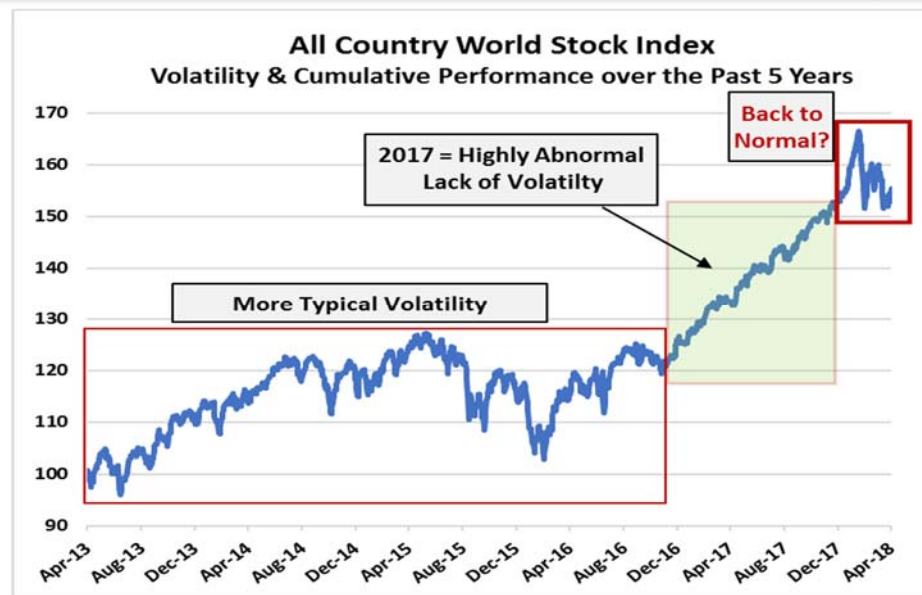
From: Aequitas Investment Advisors

Subject: **Dealing with Volatility (and Increasing Happiness?)**

Dear Client,

Following last year's unprecedented streak of steady market appreciation, volatility has returned to the markets this year with a vengeance. Through late January of this year, the US stock market had been on a record setting streak of close to 19 months without a 5% cumulative decline; a period beginning after the June 24, 2016 Brexit vote when stocks sank by more than 3% in one day. Of course, stock prices can rise and fall as investors were abruptly reminded in late January when stocks began a nine-day cumulative plummet of close to 10%, including a one-day plunge for the Dow on February 5th of 1,175 points, or close to 5%. Since late January, we've experienced gains or losses of at least 1% on 28 out of 55 trading days. *In contrast, for the entire year of 2017, we experienced only nine trading days when the market lost or gained more than 1% in a single day.* Are we now experiencing unprecedented volatility, or are we returning to more typical levels? In the graph to the upper right, one can clearly see the "green zone" during which we experienced a *highly abnormal* streak of low volatility. The stock market's gyrations we've seen this year more closely resemble the level of volatility experienced in the pre-2017 period. Most market strategists expect higher levels of volatility to continue for the foreseeable future.

The stock market surge in 2017 was propelled by unbridled investor optimism given the prospect of business-friendly deregulation as well as corporate and individual tax cuts; all of which materialized by the end of 2017. However, the surge lifted stock prices into over-valued territory and left the market vulnerable for a correction. In 2017, investors seemed to shrug off bad news from the media, but in 2018, any hint of bad economic news rattled the markets. Pundits had been calling for a stock market correction of at least 10% for many months and we came close on February 8th, but the market didn't officially fall into correction territory until March 23rd. Since then, the market has bounced around in a volatile pattern as investors assess whether the economic expansion will continue to propel stocks higher, or whether possible signs of slowing growth might lead to a



more serious correction in stock prices. Based upon the current economic indicators, the global expansion remains intact, albeit at a *slightly* slower rate of growth. Most economists see the economy continuing to expand well into 2019 which would be supportive of higher corporate earnings which we believe are necessary to bring stock valuations back to more normal levels. One might say we had two-year's worth of stock market gains in one year (2017), but we've had less than two-year's worth of corporate earnings growth. To be supportive of current stock prices levels, especially in the US, we may need another six months to a year of earnings growth. For investors, this implies that US stock prices may be flat or slightly positive for 2018 with possibly better returns outside of the US where stock valuations appear more favorable.

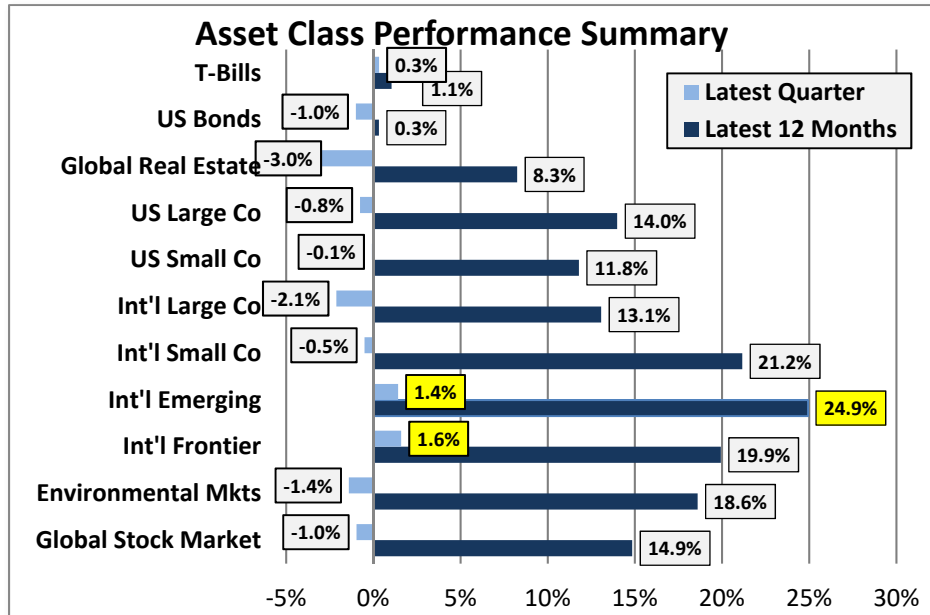
Asset Class Performance Review

Over the last twelve months, every asset class posted positive returns with the greatest gains coming from foreign stocks (a potential trend which began in the fall of 2016). Leading the way were the Emerging Markets (+24.9%) followed by Int'l Small Co's (+21.2%), the Frontier Markets (+19.9%) and the Environmental Markets (+18.6%). Next in line were US Large Co's (+14%), Int'l Large Co's (+13.1%) and US Small Co's (+11.8%). The Global Stock Market, a market cap weighted combination of US and foreign stocks, gained 14.9% for the

latest twelve months. The laggard among the stock asset classes was Global Real Estate (+8.3%) which was adversely impacted by rising interest rates. Rising rates also dragged down the total return on US Bonds (+0.30%), however, US T-Bills (+1.1%) benefited from higher rates and *for the first time in close to ten years generated a twelve month return of greater than 1%*! Investors can finally earn a decent yield on cash and money market funds thanks to the Fed’s policy of gradually normalizing short-term interest rates. While there is concern that higher borrowing costs will negatively impact economic growth, most economists feel the economy is healthy enough to absorb the Federal Reserve’s plan to gradually

Is the Glass Half Full or Half Empty?

It feels like there’s a tug of war so far this year between investors who see the glass as half empty and those who see it as half full. The glass half empty camp will point to risks to the economy including rising inflation, rising interest rates and higher borrowing costs (which might dampen corporate earnings growth), high stock market valuations, and more recently, saber rattling about tariffs and trade wars. Of course, the potential for negative geopolitical events are an ever-present risk. The glass half full investors point to improved economic conditions around the globe, lower tax rates (which have not been fully realized yet), the prospect of rising corporate earnings, high consumer confidence levels and signs of rising wages as indicators the global economic expansion will likely continue. From our perspective, we see the glass as half full, but we also consider the glass half empty arguments. Accordingly, we would characterize our view as one of cautious optimism which is why we believe a globally balanced portfolio is well suited to withstand a wide variety of economic scenarios.



Looming Trade Wars?

increase rates. Of course, the Fed can reverse course if growth begins to slow, but for now, the Fed is more concerned about keeping inflation in check rather than stimulating economic growth (a difficult balancing act for sure).

There’s been a lot of tweeting about tariffs and trade wars with China and other trading partners, including Mexico and Canada. Clearly, one can point to unfair trade practices and imbalances which should be dealt with, but most economists believe the best path toward resolution is through negotiation rather than a full-blown trade war which would likely prove counterproductive and damaging to the global economy. Christine Lagarde, Managing Director of the International Monetary Fund, recently warned that “protectionist forces” pose a substantial risk to the global economy. She adds, “The multilateral trade system has transformed our world over the past generation. But that system of rules and shared responsibility is now in danger of being torn apart. This would be an inexcusable, collective policy failure.” Perhaps the President’s trade war rhetoric is designed as a negotiating tactic as has been the case (so far) in the NAFTA negotiations. However, China has proposed its own counter tariffs and is a much more formidable trading partner than either Canada or Mexico. While there has been some de-escalation in the rhetoric between China and the US of late, the potential for a full-blown trade war poses a significant risk to the global economic expansion. Perhaps a sign that cooler heads might ultimately prevail was the President’s recent

For the latest quarter, the returns were modestly negative reflecting the increased volatility in the markets. The only bright spots were the Emerging Markets (+1.4%) and Frontier Markets (+1.6%). US T-Bills eked out a small gain (+0.3%). US Bonds (-1.0%) and Global Real Estate (-3.0%) suffered from their sensitivity to rising interest rates. The returns for the other asset classes ranged from -2.1% (Int’l Large Co’s) to -0.1% (US Small Co’s). Globally, stocks fell by 1.0% for the quarter as measured by the MSCI All Country World Index (a surprisingly minimal loss given the extreme turmoil during the quarter).



appointment of Lawrence Kudlow as Director of the National Economic Council. Kudlow is known as a “free-trader” and would likely argue strongly toward steering clear of a potential trade wars. (Other cabinet members, including Treasury Secretary Mnuchin and Commerce Secretary Ross, would likely side with Kudlow as well.)

Reinforcing the Safety Net (Just in Case)

Over the past few years, we have maintained a reduced level of interest rate sensitivity (i.e., short-duration) in our recommended bond allocation in anticipation of continued economic growth and the eventual rise in interest rates. In response to accelerated growth, and an increased concern about inflation, the Federal Reserve has tightened monetary policy resulting in higher short-term interest rates. Over the past 12 months alone, 1-year Treasury yields have increased by a full percentage point and the rest of the short-end of the yield curve has risen accordingly. We now see an opportunity to extend the duration of our bond fund allocation slightly to take advantage of more attractive yields on the short-end of the yield curve. We are also increasing the quality of our bond funds, reducing lower rated “A” credits in favor of more highly rated “AAA” credits.

As you know, the primary purpose of the bond allocation is to act as a counterbalance against potential stock market volatility and to provide liquidity for emergencies and short to intermediate-term cash flow needs. In upcoming client reviews, we will be recommending two adjustments to the bond fund composition: (1) a modest lengthening of the average bond duration from just over 3 years to just under 4 years and; (2) raising the average credit quality of the bond allocation. We believe these two adjustments will create an even stronger buffer against future stock market volatility.

Perspectives on Market Volatility (and Increasing Happiness)

In turbulent times, we remind ourselves of the words of Benjamin Graham, the father of value investing and mentor of Warren Buffet, who said, “In the short run, the market is a voting machine, but in the long run, it is a weighing machine.” What Graham meant was that the stock market is inherently volatile in the short-term as prices are impacted by investor psychology which reacts to the news of the day (i.e., “voting” to buy or sell based on short-term information). However, over the long-term, Graham believed that the corporations he invested in would produce profits and generate stock price appreciation which could be “weighed” by measuring their long-term rate of return. Times were much different in the 1930s and 1940s when Graham made his comments; there were neither televisions nor the internet, and the only way to check stock prices was by way of

a ticker tape or newspaper (after the market had closed). The fundamentals of value investing, however, haven’t changed since it still makes sense to buy stocks when prices are undervalued, or fairly-valued, and to sell when prices are too high, or over-valued (i.e., the process of portfolio rebalancing). Human psychology hasn’t changed that much, either, as investors still react to short-term information based upon the emotions of fear and greed. What has changed, however, is the amount and quality (or lack thereof) of information presented to us by the media in real time. Information which is probably only about 10% useful, leaving the remaining 90% as being just noise. Graham would certainly recommend that we ignore the noise and remain invested in a portfolio of well-diversified stocks with favorable valuations.

Barton Biggs, a successful money manager and an early advocate of global investing, shared Graham’s essential view of investing and human psychology. Biggs stated, “When an investor focuses on short-term increments, he or she is observing the variability of the portfolio, not the returns – in short, *being fooled by randomness*. Our emotions are not designed to understand this key point, but as investors, we need to come to grip with our emotional liabilities.” In other words, by focusing on short-term swings in the stock market and on information provided by the media, we lose sight of the longer-term goal of generating a favorable rate of return and achieving our long-term financial objectives.

In closing, the simple drawing to the right, inspired by Carl Richards of the Behavior Gap, attempts to convey a direct correlation between happiness and spending more time ignoring the media. From an investment perspective, once we have constructed a globally balanced portfolio which allocates sufficient dollars toward safe investments to provide for emergencies and our cash flow needs for up to 10 years, we can then confidently invest the remainder of the portfolio in a diversified portfolio of stock funds designed for long-term appreciation to combat inflation and meet our long-term financial objectives. We believe that such a globally balanced portfolio structure, bolstered by the process of rebalancing, should better enable us to ignore the noise, sleep better at night, and achieve a higher level of happiness.

