AEQUITAS INVESTMENT ADVISORS

INVESTMENT REVIEW – THIRD QUARTER 2018

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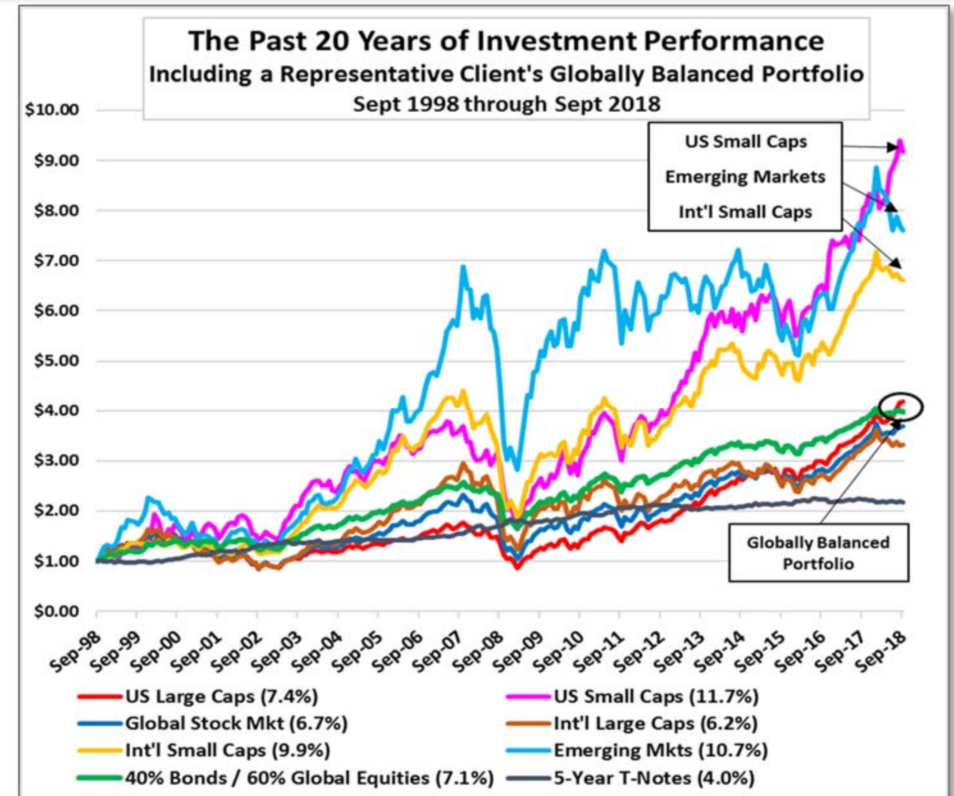
To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Important Lessons Applied Over the Past 20 Years



Dear Client,

Since the writing of our last quarterly report, the global economy has remained in expansion mode although it appears the rate of growth may have peaked. In the US, wages are rising, consumer confidence and business optimism remain strong and economic conditions are supportive of continued corporate earnings growth. The Federal Reserve is sufficiently confident about the economic outlook to have recently raised interest rates for the third time this year (the recent stock market slump, however, suggests investors are becoming nervous that higher rates might stifle economic growth). Earlier this month, Chairman Powell reiterated the Fed's policy of gradual interest rate hikes to keep inflation stable while maintaining maximum employment. Powell remarked that we live in "extraordinary" times with both low inflation and very low unemployment; an unusual combination referred to as a Goldilocks economy, i.e., one that is not too hot or cold. Beyond our borders, the International Monetary Fund's recent outlook forecasts a leveling of growth for the global economy over the next twelve months with relatively favorable prospects in the US among developed countries and Emerging Asia and Emerging Europe in the developing world. The IMF sees slower global growth in 2020 given the impact of higher interest rates, receding fiscal stimulus and trade pressures. Consumer confidence rose slightly around the world over the past three months, according to the September Ipsos Global Consumer Confidence Index, with the highest levels of confidence being reported, in descending order, in Sweden, the US, Germany, China, Canada, Great Britain, Japan, Israel and Poland. On the trade war front, deals have been signed with South Korea, Mexico and Canada and talks are taking place with the European Union and Japan. World trade volume, despite the trade disruptions, grew by close to 4% over the past 12 months. Based upon an assumption there will be some sort of resolution to the US-China trade relationship, the consensus view from economists is that the global expansion is likely to continue into 2020.

While the overall global economic outlook appears favorable, several risks remain front and center, notably the US-China trade war and to a lesser extent the Brexit negotiations. In our last quarterly report, we discussed the implications of trade wars and their potential economic impact and have recently posted related links and updates in our website's Chart Room (aequitas-inv.com/chart-room). Economists at Oxford Economics estimate that a full-blown US-China trade war would impact about $600 billion of trade (about 4% of the current total of $17.8 trillion in global trade) and might reduce cumulative global GDP growth in 2019 and 2020 by about 1%. While these reduced growth estimates are not necessarily recessionary, the ripple effect of uncertainty and depressed business confidence might slow corporate spending and hiring and exacerbate a slowdown in the global economy. Further clouding the outlook is the possibility of "no deal" in the Brexit negotiations which would prove detrimental to growth in the UK and European Union, at least in the short-term, with less significant ripple effects on the global economy (as of this writing, there are signs of progress in negotiations heading into an important summit of European Union leaders later this month).

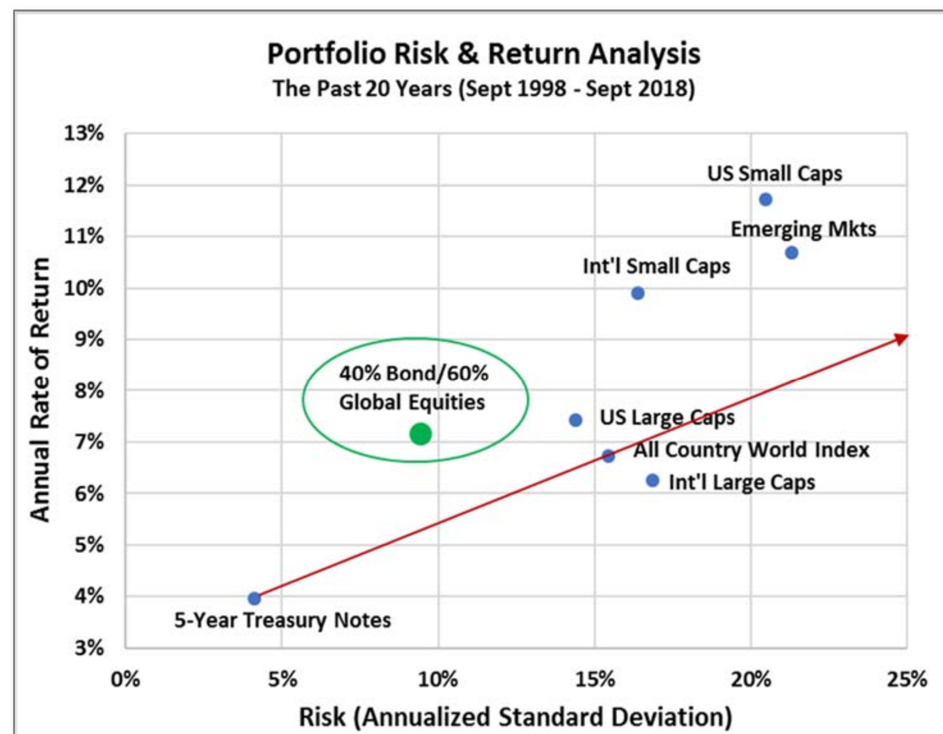
The bottom line is that while the global economy is in relatively good shape today, there are significant risks to the outlook. From an investor's standpoint, we believe the best antidote to such uncertainty is to maintain a balanced portfolio designed to weather a wide variety of future events. In the next section, we'll examine just how well a globally balanced portfolio endured the turbulence of the past 20 years and we'll discuss some of the more important lessons for the future.

The Past 20 Years Offer Important Lessons for Today and the Future

One of the significant benefits of working with clients for close to three decades is the depth of experience we've gained during both good and bad economic times and throughout a wide range of geopolitical developments. In the graph on page one, we've indicated the actual investment results over the last 20 years for a range of major asset classes along with a representative client's balanced portfolio invested 40% in Bonds and 60% in Global Equities. The three outperformers over the past two decades were US and International Small Cap stocks as well as Emerging Markets stocks which delivered average annual returns ranging between 9.9% and 11.7%. Particularly noteworthy was the lagging performance of US Large Cap Stocks (the red line represented by the S&P 500) during most of the first 15 years; even 5-Year US Treasury Notes had a higher cumulative return until 2013! The reason for the significant underperformance was due to their relative overvaluation beginning in the late 1990's as the technology stock bubble was inflating. By 1999, the weight of the technology sector in the S&P 500 had grown to about 30% of the index compared to a 6% weight just 6 years earlier (its current weight is about 26%). In 1998, the S&P 500's Cyclically Adjusted Price-to-Earnings Ratio (i.e., Nobel Laureate Robert Shiller's CAPE Ratio) had climbed to about 35 times earnings which is only slightly higher than its current 32 times earnings. What's eerily similar to 1998 is that the current S&P 500 CAPE Ratio has also been elevated to a significant extent by the rise in technology stock prices (perhaps the recent stock market sell-off marks the beginning of a correction in the technology sector).

Referring back to the graph on page one, note the green line which is the actual performance of a representative client's globally balanced portfolio (invested 40% in Bonds and 60% in Global Equities). As with client portfolios today, in 1998 our asset allocation strategy was diversified among all of the asset classes indicated in the graph, including bonds (the gray line) which critically served to reduce volatility. Believing that US Large Cap stocks were relatively overvalued, in 1998 our recommended asset allocation strategy underweighted US Large Caps and overweighted stock asset classes with more favorable valuations, including International stocks and US Small Cap stocks. While it took another 2 years for the technology stock bubble to burst, our valuation-focused asset allocation strategy ultimately benefited portfolio performance much like the tale of the tortoise beating the hare (think of undervalued stocks as the tortoise and overvalued stocks as the hare).

In the Portfolio Risk & Return Analysis scatter diagram below, we indicate the average historical annual returns for the various asset classes as well as their level of volatility, or risk, as measured by standard deviation over the trailing 20-year period. The riskiest asset classes, as might have been expected 20 years ago, ended up in the upper right section of the scatter. The broad market capitalization-weighted indices (US Large Caps, the All Country World Index and Int'l Large Caps) were slightly less risky and significantly lower in their average returns. The least risky asset class on the diagram, as expected, was high quality bonds (i.e., 5-Year Treasury Notes). Our representative client's portfolio was invested in each of the various asset classes, as well as others, and ended up with a risk level significantly less than stocks, but also favorably higher than the arrow drawn between 5-Year T-Notes and the All Country World Index of stocks. While the actual returns differed from our forward estimates 20 years ago, the risk and return results ended up closely aligned with our expectations. We cannot predict which asset classes will be the biggest drivers of performance over the next 20 years, but experience has taught us that building portfolios which are balanced with bonds



and globally diversified stocks (with attractive valuations) should improve the likelihood of achieving a similarly favorable risk/return outcome designed to help our clients fulfill their lifelong financial objectives.

Core Beliefs Based Upon Empirical Research

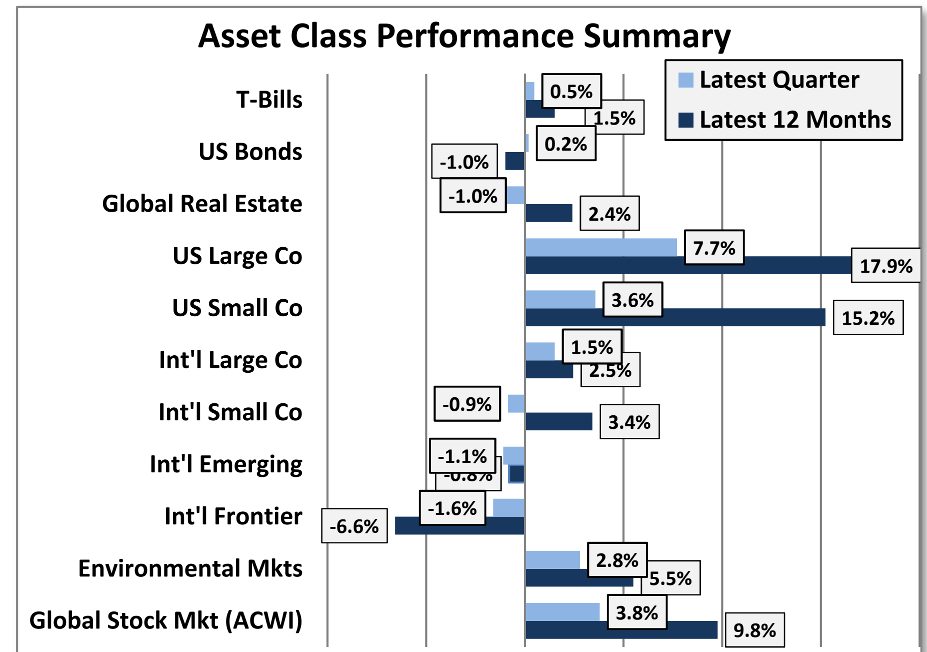
Beyond the 20-year performance results which generally met our expectations on a risk and return basis, what were some of the core beliefs we applied to portfolio construction 20 years ago and what lessons did we learn along the way?

1. Based upon the academic work of Nobel Laureate Eugene Fama and Ken French, we believed Value stocks would outperform Growth stocks which they did on average by more than 1% annually over the 20-year period. However, there were times when it was difficult defending Fama and French's Value stock proposition, especially during the technology-led Growth stock runup of the late 90s (a period not dissimilar from today). We believe patience will ultimately be rewarded once stocks with unusually high price valuations eventually came down to earth. (Value stocks have outperformed Growth stocks cumulatively over the past 20 years, although in 8 of those years Growth outperformed.)
2. We believed that Small Cap stocks would outperform Large Cap stocks and while they did, by close to 4% annually, we wouldn't expect such outperformance going forward.
3. We believed that diversifying into International stocks would improve portfolio performance on a risk-adjusted basis. This worked especially well for Emerging Markets and Int'l Small Caps over the past 20 years, but not so well with Int'l Large Cap stocks.
4. Twenty years ago, we believed that carefully selected actively managed mutual funds could outperform their respective indices and improve overall portfolio performance. Since that time, the markets have become more efficient and we learned that selecting active managers based upon past performance, no matter how carefully researched, more often than not detracted from performance. Low-cost passively managed funds tend to deliver more reliable performance which is why they are core components of our recommended portfolios today.
5. We believed that constructing balanced portfolios (i.e., a combination of bonds and stocks) would both reduce risk and deliver the performance our clients required to achieve their objectives. The results somewhat exceeded our expectations in that the 40% Bond and 60% Global Equities portfolio provided an average annual return in excess of the ACWI stock index with considerably less risk.
6. While we were not utilizing Robert Shiller's CAPE stock valuation research in 1998, his forecast at that time based upon a CAPE Ratio of 35 was that the S&P 500 would deliver an average return of about 4% for the subsequent ten years. As it turned out, the actual return was remarkably close to Shiller's forecast coming in at 3.1% for the S&P 500, including dividends, for the 10-year period beginning in October of 1998. The lesson here is that the CAPE Ratio is a valuable tool in estimating *long-term* future returns with high ratios suggesting lower returns in the future and low ratios suggesting higher returns. Today's CAPE Ratios indicate that US stocks are overvalued relative to non-US stocks; a factor we have incorporated into our current recommended asset allocation targets.

We believe that academic research is an important cornerstone in the construction of a well-diversified portfolio. In our view, basing core beliefs upon sound academic research and substantial experience instills greater confidence when planning for the future, especially in uncertain times.

Asset Class Performance Review

For the trailing 12 months ending September 30th, The MSCI All Country World Index (ACWI) gained 9.7% with US Small Caps (+15.2%) and US Large Caps (+17.9%) leading the way. Next in line were the Environmental Markets (+5.5%), Int'l Small Caps (+3.4%), Int'l Large Caps (+2.5%), Global Real Estate (+2.4%)



and US T-Bills (+1.5%). In negative territory were US Bonds (-1.0%), reflecting the rise in interest rates, Emerging Markets (-0.8%) and Frontier Markets (-6.6%); the latter two reflecting trade war pressures as well as a strong US dollar.

For the latest quarter, the order of performance was generally in line with the 12-month results. The MSCI All Country World Index gained 3.8% with US Large (+7.7%), US Small (+3.6%) and Environmental Markets (+2.8%) at the top pf the list followed by Int'l Large Caps (+1.5%), US T-Bills (+0.5%) and US Bonds (+0.2%). In negative territory were Int'l Small Caps (-0.9%), Global Real Estate (-1.0%), Emerging Markets (-1.1%) and, lastly, Frontier Markets (-1.6%).

Planning Matters Regardless of Short-Term Performance

Twenty years ago, when we constructed the 40% Bond and 60% Global Equities portfolio for our representative client, we relied on academic research and time-tested investment principles we believed would improve the odds of a successful long-term outcome at an acceptable level of risk. While the average annual rate of return was sufficient to meet our client's financial objectives and exceeded the return of the benchmark on a cumulative basis, there were years when the returns were negative as well as years when the portfolio underperformed its benchmark. We cannot control the path of the investment markets from year-to-year, but there are important planning actions which can be beneficial whether the markets are up or down, including the following:

1. Rebalancing: One of the most important investment principles, rebalancing is the ongoing trimming away from higher-valued asset classes into lower-valued asset classes.
2. Keeping Expenses Low: Investing with low-cost passive strategies will likely generate higher net long-term returns.
3. Avoid Market Timing: The markets are extraordinarily efficient and future returns are generally commensurate with risk. Allow time for the markets to perform and resist letting emotions undermine a well-designed long-term plan.
4. Embrace Academic Research: Eugene Fama and Robert Shiller won separate Nobel prizes for their research in economics. Fama demonstrated that stock prices are generally efficient and impossible to predict in the short-term. In his work with Professor Ken French, it was demonstrated that Value stocks and Small Cap stocks, on average, tend to outperform the broad stock market over time. Shiller demonstrated that future stock returns can be reasonably predicted over long-term periods by comparing current prices to the average of their past 10-year inflation-adjusted earnings (i.e., the CAPE Ratio). Stocks with lower CAPE Ratios tend to outperform stocks with higher CAPE Ratios over subsequent 10-year periods (however, not necessarily in the short-term which is why patience is required).
5. Tax Planning Actions: For individual clients, the following actions can further enhance portfolio performance:
    a. Harvesting Tax Losses: While we would hope to have gains for all of our investments every year, there will be years when certain asset classes will be down, and it often makes tax sense to take losses to offset current and/or future gains.
    b. Asset Location Strategies: Adjusting investment strategies among accounts to minimize taxes and maximize after-tax returns. For example, emphasizing income generating investments in tax-deferred accounts (e.g., regular IRAs and annuities) and emphasizing capital gains-oriented investments in taxable accounts and Roth IRA accounts.

Closing Thought

We've learned a great deal over the past twenty (plus) years and we are grateful for the trust and confidence our clients have placed in our advisory services. Working closely with our clients to help achieve their objectives while serving their evolving needs is a lifelong journey on which we are honored to participate.

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