

To: Aequitas Client

From: Aequitas Investment Advisors

Subject: Not Afraid of Volatility, Just Don't Want to Be There When It Happens

Dear Client,

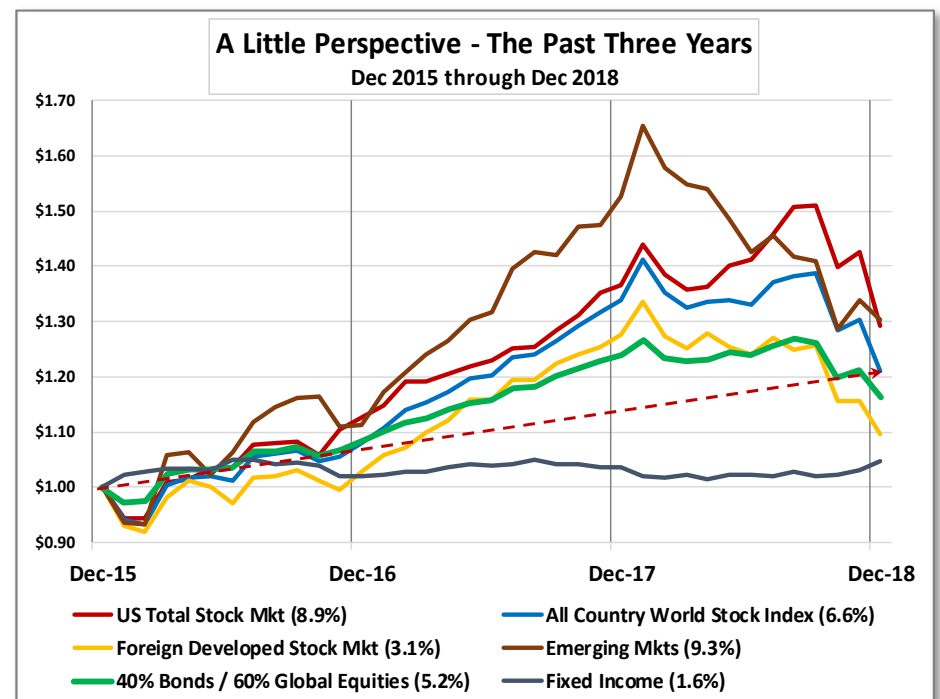
The year of 2018 was one of extreme volatility and a year which delivered several “worsts” for the stock market. First, it was the worst month of December in more than 80 years; second, 2018 was the worst year in a decade; and third, 2018 closed out the worst twenty calendar year period since the Great Depression! (Note: all three “worsts” apply to the S&P 500; other asset classes fared considerably better over the past twenty years). Of course, there’s much more information beyond this litany of the “worsts” which would be constructive to learn and benefit from. Furthermore, with continuing signs of economic expansion, albeit at a slower pace, the sell-off we experienced in December may have simply been a necessary correction to bring stock prices down to more sustainable levels.

Before proceeding, let’s briefly review the major market drivers in 2018 which caused most of the volatility. While the year began with the *best* January for the stock market in more than 30 years, optimism quickly faded as concerns about the economic impact of tariffs and trade wars began building. With China being the biggest tariff target, stocks in Emerging Asia began a downward descent of more than 20% leaving them in Bear Market territory by late October. Tariff pressures, slowing growth and Brexit concerns brought stocks in Europe and the UK into Bear Market territory as well. While foreign stocks absorbed the brunt of the damage for the first three quarters of the year, US stocks joined the downward plunge in early October as investors became concerned about the negative impact of higher interest rates and corporate CEOs began warning that earnings growth in 2019 might suffer under the weight of trade war pressures and higher borrowing costs. US stocks began their descent in early October with technology stocks leading the plunge. Between October 3rd and December 31st, the largest publicly traded stock, Apple, lost more than 30% of its value while the S&P 500 Index fell by close to 14% and US Small Cap stocks dropped by close to 18%. When all was said and done for 2018, every major US and foreign stock

index ended up in negative territory with the All Country World Index down by more than 10% making it the worst year for stocks since 2008.

A Little Perspective

Over the past 90 calendar years, the stock market has generated a positive return more than two-thirds of the time, or 2 out of 3 years on average. The average calendar year loss has been 13.2%, so 2018 was not particularly noteworthy from a longer-term perspective (the average calendar year gain has been 20.7% which is about what the market generated in 2017). In looking back over the past three years, the All Country World Index (ACWI) had two positive years in 2016 (+8.4%) and 2017 (+24%) followed by one negative year in 2018 (-10.1%). Over the full three-year period, the ACWI had an average annual compound gain of 6.6% with Emerging Markets stocks (+9.3%) leading the way followed closely by the MSCI USA Stock Index (+8.9%). A surprisingly low return came from Non-US Developed Markets stocks (+3.1%) with US Bonds delivering 1.6%. A



globally balanced portfolio of 40% in Bonds and 60% in Global Equities gained 5.2% annually.

What Did We Expect Might Happen?

An important question is how did the returns over the past 3 years compare to what we expected? After all, one of our greatest responsibilities at Aequis is to help our clients achieve their long-term financial goals and a critical underlying element toward that end is the portfolio's rate of return. At the beginning of each calendar year, we reassess our long-term return expectations for numerous asset classes among stocks and bonds. Given that it's impossible to accurately forecast short-term stock market performance, we rely upon proven valuation measures such as P/E Ratios, CAPE Ratios and Price-to-Book Ratios to formulate future long-term return expectations. Based upon the data we reviewed in early 2016, we arrived at a set of Expected Long-Term Returns for the major asset classes. In the table below, we've listed our 2016 expected returns for four major asset classes; US Stocks, Non-US Developed Markets stocks, Emerging Markets stocks and Fixed Income (represented by short to intermediate term bonds). The table also includes two diversified mixes; Global Equities, a mix of US and foreign stocks, as well as a 40% Fixed and 60% Global Equities mix. The second column indicates what our Expected Long-Term Return assumptions were three years ago for the four major asset classes and mixes. The third column indicates what the actual returns were over the past three years and the last column indicates whether the actual was higher or lower than expectation. We're happy to see that the actual return for Global Equities was higher than expected, and while Fixed Income returns were considerably lower than what we forecasted, the 40% Fixed and 60% Global Equities portfolio ended up with a slightly higher return than expected. Of course, we're only three years into a long-term forecast, so there's a lot that can still happen, plus we move the goal posts each year by revising the long-term assumptions based upon changing valuations and economic conditions. Nonetheless, by basing our long-term assumptions on what have been relatively

Asset Class	2016's	Actual 3-Year ROR's	Plus or Minus
	Expected Long-Term Returns		
US Stocks	4.7%	8.9%	+4.2%
Non-US Dev. Mkts	6.3%	3.1%	-3.2%
Emerging Mkts	8.9%	9.3%	+0.4%
Global Equities	5.6%	6.6%	+1.0%
Fixed Income	2.7%	1.6%	-1.1%
40% Fixed/60% Global Equities	4.4%	5.2%	+0.8%

reliable valuation measures, we believe we can improve the odds of a successful investment experience for our clients.

The Worst 20 Years Since the Great Depression!

A recent article in Barron's by Vito Racanelli entitled, *It's Been a Rough 20 Years for Stocks. The Next 20 Should Be a Lot Better*, the author pointed out that based upon calendar years, December 31, 2018 marked the end of the worst 20-year period since the Great Depression. Over the past 20 years, the S&P 500 Index posted an average compound annual return of 5.6% compared to its 90-year average return 10.7%. That's about half of the return an investor might have expected in 1998! Had a 45-year-old investor in 1998 based his or her plan to retire at age 65 on an assumed annual rate of return for stocks of 10.7%, he or she would either need to continue working for an extra 5-10 years now or be forced to reduce living expenses. Of course, the 5.6% rate of return assumption assumes the investor's portfolio was invested 100% in an S&P 500 Index fund; a more diversified portfolio, thankfully, fared much better. Further, by utilizing more conservative return assumptions to begin, measuring progress on a regular basis and perhaps saving a little more each year, the investor would likely have been able to retire as planned.

In the table to the right, we've indicated the actual 20-year returns for several major asset classes. Two asset classes did worse than the S&P 500; US Large Cap Growth stocks and Foreign Large Cap Value stocks. Other assets classes, however, fared much better with returns ranging from 7.5% to 9.1%. Returning to the example of the 45-year-old investor above, had he or she invested an \$100,000 IRA account in the S&P 500 in 1998 it would be worth \$297,000 today based on the 5.6% actual annual return. Instead, if the IRA account generated an 8% return over the same period (8% is the average of the 9 asset classes in the table), it would have grown to \$467,000 by the time the investor reached age 65!

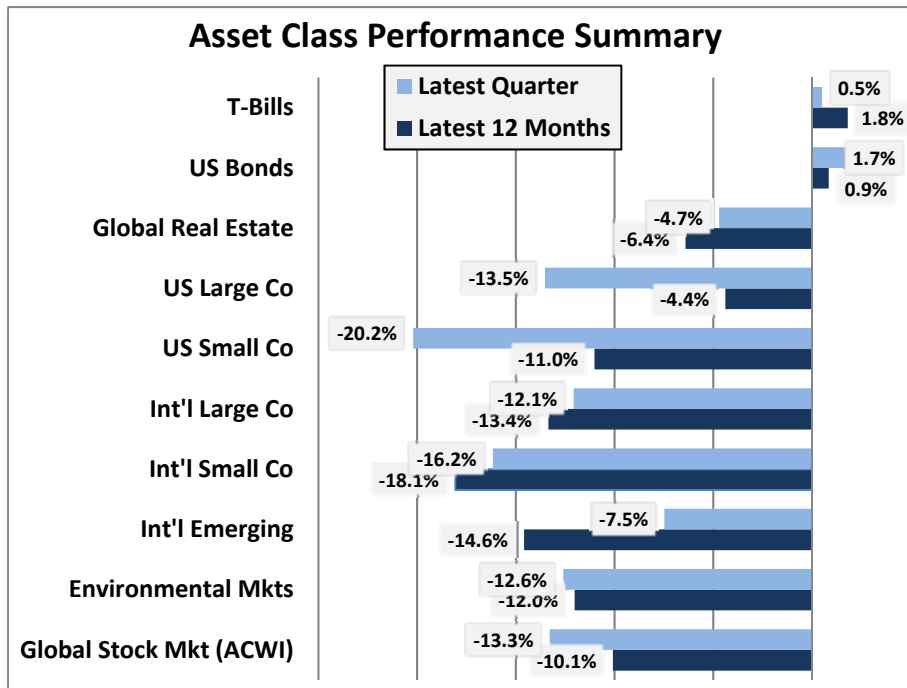
Asset Class	Actual 20-Year Returns
US Large Caps (S&P 500)	5.6%
US Large Cap Growth Stocks	5.1%
US Large Value Stocks	7.5%
US Small Cap Stocks	9.7%
US Small Cap Value Stocks	9.7%
Foreign Large Cap Value Stocks	5.4%
Foreign Small Cap Value Stocks	9.1%
Emerging Markets Stocks	8.8%
Emerging Markets Value Stocks	10.8%

While the past 20 years have been rough according to Racanelli, his Barron's

article includes an encouraging word from Nicholas Colas of Data Trek Research who commented, “The best thing about sitting at the low end of a historical range is that mean reversion should start to kick in and the next 10 to 20 years from here will likely be pretty good.” Racanelli comments further that, “Where the market will be in a year has little to do with where it is now. Twelve months ago, stocks were coming off a 22% return in 2017 and feeling fine thank you very much – until September. Then the wheels fell off. Ironically, there is more certainty in picturing the market’s next 10 or 20 years. That’s the time frame investors should use.” Amen.

Asset Class Performance Review

Over the trailing 12 months, for the asset classes listed in the chart below, only T-Bills (+1.8%) and Bonds (+0.9%) landed in positive territory. The good news is that cash (e.g., T-Bills) is now earning a decent rate of return thanks to the Fed’s program of raising interest rates. On the other hand, the Fed’s actions probably had a negative impact on the returns of the stock asset classes which were all in the red. The smallest loss was US Large Caps which declined by 4.4%, otherwise the range of losses was between 6.4% and 18.1% with the Global Stock Market (ACWI) down by 10.1%.



For the quarter, the story is pretty much the same with the distinction that Global Real Estate (-4.7%) and Emerging Markets (-7.5%) held up better than the other stock asset classes. T-Bills (+0.5%) and Bonds (+1.7%) posted positive returns while the range of negative returns among the other stock asset classes was between 12.1% and 20.2% (US Small Cap stocks were the biggest loser).

Byron Wein’s Ten Surprises for 2019

As you know, Aequitas is not in the business of making short-term predictions and history has demonstrated that attempts to do so are more often wrong than right (which is why we focus on more reliable long-term assumptions). However, there is one well-regarded pundit, Byron Wein, who for more than thirty years has published a list of *Ten Surprises* based on his assessment of economic, social and political trends. Byron’s career includes serving as Chief Investment Strategist for Morgan Stanley, Pequot Capital and now as senior advisor to the Blackstone Group. Byron confesses that of the *Ten Surprises* he may get only 5 or 6 right, but his perspective is thought provoking and challenging to the consensus view. We thought his *Ten Surprises* for 2019 were worth passing on:

1. The weakening world economy encourages the Federal Reserve to stop raising the federal funds rate during the year. Inflation remains subdued and the 10-year Treasury yield stays below 3.5%. The yield curve remains positive.
2. Partly because of no further rate increases by the Federal Reserve and more attractive valuations as a result of the market decline at the end of 2018, the S&P 500 gains 15% for the year. Rallies and corrections occur.... [in other words, expect continued volatility in the markets].
3. Traditional drivers of GDP growth, capital spending and housing, make only modest gains in 2019. The expansion continues, however, because of consumer and government spending. A recession before 2021 seems unlikely.
4. The better tone in the financial markets discourages precious metal investors. Gold drops to \$1,000 as the equity markets in the United States and elsewhere improve.
5. The profit outlook for emerging markets brightens and investor interest intensifies because the price earnings ratio is attractive compared to developed markets and historical levels. Continuous expansion of the middle class in the emerging markets provides the consumer buying thrust for earnings growth. China leads and the Shanghai composite rises 25%. The Brazil equity market also comes to life under the country’s new conservative leadership.
6. March 29 comes and goes and there is no Brexit deal. Parliament fails to

approve one and Theresa May, arguing that a change in leadership won't help the situation, remains in office. A second referendum is held and the U.K. votes to remain.

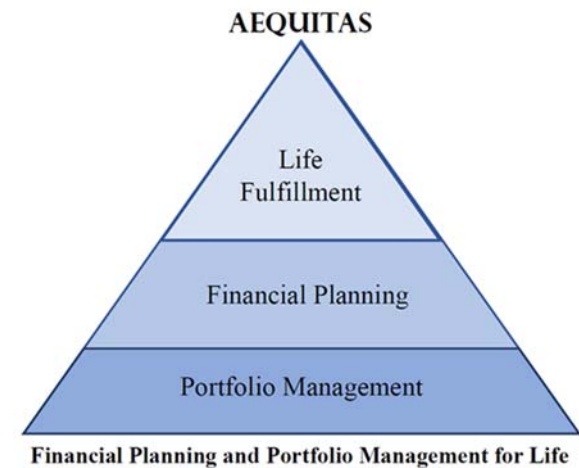
7. The dollar stabilizes at year-end 2018 levels and stays there throughout the year.
8. The Mueller investigation results in indictments against members of the Trump Organization closest to the president but the evidence doesn't support any direct action against Trump himself. Nevertheless, an exodus of Trump's most trusted advisors results in a crisis in confidence that the administration has the people and the process to accomplish important goals.
9. Congress, however, with a Democratic majority, gets more done than expected, particularly on trade policy. Progress is made in preserving important parts of the Affordable Care Act and immigration policy. A federal infrastructure program to be implemented in 2020 is announced.
10. Growth stocks continue to provide leadership in the U.S. equity market. Technology and biotech do well as a result of continued strong earnings.

We'll see how many of Byron's *Ten Surprises* pan out, but if his track record of getting 5 or 6 continues, we might have a surprisingly positive year.

Not Afraid of Volatility, Just Don't Want to Be There When It Happens

As stated at the outset of this letter, 2018 was a year of many "worsts" for the stock market and a year of heightened volatility which felt even worse given the political scene in the US and the media's bias toward sensationalism. History has taught us that the stock market has always been volatile, and we should expect up years and down years. When thinking about volatility, we were reminded of Woody Allen's remark about death, "I'm not afraid of death; I just don't want to be there when it happens." So, too, with volatility and down markets; i.e., we never want to be there when they happen. However, we can utilize volatility to our advantage by periodically rebalancing out of over-valued into lower-valued asset classes. We can reduce our portfolio's volatility by allocating a significant amount toward high quality bonds (i.e., sleep at night money). And as long-term investors, we can more confidently plan for the future by basing our future return assumptions on relatively reliable valuation methodologies while making adjustments as circumstances warrant.

At Aequitas, we're partners with our clients through both calm and turbulent times and are focused on helping clients achieve their lifetime objectives. Toward that goal, we welcome your comments and questions and look forward to seeing you in 2019. Hopefully, it will be a peaceful and joyous year for all!



YOUR TEAM AT AEQUITAS!