

To: Aequitas Client

From: Aequitas Investment Advisors

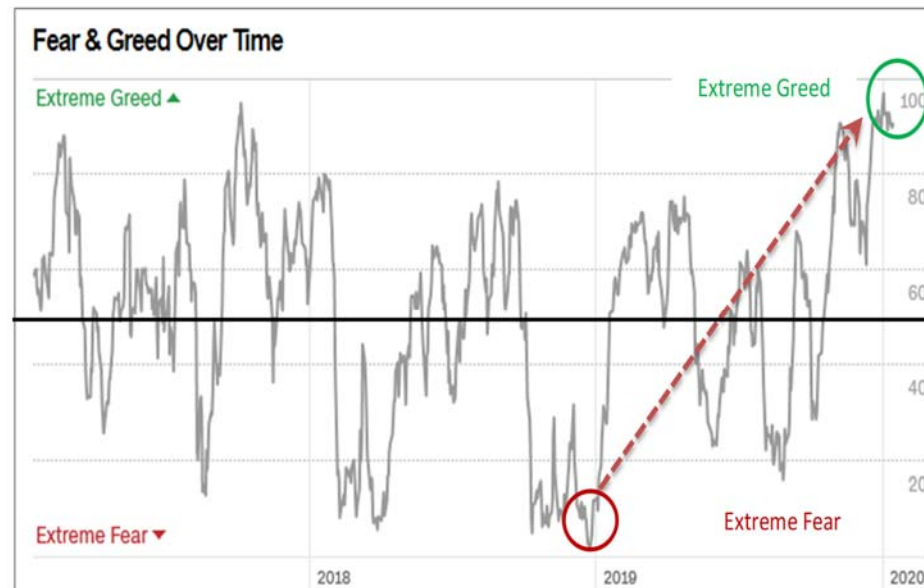
Re: **Hindsight is 2020**

Dear Aequitas Client,

What a difference a year can make! As we were writing our quarterly letter one year ago, the media was running gloomy headlines, such as “US stocks post worst year in a decade as the S&P 500 falls more than 6% in 2018” (CNBC) and “U.S. Indexes Close the Worst Yearly Losses Since 2008” (Wall Street Journal). As indicated in the chart to the right, the gauge of investor sentiment at the time was in *Extreme Fear* territory following a 15% plunge in stock prices over the preceding three months and worsening trade tensions as the media ramped up fear of an impending recession. Those fears appear to have been overblown given the about face in sentiment over the first few months of 2019. After reaching an extreme fear level early in 2019, stock prices began to climb with some fits and starts along the way to record high levels by the end of the year. Buoyed by persistently strong employment figures in the U.S. and signs of easing in the U.S. vs. China trade war, stocks around the globe rose by more than 25% making 2019 the best year for the stock market since 2009.

Fear and Greed

Albert Einstein said that fear and greed were two of the greatest forces which rule the world. Of course, Einstein was referring to the impact of psychology on the course of human history rather than offering investment advice, but fear and greed are powerful drivers of stock market behavior which disciplined investors can often take advantage of. When asked to explain the remarkable investment performance of Berkshire Hathaway, the legendary value stock investor, Warren Buffet, stated, "We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." What Buffet meant was that investor fear can drive stock prices down lower than their intrinsic value (presenting a potential buying opportunity), while investor greed can drive prices up to expensive levels (indicating a good time to consider selling or trimming).



In the Fear and Greed Over Time chart above (updated daily at money.cnn.com), investor sentiment is measured over the past three years. The Index, designed by CNNMoney, is a measure of investor psychology on a scale from 0 to 100, with 0 being extreme fear and 100 being extreme greed. The Index is comprised of seven indicators, including stock market momentum, investor demand for safe haven assets and the level of “put” options relative to “call” options (a higher level of put options indicates more traders are betting stock prices will fall rather than rise in the future).

Note the extreme fear level on the chart at the start of 2019 (red circle) and how the emotions of investors swung between fear and greed throughout the year as news events unfolded. Note also, the level of extreme greed in which we find ourselves today (green circle). While the Fear and Greed Index is an interesting tool to get a pulse on investor sentiment at a point in time, it is not a useful market timing tool given the Index’s high level of volatility (and poor track record for predicting future returns). If an investor were to sell stocks whenever greed was high, he or she would potentially need to buy stocks back just a few months later when fear was high and so on, and so on. Were this process were repeated enough, such an investor might end up broke given the overwhelming academic evidence informing us that market timing does not work and can be very costly!

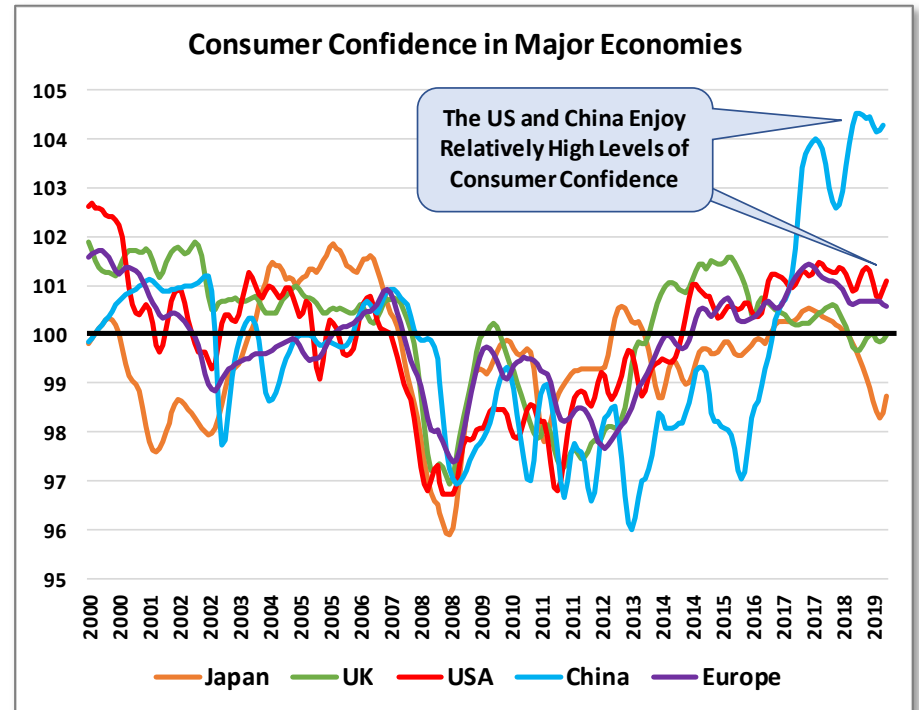
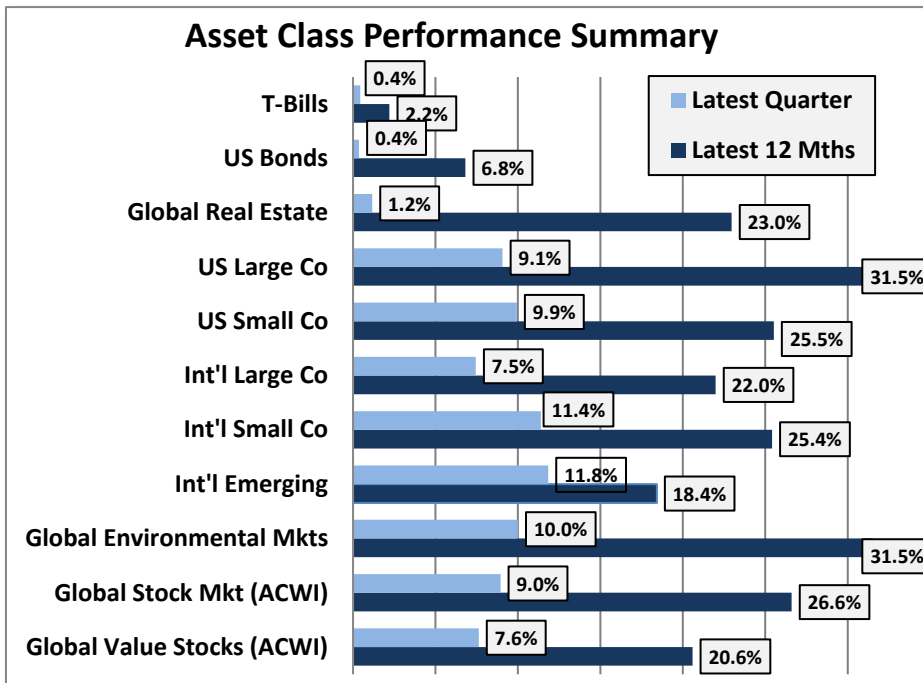
What's the point, then, of talking about the Fear and Greed Index if it's not a useful tool for investors? While the Index, itself, may offer little value for long-term investors, it does serve as an important reminder that the stock market is largely driven *in the short-run* by human emotion as investors react to news events and headlines of the day. Instead of reacting to the headlines (which can only create anxiety these days), we believe investors are better served by establishing an acceptable level of risk (e.g., developing an appropriate balance between bonds and stocks) and rebalancing between the two on a *regular* basis in order to take advantage of the emotions which swing the markets (i.e., add to stocks when prices are low and trim when prices are high).

Asset Class Performance Review

Wow! Stock market returns over the past twelve-months were remarkably positive around the globe ranging from 18.4% in the Emerging Markets to a 31.5% tie between the Environmental Markets and U.S. Large Companies. Within Fixed Assets, U.S. Bonds gained 6.8% and U.S. T-Bills picked up 2.2%. The all-encompassing Global Stock Market (MSCI ACWI) surged by close to 27%. We've added a new asset class to the chart below, Global Value Stocks as represented by the ACWI Value Index which captures the returns of more than 3,000 lower-priced stocks across 49 countries around the globe. While Value

Stocks continued their underperformance relative to the broad stock market in 2019, they nonetheless delivered a solid return of close to 21% and provided a glimmer of hope for value-oriented investors.

Performance for the fourth quarter alone was better than one might hope for an entire year! Returns among the stock asset classes ranged from a low of 1.2% for Global Real Estate to a high of 11.8% for the Emerging Markets. The benefit of global diversification was demonstrated once again with leading performance from the Emerging Markets (+11.8%), Int'l Small Companies (+11.4%) and Global Environmental Markets (+10%). U.S. Bonds eked out a gain of 0.4% matching that of U.S. T-Bills.



Consumers to the Rescue?

Unlike this time last year when fears of an impending recession were running high, most economists now see little risk of a recession in the near term. One of the big reasons for optimism is the relatively high level of consumer confidence around the globe, especially in the two largest economies, the U.S. and China. In the Consumer Confidence chart above, a reading of 100 or higher, indicates that consumers are feeling relatively positive about their financial conditions.

Economists view consumer confidence as a major driver of economic activity given that consumption is responsible for more than 70% of global growth. A confident consumer is more likely to spend money which, in turn, generally leads to stronger corporate earnings and adds underlying support for stock prices.

The World Bank recently published their economic outlook for 2020 with a forecast that global growth is expected to recover somewhat this year as trade tensions ease and central banks maintain accommodative monetary policies (i.e., maintain low interest rates). Their outlook is for tepid growth around the globe with slowing growth in the three largest economies, the U.S., China and Japan. Their forecast is for a leveling of growth in Europe, albeit sub-par, and modestly improving growth in many of the Emerging Markets. While the outlook appears somewhat favorable, they point to large challenges ahead and threats to prolonged growth including high levels of government debt and the impact of climate change. These issues, as well as other geopolitical challenges, will need to be addressed sooner rather than later in order build a more sustainable global economy.

China Growth Update – Kicking the Tires

As part of our investment committee’s ongoing due diligence process, Aequitas recently conducted a conference call with Andy Rothman, Investment Strategist at Matthews Asia, who is principally responsible for developing research focused on China’s ongoing economic and political developments. What prompted our call was the desire to re-validate our conviction in investing in this region of the world in light of the trade war with China, and our investment committee came away with greater confidence in our current positioning in this region.

Prior to joining Matthews Asia in 2014, Andy spent 14 years as a China macroeconomic strategist. Previously, he spent 17 years in the U.S. Foreign Service, with a diplomatic career focused on China, including a position as head of the macroeconomics and domestic policy office of the U.S. Embassy in Beijing. In total, Andy has lived and worked in China for more than 20 years.

One of the key takeaways from our call was the fact that the China consumer story should remain strong in 2020 (and beyond). This is important because the consumer and services parts of the economy last year accounted for 75% of China's GDP growth. The chart at top right, courtesy of Matthews Asia, shows more broadly how China’s growth over the next few years is expected to lead the world in Real (inflation-adjusted) GDP Growth. More recently, with a partial trade deal in place and tensions easing, China continues to boast a vibrant, entrepreneurial economy, creating opportunities for investors with a long-term view. While many U.S. investors remain underexposed to this region, we believe



China remains one of the world's most important consumer stories will continue to be a greater portfolio diversifier and a key driver of global economic growth in the future.

Hindsight is 2020

Some pundits suggest there are eerie similarities between where the U.S. stock market is today and where it was twenty years ago in the late 1990s at the time of the Tech Bubble. One clear similarity is that the technology sector has helped propel U.S. stock prices (as measured by the S&P 500) to their most expensive level since the Tech Bubble; however, we haven’t reached the extreme level of overvaluation we saw in early 2000 as evidenced in the table below. On all three

Comparison of S&P 500 in 2020 vs. The Tech Bubble of 2000		
	January 2000	January 2020
Technology Sector Weight	33%	20%
P/E Ratio (Trailing Earnings)	30 x	25 x
P/E Ratio (Forward Earnings)	24 x	18 x
Shiller PE10 Ratio	44 x	32 x

Price-to-Earnings valuation measures, the S&P 500 today is considerably less expensive than it was in 2000 which is a good thing because the S&P 500 had a negative cumulative total return between the year 2000 and 2010. However, despite being less overvalued today than in 2000, it's likely the S&P 500 will deliver sub-par performance over the next ten years based upon historic patterns.

Where the S&P 500 does appear to be significantly overvalued is in relation to stocks outside of the U.S. In the chart below, Topdown Charts has compared the valuations over the past 25 years of U.S. and non-U.S. stocks based upon the Shiller Cyclically Adjusted Price to Earnings Ratio (PE10) which has proven to be a useful measure to estimate future stock market returns over 10-year periods. Note that while U.S. stocks look somewhat expensive today compared to their average PE10 (green line), they appear to be very expensive relative to non-U.S. stocks (blue line) with the widest valuation spread in the last 25 years. This suggests that U.S. stocks are likely to underperform non-U.S. stocks over the next



5 to 10 years. For this reason, we recommend maintaining a relatively high allocation to non-U.S. stocks as well as an underweight to higher priced stocks in general which may have the greatest vulnerability to downward price corrections and/or long-term underperformance.

Sage Advice for 2020 from David Booth *The Market Has No Memory*

A founding principle of the investment strategy put into practice by Aequitas Investment Advisors is to apply sound academic research in the construction of our clients' portfolios. There is arguably no investment firm more distinguished in its application of academic science than Dimensional Fund Advisors (DFA) which was founded in 1981 and today manages more than \$600 billion on behalf of its investors. In a recent interview, DFA's founder, David Booth, offered a few sage observations regarding the lessons learned in 2019 and how investors might approach 2020:

- The market has no memory. Don't time the market in 2020. Don't try to figure out when to get in and when to get out—you'd have to be right twice. Instead, figure out how much of your portfolio you're comfortable investing in equities over the long-term so you can capture the ups and ride out the downs. A trusted professional can help you make this determination, as well as prepare you to stay invested during times of uncertainty.
- Not enough "experts" subscribe to this point of view. They're still trying to predict the future. You've probably heard the saying, "The definition of insanity is doing the same thing over and over again and expecting a different result." I've seen people make this same mistake for 50 years.
- We'll never know when the best time to get into the market is because we can't predict the future. And if you think about it, that makes sense. If the market's doing its job, prices ought to be set at a level where you experience anxiety. It's unrealistic to think the market would ever offer an obvious time to "get in." If it did, there would be no risk and no reward.
- So what should you do in 2020? Keep in mind 2019's most important lesson (which is the same lesson from every year before): Stay a long-term investor in a broadly diversified portfolio. Reduce your anxiety by accepting the market's inevitable ups and downs. Make sure the people advising you align with your perspective. [Instead of] trying to time the markets.....*you'll find you have more time to do the stuff you love to do.*

In closing, here's to a more peaceful and less turbulent year ahead – a year to be grateful for our many blessings.