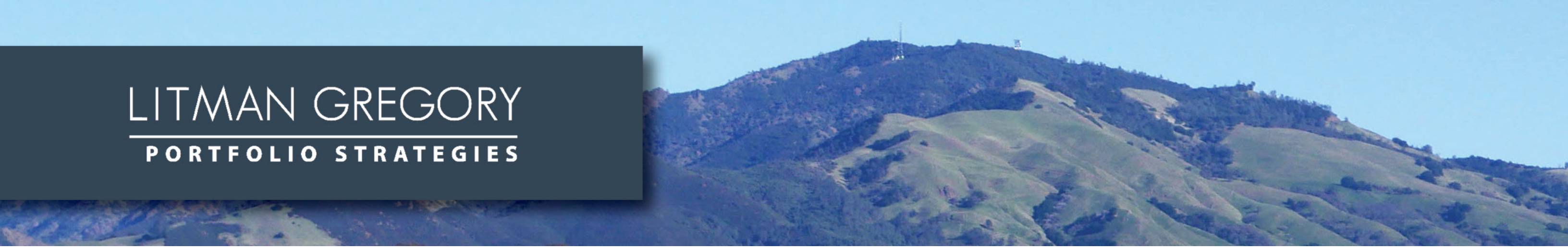

Reflecting on Where We've Been, A Roadmap for Where We're Headed

JANUARY 2019

2018 in Review

In stark contrast to 2017, during which a global high tide floated almost all asset classes, 2018 was an extremely difficult year to make money in financial markets. Perhaps after nearly 10 years of economic growth and strong equity market returns, investors couldn't resist the urge to preserve their gains before the music stopped, even if timing the markets goes against their longer-term interests.

Investors came into 2018 energized by the promise of continued synchronized global growth and new highs that the stock markets of 2017 delivered. In 2019, investors across the globe instead welcomed in the New Year by licking their wounds from the worst annual returns for global equity markets since the financial crisis ignited roughly 10 years ago. Larger-cap U.S. stocks declined 9% in December alone and nearly 20% from peak to trough in the fourth quarter; smaller-cap stocks fared even worse, sinking over 20% for the quarter. We certainly weren't surprised by this pullback, having expressed our concerns for some time regarding U.S. equity valuations being disconnected from supporting fundamentals, such as corporate earnings that embed unsustainable profit margins. And our portfolios have been underweight U.S. equities for some time to reflect this view. Yet the swiftness of the decline was certainly different than anything we've experienced since 2008.

Similarly unlike 2017, when non-U.S. equity markets soared and seemed destined to lead global financial markets forward, foreign stocks suffered throughout most of 2018, with year-end losses in the mid-teens for both developed international and emerging markets (despite their relative outperformance versus U.S. stocks in the fourth quarter). The proverbial "herd" bolted from these markets early in the year as fears surrounding ongoing U.S.-China trade tensions and political and fiscal uncertainties in Europe escalated. Meanwhile, contrarians, us included, continued to seek the rewards of much more attractive valuations—relative to U.S. stocks—and more promising fundamentals than are currently reflected in these valuations. It should be no surprise then that our preference for foreign markets stung our performance in 2018.

Negative equity returns aside, what particularly stands out about 2018 is the *breadth* of negative returns across almost every type of asset class and financial market, whether bonds, equities, or commodities. Over 80% of Morningstar's investment "categories" were negative for the year, and only a strong rally for Treasury bonds helped the U.S. aggregate bond index end the year basically flat. We have intentionally reduced the interest rate sensitivity of our portfolios' fixed-income allocations over the past five years to reflect the asymmetrical outlook for interest rates (i.e., far more likely to go higher than lower). And our more credit-sensitive absolute-return-oriented managers have added significant value over the last five years, despite mixed performance in the fourth quarter of 2018 as Treasury yields plummeted.

The Second-Longest Market Expansion in History

This recent year-end marked the 10-year anniversary since the eye of the storm of the *Great Recession,* when global economic uncertainty was at its peak and almost fully reflected in equity valuations that had declined more than 40%. While investors may not fully remember what happened or, maybe more importantly, how they felt, that historical period is a constant reminder to us of not only how severe downturns can be but also the opportunities that are presented when fears run high. This anniversary seemed like an opportune time to reflect on where we've come from, discuss how we have done for our clients, and align these reflections with our long-term disciplined investment process that emphasizes risk management as much as it does return generation.

We exhaustively drive home that the long-term success of our fundamentally grounded, valuation-driven investment approach almost guarantees that our portfolios will underperform their respective benchmarks over sometimes extended periods of time during a market cycle, particularly when momentum—not fundamentals—is fueling equity markets, which has been the case the past few years (think FAANG stocks). It is exactly during these challenging periods that it is most critical, but also of course most difficult, for any investor to stick with their approach and remain disciplined in order to ultimately harvest the long-term rewards. For us, executing this approach with unemotional discipline and patience has proven its worth over multiple market cycles over the past 30-plus years.

Around the nadir of the 2008 financial crisis, stocks were arguably cheap but getting cheaper, especially some of the highest-quality companies. And anything but U.S. Treasury bonds and the highest of quality corporate bonds had little to no market. Consequently, yields on these securities soared as prices declined. With equity markets moving faster than our ability to assess the longer-term implications of current events, we moved some of our equity exposure to the sidelines in the fourth quarter of 2008, and then began to aggressively take advantage of investments such as high-yield bonds that even under dire stress-testing scenarios were priced to deliver exceptional risk-adjusted returns. This environment aligned well with one of the major tenants of our process: very selectively buy high-quality investment assets at a steep discount to what we reasonably believe to be fair value. Concurrently, our active equity managers were buying great global companies at discounted prices, while active fixed-income managers were having a similar field day with great opportunities in non-core bonds. Consequently, over the next four to five years, our portfolios did quite well in absolute terms and relative to their applicable benchmarks, even with less equity risk as we never got fully allocated to equities post-2008. For reference, our Balanced portfolio returned 13% per year for the five years ending December 31, 2013, whereas its strategic benchmark, which equates to 40% investment-grade bonds and 60% global equities, returned only 11.4%.

In 2013, roughly five years after the onset of the financial crisis, and post three rounds of quantitative easing, larger-cap U.S. equities jumped a staggering 32% and smaller U.S. companies gained 38%, quickly dislocating “price” from “earnings,” with equity investors in effect just paying significantly more for the same earnings stream. This timing marks the onset of the next five years that were less conducive to our fundamentally grounded, valuation-driven investment approach, as U.S. equities continued to soar unabated—at least until the most recent quarter—driven almost exclusively by lofty growth expectations for a select handful of very large growth companies that make up a meaningful percentage of the market-cap-weighted U.S. equity indexes. Meanwhile, except for 2017, foreign equities, whose valuations were much more compelling in our view, significantly lagged U.S. equities over the last five years: 8.5% for the S&P 500 versus just 1.3% for the MSCI All Country World ex USA Index.

In keeping with our disciplined, valuation-based investment approach, as the U.S. stock market continued to rally and become more and more expensive, we opportunistically reduced our exposure to U.S. stocks in favor of international stock markets that hadn’t performed as well but that were trading at relatively cheap valuations compared to U.S. stocks and their own history. More importantly, international stocks offered the level of returns we expect when taking equity risk. This environment isn’t unique to us but certainly the duration is testing even our patience. Over the past five years, our portfolios have been underweight the best-performing—yet most expensive—equity market in favor of the worst-performing—and cheapest—equity markets. As we learned in Finance 101, “buy low—sell high.” Unless financial markets have ceased to move in cycles, the current conditions are unsustainable and we’re positioned to benefit when the cycle does in fact turn once again, as it always has.

For longer-tenured clients that have been with us since at least late 2008, the good news is that over the full 10 years ending December 31, 2018, our portfolios have done well in absolute terms, with our Balanced portfolio returning roughly 7.7% annualized, in line with its strategic benchmark. And for all clients, despite the length of our history together, our portfolios are positioned to perform well moving forward, which is most important as historical returns are meaningless now.

The Next 10 Years

A year ago, equity return expectations were lofty as most investment strategists expected 2018 would bring a continuation of the synchronized global economic recovery. Today, those same strategists are debating whether the next recession will start in 2019 or 2020. In any case, the sharp market pullbacks witnessed this past year only reinforce our view that no one can consistently predict short-term market moves. Over the next year, given the uncertainty stemming from the same macro risks (political, trade, monetary), the range of potential equity market outcomes is just as wide as it was going into 2018. Our approach and preparation remain the same. We construct and manage portfolios to meet our clients' longer-term return goals, which means successfully investing through multiple market cycles, not just the next 12 months. Given our current investments and positioning, we are confident our portfolios are positioned to perform well over the medium to long term and to be resilient across a range of potential shorter-term scenarios.

If the current recession fears are overdone, we expect to generate strong overall returns with outperformance from our foreign equity positions, especially if currencies are favorable; active managers who are taking advantage of recent price drops to buy quality cash-generating companies at low prices; and flexible bond funds that make money independent of the direction of interest rates. On the other hand, if U.S. stocks slide into a full-fledged bear market, our portfolios have "dry powder" in the form of lower-risk fixed-income and non-correlated alternative strategies that should hold up much better than stocks. We'd then expect to put this capital to work more aggressively; for example, by increasing our exposure to U.S. stocks at lower prices and valuations implying much higher expected returns over our medium-term horizon.

In the period since the financial crisis, there has seemingly been little need to own anything other than U.S. stocks. But it should be particularly clear after this year (and past quarter) that isn't a sound long-term approach. The results of the past 10 years are not sustainable, and they won't be repeated over the next 10 or 20 years. Even after their fourth quarter declines, U.S. stocks are still expensive. However, many markets elsewhere are oversold, strengthening their appeal for long-term, value-seeking investors like ourselves. Europe is historically cheap, with a lot of the worries (e.g., Brexit, Italy's political and debt concerns) likely already priced in. And the selloff in Asia has been particularly severe. Here again the market seems to be overreacting to potential risks (e.g., a slowdown in China) rather than reflecting the true value of emerging markets—a vast investment opportunity set that continues to expand at a faster rate compared to developed markets. Despite the risks we see over the short term, we have a high conviction level that our investments in European and emerging-market stocks will earn significantly higher returns than U.S. stocks over the next five to 10 years. We're becoming less contrarian in this view as many well-respected, valuation-driven investment firms are echoing our conviction. Ultimately, capital flows to financial markets that offer the best risk-adjusted returns. As Rob Arnott of Research Affiliates states, *"…the most rewarding investment opportunities nearly always arise out of discomfort—that the best opportunities are often born from cheaply valued markets and fear-induced environments, while the worst tend to emerge from richly valued markets in conditions marked by comfort and complacency. What is comfortable is rarely profitable."*

In Closing

The low volatility seen in many major markets in recent years was supported by the considerable liquidity provided by the major central banks post-2008. The air has been leaking out of the balloon with the Federal Reserve raising interest rates and reducing its balance sheet. Global growth has been slowing and the U.S. business cycle is nearing its longest period of expansion in history. It should be no surprise that markets are adjusting to these new realities.

For us, on behalf of our clients, successful investing is a process of consistently making sound, well-reasoned decisions over time, and across market and economic cycles. Our goal is never to track or beat a particular benchmark from one year to the next, but rather to provide our clients with the optimal return for the environment we're given and the risk profile of their particular strategy. This is our sole mission! Thus, in many instances, our investment decisions are motivated by a prudent desire to hedge significant economic and financial risks that might never play out (but were legitimate and with implications potentially devastating). Given this approach, it is normal—not unusual—for us to go through periods where we will look out of sorts with the broader market. As we continue to execute our approach with discipline and patience during the inevitable periods when it is out of favor, we will continue to achieve successful and rewarding long-term results for our clients, as we have over the life of our firm.

As always, we appreciate your trust in us and welcome any opportunity to provide more insight and transparency into our process and positioning.

—Litman Gregory Investment Team

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