LITMAN GREGORY ASSET MANAGEMENT

Quarterly Market Review - Q4 2018

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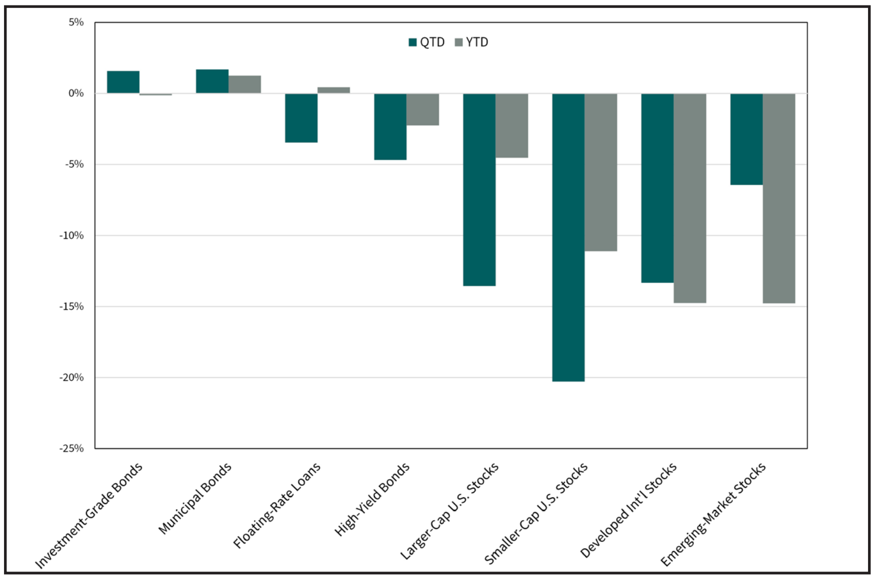
Quarterly **Market Review**

FOURTH QUARTER 2018

From a return perspective, 2018 could largely be considered *the year that wasn't.* Despite a few half-hearted rallies leading into the closing day, global financial markets ended December with the worst annual returns since the great financial crisis. Larger-cap U.S. stocks fell nearly 14% in the fourth quarter, wiping out year-to-date gains and ending down 4.5%. Smaller-cap stocks fared worse, falling 20% in the quarter and 11% for the year. Foreign stocks suffered through most of the year, with mid-double-digit year-end losses for both European and emerging-market stocks (despite their relative outperformance versus U.S. stocks in the fourth quarter).



Source: Morningstar Direct. Data as of 12/31/18.

In addition to the equity market declines, what 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. Even core investment-grade bonds were in the red until the final weeks. It was extremely difficult to make money in the financial markets last year.

The lackluster performance of so many asset classes, culminating with the fourth quarter's dramatic U.S. equity decline, is largely due to the uncertainty that prevailed throughout much of 2018. As the year wore on, early positive market indicators such as still-solid U.S. economic growth and declining unemployment numbers were swamped by investors' fears surrounding ongoing U.S.-China trade tensions, political uncertainties in Europe, and continued Fed tightening, among others.

It was a challenging year for our globally diversified active portfolios, driven by sharp declines in international and emerging stock markets and underperformance from most of our active equity managers. In absolute terms, most investments were negative for the year. However, several of our actively managed bond funds and floating-rate loan funds posted positive returns.

Our fourth quarter portfolio performance also demonstrated the potential risk-management and diversification benefits of our lower-risk alternative strategies and our positions in trend-following managed futures funds, as they outperformed U.S. stocks.

A Consistent Focus

Throughout the history of our firm, we've succeeded on behalf of our clients by emphasizing the importance of having a long-term perspective. With a long-term perspective comes the necessity of discipline and patience in sticking to your investment process and executing it consistently over time rather than being subject to swings in investor sentiment and market consensus, which more often than not detracts from returns versus enhancing them.

While today's headlines may be filled with distress signals and warnings of market weakness, it's worth remembering that just one year ago those headlines boasted 20%-plus global equity gains and historically low market volatility. In fact, most investment strategists expected 2018 would bring a continuation of the synchronized global economic recovery. 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, 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, 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, active managers, and flexible bond funds. 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 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.

Speaking of U.S. stocks, 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 this past quarter) that isn't a sound long-term approach. The multiyear period of U.S. stock market outperformance versus the rest of world is reaching an extreme relative to history. 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 high conviction 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.

Our allocations to foreign stocks also provide our portfolios with diversification away from the U.S. dollar. After the dollar's strong performance the past several years, a U.S. budget deficit not seen outside of recessions or war, and the overvaluation we see in U.S. stocks, we believe the U.S. dollar is a risk factor that investors would be prudent to diversify away from.

In Closing

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. 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 the trust you place in us and encourage you to contact your Wealth Advisor with any questions about your specific situation.

As always, we appreciate your trust in us and welcome questions.

Best regards,

Litman Gregory Research Team

Asset Class **Views**

Asset Class	View	Rationale
Equities		
U.S.	↓	Valuation risk is high given current market levels.
International—Europe	↑	Earnings are likely to improve and be higher than market expectations. Valuations are attractive both in absolute terms and relative to U.S. stocks.
Emerging Markets	↑	Long-term return potential is attractive, but there could be greater shorter-term downside risk.
Fixed-Income		
Traditional Investment-Grade	↓	Very low current yields and the likelihood of rising interest rates imply low potential returns.
Municipal Bonds	↓	Fundamentals are generally improving, but low yield levels make municipal bonds unattractive.
Multisector Income	↑	Mid-single-digit return potential in almost any market environment and an attractive way to mitigate potential risk from rising interest rates.
High-Yield Bonds	↔	Fundamentals are healthy and we expect below-average defaults in the near term. However, in the below-investment-grade space, we prefer floating-rate loans.
Floating-Rate Loans	↑	Strong underlying fundamentals and offers protection from rising interest rates.
Alternative Strategies		
Arbitrage Strategies	↑	Mid-single-digit return potential that offers a degree of portfolio protection and additional diversification relative to stocks and bonds.
Managed Futures	↑	Managed futures have the potential to improve our portfolios' risk/return profile across a wide range of potential outcomes, particularly an equity bear market.

U.S. Stocks

	QTD	YTD
Vanguard 500 Index	-13.55%	-4.52%
iShares Russell 1000 Growth ETF	-15.82%	-1.65%
iShares Russell 1000 Value ETF	-11.66%	-8.42%
iShares Russell 2000 ETF	-20.29%	-11.11%

Source: Morningstar

- Larger-cap U.S. stocks finished the year in negative territory for the first time in nine years. Losses were punctuated by a near 20% peak to trough decline in the fourth quarter, including a near 10% loss in December, the worst December performance since 1931.
- Smaller-cap U.S. stocks fared worse than larger caps, losing 20% in the fourth quarter and 11% for the year.
- Overall, we continue to view the U.S. stock market (both larger caps and smaller caps) as overvalued and unattractive relative to the risks looking out over the next several years. As such, we remain underweight to the U.S. market.

Developed International Stocks

	QTD	YTD
Vanguard FTSE Developed Markets ETF	-13.34%	-14.75%
Vanguard Total International Stock Index	-11.70%	-14.44%

Source: Morningstar

- Developed international stocks struggled again this year, beset by macroeconomic and political uncertainty across the eurozone.
- A rising dollar was once again a headwind for U.S. dollar–based investors in international stocks as the euro fell roughly 5% versus the U.S. dollar.
- International stocks continue to confront near-term challenges—a stronger dollar, uncertainty around Brexit, a global economic slowdown. However, these fears are largely reflected in stock prices. If sentiment improves, we believe European stocks can surprise on the upside.

Performance as of 12/31/18. The funds and indexes are listed for illustrative purposes only as market indicators.

Emerging-Market Stocks

	QTD	YTD
Vanguard FTSE Emerging Markets ETF	-6.43%	-14.77%

Source: Morningstar

- Emerging-market (EM) stocks struggled as well, ending the year down nearly 15%. However, much of their underperformance came earlier in the year, as they actually held up relatively well versus U.S. stocks in the fourth quarter.
- Uncertainty around U.S.-China trade negotiations, a rising U.S. dollar, and an economic slowdown in China continue to weigh on EM equity performance. However, similar to international stocks, we believe these fears are largely reflected in stock prices.
- Using what we believe are conservative assumptions with respect to earnings growth and valuation multiples, we think EM stocks can generate mid- to high-single-digit annualized returns over our five-year investment time horizon.

Performance as of 12/31/18. The funds and indexes are listed for illustrative purposes only as market indicators.

Investment-Grade Bonds

	QTD	YTD
Vanguard Total Bond Market Index	1.59%	-0.13%

Source: Morningstar

- Core bonds, which typically perform well when stocks do poorly, had losses for the year through November. However, a strong rally in December resulted in flat returns for the year.
- Credit-oriented sectors of the bond market sold off in the fourth quarter given their higher correlation to stocks. However, our analysis suggests still strong underlying fundamentals for the U.S. economy, which we believe is supportive of credit-oriented fixed-income.
- Our return expectations for U.S. core bonds remain muted given the low yield environment and our expectation that interest rates will rise modestly in the coming years. As such, we remain overweight to flexible fixed-income strategies we believe can generate higher returns and better manage their sensitivity to rising interest rates.

Municipal Bonds

	QTD	YTD
Vanguard Intermediate-Term Tax-Exempt	1.67%	1.25%

Source: Morningstar

- A generally healthy economic backdrop in the form of rising GDP, low unemployment, and rising home values should support municipal debt.
- Our outlook for municipal bonds and core investment-grade bonds is similar. The return potential for municipal bonds is limited given the very low yield environment and current tax reform. We prefer flexible and absolute-return-oriented bond funds.

Performance as of 12/31/18. The funds and indexes are listed for illustrative purposes only as market indicators.

High-Yield Bonds and Floating-Rate Loans

	QTD	YTD
ICE BofA ML U.S. Cash Pay High Yield TR USD	-4.67%	-2.26%
S&P/LSTA Leveraged Loan Index	-3.45%	0.44%

Source: Morningstar

- Floating-rate loans, whose coupons adjust with changes in interest rates, suffered sharp outflows in the fourth quarter, which weighed on performance.
- We view the fourth quarter price action in loans as temporary and more technical in nature. And, given the much higher yields currently offered by floating-rate loans, we believe potential returns are very attractive relative to core investment-grade bonds.
- Our preference for floating-rate loans over high-yield bonds is due to the attractive return potential and seniority in the capital structure. We continue to own positions in diversified, high-quality floating-rate loan funds to further benefit from and protect against rising short-term rates and unexpected inflation.

Alternative Strategies

	QTD	YTD
AQR Diversified Arbitrage	-1.80%	2.19%
Arbitrage Event-Driven Fund	-0.67%	-0.15%
AQR Managed Futures Strategy HV	-9.39%	-14.44%
Natixis ASG Managed Futures Strategy	-5.72%	-12.35%
PIMCO TRENDS Managed Futures Strategy	6.35%	2.36%

Source: Morningstar

- The lower-risk arbitrage strategies produced modest gains for the year, outperforming global stocks and U.S. core bonds.
- Our position in a diversified basket of trend-following managed futures funds had a difficult year but did strongly outperform U.S. stocks in the fourth quarter.
- Alternatives continue to play a key role in our portfolios as diversifiers, generating returns that don't move in tandem with stocks or bonds and providing very important risk management characteristics.

Performance as of 12/31/18. The funds and indexes are listed for illustrative purposes only as market indicators.