4th Quarter 2018: Quarterly Recap and Near-term Outlook

I have written, and rewritten, at least three versions of this Quarter's *Recap and Near-term Outlook*. In each trash-binned version, I spun a clever tale of why Q4, and all of 2018, was not so bad in a historical context. I offered the appropriate financial planning platitudes; the importance of a long-term focus, staying the course despite short-term setbacks, that attempts to time the market most often fail, that diversification does not always work in the short-run but remains crucially important in the long-run. I provided historical analysis of how 2019 should, with high probability, be a better year simply because of 2018's set-backs.

When Long-Run Themes Fail in the Short-Run

All had the luxury of being true. Each version was exactly what a big name, big bank, traditional, sales-centric firm would produce. As a sole-practitioner, there is safety, comfort, in doing things, saying things, being a "way", simply because those are the things, and that is the way, big firms do them. Being different, going one's own way, is risky, and uncomfortable.

But each version was an inauthentic version of me, of how I think, of how I communicate. Despite working very hard to build a very different experience for investors — small, independent, responsive, rigorously honest, client-centric — I can forget to embrace what it means for me to also be different. So, at the risk of appearing pert, what follows is a wholly authentic discussion of Q4 and 2018. I knowingly accept the "uh-oh" that you just said to yourself in your head. But I believe, for this *Recap*, the rigorously honest approach is the best approach.

Q4 Quarterly Recap

That sucked. At best, it merely felt like it sucked. There it is.

The concerns raised in last quarter's *Near-term Outlook* reached a boiling point. During Q4, fallout from the populist economic agenda undertaken by the Trump administration and Senate/House leadership — poorly thought-out tax-cuts, mounting data that tactics regarding global trade and tariffs are affecting global GDP, record fiscal spending, record budget deficits, record debt issuance, the Federal Reserve unwinding its $4+ trillion dollar balance sheet, its effect on rapidly rising interest rates, risk of yield-curve inversion, government shutdown, and too many geopolitical risks to list — caused investors to lose faith in, and ultimately unwind trades supporting, the global economic growth thesis. Investor risk appetite evaporated. And within days, indiscriminate selling lead to the abandonment of even the most well-reasoned investment plans.

Lake Jericho's primary investment thesis, since the early months of 2015, has been continued global economic growth out from the depths of the great recession. We had been positioned for sustainable

global growth rates, slightly higher rates of growth in international markets, particularly emerging economies, the slow normalization of interest rates by the world's central bankers, and a soft U.S dollar.

Versus our peers, Lake Jericho leaned more heavily into the global economic growth thesis via significant over-weights to international investments, small- and mid-sized companies, and somewhat beaten-down cyclical sectors via our value-oriented biases. These strategies each significantly lagged simple, unsophisticated portfolios of large, U.S. company stocks during 2018. Two of the strategies lagged by the deepest and the longest measures in modern investment history. As the global economic growth thesis succumbed to mounting selling pressure, Lake Jericho managed/advised portfolios significantly underperformed versus peers.

As measured by the S&P 500® Index, the late Q3 market peak to the Christmas Eve market low took only about 12-weeks, and resulted in a loss of about -19.8%. While this escaped the technical definition of a bear market decline (-20%), the speed and the depth of the decline did feel *exactly* like a bear market.

And volatility returned with a vengeance. Especially in December, as the S&P 500® gained or lost more than 1% in 10 of the month's 20 trading sessions, ending the month with a loss of -9.03%. In all of 2017, a daily gain or loss of more than 1% occurred only 8 times. Both the Dow Jones Industrial Average and the S&P 500® had their worst December performance since 1931, when stocks were battered during the Great Depression.

As Lake Jericho client portfolios are, most typically, balanced, globally diversified strategies that incorporate varying combinations of multiple asset types, each asset type has a significant impact upon returns. Reviewing those asset types below, you begin to see where, and how, Lake Jericho so widely underperformed during 2018. Atop the following page, we present the Morningstar, Inc. Target Risk Portfolio Series of benchmarks, for a comprehensive, and relative performance comparison against balanced, globally diversified strategies.

- The S&P 500® Index, a broad market index of the 500 largest U.S. companies, finished Q4 with a total loss of -13.53%, for a 2018 annual loss of -4.39%.
- The Dow Jones Industrial Average, a measure of 30 "blue-chip" U.S. companies, finished Q4 with a total loss of -11.31%, for a 2018 annual loss of -3.48%.
- The technology and consumer-cyclical heavy NASDAQ Composite Index lagged other broad-market indices during Q4, with a total loss of -17.29%, for a 2018 annual loss of -2.84%.
- After leading their large-company counterparts for much of 2018, small- and mid-sized U.S. companies reversed course significantly during the second half of the year. One measure of performance of small- and mid-sized companies, the Russell 2500™ Index, finished Q4 with a total loss of -18.49%, for a 2018 annual loss of -10.00%.
- International developed markets, as measured by the MSCI World (ex-U.S.) Investable Market Index, finished Q4 with a total loss of -13.28%, resulting in a 2018 annual loss of -14.68%. International emerging markets, as measured by the MSCI Emerging Markets Investable Market Index, finished Q4 with a loss of -7.43%, leaving the index with a loss for 2018 of -15.04%.
- Bond markets, in the face of increased interest rate volatility, provided a bit of shelter for investors during Q4, reversing the effects of what had been rising rates throughout 2018. The Bloomberg Barclays U.S. Aggregate Bond Index finished Q4 with a total return of 1.64%, leaving the 2018 annual return positive at +0.01%.

Statistically, 2018 was not an outlier in terms of normal patterns of up-years and down-years in investment markets. But Q4 was one of the most dramatic single-quarter declines in U.S. markets in decades. What then, and how, are we to think of the current political and economic environment? Has the return to historically normal levels of volatility changed our approach? How are we to invest, successfully, in 2019?

Morningstar, Inc. Target Risk* Portfolio Series

Benchmark Comparisons For All Periods Ending December 31, 2018

Target Risk Portfolio	Q4 2018	YTD 2018	1 Year	3 Year Total Return	5 Year Total Return
Conservative	-1.24%	-1.20%	-1.20%	10.65%	13.36%
Moderately Conservative	-4.09%	-2.87%	-2.87%	14.87%	18.54%
Moderate	-6.81%	-4.76%	-4.76%	18.56%	22.13%
Moderately Aggressive	-9.67%	-6.74%	-6.74%	22.20%	25.22%
Aggressive	-12.03%	-8.17%	-8.17%	24.68%	27.69%

* The Morningstar Target Risk Index family is designed to meet the needs of investors who would like to maintain a target level of equity exposure through a portfolio diversified across domestic, international, and emerging market equities, bonds and inflation-hedged instruments. The Morningstar Conservative Target Risk Index seeks approximately 20% exposure to global equity markets. The Moderately Conservative Index seeks approximately 40% exposure to global equity markets.. The Moderate Index seeks approximately 60% exposure to global equity markets. The Moderately Aggressive Index seeks approximately 80% exposure to global equity markets. The Aggressive Index seeks approximately 95% exposure to global equity markets. Benchmarks are constructed with no management fees, and with no transaction costs, while Lake Jericho portfolio performance is actual performance, net of all fees, including investment management, administration, and transaction expenses.

The past decade lulled even the most cynical among us into a sense of entitlement to positive annual returns. But market pullbacks occur, and they do so more often than we are currently prone to realize. We are naturally prone to most clearly remember recent experiences, such as the positive annual S&P 500® returns from 2009 through 2017. So accustomed to low volatility and positive returns are we, that we can easily be possessed of a sense of something due us by the markets. But that is simply recency bias on display, as we are far less prone to clearly recall distant events, such as how we had to climb from the depths of the great recession, and 2008's S&P 500® annual loss of -37.00%.

2018 then, comparatively, was not that bad. But after a decade of rare calm, 2018 should be a gut-check, an overdue reminder, that this is what markets normally do. Most of the time, markets go up. Which is why we commit to a long -run thesis, and tend to remain fully invested, unless and until we are convinced that something significant has changed. But sometimes markets go down. Occasionally markets go down a lot. And on more rare occasions, markets go down a lot and do so quickly. Downturns are sometimes short lived (2008, January/February of 2016). Downturns sometimes persist for many years (2000-2002). Sometimes downturns will precede a recession. Most times downturns do not. All of that is insultingly obvious, yes. But it is an obvious way to illustrate that there are different "types" of markets, and different types of markets necessarily require different approaches to remain successful.

Near-term Outlook

Rather than spend this Quarter's *Near-term Outlook* discussing specific economic and investment risks, I believe it more important this Quarter to highlight a few observations from the 2018 experience, what I learned, and changes made to better manage downside risks, whatever they might be, in your portfolio.

- Invest for the market that you have, rather than the market that you think you should have: Hind-sight being 20/20, I now clearly see early warning flashes by a number of technical indicators, late in Q3 and into the first days of October, that we were likely not in for a typical bull market correction. I could not have been more wrong in my October 11 email to you, in which I suggested that we were. Those first early warnings, to the first downward leg, was measured in days, rather than the typical weeks, or months. By the time secondary indicators provided confirmation, we were firmly into correction territory, and much of the damage had been done. In short, fundamental models fail us when markets are driven entirely by behavioral biases and emotional responses.

Although I put much more weight on fundamental analysis than I do technical analysis, as technical indicators are largely a derivative of investor behaviors rather than objective facts, technical analysis does provide valuable insight and, in certain market conditions, does possess great utility. What is clear to me, as a result of the 2018 experience, is that we are in a market cycle that is driven more meaningfully by investor sentiment and behavioral biases than it is driven by company and market fundamentals. As such, I have incorporated a series of technical indicators (each as a confirmation source of the others) that will guide Lake Jericho as we move from our typical "low-transaction" approach towards an approach far more responsive to the types of signals displayed during 2018.

- Long-run themes can fail investors in the short-run: While I remain confident in the continued global growth thesis long-term, as I believe that the fundamentals supporting this thesis remain intact, as long as daily Tweets undermine faith in that thesis then investment choices made in support of that thesis will suffer. Economist John Maynard Keynes once said "The market can remain irrational longer than you can remain solvent."

  Although I am not prepared to abandon the continued global growth thesis, from mid-December to mid-January I made a number of significant changes within client portfolios that enable Lake Jericho to adapt more quickly to changing market conditions. When looking at December 31, 2018 account statements, you are likely to see larger than typical cash positions in your portfolio. This was the result of our eliminating many non-core positions, as we transitioned to fewer holdings with higher core allocations and with fewer, but more concentrated, satellite positions. Portfolios remain balanced, globally diversified portfolios. But we are reaching our desired exposures with far fewer positions. Heeding Keynes advice, rather than continue to fight, and to suffer, an irrational market, we are now far more nimble, and able and take advantage of the irrational moves by others.

- The trend is your friend: With robust technical indicators in place to capably identify trends, or more importantly change in trend, and with fewer holdings in portfolios, we are better positioned to quickly "dial up" or "dial down" risk depending upon changes in trend. You will see more activity in this regard than you have historically seen from Lake Jericho. We certainly do not consider our improved approach to be market timing in the traditional sense. The research on that subject is overwhelming, and if I ever tell you that I can time the market successfully, you should immediately fire us. However, we will now respond more often, and more meaningfully, to changing trends in markets, and asset classes, when indicators instruct and confirm. As well, we will more often employ various hedging strategies to provide additional downside protection for client portfolios.

As always, I am available at any time, any day of the week, to discuss specific portfolio performance questions. Until then, be well, enjoy the rest of your week, and thank you!

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Lake Jericho, LLC

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