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January 17, 2019

## 2018 Year End Review

*Across the board, it was an extremely challenging year to make money in the financial markets.*

U.S. and global stocks dropped sharply in the last quarter, capping a year marked by turbulence and losses across most asset classes. Among investors' worries are signs of a global economic slowdown, exacerbated by ongoing Federal Reserve monetary tightening, U.S.-China trade tensions, and political uncertainties in Europe (Brexit, Italy) and the United States.

After tumbling 7% in October and then stabilizing in November, U.S. stocks fell again in December as investors reacted negatively to the Fed's language surrounding

its 25-basis-point rate hike (Vanguard 500). While the Fed's updated forecast implied one fewer rate hike in 2019 than previously communicated (two instead of three), Fed chair Jerome Powell gave no indication it would ease up on its balance sheet reduction program (rolling off hundreds of billions of maturing assets purchased during quantitative easing), nor that a pause in rate hikes was imminent (although he didn't rule it out). As one commentator summed it up: "This was a more dovish Fed, but not dovish enough for the markets."

Larger-cap U.S. stocks dropped 9% in December and fell 13.6% for the quarter (its worst quarter in seven years). For the year, U.S. stocks were down a more modest 4.5%. The negative year broke the S&P 500's remarkable nine-year run of positive returns. Smaller-cap U.S. stocks fell more sharply, losing 20% in the fourth quarter and 11% for the year (iShares Russell 2000 ETF). Foreign stocks struggled as well, with developed international markets and emerging markets both down 14.8% (Vanguard FTSE

December Benchmark Returns			
	MTD	QTD	YTD
<b>EQUITY BENCHMARKS</b>			
Vanguard 500 Index	-9.0%	-13.6%	-4.5%
iShares Russell 1000 ETF	-8.9%	-13.7%	-4.9%
iShares Russell 1000 Value ETF	-9.4%	-11.7%	-8.4%
iShares Russell 1000 Growth ETF	-8.4%	-15.8%	-1.7%
iShares Russell 2000 ETF	-12.0%	-20.3%	-11.1%
Vanguard REIT	-8.0%	-6.5%	-6.1%
iShares MSCI ACWI ETF	-7.2%	-12.7%	-9.1%
Vanguard FTSE Developed Markets ETF	-5.7%	-13.3%	-14.8%
Vanguard FTSE Europe ETF	-4.8%	-12.9%	-14.9%
Vanguard FTSE Emerging Markets ETF	-3.3%	-6.4%	-14.8%
<b>FIXED-INCOME BENCHMARKS</b>			
Vanguard Total Bond Market Index	1.8%	1.6%	-0.1%
Vanguard Intermediate-Term Tax-Exempt	1.2%	1.7%	1.3%
iShares TIPS Bond ETF	0.5%	-0.5%	-1.4%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	-2.2%	-4.6%	-2.3%
S&P/LSTA Leveraged Loan Index	-2.5%	-3.5%	0.4%
<b>ALTERNATIVE BENCHMARKS</b>			
HFRX Global Hedge Fund Index	-1.9%	-5.6%	-6.7%
Bloomberg Commodity Index	-6.9%	-9.4%	-11.2%
SG Trend Index	1.0%	-5.1%	-8.1%
3-Month LIBOR	0.2%	0.6%	2.1%



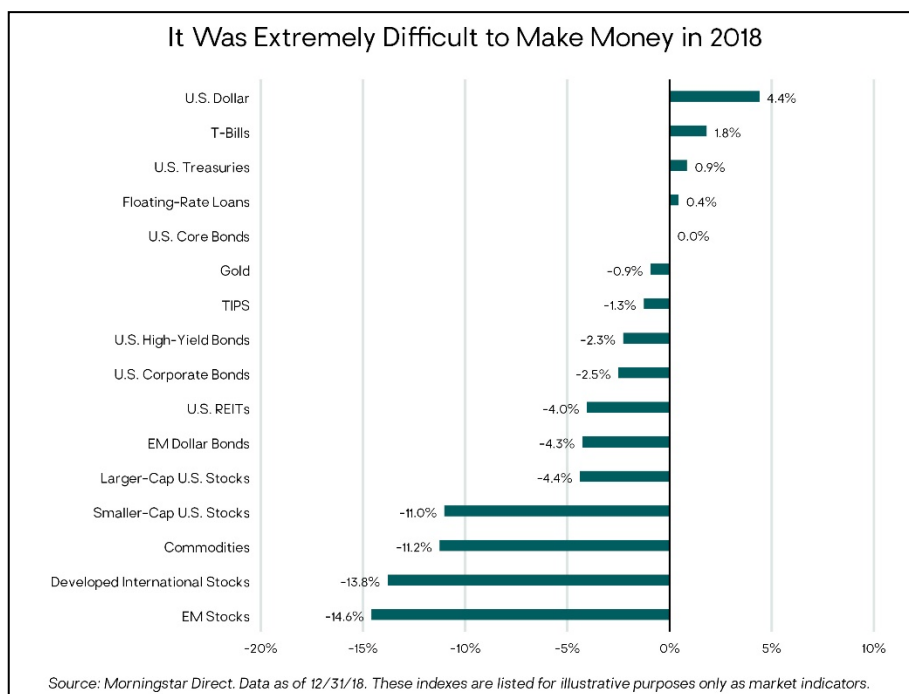
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Developed Markets ETF and Vanguard FTSE Emerging Markets ETF). However, their underperformance versus U.S. stocks came earlier in the year. In the fourth quarter, emerging-market (EM) stocks beat U.S. stocks by seven percentage points, while developed international stocks matched the U.S. market's return.

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. (And don't forget cryptocurrencies: Bitcoin plunged 72% for the year.) A study done by Deutsche Bank in mid-November noted that 90% of the 70 different asset classes they track were posting negative returns for the year. This was the highest percentage of losers in the study's 100-year history. Our chart below shows the year's performance of sixteen different asset classes.

Core bonds, which typically perform well when stocks do poorly, had losses through November (Vanguard Total Bond Market Index). But a strong rally in Treasury bonds in December resulted in a flat return for the year. Only the U.S. dollar index and U.S. Treasury Bills (T-Bills) had a return above 1%. And after adjusting for inflation, T-Bills' real return was negative as well.



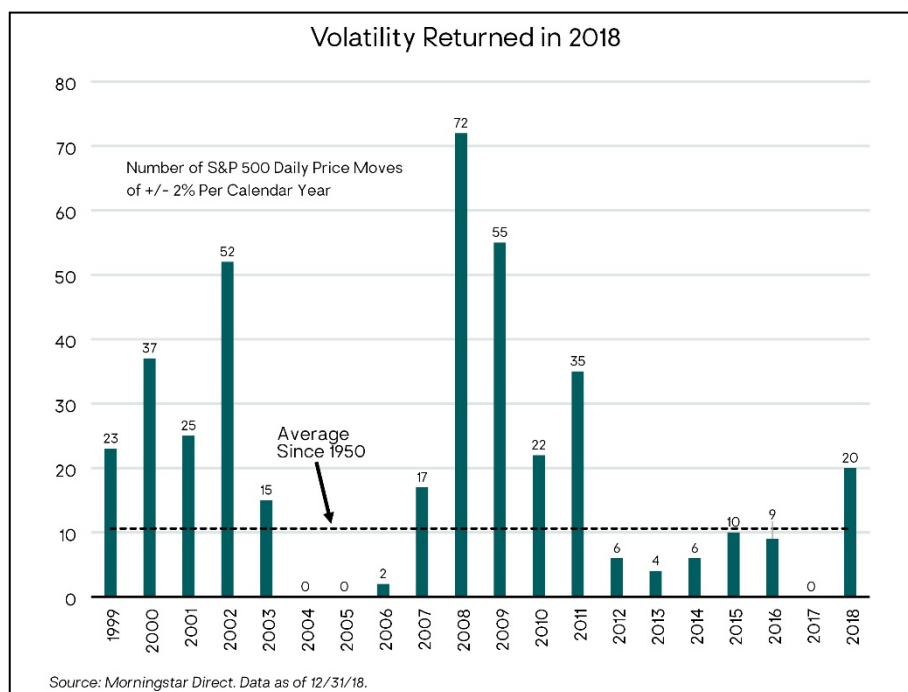
The contrast with 2017's strong market results is also striking—and serves as a useful reminder of the unpredictability of markets. It may feel like ancient history, but it was only a year ago that we were reporting 25% to 30%-plus returns for international and EM stocks. U.S. stocks were tallying 20%-plus gains, market volatility was at a historical low, daily market price swings were exceptionally muted, and losses were few.



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Most investment strategists expected 2018 would bring a continuation of the synchronized global economic recovery. The sharp market pullbacks this year were contrary to the 2017 year-end consensus (just as 2017's unusually strong returns were a surprise after a difficult 2016) and only reinforce our view that no one can consistently predict short-term market moves.



It also reinforces the importance of maintaining a balanced and contrarian perspective: *when an outlook becomes the overwhelming consensus view, you should assume it is already reflected to a strong degree in current financial market prices.* Extremely high (or extremely low) asset prices and valuations are already discounting extremely optimistic (or extremely pessimistic) outcomes. Those circumstances can create opportunities for fundamental, valuation-driven, long-term investors such as ourselves and many of the active managers with whom we invest.

## Looking Back: Key Drivers of Our 2018 Portfolio Performance

While we'd never predict what the stock market will do in any given year, U.S. stocks' poor performance in 2018 wasn't a particular surprise to us. Our portfolios have been positioned for these expected returns from U.S. stocks for a while. This is based on our "medium-term" (five- to 10-year) forward-looking analysis of valuations, normalized earnings growth, and dividend yield, across a range of scenarios we view as reasonably likely or plausible.



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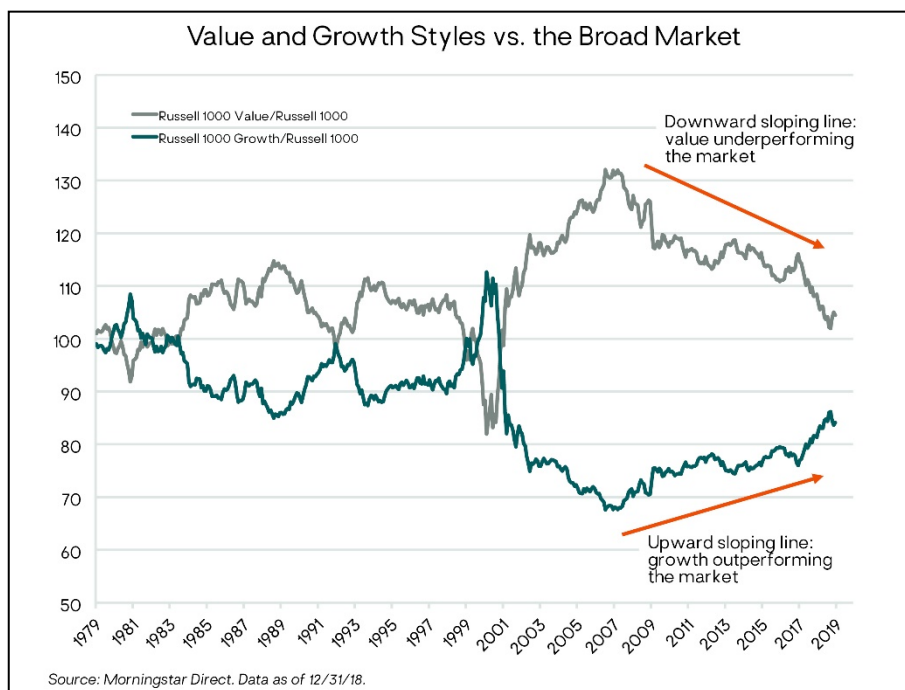
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It was a very challenging year for globally diversified active portfolios, driven by sharp declines in international and emerging stock markets and underperformance from most active equity managers. U.S. equity growth-oriented managers were a small bright spot of positive returns. Value-oriented managers struggled, though, continuing a multiyear trend we have commented on before. By some measures the disparity in performance of growth versus value stocks is now at an extreme not seen since the peak of the tech stock bubble in 2000.

*We don't believe this divergence is sustainable. We believe that like most market cycles, this one will turn again (but the precise timing is uncertain and unknowable). The analogy of a*

*rubber band only being stretched so far before it snaps back is a good one. We believe value investing remains a sound and profitable *long-term* investment approach. And based on our ongoing due diligence, we remain confident in the expertise and skill of the active managers with whom we are invested.*

The multiyear period of U.S. stock market outperformance versus the rest of world is also reaching an extreme relative to history. We don't believe this trend is sustainable either. The last 10 years' performance is certainly not going to repeat over the next 10 years. As with value investing, we don't believe global equity investing is dead or destined to perennially underperform the U.S. market. And as noted above, during the market rout in the fourth quarter there were some glimmers that this cycle may







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be in the process of turning, with EM stocks outperforming the S&P 500 by seven percentage points and developed international stocks performing in line with U.S. stocks.

## Looking Ahead: Investment Outlook(s) and Time Horizon(s)

We've emphasized the importance of having a long-term perspective in becoming a successful investor. In fact, the terms "long term" and "investor" are inseparable in our mind. With a long-term perspective comes the necessity of *discipline* (sticking to your investment process and executing it consistently over time) and *patience* (the temperament to allow your investment objectives to be realized over time and not be overly sensitive to shorter-term price volatility and portfolio swings that can trigger actions detrimental to achieving your investment goals).

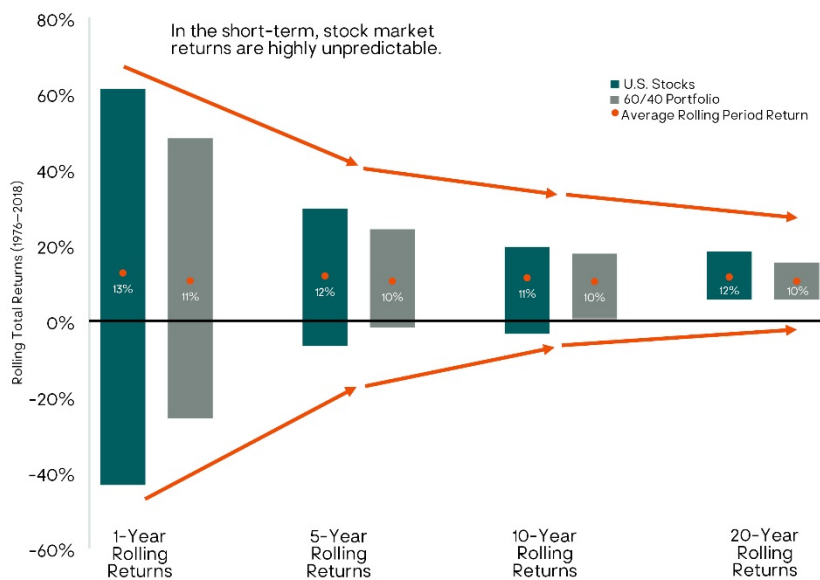
The chart on the next page is a nice representation of why we say our confidence in achieving rewarding investment outcomes increases as one's time horizon extends. As the time horizon lengthens, the range of reasonable expected outcomes narrows, the shorter-term cyclical spikes and dips are smoothed out, and the underlying fundamental/economic drivers of financial asset returns play out.

With that framework in mind, we'll discuss our current outlook on the markets across three distinct time horizons: short, medium, and long term.

### SHORT TERM (12 MONTHS)

Over the next twelve months, uncertainty is high and the range of potential equity market outcomes is wide. There are reasonably likely scenarios that would be very positive for our portfolios given our positioning. And there are scenarios where our portfolios wouldn't do as well. However, we *don't*

The Range of Outcomes Narrows as Your Investment Horizon Extends



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



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*make investment decisions based on a short-term forecast, outlook, or prediction; the uncertainty is too high, the unknowns too many, and the range of potential outcomes too wide for us to have the confidence to do so. But we *do* construct and manage our portfolios to specific short-term downside loss thresholds. This includes stress-testing each portfolio's allocation across a range of short-term scenarios to ensure their exposures to risk are consistent with each portfolio's defined risk objective.*

As such, we will highlight two divergent short-term macro scenarios: one bullish for stocks and one bearish. Each scenario reflects the 2019 outlook of a highly respected, independent, macroeconomic investment research firms BCA Research and Capital Economics. We think either of these scenarios has reasonable odds of playing out (as well as any number of variations on them). But each has very different implications for investment returns.

## **BCA's Bullish Scenario**

In a nutshell, BCA sees slowing but still solid U.S. economic growth next year. They expect a *reacceleration of global growth in the second half of the year*, as the effects of more aggressive Chinese fiscal and monetary stimulus kick in and the drag from tight financial conditions dissipates. Given solid U.S. growth and further unemployment declines, they expect the Fed to continue its gradual path of interest rate hikes—several more hikes next year than the market currently expects. As such, they see the U.S. dollar strengthening until the middle of the year (due to stronger U.S. growth and higher U.S. rates relative to the rest of the world), but then weakening as growth outside the U.S. reaccelerates. They believe asset markets have already discounted the deceleration of growth they expect to see in the first half of the year. In this scenario, a U.S. recession is unlikely until late 2020. If so, “this will provide enough time for a blow-off rally in stocks starting in mid-2019.”

Their broad expectations for financial assets in 2019 are as follows: Global equities will generate low double-digit returns. Cyclical/value stocks will outperform more defensive stocks, driven by a strong second half of the year. International and EM stocks (which are undervalued and have more cyclical exposure) will likely outperform U.S. stocks during this period. A declining dollar will be an additional tailwind to dollar-based investors in foreign markets. Meanwhile, core bond returns will be hurt by rising interest rates and credit-oriented bond funds will outperform.

## **Capital Economics Bearish Scenario**

Capital Economics is not forecasting a U.S. recession in 2019, but they expect the economy to slow “sharply” due to tighter monetary policy and the fading boost from the 2018 tax cuts. They estimate the Fed will hike rates two more times in early 2019 but begin *cutting* rates in 2020. They expect the Chinese economy to lose momentum but then stabilize by the middle of the year due to monetary and fiscal stimulus. Overall, they expect slower global growth than the consensus expects, driven by slowing global demand and tighter financial conditions. However, they don't see a repeat of the EM crisis fears that gripped the markets in 2018. They expect the U.S. dollar to weaken as Fed rate cuts come into view while other major central banks remain on hold.



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The implications for financial assets in 2019 are as follows: U.S., international, and EM stocks will all have losses next year. Despite their lower valuations, foreign markets will be dragged down by falling U.S. stocks, but U.S. stocks will experience the steepest declines. Core bonds should do okay. The dollar will remain strong for much of the year, but then weaken as the 2020 Fed rate cuts come into view.

In many ways, the Capital Economics scenario is a less severe version of our 12-month stress-test “reasonable worst-case” bear market scenario. (And in some respects, the BCA scenario might be thought of as a 12-month “reasonable best case.”) As we’ve discussed many times before, this type of bear market scenario would likely be negative for our portfolios in the short term, despite our modestly underweight overall equity positioning. That is why we call it a “reasonable worst-case” scenario. But the key point is that our analysis shows the potential 12-month loss in such a scenario to be *consistent with the stated downside risk threshold for each type of portfolio we manage*.

## **MEDIUM TERM (5–10 YEARS)**

As we extend the time horizon to the medium term (5–10 years, closer to the length of a typical market cycle), our confidence in analyzing potential financial market returns increases meaningfully. This creates opportunities to *tactically tilt* our portfolio to asset classes and strategies where we believe the investment odds are strongly in our favor. We may also under-allocate to areas where the risk-return profile is very unattractive (high risk/low return) based on our analysis.

Presently, we have an increasing level of conviction that European and EM stocks could earn *significantly higher returns than U.S. stocks over the medium term*.

We’ll focus here on our constructive tactical views on Europe and emerging markets, since these markets were particularly challenging in 2018 and, not coincidentally, sentiment toward them seems quite negative.

## **Europe**

As shown in the earlier chart, developed international stocks have underperformed U.S. stocks for several years now. This is true for European stocks as well. There have been many factors behind this underperformance, starting from the Greek debt crisis in 2011/12 and continuing with the ECB’s delay in implementing quantitative easing and recapitalizing European banks, Italy’s political and debt concerns, and Brexit. Some of these problems reflect Europe’s ongoing challenge of managing a currency union without a true fiscal and political union. We do think this warrants an additional valuation discount over and above what European stocks have gotten historically versus U.S. equities, and we apply such a discount in our analysis. (It’s possible even this may seem inadequate *in the short-*



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term if Europe were to muddle into a crisis.) But factoring this in, our base case expectation is for a low double-digit annualized return from European stocks over the medium term. This is quite attractive relative to the expected return from U.S. stocks for the same period.

With European headlines showing political disfunction and disappointing growth, and on the heels of a multiyear period of strong U.S. stock market performance, it is natural to question why we should invest in Europe (or international stocks) at all. We recall hearing similar questions in the late 1990s. Back then the United States was in a bull market driven by the Internet and telecom sectors. Europe's market was, and still is, not heavy in tech companies, so it lagged. There were also uncertainties at that time surrounding the formation of the European monetary union (the eurozone). Germany, the largest economy in Europe, was known as "the sick man of Europe." All that was true at that time, but what short-term-focused investors missed was that European equities had become cheap relative to U.S. stocks and Germany was implementing labor reforms that were making it globally competitive. As the cycle turned, our globally diversified portfolios performed very well.

We see something similar happening today. Europe is historically cheap, meaning a lot of the current headline concerns are recognized by the markets and *likely already priced in*. European companies are restructuring and becoming more competitive, which bodes well for future earnings growth. Another part of the reason why Europe has been held back economically since the 2008 financial crisis is it had no program—akin to the United States' TARP facility—to quickly recapitalize its banks. This meant the road to a healthier, better-capitalized banking system was a long and painful one. This weighed on the economy and company-level profits. It's hard to be confident the worst is definitively over. But based on our research, including conversations with international investors we respect, it does appear European banks in general are now much better capitalized and no longer pose the kind of systemic risk that investors continue to worry about and which is reflected in currently depressed stock prices.

## **Emerging Markets**

EM stocks have underperformed U.S. stocks cumulatively the past several years—although it should be remembered EM stocks outperformed in 2016/17. One significant risk factor and an unknown currently weighing on EM stock prices is whether China can unwind the credit-boom excesses in its economy in a non-disruptive way (often referred to as a "soft landing"). China's balancing act has become trickier given growth headwinds related to trade and protectionism gained steam in the second half of 2018. Our base-case return expectation for EM stocks is similar to European stocks, though we are a bit less overweight to EM stocks because of the China debt-related risks.

The risk of an ongoing escalating trade war with the United States is a reason for nearer-term caution. If protectionism really takes hold, it would mean slower global growth and less open markets—both of which are likely more negative for EM stocks. On the other hand, the potential exists for a positive surprise on the trade policy front; if so, EM stocks would likely respond strongly. More broadly, should global growth stabilize and reaccelerate next year (e.g., as in the BCA scenario above), EM stocks are likely to be a primary beneficiary.





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Despite the risks we see over the short to medium term, it's important to stay the course with emerging markets through their inevitable ups and downs. Among the reasons we maintain a positive longer-term outlook on EM stocks are the following:

- Emerging markets offer a vast investment opportunity set that continues to expand and represents a faster growing area of the world compared to developed markets. According to a McKinsey study, EM economies accounted for almost two-thirds of the world's GDP growth and more than half of new consumption over the past 15 years. Faster economic growth is a function of demographics and productivity, areas where EM countries have advantages.
- The rising middle class within EM countries is also an important longer-term trend. Rising incomes in China and other emerging markets should generate significant growth in domestic consumption. McKinsey estimates emerging economies will represent 62% of total global consumption growth between 2015 and 2030. This should translate into significant profits for companies catering to these consumers.

## **LONG TERM (10 TO 20-PLUS YEARS)**

The third time frame relevant for our investment outlook is the long term, which we define as 10 to 20-plus years, encompassing multiple market cycles. This is the time horizon under which we construct our *strategic* portfolio allocations. *Over the long term, we are highly confident of the benefits from owning a globally diversified portfolio* containing a mix of

- (1) longer-term return-generating assets (primarily U.S., international, and EM public equities, but also private equity, private real estate, and other selected private fund investments for clients, where appropriate);
- (2) shorter-term risk-reducing assets (primarily high-quality core bonds); and when appropriate,
- (3) diversifying or hybrid investments (such as selected alternative strategies and absolute-return-oriented and flexible fixed-income funds).

When there are no compelling medium-term tactical opportunities, we invest according to our strategic portfolio allocations. The strategic allocations are constructed to maximize the expected long-term portfolio return for a given level of portfolio risk. *We strongly believe that adhering to a globally diversified portfolio, consistent with one's risk tolerance, temperament, and objectives through multiple market cycles offers the best odds of achieving one's long-term investment goals.* Investment discipline and patience are required as well.

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 clear that isn't a sound long-term investment approach. *The results of the past 10 years are not sustainable, and they won't be repeated over the next 10 or 20 years.*

Global equity diversification makes sense for many reasons. First, it gives investors access to a broad set of opportunities (i.e., different business models and different entities—corporations and sovereigns—tapping into different growth and return drivers across the globe). Second, diversification



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across assets that do not move in tandem with each other (that are not perfectly correlated) smooths the investment experience for investors and as a result, facilitates a long-term approach. Third, a well-diversified portfolio also provides greater flexibility to make tactical shifts in pursuit of higher returns without increasing risk in a material way. So, a broadly diversified long-term portfolio with a medium-term tactical overlay should increase the odds of generating superior risk-adjusted returns.

Global diversification includes having exposure away from the U.S. dollar. Currencies, like many things, move in cycles, sometimes very long ones as history suggests. The dollar has seen extended periods where it has declined relative to other currencies. These periods have coincided with strong foreign stock market performance. 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. A dedicated allocation to foreign stocks achieves this diversification goal.

## Closing Thoughts

The financial markets proved extremely challenging in 2018 across the board. A historically high percentage of markets posted losses for the year. Several stock markets and asset classes fell into official "bear market" territory, dropping more than 20% from their highs. Given our globally diversified approach, our portfolios were not immune. Having said that, in light of the multitude of macro risks (central bank tightening/QE unwinding, slowing global growth, ongoing U.S.-China trade tensions, widespread geopolitical uncertainties), coupled with unattractive U.S. stock market valuations and excessively optimistic earnings expectations, we weren't surprised by the negative year.

No one knows what the next year will bring. We may see some continuation of recent market trends or a stabilization or reversal in some of them. The market consensus will undoubtedly be surprised again. The only certainty is the lack of certainty. But as discussed above, *what we are confident about is our investment approach. With its strategic portfolio foundation and tactical flexibility, we believe it will be successful across market cycles.*

As students of financial market history, we know the headwinds our portfolios have faced over the past five to 10 years will eventually turn to tailwinds. So we stick to our process and maintain our allocations to these areas. This may *feel* uncomfortable. But as long as we remain confident in our analysis and process, that's exactly what's *necessary* to achieve long-term success and avoid the pitfalls of performance chasing and emotionally driven investing.

Related to this, our confidence in the active fund managers with whom we invest remains high, and we are optimistic about their potential for strong performance in the years ahead as the headwinds and trends shift. That said, we continually update our due diligence on our managers and will make changes when appropriate should our conviction wane.

Our portfolios are positioned to perform well over the medium to long term and to be resilient across a range of potential scenarios. Over the short term, if the current recession fears are overdone, we expect to generate strong overall returns. 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 cash that should



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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.

*Successful investing is a process of consistently making sound, well-reasoned decisions over time, and across market and economic cycles.* We believe our diversified, fundamental, valuation-based investment approach meets this definition. As long as we continue to execute our approach with discipline and remain patient during the inevitable periods when it is out of favor, we have no doubt we will continue to achieve successful and rewarding long-term results for our clients.

As always, we appreciate your confidence and trust and we wish everyone a happy and healthy New Year.

Best Regards,

**Robert D. Yarosz**  
Director, President

**Thomas W. Rendl, Jr.**  
Lead Portfolio Manager

*The Compass Asset Management Team*

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