Portfolio Managers Commentary – Q2 2018

"Investment wisdom begins with the realization that long-term returns are the only ones that matter" – William Bernstein

The rock of Gibraltar it ain't

Since the beginning of the decade, problems in Europe have occasionally drifted across the Atlantic. If it's not Greece, it's Portugal. If not Portugal, it might be Italy or Spain. And if not Italy or Spain, Brexit briefly created turbulence in 2016.

More recently cracks in the European financial system have taken a backseat to firmer growth on the continent. But problems are simmering just below the surface. Enter the dysfunctional nature of Italian politics and the two anti-establishment parties that took top honors in an early March election.

A coalition was eventually formed between the two groups, but the president of Italy rejected a finance minister who has expressed doubt about the euro, which unites much of Europe. Concerns the government might ditch the common currency led to a massive spike in Italian bond yields and a global sell-off in stocks at the end of May. We could have seen new twists and turns, but for now cooler heads have prevailed. Bonds yields came off their highs as government officials salvaged the coalition and staved off new elections later this year.

My synopsis is simply a thumbnail sketch of events, but you may be asking, "Why the overview of what is only the latest in decades of dysfunctional Italian politics? Why should I care?" First, it's a reminder that Europe's ongoing financial problems haven't been solved, and what happens in Europe can sometimes trigger uncertainty among U.S. investors…at least temporarily.

Should you be concerned? Well maybe? If you own stocks in the Eurozone, the political and financial issues aren't about to go away anytime soon. During the past few months the ongoing weakness in European stock markets continues.

While Italians aren't clamoring to get rid of the euro, if it were to happen it would have enormous consequences for Italy, which would then reverberate throughout Europe. We'd likely see a run on Italian banks, as citizens moved cash to safer shores. The collapse of Italian banks would roil the European financial system, and its impact would likely be felt around the globe.

Yes, we are interconnected globally but the odds of a *"Quitaly"* or *"Italexit"* - as financial commentators are once again trying to coin a new term - remain low. Yet now it's on the radar.

If nothing else, the drama in Italy is simply a reminder that Europe hasn't solved its financial or political problems.

Crosscurrents

Shorter term, I believe the U.S. and Canadian markets are trying to push higher. The tech-heavy NASDAQ Composite, and key measures of mid-sized and small companies touched new highs recently after the sell-off experienced in February and March.

Much of the underlying momentum can be traced to faster economic growth, rising corporate profits, and still-low interest rates.

Another factor that lends support is companies in the S&P 500 Index repurchased a record $189.1 billion of their own shares in the first quarter, according to S&P Dow Jones Indexes Senior Analyst Howard Silverblatt. He expects buybacks to remain strong through the rest of 2018.

But the Dow Jones Industrials and the S&P 500 Index failed to recapture their January highs. These indexes are made up of the nation's largest companies, some of which derive a significant share of sales from overseas.

Though not far from the January highs, a strong U.S. dollar may be putting modest pressure on these stocks along with some moderation in overseas growth which may also be a factor.

I believe much of the economic uncertainty stems from escalating trade tensions between the U.S. and its major trading partners. Free trade/fair trade - it's a very complex issue that's being fought with simple soundbites. The President believes America has not been treated fairly, and he is using his authority to selectively levy tariffs against offending nations.

It's a risky strategy that may eventually break down barriers. Or, it could escalate into a series of retaliatory measures that impede the U.S. and global economy. You may agree or disagree with the President's actions. But the market, which is collectively made up of millions of large and small investors, hates heightened uncertainty. Tit-for-tat levies increase short-term economic uncertainty. Currently, it has injected volatility and uncertainty into the headline-grabbing major averages. Like many obstacles that will crop up, I believe this will eventually pass.

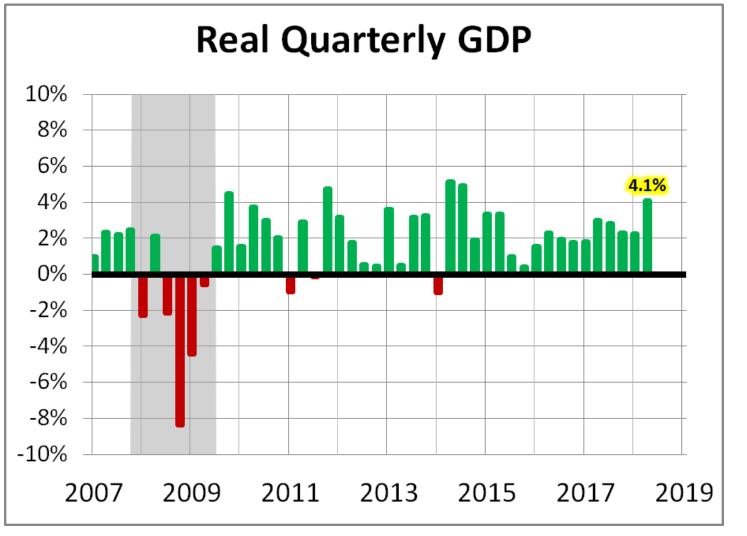
Boom

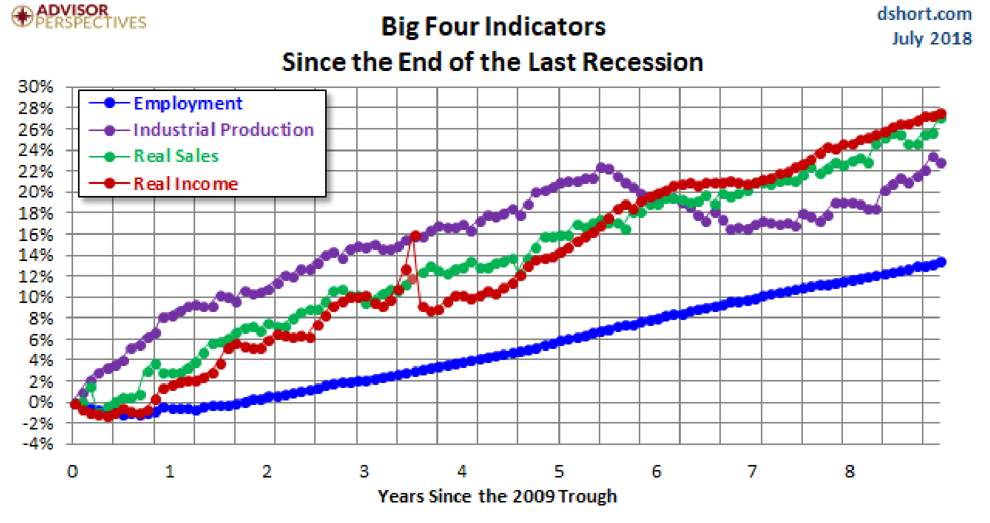
A quick review of the economic data strongly suggests the noise from the trade headlines isn't affecting the U.S. economy and GDP growth.

In the second quarter the expansion kicked into high gear with the U.S. government reporting that economic output expanded at an annual rate of 4.1%, the fastest pace in almost four years.

So far, we see no signs that the economy is about to slow down. The four big economic indicators we monitor are all heading in a positive direction. Employment, Industrial Production, Retail Sales, and Personal Income continue to grow.

Once these indicators start to turn negative then we'll become cautious on the economic outlook and the stock market but until then the expansion should continue.





Risks never disappear, and trade tensions have created unwanted uncertainty, but I am cautiously optimistic that the economy is on firmer ground.

Consumer and business confidence is much higher today than in the past which is an important ingredient for growth. In addition, fiscal stimulus, including the recently passed tax cuts, is still in the pipeline.

Traits of a Successful Investor

This quarter, my goal is to share with you some of the basic building blocks that will put you on the path to becoming a lifelong student of investing. Even the best of the best never stops learning. In fact, being a lifelong student might just be the first principle of becoming a great investor.

Study after study shows that investor performance suffers from some very basic mistakes that should be relatively easy to fix. That being said; below I've listed 5 key principles that I think will be of great benefit to anyone who has capital at risk in the financial markets:

1. **Create a long-term plan and follow that plan**

   "A plan is a bridge to your dreams. Your job is to make the plan or bridge real, so that your dreams will become real. If all you do is stand on the side of the bank and dream of the other side, your dreams will forever be just dreams. First make your plans real and then your dreams will come true."

   —Robert Kiyosaki, the author of *Rich Dad Poor Dad*

   Agreed, but I take exception with one part of the quote. It's not your job to make the plan real. With your input, that's *my* job!

   If we were to go back 50 or 60 years, the choice of investment vehicles was limited. You might choose between stocks, bonds, mutual funds and cash. Still, how might you create the proper balance between these choices? Today, there has been an explosion of investment vehicles. It provides us with choices, but choices create complexity and even confusion for all but the most experienced investors.

We have assisted many of you in developing a long-term financial plan that's designed with your financial goals in mind.

Great investors have a financial plan. It becomes our guide. It is a financial roadmap that puts you on the best path to your financial destination. It is the bridge to your dreams.

2. **Learn to control your emotions**

Successful investors learn how to control their emotions.

Most of us remember Mr. Spock from the original *Star Trek* series. He was half human and half Vulcan. His Vulcan half made him the epitome of rational thought and he rejected emotional responses. I get that he was a fictional character, but none of us can match Mr. Spock's steely devotion to logic.

However, we don't need to be as stoic as Mr. Spock if we have a well-thought-out financial plan. The plan is grounded in empirical research. It provides us with boundaries. It keeps us on track when storm clouds gather.

We recognize the plans we recommend are not bulletproof, but we are confident they put people on the best long-term path for reaching their goals.

I also know that when volatility strikes, some folks take it in stride while others want to take a detour from the plan. They are tempted to react emotionally. I get it, I really do.

While heading to the safety of cash may feel good in the short term, I've seen the anguish of those who have opted for the sidelines near a market bottom and then watch in dismay as shares began to climb. Remember, longer term, markets rise in most years.

Recall 2008. According to a Fidelity study, "Investors who stayed in the markets saw their account balances - which reflected the impact of their investment choices and contributions - grow 147%" between Q4 2008 and the end of 2015.

"That's twice the average 74% return for those who moved out of stocks and into cash during the fourth quarter of 2008 or first quarter of 2009." Stocks bottomed in early March. Even worse, over 25% who sold out of stocks during that downturn never got back into the market.

The opposite is true, too. Don't become overconfident when stocks are surging. Some folks begin to feel invincible and are tempted to take on too much risk. It gets them into trouble, too.

Sticking with the plan helps to avoid mistakes that can be costly in the long run. If you feel too much distress during times of volatility, let's talk and see if your tolerance for risk has changed.

3. **Become disciplined and be patient**

   Like the control over emotions, a financial plan helps to enforce discipline. By design, the plan puts you on a gradual path to wealth accumulation, which encourages patience. There are no shortcuts.

   We are open to innovation and empirically verified research, but I would caution you to be very careful about what I call the "flavor of the month." Remember the dot-com boom? Like shooting stars, fast-growing companies soared into view for a brief period before fading into obscurity.

   The legendary investor Warren Buffett sticks to what he knows best and invests over a very long-time horizon. His disciplined approach and his patience have brought him rich rewards.

4. **You must diversify**

   Here's a principle I live by: a one-investment portfolio is too risky. Diversifying among stocks, bonds, cash, real estate, and commodities doesn't guarantee there won't be short-term losses, but it greatly reduces risks and allows you to participate in investments that are rooted across the global economy.

5. **Never lose a healthy level of skepticism**

   A good investor asks questions. Following simple but time-tested principles can prevent fraud.

   Be wary of investments that promise riches or offer returns that are too good to be true. Today, a con artist won't use the phrase "get rich quick."

> But you will see ads that hype strategies that have quickly turned a meager sum of cash into a big pile of wealth. Such claims should be viewed with a healthy level of suspicion. If these strategies worked, wouldn't high-powered institutional investors implement them? They don't.
>
> If you come across such a tempting scheme, please ask me to review it. I promise to offer you an objective analysis and I'll point out advantages, if any.
>
> More importantly, I'll counsel you on the questions you need to pose to those who are asking for your trust. I can't begin to tell you how much it pains me when I see someone get scammed.

Let me sum this up by getting back to what is the foundation, or the cornerstone, of becoming a skilled investor. I mentioned it just as we began. Become a lifelong student. Never stop learning and immerse yourself in the principles I have shared.

I hope you've found this review to be educational and of value. Once again, let me emphasize that it is my job to assist you! If you have any questions or would like to discuss any matters, please feel free to give me or any of my team members a call.

Thank you very much for the trust and confidence you've placed in my team and my firm.

Sincerely,

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Market Commentary

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