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Understanding Recent Performance

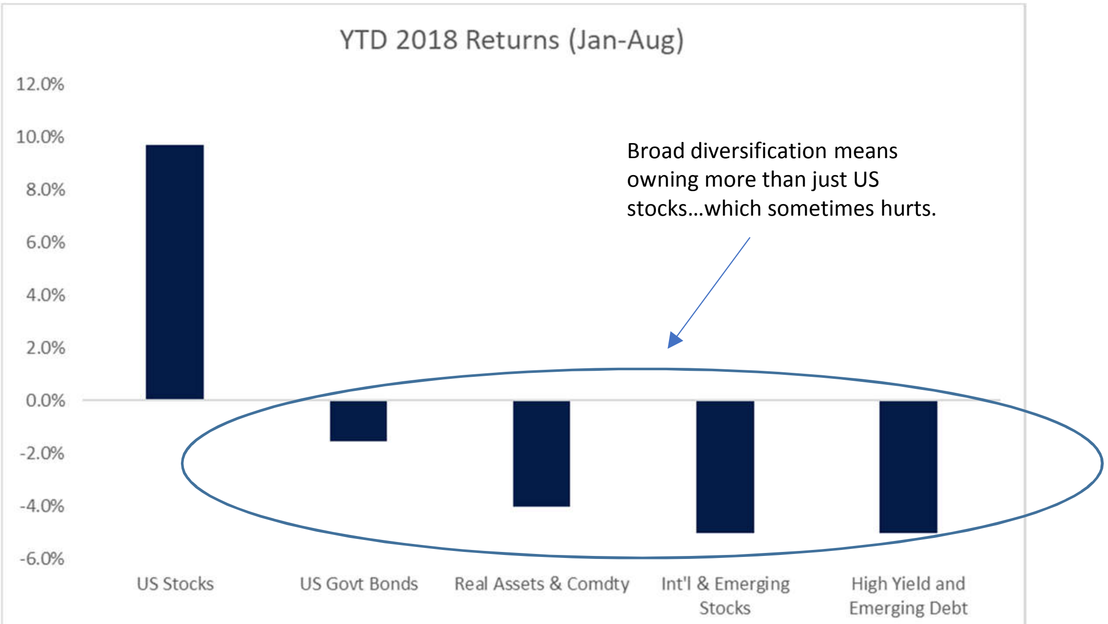
- We manage an “institutional-style” diversified portfolio.

- The hallmarks of this approach include
    1. broad diversification (i.e. stocks, bonds, real assets and commodities)
    2. global exposure (international and emerging market…not just U.S.)
    3. downside-risk management

- While a diversified portfolio is the best long-term plan, it can (like recently) have periods of short-term disappointment (especially compared to a single asset class like US stocks).

When Diversification Disappoints

US stocks have outperformed every other asset class in 2018



Observations:

- In 2018, US stocks have outperformed every other major asset class by a wide margin.
- Despite overweighting US stocks, our broader diversification hurt performance.
- This dramatic US outperformance was largely due to US trade war rhetoric (hurting other assets) while large US tech stocks experienced a huge rally.

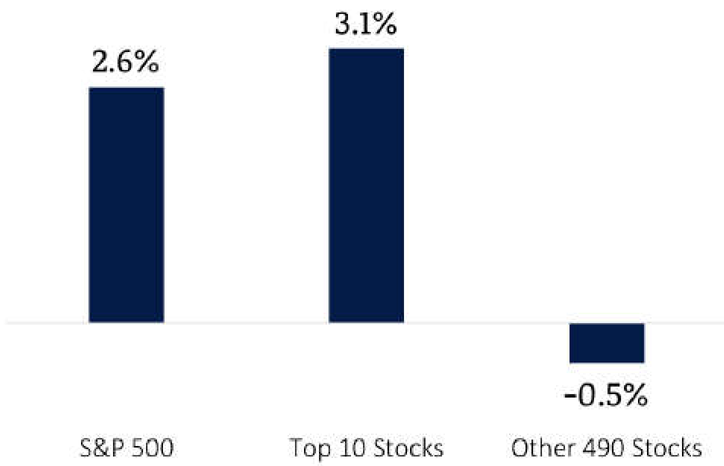
SOURCE: BLOOMBERG

US Stocks = S&P 500
Real Assets & Commodities = 1/3rd SPDR S&P Global Natural Resources ETF (GNR) + 1/3rd iPath Bloomberg Commodity Index ETN (DJP) + 1/3rd ETFS Physical Swiss Gold Shares (SGOL)
Int'l &* Emerging Stocks = 50pct Ishares MSCI EAFE ETF (EFA) + 50pct iShares MSCI Emerging Markets ETF (EEM)
US Govt Bonds = 25pct Ishares 20+ Year Treasury Bond ETF (TLT) + 25pct Pimco 15+ US TIPs (LTPZ) + 25pct iShares 7-10yr Treasuries (IEF) + 25pct iShare Tip Bond Fund (TIP)
High Yield & Emerging Debt = 50pct iShares High Yield Bond Fund (HYG) + 50pct VanEck JP Morgan EM Local Currency Bond Fund (EMLC)
All returns presume monthly rebalancing, no transaction or other expenses. For educational purposes only

When Diversification Disappoints – Part 2

Even Diversifying ACROSS US stocks has disappointed this year

S&P Performance Attribution, First Half 2018



Top ten stocks = Amazon, Facebook, Apple, Microsoft, Netflix, Adobe, Cisco, Nvidia, Visa, Mastercard. Source: Bloomberg

Observations:

- This chart shows the attribution returns for the S&P 500 during the first six months of 2018.
- Through June, just a handful of large US technology stock drove all of the gains.

So Why Have US Stocks Done so Much Better?

A Combination of Temporary & Idiosyncratic Factors

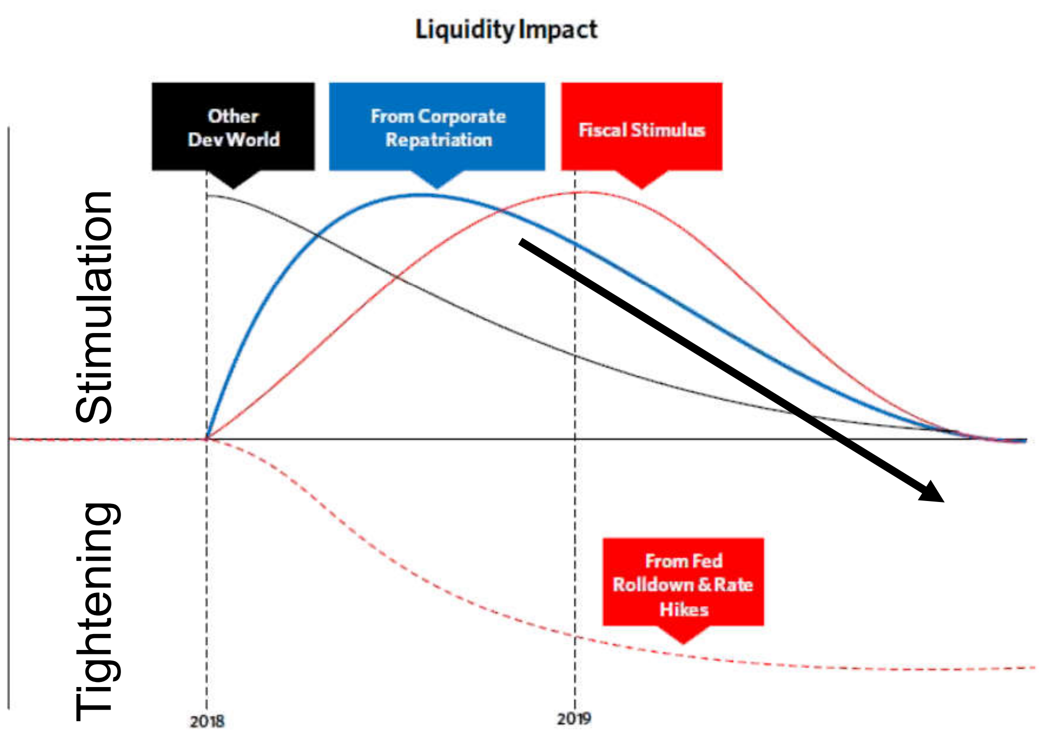
1) **Temporary Factors (One Year US Government Stimulus) :** The combination of Trump Tax Cuts and corporate cash repatriation tax amnesty have delivered a one-time stimulus package that is temporarily super-charging U.S. stock earnings. This effect has now peaked and will fade entirely in 2019.

2) **Idiosyncratic Factors (Trade War Rhetoric):** As the U.S. has threatened and/or levied trade tariffs on most of the economic world, sentiment for most every other asset class has fallen. This has caused commodities, international and emerging market stocks to sell off.

Political risks and actions are highly unpredictable and, <u>on balance</u>, are a reason to diversify rather than concentrate risk in any one region.

Temporary Drivers of US Stock Performance

US: FADING OF FISCAL STIMULATION AND CORPORATE CASH REPATRIATION WILL MAKE FOR A DANGEROUS 2019-20



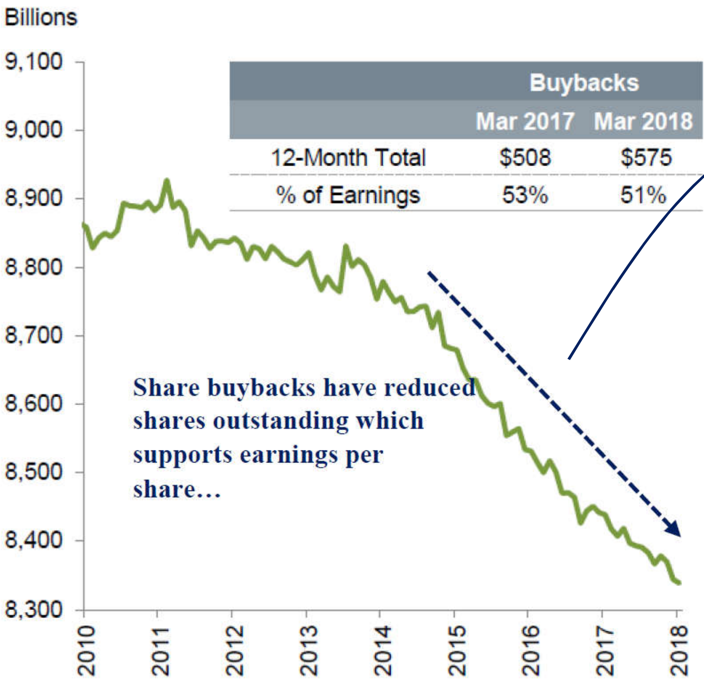
Combined sources of US & global stimulus have peaked, and are now winding down…

…Meanwhile, the impact of Fed tightening has been completely masked.

US Stock Earnings Growth Fueled by Buybacks

US Share Buybacks Have Supported Returns and Elevated Valuations

S&P 500 Share Count

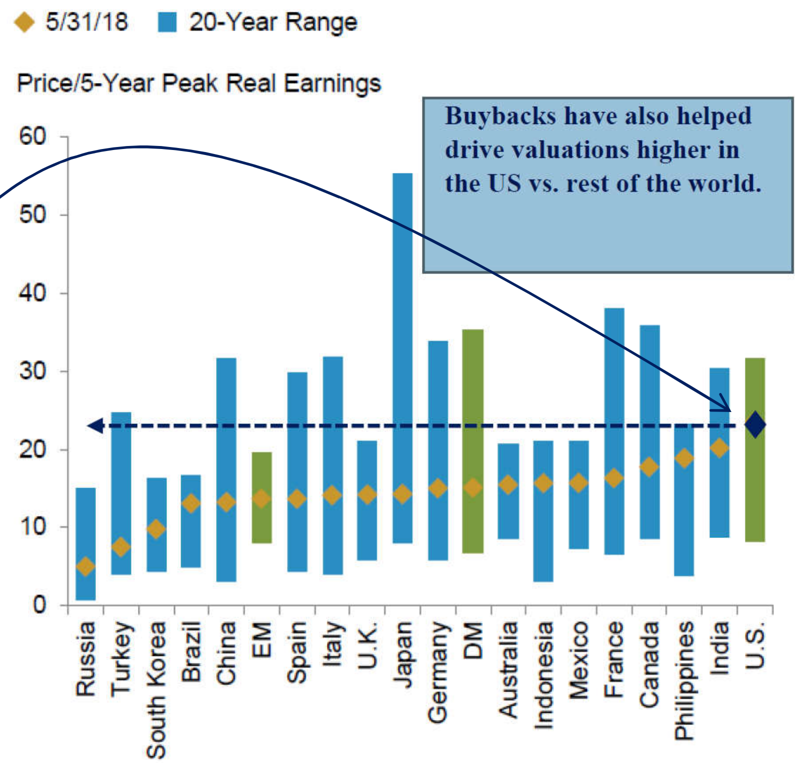


	Buybacks	
	Mar 2017	Mar 2018
12-Month Total	$508	$575
% of Earnings	53%	51%

Source: S&P, Fidelity

Cyclical P/Es

Source: Haver Analytics, Fidelity



Diversification Q & A:

Given the recent failure of diversification, why bother?

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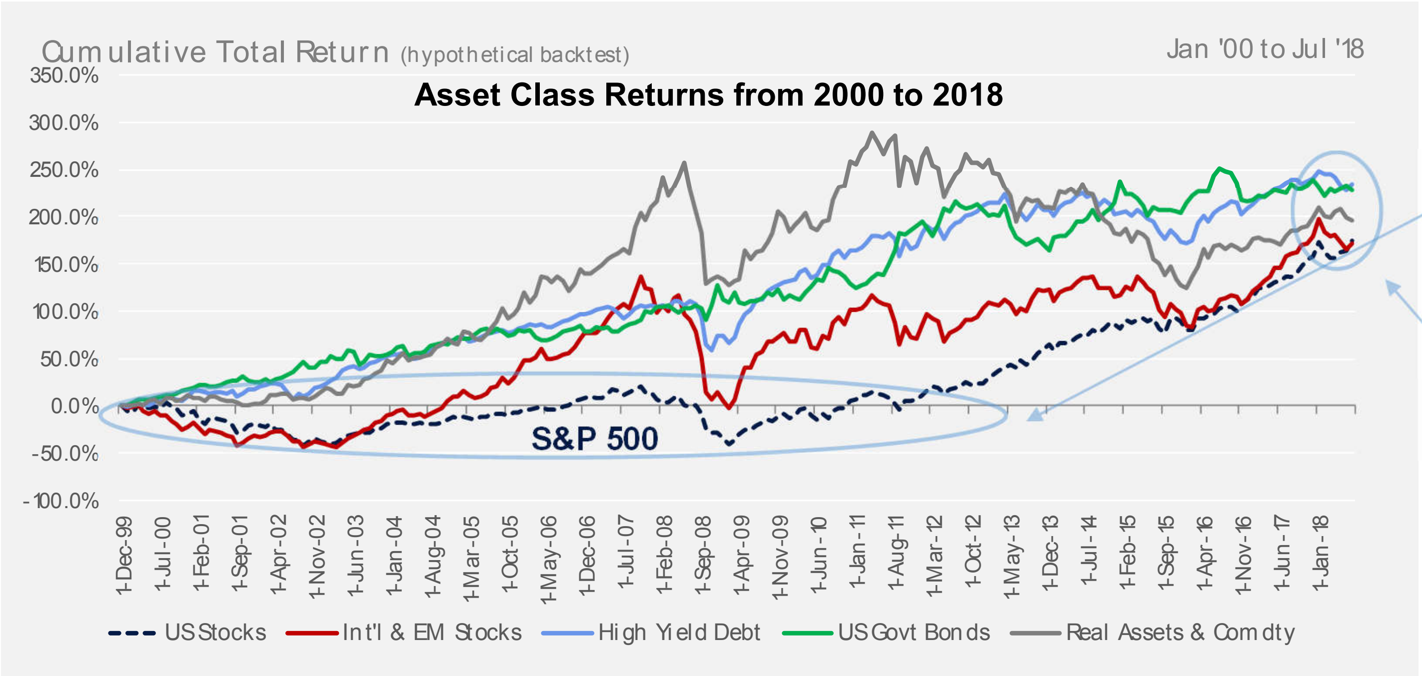
Why Diversify?

In the long run, having lots of growth drivers is best



Observations:

1) Extended periods of bad performance of a single asset class (like US stocks) is not uncommon.

2) However, over long periods of time, asset classes tend to perform about the same.

3) **Owning a diversified portfolio of many asset classes ensures you always have a growth driver.**

SOURCE: BLOOMBERG

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Diversified Portfolio = Equal weighted portfolio of all the above (20% US stocks + 20% Int'l & EM stocks + 20% High Yield Debt + 20% Govt Bonds +20% Real Assets & Commodities)
All returns presume monthly rebalancing and no transaction or other expenses. For educational purposes only.

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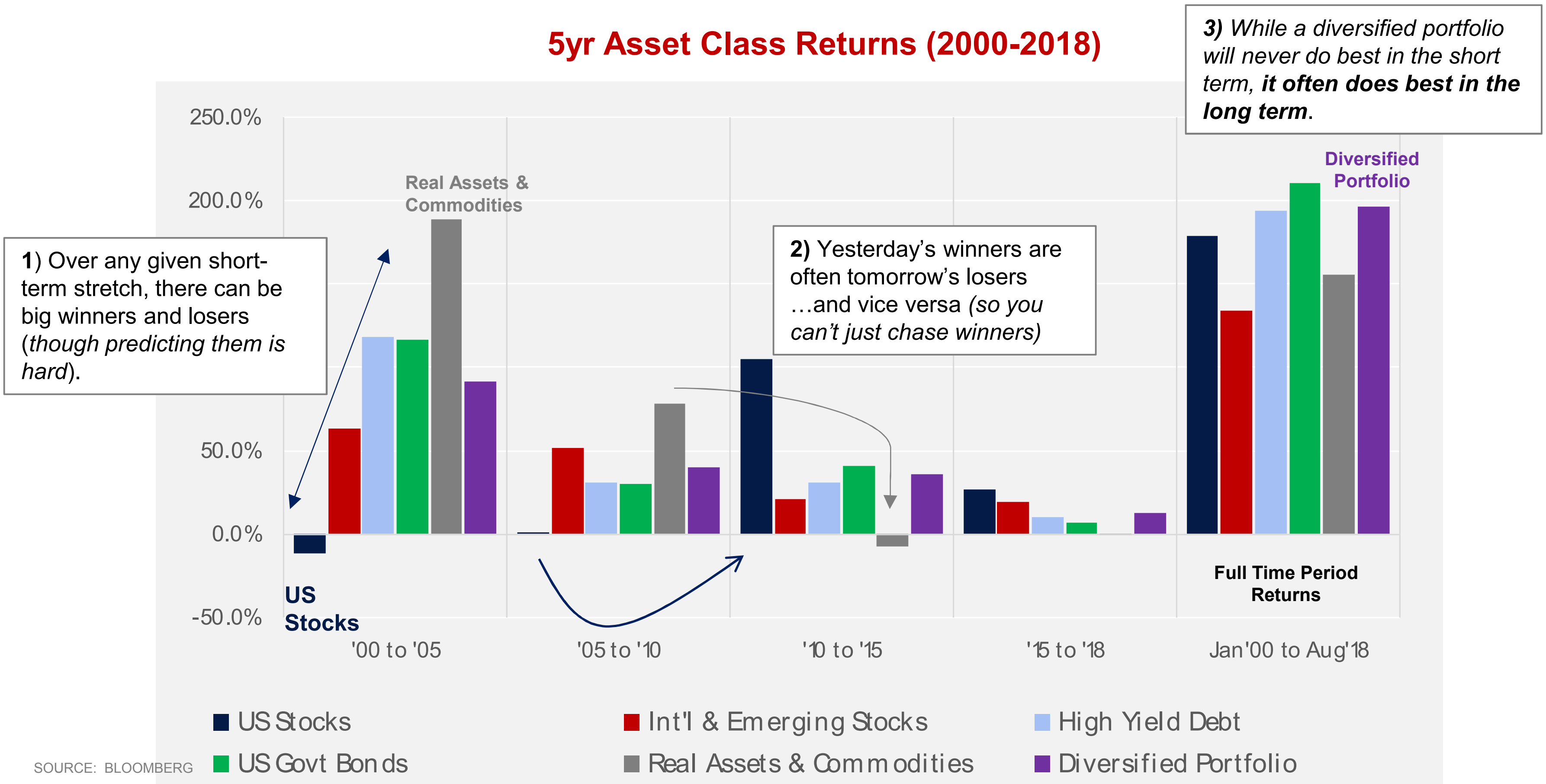
Why Diversify?



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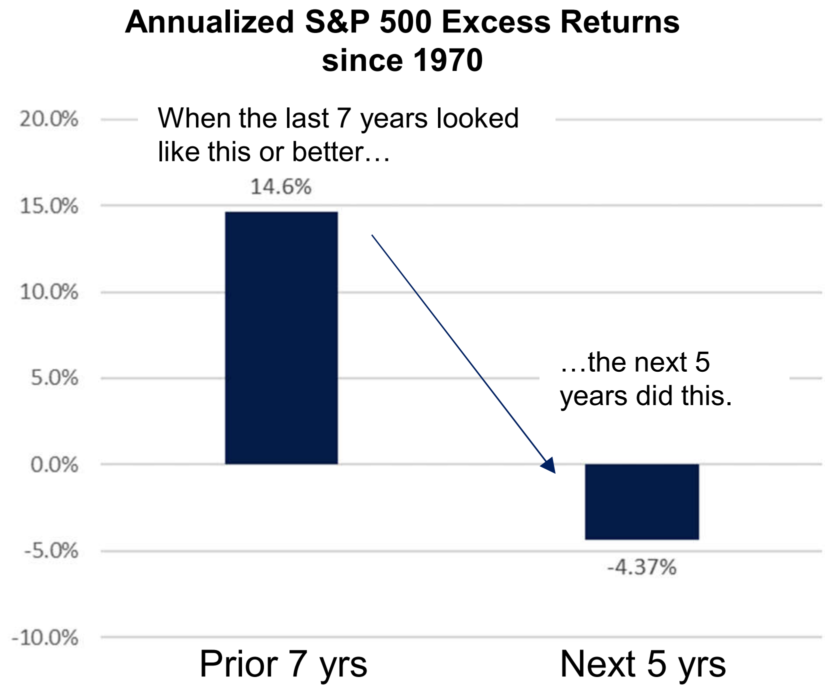
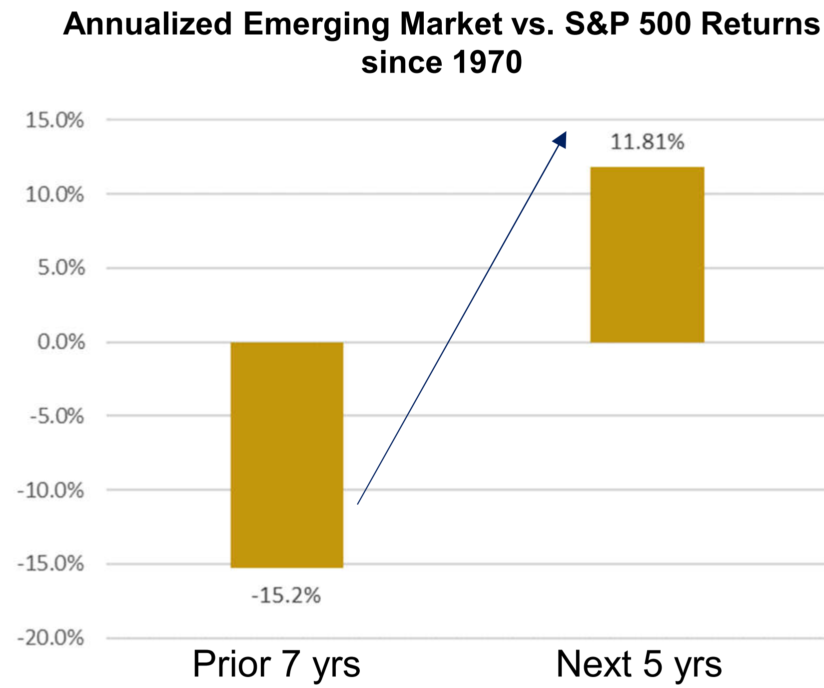
Yesterday's Winners are Tomorrow's Losers

…and vice versa

When past returns are not indicative of future returns

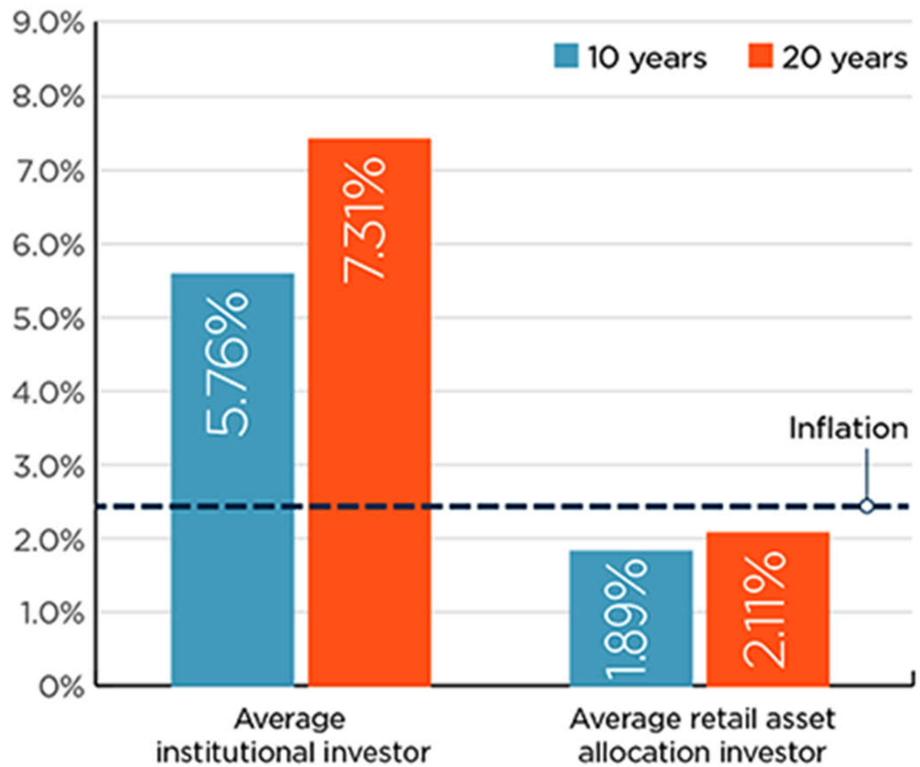




Excess returns mean returns above T-bill returns (i.e. premium over risk free return). Emerging Market vs S&P 500 = MSCI Emerging Market Index (MXEF Index) – S&P 500 Index total returns

The Best Investors in the World Diversify

Invest like an Institution



Dalbar Study 2015

Institutional investors have dramatically and consistently outperformed the average investor.

How? Disciplined diversification.

What Happened

Two portfolio exposures have driven nearly all current losses

1) Emerging Market Stocks & Bonds

2) Commodities and Real Assets

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Rationale for Owning Them

1) Emerging Market Stocks
   - Have the highest long-term expected return of any asset class (roughly 2x US stocks)
   - Trading at steepest discount to US stocks in over 16 years
   - Heavily favored by leading institutional managers

2) Real Assets & Commodities
   - Historically the best performing “late-cycle” asset class
   - Important source of inflation protection to grow real earnings

Why Have They Done So Poorly?

Tariffs and Trade War Fears

Political rhetoric around tariffs and trade wars have uniquely punished emerging market assets (especially China) and commodity prices…as fears mount they will trigger a global slowdown.

"Smart Money" Quotes on Emerging Markets

Recent Quotes from Leading Manager

Jeremy Grantham, GMO
"Suggested action plan for everyone: *What I would own is as much Emerging Market Equity as your career or business risk can tolerate*, and some EAFE. I believe each of these, especially Emerging, has more potential than most think." - Jan 2018

Janus Henderson
"Emerging markets equity (EME) exhibits the highest long-term expected return across the three public equity regions: U.S., non-U.S. and emerging markets. In fact, at the index level, it is the only region that exceeds the long-term required rate of return (7% to 8%) of most U.S. institutional investors, and yet most U.S. investors have neglected their allocations to emerging market equities." – March 2018

Research Affiliates
"Fear of emerging markets seems more elevated today than at any time since the early 2016 EM lows...when the risks and the bad news are well known to the market and fear reigns supreme, *it's time to buy, not sell*." - June 2018

Jeffery Gundlach, Doubleline
"Emerging markets are cheaper than the S&P based on the Shiller CAPE ratio. That ratio is 16 for emerging markets versus 30 for the U.S. It is not foolhardy to predict convergence, which would be a 100% outperformance for emerging markets," Nov, 2017

Goldman Sachs
"EM fixed income investment universe is vase, diverse and…stands to benefit from promising macro and micro dynamics including strong growth, good demographics, overall balance sheet resilience and corporate earnings growth potential. These benefits will accrue over a medium- to long-term investment horizon." - July 2018

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Disclosures

Diversification does not eliminate the risk of experiencing investment losses. PAST PERFORMANCE IS NOT AN INDICATION OF FUTURE PERFORMANCE. There is no guarantee, express or implied, that long-term return and/or volatility targets will be achieved. Realized returns and/or volatility may come in higher or lower than expected. References to investment objectives, target returns or other goals Almanack seeks to achieve in managing an account are aspirational only and should not be considered a guarantee that such results will be achieved.

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*All simulated portfolios were rebalanced monthly and presumed no execution or trading expense. All performance and price data was obtained from Bloomberg, LP and are publically available indices and funds.

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