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KWB Wealth

2019

1ST QUARTER NEWSLETTER

## KEY TAKEAWAYS

Despite strong economic data, 2018 was the first negative year for the S&P 500 since 2009.

The stock market must decline for investors to enjoy higher returns than less volatile investments.

The key to asset allocation is fighting through the tough years to potentially reap the rewards of the good years/ compounding.

We believe 2019 should rebound as indicators that have flashed before previous recessions are not present.

# 2018 In Review / 2019 Preview

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There is only one way to describe what happened to investors in 2018: IT WAS TOUGH! If you could have known that the US economy would add over 2.6 million jobs, that earnings per share growth would top 30%, and that Gross Domestic Product (GDP) would grow by over 3% for the first time in years, would you be bullish or bearish on stocks? That's what happened in 2018 and here's how the markets responded:

S&P 500 – down 4.5%
S&P 400 (US Mid Cap Stocks) – down 11%
S&P 600 (US Small Cap Stocks) – down 8.5%
MSCI EAFE (International Large Caps) – down 14%
MSCI Emerging Markets – down 15%
Barclays US Aggregate Bonds – up 0.10%

That's right. Every major equity asset class was down in 2018 and bonds barely squeaked out a positive return at the end of the year after being down as much as 3% in May. There was no place to hide unless you stayed in cash (as measured by the Bloomberg Barclays 1-3 Month Treasury Index, which was up 1.8%)

What caused 2018 to be such a rotten year? Was it tariffs? The Federal Reserve? The midterm elections? Government ineptitude? High frequency or computer-driven traders? A global economic slowdown? In truth, it was probably an amalgam of all these things. Each one throwing a little dash of volatility into the market. There's nothing to pinpoint as 'the' problem and, unfortunately, with something as intricate as the market, there never will be one single cause for a downturn. Let me explain why that's the case.

When we think about "the market" what we are really talking about are investors (individuals, mutual funds, hedge funds, endowments, foundations, etc.) buying and selling issues of stocks and bonds. Worldwide, "the markets" are made up of billions of these people and each one has their own distinct timeframe. An endowment for a large university or a foundation may have an infinite timeframe. A hedge fund that uses momentum and high frequency trading as its main source of return might have a timeframe of a few minutes or even seconds. Then, there is everyone in between. These investors in between may have a timeframe of a year or five or even thirty. Some even change timeframes as life happens and their plans inevitably shift from longer-term to shorter-term. "The market" is a complex, adaptive system that changes at the whims of these billions of participants.

It stands to reason, that as losses happen, people with shorter timeframes may decide to shorten their timeframe even more. The endowment that lived through 2008 may see the late year selloff as an opportunity or a threat depending on how well funded the university is in the coming years. There is just no way to know how every entity will react when the market declines. Sometimes you get a 3% pullback (the largest pullback in 2017) and sometimes it's a 20% correction/bear market. The decline in 2018 was not triggered by any poor economic news. Quite the contrary, the decline happened despite very good economic news. People tend to make decisions based on their emotions and then justify those decisions with logic after the fact. These reactions/emotions are unpredictable.

However, what is knowable is that the market MUST decline, sometimes excruciatingly far, for investors to enjoy higher returns than less volatile investments. If stocks never fell more than a couple percent, why would anyone expect to make significantly higher returns than just holding bonds or cash? Long-term investors in stocks are compensated for taking on the larger risks (i.e. volatility) inherent in the stock market.

Therefore, we believe it is crucial to have a strong plan in place that takes into consideration your risk tolerance, your necessary returns, and your long-term objectives. How can you know if you can stomach the markets ups-and-downs without knowing your own tolerance for risk? How can you decide how much risk to take without first knowing how much return you need to fund your retirement? Creating a plan and revisiting it through the years with your KWB Wealth Manager puts you in a better frame of mind to tackle these challenging market environments.

## OUTLOOK FOR 2019

One thing that gives us confidence heading into 2019 is the fact that rotten years tend to be followed by good years.

Chart 1 shows a "quilt" chart of major asset classes over the last 15 years. At the top of each year is the best

| 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| REITs 31.6% | EM Equity 34.5% | REITs 35.1% | EM Equity 39.8% | Fixed Income 5.2% | EM Equity 79.0% | REITs 27.9% | REITs 8.3% | REITs 19.7% | Small Cap 38.8% | REITs 28.0% | REITs 2.8% | Small Cap 21.3% | EM Equity 37.8% | Cash 1.8% |
| EM Equity 26.0% | Comdty. 21.4% | EM Equity 32.6% | Comdty. 16.2% | Cash 1.8% | High Yield 59.4% | Small Cap 26.9% | Fixed Income 7.8% | High Yield 19.6% | Large Cap 32.4% | Large Cap 13.7% | Large Cap 1.4% | High Yield 14.3% | DM Equity 25.6% | Fixed Income 0.0% |
| DM Equity 20.7% | DM Equity 14.0% | DM Equity 26.9% | DM Equity 11.6% | Asset Alloc. -25.4% | DM Equity 32.5% | EM Equity 19.2% | High Yield 3.1% | EM Equity 18.6% | DM Equity 23.3% | Fixed Income 6.0% | Fixed Income 0.5% | Large Cap 12.0% | Large Cap 21.8% | REITs -4.0% |
| Small Cap 18.3% | REITs 12.2% | Small Cap 18.4% | Asset Alloc. 7.1% | High Yield -26.9% | REITs 28.0% | Comdty. 16.8% | Large Cap 2.1% | DM Equity 17.9% | Asset Alloc. 14.9% | Asset Alloc. 5.2% | Cash 0.0% | Comdty. 11.8% | Small Cap 14.6% | High Yield -4.1% |
| High Yield 13.2% | Asset Alloc. 8.1% | Large Cap 15.8% | Fixed Income 7.0% | Small Cap -33.8% | Small Cap 27.2% | Large Cap 15.1% | Cash 0.1% | Small Cap 16.3% | High Yield 7.3% | Small Cap 4.9% | DM Equity -0.4% | EM Equity 11.6% | Asset Alloc. 14.6% | Large Cap -4.4% |
| Asset Alloc. 12.8% | Large Cap 4.9% | Asset Alloc. 15.3% | Large Cap 5.5% | Comdty. -35.6% | Large Cap 26.5% | High Yield 14.8% | Asset Alloc. -0.7% | Large Cap 16.0% | REITs 2.9% | Cash 0.0% | Asset Alloc. -2.0% | REITs 8.6% | High Yield 10.4% | Asset Alloc. -5.8% |
| Large Cap 10.9% | Small Cap 4.6% | High Yield 13.7% | Cash 4.8% | Large Cap -37.0% | Asset Alloc. 25.0% | Asset Alloc. 13.3% | Small Cap -4.2% | Asset Alloc. 12.2% | Cash 0.0% | High Yield 0.0% | High Yield -2.7% | Asset Alloc. 8.3% | REITs 8.7% | Small Cap -11.0% |
| Comdty. 9.1% | High Yield 3.6% | Cash 4.8% | High Yield 3.2% | REITs -37.7% | Comdty. 18.9% | DM Equity 8.2% | DM Equity -11.7% | Fixed Income 4.2% | Fixed Income -2.0% | EM Equity -1.8% | Small Cap -4.4% | Fixed Income 2.6% | Fixed Income 3.5% | Comdty. -11.2% |
| Fixed Income 4.3% | Cash 3.0% | Fixed Income 4.3% | Small Cap -1.6% | DM Equity -43.1% | Fixed Income 5.9% | Fixed Income 6.5% | Comdty. -13.3% | Cash 0.1% | EM Equity -2.3% | DM Equity -4.5% | EM Equity -14.6% | DM Equity 1.5% | Comdty. 1.7% | DM Equity -13.4% |
| Cash 1.2% | Fixed Income 2.4% | Comdty. 2.1% | REITs -15.7% | EM Equity -53.2% | Cash 0.1% | Cash 0.1% | EM Equity -18.2% | Comdty. -1.1% | Comdty. -9.5% | Comdty. -17.0% | Comdty. -24.7% | Cash 0.3% | Cash 0.8% | EM Equity -14.2% |

**CHART ONE:** Sources: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
*See disclosures below for more details.



KWB & Associates, Inc.
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performing asset class and at the bottom, the worst. Most of our clients live in the box labeled "Asset Allocation." Over the past 15 years, that box has returned 6.2% per year, but you had to live through some very difficult years to earn that 6.2%. Notice after each negative year (2008, 2011, and 2015) the market bounced back in the following 2-3-year period. The key to asset allocation is fighting through the tough years so that you can potentially reap the rewards of the good years and let the compounding effect work its magic.

It's also important to remember that the more you look, the more likely you are to see "losses" (a.k.a. volatility) in your account. Chart 2 shows how likely you are to see positive and negatives by the frequency of often you look. If you only look at your statements once a year, you'd see gains 75% of the time. If you look daily, you'll see a loss 46% of the time. That fact can be tough on your psychology and cause you to make decisions that could be extremely detrimental to your long-term goals.

**S&P 500: 1926-2018**

| Time Frame | Positive | Negative |
|---|---|---|
| Daily | 54% | 46% |
| Quarterly | 69% | 31% |
| One Year | 75% | 25% |
| 5 Years | 88% | 12% |
| 10 Years | 95% | 5% |
| 20 Years | 100% | 0% |

**CHART TWO:** Source: https://awealthofcommonsense.com/2019/01/diversification-is-almost-undefeated/

As for our outlook for 2019, we believe that markets should rebound because the various indicators that have flashed before previous recessions (inverted yield curve, elevated valuations, declining confidence in businesses, euphoria, etc.) are not present at this time. Even when they present themselves, there is typically a lag between the signs flashing and the start of a recession. So, while there most certainly could be a continuation of the volatility we saw in 2018, we still expect 2019 to end in a better place than where it began. In the meantime, we are diligently managing and monitoring your portfolios to Advance & Defend where appropriate.

As always, if you have any questions or concerns please contact us and thank you for your continued confidence in KWB Wealth.

*The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.*

*The Standard & Poor's 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.*

*Investing involves risk including loss of principal.*

*No strategy assures success or protects against loss. The economic forecasts set forth in this newsletter may not develop as predicted and there can be no guarantee that strategies promoted will be successful.*

*International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors. Investing involves risk including loss of principal.*

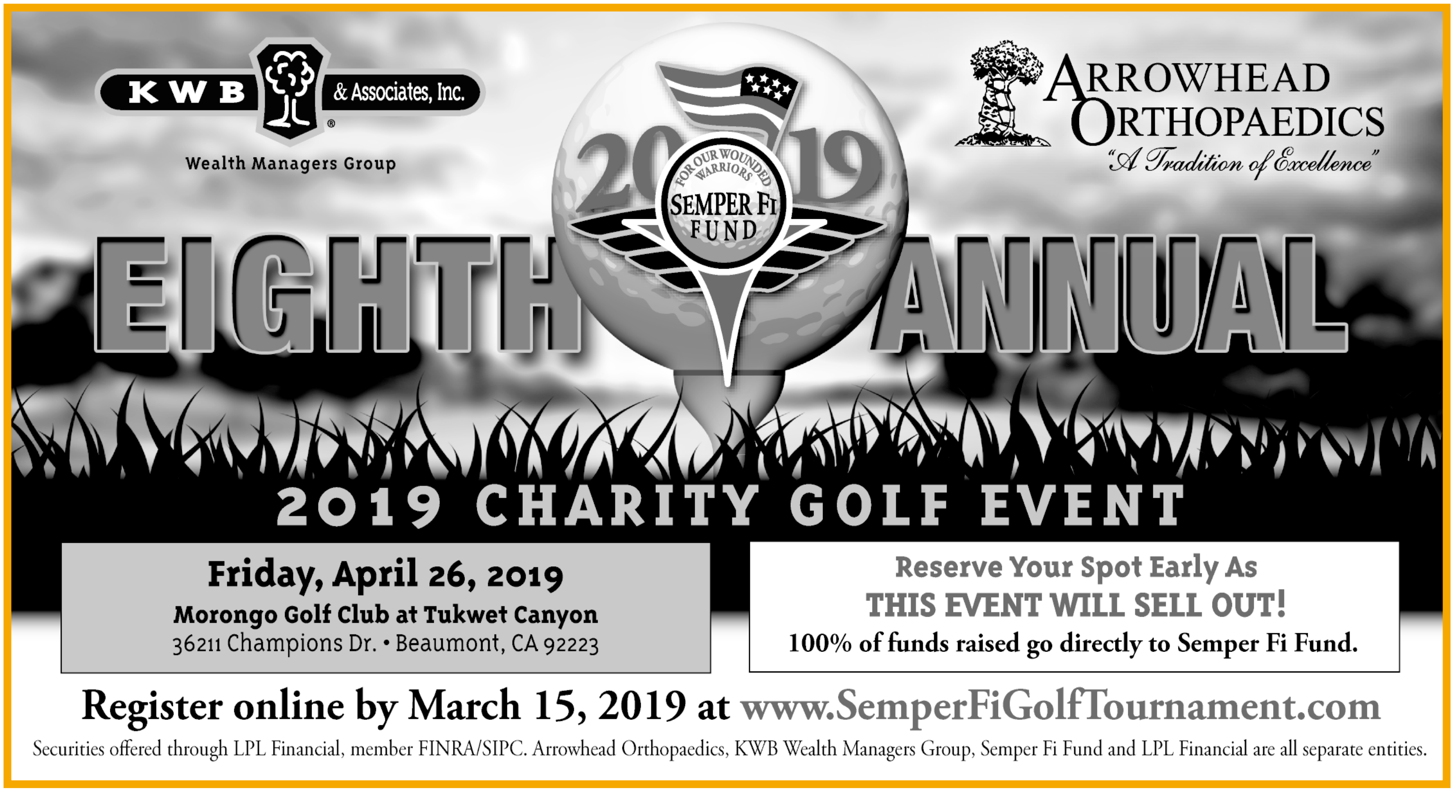
*The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. The MSCI EAFE Index consists of the following developed country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.*

*The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia. The MSCI EM Index consists of the following emerging market country indices: Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Egypt, Greece, Hungary, Poland, Qatar, Russia, South Africa. Turkey, United Arab Emirates, China, India, Indonesia, Korea, Malaysia, Philippines, Taiwan, and Thailand.*

*The S&P Midcap 400 Stock Index is an unmanaged index generally representative of the market for the stocks of mid-sized US companies. The S&P Small Cap 600 Index is an unmanaged index generally representative of the market for the stocks of small capitalization U.S. companies. The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.*

*The S&P Small Cap 600 Index is an unmanaged index generally representative of the market for the stocks of small capitalization U.S. companies.*

*The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.*

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