SIA Perspectives

Stegner Investment Associates, Inc. — 4th Quarter 2018

In last quarter's *SIA Perspectives*, we noted a surge in stock market returns for the 3rd quarter as investors shrugged off issues such as trade wars, Britain's exit from the European Union (EU) and China's slowing economic growth. Our reports showed that, through September, many stock market benchmarks reached record levels as announcements of excellent corporate earnings energized investors. In fact, a balanced portfolio of stocks and bonds posted solid returns for the first nine months of 2018.

However, in October, investor sentiment reversed quickly and declines from both stock and bond markets eliminated the positive portfolio returns only reported recently. The sharp reversals were due to many of the same issues investors shrugged off in the 3rd quarter. Adding to the angst was investors' obsession with language issued by representatives of the U.S. Federal Reserve ("Fed") regarding the future level of interest rates.

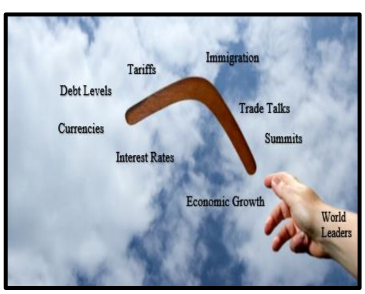
These widespread market jitters continued throughout the 4th quarter, with increasing levels of price volatility not only day-to-day, but also intraday. In fact, downswings during October and December forced many stock market benchmarks into "bear market" territory with 20% declines from September highs. The year ended with most portfolios posting the poorest returns since 2008.

In another quick reversal, stock markets around the world rebounded strongly during the first three weeks of 2019. Investors cheered good news, which included a strong U.S. jobs report for December, calming comments from the Fed and better-than-expected earnings announcements. All major stock market benchmarks – including international and emerging markets – have moved higher by 6-10% and reversed most of the losses delivered in 2018.

What Happened in 2018?

1st Quarter- Newton's Law

Our use of Newton's cradle to explain 1st quarter results demonstrated the swings in financial markets as investors gauged the impact of the passage of the Tax Cuts and Jobs Act. In addition, talks about trade between the U.S. and China swung back and forth. Markets soared early in the year and then sold-off just as quickly, leading to slight losses for most stock and bond market benchmarks for the first three months.



2nd Quarter – Boomerang Effect

As an icon for the 2nd quarter theme, the boomerang effect illustrated world leaders tossing out ideas only to receive a reaction that was the opposite of what was expected. As world leaders attended high profile and historic summits, investors attempted to weigh the impact of key decisions made during these meetings. Trade agreements and tariff announcements were some actions that dominated headlines and had great impacts on financial market returns throughout the quarter.

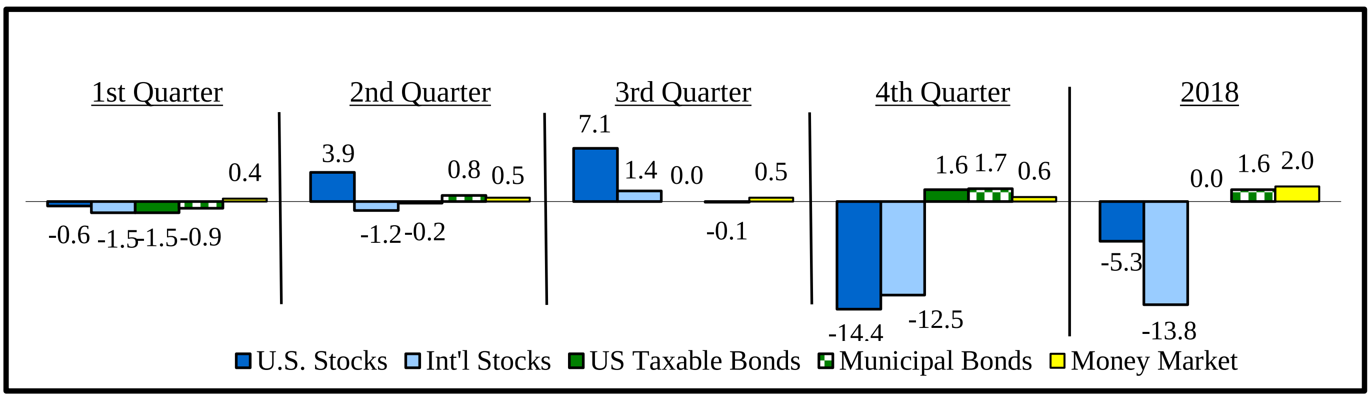
3rd Quarter – Balancing Act

The scales of justice image imparted our advice to balance negative emotional news, such as the U.S. Supreme Court justice hearings and mid-term elections, with the positive news of continued economic growth and a favorable interest rate environment. Spectacular earnings announcements in the U.S. led to solid stock market returns for the third quarter.

4th Quarter – Butting Heads

Uncertainty caused by "head butting" between world leaders, and members of the U.S. Congress, seriously impacted financial markets during the 4th quarter. In addition, the viability of the Fed's independence was worrisome to investors. Simmering trade talks between the U.S. and China, protests in France, Italy's arguments with the EU and further evidence of a slowdown in China cast a pall on the outlook for economic growth in 2019.

How Did Various Asset Classes* Perform?



**Representative benchmark index total returns for all charts are detailed on the last page of this Perspective*

Quarterly performances listed above for five major asset classes indicate a relatively tame first half of 2018, despite significant bouts of volatility within each quarter. U.S. stocks led developed markets in each quarter and finished the year with a smaller decline than the double-digit losses generated in stock markets overseas. Meanwhile, most bond benchmarks fell in the first two quarters, then rebounded in the 4th quarter, as stock declines mounted. Improving yields from money market funds led to the best gains for the year and marked the first time in over a decade that they were the best performing asset class.

Why Were Stocks So Volatile?

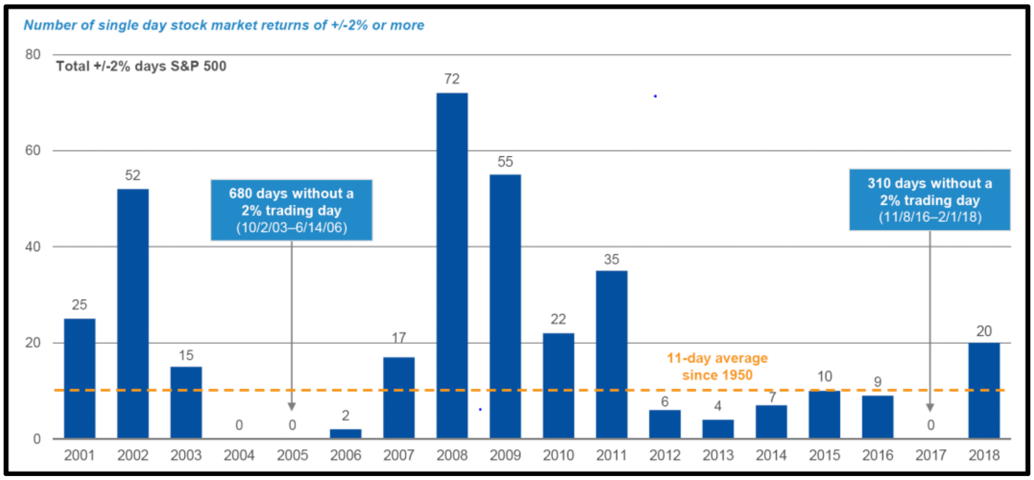
Major stock market segments delivered several bouts of volatility throughout the year including two periods of declines of more than 10%. Economic and political factors mentioned earlier were a major cause of this volatility, but another underlying factor that investors considered was the increasing appeal of rising yields being produced by short-term investments (including money market funds).

As a reminder, the Fed kept its benchmark rate of interest near zero for seven years. In addition, the Fed bought trillions of dollars of government bonds and this demand pushed down longer-term interest rates. In this low interest rate environment, investors earned virtually nothing from their short-term investments and instead bought anything that could generate a better return including riskier debt, real estate and stocks.

As the Fed raised rates, nine times since 2015, the yield on short-term investments also moved higher. In fact, the current yield of 2% earned from money market funds is now competitive with the dividend yield of many stock benchmarks. The 4th quarter volatility in the stock market can be explained somewhat by investors rebalancing exposure to stocks in favor of money market funds.

Efforts from the Bank of Japan and the European Central Bank (ECB) supported the Fed's actions and these moves served as a tailwind for global financial markets. However, in 2018 central banks around the world announced plans to begin to wind down their massive bond buying programs – also known as quantitative easing (QE). Widespread nervousness accompanied these announcements, as attempts to unwind this stimulus, have never been tested.

The magnitude of these jitters in 2018 is illustrated in the chart below. The chart lists the number of days in each calendar year that the S&P 500 Index moved higher or lower by two percentage points. As noted, the volatility of the stock market in 2018 was very surprising, especially following the relative calm of 2017.



Source: BlackRock

The level of volatility in 2018 was not unprecedented, but the moves last year were significantly more than in any of the previous seven years. In fact, the 20 days of 2% moves recorded in 2018 is almost twice the average since 1950. This volatility was unsettling and confusing to undisciplined investors and led many to panic late in the year, thus intensifying stock market declines.

In the table below, we list the quarterly returns for major stock market segments to illustrate the volatility throughout 2018. The calendar year return is disappointing, but we have also included results for 2017 as a reminder of how great returns were for that year. Combining these two years with 2016's results produce very good three-year returns. For long-term investors, the five and ten-year periods were great contributors to portfolio performances.

2017	1st Qtr 2018	2nd Qtr 2018	3rd Qtr 2018	4th Qtr 2018	2018	STOCKS	3 Yr Annual	5 Yr Annual	10 Yr Annual
21.8%	-0.8%	3.4%	7.7%	-13.5%	-4.4%	U.S. Large Cap	9.3%	8.5%	13.1%
18.5	-0.5	2.8	5.0	-15.4	-9.1	U.S. Mid Cap	7.0	6.3	14.0
14.6	-0.1	7.8	3.6	-20.2	-11.0	U.S. Small Cap	7.4	4.4	12.0
25.0	-1.5	-1.2	1.4	-12.5	-13.8	International	2.9	0.5	6.3
37.3	1.4	-8.0	-1.1	-7.5	-14.6	Emerging Mkt	9.2	1.6	8.0

Also of note in the table on the previous page is the performance of markets outside the U.S. Although trailing for much of 2018, international and emerging markets posted outsized returns in 2017, which supports the diversification strategy that we employed for most clients.

What Happened to Bond Prices?

Performance for the first three quarters of 2018 for most bond market segments reflected investors' worries about the impact of higher interest rates. But in the 4th quarter, investors were surprised by a rally when the Fed displayed a willingness to possibly slow the pace of interest rate increases in 2019. This burst of performance pushed total returns higher for most segments, which buffered negative returns from portfolio's exposure to stocks.

2017	1st Qtr 2018	2nd Qtr 2018	3rd Qtr 2018	4th Qtr 2018	2018		3 Yr Annual	5 Yr Annual	10 Yr Annual
3.5%	-1.5%	-0.2%	0.0%	1.6%	0.0%	Taxable U.S.	2.1%	2.5%	3.5%
10.5	3.6	-4.8	-1.7	0.9	-2.1	Taxable Global-ex U.S.	3.1	0.0	1.7
4.3	-0.9	0.8	-0.1	1.7	1.6	Municipal Intermediate	2.0	3.0	3.9
1.0	0.4	0.5	0.5	0.6	2.0	Money Market	1.1	0.7	0.4

During 2018, bond investors developed new concerns of an "inverted yield curve". An inversion takes place when short-term rates are higher than long-term rates and, in the past, has indicated a looming recession. However, the cause of this inversion is very different than in past cycles and therefore a recession is not imminent and appears unlikely. The allocation to bonds in a portfolio is to provide income and stability and to offset bouts of poor performance of more volatile asset classes. Last year's results and those of the past 3, 5 and 10-year periods are a reminder of the stability this asset class provides.

How Did SIA's Investment Strategy Perform?

Most client portfolios posted disappointing absolute results in 2018 for the first time in a decade, but relative returns versus tailored benchmarks have generally landed once again in the top quartile.

2018	Value	Blend	Growth
Large	-8.3%	-4.4%	-1.5%
Mid	-12.3%	-9.1%	-4.8%
Small	-12.9%	-11.0%	-9.3%

These relative returns were driven by impressive performances from most of our fund managers, plus a slight strategic overweight to stocks early in the year. In addition, within the stock allocations, an overweight to U.S. large cap stocks, relative to mid and small cap targets added to results. We acted on a similar opportunity during late summer, this time by trimming outperforming small cap growth managers, which helped buffer the downdraft of the 4th quarter. An overweight to "growth" stocks in most market segments also boosted results, as noted in the grid of U.S. stock market returns for last year.

Our taxable bond performance was excellent on relative basis for 2018, with the non-core managers posting top-notch results for the first three quarters, and our core managers posting excellent results for the 4th quarter. Our 1, 3- and 5-year returns for taxable bonds placed in the top quartile versus peer benchmarks.

How Does Tax Reform Impact Our Investment Advice?

During 2018, we evaluated the tax reform legislation that made sweeping changes to the Internal Revenue code for the first time since 1986. The Tax Cuts and Jobs Act (“Act”) had huge impacts on businesses and individuals. Our extensive study included input from many professional resources, which led us to reassess our investment strategies for each client. As we reviewed portfolios, we considered the impact of the Act’s adjustments to:

1. Tax Rates: many marginal rates are lower and most workers noticed a boost to their paychecks beginning last February.

2. Limits on State and Local Taxes: the entire deduction for state and local taxes, including property tax and either income or sales tax, is now limited to $10,000 (or $5,000 if married and filing separately). The home equity debt interest deduction has new limits and the use of home equity loans have new restrictions.

3. Higher Standard Deductions: this deduction doubled to $12,000 for single filers and $24,000 for joint filers. The combination of a higher standard deduction and the reduction or elimination of many itemized deductions will mean that some taxpayers, who once benefited from itemizing, will now be better off taking the standard deduction.

4. Charitable Contributions: deduction limits generally did not change, however the increase in the standard deduction could minimize the tax benefit of giving to charity.

5. Investment Taxes: there is no change to the 20% top rate on dividends and capital gains or the 3.8% surtax on investment income imposed by the Affordable Care Act.

6. Estate Taxes: the estate tax and generation skipping tax exclusion doubled to $11.2 million per person and adjusts each year for inflation. However, in 2026 this exclusion will return to an inflation-adjusted $5 million. Gifts to others can be excluded up to $15,000 annually.

7. Corporate Taxes: “C” corporations receive a permanent reduction in the tax rate from 35% to 21%. In addition, there is a new deduction for some owners of pass-through business entities, that are treated as such for tax purposes, and includes: sole proprietorships, partnerships and S corporations. However, many specified service businesses are excluded.

8. Capital Gains and Investment Income: While the Act did not change the long-term capital gains rates, the ordinary-income tax rates and tax brackets will have an impact on your tax liability. For clients with taxable accounts (brokerage, trusts, etc.), we looked for opportunities throughout the year to minimize the potential tax liability.

SIA is committed to following these changes and providing advice that will assist in enhancing the positive impacts of the Act.

What is Our Role as Your Investment Consultant?

During the first quarter of 2017, we introduced to clients our seven value-added practices. Each quarter since then, we provided details about each one these practices. Over the course of the past two years we introduced them in our *SIA Perspectives* in the following order:

1. Behavioral Coaching
2. Rebalancing
3. Total Return versus Income Investing
4. Asset Allocation
5. Cost Effective Implementation
6. Asset Location

This quarter, we are highlighting the last value-added practice: “Determining Appropriate Savings and Withdrawal Rates”.

For clients who are in the accumulation phase, annual savings goals must be determined to ensure that future withdrawals can support spending needs. For most clients, our initial discussions focus on developing this savings strategy and then it is our role to monitor and, if necessary, adjust this strategy over time.

Since most clients have several “buckets” of financial resources, it is also our responsibility to assist in determining which buckets are the most effective for implementing savings and withdrawal strategies.

As clients transition from the accumulation phase to the withdrawal phase, our role is to establish realistic shorter-term expectations to ensure longer-term success. Working closely with each client, we rely on our 30+ years of experience, and leverage studies provided by industry experts, to establish the most effective annual withdrawal rate. Whether it is an individual using the portfolio to supplement income in retirement or an endowment using monies to make grants or to use for operations, both types of clients must determine a reasonable, and sustainable, rate of annual withdrawals as a percentage of assets.

Studies have proven that a spending rate of approximately 4% of assets (or less) has the highest likelihood of success for a portfolio with at least 60% of assets in stocks. This withdrawal rate is a good initial strategy, but we also consider the importance of having a flexible spending policy that can adjust this rate of withdrawal when financial markets fail to meet expected return rates.

What is the Outlook for 2019?

Investors will remember 2017 as a year that exceeded most expectations, as the world’s leading economies accelerated in sync. In turn, stock prices rallied in unison, spurred by low global interest rates and by the hopes of a business-friendly agenda in Washington that included deregulation and tax cuts.

Investors will remember 2018 as one of the most disappointing performances of the past ten years. Despite the U.S. economy soaring ahead, the rest of the world’s economies slowed. Global trade frictions mounted, and world stock markets tumbled. Bonds and money market funds provided expected stability and this performance was a reminder of the benefit of diversification.

In 2019, world markets may prove to be in sync again, but this time it may be due to slowing together instead of speeding up. Slowing growth does not mean a recession is inevitable. In fact, U.S. output is expected to slow from a 3% rate to possibly 2%, but this is still solid growth. Meanwhile, China’s growth is clearly slowing, but its output is still expected to be 5-6%. Ongoing discussions with the U.S. and China regarding tariffs, the Brexit decision, French protests and Italy’s budget add to the accumulating doubts. For now, the shutdown implemented by the U.S. Government adds to the near-term uncertainty.

We are committed to being disciplined long-term investors, but we also know that many of these issues require close monitoring and critical assessment as to the potential impact on our investment strategies.

Behind the Scenes at SIA

Throughout the year, we used financial market volatility opportunistically and employed several strategies to add value to portfolio performance. Specific strategies that we implemented for clients during the year included:

1. Using available cash balances to "average-in" during stock and bond market declines.
2. "Averaging-out" during market rebounds in order to replenish balances needed for future withdrawals.
3. Employing "tax loss harvesting" by using downswings in various investments to generate useful losses, while simultaneously reinvesting proceeds to take advantage of sharp moves to the upside.
4. Monitoring and adjusting portfolios to lower the impact of mutual fund capital gains and income payouts.
5. Sweeping cash balances from low yielding bank deposit funds into higher yielding money market funds.

As part of our five-year strategic plan, we finished the renovation of commercial office space right next door to our main office (100-year old house). We look forward to using this expansion to meet with clients and other professionals.

We recently took time to celebrate the life of Vanguard's ex-chairman Jack Bogle and reminisced about how he impacted SIA's investment process and our firm's culture. He was a true hero and will always be remembered as the champion of the individual investor.

"Stay the course. It is the most important single piece of investment wisdom I can give to you."

**Benchmark Indexes used in this SIA Perspective include as asset class returns the Dow Jones Total US Stock Market Index, Barclays US Aggregate Bond, Global Ex-US and Municipal Bond Index, US Treasury Bill Index. For stock segment returns we provide the S&P 500 Index, Russell Mid Cap and Small Cap Index, MSCI EAFE and MSCI EM Index total returns.*