WINTER

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When we look back fondly on the "good old days" we are usually reflecting on happy events in our distant past. For investors however, those halcyon times were but a mere twelve months ago. As we began 2018, the stock market had just completed the year 2017 with historically low volatility and generous returns of over 20% as measured by the S&P 500.

Twelve months later investors are reeling after a precipitous decline in stocks over the fourth quarter of the year. The S&P 500 posted a decline of 14 % in the fourth quarter of 2018 and a decline of 6.2% for the full year. From its high point reached on September 20, 2018 the S&P 500 declined by just under 20% to the low point at the close on Christmas Eve according to the Wall Street Journal. Much of this decline came in large single day drops and the renewed volatility, spurred in part by algorithmic and other automated trading systems, only added to the drama.

Macro-economic factors blamed for the swift decline included the trade war with China, the increase in interest rates by the Federal Reserve, slowing earnings growth rates and the weakness in overseas' economies and markets. These remain significant issues and may continue to promote stock market volatility and put downward pressure on stocks in the short run. However, in our opinion, the current valuations of both the U.S. and many foreign stocks markets more than reflect these concerns. We believe there is reason to be optimistic about the prospects for solid long term returns for equities around the globe.

The recent market decline was marked by the downfall of many of stocks that led the market in 2017 and 2018. We observed in past newsletters that in 2017, the advance in the market was led by a few high-profile growth stocks and that continued into 2018. As of September 30, 2018, the Russell 1000 Growth ETF, dominated by companies such as Apple, Alphabet, Amazon and Facebook, had advanced over 17% year to date. The Russell 1000 Value ETF, led by companies such as J.P. Morgan, ExxonMobil and Johnson & Johnson, had advanced just under 4% over the same period. Both gave up these gains in the fourth quarter of 2018 with the Russell Growth ETF finishing the year down 1.7% and the Value ETF down 8.4%. The retreat of former stellar performers such as Facebook, Amazon, Apple, Netflix and Google (FAANG) exacerbated the damage on the way down as much as they had lifted the market on the way up. Still, despite the dramatic decline in

growth stocks in the fourth quarter of 2018 they still outperformed value stocks for the full year.

Much of the decline in the leading growth stocks began as company specific issues such as the privacy concerns confronting Facebook. The rout became much broader in the fourth quarter and even companies with no visible issues retreated. However, before the dramatic fourth quarter there had been a broad-based decline occurring throughout the market over 2018 that was masked by the success of a few large growth stocks. At year end, 301 of the 505 stocks in the S&P 500, almost 60%, were down over 20% from their annual highs. Only one third of the stocks in the S&P 500 advanced in price in 2018. The average stock in the S&P 500 declined by 9.9% for the year. Despite their collapse in the fourth quarter, several large cap growth stocks still held up the overall index as the S&P 500 ended the year with a total return of -4.4% (price change plus dividends).

In the U.S., mid and small cap companies fared worse than the S&P 500 with declines of over 11%. Foreign stocks suffered from slowing economies and the effects of a strong dollar and indices for foreign developed and emerging markets declined more than 16%, with foreign small caps losing more than 20%.

As 2019 begins the volatility in the stock market of the past few months is likely to continue. With almost 60% of the stocks in the S&P 500 already more than 20% below their 2018 highs is the correction nearing an end or are we headed for a prolonged bear market? While we believe the decline in stocks will not persist through 2019, we know that things can certainly get worse. For all the strength in the US economy, weakness overseas persists and the current trade war with China is already impacting US companies. The stock market has been roiled by the recent interest rate increases by the Federal Reserve and their plans to continue these increases in 2019. While these moves by the Fed have been clearly stated and orderly there is a belief that further moves will damage a vulnerable economic recovery. The Fed may take the decline in the stock market into consideration in planning future rate increases but it is worth remembering that their actions have been predicated on an orderly increase in rates during a robust economic recovery.

There is an old saying on Wall Street regarding fundamental analysts, those who try to put valuations on companies based on estimates of earnings, revenues and profitability among other factors. The saying is that "… in a Bull market you don't need them and in a Bear market you don't want them…". That is that valuations don't matter when stocks are rising and when they are falling, they may go right through any reasonable valuation targets you have and continue to fall much further. We have seen some of the former as many stocks soared over the past few years, some well above any normal valuation metrics. Maybe we are now in the midst of the latter and stocks will continue to fall below levels that reflect

good long-term value. Still, with valuations considerably lower than just a year ago, we believe prospects for solid long-term returns are good.

It isn't often easy to stick to the fundamentals, however. Many Wall Street analysts, like the old saw quoted earlier, are quickly reducing the lofty target prices they had had on individual favored stocks just a few weeks ago. Estimates for earnings growth are coming down for 2019 and the price that investors will be willing to pay for those earnings (P/E ratio) may decline too as a reflection of investors' caution and lack of confidence.

We believe that while the difficulties faced by the market are serious, many stocks are selling at reasonable valuations. As long-term investors we expect these periods of volatility and the inevitable years of negative returns. We also expect good quality companies to persevere over the long term and reward patient investors over time.

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