Quarterly Newsletter - July 2019

July 15 2019

Dear client,

What goes up, must come down and vice versa. This is a basic belief in our investment method. Asset classes will revert to their long-term average return.

It is for this reason you want to have a diversified portfolio with asset classes that move independently of each other ? while one goes up, the other goes down. Economists refer to independently moving assets as having negative or low correlation. This is an important concept for investors because it provides rebalancing opportunities ? trim from what is doing well and buy what is doing poorly knowing they will eventually trade places.

In the short-term, it might feel great if all the asset classes in your portfolio were to go up at the same time. What a return you would earn! But this is not desirable because if they all rise at the same time, they could also all fall at the same time, making for a very bumpy ride. Too bumpy for many investors to stay invested. If you are adding money to your portfolio you don't want everything ?up? at the same time because you don't want to buy at high prices. Instead, a diversified portfolio with low correlated assets can actually reduce the volatility in your portfolio without reducing the long-term expected return and it can provide better buying opportunities on the way in.

The stock portion of your portfolio is equally split between US stock and international stock with the intent to keep the portfolio's correlation low. This percentage split is based on worldwide market capitalization, meaning the value of stocks worldwide is roughly split 50% in the US and 50% in all other countries. Historically there has been low correlation between US and international stocks, however over the last two decades studies show it has been increasing ? they have started to move more in sync with each other. Part of this is likely the result of global integration. The financial markets are more globalized and supply chains regularly cross borders. The tech bubble in 2001 and Great Recession in 2008 also contributed ? both crashes brought down world markets together, minimizing a key benefit of global diversification. In 2008, all US and international stock positions were hit hard, losing 30% ? 50%. Unfortunately, in time of crisis when low correlation is most desired, for US versus international equities it increased.

But there's good news for the globally diversified investor. Recent statistics show the correlation trend between US and international equities has reversed, decreasing back to levels from the 1970's through the 1990's. A reduction in volatility risk without a reduction in expected return is always welcomed!

Still, it can be difficult to hold onto a diversified portfolio. You own both the winners and the losers so it means your return has not been as good as a US only portfolio recently. It may be tempting to put all your money in US stocks right now. The S&P 500 just had its' best first half of the year in 22 years and it has outpaced international indexes over the last ten years.

You do not have to look too far back in history to find another long period that US stocks outperformed international stocks. From April 1991 to March 2001, the return for the S&P 500 more than doubled that of the MSCI EAFE (the index for international large company stock). Then the tech bubble burst and things changed. From December 2001 to November 2007 (near the peak of the markets before the Great Recession), the MSCI EAFE more than doubled the return of the S&P 500.

Long periods of outperformance are accompanied by rising valuations. When a company has a higher price, the expected future return is reduced. The opposite applies to underperformance. Underperformance causes lower valuation and therefore a higher expected future return.

We are not predicting an imminent fall in US stocks. We are simply illustrating there are long periods that one sector of the market outperforms the others so it bears repeating ? what goes up, must come down. We do not attempt to guess when this change may take place or what may cause it. We simply own all asset classes believing they will revert to their mean. As we have said in past letters, we ride all horses at once.

We have two primary jobs: first is to quantify how your portfolio affects your life through our financial planning process and second is to manage your portfolio risk through our asset management method. The focus in our financial planning process is consumption smoothing which is an economic-based approach to computing a level of spending that is sustainable throughout your life. We compute how much you should be saving and spending now so that there is not a disruption in your standard of living later.

This approach is much different from most other conventional financial plans that instead ask how much you plan to spend in retirement and then tell you the likelihood of success. The problem with this latter approach is most people do not know what they spend now and therefore can only guess about retirement. A slight incorrect guess now can mean over or under saving which can dramatically impact their present and/or future lifestyle. Our approach calculates what you can afford to spend year-over-year taking into account known cash flow events, it is not dependent on a guess of what you think you will spend.

Within the context of your financial plan we discuss cash flow, tax strategies, charitable giving, and estate planning, among other topics. The process can be quite liberating and once we have a baseline plan in place we can look at alternative scenarios such as earlier retirement, purchase of a second home or even how a major market correction might impact your affordable spending. If it has been awhile since you have come in for a review, we strongly encourage you to schedule a meeting.

We will end with a trivia question. We track about 25 indexes measuring returns of short and long term bonds, government bonds, REITs, large cap and small cap stocks, value and growth stocks, US and international stocks and inflation. What do you think was the best performing asset class over the trailing twelve months (June 30, 2018 ? June 30, 2019)? Based on this letter you might guess US large stocks.

But the answer is ? long-term treasury bonds. The Long-Term Government Bond Index returned 18.38% and the Barclays US Treasury Bond Index returned 12.3%. The S&P 500? Well, that was only10.42%! The future is unknowable and often unexpected so ride all your horses.

Jim John Richard & Ryan