Quarterly Newsletter - October 2018

October 15, 2018

Dear Client,

We would like to begin this letter with excerpt from a Tom Friedman column published in the October 2, 2018 New York Times. He puts what we are thinking better than we can:

I began my journalism career covering a civil war in Lebanon. I never thought I'd end my career covering a civil war in America.

We may not be there yet, but if we don't turn around now, we will surely get where we're going ? which was best described by Senator Jeff Flake on Monday: ?Tribalism is ruining us. It is tearing our country apart. It is no way for sane adults to act.?

Sure, we've experienced bouts of intense social strife since the American Civil War of 1861. I grew up with the assassination of Martin Luther King and raging street battles over civil rights and Vietnam. And yet this moment feels worse ? much less violent, blessedly, but much more broadly divisive. There is a deep breakdown happening between us, between us and our institutions and between us and our president.

And nothing is sacred. Brett Kavanaugh defended himself the other day with the kind of nasty partisan attacks and ugly conspiracy theories that you'd expect only from a talk radio host ? never from a would-be justice of the Supreme Court. Who can expect fairness from him now?

And this fracturing is all happening with a soaring stock market and falling unemployment. Can you imagine what it will be like when we face the next recession?

Yes ? the next recession. This is the question for investors and for markets.

The equity markets are all over the place. Over the past twelve months US equities have done much better than international. But - please remember the 1998 through 2000 period. Very dramatic over performance by US stocks, and especially the NASDAQ technology stocks. Many people gave up on international investing and put a lot of money into the NASDAQ. We did not do so ? we stuck to our diversification and rebalancing method ? buying bonds and non-US equities, trimming the US growth stocks as they powered up and up. Then came the 2000 tech bust ? and our method suddenly looked much better.

This was followed by the 2007-2009 market crash. And during the crash there was again a wide divergence between the returns of one asset class over the others. But now it was bonds that did very well. Long term bonds went up in value while equities, all round the world, fell and fell a lot ? 60% in some cases. And again, we rebalanced. We sold bonds and bought stocks ? all round the world. This was emotionally difficult. The TV and newspapers were full of the same advice ? don't buy stocks. Buy only bonds and wait for the dust to settle. We did the entire opposite of that. And our method paid off.

And now, once again, US equities have become the top performer. But this was not the case just 6 months ago. Please look at the following table which contains the broad index returns we publish in our performance reports. The better performing asset classes have been highlighted below. The table clearly shows the switch from international overperformance to US overperformance:

Trailing 12 month returns as of

9/30/17
12/31/17
3/31/18
6/30/18
9/30/18

S&P 500 (US large cap)
18.6
21.5
14.0
14.4
17.9

Russell 2000 (US small cap)
20.7
14.6
11.8
17.5
15.2

MSCI EAFE (foreign large cap)
19.1
25.0
14.8
6.8
2.7

MSCI EAFE small (foreign small cap)
21.8
33.0
23.5
12.4
3.7

MSCI Emerging
22.5
37.3
24.9
8.2
-0.8

This is what we expect within a diversified portfolio. Relative performance of component asset classes should be of no concern to a disciplined investor. It provides rebalancing opportunities.

And how quickly things can change. The fourth quarter has started with a steep decline in US equities and all might be different next quarter.

The most important things for any investor are time and discipline. Over a long-term horizon ? ten years or so ? equities generally do quite well. Over ten years or so market corrections generally do not matter. Over ten years the relative performance of one asset class over another will very likely also not matter ? provided rebalancing is consistently applied.

As we said in our last letter the larger question we face as investors is whether our future will be one of inflation or deflation. The recent correction in the US comes from rising interest rates as initiated by the Fed due to their concern about potential inflation. The long-term trajectory of current US fiscal policy is, we believe, inflationary. Gigantic tax cuts plus huge deficits plus unprecedented Presidential jawboning of the Fed add up to an inflationary risk. Inflation generally favors equities.

But, very much on the other hand, let's get back to our original question about the next recession. There will be another recession because there always are recessions. If the degraded state of US politics turns the next recession into another 2007-2009 worldwide financial crisis, which it well might, then deflation is very much back on the table. And deflation favors bonds.

Which horse do we ride? US equities? International equities? Bonds? We have absolutely no idea what will happen. Nor does anyone else. We ride all the horses. We believe asset class and country diversification and rigorous rebalancing are the best that we or anyone else can do.

Jim, John, Richard and Ryan