Dear Clients and Friends,

Executive Summary:

- Volatility in the markets had been declining for years and reached an extremely low level in 2017. In 2018, volatility returned.

- 90% of asset classes posted negative returns in 2018, the highest percentage since 1901.

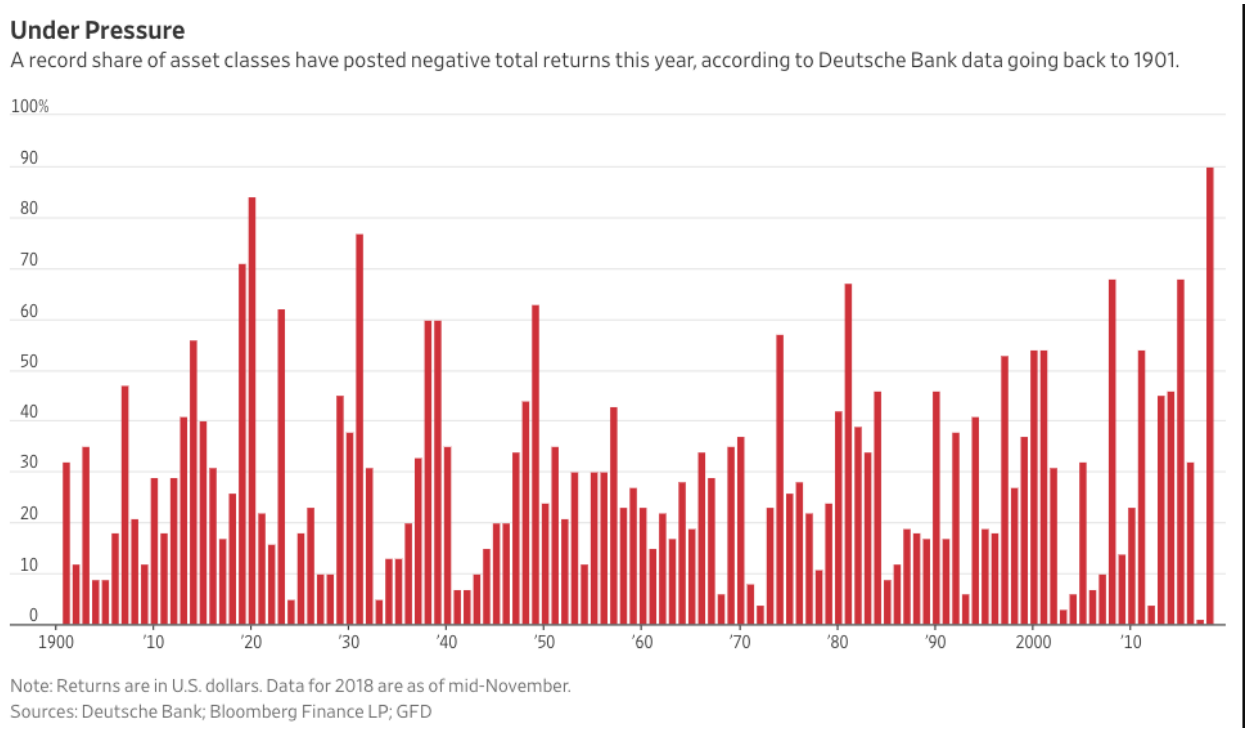
- The same instincts that have enabled us to survive as a species for thousands of years work against the long-term mindset required for successful investing. Resisting these instincts is critical for investment success.

- The 60/40 stock to bond portfolio allocation has had a great downhill run the past 30 years or so as interest rates declined. We believe alternative investments will be needed in the event that interest rates rise.

From 2009 to 2017, the S&P 500 (a proxy for U. S. stocks) experienced positive returns in every year.

> "It is not supposed to be this easy to make so much money, especially with such remarkable consistency" – Forward to *Reducing the Risk of Black Swans* by Larry Swedroe (December 2017)

In 2018, we saw a return of volatility after 2017 was the most tranquil year in decades. To provide some perspective, the S&P 500 had historically been negative 4 out of every 10 months, but in 2017, it was positive every single month. The S&P 500 concluded 2018 with a -4.38% return after 9 consecutive positive years. This was a broad-based selloff that saw more asset classes lose money than any year since 1901. With 90% of assets classes posting negative returns in 2018, holding a portfolio of many assets did little to ease the pain. While diversification works over time by reducing downside risk, in some years, it can feel like an epic fail.



Losing money is never a good feeling and we share in that. Our personal money and the money of our family members are invested in the same strategies as clients. Although any given year can be painful, we know that *the willingness to lose money in any given year or even consecutive years (taking on risk) is a pre-requisite to earning risk premium (earning a premium over cash) over the long-term.* It is that simple.

> "However, just because something is simple doesn't mean it is easy. Staying in the trade and seeking to earn the average [return] requires patience, discipline, and an ability to mentally manage substantial uncertainty – for an uncertain period of time. While not everyone can do that, the motivation to develop this practice is clear, as the ability to handle uncertainty is directly proportional to the quality of the long-term outcome that can be generated (i.e. the quality of your life). There are no shortcuts or magic pills.
>
> We don't generally associate inactivity with practice, but maintaining a target asset allocation each year is active and it does require practice. Every decision is an active decision, including a decision not to change. Practice is such a powerful thing that it doesn't have the ability to discriminate between what is good for you and what is not. If you practice negative habits that are not conducive to your growth, you will become really good at those negative habits. If you practice positive habits that are conducive to your growth, you will become really good at those positive habits." - Ross Stevens, CEO Stoneridge, *2018 Shareholder Letter*

Adopting a long-term mindset is learned behavior, and it provides a key benefit to our financial health. However, this mindset goes against our innate instincts, which have enabled us to survive as a species for thousands of years. We are not hardwired to be successful investors.

Loss Aversion. Research by behavioral economists [psychologists] has shown that investors feel twice as much pain from losses as they do pleasure from gains. Checking portfolios frequently is the single biggest culprit in increasing the number of times you "experience" a loss. The chances of experiencing a loss on a daily, monthly, quarterly, or annual basis, based on 100% allocation the S&P 500 has been 46%, 38%, 32%, 27%, respectively. Experiencing frequent "pain" increases the odds of throwing in the proverbial towel.

Recency Bias. "In markets, when there's a consensus, it gets priced in. The consensus is also typically believed to be a good rough picture of what's to come, even though history has shown that the future is likely to turn out differently than expected. In other words, humans by nature (like most species) tend to move in crowds and weigh recent experience more heavily than is appropriate. In these ways, and because the consensus view is reflected in the price, extrapolation tends to occur." – Ray Dalio, CEO of Bridgewater, *Principals for Navigating Big Debt Crises*

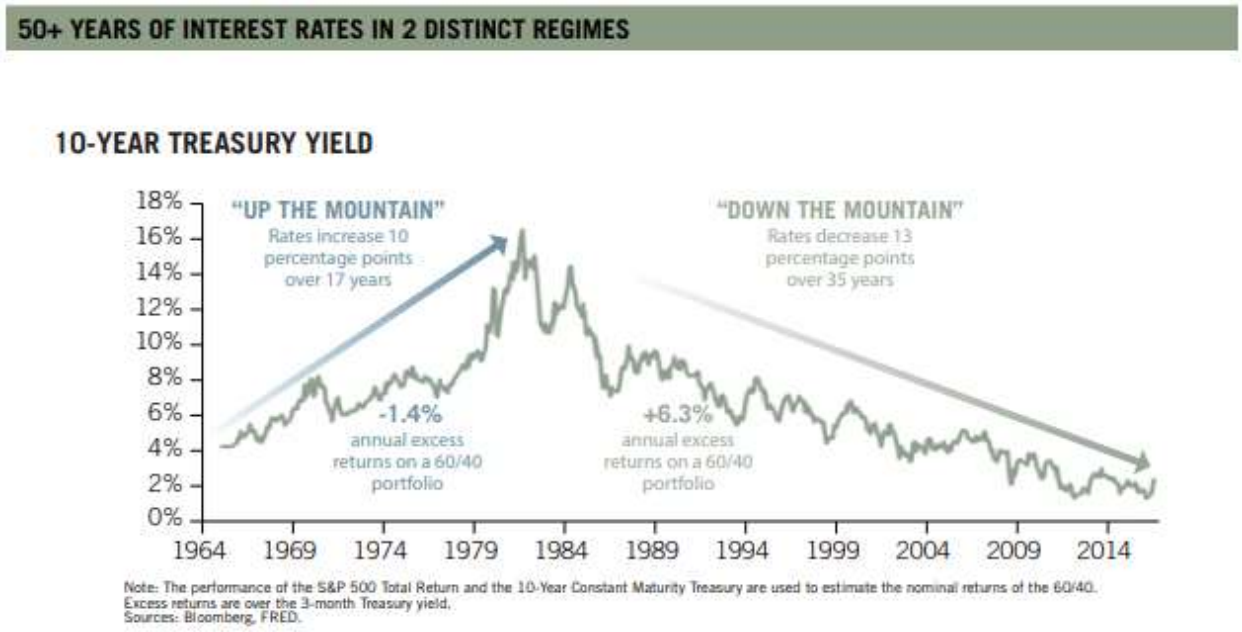
Overconfidence. In January of last year, one of our clients said, "Everyone knows the market is going to go up. We need to add more risk to the portfolio." Overconfidence is one of the most common biases examined in behavioral studies. It affects most individuals, both professionals and laypeople. In a 1981 study, Ola Svenson, Ph.D. asked students how to rate their driving skills. Up to 93 percent claimed to be better than the average, a statistical impossibility.

The Magical 60/40 Portfolio vs. Our Fiduciary Duty

From a business risk perspective, allocating to traditional stocks and bonds would be the least risky path. Furthermore, it would be even less risky to recommend mostly U.S. stocks and bonds, and disregard any evidence that suggests otherwise. In fact, if we sat around thinking about how to grow our firm, one of the last items we should spend our time on is being historically informed. Why? Because we know that our clients are less likely to fire us while experiencing inadequate returns, *as long as most people they know are in the same boat.* From a human behavioral standpoint, we are conditioned to think that being outside of the herd as risky. There is plenty of evolutionary logic behind this idea. Herding provides a sense of safety.

> "If we spend too much time as professional investors calibrating ourselves to our clients' comfort thresholds, there is significant risk that we will make sacrifices to our process, our investment discipline and ultimately our fiduciary duty of acting in our clients' best interests." - Advisor Perspectives, July 2011

The 60/40 stock/bond allocation has been, and continues to be, the most commonly used allocation across the industry. It has been battle tested over the last few decades. However, limiting our perspective to only the last few decades would be the equivalent of limiting our analysis of a runner's time to only the downhill part of the race, and extrapolating forward. If our life savings, and therefore, financial security, depend on conclusions we reach from looking at history, we better make sure our lens is wide enough. This graphic, which has been displayed in previous newsletters, gives us a broader perspective. It clearly demonstrates that the returns of a stock/bond blended portfolio is strongly influenced by the direction and magnitude of changes in interest rates. The 7.7% annualized difference between these two interest regimes is staggering.



None of us knows for sure the timing and direction of interest rates. However, we can certainly agree that rates have a stronger potential to rise than fall, given that the 10-year Treasury note yield currently stands at a historically low rate of 2.7%.

Alternatives

While we acknowledge that it has not been necessary to include alternative investments to stocks and bonds over the past few decades, we firmly believe that in order to earn sufficient returns in the current environment alternative assets have become a necessity.

More specifically, we recommend including assets that will benefit from rising rates. The easiest example is a money market fund (a.k.a. cash). These funds earned 0% 24 months ago and today they yield more than 2%. Federal Reserve Bank rate increases and money market fund returns move in the same direction. Assets that move in tandem with short-term rates are referred to as "floating-rate" assets. This is in stark contrast to stocks and bonds, or any assets whose value depends on a long-term earnings stream. These "duration" assets suffer a valuation drop when rates rise.

Allocating to a portfolio of both floating-rate and duration assets will better enable investors to reach their financial goals in flat or rising rate environments.

Our current alternative exposure mainly consists of reinsurance and multi-asset option writing. Both strategies earn returns over time by collecting premiums to cover risks others seek to avoid. In other words, both strategies sell "insurance" to market participants. Also, both strategies earn a component of their return from the yield they receive on conservatively investing the capital received from shareholders and premiums collected in floating-rate securities.

The nature of selling insurance is to collect a premium over time to insure potentially large loss events. The return stream (premiums exceed payouts or payouts exceed premiums) can feel uncomfortable for those that are examining their portfolios frequently. Here are some relatable examples.

Most people know that paying for car and homeowners insurance is a losing trade over time. However, when an accident occurs, the insurance company makes a large payout relative to the annual premium. The insurance company recognizes in that year that it "loses" and the insured "wins". However, over many policyholders and many years the sum of premiums collected less expenses and infrequent payouts for claims results in a stream of profits for insurance companies.

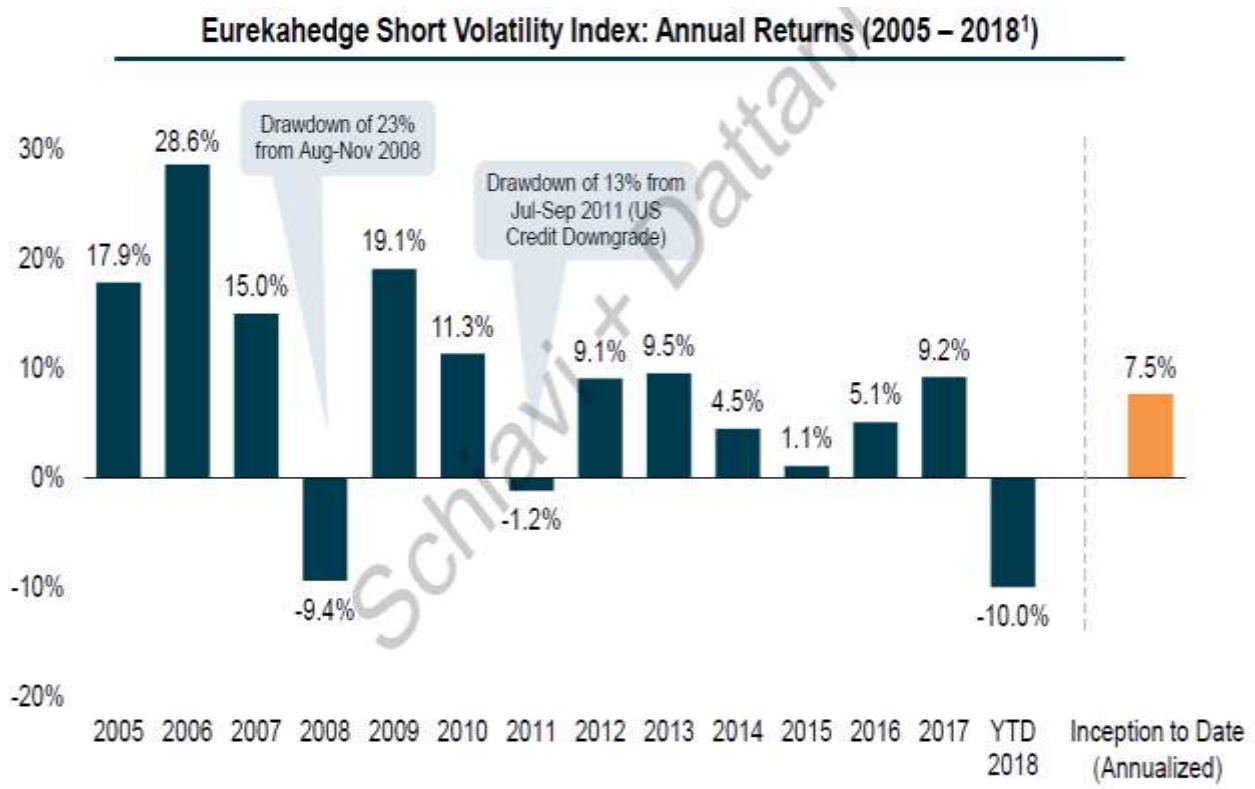
Vegas slot machines are geared to payout a certain amount of winnings. The amount taken in per hour can be dwarfed by a large payout when someone hits the jackpot. However, over time, the hourly slot revenue exceeds the payout.

When a portfolio contains exposure to securities that capture a return stream similar to that of insurance companies, large payouts that happen to coincide with downturns in the stock market can make it feel like the portfolio is capturing more downside on "down" days than upside on "up" days. It is important to understand that coincidences do occur in the short-term, but not over longer periods of time.

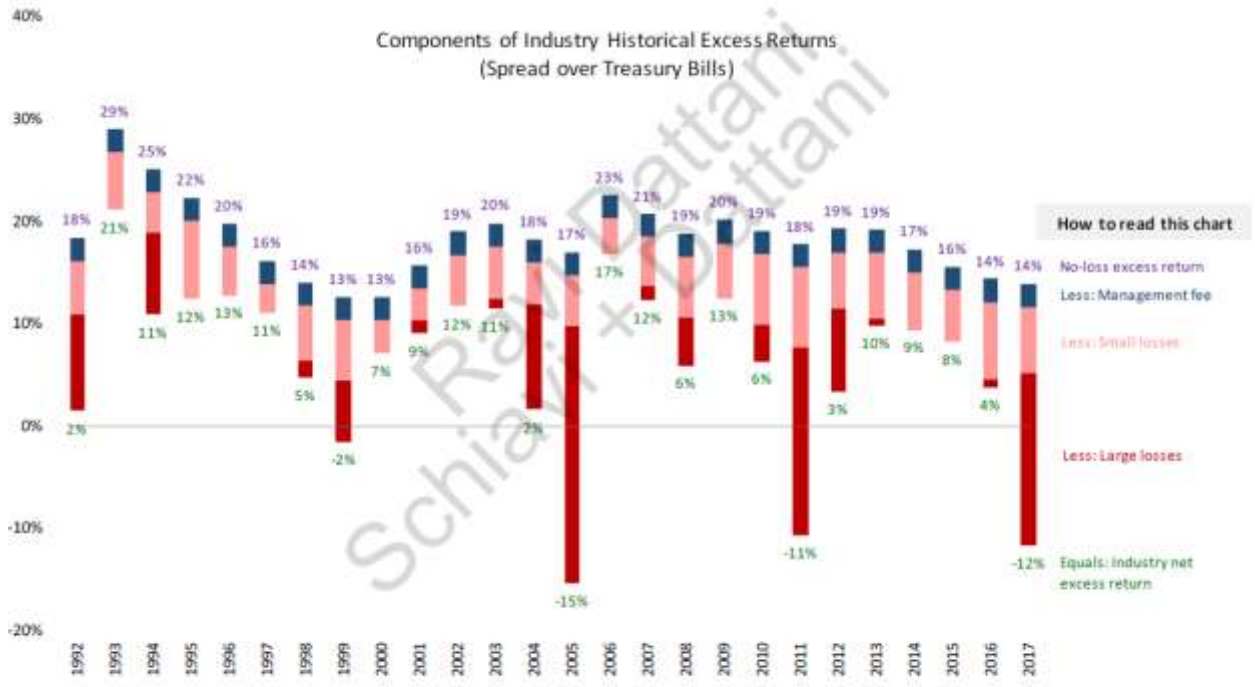
Below are two graphics that show the historical return stream of the Eurekahedge Short Volatility Index, which represent a reasonable proxy for the Stone Ridge All Asset Variance Risk Premium Fund (AVRPX).

Historical Monthly Performance

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2018	-2.21	-4.84	-2.11	1.12	-0.09	-0.53	2.56	0.41	0.36	-3.14	0.33	-5.49	-13.10
2017	1.41	0.51	1.30	0.92	0.58	0.40	0.64	0.67	0.88	0.41	-0.16	1.17	9.06
2016	-2.76	-0.10	2.05	0.12	1.38	-1.56	1.20	1.26	1.09	0.98	0.80	0.65	5.09
2015	-0.02	2.24	0.42	0.26	0.77	-0.02	1.04	-4.74	0.72	0.81	0.53	-0.76	1.09
2014	-0.54	1.83	1.35	0.64	1.20	0.67	-0.69	1.91	0.39	-2.88	1.12	-0.51	4.47
2013	1.63	0.40	1.39	0.61	-3.07	0.14	2.50	-0.28	1.95	1.81	0.76	1.41	9.53
2012	1.50	1.39	-0.37	1.23	-2.12	2.34	-0.27	3.17	0.95	-0.45	1.31	0.14	9.07
2011	1.12	1.15	1.31	1.90	1.45	0.73	-1.48	-10.25	-1.14	1.14	0.06	3.49	-1.20
2010	-0.44	2.17	1.75	-0.60	-2.85	1.49	2.36	2.24	0.33	1.65	0.72	2.10	11.35
2009	-0.86	2.54	-1.32	3.99	2.17	2.75	-0.87	1.41	1.32	0.02	3.81	2.84	19.10
2008	-4.21	3.51	2.05	2.52	2.86	1.02	1.35	2.50	-14.15	-8.10	-2.68	5.38	-9.41
2007	1.81	-1.24	-1.21	2.21	3.12	0.88	-1.57	0.34	3.02	1.94	2.16	2.74	14.97
2006	2.30	1.67	2.91	1.74	1.23	3.01	1.82	4.24	0.77	1.09	1.83	2.88	28.63
2005	0.28	0.69	1.04	-4.56	2.78	-0.04	0.82	4.41	6.35	-0.35	3.17	2.36	17.86



For a historical perspective, the following graphic represents a reasonable proxy of the return stream of the reinsurance industry and, therefore, your exposure to the Stone Ridge Reinsurance Risk Premium Interval Fund (SRRIX). Note that the return stream is presented as the amount earned in excess of T-bills (or short-term interest rates), but are gross of fees. The targeted return for this fund is 4-6% above cash.



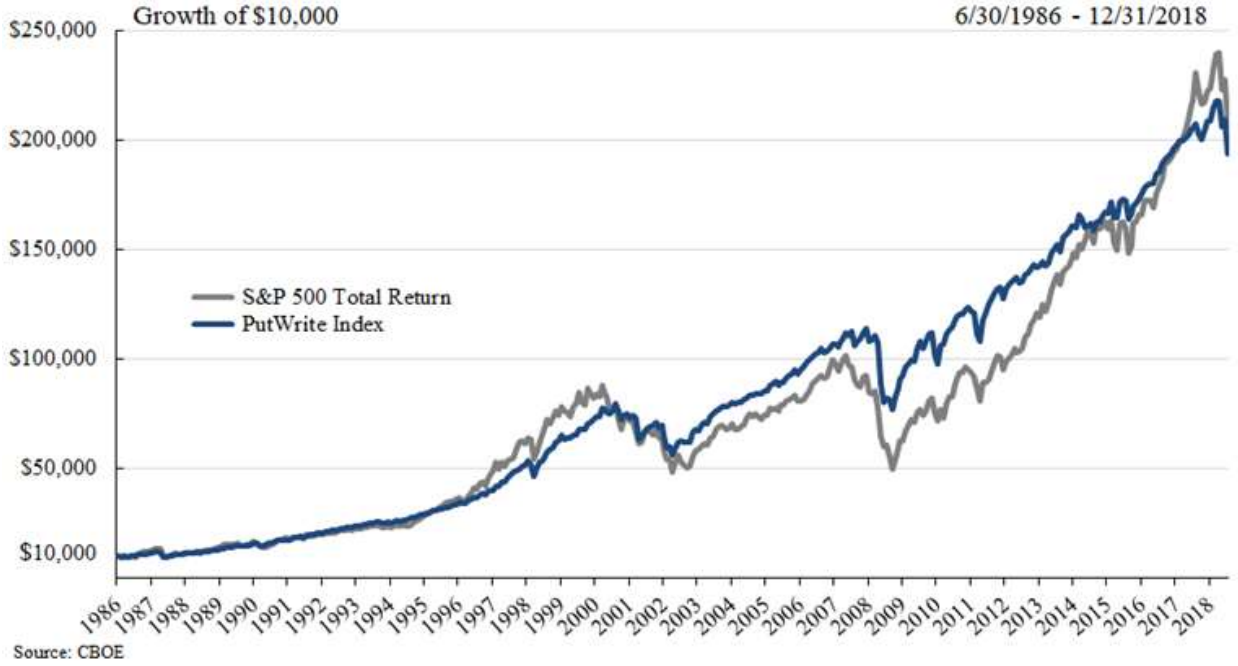
Source: Stone Ridge, Bloomberg, AIR Worldwide, Guy Carpenter, public data from Swiss, Munich, and Hannover Re. No-Loss Excess Returns are calculated as Gross Return on Capital (see appendix for methodology) minus the T-bill rate (which is based on the Goldman Sachs Financial Square Treasury Instruments Fund (FTIXX), a money market fund that invests in short-term US T-bills).

Portfolio Changes

We will be resizing our alternative (alt) category so that no single position exceeds 10% of a client's portfolio. We have not lost confidence in any of our alt positions, but feel that clients will be more comfortable with an additional holding to soften the near-term impact of any single holding.

In order to resize our alt positions, we will be adding the Ironclad Managed Risk Fund (IRONX). This fund will be familiar to many of you. IRONX earns its return by opportunistically selling put options on the S&P 500 Index. A good proxy for this fund is the CBOE Put/Write Index. See the following graphic.

There may be additional trading done in client portfolios to rebalance to recommended investment allocations.



6/30/1986 - 12/31/2018	S&P 500	PutWrite
Total Return	9.75%	9.54%
Standard Deviation	14.94%	9.95%

On Our Radar: Natural Resources / Commodities

The fundamental reason to include commodity-related exposure in the portfolio is that doing so has historically provided outsized returns in inflationary environments. Although our portfolios contain a small exposure to natural resources, it has been difficult to maintain the positions given that the returns have been dismal for the last decade. There were pronounced declines in commodity-related investments during last quarter as oil prices dropped.

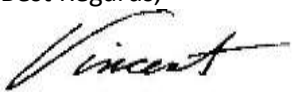
We have evaluated this exposure to determine whether valuations are so deeply discounted that this asset class is poised for a recovery or whether there has been a fundamental shift in the supply and demand of commodities that will continue to challenge the return stream going forward. Based on our call with the Victory Global Natural Resources Fund team, we feel that this market is extremely oversold and that targeted exposure should be maintained. According to their analysis, there are many companies that are trading at 55-60% discounts to the discounted cash flow of their underlying projections. The last time that this discount reached comparable levels was near the end of 2015. Natural resources stocks rallied considerably in 2016. The category is up 8% in the first 14 trading days of 2019.

While we will continue to review whether we want to include dedicated natural resources exposure, the deep discounts that exist in natural resources stocks merits holding this exposure for now.

We use these newsletters to communicate important financial and investment considerations with the hope that they are read and understood in their entirety. However, it is often more effective to have one-on-one personal meetings or calls to discuss any and all specific concerns you may have. Please do not hesitate to reach out to us should you be experiencing an unacceptable level of financial anxiety. We have decades of experience successfully guiding clients through difficult times.

We continue to work daily to earn your trust and confidence.

Best Regards,



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PS - Check out our upgraded website at www.sdfinancialadvisors.com and give us some feedback.