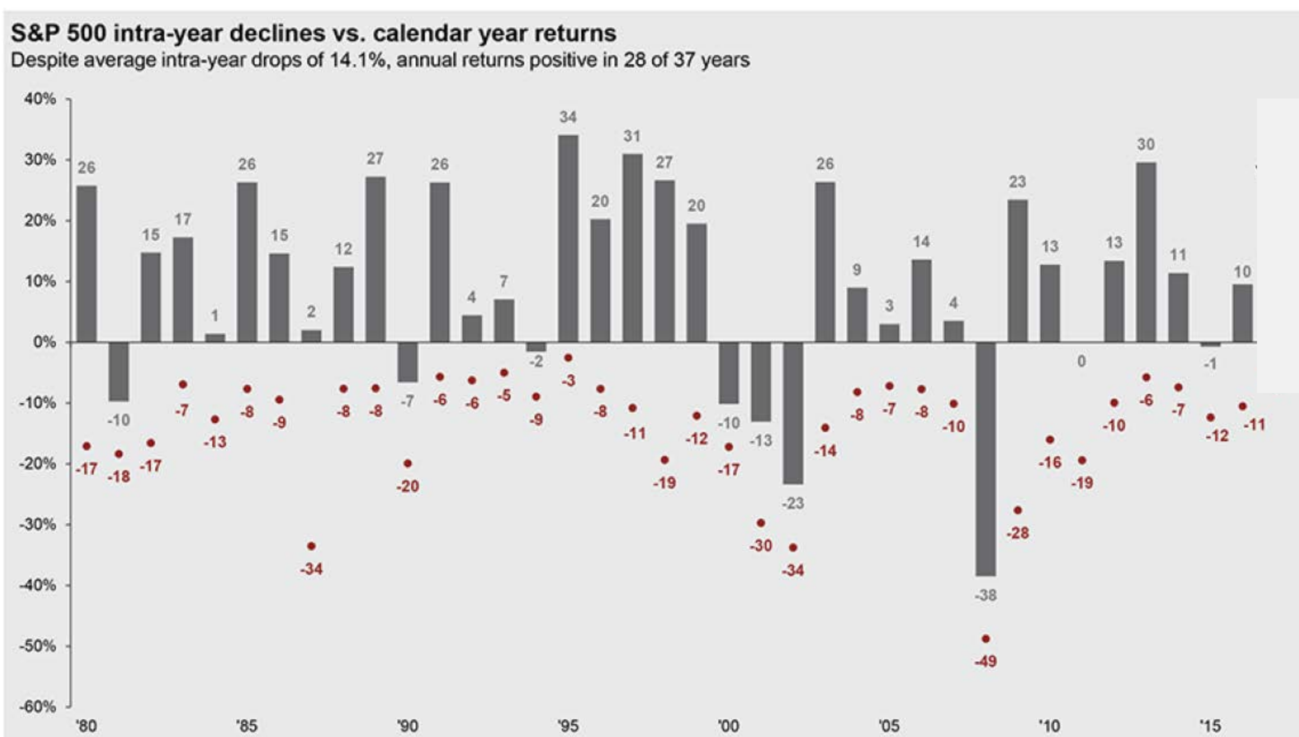
Special Comment on Q4 2018 Financial Market Correction

Since the end of Q3, the US stock market (along with almost all risky financial assets) have experienced a significant drawdown. The SP500 is now down about 16% from the recent market top in late September and down about 10% this month alone.

The depth of the correction, although now material, is by no means out of the ordinary. On average a 15% to 20% correction happens once every two years. However, after a full decade of very low volatility and only three other corrections of this magnitude, it has a particularly pointed impact.

In addition, the speed of the decline has been swift, with the stock market going from an all-time high to current levels in less than 3 months.

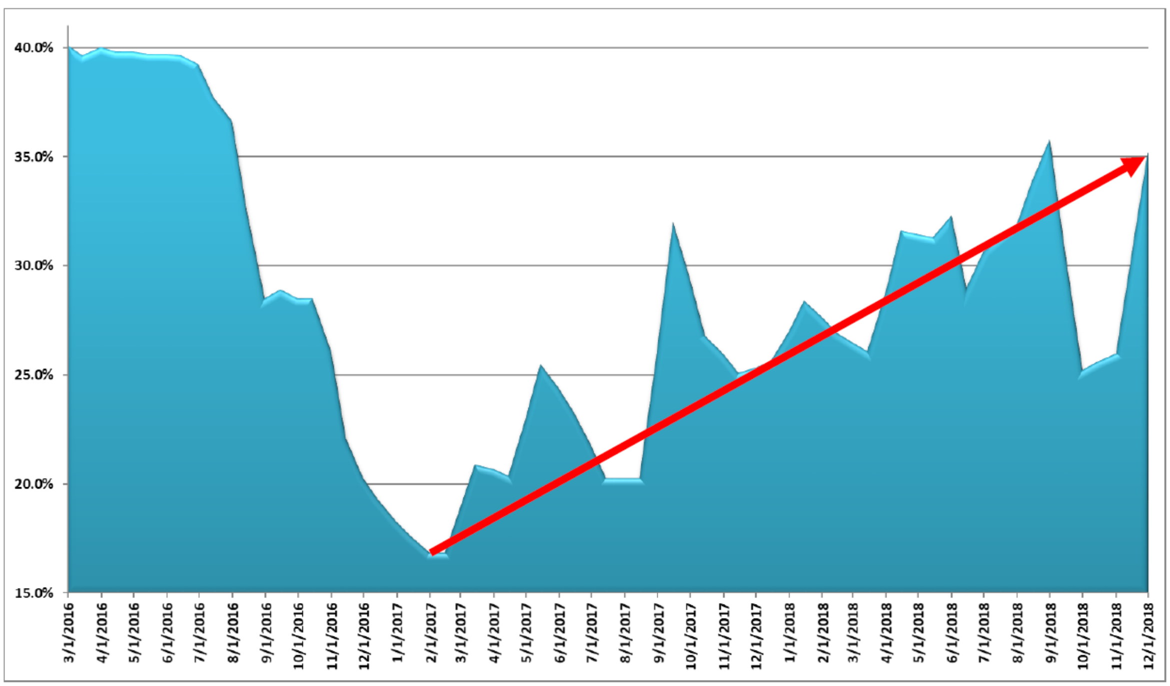


Above: 1980 – 2018 intra-year SP500 drawdown (red); final return (gray bar)

An important question to ask**; is this simply a run of the mill correction, or the beginning of a more protracted bear market often associated with a significant slowdown or recession?** We will discuss this briefly below, along with what we have done to date it terms of portfolio defense and what we are planning to do in the near future.

Normal Correction or Bear Market/Recession?

One of our main aggregation tools in determining if a recession is likely or not, is our own **Traphagen Recession Index (TRI).** This incorporates our own data along with third party metrics, that has had predictive ability in the past. Right now, **we see a ~ 35% chance of a recession in 2019**. This is roughly 15% above normal and trending higher, but we are not in the 'recession likely' camp just yet. **That being said; we are planning some defensive actions for early 2019 and will continue to monitor this metric for further increases.**



Above: 3/2016 – 12/2018 Chart of the Traphagen Recession Index (TRI)

It is tough to get a sustained 20%+ stock market drop without a recession, **so even if we are heading for a slowdown (but not an outright contraction in GDP/earnings), this volatility could present a great buying opportunity.**

If we feel an actual recession is likely, our short-intermediate emphasis would be more on capital preservation without deviating from long term goals.

Defensive Portfolio Actions taken over past couple years:

We do not believe in short/intermediate term market timing; research has proved this to be detrimental to long term returns. A ‘Buy and hold’ portfolio in line with a level of risk the investor is comfortable with is the ‘secret’ to long-term wealth.

This being said, given applicable historical data and analysis we can get an idea of broad stock and bond valuations. This helps us estimate longer-term asset class returns. For several years we were somewhat cautious on stock/bond valuations (even though the economy was quite positive) and we began to take action beginning in 2015. As we have communicated several times in the past we have added more and more alternative and private investments into portfolios. **Right now, most clients have between 30% and 40% of their portfolios in these investments, which have little or nothing to do with the stock market, bond market, or economy.** This year, with global stocks down around 11%, the overall pool of alternative investments is near breakeven with the private investments up around 8%.

In addition, on the stock side, we have tilts to value, dividend, and quality companies through individual stock exposure and funds. We are also overweight the healthcare sector which tends to be a more recession resilient portion of the market.

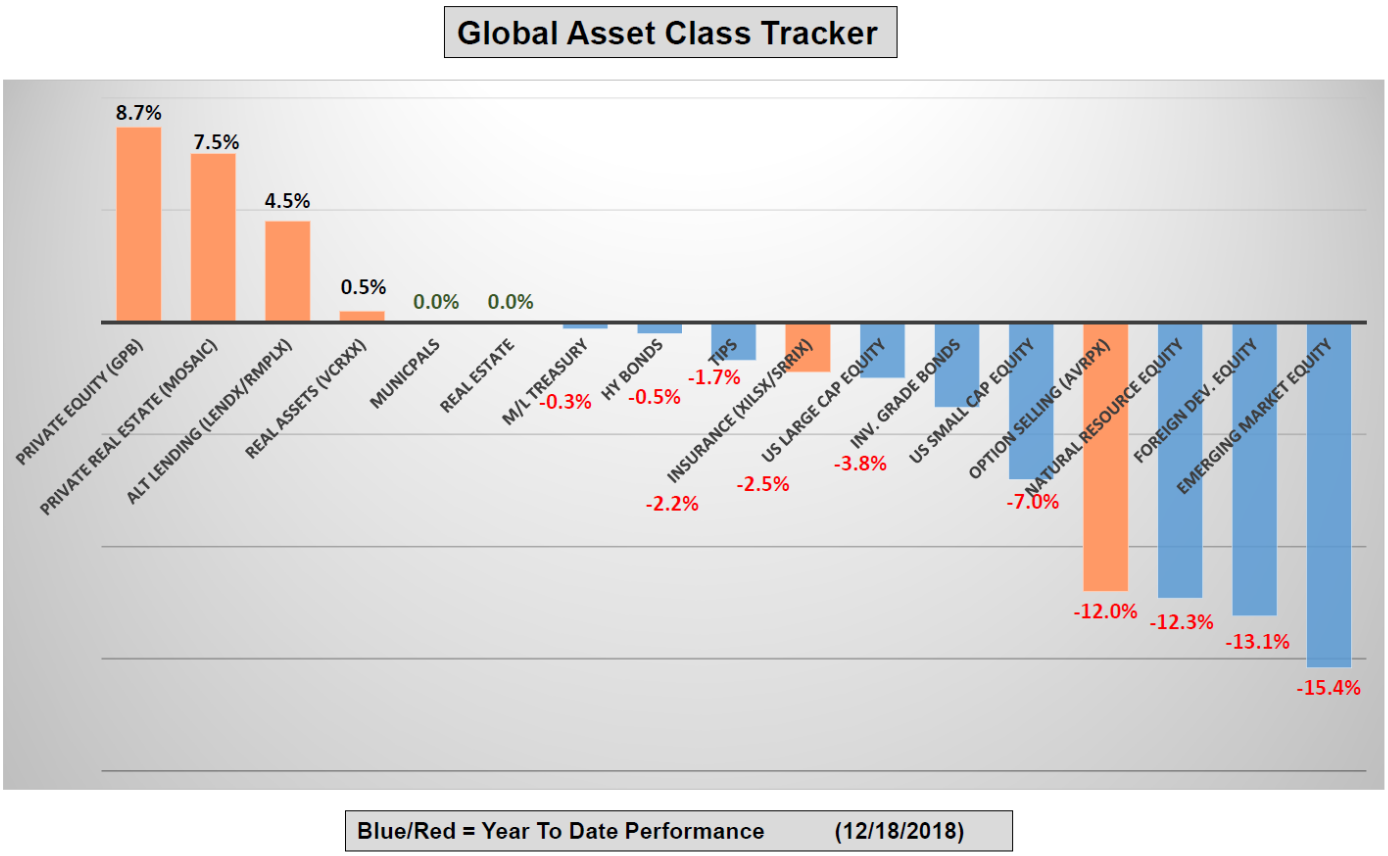
For conservative investors, most high quality bonds are now near breakeven or slightly higher on the year which also provides protection.

Related to the above, with all client portfolios we have a max target BETA (or max risk we can take by mandate). **Currently we are below this max level of risk on all portfolios by 10% to 30%. This is significant and already reflected in your investments.**

Defensive Portfolio Actions Likely Over Next Month:

Although our base case in no outright recession in 2019, we will most likely be adding some additional defensive actions within the next couple weeks.

- Addition of some ultra-short term bonds/cash into portfolios which now yield 2.5% - 3.5%
- Transition from high yield and investment grade corporate bonds to higher quality Treasuries
- Possible overweight of additional recession resilient stocks (utilities, consumer staples, etc.)



Above: Year to date asset class returns (Orange = TFG alternatives)

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In conclusion, we want to ensure you; that your entire Traphagen team is monitoring the economy, the FED, interest rates, and what impact this can have on portfolios consistently**. It is important to understand we are already well- defensed across the board, materially below our max risk targets for all portfolios**, and looking to make some additional defensive trades within a couple weeks. If we see a recession more likely as we enter 2019, we are ready to take yet additional action.

Investing is a long-term exercise, and although painful; times like this (especially when we have 30% to 70% of portfolios outside of the equities market) are opportunities to purchase cheap stocks with that protected capital.

We wish all a great holiday season and a prosperous 2019. As we all celebrate at this time of year, be comforted that we are monitoring all developments and will take additional action if warranted to protect your hard-earned capital.