A Few Words on the Past Year **January 16, 2019**

The year 2018 will be remembered as the year that principles carried the investor forward rather than the market. The year was a lesson in market behavior and how anyone that only focused on the market and current events would have been twisting in the wind. We have long stated our belief that optimism is the only realism when it comes to long-term investing. Certainly 2018 tested that faith. Thus, we thought an overall recap of our guiding principles, followed by our current observations, may be of comfort during this period of market unrest.

PART ONE: GENERAL PRINCIPLES

- It is still worth restating our overall philosophy of investment advice, even in the context of a letter primarily focused on this past year. It is goal-focused and planning-driven, sharply distinguished from an approach that is market-focused and current-events-driven. Every successful investor we have ever known was ***acting continuously on a plan***. In our experience, investors fail by ***reacting to current events in the economy and the markets.***
- We neither forecast the economy, nor attempt to time the markets, nor predict which market sectors will "outperform" which others over the next block of time. In a sentence that always bears repeating: We are planners rather than prognosticators.
- Once a client family has a plan in place—and have funded it with what have historically been the most appropriate types of investments—we rarely recommend changing the portfolio ***so long as your long-term goals haven't changed.*** As a general statement, we have found that the more often investors change their portfolios (in response to the market fears or fads of the moment), the worse their long-term results.
- In summary, our essential principles of portfolio management are fourfold:
  1. The performance of a portfolio relative to a benchmark is largely irrelevant to long-term financial success.
  2. The only benchmark we should care about is the one that indicates whether you are on track to accomplish your financial goals.
  3. Risk should be measured as the probability that you won't achieve your goals.
  4. Investing should have the exclusive objective of *minimizing that risk.* (As a side note, this is also why we feel stocks are the less risky option for most clients facing a 30+ year retirement of increasing costs.)

PART TWO: CURRENT OBSERVATIONS

- 2018 was perhaps the strangest year we have experienced in our careers as financial advisors. While the economy did well, markets did poorly. In addition, the significant divergence of overall returns among the major asset classes was pronounced and far larger than average. The year past was one of the truly great years in the history of the American economy and by far the best one since the global financial crisis of 10 years past. Paradoxically, it was also a year in which the equity market could not get out of its own way.

- It is almost impossible to cite all the major metrics of the economy which blazed ahead in 2018. Worker productivity, which is the long-run key to economic growth and a higher standard of living, surged. Wage growth accelerated in response to a rapidly falling unemployment rate. Household net worth rose above $100 trillion for the first time, yet household debt relative to net worth remained historically low. Finally—and to us this sums up the entire remarkable year—for the first time in American history, the number of open job listings exceeded the number of people seeking employment.
- Earnings of the S&P 500 companies, paced by robust GDP growth, leaped upward by more than 20%. Cash dividends set a new record; indeed, total cash returned to shareholders from dividends and share repurchases since the trough of the Great Panic reached $7 trillion.
- But the equity market had other things on its mind. Having gone straight up without a correction throughout 2017, the S&P 500 came roaring into 2018 at 2,674—probably somewhat ahead of itself, as it seemed to be discounting the entire future effect of corporate tax cuts in one gulp. There ensued in February a 10% correction, followed by several months of consolidation. The advance resumed as summer waned, with the S&P Index reaching a new all-time high of 2,931 in late September. It then went into a savage decline, falling to the threshold of bear market territory: S&P 2351 on Christmas Eve, off 19.8% from the September high. Small-cap stocks as represented by the Russell 2000 fell 27.7% from their respective high on August 31. Foreign stocks of the MSCI EAFE index peaked on January 26, hitting bottom on Christmas Eve declining 24.4%. A rally in the last week of trading carried the market back up to 2,507 on the S&P, but that still represented a solid 6% decline on the year, ignoring dividends. 2018 thus became the tenth year of the last 39 (beginning with 1980) in which the S&P 500 Index closed lower than where it began. At the long-term historical rate of one down year in four, that's actually just par for the course.
- The major economic and market imponderable as the year turns is trade policy, which in the larger sense is an inquiry into the mind of President Trump. We think it's fair to say, as the economist Scott Grannis recently did in his blog, that while corporate tax and regulatory reduction have been an economic benefit, Trump's "tweets and his tariff threats have created unnecessary distractions and unfortunate uncertainties, not to mention higher prices for an array of imported consumer goods."
- These and other uncertainties—perhaps chief among them Fed policy and an aging expansion—were weighing heavily on investor psychology as the year drew to a close. For whatever it may be worth, our experience has been that negative investor sentiment—and the resulting equity price weakness—have usually presented the patient, disciplined, long-term investor with enhanced opportunity. As the wise and witty Sage of Omaha wrote in his 1994 shareholder letter, "Fear is the foe of the faddist, but the friend of the fundamentalist."

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