IN THIS REPORT

The Colony Group

MARKET PERSPECTIVES

QUARTER FOUR 2018

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The fourth quarter of 2018 will go down as one of the worst for investors since this recovery began in March of 2009. Indeed, the MSCI All Country World Index (ACWI), a measure of global equity performance, returned -12.8%, its sixth worst quarterly performance since the index's inception in 1998. Pundits point towards a multitude of factors contributing to investors' sudden aversion to risk, including a host of political and policy uncertainties such as Brexit, monetary tightening, and escalating trade tensions. While these risks may weigh heavily on investors' psyche, they are not new. The most significant catalyst for the fourth quarter selloff, in our opinion, was the deceleration in global growth combined with Federal Reserve Chairman Jay Powell's commitment to keep raising interest rates.

Investors were indiscriminate with their selling during the quarter, with nearly all asset classes experiencing declines. The one notable exception was fixed-income, where all but the riskiest sectors recorded positive returns for the quarter despite being flat for the year. The Bloomberg Barclays US Aggregate Bond Index, the most widely used fixed-income benchmark, returned +1.6% and +0.0% for the quarter and year, respectively. International equities, as measured by the MSCI Europe Australasia Far East Index (EAFE), experienced sharp losses for the quarter (-12.5%) and the year (-13.8). U.S. equities converged with their international counterparts, which peaked back in February, with the broad Wilshire 5000 Index declining -14.4% and -5.3% for the quarter and year. Generally, alternatives and real assets performed relatively better than equities for both the quarter and year; however, returns for both were negative.

Market participants are discounting a rising probability of a U.S. economic contraction in 2019. While it is clear that growth is decelerating from the above-average pace seen during the first three quarters of 2018, which was boosted by fiscal stimulus in the form of tax cuts and spending increases, we are not yet convinced that we are heading into an imminent recession. We believe that changes to monetary and fiscal policy will ultimately decide the trajectory of growth in 2019.

Is this time different?

The phrase "this time is different" is often heard near market tops, serving to underscore a level of complacency that is typically pervasive during the late phase of a cycle. Today, however, fear and pessimism seem to reign, likely due to lingering memories of losses incurred during the 2008-2009 financial crisis. While the economy may be in a later phase of the cycle, we believe there are key differences between the outlook for risk assets today versus prior to previous large market dislocations.

Since 1946, the S&P 500 has suffered through 11 bear markets (defined as a decline in the index of at least 20%), averaging a peak-to-trough decline of -34%. Averages can be misleading, however, as there were a few steep drawdowns that skewed the average lower. These include a -48% decline during the recession of 1973, a -49% drawdown associated with the dotcom bubble, and a -56% loss during the financial crisis. Excluding these three outliers, the average decline during a bear market is closer to -27%. What differentiates these three periods from the others is that each of those times the economy experienced a buildup of imbalances that eventually led to a recession. In the case of the most recent two bear markets, the imbalances took the form of bubbles in the internet and housing sectors. The 1973 recession was caused by an external shock in the form of a sharp rise in oil prices resulting from the Organization of Petroleum Exporting Countries oil embargo.

How can we be sure that similar imbalances are not present today? While there is no way to know for certain, we believe that signs would be more noticeable by now. It was evident to many that excesses were forming in the housing market and that valuations for dotcom companies had reached extremes and that spending on the internet sector was unsustainable prior to those bubbles bursting. Less obvious, however, was how large these bubbles had become and how painful and sudden their deflation was. Regardless, these types of excesses are not readily apparent today.

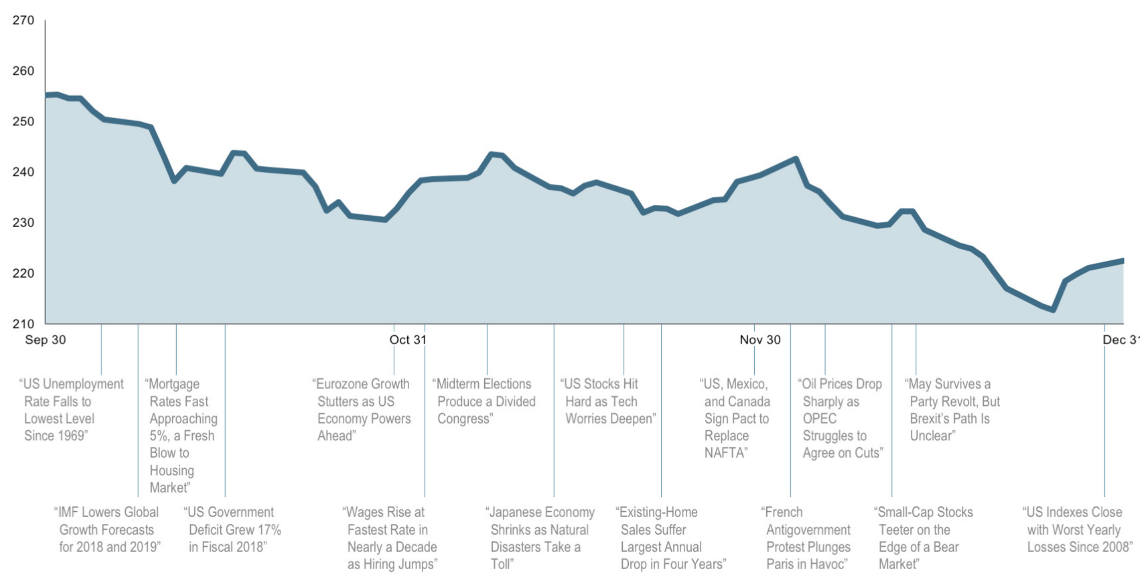
For sure, we have concerns about the rising levels of global debt, particularly the level of sovereign debt for select countries. Yet, we acknowledge the longer sustainability of this type of debt due to most nations' ability to control the supply of its currency.

WHAT THIS MEANS

We know from nearly a century of empirical evidence that equity markets move through cycles. There are up cycles (bull markets) and, unfortunately, down cycles (bear markets). We view the volatility associated with bear markets as consideration for earning generally higher returns over time from equities. Helping our clients understand and accept that bear markets happen and assisting them in navigating these downturns through rebalancing and allocation shifts is one of the most important roles that we have as advisors.

With the understanding that there will inevitably be another bear market somewhere in the investment markets at some time in the future (in fact, we already experienced several 20%+ declines in select indices during 2018), it is important to recognize that not all bear

MSCI ALL COUNTRY WORLD INDEX WITH SELECTED HEADLINES FROM Q4 2018



These headlines are not offered to explain marketplace returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCIACWI Index [net div.]. MSCI data © MSCI 2019, all rights reserved.
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results.**

markets are the same. Investor perspectives are heavily influenced by the most recent past. As such, we appreciate why some investors are so anxious as a result of the recent stock market selloff. The last two bear markets were among the most painful in history.

We remain vigilant for signals of a recession and are prepared to change our portfolio positioning as the data changes. Should a sustained bear market materialize in the U.S. equity markets, we are encouraged by our belief that the next time will not be different; it is more likely to be similar to the previous nine bear markets that were not the result of a bursting asset bubble.

Conclusion

The many risks confronting investors today have been discussed at length by the media, which never overlooks a chance to promote a crisis. These risks are unsurprisingly causing investor angst, which is manifesting itself in the form of heightened volatility across the spectrum of risk assets.

So how can we remain constructive on risk assets given the recent slowdown in U.S. economic growth and the heightened level of discord amongst policymakers? Most economists are forecasting a slowdown in the pace of growth solely because the impact of fiscal stimulus is waning. We believe it will take something more to push the economy into a recession, however. That something, many believe, could result from a policy misstep.

Politicians are not oblivious to the markets. They understand the role that voter confidence has in their ability to get re-elected and the tendency for the investment markets to reflect this confidence. In this, politicians' interests are aligned with investors'. A vibrant, growing economy is necessary for job creation and rising standards of living, which in turn drive confidence, raising the approval ratings of elected officials. Therefore, politicians will often use the means at their disposal to support the economy in order to maximize their chances of being re-elected.

We believe that smart investors elect to manage risk rather than time the markets. The difference in the two approaches is subtle but important. Risk managers, in recognition of the difficulty in getting both halves of the market-timing decision right (when to get out and when to get back in), prefer to make deliberate, measured changes to their portfolio. This time-tested approach serves to minimize trading costs and taxes while allowing the portfolio to be opportunistic or defensive based on an assessment of the risks. We have adopted this philosophy because we believe it is the most effective way to reduce costs, minimize taxes, and optimize long-term returns.

See Colony Spotlight on page 4.

COLONY SPOTLIGHT

▸ The Colony Group is Honored with Two Industry Awards

We are proud to announce that we are the winner of the 2018 Trailblazer IMPACT Award™, part of Charles Schwab & Co., Inc.'s Impact Awards® program. This award is presented to a firm that combines an entrepreneurial spirit with a drive to help the financial services industry reach new heights – either through special initiatives, or simply as a result of the passion and commitment that they bring to their business every day.

The Colony Group is just one of only two firms to win two IMPACT Awards®; the Best-In-Business IMPACT Award™ in 2010 and now the Trailblazer IMPACT Award™.


Watch our video unveiled at Schwab IMPACT® conference

▸ Nina Mitchell Named One of InvestmentNews' Women to Watch

InvestmentNews has recognized Nina Mitchell, Principal & Senior Wealth Advisor at The Colony Group & Co-President, Colony Sports and Entertainment as a 2018 Women to Watch honoree. As one of the 22 winners, Mitchell was chosen from several hundred nominations nationally for her leadership, contributions and impact in the financial advice industry.

Each of the advisors and executives who made the fourth annual InvestmentNews Women to Watch list were chosen from a selection process designed to identify women who possess leadership skills, the ability to effect change in the industry, a willingness to share their expertise with other women, and are committed to giving back to the community.

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