PENNIALL PERSPECTIVE
January 2019

The New Year always brings about reflection on the year that just concluded and the distant past. Whether your reflections are positive or negative, the turning of the proverbial page allows for a clean slate on which to set or reset goals and expectations for the year ahead. While investing should be viewed as a long-term endeavor with no true beginning or end, revisiting your expectations periodically is critical to achieving positive results and a pleasant investing experience. And your expectations are a critical component in this equation. To that end, we want to highlight a concept called the Happiness Equation.

The Happiness Equation[1]

As an investor, your happiness depends on having realistic expectations about returns and viewing market events in proper context. These two factors can drive your sense of financial well-being and influence your financial outcome.

To say that "money isn't everything" is more than a cliché. Studies in the early 1970s demonstrated that a sense of well-being, or happiness, had not increased commensurately with income over the previous half century.[2]

That trend continues as the modern world has arguably made well-being more elusive than ever. Fortunately, positive psychology arose in the 1990s, attempting to find the key to understanding what makes people flourish. It has spawned the so-called happiness literature that seeks modern truth by weaving together science and ancient wisdom. How to be happier is now the most popular course at Harvard and Yale.[3]

Business people and entrepreneurs are also contemplating some of these age-old questions. Mo Gawdat, a serial entrepreneur and Chief Business Officer at Google X, tried to engineer a path to joy in his book, Solve for Happy, by expressing happiness as an equation.

HAPPINESS ≥ Your Perception of the EVENTS of your life − Your EXPECTATIONS of how life should behave

According to Gawdat's model, if you perceive events as equal to or greater than your expectations, then you're happy—or at least not unhappy.

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[1] Adapted from The Happiness Equation by Brad Steiman, published on the Dimensional Funds Website.

[2] In his seminal article, Easterlin (1974) saw that while industrialized countries had experienced phenomenal economic growth over the past 50 years, there had been no corresponding rise in the happiness of their citizens. Easterlin, Richard A. "Does Economic Growth Improve the Human Lot? Some Empirical Evidence," University of Pennsylvania, 1974.

[3] Ben-Shahar, Tal. Happier: Learn the Secrets of Daily Joy and Lasting Fulfillment. "Yale's Most Popular Class Ever: Happiness," The New York Times, 26 Jan. 2018. www.nytimes.com/2018/01/26/nyregion/at-yale-class-on-happiness-draws-huge-crowd-laurie-santos.html

Investors wanting to increase their wealth and well-being should consider his model. You cannot control many events that affect your portfolio, but events themselves are not part of the equation. Fortunately, you have some control over the two variables driving happiness—your perception of the events and your expectations.

Your happiness as an investor depends on how your perception of events stacks up against your expectations. Proper expectations alongside the appropriate perception can help you stay the course and may improve your wealth and well-being. As David Booth, Executive Chairman and Founder of Dimensional Fund Advisors, says, “The most important thing about an investment philosophy is having one you can stick with.”

We will continue to focus on your goals and properly setting your expectations as we meet with you in the year ahead but do not hesitate to contact your advisor to have a conversation about your goals, your portfolio and the proper expectations you should have with respect to these topics.

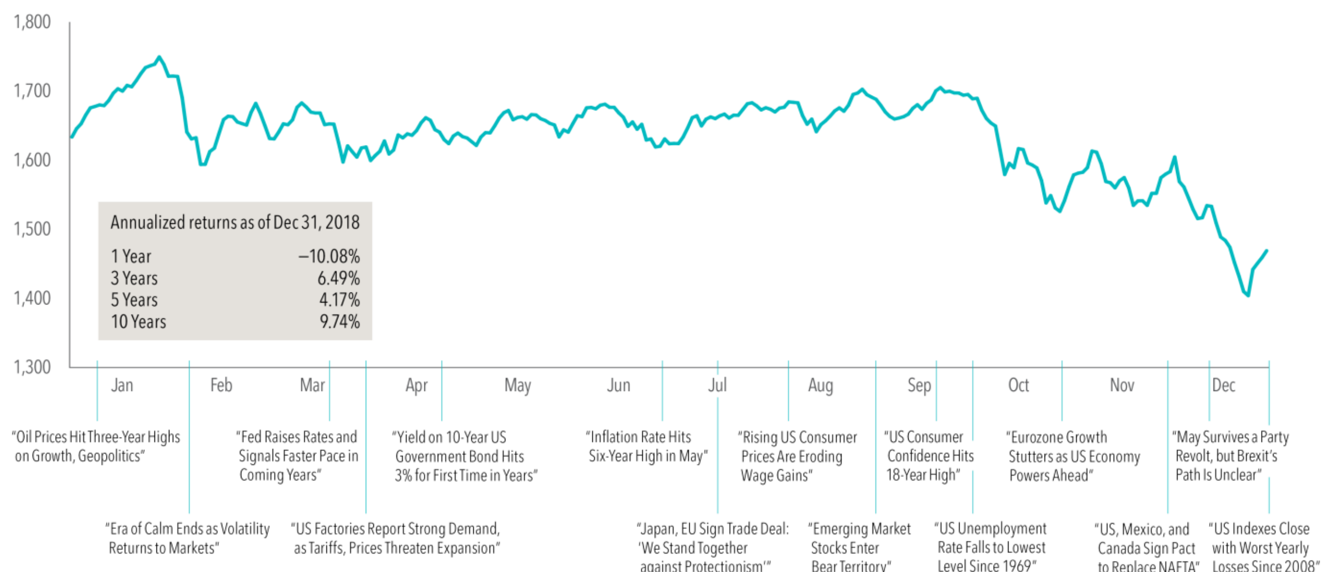
Market Updates – Year in Review

After logging strong returns in 2017, global equity markets delivered negative returns in US dollar terms in 2018. Common news stories in 2018 included reports on global economic growth, corporate earnings, record low unemployment in the US, the implementation of Brexit, US trade wars with China and other countries, and a flattening US Treasury yield curve. Global equity markets delivered positive returns through September, followed by a decline in the fourth quarter, resulting in a −4.4% return for the S&P 500 and −9.4% for the MSCI All Country World Index for the year.

The fourth quarter equity market decline has many investors wondering how equities may perform in the near term. Equity market declines of 10% have occurred numerous times in the past. The S&P 500 returned −13.5% in the fourth quarter while the MSCI All Country World Index returned −12.8%. After declines of 10% or more, equity returns over the subsequent 12 months have been positive 71% of the time in US markets and 72% of the time in other developed markets.1

Exhibit 1: World Stock Market Performance

MSCI All Country World Index (IMI) with selected headlines from 2018



Source: MSCI. Past performance is not a guarantee of future results. In US dollars, net dividends. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

On Stocks

Global equity markets, as measured by the MSCI All Country World Index, ended the year down −9.4%, with significant dispersion by country.

US equities generally outperformed other developed markets for the year, although they lagged other developed and emerging markets in the fourth quarter. The S&P 500 Index recorded a −4.4% total return for the year and −13.5% return in the fourth quarter.

Returns among other developed equity markets were negative. The MSCI World ex USA Index, which reflects non-US developed markets, was down −14.1% for the year and −12.8% for the fourth quarter, and the MSCI Emerging Markets Index fell −14.6% for the year and −7.5% for the fourth quarter. US small cap stocks, as measured by the Russell 2000 Index, returned −11.0% for the year.

Currency movements detracted from US dollar returns in 2018 for non-US dollar assets. The strengthening of the US dollar vs. weakening of non-US currencies had a negative impact on returns for US dollar investors with holdings in unhedged non-US dollar assets, and detracted 3.5% from the returns as measured by the difference in returns between the MSCI All Country World ex USA IMI Index in local returns vs. USD. The US dollar strengthened against most currencies, including the euro, the British pound, and the Canadian dollar, and weakened against the Japanese yen.

On Bonds

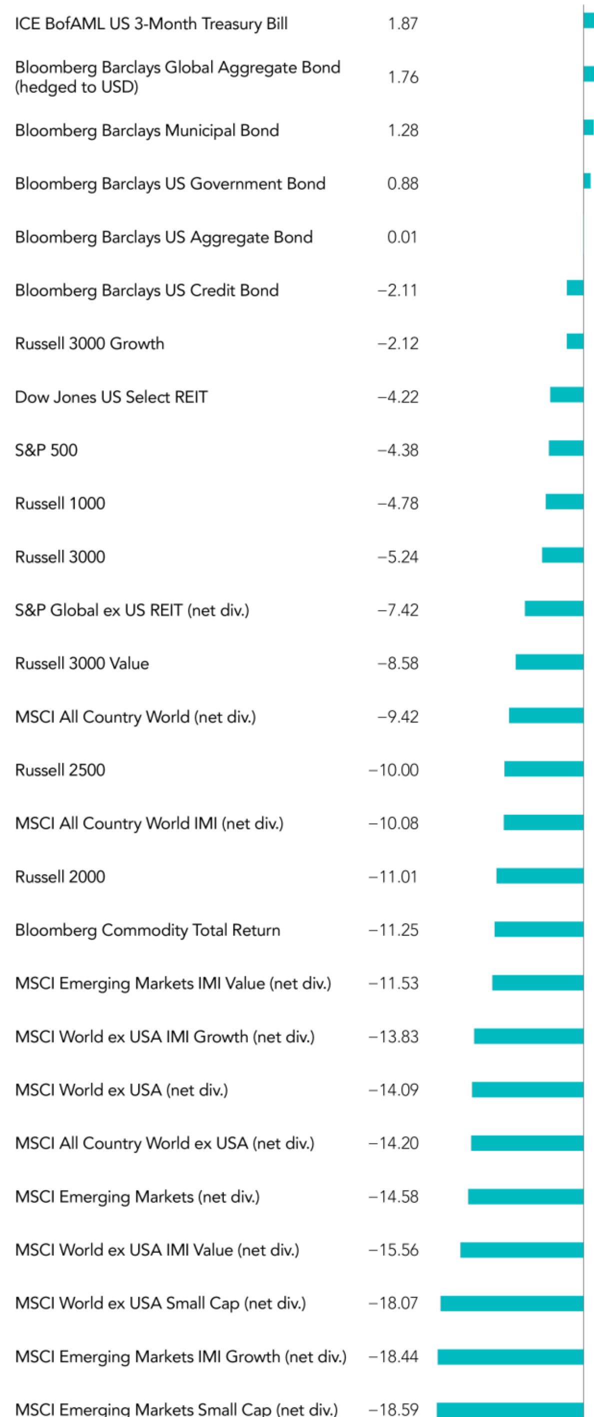
Over the full year, the return on the US fixed income market was relatively flat; the Bloomberg Barclays US Aggregate Bond Index returned 0.0%. Non-US fixed income markets posted positive returns in 2018, contributing to the return of the Bloomberg Barclays Global Aggregate Bond Index (hedged to USD) at 1.8%.

Yield curves were upwardly sloped in many developed markets for the year, indicating positive expected term premiums. Realized term premiums were negative in the US as long-term maturities underperformed their shorter-term counterparts and positive in developed markets outside the US. For example, the FTSE Non-USD World Government Bond Index 10+ (hedged to USD) returned 4.4% for the year vs. 3.0% for the 1-10 Index.

Credit spreads, which are the difference between yields on lower quality and higher quality fixed income securities, widened during the year, as measured by the Bloomberg Barclays Global Aggregate Corporate Option Adjusted Spread. Realized credit premiums were negative both globally and in the US, as lower-quality investment-grade corporates underperformed their higher-quality investment-grade counterparts. Treasuries were the best performing sector globally, returning 2.8%, while corporate bonds returned −1.0%, as reflected in the Bloomberg Barclays Global Aggregate Bond Index (hedged to USD).

In the US, the yield curve flattened as interest rates increased more on the short end of the yield curve relative to the long end. The yield on the 3-month US Treasury bill increased 1.06% to end the year at 2.45%. The yield on the 2-year US Treasury note increased 0.59% to 2.48%.5 The yield on the 10-year US Treasury note increased 0.29% during the year to end at 2.69%. The yield on the 30-year US Treasury bond increased 0.28% to end the year at 3.02%.

In other major markets, interest rates decreased in Germany and Japan, while they increased in the United Kingdom. Yields on Japanese and German government bonds with maturities as long as 10 years finished the year in negative territory.



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