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Putting 2018 in Perspective

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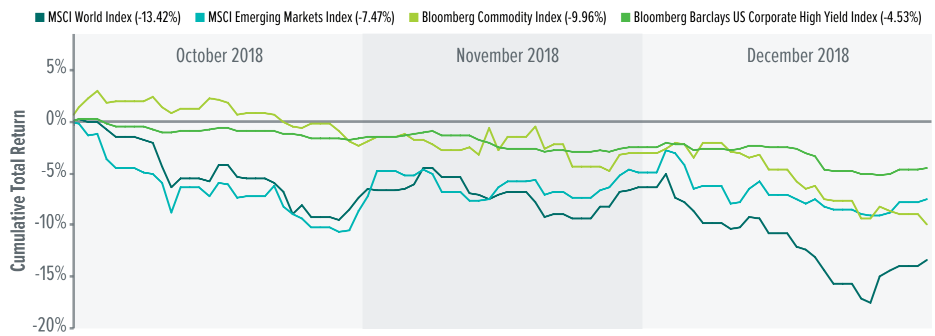
Snapshot

- Despite a strong start to the year, capital markets finished 2018 with an intense bout of volatility and risk aversion.
- Full-year 2018 returns were much less extreme than December's performance, and by no means historically extraordinary.
- We believe investors are best served by maintaining a thoughtful investment strategy—which might include capitalizing on opportunities during a downturn—rather than letting emotions drive decision-making.

Despite a strong start to the year, capital markets finished 2018 with an intense bout of volatility and risk aversion. Broad-based selloffs in the fourth quarter erased gains accumulated across most asset classes earlier in the year and pushed equity markets into negative territory for the year. Exhibit 1 depicts the extent of this selloff—with risk assets trending steadily down during the fourth quarter, having few places to hide.

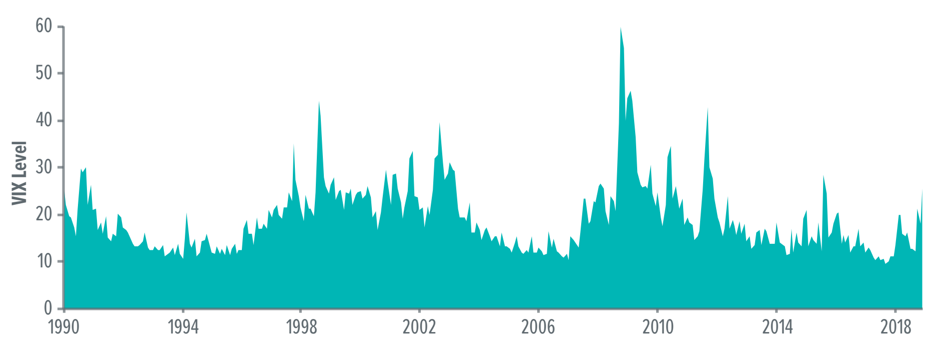
Exhibit 1: Fourth Quarter Returns



Daily data from October 1, 2018 to December 31, 2018. Past performance is no guarantee of future results.
Sources: MSCI, Bloomberg Indices, Bloomberg. MSCI World Index (net total return, USD), MSCI Emerging Markets index (net total return, USD), Bloomberg Commodity Index (total return, USD), and Bloomberg Barclays US Corporate High Yield Index (total return, USD)

Exhibit 2 illustrates the tumult, as measured by the so-called fear index—Chicago Board of Options Exchange Volatility Index (VIX)—which surged to 25 from 12 over the fourth quarter, exemplifying the market's forward-looking volatility expectations.

Exhibit 2: Volatility Spikes to End the Year

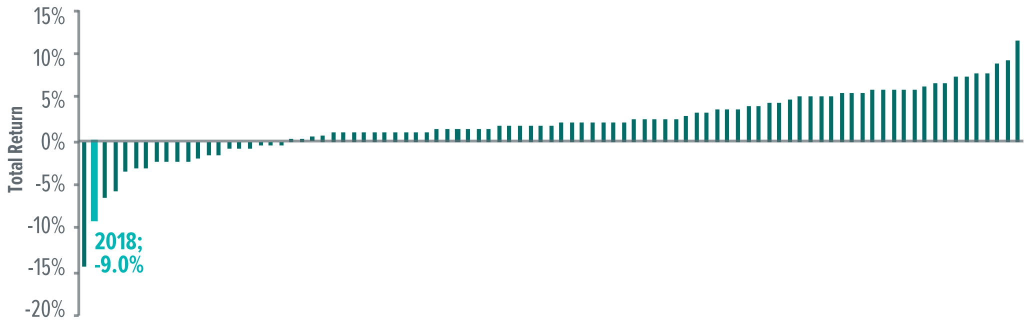


As of December 31, 2018. Month-end values are used.
Sources: CBOE, Bloomberg

“The Worst December since the Great Depression”

The year concluded with attempts by the financial press to portray the market downturn as one for the ages. The most notable of these reports centered on the S&P 500 Index registering the “worst December since the Great Depression.”[1] While technically true (as shown in Exhibit 3), headlines making this claim failed to convey necessary context for understanding the December (and fourth-quarter) plunge—grossly overselling the extent of the market decline.

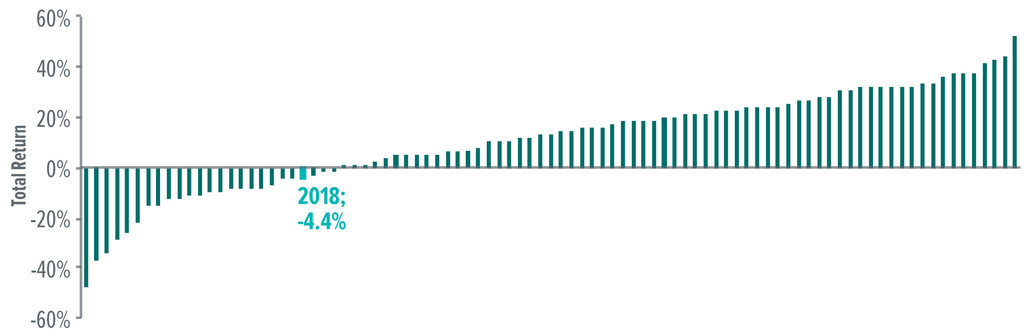
Exhibit 3: S&P 500 Index Performance in December 2018



As of December 31, 2018. Data series extends from 1928 to 2018. Returns prior to March 4, 1957 provided by Bloomberg based on S&P 500 Index methodology, which computes data based upon the S&P 90 Index prior to S&P 500 Index inception.
Source: Bloomberg, S&P. Past performance is no guarantee of future results.

U.S. equities (as measured by the S&P 500 Index) were actually performing above average for 2018, even with October’s sizeable selloff, until volatility struck in December. This contrasts sharply with performance in 1931 at the dawn of the Great Depression: that year, before marking the worst December on record, U.S. equities also endured the weakest January-to-November period since 1928. Exhibit 4 demonstrates that full-year 2018 returns were much less extreme than December’s performance (even when including December), and by no means historically extraordinary.

Exhibit 4: S&P 500 Index Calendar Year Performance



As of December 31, 2018. Data series extends from 1928 to 2018. Returns prior to March 4, 1957 provided by Bloomberg based on S&P 500 Index methodology, which computes data based upon the S&P 90 Index prior to S&P 500 Index inception.
Source: Bloomberg, S&P. Past performance is no guarantee of future results.

In fact, when limiting our focus to monthly returns since the turn of the century, the most recent December decline appears unlikely but not unprecedented (with a standard deviation [2] of 1.8, assuming an annual volatility of 19% based on our latest Capital Market Assumptions). Since 2000, there have been four months with softer total returns—they just happened to not be Decembers.

[1] See CNBC.com on December 17, 2018; CNN.com on December 18, 2018; and Marketplace.org on December 25, 2018, for example.

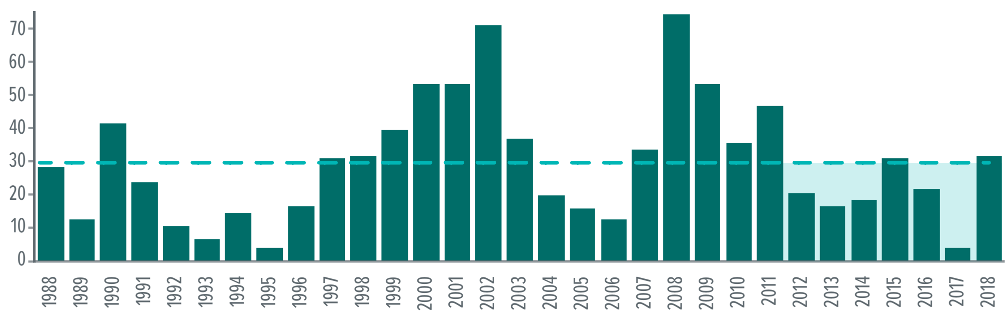
[2] Standard deviation is a statistical measure of historical volatility. A statistical measure of the distance a quantity is likely to lie from its average value. It is applied to the annual rate of return of an investment, to measure the investment’s volatility (risk). Standard deviation is synonymous with volatility, in that the greater the standard deviation the more volatile an investment’s return will be. A standard deviation of zero would mean an investment has a return rate that never varies.

The Outlier That Was 2017

The dislocation at the end of 2018 may have felt particularly outsized because it occurred amid an unusually long period of volatility. Looking back to Exhibit 2, it's plain to see that expected volatility measures escalated in the fourth quarter to the highest sustained levels in several years. But in a longer-term context, this was not abnormal. Year-end volatility was nowhere near that of the financial crisis of 2008 or dotcom crash in 2000; it was more akin to the minor market correction we saw at the start of 2016.

This point is illustrated in Exhibit 5, which shows the number of daily one-percent declines in each of the past thirty years. There was a large jump in single-day declines from 2017 to 2018, but the outlier was not the instability of 2018—it was the notable calm of 2017. Last year's turbulence was more of a return to normal equity-market behavior than a sign of looming crisis. And while many of its one-percent-decline days occurred in the fourth quarter, such clustering is not unusual. Since 2000, there have been 14 other quarters with at least as many one-percent-decline days.

Exhibit 5: One-Day Losses Greater Than One Percent



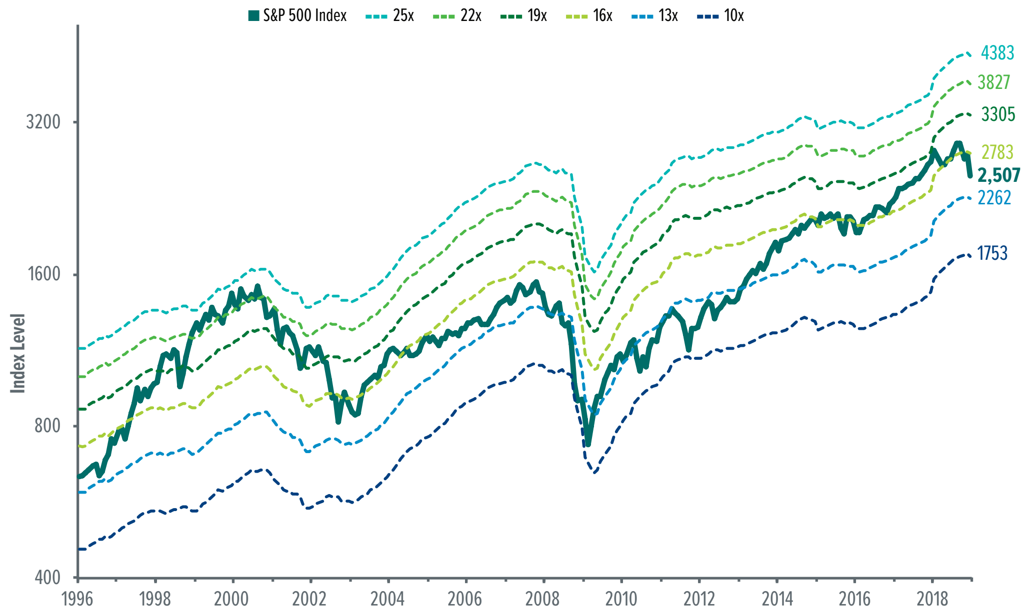
As of December 31, 2018. Past performance is no guarantee of future results.
Source: Bloomberg, S&P, SEI

The Time to Buy Is When There's Blood in the Streets

Baron Rothschild, 18th century British nobleman and founder of the legendary Rothschild family banking dynasty, reportedly said, "The time to buy is when there's blood in the streets." No, we do not see last quarter's weakness as a sign of equity prices hemorrhaging to the point of recession, drowning Wall Street with figurative blood. However, in light of the recent volatility, this quote is a good reminder that investors are best served by maintaining a thoughtful investment strategy—which might include capitalizing on opportunities during a downturn—rather than letting emotions drive decision-making.

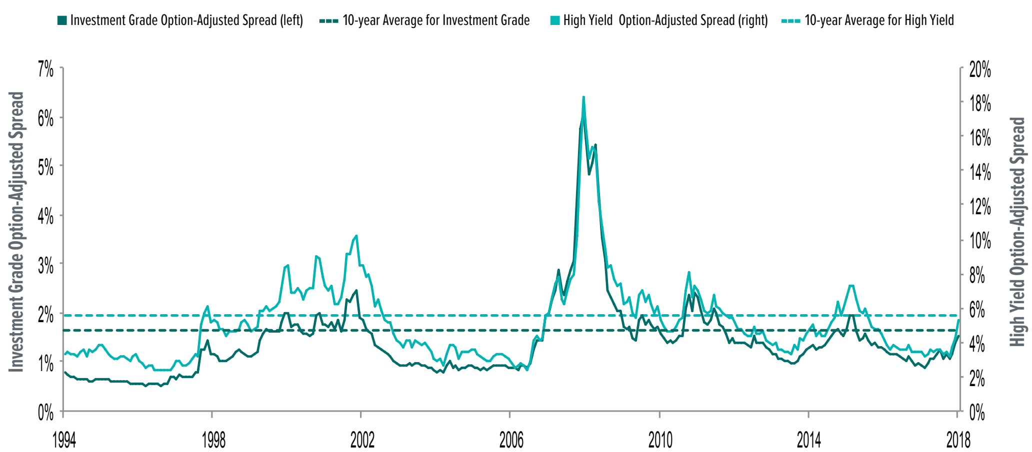
Market selloffs are often called corrections for a reason: When prices "correct," they're pulling back from overpriced or inflated levels to more moderate values that are less likely to swell into a bubble that eventually bursts. Even with the recent earnings boom over the past few years, equity multiples continued to climb as price increases far surpassed earnings growth. Meanwhile, investment-grade and high-yield credit spreads both remained historically tight, offering investors minimal compensation (by historical standards) for taking on extra risk. As we see in Exhibits 6 and 7, the fourth quarter of 2018 served as a release valve of sorts, allowing risk-asset valuations across capital markets to settle at more moderate levels—and, as equity valuations pulled back, credit spreads neared their 10-year averages.

Exhibit 6: S&P 500 Index Price Levels at Different Price-to-Forward Earnings Ratios



Monthly data from January 1996 through December 2018. Implied prices are calculated using forward earnings times forward P/Es.
Sources: Factset, SEI

Exhibit 7: Credit Spreads



As of December 31, 2018
Source: Bloomberg Indices, Bloomberg. Month-end values are used. High Yield represented by Bloomberg Barclays US Corporate High Yield Index. Investment Grade represented by Bloomberg Barclays US Corporate Index.

Looking forward, we are beginning to see mixed signals about where we are in the economic cycle; we still expect the global economy to continue expanding in 2019, albeit at a moderating pace. The challenging conditions seen in the final quarter of 2018 can prey on investors' emotions. But the global economy is not exactly in dire straits, and we believe most markets have now corrected to more attractive valuation levels.

Our confidence is increasing that risk assets bottomed in late December. The sheer ferocity of the recent correction is reminiscent of other times in the past eight years when stocks sold down hard, only to turn around and hit new highs. Expected S&P 500 Index earnings growth for 2019 remain in the mid-single-digits as of late January, leading us to believe that—barring a collapse in multiples or a major black swan event—2019 may be another solid year.

Putting 2018 in Perspective: Keeping a Strategic Mindset

While examining the volatile capital markets of 2018 can provide useful insight, it is important to maintain perspective and remember to keep in mind the broader historical context. We believe that any reactionary, wholesale changes to a long-term game plan are not only ineffective, but potentially harmful, to an investor's ability to achieve long-term goals. In our view, strategic allocations should be considered a permanent—or at least durable—core positioning designed to produce well-diversified, efficient portfolios. These allocations are best tailored to an individual investor's ability and willingness to take risk (including their time horizon), with the ultimate goal of meeting long-term investment objectives.

In our November 2018 paper, *The U.S. bull market: Is it time to get out?*, we examined how timing the market successfully requires, at a minimum, two well-timed decisions (when to exit and when to reenter), both of which pose risks to meeting long-term investment objectives if poorly timed. That being said, there is a meaningful degree of activity occurring under the hood in many of our solutions as we believe that prudent active management can improve a strategy's results. Sub-advisors in SEI's actively managed strategies engage in active security selection and seek to exploit excess return sources, such as value, momentum and stability characteristics (factors); in some cases, our portfolio managers implement active tilts among these factors; and our Portfolio Strategies Group engages in active (or tactical) asset allocation. Tactical allocation positions can be thought of as temporary, as we expect them to be unwound at some point. These changes are marginal adjustments, implemented in a way that avoids overwhelming the strategic characteristics of a portfolio, but are still expected to enhance the return of a strategic portfolio or lower its risk at the margins.

Glossary of Financial Terms

Black swan event: A black swan event is an occurrence that deviates beyond what is normally expected of a situation and that would be extremely difficult to predict.

Factors: Factors, or risk factors, are characteristics of securities (such as momentum, stability or value) that can be periodically under- or over-priced, resulting in temporarily larger or smaller risk premiums.

Forward price-to-earnings ratio: The forward price-to-earnings ratio is the ratio of a company's share price to its expected earnings over the next 12 months, which can be used to help determine whether a stock is undervalued or overvalued.

Momentum: Momentum securities are those whose prices are expected to keep moving in the same direction (either up or down) and are not likely to change direction in the short-term.

Option-adjusted spreads: Option-adjusted spreads estimate the difference in yield between a security or collection of securities and comparable Treasurys after removing the effects of any special features, such as provisions that allow an issuer to call a security before maturity.

Stability: Stability securities exhibit lower risk and higher quality, and can benefit from the power of long-term compounding as a result of the investors tendency to misprice lower risk.

Value: Value securities are those that are considered to be cheap and are trading for less than they are worth.

Index Definitions

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market.

The Bloomberg Commodity Index reflects commodity futures price movements. The index rebalances annually weighted 2/3 by trading volume and 1/3 by world production and weight-caps are applied at the commodity, sector and group level for diversification.

The Chicago Board Options Exchange Volatility Index (VIX) tracks the expected volatility in the S&P 500 Index over the next 30 days. A higher number indicates greater volatility.

The MSCI Emerging Markets Index is a free float-adjusted market-capitalization-weighted index designed to measure the performance of global emerging-market equities.

The MSCI World Index is a free float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets.

The S&P 500 Index is a capitalization-weighted index made up of 500 widely held U.S. large-cap companies.

Important Information

This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events, or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice and is intended for educational purposes only.

There are risks involved with investing, including loss of principal. Diversification may not protect against market risk.

Index returns are for illustrative purposes only and do not represent actual fund performance. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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