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"If owning stocks is a long term project for you, following their changes constantly is a very, very bad idea. It's the worst possible thing you can do." – Daniel Kahneman

Dear Clients and Friends,

Looking back at the third quarter of 2018, we saw a very strong economy propel the markets forward with impressive performance. The S&P 500 increased 7.71% during the quarter bringing year-to-date returns to 10.56%. In fact, each of the 10 sectors that comprise the S&P 500 had positive performance during the quarter, with Healthcare leading the way with an increase of 14.56%. Most other equity market indices also performed well during the quarter and for the year thus far, with the exception of emerging markets which have declined over 7.4% this year. Undoubtedly, a strong U.S. dollar and threats of tariffs and trade wars have impacted emerging markets.

Bonds have also had a poor showing during the quarter and so far in 2018. As measured by the Barclays Global Aggregate Bond Index, bonds declined 0.92% during the quarter and are down 2.37% through September 30, 2018. The Federal Reserve's aggressive interest rate hikes this year are a direct reason for the decline in bonds. With the last interest rate increase on September 26th, the Fed has now hiked rates three times in 2018 with one more expected before year end.

Pro-growth policies continue to push the U.S. economy forward, as we saw real gross domestic product (GDP) hit 4.2% during the second quarter, as many economists now believe that we can reach 3% growth for the full year. Consumer Confidence has surged to its highest level since 2000 while an unemployment rate of only 3.9% is the lowest we have seen in 18 years. In the wake of this strong economy, corporate profits have remained healthy as tax reform and a reduced regulatory environment continue to make positive impacts.

Of course, all of this good news comes with some fear and hand-wringing. Fears of inflation continue to mount as evidenced by rising interest rates while the current administration's rhetoric regarding tariffs and trade wars continues to escalate, particularly as it relates to China. In general, global economic news is quite strong except in a handful of locations such as China, where growth has clearly continued to slow. There is little doubt that continued tough rhetoric has made an impact on their markets and economy.

Speaking of bad news, as the third quarter ended and October began, the markets started drifting lower as we have seen occur many times during the month of October. This downward drift seemed to crescendo last week as almost all market indices sold off in the largest decline since February. The sudden spike in interest rates saw the 10-Year U.S. Treasury Bill climb to over 3.1% for the first time since 2011. The Federal Reserve indicated that interest rates may need to continue rising for the remainder of this year and possibly next year in order to keep inflation in check. These actions and comments along with fears that the long running bull market is losing strength has given investors a jolt.

What investors experienced back in February and again last week is simply volatility. Unfortunately, volatility has become a bad word in the lexicon of investors and something that we advisors are equally (probably more) guilty of creating such a negative connotation. It is completely understandable that many investors become unnerved when seeing stock prices and account values decline during periods of market uncertainty. No one likes to lose money. Investors hate to ride the rollercoaster up and down and we advisors try to set up portfolios to minimize these peaks and valleys. What is easy to forget, however, is that volatility is a necessary ingredient to achieve long-term positive returns in the markets.

What we believe has occurred in error over the last few decades is that the words volatility and risk have become synonyms for each other. We believe that these are distinctly different and of paramount importance for investors to keep differentiated. Volatility, in its simplest terms, refers to the movement of the price of an asset up or down (technically, how it deviates from its mean). For example, stock prices are volatile because they move up and down with some company's price changes being greater or more frequent than others. Remember, this means that a stock price that continues moving higher is considered just as volatile as a stock that is going down. Should this measure of changes in price really tell an investor that their portfolio is too risky? It is suddenly a bad company or a good company just because its price keeps changing?

On the other hand, we have a very concise definition of true risk - It is a permanent loss of capital. Risk is losing money, not watching prices move higher and lower. Risk is making a bad investment by purchasing it at a high price and selling it at a low price.

The very fact that stock prices move often and may have large price swings is the exact ingredient that allows investors the ability to buy low and sell high. Without volatility, there would be no opportunity to make long-term market returns. According to Investopedia, the average annual return of the S&P 500 from 1928 to 2017 is 10%, or 7% if adjusted for inflation. The "price" that investors must pay for this opportunity is patience and remaining focused on their goals versus checking stock prices and account values. This thought was stated very clearly by Nobel Laureate and Professor Emeritus of Psychology and Public Affairs at Princeton University, Daniel Kahneman, at the top of this letter. Professor Kahneman has written extensively and received his 2002 Nobel Prize for his work on behavioral economics and the psychology of judgment and decision-making. Closely following stock price changes and making decisions based upon short-term events is counter-productive to achieving long-term investment success.

We will close our letter to you with the chart below from the Capital Group/American Funds that clearly displays how market downturn are simply prolonged periods of volatility. These events occur with regularity and are a necessary component of the markets that allow investor the opportunity to buy low and sell high. Again, patience and understanding of these dynamics are critical for long-term success in growing our capital.

Market Downturns Happen Frequently and They Don't Last Forever

Dow Jones Industrial Average 1900-2017

	-5% or more	-10% or more	-15% or more	-20% or more
Average Frequency[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.75 years
Average Length[2]	46 days	115 days	216 days	338 days

[1] Assumes 50% recovery of lost value
[2] Measures market high to market low
The Dow Jones Industrial Average is an unmanaged, price-weighted average of 30 actively traded industrial and service-oriented blue chip stocks.

As always, we thank you for your continued support and confidence, and we hope that you and your family have a safe and enjoyable remainder of the year and we wish you the best for the upcoming holiday season. Meanwhile, please feel free to contact us anytime with questions or comments.

Best regards,

Bob

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CHUCK

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