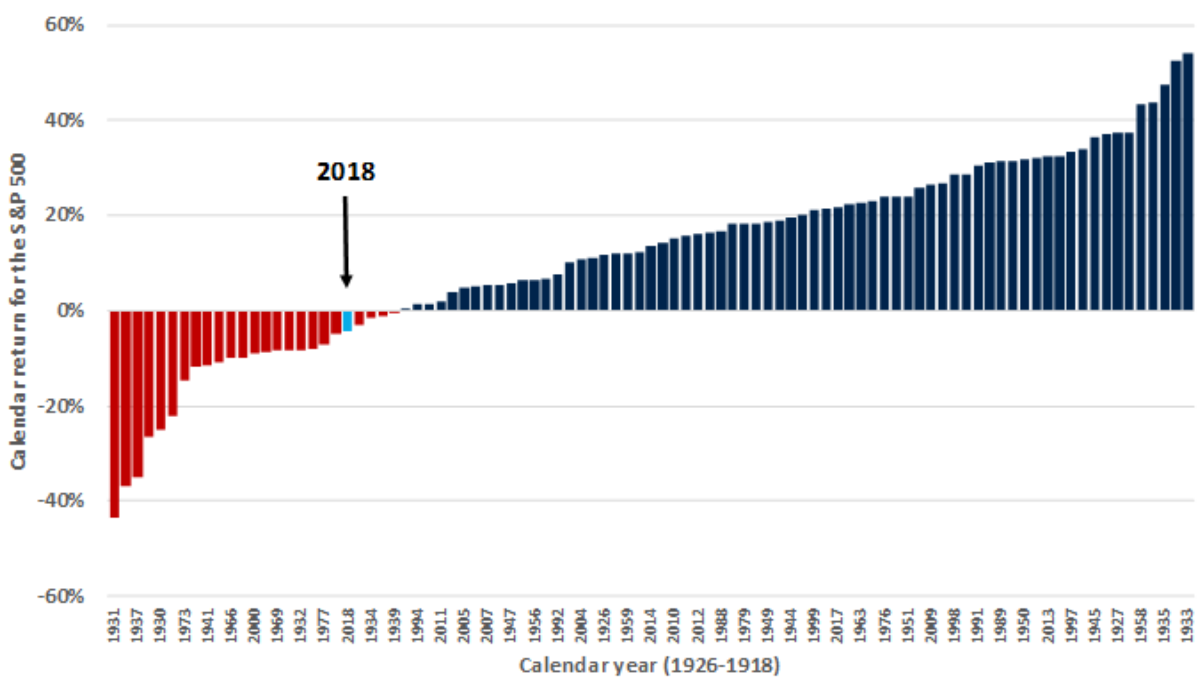
Private Ocean

The Latest Bump in the Road

Investors have been rewarded well by the markets over the past decade. Not only have stocks provided sound returns, but risk - as measured by price swings - has also been relatively low. That changed last year, as 2018 delivered both poor returns and more market swings than we have experienced in a while. While it is painful to experience negative returns, it is important to remember that occasional market downturns are the very reason we earn a premium for investing in stocks. Otherwise, we should not expect to earn more on stocks than we do on the cash in our savings account - because risk and return are two sides of the same coin. Your portfolio is constructed based on your goals and your willingness and ability to take risk, and the bumps in the road we experienced last year should not take the focus away from your long-term financial plan.

Moreover, it is helpful to put the latest market decline into perspective. We ranked the yearly return of the S&P 500 index from 1926-2018 from worst to best, and as you can see in the chart below, the 4.4% decline in 2018 (in light blue) is disappointing, but far from the historical low:



Sources: Dimensional Fund Advisor, Private Ocean; The chart ranks the yearly return for the S&P 500 index from 1926-2018; Past performance is not a guarantee of future results.

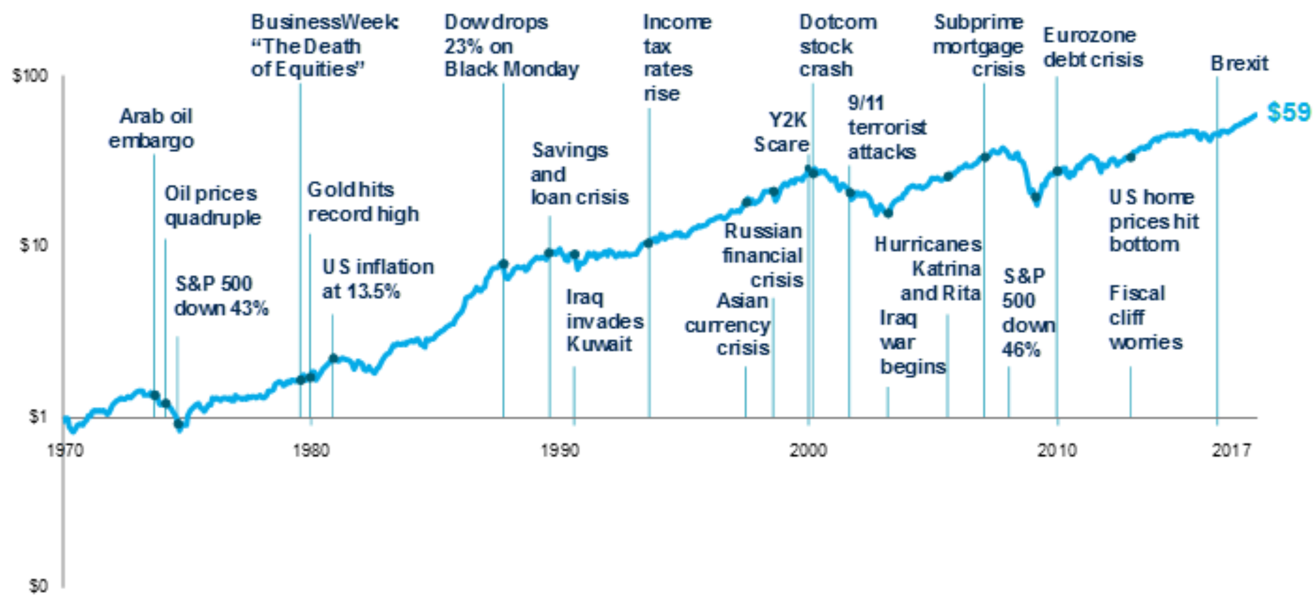
Not a great year for stocks…
Whereas global stock markets (i.e. U.S., international developed, and emerging markets stocks) returned a whopping 24% in 2017, they were down 10% in 2018. As we mentioned in our annual letter last year, with U.S. stock returns of +21%, international developed returns of +24%, and emerging markets returns of +37%, 2017 provided returns that were higher than what we should expect in an average year.

Conversely, at -5% for U.S. stocks, -14% for international developed stocks and -15% for emerging markets stocks, 2018 provided returns that were lower than one should expect in an average year. Some years will provide stellar returns and other years will provide poor returns, but the long-term investor is typically rewarded well.

… and mixed results for other parts of the portfolio
When stocks decline, other parts of the portfolio behave differently and often do well. That is not always the case, particularly not in the short term. 2018 was one of those years when the other parts of the portfolio did not make up for the losses in stocks:

- **Bonds** earned relatively low returns, mainly because of rising interest rates during the year. Muni bonds returned +1.3% and taxable U.S. bonds returned -0.1%. Although these returns are lower than we would expect in an average year, bonds continue to serve as the ballast in your portfolio. Moreover, because of the interest rate increases, your bonds are now earning higher interest.
- **Real estate**: U.S. and international real estate were down 4% and 6%, respectively. We invest in liquid real estate funds (also known as REITs) to get exposure to the real estate markets, since these are cost-efficient and can be sold quickly if needed. REITs tend to follow the stock market in the short to medium term, so it is not uncommon that they decline (rise) in price when the stock markets decline (rise). In the long run, however, REITs follow the underlying real estate markets more closely and provide a valuable source of diversification.
- **Alternatives:** Both the multi-strategy alternative and the managed futures funds had a particularly challenging year. There are no underlying reasons that concern us about their performance, but it is nonetheless disappointing. One positive aspect is that both funds have provided positive returns since the stock markets started its worst declines in the beginning of December.

In other news
There was no shortage of geopolitical events last year, including trade wars, mid-term elections, a U.S. - North Korea summit, and continued violence in Venezuela - just to name a few. Looking forward, 2019 looks like a busy year as well, with the likely release of the Mueller report, Brexit (or not), a split Congress, and continued friction among the world's largest powers. There are always risks on the horizon, and the link between geopolitics and the markets are tenuous at best. Even when negative risks materialize, markets are expected to provide positive returns in the long run. For example, despite oil crises, the Cold War, 9/11, financial crises, and plenty of other events, the world's stock markets have continued to rise over the past five decades, as shown in the chart below:



Source: MSCI data © MSCI 2018, all rights reserved. The chart shows MSCI World index in US dollars from 1970-2017. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is no guarantee of future results.

Looking past the bump

It is times like these when it is particularly important to ignore the daily market noise and focus on your long term financial plan and variables that are in your control. Many investors hurt their portfolio by making changes because of market declines, either from emotional reactions or the mistaken belief that they can beat the market. As we have discussed many times before, market timing does not work without extraordinary luck. To paraphrase the French economist Raphael Douady, 'we don't buckle up right before the accident is coming, we buckle up before we start the car'. In the same fashion, your portfolio is built for you for the long run, and constructed to withstand different market environments.

Wishes for a Prosperous 2019

As we enter the new year, we bid 2018 farewell and wish you a prosperous 2019. Or, as we say in my home country of Norway, Godt Nytt År og takk for det gamle!

Warm Regards,
Max Holvik, CFA, CAIA®
Investment Research Manager

***Returns data from Morningstar Direct**: Russell 3000 is used as proxy for U.S. stocks, MSCI World ex USA NR USD Index is used as proxy for international developed stocks, MSCI EM IMI NR USD Index used as proxy for emerging markets, Bloomberg Barclays US Aggregate Float Adj TR Index used as proxy for U.S. taxable bonds, Bloomberg Barclays Municipal TR Index used as proxy for municipal bonds, Dow Jones US Select REIT TR index used as proxy for US real estate, Dow Jones Global ex US Select REIT TR index used as proxy for international real estate, QSARX is our multi-strategy alternative fund allocation while AQMRX is our managed futures fund allocation.*