SIGNATUREFD

MARKET SENSE: THE INFINITE GAME

This quarterly letter will provide a brief update of recent market conditions and the economic landscape. We will also cover the investment philosophies and processes that have successfully navigated us through many market twists and turns over the past 21 years.

Markets were mixed in the third quarter with several of the trends from spring remaining intact. The U.S. large cap market again drove global results. Smaller U.S. companies kept pace early in the quarter, but by September began lagging. Outside the U.S., equities rose slightly in developed markets while they again fell in the emerging countries. Bonds were mostly flat on the quarter, with the rate on the 10-year U.S. treasury pushing back above the psychologically important level of 3.00% and rising nearly 1% from this time last year. Our fixed income positioning, which includes less rate-sensitive, alternative fixed income, has helped preserve capital over this time as core fixed income has generated slightly negative returns.

For equities, the bull market that began in March 2009 continues, and clients invested throughout this period have seen significant gains. Most client portfolios are within just a few percent of all-time highs reached early this year, helping provide a solid foundation for clients' long-term financial plans. The table below provides a quick snapshot of performance for several key benchmarks for the most recent quarter and past 52-weeks.

	3rd Quarter	52 weeks
S&P 500	7.71	17.91
Dow Jones Industrial Average	9.63	20.76
MSCI EAFE (Developed International)	1.35	2.74
MSCI EM (Emerging Markets)	-1.09	-0.81
Bloomberg Commodity Index	-2.02	2.59
Barclays Global Aggregate Bond Index (Global Bonds)	-0.92	-1.32
Barclays U.S. Aggregate Bond Index (Taxable Bonds)	0.02	-1.22
Barclays Municipal 5 Yr Index (Tax-Free Bonds)	-0.20	-0.60
HFRI Fund of Funds Composite Index	0.44	3.25

Turning more philosophical, the third quarter continued to present disciplined investors with more questions than answers. It is in times of maximum obscurity that one's convictions get tested the most. Without guiding principles, decision making becomes extremely difficult. A boat without a rudder will give the appearance of progress, proceeding with the prevailing current. However, if one has a clear destination in mind, and a well-developed plan to get there, then having a rudder is essential. Of course, one will use the current when helpful, but will be comfortable going against the current when it is necessary in-light of the bigger objective – reaching the intended destination.

CURRENT MARKET AND ECONOMIC CONDITIONS

At the end of the quarter, Federal Reserve chair Jerome Powell offered up the following assessment of the U.S. economy, "[Most economists see] the unemployment rate remaining below 4 percent through the end of 2020, with inflation staying very near 2 percent over the same period. From the standpoint of our dual mandate, this is a remarkably positive outlook. Indeed, I was asked at last week's press conference whether these forecasts are too good to be true--a reasonable question! Since 1950, the U.S. economy has experienced periods of low, stable inflation and periods of very low unemployment, but never both for such an extended time as is seen in these forecasts."

Indeed, we would agree with his assessment of the current situation and add that there are many other confirmatory data points to show how well the current economy is performing in the U.S. We have held a constructive view of the economic cycle for several years, and since 2011 have had an underweight position in core fixed income, with an overweight position in equities and other risk assets that are economically sensitive. This has served clients well.

OUR QUANTITATIVE MODELS AND THE COLLECTIVE VIEW OF ALL THE INDEPENDENT RESEARCH THAT FEEDS OUR DECISION-MAKING PROCESS REMAIN MOSTLY POSITIVE.

Our quantitative models and the collective view of all the independent research that feeds our decision-making process remain mostly positive. Of course, there are pockets of concern, as there always are. But, barring an outside shock of unpredictable nature, the data doesn't appear consistent with a recession in the near-term. Our objective therefore is not to argue for arguments sake, nor to provide wild forecasts on the slight chance of being proven right. We do think it is prudent for investors to pause and re-confirm strategy.

We believe we are operating in a late-cycle environment. And, even if the economy does continue to grow, much of this may already be anticipated and priced into the capital markets. We would reiterate the fact that markets and economic cycles don't play out in a coordinated fashion. In fact, the market is one of the best leading indicators of future economic activity, thereby making it very difficult to reliably use economic data to drive portfolio decisions. Why is this? Simply stated: investors are not compensated for reacting to today's news, but they can be richly rewarded for correctly anticipating the future. Thus, we would rephrase the question that was asked of Chairman Powell: "Is it possible that the future turns out even better than investors currently anticipate?" This doesn't suggest a need to get immediately defensive in portfolios, but it does mean we should be mindful of key factors:

- Both employment and inflation data are running at near perfect levels. This typically doesn't happen, yet investors are becoming accustomed to this condition. There is scarce room for additional improvement and the chance of worsening conditions for either (or both) data points is far from remote.

- We previously stressed that the U.S. has performed materially better than the rest of the world. The global economy is largely self-adjusting, and this type of deviation is unsustainable over time. Interest rates and currencies will continue to act as equalizers, slowing the U.S. and/or providing stimulus to allow for an increased pace of growth outside the U.S. In either scenario, U.S. stocks could lag, perhaps materially.
- Though still at low levels, interest rates have risen dramatically. Rates impact the economy with an unpredictable, but often long lag time. The Federal Reserve just completed its 8th 25 bps rate hike since starting to raise rates in December 2015. Moreover, 10-year rates, which bottomed under 1.4% in 2016 are now appearing to break decisively above 3.0%. This is happening while the Fed is also reducing the size of its balance sheet – effectively selling or allowing holdings to mature. As of October 1st, this is now proceeding at a pace of $50 billion per month. Central Banks in Europe (ECB) and Japan (BOJ) are behind the U.S., but the ECB has forecast an end to bond-buying starting in January 2019 and the BOJ is unlikely to get more aggressive. This means that for the first time since 2008, the net balance of central bank assets will be shrinking not expanding. Global liquidity could tighten, and this impacts markets before the real economy.
- Finally, we would point to the potential that investors are underestimating the impacts of a growing trade war. The Trump administration appears to be looking to settle disputes within North America and Europe to concentrate on a single-front battle. The Chinese have likewise held off with significant dialogue ahead of our mid-term elections. But, once November passes, we will be watching closely to see how the economic struggle evolves.

OUR PROCESS WAS CONSTRUCTED TO ALLOW FOR PRUDENT CHANGES THAT ARE SUPPORTED BY OBJECTIVE DATA AND RESEARCH

SignatureFD has been optimistic on the market and economy. The above is meant to provide a framework for possible outcomes - things we are watching, so we can be prepared to act. Our process was constructed to allow for prudent changes that are supported by objective data and research. At this time, the outlook remains constructive, but we are vigilantly monitoring incoming information.

HOW DO WE DEFINE SUCCESS?

How does an investor define success? Is it outperforming indices such as the Dow Jones Industrials or the S&P 500? Or, maybe doing better than your neighbor or co-worker? Human beings have an innate desire to compete and win. But, simply beating a benchmark is a finite game that begs the question, “What’s next?”

I recently read *Finite and Infinite Games* by James Carse, a professor at NYU. The thesis for the book is that finite games are the familiar contests of everyday life; they are played to be won, which is when they end. But, infinite games are more mysterious. Their object is not winning, but ensuring the continuation of play. The rules may change, and the boundaries may change, but the game never comes come to an end. The primary takeaway for

me is that the objective of these finite games is to win a title and the recognition of peers. These games have a starting point, an ending point and result in a relative winner. But, infinite games are more ethereal. They have no starting point, and they stretch to the horizon and beyond, a point never attained. The objectives change over time, but the most important feature is the game doesn't end. So, it almost feels like a continual completion of evolving goals and objectives.

INVESTMENT PHILOSOPHY AND PROCESS

Playing an infinite game requires both strategy and discipline. It is about setting objectives and plotting the course. It is about knowing when to use the prevailing current and when to go against it and instead rely on your rudder to steer you. Strong guiding principles and defined processes act as rudders when the current becomes strong.

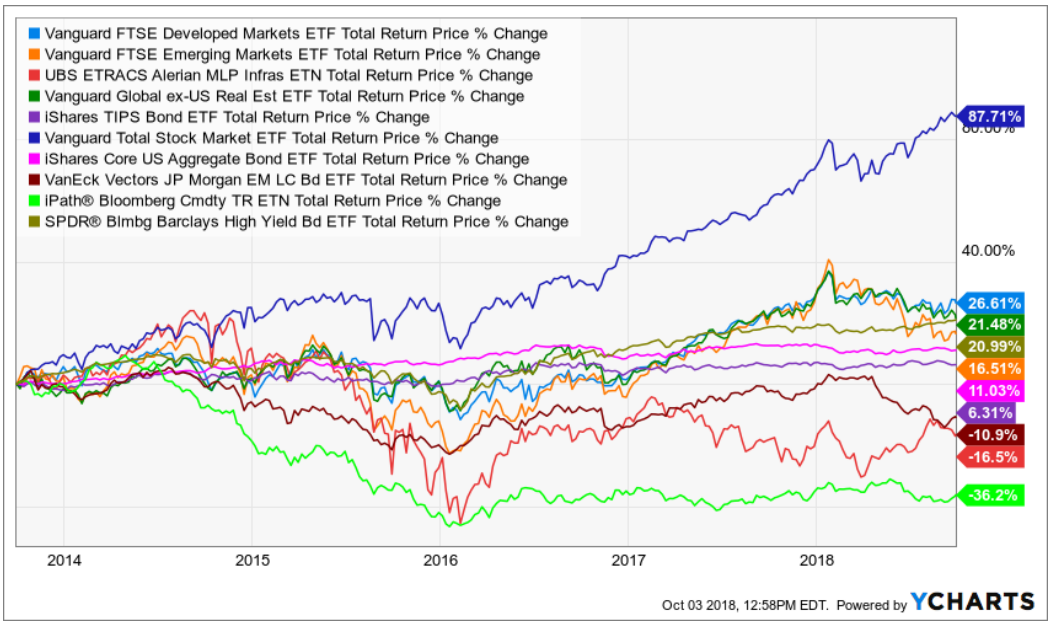
WE ARE HEARING MORE QUESTIONS ABOUT THE VALUE OF DIVERSIFICATION, FUNDAMENTAL VALUE, AND FOCUSING AS MUCH ON RISK AS ON RETURN.

At SignatureFD, we have 10 time-tested investment beliefs – that have acted as our rudders. As the economic cycle matures and the time since the financial crisis lengthens, we are hearing more questions about the value of diversification, fundamental value, and focusing as much on risk as on return. Thus, we wanted to delve more deeply into a few of these beliefs for a deeper perspective on why they have worked for us and our clients over time.

"DIVERSIFICATION WORKS"

Of the core beliefs, at present, this one seems to be the most questioned. Diversification, by nature, means there will potentially always be something in the portfolio that is not working. A critical distinction to remember – just because something doesn't work for a finite period, doesn't mean it won't be successful over the long-term. Simply, diversification works over time, but not all the time.

We often get questions about the purpose of investing in diversifying assets. In the current environment, this has come in the inquiry of why invest in both U.S. and international stocks? From a fundamental perspective, based on data from the IMF, 35.2% of the increase in global GDP this year is expected to come from China, nearly double the contribution from the United States (17.9%). The remaining balance is likely to come from all other developed economies (20%) and from other emerging economies (26%). The message is clear: 80% of global growth is coming from outside the U.S. This is confirmed by the fact that the U.S. currently represents only about 35% of global financial markets, 25% of global GDP, and 5% of global population, yet many U.S. investors have no meaningful investments outside the U.S.



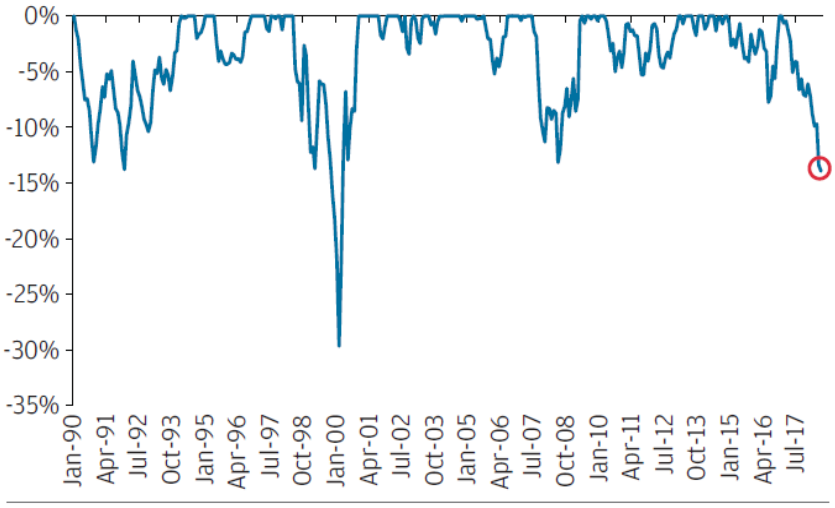
The performance chart above shows the investment performance of key asset classes over the past five years. Note the persistent and significant deviation that has been produced by the dark blue line, which represents the U.S. market. This performance gap represents over 60% cumulative difference across the five years, or more than 10% per annum. Is it possible that the U.S. continues to dramatically outperform? Yes, but based on history this would clearly be an exception. The more likely result is that the U.S. market starts to lag and some or all the other diversifying assets gain back some of the relative ground lost over the past five years.

"PRICE MATTERS"

"Price is what you pay, value is what you get." This is a favorite saying of Warren Buffett. The critical message we take away is that one should remember they are in control of investment decisions. You are never forced to accept an offered price. A disciplined investor will follow a process, assess what an asset is worth and decide to buy or sell based on the market price. Investors are inherently reactive and emotional regarding prices, but this becomes even more acute during market downturns and late in strong bull cycles. **At SignatureFD, we strongly believe that market timing is not a repeatable strategy, but that buying low and selling high will work over time.** This means we constantly seek to add value to portfolios by progressively adding to undervalued assets, while trimming asset classes that have become fundamentally overpriced. We methodically follow our robust research process and talk continually to money managers active in all corners of the markets.

Over the recent past, assets that have 'worked' and in many cases exhibit high valuations and have continued to run, while those that present more attractive valuations remain largely uninteresting to investors. It is not possible with foresight to know what a catalyst for a shift will be, but that doesn't preclude a shift from happening at some point. If something can't go forever, it won't.

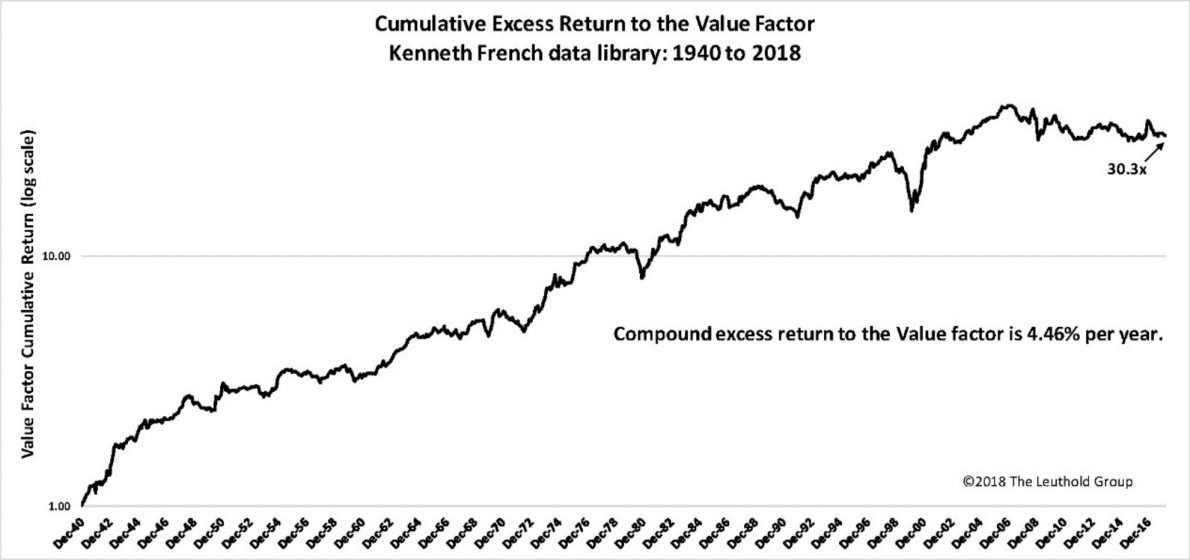
Value oriented factors such as low price/earnings, price/book, and high dividends have significantly lagged the market over the past five years. Notice in the chart below that cumulative underperformance has been almost 15%. Though not shown on the chart, data firm Factor Research concludes that, momentum, the most successful factor over this same period, has outperformed by more than 30%, producing a gap between the two of nearly 45%.



Source: J.P. Morgan Asset Management.

But, looking out over a much longer time, one can see the benefit of following a process that is rooted in buying fundamental value. The guidance we shared about diversification on the previous page also holds for value-oriented investing in that it works over time, but not all the time. Larry Swedroe, an author of numerous well-regarded investing books, points out that, "Over five- and 10-year periods, it has been negative 22% and 14% of the time, respectively. Thus, periods of underperformance, such as the one we've seen recently, should not come as any surprise." The market of the late 1990's was the most historic stretching of growth-oriented investments over value stocks – think Pets.com and Webvan. However, that period eventually reversed, and value stocks snapped back dramatically in 2000-2002.

The chart below shows the excess return from value investing going back to 1940. Periods of underperformance come and go, but if you are forced to pick one simple strategy for long-term investing success, buying value is likely to be at the top of your list.



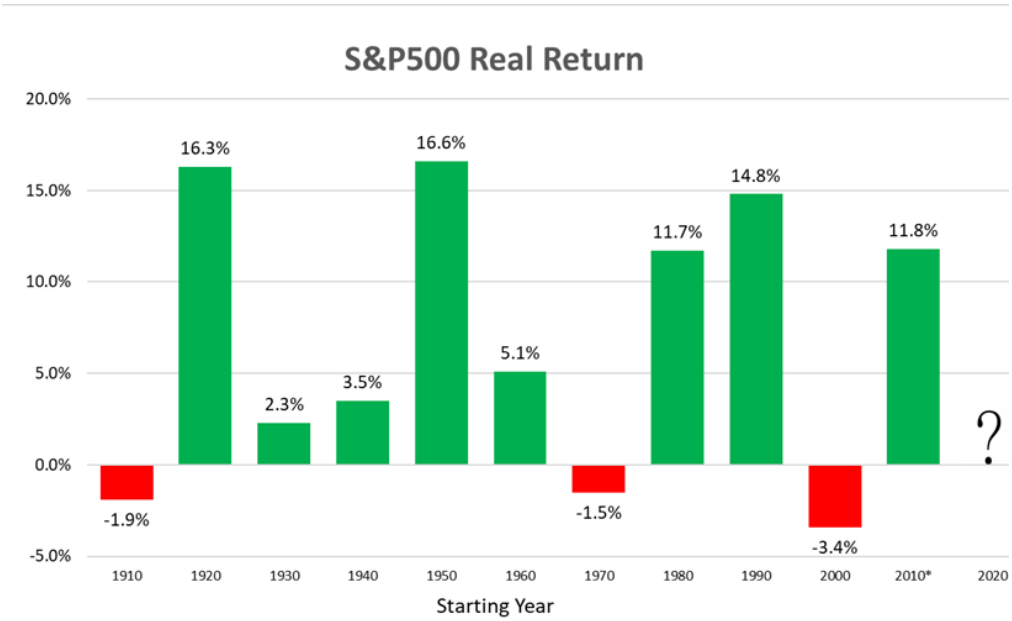
All charts and tables run through March 31, 2018

"DON'T LOSE MONEY"

Our clients have entrusted us to take their accumulated savings and grow that principal to meet their defined future goals. Permanent loss of capital is the biggest impediment to success. This belief doesn't mean avoiding risk, and we discuss that often on our team. It means methodically choosing investments where the rewards can outweigh the risks. Said differently, risking as little as possible to make as much as possible. This principle means that all investments must have an inherent foundation based on something that can be valued, not just a speculative concept.

As example, we are often asked about 'hot' investment ideas or an investment 'tip' someone may get from a friend or colleague. Not surprisingly, these questions have been dominated by crypto-currencies and cannabis stocks over the past year. We always start by framing the difference between investing and speculating. There is nothing inherently wrong with speculating if one understands the trade-off of spectacular gain and complete loss. However, our process keeps us focused on long-term, process driven investing instead of speculating.

As we move toward a late market cycle, we are forced to confront the reality that risks rise, while at the same time future return potential recedes. With a sound process, this worsening trade-off between the two is pushing us to be more cautious. Though we don't think it is possible to time market moves, risk management does help decide if it is prudent to play offense or defense.



Note: Returns are adjusted for dividends and inflation
2010 return is for the 104 months through August, 2018.

Our process is designed to minimize the chances of a permanent loss of capital in any specific investment and protect capital in major market declines in order to create the potential for client portfolios to get back to 'higher water mark' as quickly as possible. We think this is relevant today as the longer-term forward outlook is starting to look less promising. The chart above shows the cyclicality of returns in the U.S. market for more than 100 years. You will see that decades with double-digit real (i.e. after inflation) returns tend to be followed by decades with lower returns. The only exception to this was the super-bull market of 1982-2000 with two double-digit decades back-to-back. However, this was then followed up by the worst decade ever for equity returns.

Valuations are not very useful for near-term projections, but they are accurate for long-term return forecasts. These long-range forecasts don't drive our near-term decision making. However, they do help put risk and return in context. The simple math is that the returns of the next ten years are unlikely to be as strong as what we have seen since 2009. We utilize the data from multiple independent sources to build these long-range projections, and as a sample, here are a few key observations based on current fundamentals:

- **Ned Davis Research** – They have found, one of the strongest correlations to forward return is percent of financial assets households have in stocks, and currently this is forecasting a ten-year annual return of 1.5%.
- **BCA Research** – They recently completed a comprehensive review of 10-year forward returns and projected 1.5% real returns in the U.S. The good news in the report was that international assets were projected to produce better results, with many geographies forecast to earn 5-8% real.
- **GMO** – The large asset manager has done 7-year forecasts for many years. They often forecast on the conservative end, but their projections have been directionally good. The most recent monthly report projected that U.S. stocks and developed market international stocks will lose money after-inflation over the next seven years. Only emerging market equity and debt will produce positive results based on their calculations.
- **Hussman Strategic Advisors** – 12-year returns forecast from their version of the 10-year Cyclically Adjusted PE ratio shows 12-year forward return of -2.0% per annum.
- **PE10 Model** – When looking at simple 10-year trailing earnings multiples, the market is currently in the 97% of most expensive markets. Only the tech bubble years of the late 1990's had higher valuations on this measure. The forecast future 10-year after inflation return based on this measure is currently 3.5%.
- **JP Morgan Asset Management** – This is probably the most robust methodology that we follow, and it forms the basis for our team's financial planning models used with clients. The 2018 data produces a 10-15 year forecast for large cap U.S. equities of 5.5%.

WITH RETURNS FORECAST TO BE MORE MODEST THAN THE PAST SEVERAL YEARS, A FOCUS ON PRESERVING CAPITAL SEEMS PRUDENT.

The market anticipation of inflation for 10-years is 2.1% per annum, so we will use this to adjust the real return forecasts above. If we take all the above into account, the range of forecasts for the *long-run (7-10 years)* would place U.S. equity returns at 0%-6%. With returns forecast to be more modest than the past several years, a focus on preserving capital seems prudent.

CONCLUSION

Global financial markets are the most competitive environment in the history of humanity. It is only with the discipline of core beliefs and decision-making processes that an investor has a chance against this competition. We can't ensure that every result is optimal, clearly that is not within our control. What we can control is the method in which a decision is made. If the decision-making process is optimized, then long-term results are likely to follow. Thus, the chance of achieving goals will be maximized.

Thank you for your confidence in our investment team and our firm. We are grateful and fortunate to be working together in the INFINITE game that we call life. Please reach out to any of our team members with questions.

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