rebalance

Market Review

Winter 2019

Baggage, Poker and Investing

Psychologists describe "emotional baggage" as "feelings you have about your past and the things that have happened to you, which often have a negative effect on your behavior and attitudes going forward."

These psychologists help the baggage-ridden patient realize why his or her baggage continues to color the present in order to make better life decisions.

Rebalance often meets prospective clients with "investing baggage" who have had disappointing returns in the past, and our team tries to find out what happened. We often learn that the client was paying hidden fees over many years and that 30% to 40% of their returns were invisibly siphoned out of their portfolio. Or, perhaps, their broker bet big on a stock or a mutual fund that worked for a while…and then stopped working.

For instance, many investors kept buying tech stocks in the dotcom bubble which began in 1995, making outsized returns as the NASDAQ index climbed to a peak in March 2000, only to watch their "blue chip" internet stocks sink from hundreds of dollars to single dollars per share.

There are thousands of investing "methods" that work, that is, until they don't. Most of these so-called methods function as bets and only work because they benefit from good luck, not from a sound investment process. When these bets stop working, a significant amount of money can be permanently lost. The investor now has the baggage of an internal belief that says: "The market is a very risky place, and I'll probably lose money in it."

Random Events in 2018

Take 2018 as an example. In most years, stocks and bonds move in different ways. A bad year for stocks might be a great one for bonds. When the world worries about inflation, commodities such as gold tend to do well (which is why **Rebalance** portfolios contain a well-designed mix of investments).

But in 2018, for the first time in decades, every major type of investment fared poorly. Stocks, bonds and even commodities around the world declined. During a highly volatile fourth quarter, U.S. stocks had their worst quarter since 2008. Periods of uncertainty such as 2018 are inevitable and happen frequently. These volatile periods are also when investors tend to make their worst mistakes – leading to permanent "baggage."

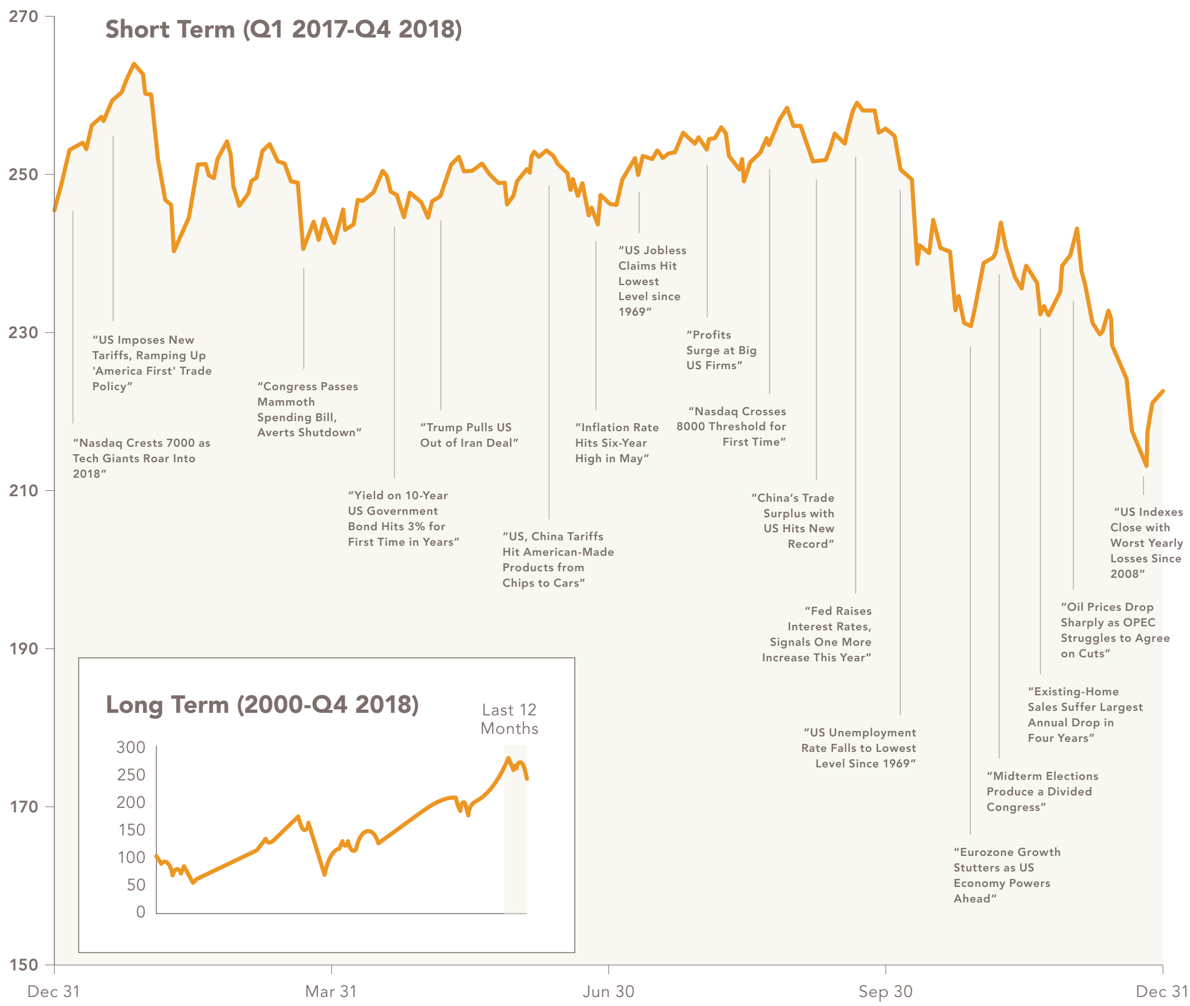
What Baggage-Plagued Investors Can Learn From Poker

Annie Duke, a former professional poker player, wrote *Thinking in Bets* to help others learn from her poker-playing experiences and make better decisions. Her lessons also are pertinent to investing and might help those who carry "investor baggage."

Duke explains that people do not like the idea that luck plays a big role in our lives. While we know luck exists, we often resist the idea that even though we work hard and put forth our best efforts, things don't always turn out the way we want or plan them to. To survive, our brains are wired to quickly create order out of that chaos.

World Stock Market Performance

MSCI All Country World Index with selected headlines from past 12 months



Professional poker players have an interesting job. They must make up to 20 decisions within two minutes and win or lose a sum of money that would buy most of us a new home. There is always an element of luck that can dictate the outcome of a hand. How does a professional poker player know the difference between skill and luck?

Ms. Duke first has us imagine the best and worst decisions we made last year. We generally consider decisions that worked out well as "good" and the decisions that didn't work well as "bad." We naturally link the outcome of a decision with its quality.

Professional poker players call this "resulting" and they rigorously strive to avoid it. To improve, great players strive to evaluate their decision-making processes irrespective of the outcome. One could make a great decision given all of what was known and bad luck could enter into a situation to produce a bad outcome. With good luck, a poor decision-making process can still produce a winning hand. Even the best poker player can make all the "right" decisions — based upon years of training and playing — and still lose because of bad luck.

Every poker player has had bad luck, but the great ones continually ask: "What could have been improved in how I played that hand? Where did my decision-making process fall apart?" Sorting out the difference is the key to becoming a great poker player.

Likewise, finding the right investing process in the face of randomness in the markets is challenging. The many factors that influence public companies and their stock prices are not predictable; they impact our investment outcomes in the short term.

Like successful poker players, sophisticated investors do make money in the markets. They have to. IBM must pay the tens of thousands in pensions to retirees. Large university endowments must distribute funds for school operating expenses. To these investors, a bad year doesn't mean a bad process. They study processes that have proven via arduous research to yield higher odds for success and they think in five to ten-year time horizons.

Our own Investment Committee member Professor Burton Malkiel wrote arguably the most famous book in finance, *A Random Walk Down Wall Street*. Originally published in 1973 and now in its 12th edition, Professor Malkiel's book has become a guide for some of the most sophisticated institutional investors worldwide. **Rebalance** clients reap the benefits of having an Investment Committee that understands how to invest in the face of uncertainty and short-term randomness.

Rebalance invests in broad-based index funds, which confines our risk to the single idea that capitalism will survive and that public companies, like gladiators, will operate and increase your value and view their survival as "kill or be killed." By owning almost all companies in the public markets, we own the losers and the winners, and over time, receive a return that is worth the risk taken.

We have found that clients who join our program with baggage soon begin to leave it behind. Like a great poker player, they learn that with **Rebalance** they have more control and their outcomes are more certain.

Very truly yours,

Your **Rebalance** Team

Long-Term Market Summary

Index Returns*

	Stocks				Bonds	
	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
1 Year	-5.24%	-14.09%	-14.58%	-5.90%	0.01%	3.17%
5 Year	7.91%	0.34%	1.65%	5.28%	2.52%	4.11%
10 Year	13.18%	6.24%	8.02%	10.05%	3.48%	3.98%

***Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

The **Rebalance** Investment Committee works with two broad asset classes for the basic building blocks of our client's retirement portfolios: Growth and Income. During the second quarter of 2018, these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks. Stocks declined sharply when the Federal Reserve raised interest rates as the trade conflict between the United States and China continued. Companies struggled to manage the impact of tariffs on imported goods, pressuring stock prices. Falling oil made energy stocks the biggest losers in the period. Investors moved toward defensive stocks as a result, leading utilities to advance amid a general stock market decline in the final months of the year.

Small U.S. Stocks. Stocks of smaller U.S. companies had a rough final quarter of the year as investor fear of a global slowdown created significant volatility for most stocks. Importation concerns due to hard times abroad led investors away from the relatively higher risk areas of the market, small caps included.

International Developed Stocks. Europe slowed over political discord related to Brexit. Deteriorating trade relations between the world's two largest economies, the United States and China, had a knock-on effect on global trade elsewhere. Economic growth in the Eurozone bloc fell to 0.6% compared to 2.7% a year earlier. Japanese stocks also took a hit as the global economy slowed, as did markets in much of the surrounding region. The Bank of Japan responded by keeping monetary policy accommodative, though monetary authority borrowing rose to exceed total output by November.

Emerging Market Stocks. Stocks of emerging economies declined as China faced up to a sharply slower economy vs. projections. Aside from poor trade relations with the United States, weaker commodity prices led investors to move away from export economies in the emerging world. Sentiment in Brazil improved as a new president took office and focused on reforming the top-heavy pension system there.

Real Estate. U.S. real estate finished 2018 relatively down over 4% in line with the broader U.S. equity market. The benefit of lower correlation was visible in all quarters of the year, especially in the fourth quarter with REITs outperforming U.S. equities by 6.8%. Real estate returns were anchored by their attractive dividend yield, steady cash flows and dividend growth, a strong private market bid and selective M&A and attractive valuations in the face of increased economic uncertainty. The more defensive real estate sectors outperformed, including the less-cyclical freestanding, manufactured homes, and healthcare property sectors.

Income Asset Classes

High Grade Corporate Bonds. U.S. investment-grade corporate bonds declined only slightly on the quarter. Corporates underperformed relative to government bonds as risk concerns ticked up amid a volatile stock market. The U.S. bond market overall returned 1.6% as yields fell. The benchmark 10-year Treasury yield fell 36 basis points to 2.69%. The Federal Reserve, meanwhile, moved the benchmark rate upward for the fourth time, to a target of between 2.25% and 2.50%.

High-Yield Corporate Bonds. This bond asset class had the largest fixed income decline in the quarter. Concerns about the credit quality of these companies reflected an increase in risk aversion as investors moving out of stocks moved into higher-grade bonds.

Emerging Market Bonds. Bonds issued by emerging economies improved over the period, driven by a weakening U.S. dollar and strengthening currencies among oil-exporting nations. Increased investor demand helped drive up prices despite global tensions over trade.

Preferred Stocks. Preferred shareholders have a place in line ahead of common stock holders whenever a company pays dividends or distributes assets to shareholders. In other cases, should dividend payments be missed, preferred shareholders get all of their dividend payments before the common shareholders receive anything. Preferred stock offer more stable cash flow than common stock, but tends to be vulnerable to rising interest rates, as has been the case in 2018.

Treasury Inflation Protected Bonds (TIPS). The U.S. government backs TIPS. They provide ultra-low volatility and an inflation hedge. TIPS tend to behave differently from other types of investments with a low correlation to stocks and bonds, making TIPS a valuable portfolio diversifier.

The Rebalance Investment Committee

Burton Malkiel, Charles Ellis and Jay Vivian comprise the **Rebalance** Investment Committee. They are renowned for creating and implementing sophisticated investment methods used today by elite pensions and endowments. The Investment Committee actively develops, oversees and sets policies for the portfolios offered to **Rebalance** clients. Their core ideas include diversification across multiple types of assets on a global basis and disciplined portfolio rebalancing. They also advocate techniques for keeping investment fees low.

Professor Malkiel is an emeritus Princeton University economics professor, a former board member of The Vanguard Group, and the author of the investment classic A Random Walk Down Wall Street.

Dr. Ellis was for three decades the managing partner of Greenwich Associates, the leading strategic advisor and consultant to large institutional investors around the world. He was Chairman of the Investment Committee of the famed Yale Endowment, and he has served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.

Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over $100 billion in IBM investment funds for more than 400,000 employees worldwide.