Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Third Quarter of 2018

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Executive Summary

- The U.S. stock market posted a very respectable return of +7.1% during the quarter, with much of the total due to continued strength in technology and consumer discretionary stocks, and smaller company stocks. Overall, economic growth and earnings data remained extremely robust, ultimately overshadowing concerns surrounding the escalating U.S.-China trade war.

- Smaller company returns lagged the broader market and growth stocks handily outpaced value stocks. Overall volatility was subdued.

- In contrast, international developed market gains were modest (+1.3%). European banks were generally weaker amid concerns over exposure to emerging markets as well as worries over the Italian budget and Brexit. Emerging market equities lost value (-1.9%), again due to U.S. dollar strength and rising trade tensions.

- As for fixed income, interest rates rose modestly in Q3, and bond yields generally remained well below their historical averages.

- This quarter, we take a break from our discussion about thematic investing to focus on globally-diversified balanced investing. Globally-diversified balanced portfolios are ones that hold both U.S. and foreign equities, including those in emerging markets, and that also hold a diversified range of fixed-income securities to balance the equity risk. This is how Artemis invests its clients' assets.

- Our discussion centers on why such portfolios provide the best long-term protection against bear markets and why they are more resilient than less diversified portfolios. But this does not mean they outperform in every year, particularly when equity outperformance is concentrated in a few sectors, as we are witnessing in 2018 thus far.

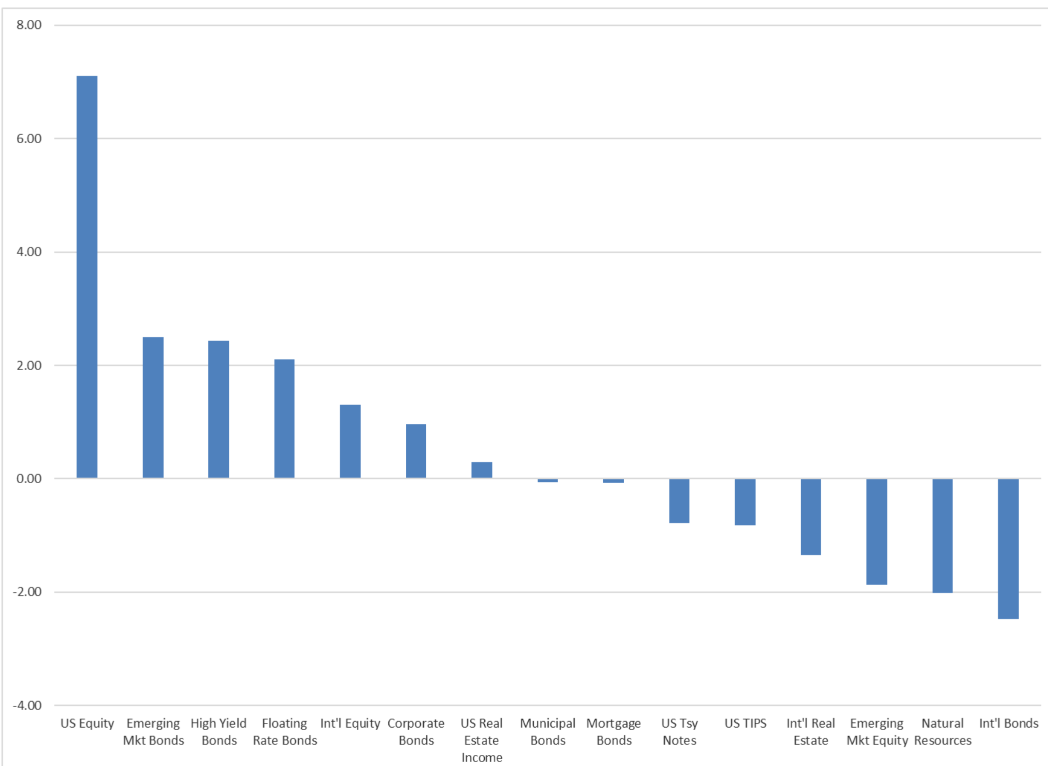
- Artemis portfolio strategy. A few months ago, we modestly reduced risk exposure in all of our client portfolios, which detracted from returns a bit, given how strong the quarter ultimately turned out to be. And we took a pause on implementing our thematic investment choices because the technology sector began to stumble in September.

Quarter in Review – Q3 2018

This quarter marked a continuation of trends that emerged in Q2, with U.S. equities significantly outperforming other regions. The U.S. stock market posted a very respectable return of +7.1% during the quarter, with much of the total due to continued strength in technology and consumer discretionary stocks, and smaller company stocks. See Figure 1.

Overall, economic growth and earnings data remained extremely robust, ultimately overshadowing concerns surrounding the escalating US-China trade war.

Figure 1: Index Returns by Asset Class in Q3 2018 (percentage points)



In contrast, international developed market gains were modest (+1.3%). European banks were generally weaker amid concerns over exposure to emerging markets as well as worries over the Italian budget and Brexit. However, Japanese equities saw strong gains amid a weaker yen and greater clarity on the medium-term outlook following Prime Minister Abe's re-election.

Once again, emerging market equities lost value (-1.9%) due to U.S. dollar strength and rising trade tensions. The basic problem with emerging market equities currently is that with most industrial products and commodities priced in dollars, a higher dollar on the back of higher U.S. interest rates creates double pressure on these economies in terms of import costs and financing. And none of these economies is receiving a lift from rising Chinese export demand because the Chinese government has been tightening fiscal and monetary policy in its quest to reduce overall debt.

In terms of fixed income, the Federal Reserve raised the federal funds rate for the third time this year, prolonging a challenging environment for bonds. U.S. core fixed income, as measured by the Barclay's Aggregate, was flat, and the U.S. 10-year Treasury yield rose 20 basis points (i.e., prices fell) over the quarter. Once again, more credit-sensitive fixed income sectors, namely high yield and floating rate bonds, outperformed.

Emerging markets bonds experienced a tumultuous quarter, but this was largely centered on idiosyncratic factors. With the effects felt most keenly in currency markets, hard currency sovereign and corporate emerging market bonds made positive returns, but local currency bond prices were down.

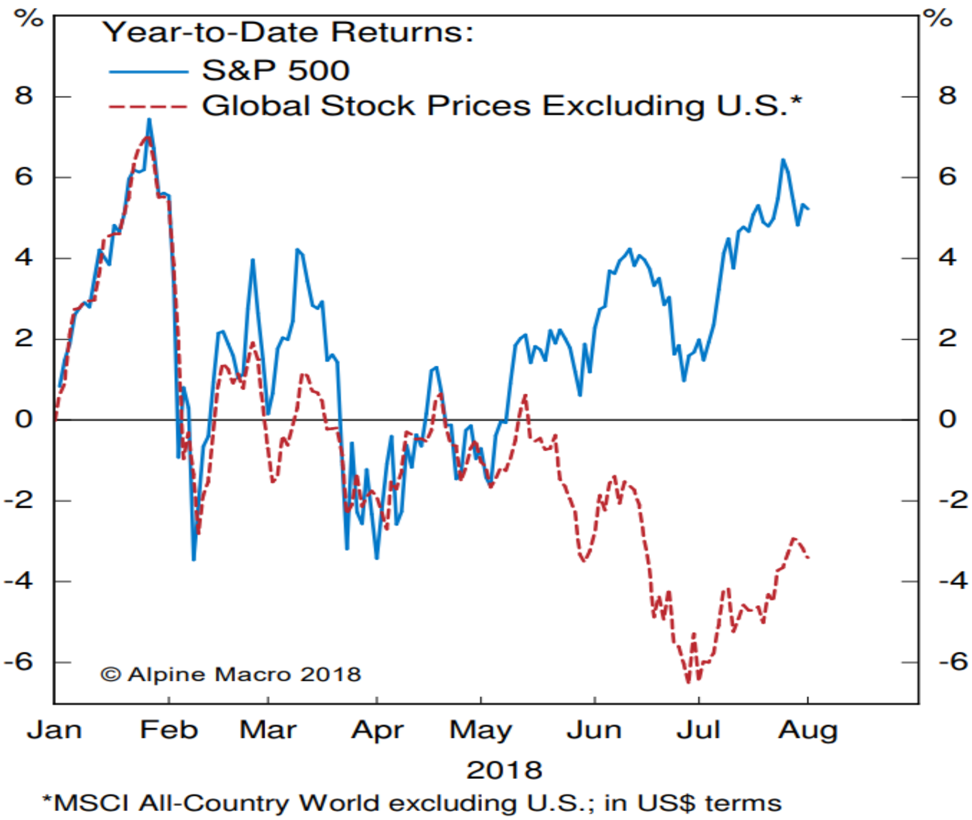
Globally-diversified Balanced Investing in Context

As most of the readers of this report know (and our clients certainly know), Artemis's overall investment philosophy is underpinned by a belief that holding a globally-diversified, balanced portfolio is the best route to long-term investment success. Globally-diversified balanced portfolios hold both U.S. and foreign equities, including those in emerging markets, and also hold a diversified range of fixed-income securities to balance the equity risk.

Admittedly, holding such a portfolio has been a tough sell this year (as my colleagues and I are discovering as we engage with clients in annual reviews of investment performance). The reason is simple – globally-diversified balanced portfolio returns in 2018 have been lackluster at best and don't come anywhere near the returns realized year-to-date in the U.S. stock market. While one might argue that looking at the return of the S&P 500 (or worse still, the technology-heavy NASDAQ return), is not the correct benchmark (and I would wholeheartedly agree), it is natural to wish for returns close to the best-performing asset classes. One of the main problems this year is that after outperforming U.S. equities in

2017, international markets are underperforming the U.S. market this year -- and the performance gap is one of the widest on record. See Figure 2.

Figure 2: Diverging Equity Returns in 2018



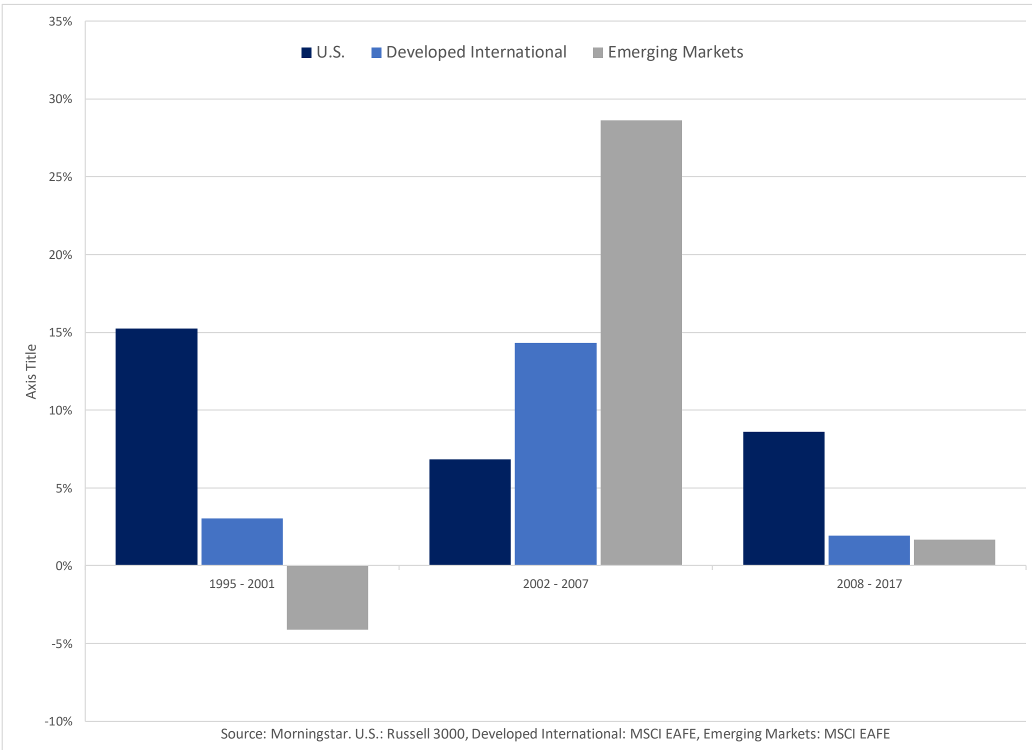
Source: Alpine Macro

In brief, it has not paid to be a globalist this year, in large part because the U.S. has been the only major economy stimulating its economy with tax cuts, increased government spending and deregulation. In other words, the rather startling divergence shown in the chart above is largely policy-driven.

But let's remember -- market leadership can and does rotate, and it is very difficult to know when those pivot points are going to happen. As Figure 3 shows, the U.S. equity market way outperformed international markets in the late 1990s due to the internet boom in the U.S. and a serious currency crisis in many developing countries. But this turned around after the technology sector bust in the U.S. in 2000. The next five years were all about accelerated growth in China, which lifted the fortunes of most emerging market countries, as well as

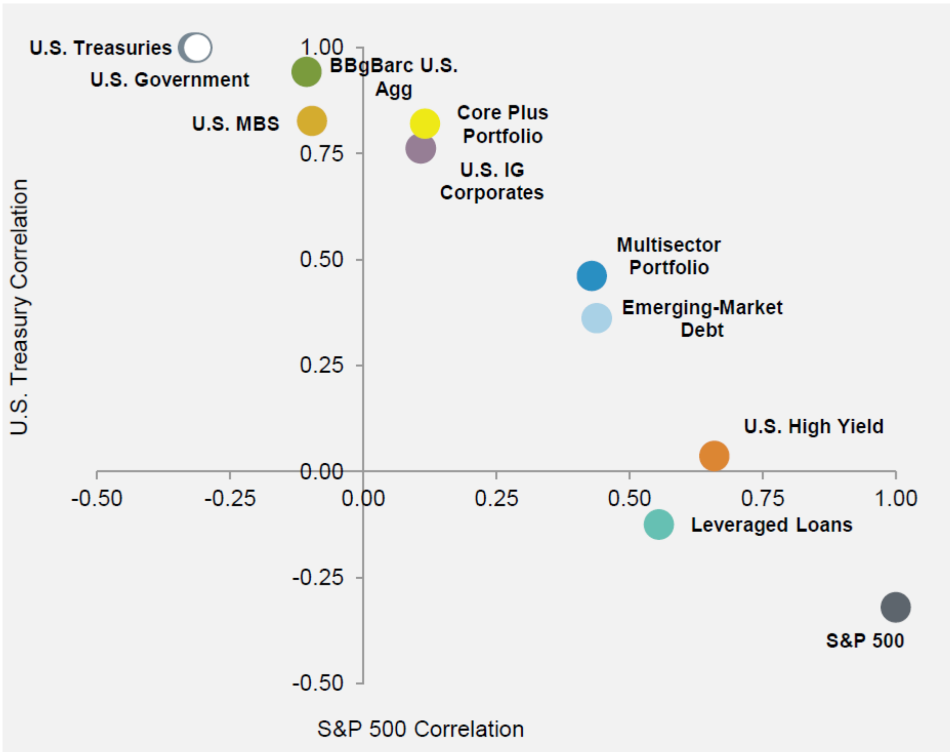
Europe and Japan. Then, without warning, we reached another pivot point in 2008, and so on. Are we at another pivot point now? I don't know, and no one else does either, and that's precisely the point.

Figure 3. Global Stock Market Returns During Different Periods



But the low returns we are experiencing with globally-diversified balanced portfolios in 2018 are not only due to diverging equity market performance. They are also due to low and, in some cases, negative fixed-income returns. A few segments of the fixed-income market namely, high yield and floating rate debt, have performed quite well year-to-date, largely because they are much more sensitive to credit risk than they are to interest-rate risk. Taking credit risk in a booming economy is reasonable as credit defaults are typically low in an expanding economy. However, these sectors of the bond market are more highly correlated to equity market returns, so they offer little protection when equity markets become distressed. See Figure 4.

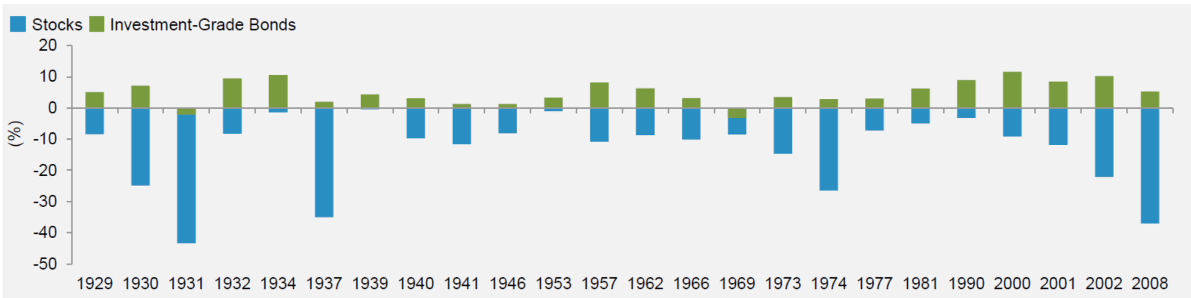
Figure 4. Fixed Income Sectors and Correlation to the S&P 500



Source: Fidelity

In contrast, more interest-rate sensitive segments of the bond market, also called investment-grade bonds (i.e., most of the rest of the segments shown in Figure 4), are performing poorly this year because we are in an increasing interest rate environment. (Remember that the price of interest-sensitive debt declines when interest rates rise.) Thus, one might ask why should investors hold any of these types of bonds when it is fairly obvious that we are in such an environment? The answer is that, irrespective of the interest rate environment, interest-rate sensitive debt tends to perform well when equity markets are underperforming. (See Figure 5.) And since we never know when equity markets are going to become distressed, we can't second-guess when to hold and when not to hold these portfolio stabilizers.

Figure 5. Bond Returns in Years When Stock Were Down, 1926-2016



Source: Morningstar and Fidelity

Research conducted during the last decade helps to put this discussion in context. One study analyzed the performance of progressively more diversified retirement portfolios (i.e., ones that are experiencing annual withdrawals) based on the average of the 17 rolling 25-year periods between 1970 and 2010. The study is notable for including the early 1970s market downturn, when both bonds and stocks were devastated and inflation was rampant; the bear market of 2001-2002; and the more recent financial crisis of 2008. The study identified three key metrics: the average internal rate of return, average three-year draw-down, and the median ending account value. These statistics are captured in Figure 6.

Figure 6. Performance of Progressively More Diversified, Global Portfolios in Distribution Mode: 1970-2010

Portfolio Asset Allocation	17 Rolling 25-Year Periods Between 1970-2010		
$500,000 starting balance, 5% withdraw rate, 3% inflation of annual withdrawal	Average 25-Year Return (IRR%)	Median Ending Account Balance after 25 Years ($million)	Average Worst Case 3-Year Drawdown (%)
Equal-weighted **Three** Asset Portfolio: Cash, Bonds, Large U.S. Stock	9.89%	$2.49	-4.77%
Equal-weighted **Five** Asset Portfolio: Cash, Bonds, Large U.S. Stock, Small U.S. Stock, Non-U.S. Stock	11.46%	$3.86	-9.44%
Equal-weighted **Seven** Asset Portfolio: Cash, Bonds, Large U.S. Stock, Small U.S. Stock, Non-U.S. Stock, Commodities, U.S. REITs	**11.96%**	**$4.67**	**0.73%**
60/40 Allocation: 60% U.S. Stock, 40% U.S. Bonds	11.58%	$4.22	-12.73%

Source: Craig l. Israelsen, "Still Seeking Stability", *Financial Planning*, April 2011

The most notable finding is that the seven asset-class portfolio, which included allocations to large and small U.S. equities, non-U.S. equities, U.S. bonds, cash (T-bills), real estate and commodities, had the higher average rate of return of 12% over the 17 rolling 25-year periods. Moreover, it was the only portfolio to have an average worst-case drawdown that was positive (+0.73%) over the same periods.

The bottom line: well-diversified global balanced portfolios provide the best long-term protection against bear market scenarios and are the most resilient overall, even when they are in distribution mode. Isn't that what we all want?

Artemis Portfolio Strategy

We modestly trimmed all of our clients' equity exposure during the quarter, which turned out to be a bit early judging by Q3 results. However, given October's volatility in both domestic and international markets, I'm glad we stepped on the brakes.

We did not, however, add to our technology themes during the quarter, namely because the technology sector started to wobble in September and is still facing additional headwinds as I write. We are holding off for the moment and waiting for a better entry point. We'll see. In the short run, we will be doing some tax-loss harvesting before year end.

In terms of fixed income, we are not planning any moves currently but will be rotating out of some of the more credit-sensitive holdings once the Federal Reserve signals an end to the current rate-hiking cycle

Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of $150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **Bank of America Merrill Lynch Global Government Bond II Ex-U.S.** tracks the performance of public debt of investment-grade sovereign issuers, excluding the U.S.

The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.