JANICZEK® WEALTH MANAGEMENT

Portfolio Matters

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REFRAMING VOLATILITY & RISK

Confusing These Can Be Hazardous To Your Portfolio

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BOTTOM LINE

- Our January rebalancing de-risked portfolios
- Q1 equity swings coming from abnormally quiet market
- Higher interest rates to bring greater bond volatility
- Our evolving thoughts on alternative investments

"The Return of Volatility." "Volatility Is Back With A Vengeance." These are some of the headlines recapping the first quarter of 2018. Many of them discuss volatility and risk interchangeably, as though they were both the same … but they're not.

What is volatility? What is risk? Perhaps the simplest definitions come from Jason Zweig's *The Devil's Financial Dictionary.* Volatility is "the extent to which an investment's short-term returns differ from its long-term average returns … colloquially known as *'Oh my God!'*" Risk, on the other hand, is "the gap between what investors think they know and what they end up learning about their investments, about the financial markets, and about themselves."

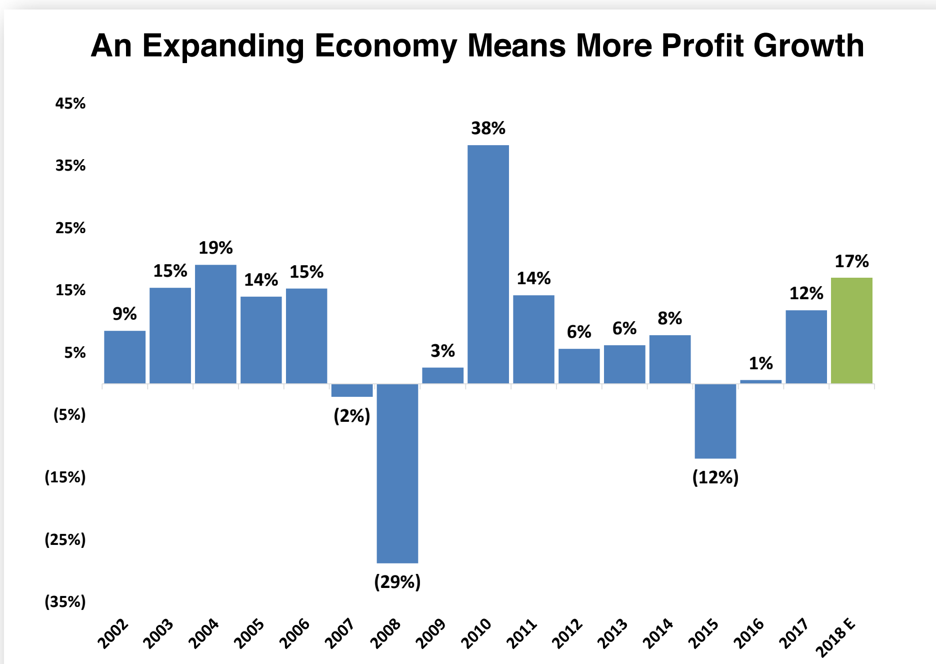
Risk and volatility are different, and we intend to set the record straight. In this issue of Portfolio Matters, we cover the first quarter's risks and volatility that was (and wasn't) witnessed in markets, and provide investors some clarity on thinking about the two individually and separately.

Economy
The key components in the economy are looking good right now, and by some measures, our prosperity has never been better.

The latest GDP report showed our economy expanding at a 2.9% clip, and the leading economic indicators continue to trend higher, suggesting further expansion as we continue into 2018. Although the first quarter's growth has been consistently weak in recent years, current expectations are for growth of about 3.0%. The economy may be breaking out of the subpar growth seen since the end of the Great Recession, and we expect GDP growth of about 3.0% for 2018.

The consumer is in great shape. Unemployment of 4.1% hasn't been this low since the go-go years of the late 1990s. And initial claims for unemployment benefits are trending at lows not seen since the early 1970s … when our labor force was 33% smaller! Further, homeowners are seeing their houses appreciate nicely, resulting in a net worth for the average consumer posting yet another all-time high.

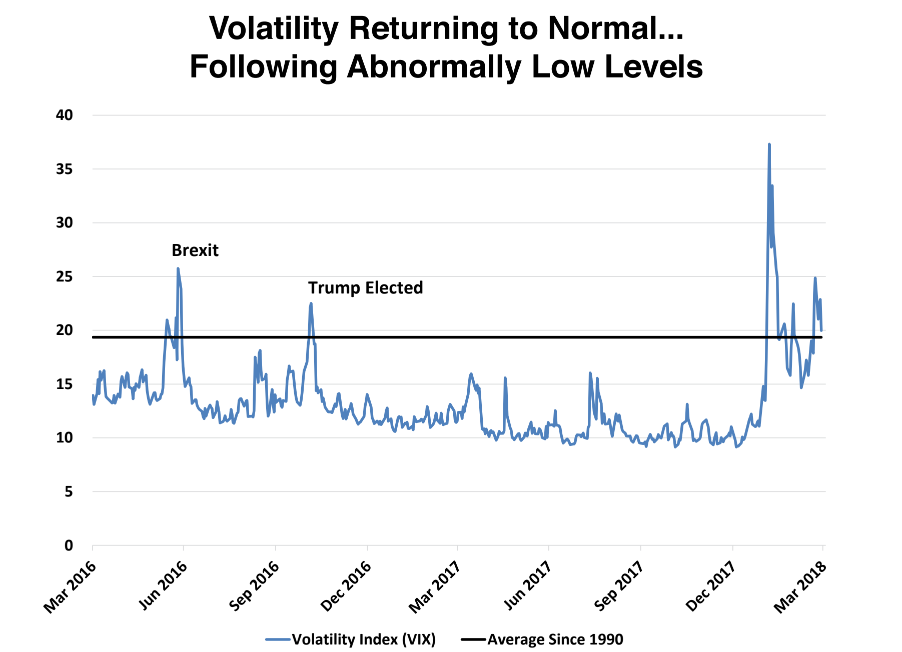
The corporate sector is also benefitting from the current economic environment. Profit growth is now estimated to be 17% higher in 2018, and this jump goes beyond lower corpo-



Source: Bloomberg

rate taxes. Rather than higher profits coming from cost cutting (like we saw in the early part of the expansion), the business sector is seeing a healthy 7-8% topline revenue growth.

So, where could this go wrong? One area that we don't believe is a major concern (yet) is a trade war. The proposed tariffs and strong rhetoric shouldn't really surprise anyone, given Trump's negotiating style. The President's formula seems to begin with a strong, even extreme position, then work back towards a middle ground. Ignoring tone and style, one would have to be impressed with his negotiating track record, and we don't think the current tariffs will evolve into the trade war that many are speculating. As one market strategist noted, "Focus on where he ends up, not where he starts."



Source: Bloomberg

Consider how stocks and bonds reacted to the headlines of possible trade wars. While stocks sold off on fears that tariffs would lead to higher inflation, bonds told a different story. By looking at inflation-indexed bonds, or bonds whose interest payments are linked with inflation, we find that the bond market wasn't nearly as concerned as the stock market about trade wars. Without confirmation from the bond market, the evidence suggests the fear of tariffs and trade wars to be a bit overdone.

However, we do see some evidence, on the margin, that expectations may be overshooting reality. The Citigroup Economic Surprise Index measures how a range of economic data releases fared versus expectations. The index had been steadily on the rise the last 6 months of 2017, indicating that actual economic results were higher than expectations. But the index retreated in January, indicating more negative surprises than positive ones. In this light, the February selloff in stocks made perfect sense. While this index alone won't predict where the economy is headed, we find it a useful indicator for assessing expectations versus reality.

While tax reform is a clear boost to 2018, the latest projections from the Congressional Budget Office (CBO) show increased challenges in future years. The key trade-off in the minds of the Trump administration is whether faster economic growth can offset lower tax revenue. Time will tell, but one additional input is the ability to cut government spending. Tax reform at this stage of the cycle is, admittedly, puzzling. But when viewed as a catalyst for reducing overall government spending, the move makes a little more sense.

Above all, we believe interest rates will remain the biggest factor for the rest of 2018. The Fed raised the benchmark short-term interest rate in March to its current target of 1.50% to 1.75%. Both the Fed and the market are telegraphing 2 more increases by December 31st, and the Fed is signaling short-term interest rates in a 3.25% to 3.50% range in 2019.

The speed at which the Fed raises rates to prevent the economy from overheating has been a challenge in every economic cycle. But the challenge this time includes a new twist. Raising too slowly historically meant the economy overheats and inflation gets toxic. However, raising too slowly this time from the lowest levels ever seen, and the Fed may not have any room for cuts whenever the next recession begins.

Asset Allocation

Stocks around the world saw negative returns in the first quarter for the first time in a while. Globally, equities fell 1.4%, the first decline in 2 years. Global bonds rose 1.4%, although performance among regions varied widely. Alternatives, broadly speaking, rose 0.3%.

For our clients, the first quarter saw some trading activity. We rebalanced portfolios, bringing allocations back to their long-term targets. For the better part of this 9-year bull market run in stocks, we have held higher levels of equities (mostly U.S. blue chips) and benefitted from those positions. As such, returning our clients' portfolios to neutral means trimming those equity profits, and we do so with a careful eye on managing the tax bill.

As the title of this edition of *Portfolio Matters* suggests, risk and volatility are terms often thrown around interchangeably. However, we see some key differences between the two that too many investors gloss over.

Simply put, we define volatility as the degree to which investment prices vary. The VIX Index provides one measure of volatility in the market, and its average since its inception in 1990 is 19. In February, the equity market in the U.S. had a rather dramatic decline, a full 10% correction in just 4 days. The VIX spiked from 11 to 50 during this selloff before returning to … 19.

Lost in the volatility conversation is the fact that stocks have been extraordinarily non-volatile in recent years. Trading near 11, the VIX had been below its long-term average for 89% of the trading days since 2013. So, unless you believed that stocks had fundamentally changed and were permanently less volatile than in the past, you would have expected a return to more normal times. Put into this context, the first quarter's volatility isn't all that surprising.

Further, a 10% selloff is perfectly normal despite what the talking heads on TV will have you believe. Many investors won't recall, but we've seen a correction of 10% or more in 6 of the last 8 years. Since 1980, the average peak-to-trough decline in the market in any year is nearly 14%, making the February drop less than average! (Someone should mention this to the media during the next end-of-the-world, below-average selloff.)

Risk is a different story. Risk is not volatility, but rather the chance that an investor experiences a permanent loss of capital. Think about it this way: what is the risk of a volatile investment? The risk is that the investment's price has declined when it comes time to sell.

There are several powerful ways that individuals can manage risk, beginning with diversification. Interested in the returns that stocks offer but would like to reduce the volatility? Add some bonds to your portfolio. Doing so retains 90% of the return with 1/3 less volatility.

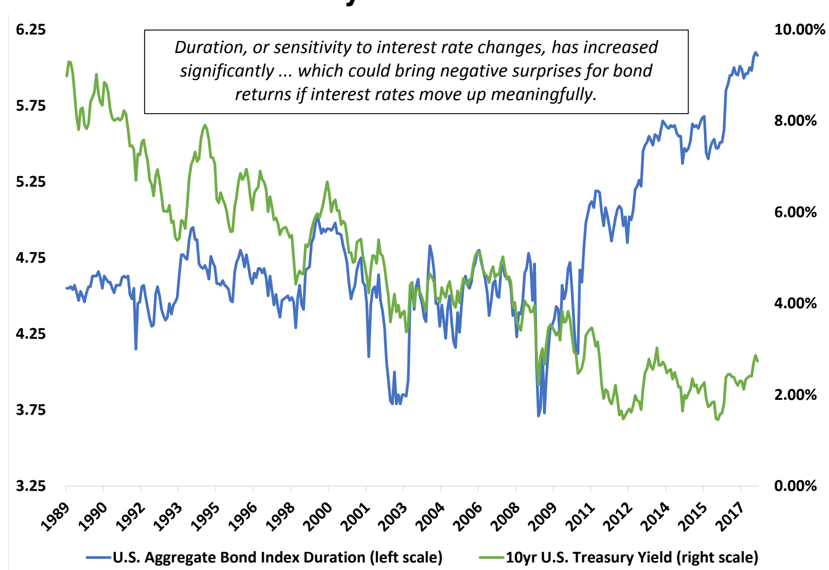
Another risk reducing tool is rebalancing. With a very long time horizon and a better understanding of volatility, an investor could theoretically hold 100% equities to maximize returns and growth. However, on planet Earth, life happens, as do market selloffs. Intentions of such long time horizons and a tolerance for volatility tend to disappear.

It works like this: set your long-term portfolio mix for stocks and bonds to deliver the return you need at the lowest risk possible, then allow for normal volatility to change that mix in the short-term. Should normal volatility become abnormal, and your mix of stocks and bonds strays beyond your tolerance, rebalance. Note that the little voice in your head won't want to rebalance. "Hey, things are going up, why sell?" "The world is collapsing, why buy?" Because the evidence shows that rebalancing (a.k.a., "buying low and selling high") will not only maintain the right mix to meet your goals, but it will enhance your expected returns over time.

Finally, and perhaps most importantly, aligning the portfolio's investments with the purpose of those investments. Saving for retirement in 10 or more years? Consider an equity heavy portfolio to maximize potential growth. Saving to buy that condo on the beach next year? Given the time horizon, deploy a bond- or cash-heavy allocation to minimize the possibility of selling on a downswing in the market and losing money.

The current environment offers a great teachable moment. The economy is good, and markets are delivering nice returns. Of course, you have plans and goals for the money you are earning, both in your job and in your portfolio. And you'd like to do whatever you can to ensure that the next recession, whether it comes in 2019 or 2029, won't knock you off track. Too many folks attempt one or both of the following: 1) maximize returns at the wrong time, i.e., buy into markets that are going up … until they go down; or 2) try to time the market by selling at the first sign of decline and buying when things head higher … buying high and selling low, shrinking their assets along the way.

Interest Rates & Bond Duration: A Potentially Lethal Combination



Source: Bloomberg

There's a better way to invest, and rebalancing your portfolio to your plan is the foundation of successful investing. The best part? This requires no ability to predict the future. It DOES require knowledge and understanding of not only how *investments* work, but how *investors* work. Such a process will not save you from volatility, but it will reduce the risk that your portfolio produces returns that fall short of what the market offers you.

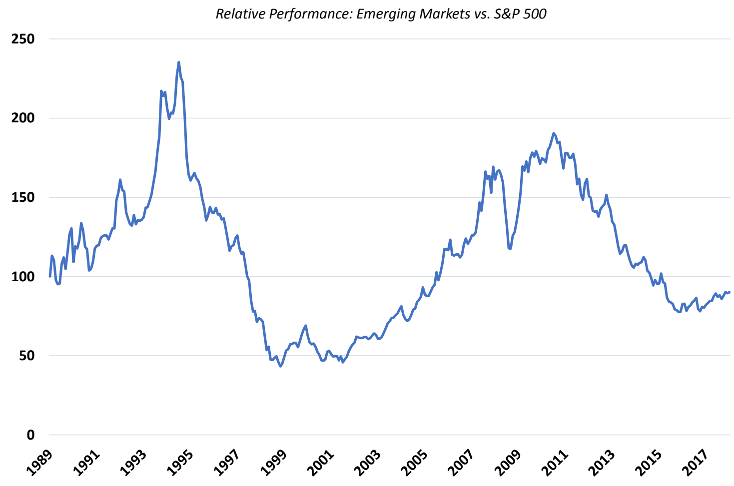
Fixed Income
The 10-year Treasury yield rose during the quarter, flirting with the 3.0% level in February before settling back at 2.74% by March 31st. As such, the benchmark U.S. Aggregate Bond Index fell 1.4%, its first negative return since the fourth quarter of 2016. Municipal bonds also fell, posting a negative 1.2% return. Outside the U.S., international bonds rose 3.6%, with developed markets outperforming emerging markets.

In a quarter in which fear returned to the marketplace, it's a bit odd to see junk bonds outperforming AAA-rated issues. But that's exactly what happened, with high yield's negative 0.9% return besting the 1.2% decline from AAA-rated corporate bonds. As for maturities, the shorter, the better in the first quarter. Treasury notes in the 1-3 year range delivered a negative 0.2%, better than 7-10 year Treasury bonds' 1.9% negative return for the quarter.

We've discussed the potential for Fed action on short term interest rates, but it's long-term yields that matter for bond investors. The difference between short-term rates and long-term rates is the yield curve, and it's an important indicator for both bonds and the overall economy. We've discussed the yield curve before, but it's worth a review heading into the second quarter.

Historically, no recession has taken place without the yield curve inverting in advance. An inverted yield curve is one in which short term yields are higher than long-term yields. During

Shifting Tides: Emerging Markets & The S&P 500 Index
Relative Performance: Emerging Markets vs. S&P 500



Source: Bloomberg

the first quarter, the yield curve did flatten a bit, i.e., short term rates rose faster than long term rates. Does this signal the end of the bull market and the beginning of the next recession? Not exactly.

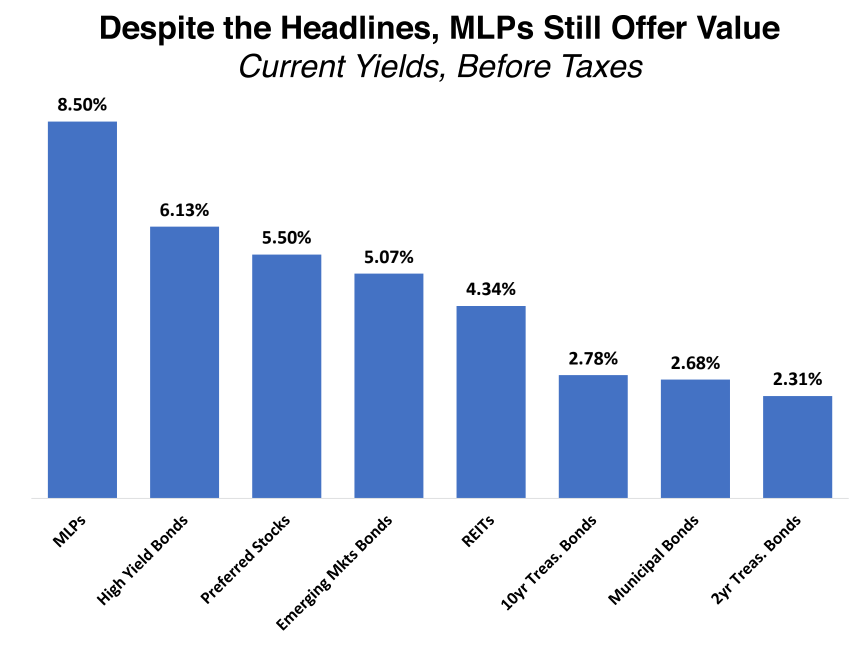
During the quarter, the spread between 10-year Treasury yield and the 2-year yield shrank to 0.47%. That is below the historical average of 0.97%, however, it still represents an upward sloping yield curve. Note that this is down from the December 2013 high of 2.60%, so the flattening has already been slowly taking place for over 4 years. Further, history offers us examples of flattening yield curves that did not result in a recession, so while we do monitor this indicator (and the press obsesses over it), we don't see it sounding meaningful alarm bells at this time.

In fact, we think there's not enough attention being paid to the opposite side of the coin: the risk that the 10-year yield rises more than expected. There are several contributing factors to this risk, including 1) nominal GDP growth, and 2) a deficit-driven weaker U.S. dollar. Either of these factors could lead to a higher 10-year yield and, after 35 years of interest rate tailwinds, many bond investors could be caught off guard by rising long-term interest rates.

As a result of our recent rebalancing, we've reduced the interest rate sensitivity in our bond holdings. Our clients will notice a larger position (almost 20% of total bonds) in short-term bonds. This is an intentional move that gives up some return in order to have more stable capital regardless of interest rate movements. Should a recession surprise the markets, short term bonds will provide us liquidity when we need it. And should rates spike like they did during the so-called Taper Tantrum of 2013, short term bonds will provide capital to take advantage of opportunities.

Equities
U.S. blue chip stocks, as measured by the S&P 500 Index, fell 0.7% and ended a streak of 15 consecutive months of positive returns. Non-U.S. developed equities fell 1.3% and emerging markets notched a 1.3% gain to continue their recent run of outperformance over their more developed counterparts in the last few years.

The premium, or extra return, offered from smaller stocks was pretty slim albeit positive during the first quarter. Value oriented stocks struggled as higher interest rates presented a bigger drag. The universe of value



Source: Bloomberg

stocks typically has a larger exposure to sectors such as utilities and REITs, both which were laggards as interest rates rose.

But before throwing in the towel on value, small cap, or both, consider this: small cap value stocks are among the most attractively priced stocks in the market. By contrast, large cap growth stocks … the same names that have been everyone's favorite during this bull market run … are some of the most expensive in the market, trading 16% higher than their long-term average. Remember, risk is about permanent loss of capital, right? Well, buying stocks this rich won't guarantee you lose money, but sure will be difficult to obtain merely average returns over time from these entry levels.

Much like the late 1990s, the sector in the spotlight remains technology. Over the last 12 months ending March 31st, tech stocks have nearly doubled the S&P 500 Index. And when tech outperforms an S&P 500 Index that's up by double digits, it's usually not the best of times for value investors. But this still doesn't mean the right value process can't deliver in a technology-crazed environment, as two of our managers have shown.

For example, one of our managers runs a thoroughly value-driven U.S. equity portfolio that is beating its value benchmark despite the tailwinds for tech/growth stocks (and headwinds for value investors.) How? First, the portfolio excludes all utilities and REITs due to their heavily regulated and unique structures.

Second, by starting with smaller names and working its way up, the fund can still find value inside the tech sector. Indeed, the fund's weighting to tech is 16%, its second largest sector weighting. But the positions it holds in tech have a P/E ratio of 14.9, a full 33% cheaper than the S&P 500's tech holdings that trade at 22.5 times earnings.

The environment for value investors isn't all bad, as financial services offer a bright spot. This group has struggled with the low interest rate environment, so rising rates will offer some more opportunities for the sector. Unlike technology, the value universe has traditionally included a large number of financial services companies, and our manager holds nearly 25% of the fund in this sector. By comparison, the S&P 500 has a 15% weighting, or 40% less.

Stepping back, we see attractive opportunities outside of the U.S. stock market, particularly in emerging markets. While its dangerous to lump all emerging markets together, some general comments apply to many of these countries. Many of them boast younger populations with faster growing incomes. Their infrastructure buildout leapfrogs the older, inefficient infrastructure seen in many developed nations. And their government balance sheets are often in much better shape.

Whether investing in emerging markets or developed markets, there is value to be had outside the United States. An investor buying U.S. equities at today's valuations should expect average returns or less. Conversely, the prices available in emerging markets suggest expected returns over time that are at least as good as their historical averages.

Alternatives

Over the past few years, we have whittled down our use of alternative investments, at least, in the publicly traded markets. Accordingly, we will whittle down time allocated in this commentary as well.

Remaining in our client portfolios are 2 investments we've historically viewed as alternatives. The first are REITs, although we'd note that REITs have now been given an explicit weighting in the equity indices, so it's difficult to label them as truly alternative.

REITs were banged up a bit in the first quarter thanks to rising interest rates. This is unsurprising, and we'd expect them to continue to react to short-term interest rate swings. However, over time their funds from operations, i.e., the rents they collect from tenants, will reset to both the economic and interest rate environments.

The second alternative investment we've maintained are our MLPs, and this group of investments had no joy ride in the first quarter. It seems that this group can't catch a break, and the latest news was an unfavorable tax ruling on March 15th that affects different MLPs in different ways. Specifically, MLPs that own and operate intrastate pipelines will no longer benefit from a tax allowance previously in place. On the day of the ruling, the entire group dropped nearly 5%.

We've explored what the ruling means for the names our MLP manager owns, and we find more fear than risk here. Most importantly, the ruling applies to MLPs who deploy a certain tariff structure, while others utilizing a different structure are unaffected.

After reviewing the names in the MLP portfolio, we conclude that only 4% of the fund is impacted by this ruling. So, while naïve investors sell all MLPs on this news, the intelligent investor will pursue value where its offered. With MLPs offering tax-advantaged yields of 9%, we see plenty of value in this space.

Over the past decade or so, we have conservatively used publicly traded alternative strategies that come in a regulated and liquid vehicles (specifically, a mutual fund). We've had some winners and losers along the way, but as we look out at markets for the next decade and beyond, we observe a few things that may change our approach to alternative investments.

First, the need for hedged strategies may very well be greater going forward after such strong tailwinds in equity markets. But what that really means is that there's a need for investments that don't move in tandem with stocks, especially when stocks are headed lower. Whether one obtains that uncorrelated return via hedged strategies (and their fees) or via a diversified portfolio utilizing a rebalancing process remains to be seen.

Second, we cannot dismiss the observation that the publicly traded equity markets have shrunk over the years. More and more companies have chosen to remain private, avoiding the cost and burden of life as a publicly traded company. The Wilshire 5000 Stock Index, which is the broadest equity index in the U.S., now contains only 3,492 companies. A JP Morgan report stated the total number of publicly traded companies in the U.S. has fallen 46% since 1996, and there are now fewer publicly traded companies today than there were in 1976.

What this means for the fundamental factors we're trying to get exposure to remains unknown, but it does require us to explore the issue further. After all, the data suggest there are more privately held companies than before, and the private equity and debt markets have become more accessible than in years past. So, stay tuned, and if you have thoughts on the matter, please let us know.

Conclusion

Let's return to our theme of volatility and risk. Here's another definition of risk, this one from Peter Bernstein's famous investment book *Against The Gods: the Remarkable Story of Risk.*

"The word 'risk' derives from the early Italian *risicar*e, which means 'to dare'. In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about."

Investors accept volatility as part of the game of investing, and stocks in particular can offer up some impressive volatility at times. But the risk of permanent losses for investors comes with their decisions, their conclusions, and their actions. This is where an advisor adds value.

Advisors cannot predict the future any better than anyone else can. But what advisors can do is help investors make the best decisions, both for the portfolio and for the individual. In essence, we help manage uncertainty.

The tools advisors bring to their clients are both technical and personal. The technical tools include all the expertise, the investment acumen, the tax strategies, etc. But what gets overlooked, tragically, are the personal tools. These are incredibly powerful, and they include the alignment of your goals, your plans, your envisioned future with the actions you take today.

When it comes to investing, the risks investors take have little to do with Bitcoin or tech start-ups. Rather, they include how much volatility you can accept, say, given your cash flow. Or how about volatility with respect to your tolerance for paper losses?

The risk is that you sell at the worst time, and that you join in on the rally just as its topping out. It's the psychological factors that contribute to the risk of permanent loss. For individuals, this can mean a lesser future than the one originally envisioned. But there's a better way.

Volatility happens, and risks increase by reacting the wrong way at the worst time, resulting in loss. As usual, Warren Buffett puts this thinking into words that drive the point home, "I would much rather earn a lumpy 15 percent over time than a smooth 12 percent." Agreed, and a trusted advisor can help.