Modera Perspectives – Fourth Quarter 2018

Investment Commentary:

"If you don't know where you are going, you'll end up someplace else." **— Yogi Berra**

Immediately following the third quarter, the best quarter since 2013[1], US stocks, as represented by the S&P 500, gave back those gains and more in the fourth quarter of 2018. It was challenging to find consistently profitable investments over the course of 2018, regardless of the index, geography, or asset class (see below for more details on investment performance).

The good news is that such short-term market volatility and uncertainty can create large opportunities for our clients. We at Modera Wealth Management would phrase Yogi Berra's quote a little differently: ***If you have an investment strategy and financial plan in place, you have a significantly better chance to end up where you intended to go.***

What This Means for You

We know that market turbulence can be frightening especially when the headlines are sounding alarms. Market declines drive home the importance of diversification and keeping a long-term perspective. While unpleasant to experience, volatility is an expected part of the investment experience.

You may have heard all this before, nevertheless our message and strategy remain both consistent and intentional. We look at periods of market turbulence as rebalancing opportunities to take advantage of buying asset classes at lower prices, which will bring reduced allocations back to their target levels.

Modera's approach is unchanged in the face of this market volatility. It is critically important to maintain a strict investment discipline in order to achieve a successful financial plan. While we cannot control or predict market movements, we can control how we react to these movements.

A Deeper Review of 2018 Global Investment Performance

The year 2018 will be one for the history books, on a number of levels.

What may be most notable about 2018 is that the performances across several indices and asset classes were down. Indeed, even the price of the 10-year Treasury note declined during 2018, as its yield rose from 2.47% on 12/31/17 to 2.68% on 12/31/18. To put this in perspective, it is extremely rare to see both the S&P 500 and the 10-year U.S. Treasury down in the same calendar year – the last time that happened was in 1969.[2]

As briefly referenced above, the steep decline in U.S. stocks during the fourth quarter also made it the worst quarterly performance since the financial crisis; though to be fair, this statistic is somewhat misleading since stock performance was also abnormally positive in the prior quarter. In fact, we highlighted in last quarter's investment report that some reversion to the mean was well overdue for

[1] https://money.cnn.com/2018/09/28/investing/stocks-markets-third-quarter/index.html
[2] http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/histretSP.htm

the U.S. stock market. In addition to large-cap stocks, the smaller-cap U.S. companies as represented by the Russell 2000 were also hit hard in the fourth quarter, down 20.2%, ending the year with an 11% loss. REITs, which tend to be less correlated with the performance of other asset classes, also were dragged 5.5% lower in the fourth quarter despite declining interest rates and finished the year down 4.2%.

Data ending 12/31/2018 (not annualized if less than 1 year)

Indices	Q4 2018	1 year	3 years	5 years	10 years
Equities					
MSCI ACWI (All Country World)	-12.7%	-8.9%	7.2%	4.8%	10.1%
S&P 500 (U.S. Large Cap)	-13.5%	-4.4%	9.3%	8.5%	13.1%
Russell 2000 (U.S. Small Cap)	-20.2%	-11.0%	7.4%	4.4%	12.0%
MSCI EAFE (International Developed)	-12.5%	-13.4%	3.4%	1.0%	6.8%
MSCI EM Emerging Markets (International Emerging)	-7.4%	-14.3%	9.7%	2.0%	8.4%
Fixed Income					
Citigroup World Government Bond Hedged (Global Bonds)	2.4%	2.6%	2.8%	3.6%	3.3%
Barclays U.S. Aggregate (U.S. Investment Grade Bonds)	1.6%	0.0%	2.1%	2.5%	3.5%
Barclays Municipal Bond 5Y (4 - 6) (Municipal Bonds)	1.6%	1.7%	1.5%	2.0%	3.1%
Barclays U.S. Corporate High Yield (U.S. High Yield)	-4.5%	-2.1%	7.2%	3.8%	11.1%
Other Indices					
S&P Developed REIT (Global Real Estate)	-5.5%	-4.2%	3.5%	6.7%	11.5%
HFRI FOF: Conservative Index (Diversifiers)	-2.3%	0.1%	2.0%	1.9%	3.2%

Source: Zephyr Analytics & Morningstar

International equities also finished the year down, with developed foreign equity markets (as measured by the MSCI EAFE Index) and emerging market equities (as measured by the MSCI EM Emerging Markets Index) down 13.4% and 14.3%, respectively, for the year. Some consolation, however, was that emerging markets outperformed U.S. equities in the fourth quarter, as the increases in the U.S. dollar during much of 2018 reversed slightly by the end of the quarter, and investors sought out value investments and diversification globally. In addition to its performance in 2018, it is worth noting that emerging markets are still up 9.7% annually over the past three years.

On a bright note, government bonds overall outperformed in the fourth quarter (up 2.4%, as measured by the Citigroup World Government Bond Hedged Index), as investors sought safety amid uncertainty. We also saw slight positive gains in corporate investment-grade and municipal bonds (both up 1.6%) during the fourth quarter, as investors sought safe havens from equities. Here again, we see why portfolio diversification is important. Despite what was otherwise a more challenging year for bond investors while interest rates were rising through much of 2018, diversification in high-quality bonds still provided positive performance during the stock market correction.

Market Drivers in 2018 Remain Issues to Watch in 2019

There were several factors driving the increased volatility of investment performance across asset classes as we closed 2018, which may carry over into 2019:

- **The Federal Reserve**: The late Fed Chairman William McChesney Martin famously said the Fed's job was "to take away the punch bowl just as the party gets going." In December 2018, the Fed raised rates for the eighth time since the end of 2015[3]. Many are trying to determine how many more rate increases will be forthcoming and whether the party will keep going or when the proverbial punchbowl will crash to the floor. It is hard to tell, but it is safe to say that the Federal Reserve's tighter monetary policy actions are starting to act as a brake on our strong economic growth to control potential inflation and also provide the Fed with more ammunition to aid the economy in the event of a future recession. It is not unusual to see stock market corrections during periods of monetary tightening. We have planned for this (as we communicated in prior Modera Perspectives) by adding inflation protection, reducing duration, maintaining credit quality, and diversifying within our fixed income holdings.

- **Tariffs and Trade Wars**: One of the President's key agenda items has been negotiating new international trade agreements and reducing our trade deficits with trading partners such as China. But as the year progressed, it became increasingly clear that negotiations would not be quick. Without a resolution, investors are increasingly concerned that these trade disputes with U.S. trading partners could negatively impact corporate earnings into 2019 and beyond.

- **Economic Slowdown:** The two factors above are enough to get investors worried about slowing Gross Domestic Product (GDP) growth. But corporate confidence is another factor to watch – for example, with increased uncertainty, CEOs may take more of a wait-and-see attitude on capital deployment and other operational decisions about their businesses in 2019. In addition, this current economic upcycle is getting long in the tooth – it will be the longest expansion period <u>ever</u> in U.S. history if the economy continues to grow through the summer of 2019[4], which seems likely. But if history is any guide, this record run may be due to experience a slowdown at some point within the next few years.

- **Concentrations in Investments and Machine Trading**: Many funds have come to be dominated by just a few of the largest companies by market capitalization, including names like Facebook, Apple, Amazon, Netflix, and Google (infamously known as "FAANG" stocks). At the top of the market (i.e., 10/1/2018), we estimate that these stocks accounted for nearly 13% of the S&P 500 market capitalization and comprised over 30% of the index's performance from 1/1/2018 through 9/30/2018 (data from Blackrock and DFA). However, these companies are also the easiest source of liquidity for investors when markets turn south. Selling begets more selling in these same stocks. We are also seeing an increase in what is known as "algorithmic" trading activity (i.e., machine-driven trading), in which certain program trades are on autopilot and are automatically executed when certain conditions exist. As a result, the same factors that lead us up in a bull market can lead us down in a bear market, and we believe this contributed to the selling pressure we saw in the fourth quarter of 2018. While we try to avoid funds involved in this type of trading, unfortunately, we cannot always avoid their impact.

- **Liquidity and volume:** Investors who bought on dips in recent years held off in the fourth quarter and stayed on the sidelines. This reduced market liquidity exacerbated the stock market decline. There was also some forced hedge fund selling at year-end as a result of poor performance and tax-loss harvesting. Some of these issues that caused increased

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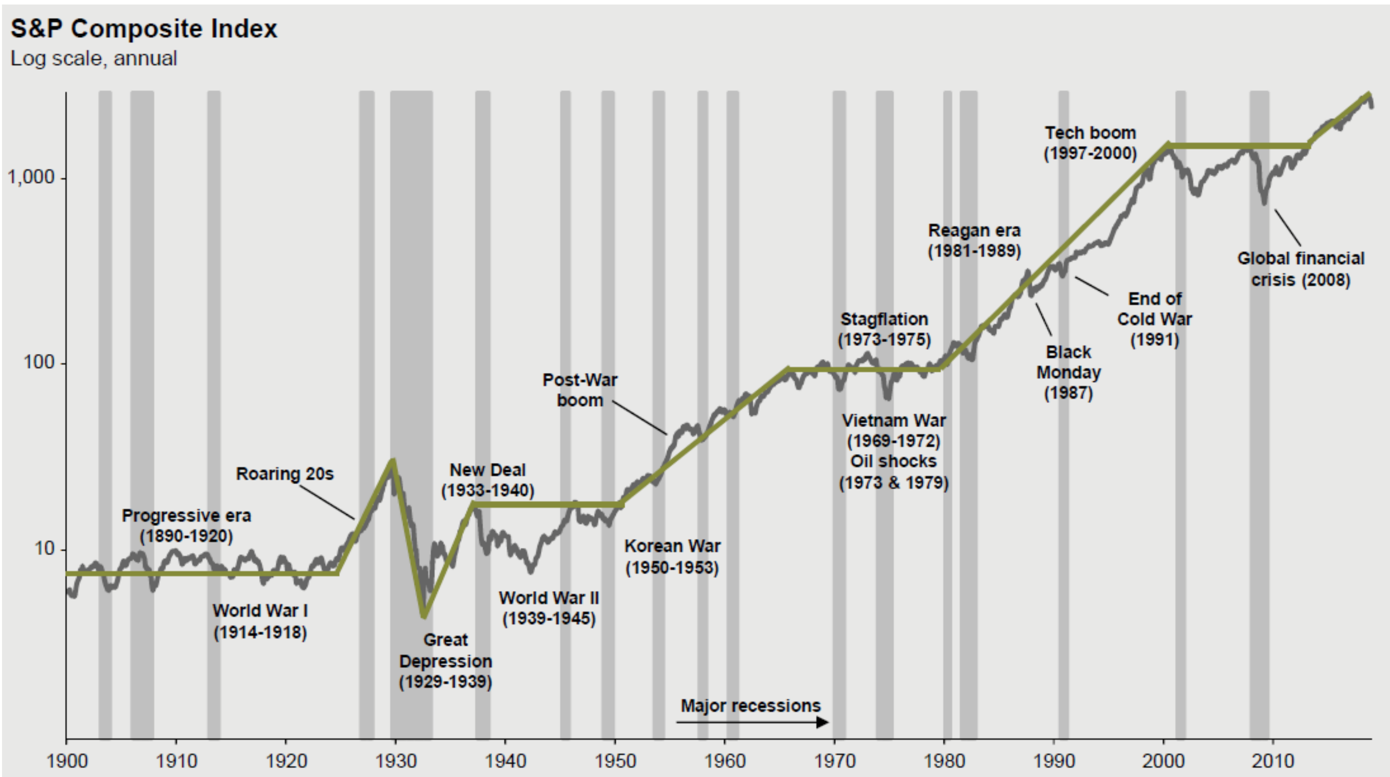
[3] https://www.thebalance.com/fed-funds-rate-history-highs-lows-3306135

[4] https://www.cnn.com/2018/12/27/perspectives/trump-stock-market-economy-forecast/index.html

selling pressure at the end of 2018 should naturally resolve themselves as we progress into 2019, and we believe this will lead to some improvement in liquidity conditions in the new year.

Taking the Long View



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns. Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Guide to the Markets – U.S. Data are as of December 31. 2018.

As we have said many times before, there are a lot of complex factors that drive the global economy and financial markets. The chart above illustrates that we have experienced many, many periods of turbulence and volatility. It will happen again. But when it comes to making investment decisions, Yogi Berra is right: You can easily get lost without a plan, particularly if you get caught up in short-term thinking. You should always know where you are going when it comes to your investments. Our goal at Modera Wealth Management is to help you keep focused on your long-term goals.

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Financial Planning Perspectives

An Equitable Divorce Requires A Financial Professional
by Brandy K. Wright CDFA®, CFP®

If you are considering a divorce, you are not alone. Statistics show that about 45% of marriages in the United States end due to divorce, as divorce rates are rising among middle-aged and older adults. While most people expect the heightened legal and emotional factors that come with a divorce proceeding, the potential financial complexities are easy to underestimate and yet can be among the most important decisions in one's lifetime. Therefore, it is important to include a financial professional on your team that specializes in divorce.

Beyond the Divorce Attorney

A divorce attorney is paid to do one thing well – successfully implement a legal divorce for the client. However, a thorough understanding of the financial implications of a divorce is critical to an equitable legal settlement and peace of mind during and after a divorce process. A professional who specializes in divorce financial analysis and planning, such as a Certified Divorce Financial Analyst, or CDFA®, can help you receive a settlement that addresses the full scope of your potential financial needs.

Modera Wealth Management offers its clients access to finance and planning professionals, such as CDFAs®, that are experienced with divorces. Here are several examples of value-added services that a Modera Wealth Management professional can provide during and after the divorce process:

- **Educate, Guide, and Organize:** You may not be the one that managed the finances when you were married; and even if you were the "money person", many financial issues in your life are about to change in a meaningful way. Modera Wealth Management can assist both during and after the divorce proceedings to help you through the process, organize your finances, and reestablish your financial independence.

- **Anticipate, Budget, and Forecast:** Modera Wealth Management professionals can also help you think about and forecast how potential divorce settlement scenarios will affect you. This encompasses your more immediate needs as well as future income and expense planning for post-divorce independence, including child support, medical costs, retirement needs, income tax planning, insurance requirements, and inflation effects.

- **Valuation of Assets:** Many different types of assets can be involved in a divorce, including bank and investment accounts, retirement accounts, pensions, insurance, primary homes and rental property, or even business ownership. Modera Wealth Management can assess the values of both your liquid and illiquid assets and provide a statement of net worth to support your legal proceedings. In many cases, a legal document called a Qualified Domestic Relations Order (or QDRO) is required when it comes to dividing up retirement assets in a divorce. A Modera professional can assist you and your attorney through the preparation, approval, and submission of a QDRO to the court.

- **Supervise the Vesting and Transfer of Assets:** Your former spouse may own assets that have little value today but could be significantly more valuable in the future (for example, stock options that vest or appreciate in value only after a set period of time). A Modera CDFA® can properly factor in such assets to help you receive a more equitable settlement.

- **Income Taxes:** A Modera CDFA® can analyze your historical tax returns for hidden or improperly valued assets that may have understated your income while you were married. For example, was your taxable income understated due to unusually high business or rental property expenses, or large capital loss carryforwards? Such temporary issues could result in a lower divorce settlement amount than you deserve.

- **Estate Planning:** Modera Wealth Management can also help you analyze and appropriately modify beneficiary designations across various documents and accounts, including your will, trusts, retirement accounts, and life insurance policies. Doing so will help ensure your wishes are updated and properly reflected after the divorce proceedings are complete.

- **Life Insurance:** Alimony payments may sometimes be required as a result of a divorce settlement. If this is the case, Modera Wealth Management can help you determine whether life insurance should be included in your divorce settlement specifically to cover potential loss of alimony and/or other support payments (i.e., in the event your former spouse passes away).

- **Calm and Steady Advice:** The process of executing a divorce can be a period filled with extreme emotion and confusion. It is invaluable to have a calm but experienced hand help guide you through the potential financial issues relating to your divorce.

Modera Wealth Management offers a variety of financial planning resources to its clients, including access to divorce specialists such as Certified Divorce Financial Analysts®. If you are considering a divorce, we encourage you to consult your Modera Wealth Manager, who can put you in touch with the appropriate professionals to guide you through the process.

Thank you for your continued confidence and trust in our services.

Modera Wealth Management, LLC

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The returns shown in the table on page 2 are annualized returns, except for periods less than one year, for selected asset classes as represented by benchmark indices. Investors cannot invest directly in an index. Unmanaged indices do not reflect management fees or transaction costs associated with some investments. Past performance is no guarantee of future results, and there is no guarantee that the views and opinions expressed herein will come to pass. This document contains forward-looking statements that use words such as "anticipates," "projects," "believes, and/or "expects," that indicate future possibilities. Due to known and unknown risks, other uncertainties and factors, actual results may differ materially from the expectations portrayed in such forward-looking statements. Readers are cautioned not to place undue reliance on forward looking statements, which speak only as of the date of this document.

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