Third Quarter Report 2018

LUCIEN, STIRLING & GRAY ADVISORY GROUP[SM]

"Smart Decisions About Serious Money"

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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

With the long bull market in stocks continuing through the third quarter, accompanied by a US economic engine that keeps breaking long-established records, a few concerning behavioral trends are emerging. These are understandable outgrowths of human nature, so they come as no surprise. Nonetheless, they're worth acknowledging because human nature has **not** evolved over the millennia to create successful long-term investors. In fact, it's quite the opposite.

One notable trend is the increasing percentage of assets that are being concentrated in US-centric investments, and the fact that many investors are abandoning diversified holdings in other parts of the world. Perhaps due, at least in part, to an outspoken "America first" political philosophy, perhaps influenced by the explosive growth and popularity of "passive" investment strategies (many of which structurally emphasize large-cap US stocks) but also undoubtedly driven by the outperformance of US equity markets over the rest of the developed world this year, more and more people are focusing their portfolios on domestic investments alone, while they eschew broader global diversification.

Another trend is the increasing number of urgent voices calling for the imminent "end" to this long US economic expansion due solely to its extended age, and the equally strong admonition to do something. At first blush, these voices might seem to be a reasonable counter-balance to the trend mentioned above, but the prevailing tone of the ads, articles and opinion pieces are not, in fact, balanced. Instead, they're fearful, reactive, and full of ominous references to "crashes." The so-called "solutions" they urgently prescribe, whether it's shifting wholesale to gold, buying various complex annuity products, or pursuing so-called "alternative investment strategies", are drastic in their long-term effect.

The fact is, nobody knows for sure what the future holds. But that doesn't stop all kinds of well-financed fear mongers, salespeople, and attention-hungry pundits from asserting, without a shadow of a doubt, that they do. This phenomenon reveals another foible of our vulnerable human nature: that we are drawn *inexorably* to the perception of total conviction and confidence. Human beings are attracted to simple, easy to repeat messages that are delivered with power, authority and without equivocation.

Perhaps this was a valuable survival trait millions of years ago when homo sapiens lived in tight, nomadic tribes and had to band close together around a dominant head man simply to survive the next hunting expedition. But in today's complex environment of social media, "fake news", inter-connected global markets, independent lifestyles and increasingly self-funded retirements that can, and do, span thirty years or more, it's a distinct vulnerability. It's a far more important survival skill nowadays to be able to embrace ambiguity, and to accept the limitations of anyone's capacity to know for sure. It's better to nurture a sense of temperamental resilience that's tied to a long-term goal-focused plan than it is to place too much stock in someone else's short-term proclamation of certainty.

Yes, every economic expansion eventually runs its course. It's typically followed by a perfectly natural period of economic contraction – also called a recession – *that eventually runs its course as well*. These cycles have been happening for hundreds, if not thousands of years. Depending on the level of excess that builds up in the interim, some recessions are quite short and mild in their effect. Others are longer and more severe. But they have all been *temporary*. There is no "end." And for the long-term, goal-focused investor, with a well-thought-out plan, a properly allocated and diversified portfolio, adequate cash reserves to cover their short-term expenses, and the patience, discipline and *temperament* to see both the expansion and the contraction through without acting impulsively and emotionally, it's all, as my mother likes to say: "just part of life's rich pattern."

Unsuccessful investors react: they constantly change their tactics and their holdings out of regret for "missed opportunities" or in a sudden flight response to a real or imagined economic "crisis." Human nature, in other words, is a failed investor, because it is pro-cyclical. It flees in fear of assets that are being marked down in price – and are therefore increasing in value – as it lunges in further pursuit of whatever asset class has been hot and is gradually having the value drained out of it.

Above all, successful investors act: they pursue disciplined, long-term strategies which have some broad historical likelihood of carrying them towards their financial goals, and they hold portfolios in service to those plans. They embrace the probability that their investment outcomes will, at times, run below their assumed rate of return, because that is the nature of short-term market fluctuations. They create structured processes because they recognize their own worst human tendencies, and they understand that the only things they can really influence in the long run are the inputs.

Thank you for your confidence and trust.

Thomas G. Twombly

President

INVESTMENT COMMENTARY

The third quarter, and the year to date through September 30th have brought positive results for our clients. Nevertheless, the last nine months has been a vastly different experience for investors than was 2017, or, in fact, any other year before that. We therefore thought it might be worth looking back to share some broad long-term perspective here.

Our final report for last year (which one can find, along with all our other reports, at https://lsggroup.com/resources/reports/) pointed out just what an anomalous set of circumstances we encountered during 2017. Every major asset class we invested in experienced positive results. Further, all the major *equity* categories plus high yield bonds enjoyed fully double-digit returns. Emerging markets equities enjoyed explosive growth of more than +37% for US investors, developed international markets also rose more than +25%, and here in the United States, remarkably, the S&P 500 climbed in every single month of the year. The run up in everything was impressive.

Meanwhile, the maximum peak-to-trough decline investors in US stocks experienced throughout 2017 was a truly paltry -3%; less than one fourth of the approximate -14% intra-year decline that long-term investors in this asset class have had to endure, on average, every single year since at least 1980. In other words, very little in the way of economic setbacks gave investors cause to temper their expectations. While we welcomed these results ourselves, we also made a point to caution our clients that continued persistence of these unusual conditions was quite likely to be ephemeral.

Through September 30th of this year (and cheating just a little because we have the advantage of editing this report a few weeks into October) this proved to be a good preparatory warning. The pockets of turbulence we've hit – to borrow a phrase from your friendly neighborhood airline pilots association – have led to more than a few white-knuckle responses from passengers.

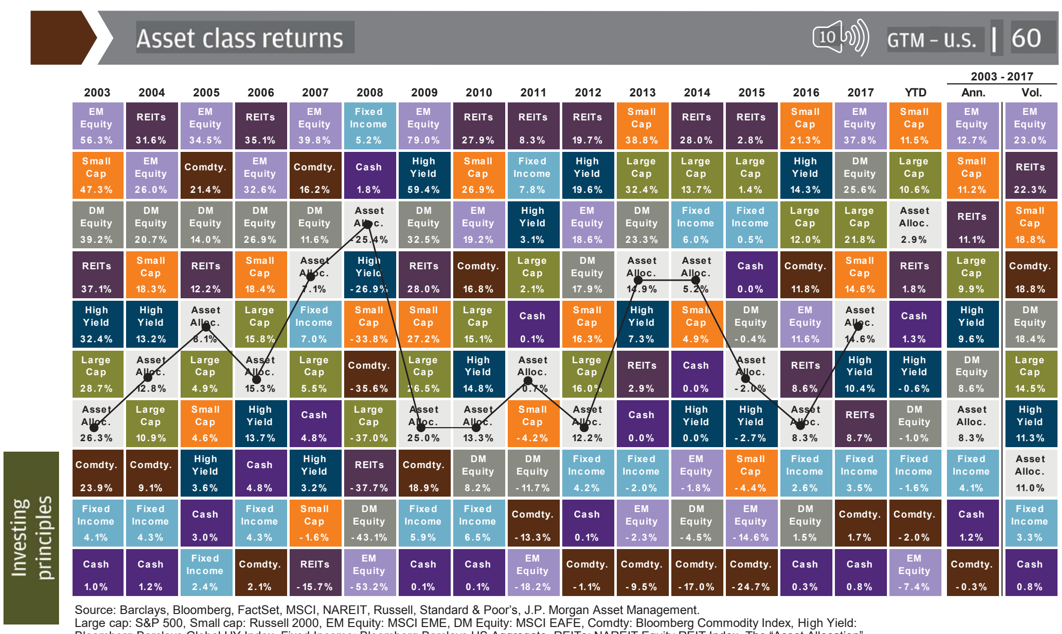
Equity markets in the US have experienced two relatively small downdrafts so far this year: one of approximately -10% in February that led to the biggest dollar value of equity liquidations since 2008; and now one of approximately -6% (so far) in the first few weeks of October that has led, again, to increased levels of fear about what the future holds. Bonds of all types, as well as developed market international stocks have posted negative results for the year thus far, and emerging market equities have undergone a brisk pull-back – all of which has resulted in a drag on results for broadly-diversified portfolios. The natural question that comes to mind is: "what, if anything, should one be doing differently?"

As a visual answer, we point you to the chart below – courtesy of JP Morgan Asset Management's 4Q 2018 Guide to the Markets. It shows, in a rainbow of colors, the comparative year-over-year results for all major asset classes from 2003 through the end of 2017. It also shows, in the third column from the right, the comparative results of the same asset classes for 2018 thus far; and in the final two columns, the cumulative average annual returns of all those asset classes for the last 15 years, as well as their long-term statistical volatility (sometimes referred to as "risk".)

Importantly, in white, it also depicts a hypothetical year-over-year example of a blended asset-allocation strategy that includes all those asset classes combined into a diversified portfolio that has been periodically rebalanced.

Does such a discipline guarantee a positive result every year? No, certainly not. Look at 2008 as an example. Even broad diversification didn't protect investors from a very challenging downdraft – and we must expect those periodically. What it did do was to provide that, so long as they remained resilient and stuck to a discipline, those investors had <u>some</u> allocations to out-performing asset classes in their portfolios from which they could shave, so they could add judiciously to other under-performing asset classes at particularly propitious levels.

The point of this illustration is that in the absence of knowing, well in advance and exactly: which asset class is going to lead; how much it will return to an investor during a given period; when precisely it will falter; how much and for how long it will fall during that period; and precisely when and what other asset class will take its place at the top of the chart – and **nobody** knows all these things – a patient, disciplined long-term asset allocation strategy that involves broad diversification and periodic rebalancing is a system that has worked over the fullness of time. Not unlike the comment Winston Churchill once made about the democratic form of government: "it's the worst possible system, except for all the alternatives."



2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	YTD	2003 - 2017 Ann.	2003 - 2017 Vol.
EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Small Cap 11.5%	EM Equity 12.7%	EM Equity 23.0%
Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Large Cap 10.6%	Small Cap 11.2%	REITs 22.3%
DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	Asset Alloc. 2.9%	REITs 11.1%	Small Cap 18.8%
REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	REITs 1.8%	Large Cap 9.9%	Comdty. 18.8%
High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Cash 1.3%	High Yield 9.6%	DM Equity 18.4%
Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 15.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. 0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	High Yield -0.6%	DM Equity 8.6%	Large Cap 14.5%
Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	DM Equity -1.0%	Asset Alloc. 8.3%	High Yield 11.3%
Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Fixed Income -1.6%	Fixed Income 4.1%	Asset Alloc. 11.0%
Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	Comdty. -2.0%	Cash 1.2%	Fixed Income 3.3%
Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -7.4%	Comdty. -0.3%	Cash 0.8%

Source: Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Barclays Global HY Index, Fixed Income: Bloomberg Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg Barclays US Aggregate, 5% in the Bloomberg Barclays 1-3m Treasury, 5% in the Bloomberg Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/02 – 12/31/17. Please see disclosure page at end for index definitions. All data represents total return for stated period. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of September 30, 2018.

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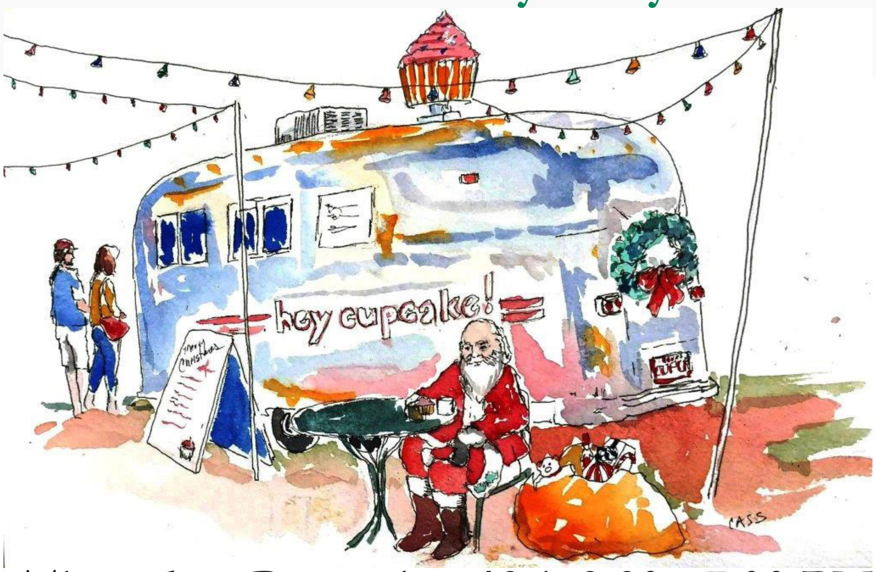
J.P.Morgan Asset Management

Save the date for Lucien, Stirling & Gray's Annual Holiday Party!



Thursday, December 13th 3:30 - 7:00 PM
4005 Guadalupe St. Austin, TX 78751
RSVP at info@lsggroup.com or 512-458-2517

General Market Results

	3rd Quarter	YTD	One Year	Three Year	Five Year	Ten Year
CPI	0.06%	2.28%	2.16%	1.95%	1.49%	1.43%
Barclays Agg Bond	0.02%	-1.60%	-1.22%	1.31%	2.16%	3.77%
S&P 500	7.71%	10.56%	17.91%	17.31%	13.95%	11.97%
DJI	9.63%	8.83%	20.76%	20.49%	14.57%	12.22%
S&P 400	3.86%	7.49%	14.21%	15.68%	11.91%	12.49%
Russell 2000	3.58%	11.51%	15.24%	17.12%	11.07%	11.11%
NASDAQ	7.14%	16.56%	23.87%	20.31%	16.36%	14.42%
MSCI EAFE	1.42%	-0.98%	3.25%	9.77%	4.90%	5.87%
MSCI EM	-0.95%	-7.39%	-0.44%	12.77%	3.99%	5.76%

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