General Market Results

	4th Quarter	YTD	One Year	Three Year	Five Year	Ten Year
CPI	-0.16	2.24	2.24	2.14	1.58	1.83
Barclays Agg Bond	1.64	0.01	0.01	2.06	2.52	3.48
S&P 500	-13.52	-4.38	-4.38	9.26	8.49	13.12
DJI	-11.31	-3.48	-3.48	12.94	9.70	13.16
S&P 400	-17.28	-11.08	-11.08	7.66	6.03	13.68
Russell 2000	-20.20	-11.01	-11.01	7.36	4.41	11.97
NASDAQ	-17.29	-2.84	-2.84	11.10	10.97	16.76
MSCI EAFE	-12.54	-13.79	-13.79	2.87	0.53	6.32
MSCI EM	-7.47	-14.58	-14.58	9.25	1.65	8.02

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FOURTH QUARTER REPORT 2018

LUCIEN, STIRLING & GRAY
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"Smart Decisions About Serious Money"

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A MESSAGE FROM THE PRESIDENT

Thomas G. Twombly

We are pleased to provide you with our report for the period ending December 31, 2018.

It was a challenging year, and the final quarter highlighted (again) the temperamental obstacles we all face in holding faithfully to a patient, long-term investment discipline that includes a healthy allocation to equities. This is especially so amidst the shrieking short-termism of our daily lives. Whether it's coming from the highest levels of our Government, or from the so-called financial "experts" paraded across our TV, smart-phone or computer screens every two minutes, it seems as if the trusted voices of poise and deliberation are few and far between these days.

A quote I read on December 13th illustrated this with shocking clarity. It came from the so-named "Chief Strategist" of an investment firm called The Quad Group and was published in an article by Heidi Chung on Yahoo Finance: *"I feel like we're rats on a sinking ship. We all run to one side thinking something good is going to happen and it doesn't, and then the wind shifts and so we all run to the other side."* My gosh, if this is what passes for "strategic" thinking nowadays, a great many people have lost their way for sure.

I'd like to share an alternate, and very personal, perspective. It spans the inevitability of decades, as opposed to the capricious weather changes noted above. It's only in that long-term context that can I conceptualize the big financial responsibilities I personally face for the remainder of my life. It's also only in that context that I can fully grasp the wisdom of stalwartly *owning* the equity investments I do (and that you do, too) despite their obvious short-term volatility, as a specific <u>defense</u> against the risks I see.

My grandfather was born in 1905. His life expectancy at birth was 47.3 years.

His eldest child, my father, was born in 1935. His life expectancy at birth was 59.9 years.

My father's eldest child (me) was born in 1961. My life expectancy at birth was 67.

My eldest child, my son, was born in 1992. His life expectancy at birth was 72.3 years.

And a male child born in the United States last year had a life expectancy at birth of 76 years.

In just four short generations, average male life expectancy at birth has expanded by almost three decades. And it continues to expand every year as advances in healthcare and nutrition continue apace. Women, on average, live longer still.

Now let me review what I've actually experienced in my family, because it's instructive. My grandfather, despite being diagnosed with Type 1 diabetes in his

early 30s, lived a long life, including more than two decades of retirement, until he died at the age of 87. My father retired from a long career at the age of 73. Today, at almost 84, he's still going strong - literally - on Christmas Day at my house he was proving to his uppity grandsons that he can still do curls with 35 lb. dumbbells in either arm. I can't know how much longer I'll live. But based on these examples, there's a strong incentive for me to focus on an investment time horizon that spans many, many decades to come - because my wife, too, is likely to live well beyond me. Her mother, who's still going strong herself, will be 94 this month.

All this is clearly good news, but it presents a completely different way of looking at "risk."

The crucial issue many people just don't grasp is this: the *joint life expectancy* of adult couples is meaningfully greater than the individual life expectancy of either member of that couple. Today, the average 65-year-old man *individually* has a 22% chance of living to age 90. The average 65-year-old woman *individually* has a 33% chance of living that long. But a couple who are both 65 years old today face a 48% probability that one of them will live to see that birthday. Would you gamble on those odds?

That's 25 years, therefore, that the *average* 65-year-old couple retiring this year must plan and invest for. (And **our** clients, by and large, because of your comparative health, education and socio-economic well-being, stand a very good chance of living longer than the average.) Furthermore, they must do so against a backdrop of relentlessly rising expenses. Using just the average inflation rate since 1958, they should expect their living costs to double or perhaps even triple during their remaining lifetimes.

Put simply, a portfolio that is heavily (or, God forbid, solely) weighted towards so-called "conservative" fixed income securities acquired in this environment of historically low interest rates runs a significant risk of failing to last anywhere near long enough to sustain those financial responsibilities. It may well be less volatile in the short run as it gradually but relentlessly loses purchasing power to taxes and inflation. But that will prove to be cold comfort in the long run to someone like me who loses first his lifestyle, then his independence, and finally his dignity because he failed to think far-enough ahead – and because he mistook a perfectly normal and, if history is any guide, *completely temporary* equity market decline for a permanent loss of capital and got scared completely out of his well-diversified portfolio by some breathless talking head on TV who's setting his hair on fire.

Based on the fund flow data from the end of December, a great many people have done exactly that recently – while fearfully and reflexively pouring a huge amount of money into bonds and cash. We're grateful, and continually impressed, to report that none are our clients.

Thank you again for your confidence and trust.

Thomas G. Twombly

President

INVESTMENT COMMENTARY

A year ago, in our report for this period we called attention to just how anomalous 2017 had been in the broad arc of financial market history. We also pointed out that investors should prepare themselves for change, because those conditions were not likely to last. Not only had every major asset class provided attractive results for the year (some of them quite outstanding) but the incredible lack of volatility we experienced during the year stood out as an abnormality.

Using large-cap US stocks as the most widely-followed example of this phenomenon, the biggest peak-to-trough decline the asset class experienced in 2017 was a meager -3%. An intra-year decline this small was a phenomenon equity investors hadn't experienced in over two decades. To take this illustration just a little bit further, there were only eight trading days in all of 2017 when the S&P 500 moved up or down by more than 1%. There was not a single 2%, 3% or 4% day in the entire year. It was just a slow, steady climb of +19%, with nary a bump to wake the fears of a snoozing traveler.

All that changed quite abruptly in 2018. And though the level of volatility we experienced during the year

was quite normal in the broad scope of history, the sharp contrast to 2017 clearly raised investor anxiety levels to outsized proportions. To illustrate that contrast, in 2018 the S&P 500 experienced sixty-four trading days of +/- 1%; twenty days of +/- 2%; six days of +/- 3%; and two days when the entire index fluctuated by more than 4%. Much of this came amidst a steep decline in the final three months of the year that stopped just a whisker short of the magical -20% that has widely come to define a "bear market." Like a bucket of ice water tossed on an unsuspecting person in the middle of a blissful reverie, it was a rude awakening.

Most other asset classes also declined for the year, providing only minor shelter in broadly-diversified portfolios. Cash, municipal debt and shorter-term bonds were the only asset classes to provide positive results, offering total returns that ranged between +1.4% and +1.8% for the year. Nevertheless, allocations we maintain in those areas provided important ballast, especially for more conservative portfolios. Longer-term debt, including US Government, investment-grade corporate, and high-yield bonds all fell by more than -2% in response to tightening monetary conditions. Small-cap stocks, developed international market stocks and emerging markets equities all fell between -11% and -14.5% for the year – again standing in sharp contrast to the +14.6% to +37.8% results they had posted in 2017. Allocations we maintain to these asset classes placed a drag on overall results for the year, much as they had provided a strong tail wind in 2017.

Looking forward, there is now a veil of uncertainty hanging over the political economy (to resurrect an appropriately descriptive term in more common use a couple of hundred years ago) that's contributing to investor negativity. At this writing, a Government shut-down that threatens to extend for an indeterminate amount of time, and rising trade tensions between the United States and China are the chief causes. But so too is anxiety about expected, but not-yet-fully-quantified, declines in US corporate profits after what can only be described as a banner year in 2018. This anxiety too is being exacerbated by the shut-down, as much of the sensitive economic data that analysts and financiers rely on for timely readings is supplied by various government agencies that are now on furlough.

Nevertheless, we see several reasons not to fixate on the negativity, and instead to remain reasonably optimistic that this long economic expansion is still intact. Chief among these is that while the **rate** of growth in the economy is indeed slowing from very high levels, the economy is still growing nonetheless, and many asset prices now look cheap relative to their historical valuations. The Federal Reserve won't need to do much more any time soon to dampen the possibility of asset bubbles forming due to easy monetary policy, which had been their concern earlier this year. They are likely, therefore, to be less aggressive about raising rates from here. Another positive for the overall economy, though it is often not being reported this way, is the steep decline we've seen in energy prices recently – chiefly oil and gas. While this has been hard on energy sector companies, this will quickly translate into a substantial reduction in most people's daily living expenses moving forward, and these savings are very likely to be spent in other areas, providing a boost to confidence and activity in the broader economy. It will also serve to reduce anxiety surrounding the headline inflation rate as we move further into 2019. We believe this will be supportive of equity valuations overall and may also eventually lead to a gradual weakening of the US dollar, which will benefit international holdings in particular.

At this juncture, we have not seen fit to make any substantial changes to client portfolios in response to recent bouts of volatility. We remain broadly diversified, cognizant that good long-term investment opportunities often present themselves at points of deep pessimism and social anxiety, and ever mindful that we're entrusted with investment assets and financial plans whose time horizon extends many years down the road.

As always, if you would like to discuss our perspective or your personal situation, we would welcome an opportunity to have a conversation.