



## **QUARTER AND YEAR IN REVIEW**

For the first time in a decade, the S&P 500 Index posted a calendar year loss. Meantime, the domestic investment-grade fixed income market barely managed to turn positive for the year, the primary savior likely having been a flight to safety wrought by the equity market's decline. The recent, rather sharp rebound in equities has us thinking investors found the selloff overdone. Still, we'd hesitate to offer the all's clear. But, while we do find a range of reasons for going-forward caution, neither further volatility, nor a reasonably positive gain for 2019 will surprise us.

### **The Double Down Drop**

Like so many coasters' initial plunge, global equities sank in October, forebodingly hovered in November and then dropped even more sharply in December. Factors probably influencing the decline included deteriorating global macroeconomic growth metrics, heightened unease regarding domestic monetary policy, domestic political and geopolitical pressures, including unexpected policy shifts, and increased investor caution regarding the potential for a near- (1-2 years out) or medium-term (3-5 years out) recession due to all of the above.






### **Fed Gained Credibility**

The latest plunge, we think, was sparked by growing concern that the Federal Reserve may foster a recession if it continues to raise rates amidst those waning metrics and rising fears of further slowing ahead. Where we found at the end of Q3 that the Fed was beginning to feel a bit more love from investors for its confidence-inspiring consistency, investors last quarter began to fret that the U.S. central bank might be overlooking the obvious. Many read the tea leaves of macroeconomic data as signaling a slowing in growth, even as the primary metrics the Federal Reserve reads to measure monetary policy effectiveness—the rates of unemployment and inflation—continued to warrant a less-accommodative stance.

### **The Trend will Portend**

As is so often the case in finance, personal perspective and agenda matter. Those wanting to see the stock market further its rebound almost are likely to want the Fed to keep policy loose. While those who continue to believe that global central bank policies since the Great Financial Crisis are destined to drown us all in a maelstrom of inflation would rather the Fed tighten the monetary policy collar. We expect that Chairman Powell will continue to utilize a data-based approach to determine future policy moves, in the meantime offering plain-text commentary both to telegraph upcoming policy shifts and explain them when they occur. Despite investor hand-wringing, the Fed's steadier hands may well further calm both to the equity and fixed income markets.

**Figure 1: Year Summary**

Overall Take			
		Equity: Stock returns were negative most places one looked in 2018 as the final few months wiped out any gains and far more	
		Fixed Income: Generally rising rates through Q3 left fixed income investors wanting for total return, though a flight to relative safety as stocks plunged offered a year-end respite	
Equity			
	Domestic U.S. stocks sank on sentiment considering a too-aggressive Federal Reserve and generally decelerating trends in macroeconomic growth		
		International International equity market returns were broadly negative as investors pondered heightened geopolitical complexity and softer macroeconomic data	

Directions and colors of arrows are indicative of the Investment Team's subjective interpretation of the quarter's market events and performance; green upward (red downward) and orange angled-upward (downward) arrows indicate relatively favorable (unfavorable) reviews in the aggregate. They are not indicative of any specific underlying data. SOURCE: SRCM

## Equity Market Review

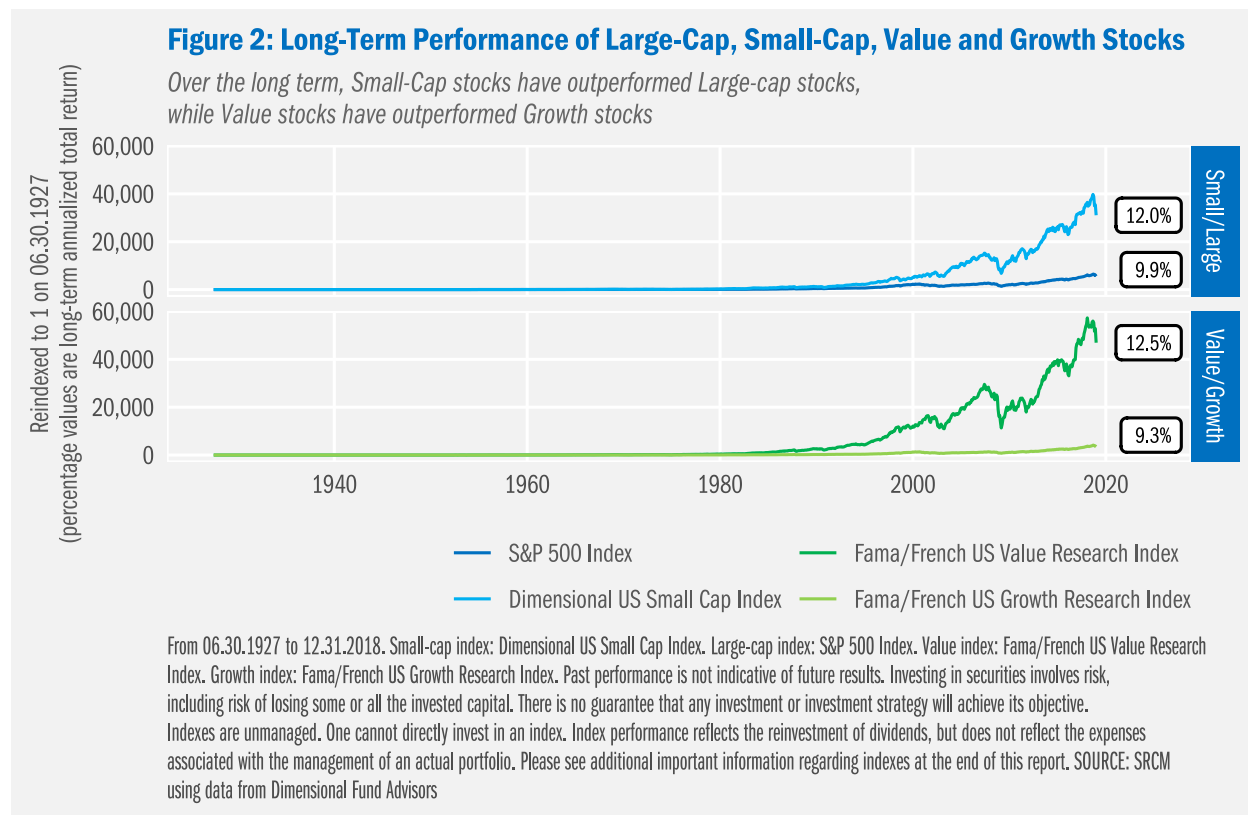
Much already has been made about how poor a year 2018 was from an equity return standpoint. Noted earlier, last year represented the first year since 2008 for which the S&P 500 Index recorded a loss. The year also happened to include two declines of 10% or more, known as corrections in industry lingo. Widely discussed, too, was the relatively weak performance of certain stock characteristics known as “factors” that research has shown to be potentially indicative of relatively stronger long-term returns.

The two primary components in the mix of factors we emphasize are Size and Value. The Size factor reflects the relative value of the companies we include in the portfolio as represented by each company’s market capitalization<sup>1</sup>. The Value factor generally represents the ratio of some measure of company size to some measure of company assets or income. Assets might include all the buildings and equipment a company maintains. Income can be measured in all sorts of ways, from “topline” revenue or sales to “bottom line” profit or net income. All those measurements in some way capture how much money the company generates from its assets.

By measuring Size and Value for all companies, we establish a relative spectrum. What’s interesting about the Size and Value factors is that within each group, research has shown one side generally outdoes the other in terms of long-term performance. For Size, smaller companies historically have outperformed larger ones, while less expensive companies (more Value) have outperformed more expensive ones over time.

<sup>1</sup> Market capitalization is simply the total number of all a company’s shares outstanding at a point in time multiplied by the contemporary price of one share. When we read a headline such as, “Apple is Once Again the World’s Largest Company at \$700 Billion,” that dollar figure is the market capitalization. There are various ways to measure market capitalization, but that basic multiplication math is the root of any of those measures.

We demonstrate that relative outperformance in Figure 2<sup>2</sup>. From mid-1927 onward, U.S. Small companies have outperformed Large companies by greater than 2% per year. And Value stocks have beaten Growth stocks by more than 3% per year on average<sup>3</sup>.



This relative performance is a key element informing our preferences when it comes to portfolio construction. As a reminder, we “tilt” portfolios in favor of these factors, rather than limiting our portfolios to exposures that solely express those characteristics. That way our portfolios may find incrementally greater benefit when outperformance comes, while perhaps not falling too far off the benchmark when it does not. In following that thinking, the greater the acceptance of risk (the more equity in the portfolio), the stronger the factor tilts.

While we can reflect on the empirical *evidence* for investing in Small stocks and Value stocks, we just as much like to emphasize the *intuition* for the preference. For example, we can think of the Law of Large Numbers

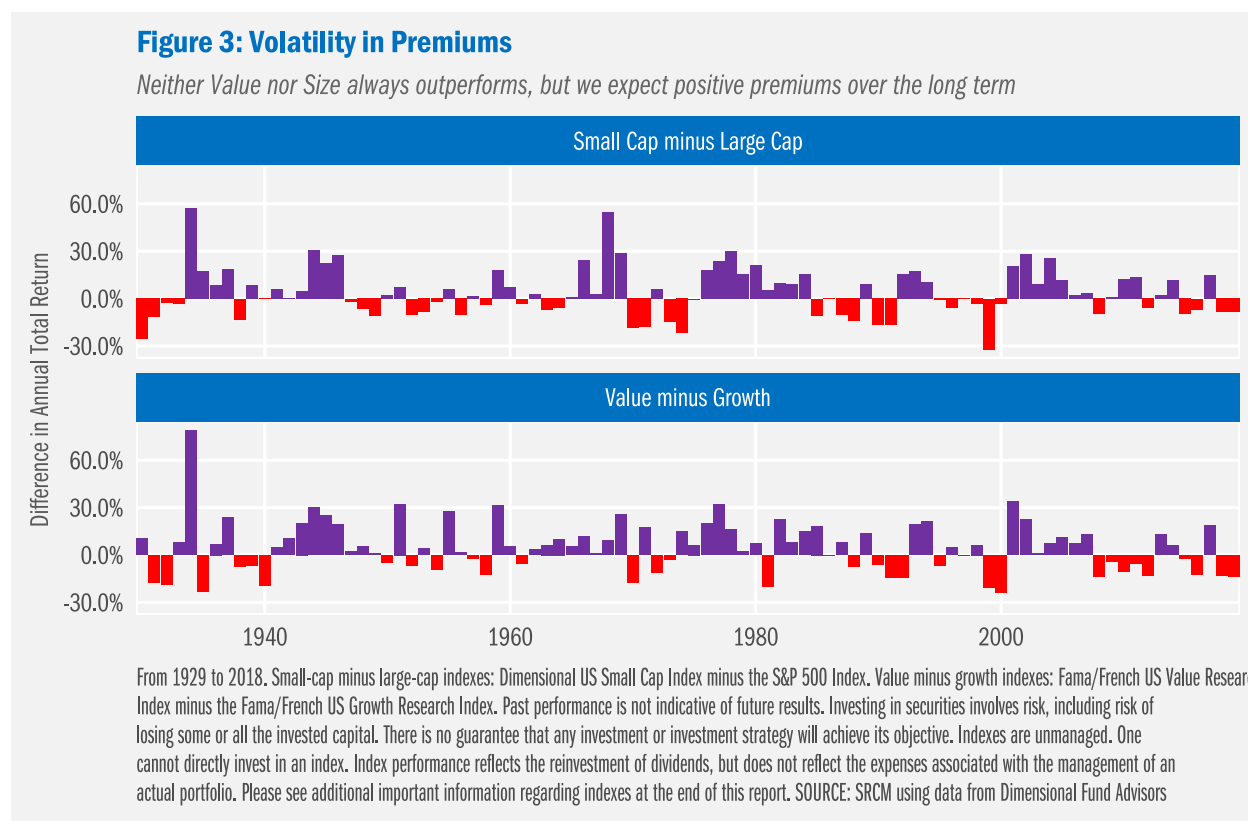
<sup>2</sup> The two groupings are mutually exclusive. Taken together, Small and Large companies comprise the entire market. Value and Growth companies together comprise that same market.

<sup>3</sup> It’s important to note that those annual returns are a *geometric average* of the cumulative return overall those years. Put simply, a geometric average is the compounded return (meaning each periodic return acknowledges the effects of the return over each period prior) required to achieve the ending value, given the starting value. We nearly always refer to the geometric average when we talk about average annual returns. Perhaps even more importantly, the average is just that. Any given year’s return might differ wildly in either direction from that average. So, while the average annual return best reflects where we have arrived over some period of time, it’s a very poor indicator of how we got here.

applying to the Size factor. It makes sense that smaller, perhaps collectively more agile companies might grow more quickly than larger, perhaps stodgier, more bureaucratic companies. On the other hand, it's easier for smaller companies to fail, but a beneficial characteristic of the smaller group is that there are far more of them. The noise of even many failures can be drowned out by the successes of a few.

### Patience, Perhaps, Required

There is a reason that the factors also are referred to as risk premiums. Here again we revisit the idea that for incremental return we generally must accept incremental risk. And that additional risk means that we should not expect that Small or Value stocks will always outperform their respective peers. Small at times has failed to surpass Large in terms of total return. Same for Value, versus Growth. Indeed, Value has underperformed Growth for some time now. Meantime, Small stocks have struggled to maintain pace with Large stocks, too. Last year furthered those periods of relative underperformance for both factors, with small-cap stocks trailing large-cap names and Value stocks strongly underperforming Growth companies.



Though Value made a strong showing in Q4 (see Figure 5), the year-end tally had Growth on top. And though small-cap stocks led the way through Q3, they found extra aversion in the fourth-quarter tumult. Notable, too, was the still weaker performance of mid-cap stocks over the year.

## Troubles Abroad

The relatively stronger performance of non-U.S. stocks that we saw in 2017 reversed in 2018. Whereas non-U.S. stocks gained 6% more than U.S. stocks in 2017 (27.8%, versus 21.2%), they fell by 9% more last year (-14.8%, versus -5.0%). Behind the extra underperformance of international stocks were currency weaknesses across much of the developed-market and emerging-market economies, in addition to worries regarding the impact of increased U.S. protectionism on global trade and political struggles within the European Union, among other potential forces to blame.

**Figure 4: Trailing Broad Equity-Market Performance**

*Best-performing segment for each period is shaded in blue; worst-performing in grey*

	3 Month	1 Year	3 Year	5 Year	10 Year
Global	-12.75	-9.42	6.60	4.26	9.46
World ex. U.S.	-11.88	-14.76	4.39	0.85	6.97
World ex. U.S. Small-Cap	-14.43	-18.20	3.82	1.96	10.02
U.S.	-13.97	-4.96	9.17	8.25	13.20
U.S. Large-Cap	-13.52	-4.38	9.26	8.49	13.12
U.S. Mid-Cap	-17.28	-11.08	7.66	6.03	13.68
U.S. Small-Cap	-20.10	-8.48	9.46	6.34	13.61
Developed Markets	-12.54	-13.79	2.87	0.53	6.32
Emerging Markets	-7.47	-14.58	9.25	1.65	8.02

From 12.31.08 to 12.31.18. Total return data for are annualized for periods greater than 1 year. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

## Maintaining Conviction

After such periods of relative underperformance for our favored investment factors—times we understand can be uncomfortable—we like to offer a reminder of a guiding statement that informs each of our investment decisions. Were there no risk of disappointment, there'd be little reason to expect any manner of excess reward. Of course, we generally do not like to find ourselves too far from our chosen benchmarks in terms of portfolio composition and/or performance. And so we will continue to stay true to our policy of tilting our portfolios away from market-neutral weights toward undersized and undervalued stocks both here and abroad with the expectation that these tilts may lead to benchmark-relative outperformance in the fullness of time.

### Figure 5: Trailing Equity-Market Performance

The tables below display the relative performance of different segments of the U.S. and international stock markets. Broad market performance is shown in the upper left of each group (3-month and 1-year periods). The remainder of the table displays the performance of various segments, including large-, mid- and small-cap stocks, Value and Growth stocks, and combinations of each. Segments that outperform (underperform) the broader market are shaded in blue (grey) in depth according to their respective relative performance.

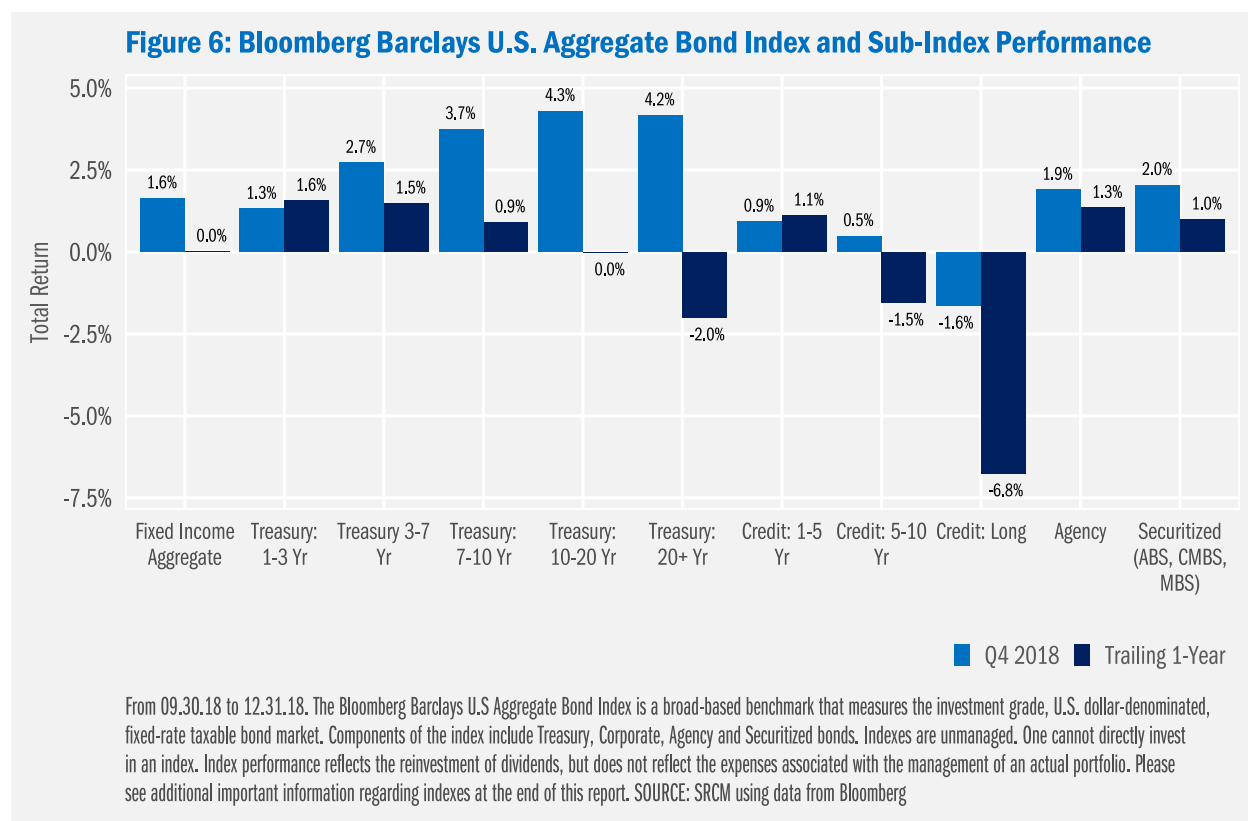
	3-Month Period ended 12.31.18				1-Year Period ended 12.31.18							
			Value		Growth				Value		Growth	
U.S. Stocks	All Stocks	-14.0%	-12.7%	-15.0%	All Stocks	-5.0%	-9.3%	-0.8%				
	Large	-13.5%	-12.0%	-14.7%	Large	-4.4%	-9.0%	0.0%				
	Mid	-17.3%	-16.9%	-17.6%	Mid	-11.1%	-11.9%	-10.3%				
	Small	-20.1%	-18.7%	-21.7%	Small	-8.5%	-12.9%	-9.3%				
International Stocks	All Stocks	-11.9%	-11.0%	-12.7%	All Stocks	-14.8%	-14.6%	-15.0%				
	Large	-10.9%	-10.6%	-11.3%	Large	-13.7%	-13.9%	-13.7%				
	Mid	-13.6%	-11.3%	-14.8%	Mid	-16.1%	-15.0%	-16.6%				
	Small	-14.4%	-13.1%	-15.8%	Small	-18.2%	-18.2%	-18.3%				

From 12.31.17 to 12.31.18. Data are total returns for the period shown. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. Indexes are unmanaged. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

## Fixed Income Market Review

Covered rather aggressively over the past year, the domestic fixed income market suffered a general rise in interest rates on the heels of less-accommodative monetary policy. The latter being driven by still-improving economic trends, bond price declines were thus otherwise connected to good news, an effect that generally had been offset by equity gains through September. How quickly sentiment turned sour in Q4. Coming in flat on the year, the broader investment-grade fixed income market turned in a strong fourth quarter as tumult in the equity markets seemed to lead investors to seek the relative safety of bonds.

That same search for relative safety arguably led to a preference for Treasury bonds, which tended to outperform corporate bonds of the same time to maturity (duration). Thus, even as bond yields were falling more generally toward the end of the year, they fell not so much among corporate bonds. The net effect is that “spreads” on the yields achieved for investing in corporate bonds of a particular maturity generally are now higher than they were a year ago.



## “Patient” Going Forward

Noted earlier, the shift upward in rates in the first three quarters of last year was prompted by less-accommodative monetary policy. Seeing continued strength in the broader economy, the Federal Reserve saw fit to push forward with its intention to pull the broader interest rate environment to a place more reflective of a macroeconomic backdrop now much healthier than that which sparked the unprecedented accommodation during the earlier part of the past decade.

The fixed income market has stilled a bit as investors ponder the likelihood that the Fed will take a breather over the next few months, awaiting news of further progress or otherwise on the economic front. With an easing of macroeconomic trends here in the U.S. and rather weaker turn of trends in Europe and elsewhere, the Federal Reserve has hinted that earlier expectations for several interest rate hikes in 2019 may not now be proper. We thus should expect that the evolution of macroeconomic trends will continue to serve as the primary drivers of Fed policy shifts later this year.

## **SRCM Portfolio Context**

Broadly speaking, SRCM portfolios underperformed their respective benchmarks during the fourth quarter and for the full-year 2019 on a net-of-fee basis. Within equity, though our portfolios generally were tilted away from weaker performing international equities, tilts toward small-cap and Value stocks generally weighted performance. These effects were correspondingly stronger for more aggressive portfolios given their generally stronger tilts to the Size and Value factors.

Within fixed income, our benchmark remains the Bloomberg Barclays U.S. 1-5 Year Government/Credit Bond Index, which reflects the performance of investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities with maturities between 1 and 5 years. Though fixed income positions generally contributed positively in the aggregate to portfolio returns over the quarter and the year, our portfolios generally were tilted more strongly toward credit exposures that tended to underperform Treasuries of the same maturity during the fourth quarter.

Past performance is not indicative of future results. Individual client portfolios may maintain exposures different from, sometimes materially so, the model portfolios for which performance is discussed above. Actual portfolio performance thus may differ from that discussion. Additional composite performance details are available upon request.

## **What News is New?**

As we welcome the New Year, we trust that markets will continue to focus on shifts in trends among macroeconomic series and corporate fundamentals. Seeing greater divergence among and a more general weakening of those trends, we expect investible markets to express a measure of volatility appropriate to that variability. With the U.S. government shutdown approaching a month in duration, investors increasingly may worry about its impact on the economy. Meantime, the ongoing drama of the United Kingdom's expected exit from the European Union is likely to continue to prove a source of investor anxiety, perhaps intensifying as we near the due-date of that departure in March.

Even so, we don't wish to express any manner of heightened anxiety relative to what we believe one normally should expect to experience when investing. While we might always like to think present times are unlike any before, that's generally true only in a semantic way. The world for sure has experienced the tendencies and tones characteristic to these times in the past. And, yet, the stock markets are near as high as they ever have been around the globe.



We find ourselves often expressing the notion that the New Year offers as much reason for optimism as it does for concern. Inasmuch as the equity market pullback may have reset expectations for investor comfort with market volatility, the decline may have established a more solid foundation for going-forward gain. With that balanced optimism in mind, we would like to share our great thanks to clients and partners for their continued trust in our work. As always, please feel free to reach out to us where additional detail and discussion may be desired.

## Important Information

Investing involves risks including the possible loss of principal. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Asset classes and their respective indexes mentioned in this report include the following:

The Dimensional US Small Cap Index is a market-capitalization-weighted index of securities of the smallest U.S. companies with market capitalizations that fall in the lowest 8% of the total market capitalization of the Eligible Market. The Eligible Market is composed of securities of U.S. companies traded on the NYSE, NYSE MKT (formerly AMEX), and Nasdaq Global Market. Exclusions from that list include non-US companies, REITs, UITs and investment companies.

Fama/French US Value Research Index: Provided by Fama/French from CRSP securities data to Dimensional Fund Advisors. The index includes the lower 30% in price-to-book of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973).

Fama/French US Growth Research Index: Provided by Fama/French from CRSP securities data to Dimensional Fund Advisors. The index includes the higher 30% in price-to-book of NYSE securities (plus NYSE Amex equivalents since July 1962 and Nasdaq equivalents since 1973).

Domestic (U.S.) fixed income (Fixed Income Aggregate): The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. Components of the index include Treasury, Corporate, Agency and Securitized bonds. The Bloomberg Barclays U.S. 1-5 Year Government/Credit Bond Index is a broad-based benchmark that includes investment grade, U.S. dollar-denominated, fixed-rate Treasuries, government-related and corporate securities with maturities between 1 and 5 years.

The MSCI All Country World Index (ACWI) captures large- and mid-cap representation across 23 Developed Markets and 23 Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set. May be referred to as “global”, “global equity” and/or “global stocks”. “Value” and “Growth” versions of this index are constructed as described in the “MSCI Value and Growth Indexes” note below.

The MSCI ACWI ex. USA Investable Market (IMI) Index captures large- and mid-cap representation across 22 Developed Markets countries and 24 Emerging Markets countries. The index covers approximately 99% of the global equity opportunity set outside the U.S. May be referred to as “World ex. U.S.”, “international equity”, “international stocks” and/or “All Stocks” in a section specifically describing only international stocks. “Value” and “Growth” versions of this index are constructed as described in the “MSCI Value and Growth Indexes” note below.

The MSCI ACWI ex. USA Small Cap Index captures small-cap representation across 22 Developed Markets countries (excluding the U.S.) and 23 Emerging Markets countries. The index covers approximately 14% of the global equity opportunity set outside the U.S. May be referred to as international small-cap stocks, “World ex. U.S. Small-Cap”, and/or “Small” in a section specifically describing only international stocks. “Value” and “Growth” versions of this index are constructed as described in the “MSCI Value and Growth Indexes” note below.

Developed markets equity (stocks): The MSCI EAFE Index captures large- and mid-cap representation across Developed Markets countries around the world, excluding the United States and Canada. The index covers approximately 85% of the free float-adjusted market capitalization in each country. May be referred to as “Developed Markets”. “Value” and “Growth” versions of this index are constructed as described in the “MSCI Value and Growth Indexes” note below.

Emerging markets (EM) equity (stocks): The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 Emerging Markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country. May be referred to as “Emerging Markets”. “Value” and “Growth” versions of this index are constructed as described in the “MSCI Value and Growth Indexes” note below.

MSCI Value and Growth Indexes: The value investment style characteristics for MSCI index construction are defined using the following variables: book value to price, 12-month forward earnings to price and dividend yield. The growth investment style characteristics are defined using the following variables: long-term forward earnings per share (EPS) growth rate, short-term forward EPS growth rate, current internal growth rate, long-term historical EPS growth trend and long-term historical sales per share growth trend. The objective of the MSCI Value and Growth Indexes design is to divide constituents of an underlying market capitalization index into a value index and a growth index, each targeting 50% of the free float-adjusted market capitalization of the underlying index. The market capitalization of each constituent should be fully represented in the combination of the value index and the growth index, and, at the same time, should not be double-counted. One security may, however, be represented in both the value index and the growth index at a partial weight.

Domestic (U.S.) equity: The S&P Composite 1500 combines three leading indices, the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600 to cover approximately 90% of the U.S. market capitalization. The S&P Composite 1500 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P Composite 1500 Index. The S&P 500 Composite 1500 Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P Composite 1500 Index. May be referred to as “All Stocks” in a section specifically describing only U.S. stocks.

Domestic (U.S.) large-cap equity: The S&P 500 Index measures the performance of the large-cap segment of the U.S. equity market. The S&P 500 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P 500 Index. The S&P 500 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P 500 Index. May be referred to as “Large” in a section specifically describing only U.S. stocks.

Domestic (U.S.) mid-cap equity: The S&P MidCap 400 Index measures the performance of the mid-cap segment of the U.S. equity market. The S&P MidCap 400 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P MidCap 400 Index. The S&P MidCap 400 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P MidCap 400 Index. May be referred to as “Mid” in a section specifically describing only U.S. stocks.

Domestic (U.S.) small-cap equity: The S&P SmallCap 600 Index measures the performance of the mid-cap segment of the U.S. equity market. The S&P SmallCap 600 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P SmallCap 600 Index. The S&P SmallCap 600 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P SmallCap 600 Index. May be referred to as “Small” in a section specifically describing only U.S. stocks.

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Publication: 01.22.19

2019-SRCM-6