THE TRUST COMPANY

INVESTMENT & WEALTH MANAGEMENT UPDATE

JANUARY 8, 2019

2018 YEAR IN REVIEW

Overview

"Volatility" is the word that best describes the market in 2018. For the year, the stock market reached new highs and gave it all back by the end of December. Stocks were sold, bought, and sold again in rapid order, causing benchmark indexes to post noteworthy gains and losses on an almost daily basis. As a result, investors rode a roller coaster of stock prices throughout the year.

2018 saw some positive highlights as well. The economy expanded at an annual rate exceeding 3.0% for the first time in several years. The unemployment rate hit the lowest mark since 1969. The Federal Reserve, based on the strength of the economy and labor market, raised interest rates four times during the year. Ultimately, the benchmark indexes listed here could not match their 2017 year-end values. In fact, several of the benchmark indexes suffered their worst annual losses in many years.

Eye on the Year Ahead

As we turn the page on 2018 and look forward to 2019, these are the current thoughts of The Trust Company.

Slowing growth does not mean there must be an impending recession. GDP growth in the US for 2018 will finish around 3%. If we finish above 3%, it would be the first calendar year for the U.S. since 2005. Current GDP projections for 2019 are in the 2-2.5% range, in-line with GDP from 2010-2017. Many pundits point to this slowing as a sign of recession. We think it more probable for a surprise on the upside.

The economy can withstand higher interest rates – for now. One source of volatility has been concern over the economy faltering because of high interest rates. The economy has become conditioned to ultra-low interest rates. While there will be an adjustment period in the market's mentality, the economy and stock market can handle interest rates in the 3-4% range.

Valuations are not expensive. Anything is possible but not all things are probable. It is possible that valuations only appear inexpensive because they do not reflect an impending recession. We do not believe that is probable given the economic data like the jobs numbers and wage growth. With the S&P 500 at a Forward P/E of 13.4x and a Free Cash Flow Yield of 5.5%, we feel there are attractive opportunities.

Market/Index	2017 Close	As of 9/28	2018 Close	Month Change	Q4 Change	2018 Change
S&P 500	2673.61	2913.98	2506.85	-9.18%	-13.97%	-6.24%
DJIA	24719.22	26458.31	23327.46	-8.66%	-11.83%	-5.63%
NASDAQ	6903.39	8046.35	6635.28	-9.48%	-17.54%	-3.88%
Russell 2000	1535.51	1696.57	1348.56	-12.05%	-20.51%	-12.18%
Global Dow	3085.41	3121.54	2736.74	-6.81%	-12.33%	-11.30%
Fed. Funds	1.25%-1.50%	2.00%-2.25%	2.25%-2.50%	25 bps	25 bps	100 bps
10-Year Treasuries	2.41%	3.06%	2.68	-31 bps	-38 bps	27 bps

STAYING RATIONAL IN AN IRRATIONAL WORLD

By Michal Emory, CFA

Can we all agree this world can be irrational? How else do you explain the popularity of the Kardashians, Justin Bieber, or 70's fashion?

I don't know what that is, but I am glad it is no longer "in" fashion. There are plenty of fashions today that leave me scratching my head. The finance world has some head scratchers too.

As humans, we can be prone to succumbing to irrational behavior. One way is through the Availability bias which is the phenomenon where people judge the likelihood of an event by the ease of which similar events come to mind. Studies have shown that people are less likely to go into the ocean after news of a shark attack. Yet, the chances of dying by a shark attack are 1 in 3.7 million according to the National Geographic.

Investors display this same phenomenon. After the Tech Bubble, a big stock market move meant that we were in a bubble destined for another burst. Or since the Financial Crisis, every rough patch meant that another cataclysmic fall was happening. This is caused by the freshness of the pain and wounds in investors' minds.

We are currently (perhaps it is over?) in our third bear market since the Financial Crisis. The first was in the summer and fall of 2011. The second started in August of 2015 and lasted until February of 2016. During the first two, the S&P 500 may not have closed down over 20% from the previous high but they had the markings of a bear market. And in each bear market, pundits were sure to forecast our impending doom.

The memos from Howard Marks of Oaktree Investments are some of my favorite pieces to read. I make sure to read each one as soon as it is out. A few years ago, he touched on a topic finally putting to words a concept that I have used when creating portfolios. He called it second-level thinking.

To be a rational investor, it is critical to engage in second-level thinking. Second-level thinking engages at a deeper level than what is easily seen at the surface. Here are some simple examples of the difference.

First-level thinking says, "This is a good company; I should buy its stock." Second-level thinking asks, "Everyone already knows this is a good company; what factors could drive its stock price higher or lower than people's expectations?"

First-level thinking says, "There is a lot of negative news; I should sell." Second-level thinking says, "There is a lot of negative news, but the market is pricing in too much negativity. I should buy."

First-level thinking says, "Trade wars and/or rising interest rates could be bad for the economy. Volatility has been up and stocks down. I should sell my stocks." Second-level thinking says, "The outlook could be bad because of trade wars and rising interest, but everyone is selling in a panic. Where are the great bargains I can buy?"

Since the answer is rarely an absolute, we look at the probability of different. What is the most probable outcome? What outcomes have a reasonable probability? What outcome is the market pricing in? What outcome presents an attractive opportunity? This doesn't mean we will always get it right. And sometimes "getting it right" means experiencing short-term loss. 2018 was a tough year. The market turned violently in October. Then the S&P 500 closed the year with its worst month since February 2009. There has been no shortage of pundits talking about how a recession is right around the corner and the party is over for the stock market. We think this is first-level thinking, and this bear market has mostly priced- in the current market risks.

At The Trust Company, how do we stay rational in this irrational world?

1) Engage in Second-Level Thinking. We look below the surface level when we build your portfolio both in the asset allocation and the security selection.

- **Listen to the Data**—Is the data telling the same story as the current perception of investors?

- **Remain Unemotional**— Whether at the economic level or down to the individual asset level, has the market's current greed or fear topic du jour been priced in?

- **Find the Value**—Where are the attractive opportunities?

2) Rigorous Investment Process. There are many facets to this. Each is designed to build portfolios that will outperform in the long-term, though will underperform sometimes in the short-term.

> "Second-level questions are at the heart of the investment decisions we make at The Trust Company."

- **Diversify**—Create a mix of investments that best suits your investment needs. These can be return generators or risk mitigators that keep the portfolio volatility in-line with what is appropriate for each Risk Level.

- **Utilize Historically Significant Factors**—Historically, certain investment characteristics like Value, Quality, and Momentum outperform over time. We look for investments that show value, are high quality, and exhibit positive momentum.

- **Continuous Research for the Best Ideas**—We pride ourselves on being product agnostic. This enables us to build portfolios that are dynamic and flexible for a variety of needs. This can entail taking an active or passive (or both) approach with security selection.

3) **Disciplined Portfolio Approach**—We all have financial goals and aspirations. A disciplined approach is a key ingredient in the success of those goals and aspirations.

- **Appropriate Risk Level** —In volatile markets like 2018, we see how critical it is to be in a portfolio that answers two questions. How much risk can you afford to take? How much risk are you willing to take?

- **Rebalancing**—Rebalancing creates a disciplined process of controlling risk. It creates a framework for buying investments that show value, while capturing gains from investments that have been outperforming.

- **Tactical Asset Allocation**—This works in two ways. One: where are opportunities within an Asset Class, Sector, or Stock that can be exploited? Two: has a particular market experienced a fundamental shift that would cause us to take some risk off the table?

It is true that there are a high number of risks right now and we do not know how they will play out. But we believe these risks are being priced in. This begs the second-level question, "If the market is pricing in these risks, then where are the opportunities?"

As Mark likes to say, "not all our friends are necessarily clients, but all our clients are friends." That is a saying that we have all adopted and consider it a privilege to be a part of your life. We wish you a successful 2019, wherever the year may lead you.

COMPANY NEWS

Samantha Varacalli Joins Seay Team as Account Administrator

Please join us in welcoming Samantha Varacalli to The Trust Company as Account Administrator for the Seay Team in Manhattan!

Samantha spent several weeks training alongside Chelsy Shields, who had been in the role since mid-2016. In December we said "so long" (but not goodbye) to Chelsy as she moved to Arkansas with her new husband, Tyler. We will miss Chelsy and wish her all the best!

Samantha graduated from Southern Illinois University in 2018 with a Bachelor of Science in Finance. She already has a solid background working in financial client services as Associate Financial Representative at Northwestern Mutual throughout college.

Samantha relocated to Manhattan with her husband, Caleb, who is an Army officer at Fort Riley. As newlyweds they are enjoying getting to know their new community. They especially like trying out Manhattan's great restaurants and going to movies, where Samantha can enjoy her favorite cuisine—popcorn.

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2019 WEALTH *management* SUMMIT

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Lawrence:
Tuesday, Jan. 29, 7:30-9:00 a.m.

Manhattan:
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Call for details and to RSVP!
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