ClearPath
CAPITAL PARTNERS

Dear Client:

Please find enclosed your reports for the first quarter of 2018.

Volatility Returns

The first quarter of 2018 proved to be a wake-up call for the complacent. Financial markets began the year on a tear; at one point in January, larger-cap U.S. stocks were up 8%. Then came February, which ushered in a 10% drop. Stocks rebounded through the first half of March, only to drop again into month-end. By the time markets closed on March 29, U.S. stocks had swung to a loss of nearly 1% for the quarter. Developed international stocks fared slightly worse, with a loss of 1%; that left emerging-market stocks as the sole bright spot, with a gain of 2.5%. Markets were set on edge by inflation worries, trade war fears kindled by the Trump administration's tough talk on tariffs, and a string of negative tech company announcements capped by a data privacy scandal at Facebook.

Portfolio Update

In what was a difficult quarter for most asset classes, our portfolios notably included a handful of positive-returning investments. Domestic growth-oriented equity managers were among the top contributors, with gains in the mid- to high single digits. Our investments in emerging-market stocks also benefited portfolio returns.

Our active fixed-income positioning also helped to support portfolios during a period when core bonds failed to play their typical "safe-haven" role. Absolute-return-oriented and flexible bond funds were either in positive territory for the quarter, or slightly down (but better than the core bond index). Our long-short strategies also provided some downside ballast versus stocks and core bonds.

Among the portfolio detractors for the quarter were our trend-following managed futures funds, which started the year with very strong returns but gave them back and then some during the February market correction. Our active global and emerging-market equity managers were also a drag on performance as they failed to match the returns of their benchmarks.

Investment Outlook

Despite the high level of drama in financial markets, the global economic and corporate earnings backdrop still appears solid—and supportive of risk assets—over the near term. The events of the past quarter have not materially changed our longer-term asset class views or risk assessments. Consequently, our portfolio positioning has not changed. That said, we do believe we are in the late stages of the current economic cycle. Additionally, mounting tension between the United States and its trading partners, particularly China, represents a wildcard that could upset the gears of the global economy. We're assessing the effects such a development would have on our portfolios.

Looking ahead, we are positioned for further volatility and the likelihood of lower equity returns as the markets ride out what is already a longer-than-usual economic cycle. With core bonds offering very little portfolio protection in this flat to rising interest rate environment, we continue

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to look to our positions in alternative strategies to behave more favorably during sustained equity market declines and generate returns independent of stock and bond markets.

We also remain defensively positioned in our equity allocation and tilted in favor of more attractive foreign market valuations. While not table-pounding opportunities, the outcomes we see for European and emerging-market stocks continue to be relatively attractive compared to U.S. stocks. The valuation of the S&P 500 is well above our estimate of its fair-value range on a normalized (longer-term) basis. As the valuation multiple comes down, it will be a significant drag on the total return of the market index over our five-year investment horizon, regardless of the earnings outlook.

The Best Defense

As we reflect on the volatility levels we have witnessed so far this year, it’s worth reiterating why we emphasize a five-year or longer time horizon as the basis for our expected-returns analysis. It is over those longer-term periods that valuation, or what you pay for an investment relative to its future cash flows, is the most important predictor of returns. Over the shorter term, markets are driven by innumerable and often random factors that are impossible to consistently predict (although that doesn’t stop lots of people from trying).

There are a lot of paths financial markets and the economy can take to reach our base case scenario destination. And there is a wide range of reasonably likely outcomes around that base case. Simply put: markets and economies are unpredictable. But when it comes to the investment world, we are often our own worst enemy. We fall prey to performance-chasing, our natural inclination to “do something,” and other behaviors that may have helped our ancestors, but hurt us as investors. The best defense is a sound, fundamentally grounded investment process like ours that you can have the confidence in to be able to stick with for the long term.

As always, we appreciate your trust in us and welcome questions.

Best regards,

ClearPath Capital Partners

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