To Our Clients and Friends:

We are pleased to bring you our report for the first quarter of 2018.

The equity markets could not have ended the quarter more differently than they began. In January the S&P 500 Index soared 5% to new highs, only to fall into correction territory a month later. For the quarter the S&P 500 index lost 0.76% and the MSCI World ex-USA Index lost 1.92%, both on a total return (price plus dividends) basis. The Bloomberg Barclays U.S. Aggregate Bond Index lost 1.46%, primarily due to the Fed’s hiking of short-term rates and their stated intention to do so at least 1-2 more times in 2018. Even with the negative returns for the quarter, the three indices are up over the last 12 months by 13.99%, 14.46% and 1.20%, respectively, a point we urge our readers to keep in mind.

It’s been a while since we have had the opportunity or need to discuss volatility, other than to note its absence, so it is instructive to mention a few key points about what it is, and, just as importantly, what it is not. Volatility was really a bigger issue during the quarter than were the equity indices’ returns. Said another way, there was a whole lot more “roller coastering” during the quarter than the relatively modest losses would indicate. Volatility is just that: a measurement of the magnitude of swings in equity markets over a given period. It is not particularly effective as a predictive mechanism. And, while higher volatility is usually accompanied by lower equity prices, it should not, by itself, trigger a reduction in one’s equity exposure, just as low volatility should not, by itself, prompt one to increase his or her equity exposure.

So why has the VIX awakened, and why have equities finally cooled off? Some factors, such as the Fed’s weaning the markets off their stimulus diet, equity valuations (particularly the tech sector) having been stretched for quite a while, and the unwinding in late January of complicated investor bets on volatility remaining low, were predictable. Others, such as trade and tariff fears and their impact on U.S. producers’ ability to sell their products abroad (particularly in China), were less so. Perhaps the most significant reason is that corrections, such as we are now experiencing, are a periodic, healthy (and overdue) necessity. In fact, since 1980, the average calendar-year peak-to-trough decline in the S&P 500

---

1 Four of the 9 largest single-day point declines in the DJIA and 5 of the 19 biggest single-day drops in the S&P 500 have occurred since February 2.
2 Volatility is most often measured using standard deviation concepts. The most common measurement is the CBOE Volatility Index (VIX). The VIX’s long-term average is around 20. Of the 57 trading days in the quarter, the VIX was above its long-term average on only 14 of them, despite hitting a 9-year high in February. Coincidentally, as of this writing the VIX is trading just below its long-term historical average.
3 The VIX spent most of January at roughly ½ of its historical average. With the S&P 500 Index losing 3.7% in February and another 2.5% in March, buying equities based on a low VIX alone would not have paid off.
4 Tech valuations have dropped significantly since January.
5 As we reported last quarter, since 2010 there have been 18 market downturns, 14 of which were between 10% and 20%. Yet the market has bounced back from each pullback and has then moved higher.
index was 13.6%.\(^6\) Last quarter we opined that due to the length of time it has been since the market corrected, reaction to the next market correction may be more irrational than most. This may well have been the reason for the wide swings in equity prices during the quarter.

Volatility does not necessarily mean market fundamentals have deteriorated. In fact, market fundamentals are pretty strong right now. At the end of the day, stock prices are going to be influenced primarily by earnings (and secondarily by valuations). The financial media can, and will, talk about the effect various factors might have on earnings, but it is really the earnings themselves (and the accompanying guidance, particularly with respect to revenues) that are the determinants. And earnings look good: Analysts’ consensus forecast is for a blistering 18.8% growth pace in S&P 500 earnings per share this year and 10.4% in 2019.\(^7\) First quarter earnings season begins this week so we will soon know how good (or bad) of a start to 2018 earnings S&P 500 companies can muster. Of course, not all of those increases (should they materialize) will be reflected in stock prices\(^8\), but those are still impressive numbers. Furthermore, thanks to economic growth the markets are now driven more by fundamentals (such as corporate earnings) and less by things such as the artificial liquidity provided by Federal Reserve stimulus packages that many believe were responsible for much of the market gains between 2009 and 2014.

Often the most tempting time to discount the value of and not pay attention to a good financial plan is in times when markets have lulled investors into expecting positive (and linear) returns, neither of which we are presently experiencing. We have said it before, but it bears repeating here: Volatility is only a problem if you are forced by circumstance (read, bad planning) or emotion (read, not having the intestinal fortitude you thought you had!) to react to it. A good plan should keep you from having to react for either reason. The only action increased volatility should prompt investors to take is an examination of their circumstances, objectives, financial resources and risk tolerance, and make sure they are all reflected and harmonized in a good financial plan. Having and sticking to allocations that properly incorporate all of these factors, along with proper diversification and periodic re-balancing, are even more important in times like these. We can help you through difficult times by not only assisting with such a plan, but also your ability to stick with it. While no outcome is guaranteed, patience historically has rewarded investors who stay the course of their investment goals.

The MCA Team thanks you for your confidence in us and, as always, we welcome your thoughts and questions.

---

\(^6\) Source: Lord Abbett, February 6, 2018. The market has generated positive returns in many years where the drawdown was significant.


\(^8\) With the S&P 500 index still trading at the upper level of its historical P/E valuation range, some of any earnings improvement is undoubtedly going to be reflected in lower P/E valuations rather than “all” of it going to increased stock prices (the “P” in the P/E ratio).