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Maryland Capital Advisors

INVESTMENT COMMENT **October 8, 2018**

Recent Performance of Global Risk Assets and Investment Strategy Review

2018 has been an interesting year for global Risk Assets (stock markets). January saw solid across-the-board returns that were wiped out in early February[1]. US, International, and Emerging stock markets moved sideways through the end of April, when YTD global Risk Asset returns were essentially zero.

Since early May, however, global investors have experienced a significant divergence in Risk Asset returns: US stocks since April 30 returned +9.7%, while International (Developed Markets) and Emerging Markets declined -4.3% and -12.5%, respectively, through Friday (see graph).

Source: MSCI US, EAFE, and Emerging Markets Indices, Bloomberg Professional

Given recent performance in global Risk Assets, what follows is a review of historical market behavior and our investment discipline that embraces market uncertainty.

Is this divergence normal?

Yes, but this recent differential between US and non-US stock market returns is the widest since an 8-month period during the Financial Crisis, starting in March 2009. In the March-October 2009 period, International and Emerging Markets *exceeded* US returns by more that 20 percentage points[2] – a similar return divergence, but in *reverse*.

One factor currently weighing on non-US investments has been a decline in currency exchange value versus the US Dollar, but this explains only ~ 4 percentage points of the performance gap since May 1. What began as a move lower for non-US markets, became more concentrated on Emerging Markets as concerns mounted from US-led trade tensions, higher interest rates, a cooling Chinese economy, and the recent run-up in oil prices.

[1] See "Some Perspective on this latest Global Stock Market Drop", February 4, 2018 Investment Comment (LIBRARY tab, marylandcap.com)

[2] Using MSCI indexes, US +42.6%, International +63.3%, and Emerging +67.0% (source: MSCI, Bloomberg)

Will the US continue to outperform non-US?

Currency exchange rates and stock market performance are unpredictable, so we have no basis for offering a forecast on near-term trends. In fact, this uncertainty is the very reason that we construct portfolios with targeted exposures to academic factors that drive return variation, on a global basis.

Our portfolio reports detail the underlying performance of each Risk segment, so clients can see how diversification contributes to overall risk and return. A review of returns in 2018, last year, and the past 15 years offers perspective and worthwhile reminders:

- Year-to-year return disparities can be meaningful. Note that US markets lagged non-US in 2017 and reversed this year.
- Over a longer investment period, these gyrations begin to disappear.

Table 1: Risk Asset Returns As of October 5, 2018	**2018 YTD**	**2017**	**15 Years**
PORTFOLIO **RISK** SEGMENTS			
US Large Cap	+9.1%	+21.2%	+9.6%
US Large Cap Value	+3.0%	+19.0%	+9.8%
US Small Cap	+2.9%	+11.5%	+10.1%
US Small Cap Value	+2.2%	+7.2%	+9.8%
International Large Cap	-3.9%	+26.4%	+6.5%
International Large Cap Value	-5.1%	+26.1%	+7.0%
International Small Cap	-6.1%	+30.2%	+9.2%
International Small Cap Value	-8.7%	+28.0%	+9.4%
Emerging Markets	-11.6%	+36.6%	+9.4%
Emerging Markets Small Cap	-16.3%	+35.3%	+11.1%
Emerging Markets Value	-8.9%	+33.8%	+10.8%
US Real Estate Investment Trusts	-2.4%	+5.7%	+8.8%
International Real Estate	-2.3%	+8.6%	+6.9%

Source: Selected Funds/Indexes, Bloomberg Professional

Note: Returns include reinvested dividends, 15-year returns annualized

We have previously detailed[3] the rationale for a global portfolio management strategy that establishes percentage targets for each Risk segment, monitors the difference between actual and targeted exposures, and periodically readjusts holdings to targets, when warranted. These prior Investment Comments demonstrated that global diversification has historically improved risk-adjusted returns. Table 2 provides an summary update of our past analysis.

Table 2: US versus Global Balanced 1970 through August, 2018	**Return**	**Growth Of $1**	**1970s**	**1980s**	**1990s**	**2000s**	**2010s**
PERFORMANCE SINCE 1970			PERFORMANCE BY DECADE				
Global Balanced Strategy Index	**+13.7%**	**$493.9**	**+13.4%**	**+22.0%**	+13.7%	**+7.4%**	+11.7%
S&P 500 Index	+10.6%	$134.5	+5.9%	+17.6%	**+18.2%**	**-0.9%**	**+14.0%**

Source: Dimensional Fund Advisors, Note: all returns annualized

It is worth noting that investors with a simple S&P 500 Index portfolio (i.e. US Large Cap stocks) outperformed a globally-balanced strategy during the current decade-to-date as well as the 1990s period. Investors with only US Large Cap stocks, however, miss the long-term benefits of global portfolios exposed to multiple factors of return. This was most recently experienced during the "lost decade" of the 2000s when US Large Cap stocks generated -0.9% annualized return – a -8.7% cumulative loss for the 10-year period. *More notably, over the nearly 50-year period, the Global Balanced Strategy resulted in 3.1 percentage points higher return than the S&P 500. The Growth of $1 column shows the significance of outperformance over such a long period of time.*

What investment action should be taken?

Recent market gyrations have presented an opportunity to rebalance portfolio Risk segment percentages back to target, where appropriate. This discipline reinforces the logic of "buy low, sell high" over time.

The helpful comments of Paul Cucchissi are greatly appreciated

[3] See Investment Comments: "Why hold non-US investments?" in July 8, 2013, also "Maintain a Global, Diverse Risk Exposure" in January 6, 2014, and "Strategy Update" in January 6, 2015