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TAGStone CAPITAL INC

Third Quarter 2019

The Reality of Market Timing:

Over the course of the holidays, it's not unusual for the stock market to be a topic of conversation at parties and other social gatherings.

A neighbor or relative might ask about which investments are good at the moment. The lure of getting in at the right time or avoiding the next downturn may tempt even disciplined, long-term investors. The reality of successfully timing markets, however, isn't as straightforward as it sounds.

Outguessing the Market is Difficult:

Attempting to buy individual stocks or make tactical asset allocation changes at exactly the "right" time presents investors with substantial challenges. First and foremost, markets are fiercely competitive and adept at processing information. During 2018, a daily average of $462.8 billion in equity trading took place around the world.[1] The combined effect of all this buying and selling is that available information, from economic data to investor preferences and so on, is quickly incorporated into market prices. Trying to time the market based on an article from this morning's newspaper or a segment from financial television? It's likely that information is already reflected in prices by the time an investor can react to it.

Why is market timing so hard? For investors to have a shot at successfully timing the market, they must make the call to buy or sell stocks correctly not just once, but twice.

SELECTED 2019 EQUITY INDICES

	Sep. '19	3rd Qtr.	YTD
S&P 500 Total Return (Large-Cap Stocks)	1.87%	1.70%	20.55%
Russell 2000 Total Return (Small-Cap Stocks)	2.08%	-2.40%	14.18%
MSCI EAFE (Developed International Stocks)	2.87%	-1.07%	12.80%
MSCI Emerging Markets (International Emerging Stocks)	1.91%	-4.25%	5.89%

SELECTED 2019 FIXED INCOME INDICES

	Sep. '19	3rd Qtr.	YTD
Barclays U.S. Aggregate (Broad Domestic Bonds)	-0.53%	2.27%	8.52%
Barclays 1-5 Yr. Credit (Short-Term Domestic Bonds)	-0.02%	1.14%	5.69%
Barclays 5-10 Yr. Credit (Intermediate-Term Domestic Bonds)	-0.53%	2.47%	12.57%
Barclays U.S. TIPS (Treasury Inflation Protected Securities)	-0.53%	1.35%	7.58%
FTSE World Gov't 1-5 Yr. Hedged (Short-Term Global Bonds)	-0.08%	0.96%	3.68%

THIRD QUARTER MARKET OVERVIEW

Third Quarter 2019 was a mixed bag for stocks, with large stocks and REIT (real estate) stocks faring well, while small stocks and international stocks struggled.

In the U.S., the S&P 500 large-cap stock index gained 1.70%, bringing that index up to a 20.55% gain for 2019 through the end of the third quarter. The Russell 2000 small-stock index, meanwhile, posted a decline of 2.40% but still finished the quarter up 14.18% thus far in 2019.

International stocks saw slight declines during Third Quarter, with the MSCI EAFE index of large, foreign stocks down 1.07% in Third Quarter and the MSCI EAFE Small Cap index down 0.44%.

Alternative asset classes saw quite a spread in performance during the Third Quarter. REIT stocks fared exceptionally well, with the Dow Jones U.S. REIT index gaining 6.83% and the Dow Jones Global REIT index gaining 3.54%. In contrast, emerging markets stocks saw a significant decline, with the MSCI Emerging Markets index falling 4.25% for the quarter.

Bonds saw modest gains during Third Quarter. The Barclays U.S. Aggregate bond index gained 2.27%.

Due to the wide array of asset class performances, Third Quarter 2019 was a testament to the benefits of diversification.

Professor Robert Merton, a Nobel laureate, said it well in a recent interview with Dimensional Fund Advisors:

"Timing markets is the dream of everybody. Suppose I could verify that I'm a .700 hitter in calling market turns. That's pretty good; you'd hire me right away. But to be a good market timer, you've got to do it twice. What if the chances of me getting it right were independent each time? They're not. But if they were, that's 0.7 times 0.7. That's less than 50-50. So, market timing is horribly difficult to do."

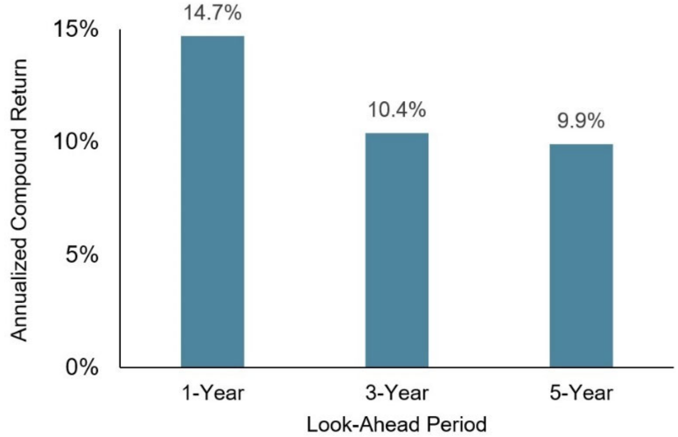
In other words, it is unlikely that investors can successfully time the market, and if they do manage it, it may be the result of luck rather than skill.

How are professionals at market timing? Dimensional recently studied the performance of actively managed US-based mutual funds and found that even professional investors have difficulty beating the market. Over the last 20 years, 77% of equity funds and 92% of fixed income funds failed to survive and outperform their benchmarks after costs.[2]

Can I time the market based on new highs? The S&P 500 Index has logged an incredible decade. Should this result impact investors' allocations to equities? Exhibit 1 suggests that new market highs have not been a harbinger of negative returns to come. The S&P 500 went on to provide positive average annualized returns over one, three, and five years following new market highs.

What about timing the market during periods of increased volatility? Exhibit 2, on the adjacent page, shows calendar year returns for the US stock market since 1979, as well as the largest intra-year declines that occurred during a given year. During this period, the average intra-year decline was about 14%. About half of the years observed had declines of more than 10%, and around a third had declines of more than 15%. Despite substantial intra-year drops, calendar year returns were positive in 33 years out of the 40 examined. This goes to show just how common market declines are and how difficult it is to say whether a large intra-year decline will result in negative returns over the entire year.

Exhibit 1. Average Annualized Returns After New Market Highs S&P 500, January 1926–December 2018



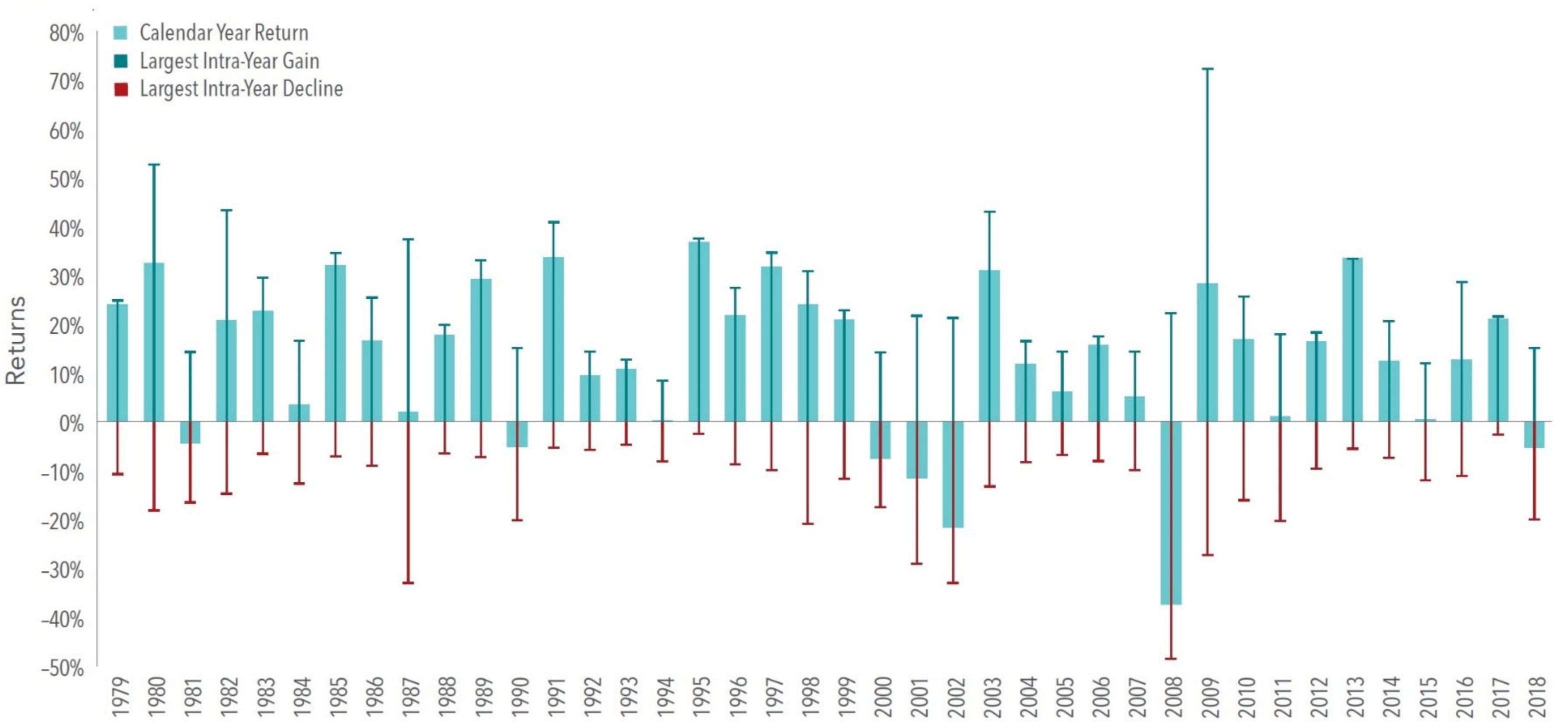
In US dollars. Past performance is no guarantee of future results. New market highs are defined as months ending with the market above all previous levels for the sample period. Annualized compound returns are computed for the relevant time periods subsequent to new market highs and averaged across all new market high observations. There were 1,115 observation months in the sample. January 1990–December 2018: S&P 500 Total Returns Index. S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. January 1926–December 1989; S&P 500 Total Return Index, Stocks, Bonds, Bills and Inflation Yearbook™, Ibbotson Associates, Chicago. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. There is always a risk that an investor may lose money.

Returns Come from Just a Handful of Days:

Further complicating the prospect of market timing being additive to portfolio performance is the fact that a substantial proportion of the total return of stocks over long periods comes from just a handful of days. Since investors are unlikely to be able to identify in advance which days will have strong returns and which will not, the prudent course is likely to remain invested during periods of volatility rather than jump into and out of stocks. Otherwise, an investor runs the risk of being on the sidelines on days when returns happen to be strongly positive.

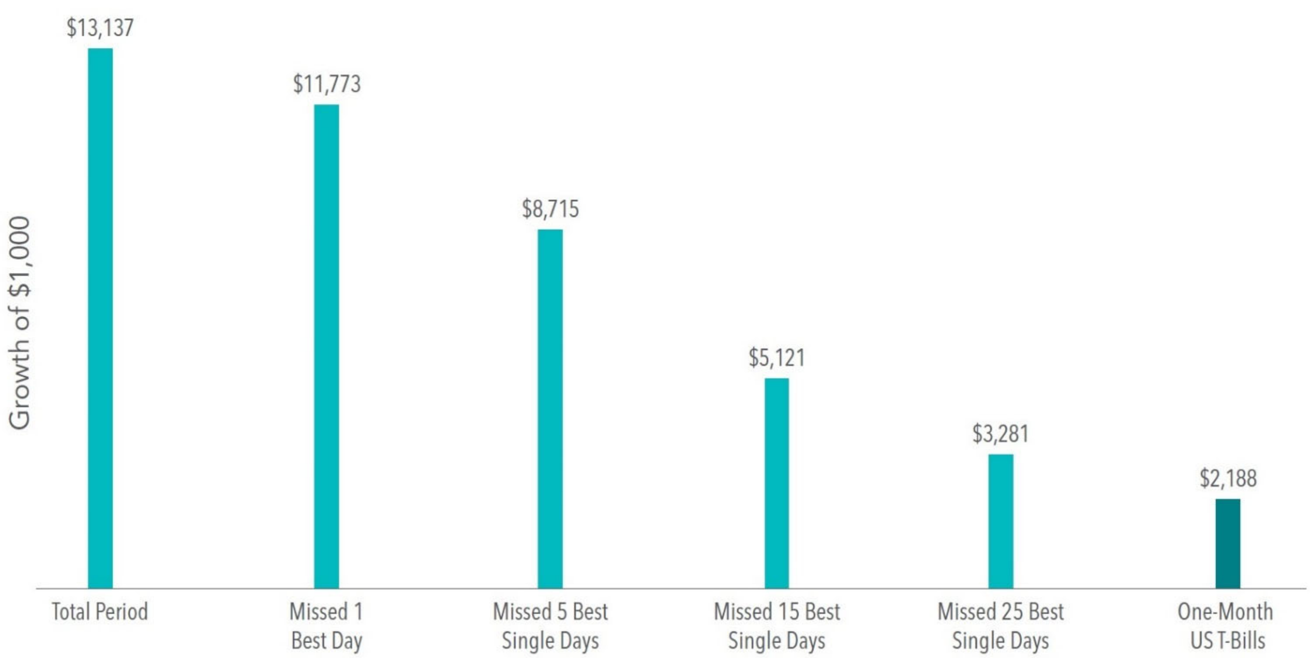
Exhibit 3, on the adjacent page, helps illustrate this point. It shows the annualized compound return of the S&P 500 Index going back to 1990 and illustrates the impact of missing out on just a few days of strong returns. The bars represent the hypothetical growth of $1,000 over the period and show what happened if you missed the best single day during the period or a handful of the best single days. The data shows that being on the sidelines for only a few of the best single days in the market would have resulted in substantially lower returns than the total period had to offer.

Exhibit 2: US Market Intra-year Gains and Declines vs. Calendar Year Returns, 1979–2018



In US dollars. US Market is the Russell 3000 Index. Largest Intra-Year Gain refers to the largest market increase from trough to peak during the year. Largest Intra-Year Decline refers to the largest market decrease from peak to trough during the year. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Data is calculated off rounded daily returns.

Exhibit 3: Performance of the S&P 500 Index, 1990–2018



	Total Period	Missed 1 Best Day	Missed 5 Best Single Days	Missed 15 Best Single Days	Missed 25 Best Single Days	One-Month US T-Bills
Annualized Compound Return	9.29%	8.87%	7.75%	5.79%	4.18%	2.74%

In US dollars. For illustrative purposes. The missed best day(s) examples assume that the hypothetical portfolio fully divested its holdings at the end of the day before the missed best day(s), held cash for the missed best day(s), and reinvested the entire portfolio in the S&P 500 at the end of the missed best day(s). Annualized returns for the missed best day(s) were calculated by substituting actual returns for the missed best day(s) with zero. S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. "One-Month US T- Bills" is the IA SBBI US 30 Day TBill TR USD, provided by Ibbotson Associates via Morningstar Direct. Data is calculated off rounded daily index values.

Conclusion:

Outguessing markets is more difficult than many investors might think. While favorable timing is theoretically possible, there isn't much evidence that it can be done reliably, even by professional investors. The positive news is that investors don't need to be able to time markets to have a good investment experience.

Over time, capital markets have rewarded investors who have taken a long-term perspective and remained disciplined in the face of short-term noise. By focusing on the things that they can control (like having an appropriate asset allocation, diversification, and managing expenses, turnover, and taxes), investors can better position themselves to make the most of what capital markets have to offer.

While market volatility can be nerve-racking for investors, reacting emotionally and changing long-term investment strategies in response to short-term declines could prove more harmful than helpful. By adhering to a well-thought-out investment plan, ideally agreed upon in advance of periods of volatility, investors may be better able to remain calm during periods of short-term uncertainty.

[1] In US dollars. Source: Dimensional, using data from Bloomberg LP. Includes primary and secondary exchange trading volume globally for equities. ETFs and funds are excluded. Daily averages were computed by calculating the trading volume of each stock daily as the closing price multiplied by shares traded that day. All such trading volume is summed up and divided by 252 as an approximate number of annual trading days.

[2] Past performance is no guarantee of future results. US-domiciled open-end mutual fund data is from Morningstar. The sample includes funds at the beginning of the 20-year period ending December 31, 2018. For further details, see the Mutual Fund Landscape 2019.