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TAGStone Capital Inc

Fourth Quarter 2018

FOURTH QUARTER MARKET OVERVIEW

The stock market sell-off that began in early October picked up much steam in December with major stock indices dropping substantially during the last month of the year. The Fourth Quarter downturn brought all major market benchmarks into the red for 2018, the first down year for the broad stock market since 2009.

There was no place to hide in equities to avoid the volatility during the quarter. The S&P 500 index of large, U.S. stocks dropped 13.52%, while the Russell 2000 index of small, U.S. stocks dropped 20.20%, entering into official bear market territory.

International stocks were as volatile too. The MSCI EAFE index of large stocks in developed countries fell 12.54% for the quarter.

Alternative asset classes performed relatively better but were still down for the quarter. Global real estate stocks, as measured by the S&P Global REIT Index fell 5.79%, while the MSCI Emerging Markets index declined 7.47% for the quarter.

Fixed income did offer a buffer to the stock market volatility with the Barclays U.S. Aggregate broad domestic bond index gaining 1.64% during the fourth quarter.

There's no downplaying the volatility that hit the stock market in the Fourth Quarter—volatility not seen since the 2008-09 financial crisis.

Why Should You Diversify?

As 2019 begins, and with U.S. stocks outperforming non-U.S. stocks in recent years, some investors have again turned their attention towards the role that global diversification plays in their portfolios.

For the five-year period ending October 31, 2018, the S&P 500 Index had an annualized return of 11.34% while the MSCI World ex USA Index returned 1.86%, and the MSCI Emerging Markets Index returned 0.78%. As U.S. stocks have outperformed international and emerging markets stocks over the last several years, some investors might be reconsidering the benefits of investing outside the U.S.

While there are many reasons why a U.S.-based investor may prefer a degree of home bias in their equity allocation, using return differences over a relatively short period as the sole input into this decision may result in missing opportunities that the global markets offer. While international and emerging markets stocks have delivered disappointing returns relative to the U.S. over the last few years, it is important to remember that:

1. Non-U.S. stocks help provide valuable diversification benefits.
2. Recent performance is not a reliable indicator of future returns.

EQUITY INDICES

	Dec. '18	4th Qtr.	YTD
S&P 500 Total Return (Large-Cap Stocks)	-9.03%	-13.52%	-4.38%
Russell 2000 Total Return (Small-Cap Stocks)	-11.88%	-20.20%	-11.01%
MSCI EAFE (Developed International Stocks)	-4.85%	-12.54%	-13.79%
MSCI Emerging Markets (International Emerging Stocks)	-2.66%	-7.47%	-14.58%
S&P Global REIT Index (Real Estate Securities)	-5.93%	-5.79%	-5.90%

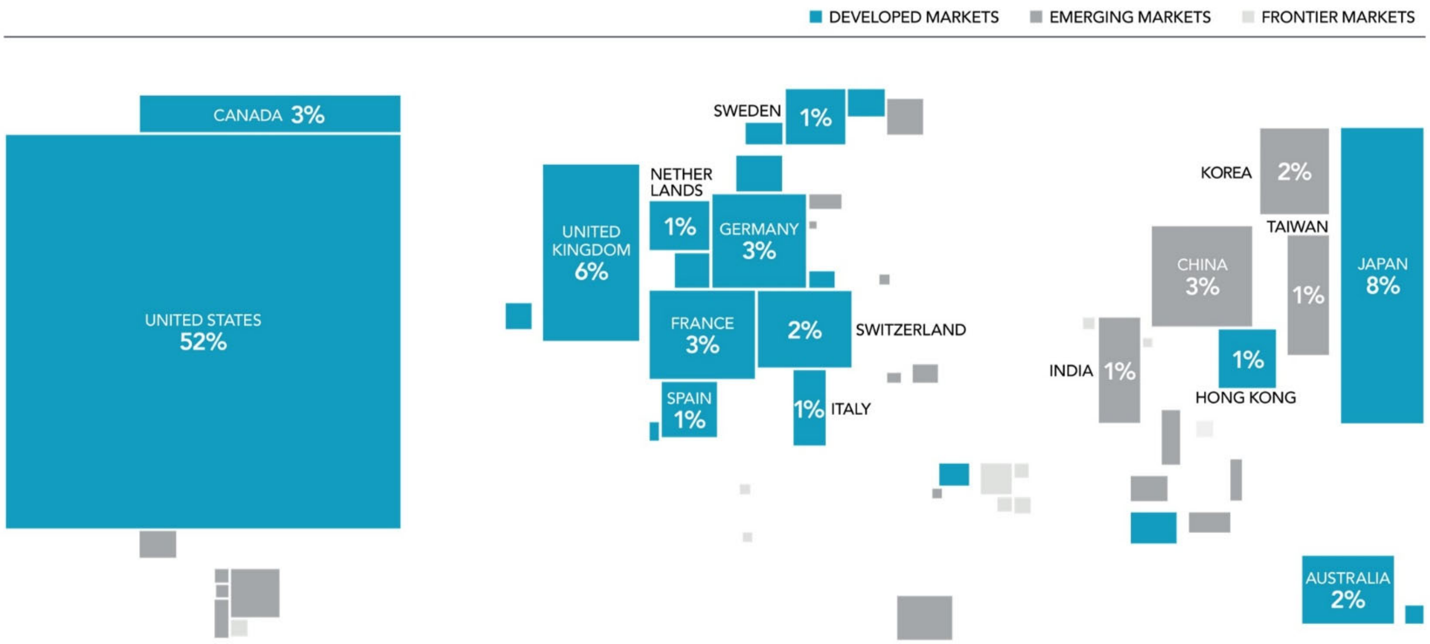
FIXED INCOME INDICES

	Dec. '18	4th Qtr.	YTD
Barclays U.S. Aggregate (Broad Domestic Bonds)	1.84%	1.64%	0.01%
Barclays 1-5 Yr. Credit (Short-Term Domestic Bonds)	0.90%	0.93%	1.11%
Barclays 5-10 Yr. Credit (Intermediate-Term Domestic Bonds)	1.38%	0.49%	-1.55%
Barclays U.S. TIPS (Treasury Inflation Protected Securities)	0.55%	-0.42%	-1.26%
Citi World Gov't 1-5 Yr. Hedged (Short-Term Global Bonds)	0.86%	1.53%	2.12%

There's a World of Opportunity in Equities:

The global equity market is large and represents a world of investment opportunities. As shown in Exhibit 1, nearly half of the investment opportunities in global equity markets lie outside the U.S. Non-U.S. stocks, including developed and emerging markets, account for 48% of world market capitalization[1] and represent thousands of companies in countries all over the world. A portfolio investing solely within the U.S. would not be exposed to the performance of those markets.

Exhibit 1. World Equity Market Capitalization



As of December 31, 2017. Data provided by Bloomberg. Market cap data is free-float adjusted and meets minimum liquidity and listing requirements. China market capitalization excludes A-shares, which are generally only available to mainland China investors. For educational purposes; should not be used as investment advice.

The Lost Decade:

We can examine the potential opportunity cost associated with failing to diversify globally by reflecting on the period in global markets from 2000–2009. During this period, often called the "lost decade" by U.S. investors, the S&P 500 Index recorded its worst ever 10-year performance with a total cumulative return of –9.1%. However, looking beyond U.S. large-cap equities, conditions were more favorable for global equity investors as most equity asset classes outside the U.S. generated positive returns over the course of the decade. (See Exhibit 2.) Expanding beyond this period and looking at performance for each of the 11 decades starting in 1900 and ending in 2010, the U.S. market outperformed the world market in five decades and underperformed in the other six.[2] This further reinforces why an investor pursuing the equity premium should consider a global allocation. By holding a globally diversified portfolio, investors position themselves to capture returns wherever they occur.

Exhibit 2. Global Index Returns, January 2000–December 2009

	Total Cumulative Return (%)
S&P 500 Index	–9.10
MSCI World ex USA Index (net div.)	17.47
MSCI World ex USA Value Index (net div.)	48.71
MSCI World ex USA Small Cap Index (net div.)	94.33
MSCI Emerging Markets Index (net div.)	154.28
MSCI Emerging Markets Value Index (net div.)	212.72

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Pick a Country?

Are there systematic ways to identify which countries will outperform others in advance? Exhibit 3 illustrates the randomness in country equity market rankings (from highest to lowest) for 22 different developed market countries over the past 20 years. This graphic conveys how difficult it would be to execute a strategy that relies on picking the best country and the resulting importance of diversification.

Exhibit 3. Equity Returns of Developed Markets

RETURNS: HIGH (top) to LOW (bottom)

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Finland 121.6	Finland 152.6	Switzerland 5.9	New Zealand 8.4	New Zealand 24.2	Sweden 64.5	Austria 71.5	Canada 28.3	Spain 49.4	Finland 48.7	Japan −29.2	Norway 87.1	Sweden 33.8	Ireland 13.7	Belgium 39.6	Finland 46.0	USA 12.7	Denmark 23.4	Canada 24.6	Austria 58.3
Belgium 67.7	Singapore 99.4	Canada 5.3	Australia 1.7	Austria 16.5	Germany 63.8	Norway 53.3	Japan 25.5	Portugal 47.4	Hong Kong 41.2	Switzerland −30.5	Australia 76.4	Denmark 30.7	New Zealand 5.5	Denmark 31.3	Ireland 41.2	New Zealand 7.3	Ireland 16.5	New Zealand 18.4	Hong Kong 36.2
Italy 52.5	Sweden 79.7	Denmark 3.4	Ireland −2.8	Australia −1.3	Spain 58.5	Belgium 43.5	Austria 24.6	Ireland 46.8	Germany 35.2	USA −37.6	Singapore 74.0	Hong Kong 23.2	USA 1.4	Singapore 31.0	USA 31.8	Denmark 6.2	Belgium 12.1	Norway 13.3	Singapore 35.6
Spain 49.9	Japan 61.5	Norway −0.9	Austria −5.6	Norway −7.3	Austria 57.0	Ireland 43.1	Denmark 24.5	Singapore 46.7	Norway 31.4	Spain −40.6	Sweden 64.2	Singapore 22.1	UK −2.6	Germany 30.9	Germany 31.4	Hong Kong 5.1	Japan 9.6	Australia 11.4	Denmark 34.7
France 41.5	Hong Kong 59.5	Italy −1.3	Belgium −10.9	Italy −7.3	New Zealand 55.4	Sweden 36.3	Norway 24.3	Norway 45.1	Canada 29.6	France −43.3	Hong Kong 60.2	Canada 20.5	Switzerland −6.8	New Zealand 29.3	Spain 31.3	Belgium 4.1	Austria 3.5	Austria 11.3	Netherlands 32.2
Ireland 35.3	Canada 53.7	Netherlands −4.1	Spain −11.4	Japan −10.3	Canada 54.6	New Zealand 35.2	Finland 16.7	Sweden 43.4	Singapore 28.4	Canada −45.5	Belgium 57.5	Japan 15.4	Norway −10.0	Hong Kong 28.3	Netherlands 31.3	Singapore 3.0	Italy 2.3	USA 10.9	France 28.7
USA 30.1	Norway 31.7	France −4.3	Norway −12.2	Switzerland −10.3	Australia 49.5	Italy 32.5	Switzerland 16.3	Denmark 38.8	Australia 28.3	Germany −45.9	Canada 56.2	USA 14.8	Belgium −10.6	Austria 25.9	Belgium 27.6	Ireland 2.3	Finland 2.0	France 4.9	Italy 28.4
Germany 29.4	France 29.3	Australia −10.0	USA −12.4	Singapore −11.0	Denmark 49.3	Denmark 30.8	Australia 16.0	Belgium 36.7	Denmark 25.6	Singapore −47.4	New Zealand 50.4	Australia 14.5	Australia −11.0	Australia 22.1	Japan 27.2	Canada 1.5	Netherlands 1.3	Netherlands 4.8	Norway 28.3
Portugal 27.5	USA 21.9	Portugal −10.3	UK −14.0	Canada −13.2	Norway 48.1	Australia 30.3	Singapore 14.4	Austria 36.5	Portugal 24.0	Denmark −47.6	Spain 43.5	Switzerland 11.8	Netherlands −12.1	Sweden 22.0	Switzerland 26.6	Switzerland −0.1	Portugal 0.9	Portugal 3.6	Germany 27.7
Switzerland 23.5	Germany 20.0	UK −11.5	Denmark −14.8	Portugal −13.8	Ireland 43.8	Spain 28.9	Netherlands 13.9	Germany 36.0	Spain 24.0	Netherlands −48.2	UK 43.3	Norway 10.9	Spain −12.3	France 21.3	France 26.3	Finland −0.7	USA 0.7	Germany 2.8	Spain 27.0
Netherlands 23.2	Australia 17.6	Austria −12.0	Hong Kong −18.6	Belgium −15.0	Portugal 43.0	Hong Kong 25.0	Sweden 10.3	France 34.5	Netherlands 20.6	UK −48.3	Austria 43.2	Finland 10.3	Canada −12.7	Netherlands 20.6	Denmark 25.2	Australia −3.4	Switzerland 0.4	Japan 2.4	Japan 24.0
UK 17.8	New Zealand 12.9	Ireland −12.7	Canada −20.4	UK −15.2	France 40.2	Portugal 24.7	Germany 9.9	Italy 32.5	France 13.2	Sweden −49.9	Netherlands 42.3	Austria 9.9	Japan −14.3	Switzerland 20.4	Sweden 24.5	Netherlands −3.5	France −0.1	Hong Kong 2.3	Portugal 23.8
Sweden 14.0	UK 12.5	USA −12.8	Switzerland −21.4	Spain −15.3	Hong Kong 38.1	Singapore 22.3	France 9.9	Netherlands 31.4	New Zealand 8.9	Italy −50.0	Portugal 40.4	UK 8.8	Sweden −16.0	Norway 18.7	UK 20.7	Japan −4.0	Hong Kong −0.5	Singapore 1.4	Switzerland 22.5
Denmark 9.0	Denmark 12.1	Finland −14.2	Portugal −22.0	Denmark −16.0	Italy 37.8	Canada 22.2	Belgium 9.0	Australia 30.9	UK 8.4	Australia −50.7	Denmark 36.6	Germany 8.4	Denmark −16.0	USA 15.3	Italy 20.4	Spain −4.7	Germany −1.9	Sweden 0.6	Finland 22.5
Australia 6.1	Netherlands 6.9	Hong Kong −14.7	Netherlands −22.1	Hong Kong −17.8	Singapore 37.6	UK 19.6	Hong Kong 8.4	UK 30.6	Italy 6.1	Hong Kong −51.2	France 31.8	New Zealand 8.3	Hong Kong −16.0	UK 15.3	Austria 13.4	UK −5.4	Sweden −5.0	UK −0.1	UK 22.3
Japan 5.1	Spain 4.8	Germany −15.6	France −22.4	Netherlands −20.8	Japan 35.9	France 18.5	UK 7.4	Hong Kong 30.4	USA 5.4	Portugal −52.2	Italy 26.6	Netherlands 1.7	France −16.9	Finland 14.6	New Zealand 11.3	Sweden −7.5	New Zealand −6.3	Spain −1.0	USA 21.2
Austria 0.4	Italy −0.3	Spain −15.9	Germany −22.4	France −21.2	Belgium 35.3	Germany 16.2	USA 5.1	Finland 29.9	Switzerland 5.3	New Zealand −53.8	USA 26.3	Belgium −0.4	Singapore −17.9	Italy 12.5	Hong Kong 11.1	Italy −9.5	UK −7.6	Finland −4.7	Sweden 20.6
Hong Kong −2.9	Switzerland −7.0	Belgium −16.8	Singapore −23.4	USA −23.1	Switzerland 34.1	Japan 15.9	Spain 4.4	Switzerland 27.4	Austria 2.2	Finland −55.2	Switzerland 25.3	France −4.1	Germany −18.1	Canada 9.1	Portugal 11.0	France −9.9	Australia −10.0	Switzerland −4.9	Australia 19.9
Canada −6.1	Portugal −8.9	Sweden −21.3	Italy −26.6	Ireland −26.2	UK 32.1	Switzerland 15.0	Italy 1.9	Canada 17.8	Sweden 0.6	Norway −64.2	Germany 25.2	Portugal −11.3	Portugal −23.1	Japan 8.2	Norway 9.4	Germany −10.4	Norway −15.0	Ireland −7.1	Belgium 18.6
Singapore −12.9	Austria −9.1	Singapore −27.7	Sweden −27.2	Finland −30.3	USA 28.4	Netherlands 12.2	New Zealand 1.7	New Zealand 16.6	Belgium −2.7	Belgium −66.5	Ireland 12.3	Italy −15.0	Italy −23.2	Ireland 5.7	Canada 5.6	Norway −22.0	Spain −15.6	Belgium −7.6	Ireland 18.1
New Zealand −22.6	Ireland −12.6	Japan −28.2	Japan −29.4	Sweden −30.5	Netherlands 28.1	USA 10.1	Portugal −1.9	USA 14.7	Japan −4.2	Austria −68.4	Finland 11.1	Ireland −18.1	Finland −31.9	Portugal 3.5	Australia 4.2	Austria −29.8	Singapore −17.7	Italy −10.5	Canada 16.1
Norway −30.1	Belgium −14.3	New Zealand −33.5	Finland −38.2	Germany −33.2	Finland 19.4	Finland 6.1	Ireland −2.3	Japan 6.2	Ireland −20.1	Ireland −71.9	Japan 6.3	Spain −22.0	Austria −36.4	Spain 3.0	Singapore 1.7	Portugal −38.2	Canada −24.2	Denmark −15.8	New Zealand 11.7

Source: MSCI country indices (net dividends) for each country listed. Does not include Israel, which MSCI classified as an emerging market prior to May 2010. MSCI data © MSCI 2018, all rights reserved. Past performance is no guarantee of future results. Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.

In addition, concentrating a portfolio in any one country can expose investors to large variations in returns. The difference between the best- and worst performing countries can be significant. For example, since 1998, the average return of the best performing developed market country was approximately 44%, while the average return of the worst-performing country was approximately –16%. Diversification means an investor's portfolio is unlikely to be the best or worst performing relative to any individual country, but diversification also provides a means to achieve a more consistent outcome and more importantly helps reduce and manage catastrophic losses that can be associated with investing in just a few stocks or a single country.

A Diversified Approach:

Over long periods of time, investors may benefit from consistent exposure in their portfolios to both U.S. and non-U.S. equities. While both asset classes offer the potential to earn positive expected returns in the long run, they may perform quite differently over short periods. While the performance of different countries and asset classes will vary over time, there is no reliable evidence that this performance can be predicted in advance. An approach to equity investing that uses the global opportunity set available to investors can provide diversification benefits as well as potentially higher expected returns.

[1] The total market value of a company's outstanding shares computed as price times shares outstanding.

[2] Source: Annual country index return data from the Dimson-Marsh-Staunton (DMS) Global Return Data, provided by Morningstar, Inc.