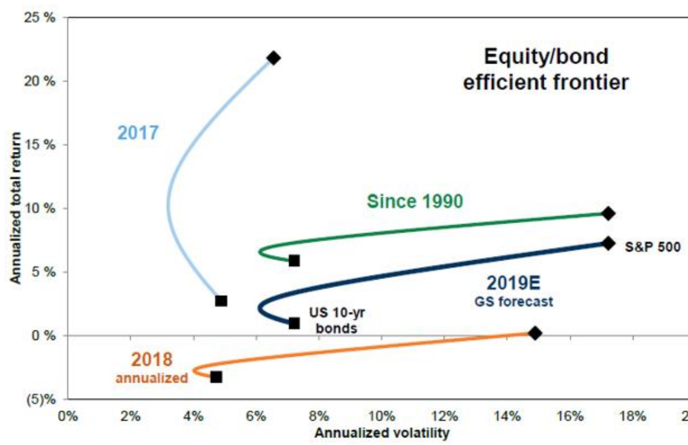
JANUARY 2ND, 2019

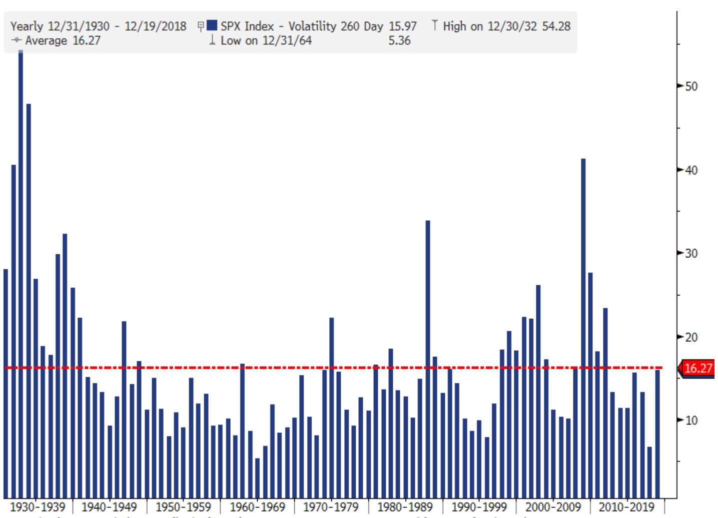
PUTTING 2018 IN HISTORICAL PERSPECTIVE AND HIGHLIGHTING A UNIQUE OPPORTUNITY

The recent decline in the stock market and associated increase in market volatility may be causing concern and prompting questions. ***This brief note puts the performance of the stock market in 2018 in proper historical context and explains the unique opportunity that the stock market's performance in the fourth quarter of 2018 may provide for associates of Glatfelter Insurance Group (GIG).***

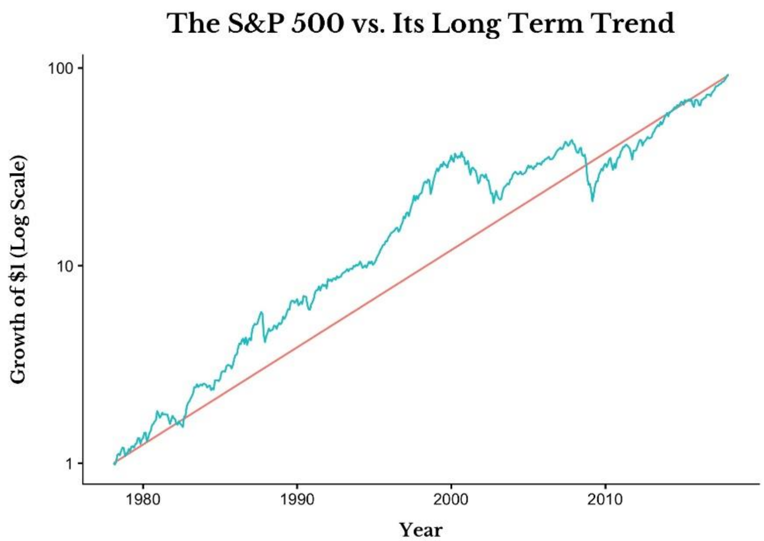
A frequently mentioned theme in much of our writing in 2018 was that 2017 was the type of year investors dream about, featuring incredibly high returns coupled with extremely low volatility. We will likely never see a year like 2017 again in our lifetimes – all return, no risk. 2018 has switched that polarity, seeing the market make strong moves up and down only to end up about where we started – all risk, no return. The chart to the right illustrates the contrast well. What a difference a year makes…



Source: Goldman Sachs

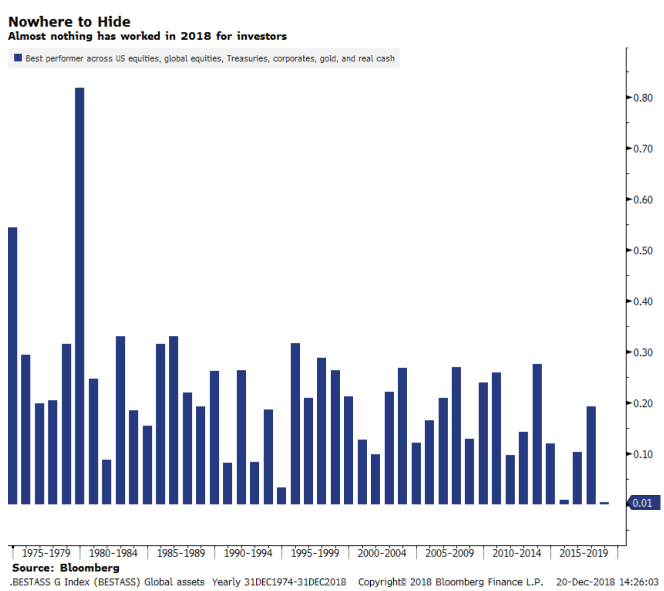


To put it in perspective, in 2017 the S&P 500 achieved over twice the average annual return over the past 30 years with about a third of the volatility. The realized volatility of the S&P 500 in 2018 is actually meaningfully below the long-run average – but it doesn't feel like it, does it? The reason why the volatility spike in 2018 feels so painful, despite the fact that volatility has been below the historical average, is due to a cognitive bias that we all are subject to: recency bias. Recency bias is the tendency to remember events that have happened recently more readily than those that happened further in the past and to project that the recent past will continue into the future. Realized volatility on the S&P 500 hit a 50 year low in August of last year, and while 2017 was truly an anomaly, equity market volatility has been substantially below average since 2013. Thus, when volatility picked up in 2018, it feels more painful, even if the realized volatility level is still below average. Recognizing this bias doesn't make the volatility markets have experienced this year any more palatable, but taking a step back and recognizing where we stand relative to history is worthwhile.



Source: DFA (OfDollarsAndData.com)
Note: Includes dividends, but not adjusted for inflation. The S&P 500 compounded at an average rate of 11.99% annually over this period.

We also tend to view long term averages in our minds as linear events; when told that the stock market has achieved 12% nominal returns over a long history, in our minds we naturally picture this as an upward sloping curve that, while we know has historically had periods of steep decline, generally goes up gently and smoothly over time. The truth is, natural systems – and the stock market is one, often subject to wild swings in investor emotions – are violent and messy and volatile. In fact, this MUST be so. In order to achieve those higher long-term returns (returns that are much higher than a risk-free investment), the volatility has to exist. Put another way, because the stock market is volatile by nature, it must offer investors superior long-term returns. Otherwise, long-term investors would simply buy risk-free assets that don't fluctuate and call it a day. Volatility is a feature of the stock market, not a bug.



Another feature of investment markets in 2018 that has the effect of amplifying the volatility this year (at least in our minds) is that *nothing* has had a good year. There was nowhere to hide. Typically, when the stock market experiences drawdowns, other parts of a properly diversified investment portfolio, like bonds, act as a cushion to help soften the blow. Not in 2018. 90% of asset classes have posted negative performance on the year and the best performing asset was just barely above 1%. That asset? Cash. The last time cash outperformed stocks and bonds in a calendar year was 1992. Going back to 1926, it has only occurred 10 times, and the vast majority of these years were during the halcyon days of the 1970s and 1980s. Only two times over that 92 year time period did cash have a positive return while both stocks and bonds posted negative returns in a calendar year. 2018 is on pace to be the third. You may find yourself asking why even be invested in the markets at all, given that you could have parked your portfolio in cash all year and had positive performance? The primary reason that would be imprudent in the long run is the data touted above; this is a rare event. It's only happened twice before. In hindsight, cash would have outperformed in 2018, yes, but believing that anyone has the ability to predict which asset class is going to outperform over the next 12 months with any degree of consistency and certainty is belied by both market history and math. We hold diversified portfolios precisely because the future is uncertain.

Given all this, it bears reminding that the market is *not* the economy. Underlying fundamentals of the US economy remain strong, as do underlying equity market fundamentals. The stock market decline that occurred at the end of the year in 2018 presents a fortuitous opportunity for investors who missed the worst December stock market performance in history. ***The structure of the GIG transaction places GIG associates in just this position.*** While economic growth is expected to decelerate from the levels seen in 2018, GDP growth is not expected to go into negative territory. While the +3.5% growth levels we've experienced in 2018 are not expected to continue in 2019, the expected GDP growth rate of between 2-2.5% is above the potential growth rate and would represent an economy that was continuing to expand at a healthy pace. Expectations for S&P 500 earnings in 2019 are for growth of about 5%. Given the solid underlying economic fundamentals, the recent market decline presents a unique buying opportunity for those that have been on the sidelines and avoided the decline. With the current S&P 500 forward price/earnings ratio of 14.5 below the long-term average of 15.5, the decline has created an opportunity in the form of a much more reasonably valued stock market. While it is natural for investors to feel unease and nervousness during times such as these, they are best served by remembering to put the current state of the markets in the proper historical perspective and sticking to a long-term strategy. For those who have been spared from the current market decline, now may be an opportune time to begin building an equities position that will be a core pillar of a long-term financial plan.

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