SEGALL BRYANT & HAMILL

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SBH NEWSLETTER

Thoughts on the Current Environment

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Nowhere to run to baby, nowhere to hide
I got nowhere to run to baby, nowhere to hide

It's not ~~love~~ [the market] I'm runnin' from
Just the heartbreak I know will come
'Cause I know you're no good for me (you're no good)
But you've become a part of me

-"An Investor's Lament." With apologies to "Nowhere to Run," Martha and the Vandellas, (Holland, Dozier and Holland, 1965)

In the last edition of *Thoughts on the Current Environment*, we noted that virtually all classes of financial assets had been behaving in a correlated fashion for a surprisingly long time and wondered where any source of diversification could be found. The markets provided a resounding answer in the fourth quarter: cash. Virtually all categories of financial assets, except for cash and very short-term bonds, continued to move in the same direction. Only this time, the direction was down. Perhaps the best way to summarize the close of 2018 is that the first nine months of the year weren't bad, but the fourth quarter was a colossal flop, one of the worst in post-World War II history.

The larger question to be addressed is not what happened but why and—equally as important—what might a decline like this imply for clients for whom a portfolio is a source of funding for retirement or for funding pension payments to beneficiaries. To be clear, this is not a discussion of what the stock market or the bond market will do in 2019. We don't rely on macroeconomic predictions, as our investment strategies are bottom-up oriented, meaning we don't have to be successful in guessing which way interest rates or the stock market will move to achieve success in our objective of generating superior risk-adjusted returns. When clients ask why the market is dropping—the many machinations in Washington, uncertainties about trade and tariffs, weakness in the Chinese economy, global populism, climate issues—the proper answer is yes, all of those are good proximate triggers for a decline. What we want to explore further in this letter is why people aren't viewing this decline as "a chance to buy the dip."

As we head into 2019, forecasts we have read in market commentaries and the popular press have been dire. We believe, however, that investing is a long-term proposition, built on a durable framework of understanding what the purpose of a portfolio should be. Keeping that in mind helps during periods of stress.

We recognize a major re-pricing of assets may now be underway. Consider that from 2009 through most of 2018, the financial markets would be characterized as "doing well" while the real economy was characterized as behaving sluggishly, unable to generate robust employment and wage growth. According to central bank data, inflation has stayed dormant and capital spending has been subdued (until this year). All of this began to shift in 2018 as the real economy chugged along, while it is the financial markets that are faltering.

Could it be, as some suggest, that the stock market is sniffing out a recession and decline in corporate profits? That could well be, but we think the root cause remains the overhanging debt burden from 2009. Not only have debt levels remained staggeringly high since 2009, but the actions of central banks around the world may have paradoxically made the problem worse. By first cutting interest rates to zero and then engaging in the outright purchase of debt and even stocks, the central banks did more than forestall a "day of reckoning." Instead, they drove prices on securities up, pushing income yields down and forcing investors to move into riskier assets than was warranted.

In a word, the financial markets have been artificially mis-priced by their actions. Sooner or later, this realization was bound to occur. Think of the cartoon character Wile E. Coyote chasing the Roadrunner off the mountain top. Sooner or later, he would realize that while the Roadrunner had wings, he did not and could not stay aloft. That realization came to the stock market in the fourth quarter of 2018. The proximate cause of this re-pricing will be attributed to a variety of sources, some of which are listed above. All are equally valid. What is different, though, is the awareness that the backstop of ever-increasing money flows is over, and the bubble may have been punctured.

In a cartoon, of course, the characters encounter all sorts of calamities and always are fine for the next scene. How about investors? The news isn't all that bad, as long as one's focus is not only the next 90 days or nine months. Let us look at some figures.

For many of our clients, the expectation is a 5% real return on their portfolio. Many pension funds, for example, use an actuarial assumption (a forecast of future returns to be earned, certified by an actuary) of 7%. This forecast embeds an assumption of inflation, such as 2%, thus creating a 5% real rate of return. Many financial planners use 5% real returns for their wealth management clients. The standard for tax-exempt charitable endowments is likewise 5%.

How valid is this expectation shared by a variety of investors? A modest model can help to determine this assumption. To test the validity of a 5% return assumption, we created a model portfolio of 60% stocks and 40% bonds, re-balanced annually, for the period 1926 through 2018. For the sake of simplicity, we used only a two-asset model, rebalancing only once per year. It could have been more complex by adding more asset classes or re-balancing more frequently, but the essence of the conclusion would not change materially. We looked at a variety of regimes over the 92-year period. The table on the following page shows this time period broken out by stock market cycle (bottom-top-bottom) as illustrative of all of them. For each of these periods, we show the real return (again, the nominal return minus the rate of inflation), as well as the "batting average" in that period, defined as the number of years that the real return was 5% or more.

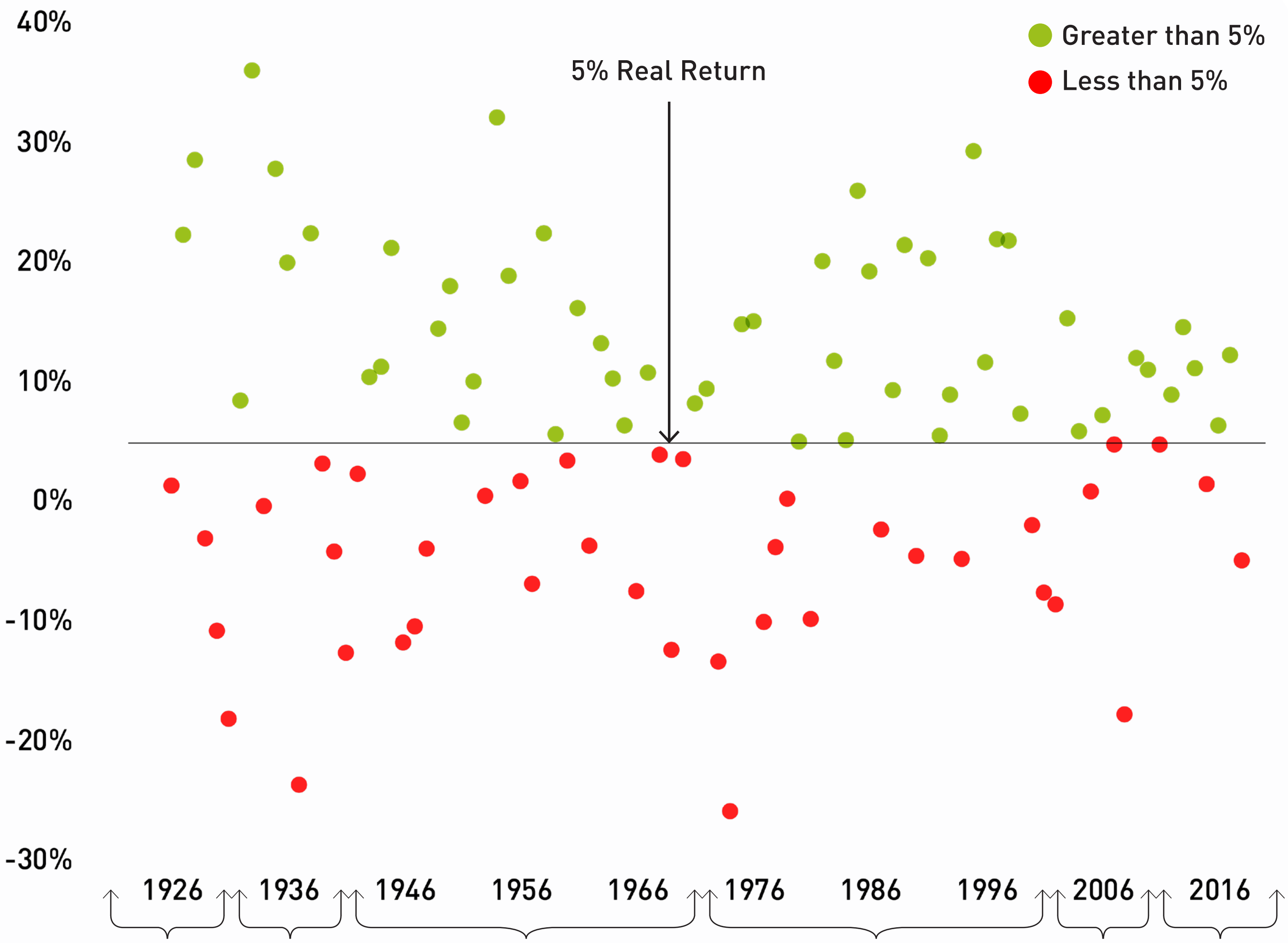
Viewing the data in this array of date ranges, one can reasonably conclude that 5% real returns are achievable over the long run, if one has the strength of conviction to stay the course. More than half the time (55%), the financial markets were able to beat our target of 5%, averaging 5.5%/year over the entire period. This analysis shows that planning on the expectation of a 5% real return has been based on reasonable expectations.

As noted, current yields are low because of an insufficient supply of high-quality and long-dated investments (bonds) to satisfy the demand of investors. We believe this can largely be attributed to the central banks absorbing much of the supply. The bond market (as measured by the Barclays Bloomberg Aggregate Bond Index) is priced to produce a current yield of 3.3% as 2019 begins, and the dividend yield of the S&P 500 Index at year-end was 2.1%. Over the last 92 years, the income component (interest and dividends) of the return has produced more than 65% of the return. Today, that ratio is 38%, which means that the portion required from gains in price has grown proportionately larger.

Whether investors were reaching for extra current income by stepping down in quality or by moving further out on the maturity curve, or by buying high-yielding stocks as bond substitutes, or whether they were trying to capture price momentum (a variant of the Greater Fool theory), the outcome was essentially the same.

The good news, of course, is that just as every bull market sows the seeds of its demise, every bear market sows the seeds of its recovery. Prices may continue to fall, which will give those investors with long-term targets the opportunity to deploy capital attractively. Patience may be required, though. Portfolio returns may have a hard time meeting expectations in the short run, but Reversion to the Mean is one of the most powerful forces in nature and in markets. Stock markets have experienced abrupt drops before, but have recovered. As surely as the days get longer in the Northern Hemisphere after December 21, the game will resume in due course.

Real Returns: Balanced Portfolio of Stocks and Bonds Over Various Time Periods, 1926 To 2018



Market Cycle	'22-'32	'33-'41	'42-'74	'75-'02	'03-'08	'09-'18
Real Return	4.9%	6.1%	3.9%	7.2%	2.0%	7.4%
Batting Average	55%	44%	55%	57%	50%	70%

Real Return/Year: Actual return of mix of 60% stocks (S&P 500 Index) and 40% bonds (Barclays [Lehman] Aggregate Bond Index) minus CPI Index.

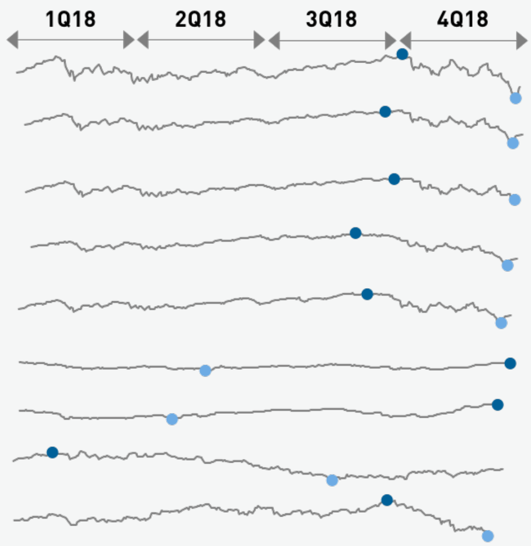
Batting Average: Number of times in period under review the real return exceeded 5.0%

Source: FactSet, SBH Research

I wish to note the contributions of SBH Research Associate Tom Dzien, CFA, to the research presented. In addition to the time periods shown, we have conducted research into other periods as well, including bull and bear markets, various interest rate cycles, etc. Please reach out to your SBH contact if you'd like to see this research in more detail.

MARKET BAROMETERS
AS OF DECEMBER 31, 2018

	Dec. 31, 2017	Dec. 31, 2018	Low ●	High ●
Dow Jones Industrial Index	24,719.22	23,327.46	21,792.20	26,828.39
S&P 500 Index	2,673.61	2,506.85	2,351.10	2,930.75
Russell 3000 Stock Index	1,582.77	1,472.14	1,495.61	1,737.97
Russell 2000 Stock Index	1,535.51	1,348.56	1,266.93	1,740.75
Russell Midcap Growth Index	970.34	915.18	853.76	1,103.90
Barclays Aggregate Index	2,036.91	2,004.36	1,976.98	2,037.14
Barclays Muni Bond Index	1,201.59	1,216.99	1,181.76	1,216.99
Gold (Price/Oz) London AM Fix	1,296.50	1,281.65	1,176.70	1,360.25
Goldman Commodity Index	2,556.71	2,203.47	2,281.21	2,956.02



Source: Bloomberg

*We're pleased to announce that the SBH Private Opportunity Fund has closed its first and second rounds of funding. If you're a qualified investor and are interested in learning more about the Fund, please send an email to contactus@sbhic.com or get in touch with your SBH contact.**

*Investments in Segall Bryant & Hamill's Private Opportunity Fund may only be made via completion of the partnership's relevant Subscription Agreement and only once a qualified investor receives the Private Placement Memorandum (PPM) and a Limited Partnership Agreement (the "Partnership Agreement") describing our Funds.

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