

Comprehensive Investment Management, LLC

Fee Only Personal Financial Planning

Winter 2019

A Review of the Financial Markets at December 31, 2018

Christmas Eve. Who doesn't love Christmas Eve? Stockings hung by the chimney with care along with visions of dancing sugar plums. Well there was no dancing on Wall Street this year. The S&P dropped 2.7% putting it in bear market territory at 20% below its September 20th high. It was the worst Christmas Eve for the markets ever. Here's what happened. The same weekend the government shut down, it leaked out that Treasury Secretary Mnuchin called the big banks to make sure they were doing ok. Why was he asking? Why wouldn't they be ok? What does he know we don't know? First panic and then stock selling algorithms kicked in.

It turned out that Mnuchin must have called just to say Merry Christmas. The day after Christmas the markets recovered with the DOW rising over a thousand points for its biggest gain ever. The markets did ok the next few days as well and the S&P closed out 2018 at 14.5% below its high. Not good, but at least the year ended trending on the up side. One out of every five years the stock market averages an off year. In 2018 the drop all came in the last quarter, which made it seem a lot worse than -4.5%.

The following describes the performance of a select group of mutual funds. Recent market activity can be newsworthy. For investment purposes, the performance over longer periods, while not predictive, is significantly more meaningful.

US Diversified Stock Funds

Last quarter I reported the Brown Capital Management Small Cap Fund was on fire with a year to date return of 31%. The first signs of flickering came in the last week of September. By December the fund's return had gone negative, ending 2018 at -7%. Primecap Aggressive Growth, a mid cap fund, was positive through November but ended down -6.9%. Both funds have a heavy commitment to growth companies, in particular Brown with 57% technology. All of our stock funds are still solidly ahead at the three year annual mark and beyond. That's what's important and that's what we should focus on.

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| Mutual Fund Categories | Quarter Return | Average Annual Percentage Returns | | | | |
|------------------------------|----------------|-----------------------------------|---------|---------|----------|----------|
| | | 1 Year | 3 Years | 5 Years | 10 Years | 15 Years |
| Short Term Bond Funds | 1.0 | 1.1 | 1.6 | 1.4 | 2.7 | 2.8 |
| Intermediate Term Bond Funds | .8 | -.7 | 2.2 | 2.4 | 4.5 | 4.2 |
| US Diversified Stock Funds | -16.8 | -4.1 | 10.5 | 9.7 | 15.5 | 10.1 |
| Healthcare Stock Funds | -14.0 | .7 | 4.0 | 10.6 | 16.7 | 12.3 |
| Foreign Stock Funds | -12.1 | -14.2 | 7.9 | 3.2 | 10.9 | 8.1 |

The Financial Markets (from page 1)

Foreign Stock Funds

It's the foreign funds that have really done a number on our 2018 returns. It can be argued you don't need to invest in foreign companies, because the large US companies do so much business in other countries. Vanguard doesn't agree. It recommends as much as 40% of your stock allocation be foreign. I prefer 20% at most, and for diversification I emphasize mid and small cap foreign companies. All of our foreign funds have positive performance at the three year mark and beyond, and are even at double digits at ten years.

| US Sectors | 1 yr | 3 yr | 5 yr |
|------------------------|-------|------|------|
| Materials | -18.2 | 6.7 | 3.0 |
| Communications | -6.7 | 5.4 | 5.5 |
| Consumer Discretionary | 0.0 | 9.6 | 8.7 |
| Consumer Staples | -8.4 | 3.6 | 6.5 |
| Energy | -19.4 | .5 | -6.5 |
| Financial | -9.9 | 10.1 | 8.2 |
| Healthcare | 5.9 | 7.9 | 11.1 |
| Industrials | -11.9 | 8.6 | 6.4 |
| Real Estate | -4.2 | 3.4 | 7.6 |
| Technology | -1.3 | 15.6 | 13.8 |
| Utilities | 4.7 | 11.2 | 10.8 |

Bonds

We prefer it if our bond funds were doing better at their job of providing a buffer to this recent rough patch for stocks. They are struggling as well because of rising interest rates. In the long term rising rates are a good thing, but in the near term not so much. Over the last ten years the bonds have returned 4.5%, a time during which bank accounts and certificate of deposits were paying close to zero. Not much we can complain about there.

Looking Ahead

A quarter of the federal government has been shut down now for the longest period ever; we are in a trade war with the second largest economy in the world, which happens to be one of our biggest trade partners; Brexit happens in March; there's a crisis of one kind or another on our southern border; Wall Street won't accept the placations of the Federal Reserve Chairman; 85% of stock price moves are driven by computer algorithms. And you want to look ahead? You're right. We have to try.

| Annual Returns Bonds vs Stocks | 1 yr | 3 yrs | 5 yrs | 10 yrs | 15 yrs |
|------------------------------------|------|-------|-------|--------|--------|
| Wellesley 65% bonds/35% stocks | -2.6 | 5.1 | 4.9 | 7.9 | 6.4 |
| Wellington 35% bonds/65% stocks | -3.4 | 7.1 | 6.2 | 9.9 | 7.5 |

US economic fundamentals continue to look good and inflation remains low. Unemployment is historically low. Growth is slowing, but it's unlikely to turn negative anytime soon. Forecasts of corporate profits are coming down, and comparisons to a robust 2018 will be difficult. Obviously it's hard for business leaders to plan when there is so much uncertainty. Understandably it makes them reluctant to spend and to expand operations.

Stock prices are predicated not just on the economy and company profits. The additional factor is whether the market has already priced in what may or may not be coming down the pike. When it doesn't know what's coming, how can the market price it in?

The well respected stock guru University of Penn professor Jeremy Siegel recently said that even if corporate earnings don't grow at all in 2019, the current market valuations aren't crazy. That means he thinks today's stock valuations are too low. Dan Weiner, our Vanguard expert, sees the lower stock prices as a great buying opportunity. He compares it to Black Friday. It's true we got a bargain on the year-end reinvestment of dividends and gains in our mutual funds. In fact the only time we really need to care about stock fund prices is when we go to sell. Since we have at least a five year window for stock sales, we've got time for a rebound.

Market Volatility 2018 vs 2017

There is no question that uncertainty was significantly up-ratcheted in 2018, what with the White House, China, Brexit and over-reaction to the comments of the Federal Reserve chairman. Therefore no surprise, the markets were volatile. Many investors apparently feel the market moves were off the charts, and they are right. The S&P hit record highs 14 times in the first 18 days, and 9 days later dropped 10%. As the year went on, there were five more highs, then a drop of 20%. The volatility of 2018, particularly in the last quarter was extreme, especially when compared to 2017 which was unusually calm.

In 2017 the S&P moved by 1% or more on just 9 trading days. That was the lowest number since 1965 (53 years). 2018 had 64 days when the index gained or lost at least 1% in value. That's above par with the average year, which is 52 days. How about 2% moves? In 2017 there was not a single day when the S&P 500 gained or lost 2% in value. In 2018 we experienced 22 such days. The long term annual average is 11 days. So, yes, volatility was double the average.

At any time, it can be frustrating to see your portfolio balance lower than what it had been earlier. But that comes with being an investor. If it makes you uncomfortable, you should reduce the risk allocation in your portfolio. If that still doesn't work, then perhaps you simply shouldn't be investing in the markets at all. The problem is that the alternative, bank accounts and certificates of deposit, are unlikely to provide a return sufficient to fund a long retirement. But they would be a better option than sleepless nights, and possibly being frightened into selling at a time when investment values are at a low point.

Vanguard's Economic and Market Outlook for 2019

Each December Vanguard issues an economic and market outlook for the coming year. It's a team effort from the Investment Strategy Group with five Ph.d's among the eight lead authors. It's 43 pages, and is quite detailed with plenty of charts and graphs. It's available at Vanguard's web site, and I will send you a copy if you are interested. Vanguard lists the following as highlights :

As the global economy enters its tenth year of expansion following the global financial crisis, concerns are growing that a recession may be imminent. Although several factors will raise the risk of recession in 2019, a slowdown in growth—led by the United States and China— with periodic "growth scares" is the most likely outcome. In short, economic growth should shift down but not out.

In 2019, we do not see a material risk of further strong rises in core inflation despite lower unemployment rates and higher wages. This is because higher wages are not likely to funnel through to higher consumer prices, as inflation expectations remain well-anchored.

As inflation moves toward target, financial stability risks rise, and unemployment rates continue to approach or drop below estimates of full employment, global central banks will stay on their gradual normalization paths. In the United States, we still expect the Federal Reserve to reach terminal rate for this cycle in the summer of 2019, bringing the policy rate range to 2.75%–3% before halting further increases in the face of nonaccelerating inflation and decelerating top-line growth. Other developed-market central banks, though, will only begin to lift interest rates from post-crisis lows.

With slowing growth, disparate rates of inflation, and continued policy normalization, volatility in financial markets is likely to accelerate. Long term, our ten-year outlook for investment returns remains guarded, given the backdrop of high valuations and depressed risk-free rates across major markets.

Vanguard polled its outlook team on various scenarios. On a trade war with China, the results were an 18% chance of escalation reducing US GDP by a third; 53% GDP is reduced by 10% to 15%, and a 29% chance the whole thing blows over. Most economists, including Vanguard, predict a trade war won't last long, because the negative impact would be so devastating for both sides. But we'll see what happens.

Surprisingly, Vanguard isn't particularly worried about Brexit. It puts good, medium and bad scenarios for Italy to leave the European Union at 16%, 68% and 16%. And if Italy leaves the Union the resulting crisis may prompt other countries to leave as well. A few years ago the prospect of Greece leaving the EU had markets on edge so Italy leaving and possibly others will be a much bigger deal.

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Investment Management &
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Q&A with the Editor

Q: When I talk to others about investing, the great majority don't seem to be particularly bothered by the recent market volatility. What do they know that I don't. What am I missing? There have been some pretty big swings in the market. How can anybody ignore that?

A: First, consider that what is going on in the economy these days is not extraordinary. 2008 was extraordinary, the worst financial crisis since the Great Depression. If you are really bothered by the changes in your account value, then reduce the risk of your portfolio. More cash and bonds and less stock. The other people you are talking to perhaps are less risk averse than you are or they have a bigger percentage in bonds and/or bank accounts than you do.

A common practice of risk averse people is to check their portfolio's balance on a regular basis. The assumption they make is the balance on a given date is theirs to keep, the same way they view a bank account balance. An investor's balance starts anew every business day. To use a gambling metaphor, each day they don't close their account, they are "letting their bet ride" to the next day. Unlike betting at a roulette wheel, there is zero risk that with one spin all their chips will be gone but there is a risk some chips will be taken away.

Those who monitor their balance closely also tend to forget the good times. When the balance goes up, they feel good about it, but when it goes down they are devastated. When you look at your balance, ask what was it three months, six months or a year earlier? Maybe you're down this year, but still way ahead of where you were two years ago.

If your stocks drop 12%, and you are allocated 50% bonds, then you are down 6%, or less when bonds perform as they normally do. On \$500,000. 6% is \$30,000. If your annual withdraw rate is 4% then in the unlikely event things don't turn around, at some point you may need to reduce your annual withdraw from \$20,000 to \$18,000. That should be manageable and nothing to panic over.