# Investment Strategy Update September 30, 2018

THOMAS BAKER, CFA, J.D. LOREN WALDEN, CFA CAL BLAKE MATTHEW KENASTON

**The Landscape:** At the end of July an astounding statistic landed on our desks: 6 stocks accounted for 98% of the S&P 500 return for the year. Facebook, Apple, Amazon, Netflix, Microsoft, Google. All our portfolios have investments in these companies and as a result our year to date U.S. equity performance is up 8.3% through September 30.

The balance of companies in the S&P 500 plus major international and emerging stock markets, along with domestic and global bond markets are collectively struggling this year. Rising interest rates, slowing growth, massive debt burdens, and now, tariffs are all headwinds. To wit, year to date, cash has outperformed bonds, alternatives and international equities. We are now feeling the effects of the rising interest rate environment we had discussed would eventually occur.

We do not have the answers to where markets are going near term. But longer term, with valuations as a guide, we believe it is prudent to reduce return expectations for US Equities. More specifically, if an investor were to buy the S&P 500 today and hold it for a decade, the expected return is likely to be about zero.

As a result, we have not altered allocations and remain:

- at the low end of U.S. equity allocations but at the mid-point for overall equity exposure favoring international markets which exhibit better value
- at the low end of bond allocations because of low overall yields – note however that bonds are looking more attractive with income rising from rates increasing
- at the high end of alternative investment allocations reflecting our penchant for broad diversification when we do not have a high conviction for returns in stocks or bonds

Tariffs have been the big surprise of 2018. Interestingly, stock market averages in the U.S. have not reacted negatively to the news. International and emerging markets have declined but they were already in decline because of a strong US dollar and already bubbling trade war rhetoric. Could it be that tariffs with China are a non-event?

Eventually tariffs cause economic pain and rising costs of goods will hurt. Our economy is service based, and consumer driven. Tariffs raise costs (inflationary) and damage domestic companies dependent upon foreign (Chinese) components and materials. Tariffs are bad for economic growth. It will take time for the negative implications to move through the economy and show up in profit margins and consumer pockets. How the trade war escalates or resolves is a wild card, but it should not be ignored. Our bond managers are lengthening average maturities to take advantage of higher yields from rising rates. They are preparing for an economic slowdown which would keep rates level (or even lower) later next year and into 2020. Mildly negative returns in bonds year to date are to be expected but know that the coupon is still being paid and the negatives will resolve with time. Blue Oak portfolios are anchored by high quality bonds. This is because when the economic cycle slows, we expect a significant amount of corporate debt to lose value and this repricing harms owners of less than stellar credit. The credit market's dislocation will deliver opportunities for investors with courage and liquidity. We intend to have both. This situation has been brewing for nearly four years without any catalyst to correct. Our question now is, are tariffs a credible catalyst? We will be watching.

**Investment Change:** During the quarter one of our international stock managers, Harbor Funds, changed their portfolio management team. The new team is unproven thus we sold. This is a rare event and we have a deep bench of excellent managers to choose from for a replacement. We will have that replacement working with us once our due diligence process concludes.

Thank you for your ongoing trust.

3000 Sand Hill Road, Building 1 Suite 205 Menlo Park, CA 94025

BLUE OAK CAPITAL, LLC