Third Quarter Investment Commentary

Looking Back: Market Review

September Benchmark Returns	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	0.6%	7.7%	10.4%
iShares Russell 1000 ETF	0.4%	7.4%	10.3%
iShares Russell 1000 Value ETF	0.2%	5.6%	3.7%
iShares Russell 1000 Growth ETF	0.6%	9.1%	16.8%
iShares Russell 2000 ETF	-2.3%	3.6%	11.5%
Vanguard REIT	-2.6%	0.5%	0.4%
iShares MSCI ACWI ETF	0.6%	4.4%	4.2%
Vanguard FTSE Developed Markets ETF	0.7%	1.2%	-1.6%
Vanguard FTSE Europe ETF	0.1%	0.6%	-2.3%
Vanguard FTSE Emerging Markets ETF	-1.4%	-1.7%	-8.9%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	-0.5%	0.0%	-1.7%
Vanguard Intermediate-Term Tax-Exempt	-0.6%	-0.2%	-0.5%
iShares TIPS Bond ETF	-1.0%	-0.9%	-0.9%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.6%	2.4%	2.5%
S&P/LSTA Leveraged Loan Index	0.7%	1.8%	4.0%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.7%	-0.4%	-1.2%
Bloomberg Commodity Index	1.9%	-2.0%	-2.0%
SG Trend Index	-1.0%	2.1%	-3.2%
3-Month LIBOR	0.2%	0.6%	1.5%

US stocks rose to the top of asset class performance charts with solid returns in the second quarter. Larger-cap US stocks (Vanguard 500 Index) gain. The divergence in global stock market performance we highlighted in the second quarter widened in the third quarter with US stocks gaining and emerging-market (EM) stocks falling. The US market was propelled by continued strong profit growth, thanks in large part to the Trump corporate tax cuts. S&P 500 operating earnings per share grew 27% year over year in the third quarter—compared to their 6% long-term annualized growth rate—and a record-high 80% of S&P 500 companies reported earnings that beat the consensus expectation. Record levels of share buybacks (estimated by Goldman Sachs to reach $1 trillion for 2018) were another support for the US market. Putting it all together, the S&P 500 index hit a new high in late September and gained 7.7% for the quarter (Vanguard 500 Index). Smaller-cap stocks gained 3.6% (iShares Russell 2000 ETF).

There are always multiple factors behind short-term market moves, but the intensifying trade conflict between the United States and China was an important one for foreign markets and EM stocks in the third quarter. Another factor was the US dollar, which appreciated against other currencies during the quarter. This was a further drag on foreign stock market returns for dollar-based investors. For the quarter, EM stocks fell 1.7% (Vanguard FTSE Emerging Markets ETF). Developed international equities fared better, posting a slight gain of 1.2% (Vanguard FTSE Developed Markets ETF).

In the fixed-income markets, the 10-year Treasury yield rose to 3.05% at the end of the third quarter, flirting with a seven-year high. As such, the core bond index had a negative 0.5% return In September and was flat for the quarter (Vanguard Total Bond Market Index). However, credit-sensitive segments performed well, high yield gaining 2.4% for the quarter (ICE BofA ML U.S. High Yield Cash Pay Index)—a meaningful divergence from rate sensitive bonds that has benefited our portfolios.

At the end of September, the Federal Reserve raised the federal funds rate 25 basis points (0.25%) as expected to a range of 2% to 2.25%. The futures market is now discounting a fourth rate hike this year in December but doesn't (yet) fully reflect the Fed's own forecast of three more hikes next year.

Quarterly Portfolio Performance and Positioning Recap

EQUITIES

All our globally diversified portfolios have a modest *tactical overweight* to EM stocks and are underweight to US large-cap stocks. This positioning was beneficial in 2017, when foreign markets outperformed US markets. But so far this year, it has been a drag on returns as US stocks outperformed international and EM markets. Considering this performance divergence, we include further details on our outlook and analysis for EM and US stocks after this positioning recap.

FIXED-INCOME

Our balanced portfolios have meaningful allocations to actively managed, flexible bond funds as well as high yield funds. In the third quarter, these funds contributed positively to portfolio returns and outperformed the core investment-grade bond index. This is also true for the year-to-date period and the past several years. We continue to expect these positions to outperform over the next several years, particularly if interest rates continue to rise. The performance of our actively managed core investment-grade bond funds was also positive for the quarter. These managers have all outperformed the core bond index over our longer holding periods as well. We hold these core bond funds as risk mitigators in the event of recession or some other shorter-term “risk-off” scenario.

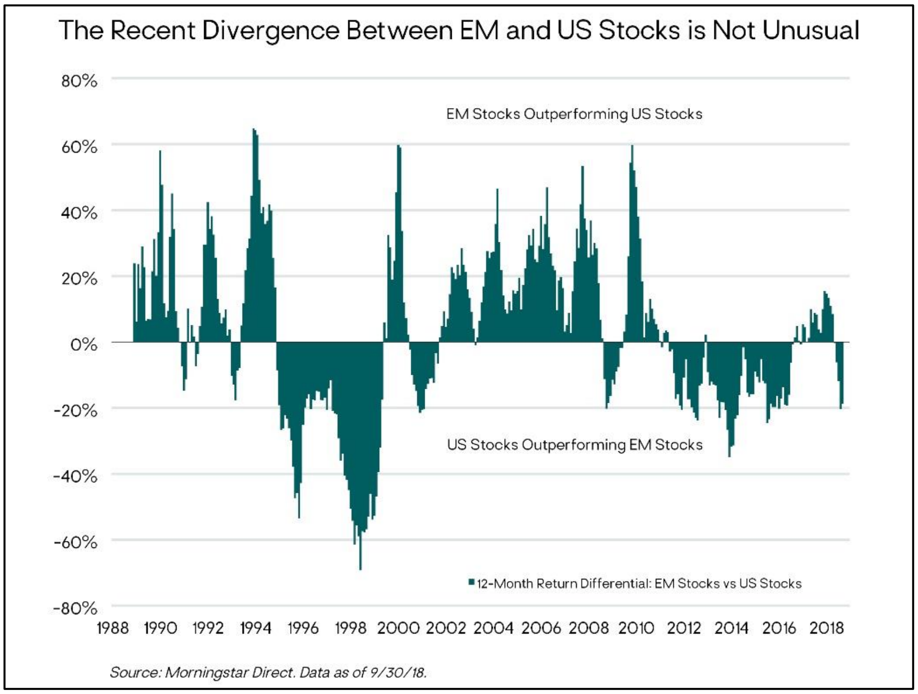
NON-TRADITIONAL INVESTMENTS

For qualified investors, our insurance and opportunistic credit strategies continue to deliver positive results and added diversification.

Reiterating our Outlook for EM Stocks

Given the negative headlines concerning emerging markets in recent months, there are several points worth highlighting. The primary takeaway is that EM equity valuations continue to look attractive, and their longer-term growth outlook remains intact.

Divergence is Not Unusual



In 2017, EM stocks gained 31.5% and outperformed the S&P 500 by 10%. That has sharply reversed this year, with US stocks beating EM by roughly 20%. This type of volatility and this divergence in relative performance is not unusual. In more than one-third (36%) of the rolling 12-month periods from January 1988 through August 2018, EM stocks beat US stocks by a margin of 10 percentage points or more. Conversely, US stocks beat EM stocks by a 10-percentage-point or more margin in another 36% of the rolling 12-month periods. So, over shorter-term periods it’s pretty rare for both markets to perform similarly. However, over this entire 30-year period, the annualized returns for EM and US stocks were an *identical* 10.8%.

A Full-Fledged Trade War is Unlikely

The prospect of an expanding trade war between the United States and China intensified in the third quarter and has caused investor sentiment to turn against emerging markets all year. Uncertainties remain, but our base case continues to be that a full-fledged trade war is unlikely since it's in neither country's interest. It's also not clear that US stocks will be less impacted by a trade war than EM stocks given the former's global presence. At the least, we may be living in a world with an overhang of trade tensions for a while.

US Dollar Strength Is Likely to Reverse Longer Term

A strong US dollar lowers EM stock returns for US dollar–based investors and negatively impacts emerging markets with dollar-denominated debt. Longer term, we believe the fiscal stimulus of tax cuts at a time when the economy is at or near full employment will cause fiscal deficits and debt levels to rise. This should be a longer-term headwind for the US dollar and a positive for EM stocks. Undervalued currencies are also a potential tailwind for emerging markets over the medium to longer term.

The Risk of Broad-Based EM Contagion is Low

Economic crises in Argentina and Turkey have made headlines. However, these economies and their financial markets are very small, and we see the risk of contagion to other more meaningful emerging markets as low. In contrast to the late 1990s EM crisis, most other EM countries' fundamentals are healthier: they have better current account balances, better debt coverage, lower dependence on foreign capital, floating rather than fixed exchange rates, and higher foreign exchange reserves. The rapid growth and high level of private sector debt in China is a potential source of concern. But we understand this risk and still believe EM stocks should outperform US stocks over our multiyear investment horizon.

US STOCKS

No one knows exactly when this record-longest and second-strongest US bull market will end. But that doesn't stop lots of investors from fooling themselves into thinking they will see the signs before the rest of the market and be able to time their exit with minimal damage. Unfortunately, that's not the way markets work in the real world.

As is often the case at turning points in financial markets, it is precisely *because* the recent cycle for US stocks has been so strong and market participants view the United States as the best game in town (or as economist David Rosenberg recently put it, "the smartest kid in the detention room") that the outlook for the *next* phase of the cycle is darkening.

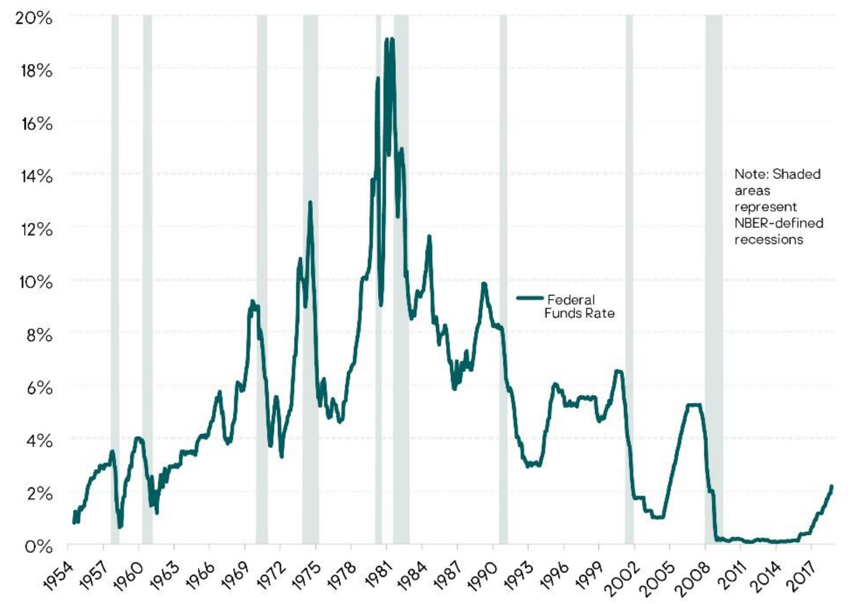
S&P 500 earnings growth expectations are now exceedingly high, and the US economy is operating at or near full capacity and full employment. These are unsustainable conditions, and the direction of their next material move is likely negative for stocks.

The tight labor market has finally translated into wage increases. History and economic theory suggest wages will continue to rise. This could negatively impact corporate profit margins and earnings growth. It could also cause companies to raise prices, which would stoke further inflation and force the Fed to tighten even more. Neither outcome is good for stock prices.

The recent rise in the dollar is likely to be another headwind for US multinational corporate profits, as it was in 2015. Trade wars, if they continue to escalate, will also have a depressing effect on sales growth and margins—both negative for earnings. The fiscal stimulus from the tax cuts has goosed corporate earnings growth this year, but those benefits will fade next year.

This huge fiscal stimulus *during a period of full employment* is unprecedented, and according to most reputable economists, ultimately counterproductive. Along with tariffs and wage growth, it also has inflationary implications. This in turn suggests the Fed will continue to raise interest rates. The Fed is projecting four more rate hikes through the end of 2019. In conjunction with the Fed's plan to unwind another $600 billion in bonds from its balance sheet next year, the table is potentially being set for monetary policy tightening consistent with those that have triggered past recessions.

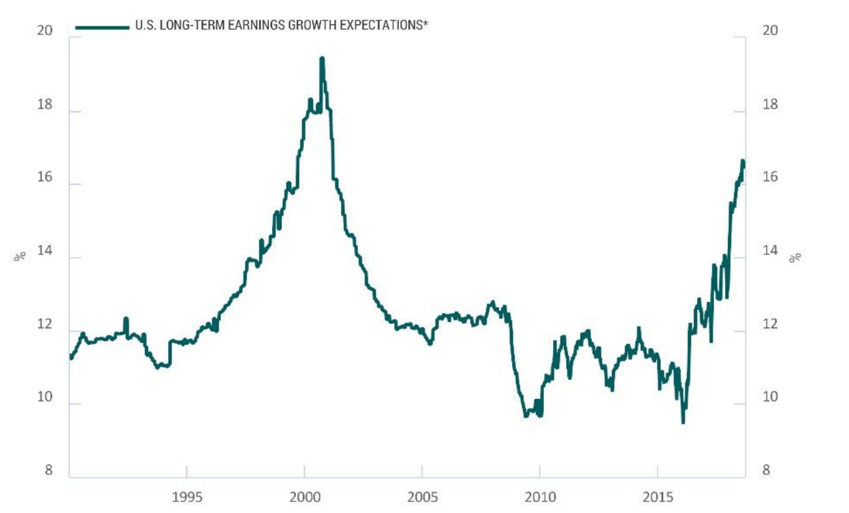
Fed Tightening and Recessions Often Go Hand-in-Hand



Source: US Federal Reserve. Data as of 9/30/18.

Coming back to S&P 500 earnings, they have been very strong over the past year, supporting the US bull market. But market earnings expectations are now *very* high. For example, BCA Research calculates that analysts expect the average S&P 500 company to grow earnings at an annual rate of 17% over the next three to five years. In BCA's words, "This is wildly optimistic." As the chart to the right shows, this forecast is topped only by the 19% growth forecast at the height of the tech bubble in 2000, just before that bear market began.

Analyst Earnings Estimates are "Wildly Optimistic"



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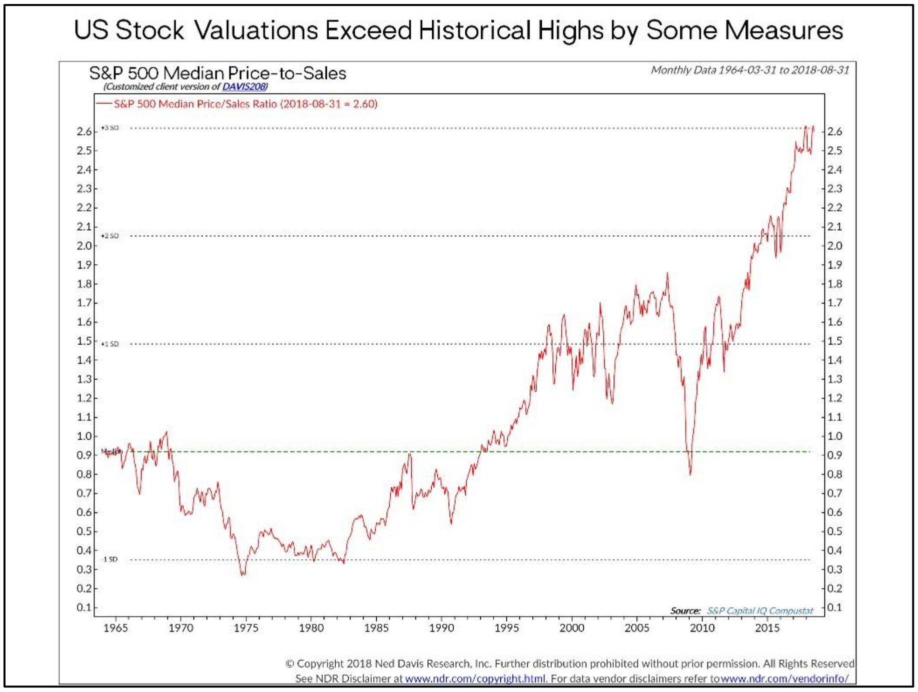
* MARKET CAP-WEIGHTED AVERAGE OF THE MEDIAN ANALYST LONG-TERM EPS GROWTH FORECAST, WHERE THE LONG-TERM GROWTH RATE IS THE EXPECTED ANNUAL INCREASE IN OPERATING EARNINGS OVER THE COMPANY'S NEXT FULL BUSINESS CYCLE. THE FORECAST REFERS TO A PERIOD BETWEEN THREE AND FIVE YEARS. SOURCE: IBES.

Ned Davis Research makes a similar point. Their analysis indicates that periods of very strong earnings and forecasted earnings growth are associated with poor *subsequent* stock market returns. The S&P 500 is now in the high-expectations/low-return zone. This may seem counterintuitive, but it is how markets operate, particularly at the extremes: when investors are extremely bullish, the market likely already reflects that optimism in current prices and valuations. The potential for actual earnings to disappoint those bullish expectations is high.

If earnings growth does fall sharply next year, it may be accompanied by a drop in valuation multiples as well. This would be a reversal of the “double-positive” effect the market has experienced from both strong earnings growth and higher valuations applied to those earnings. Capital Economics notes the market price-to-earnings ratio has tended to fall when earnings estimates have been revised down ahead of, or during, an economic slowdown. Rising interest rates from Fed tightening could also have a depressing effect on valuation multiples as higher interest rates offer more competition to stocks and reduce the discounted present value of corporate cash flows. There is certainly plenty of room for US market valuations to drop relative to history.



So, in US stocks, we have an asset class that is currently overearning, expected by the consensus to grow earnings even further above normal over the next year, and historically expensive on most reliable valuation metrics. That’s not a recipe for good returns looking forward.

Concluding Comments

By our way of thinking, being an “investor” is synonymous with having a *long time horizon*. In the financial markets, almost anything can happen in the short run because market prices are driven more by investor sentiment, unpredictable events, and human herd behavior. But as you extend your investment horizon, market returns are determined by economic and business fundamentals (earnings and dividends) and valuations (what you pay for those earnings and dividends).

No matter how we slice it, our analysis suggests the US market, on a relative and absolute basis, is the most expensive major stock market in the world and, as a result, presents a poor return-versus-risk tradeoff. We also believe skilled, fundamentally driven active managers can add a lot of value relative to market indexes in this next phase of the cycle.

Our globally diversified portfolios are positioned to perform well over the long term and to be resilient across a range of potential scenarios. Should the current trade tensions resolve, and the global economic recovery continue, we expect to generate good overall returns, with outperformance from our International holdings, active equity managers, and flexible bond funds. Alternatively, should a bear market strike, our portfolios have “dry powder” in the form of lower-risk fixed-income.

As always, we thank you for your continued confidence and trust.