THIRD QUARTER 2018

Matt's Market Update

IN THIS REPORT

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Market Review

U.S. equity indexes posted gains across all styles and market caps in Q3. The Dow Jones Industrial Average gained +4.13% in July alone and continued to rally with a gain of +9.63% for the quarter. The S&P 500 (+7.71%) and NASDAQ Composite (+7.14%) also posted strong quarterly gains. The small-cap Russell 2000 index notably lagged its large-cap peer indexes, but did post a +3.58% gain in Q3. September was particularly weak for small-caps as interest rates spiked higher to finish the quarter. Unlike larger companies with more financial flexibility, small-caps are generally thought to be more interest rate sensitive. Year-to-date, the Russell 2000 index has gained +11.51%, despite the late quarter weakness. The rally in U.S. equities has not been broad-based though. Instead, it has been driven by a small group of large-cap technology companies. This quote from the Boyar Value Group really shows how narrow the U.S. market advance has been this year: "the S&P 500, inclusive of dividends, advanced 10.56% for the first 9 months of 2018, but this movement was driven by a dwindling number of stocks. Indeed, shares of about 200 of the companies included in the S&P 500 have declined this year, and many of them have entered bear market territory, having declined by at least 20% from their peak. In short (as of the end of the 3rd quarter), about 40% of the companies in the S&P 500 are in negative territory."

The enthusiasm over U.S. stocks is masking the weak equity performance overseas. A popular global benchmark for equity performance is the MSCI All Country World Index. This index is a weighted composite of 47 sub-country indexes, including the U.S. Year-to-date, only 13 of the 47 member country indexes are positive, but the index has gained +3.83% through Q3 based on the strong showing for U.S. stocks. This contrasts with calendar year 2017, where 44 of the 47 indexes posted gains. Trade war rhetoric continues to be the main headwind for foreign equities in 2018. While trade battles are in the early innings in terms of detail and measured impact, foreign equities in many cases are seemingly being priced with worst case scenarios in mind. Emerging market equities continue to be ground zero for the worst performance this year with the average fund manager in this category posting a -9.37% decline through Q3.

Fixed-income remains under pressure with the Aggregate Index returning -0.64% for September and -1.60% YTD. The key 10-year US Treasury finished at the top of the yield range it has established over the summer with a yield of 3.05% at quarter-end. The Federal Reserve again raised short-term interest rates by 0.25% and has given no indication they intend to stop their current pattern of steady rate hikes. The market is expecting another rate hike following the Fed's December meeting. Strategies that emphasize short duration fixed-income have been the best relative performers this year.

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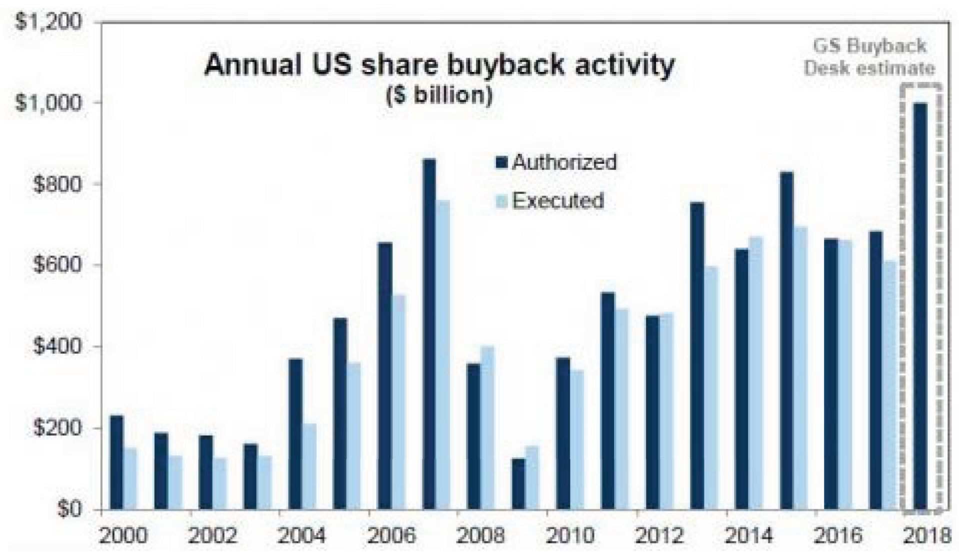
The Next Bubble to Burst?

The memories of the financial panic ten years ago are justifiably still fresh in the minds of investors. Who can forget Q4 of 2008 with the fall of Lehman Brothers, a systemic banking crisis and questions over the very survival of the financial system? Where will the next crisis emerge? One reasonable guess today is that the next panic will involve debt and more specifically, corporate investment grade debt. Consider the following stats from Gluskin Sheff research:

- There is an estimated $4.3 trillion in lower-quality corporate loans and high yield bonds outstanding today, almost double the existing liabilities eight years ago.

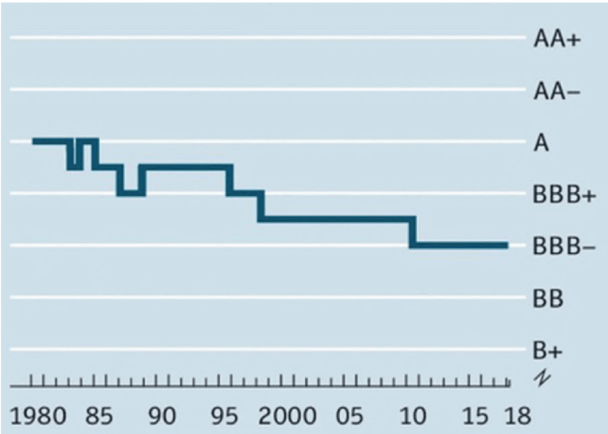
- The weighted net leverage of investment grade borrowers (valuation) is now 2.2x EBITDA (debt vs. cash flow available to service debt) vs. 1.6x EBITDA a decade ago. In other words, much more debt outstanding with less corporate cash flow to service this debt.

BUYBACK AUTHORIZATIONS HAVE SURGED IN 2018
As of August 2, 2018



Source: Birinya Associates, Goldman Sachs Global Investment Research

THE A TO B OF DECLINE
S&P Global median corporate-credit rating



Source: Economist.com

- See the chart on the left as the largest segment of the corporate bond market carries a rating of BBB-, which is one notch above junk status. Today the BBB- segment represents 55% of the outstanding debt. At the peak of the last credit expansion in 2007, the BBB- segment of the market was only 27%.

- As interest rates rise, the cost of servicing this debt and refinancing will only increase for corporate borrowers. Between now and 2020, there is $8 trillion in corporate debt that will mature and need to be retired or refinanced at higher costs.

Insider Selling at Record Levels

We've frequently commented over the years on the surge in stock buyback activity and its positive impact on the equity market. The latest numbers on this front continue to amaze. According to research from Goldman Sachs, stock buyback authorizations in 2018 have increased to a record $1.0 trillion driven primarily by tax reform and strong cash flow growth—a 46% rise from last year. According to TrimTabs Investment Research, a firm specializing in research to track market liquidity, buyback announcements surged to a record $436.6 billion in the second quarter, far

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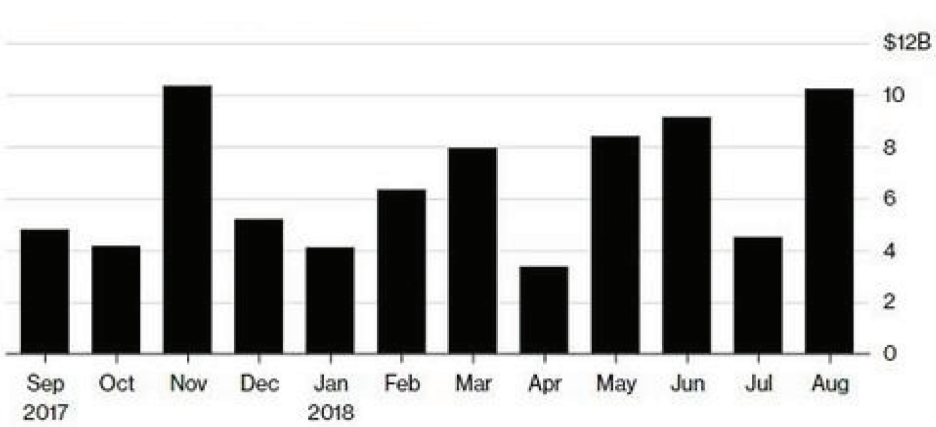


Source: Birinya Associates, Goldman Sachs Global Investment Research

surpassing the previous record of $242.1 billion set just one quarter earlier, in Q1. Combined, this meant that buybacks in the first half totaled an incredible $680 billion. Annualizing these results may indicate that Goldman's revised estimate may in fact be conservative.

While corporations are spending record amounts on stock repurchases, a completely different picture emerges when looking at the company insiders. The management or others defined as "insiders" of these companies (who possess the best information on the company prospects) are selling stock in record amounts. In fact, according to TrimTabs, insider selling reached over $450 million per day in August for a monthly amount of $10 billion, the highest monthly amount in 2018 and nearly a record for any single month. According to the latest data available as of September 21st, TrimTabs reports that insiders are selling stock at the fastest pace in September of the last decade, just as buyback announcements have hit record levels. "While insiders are selling hard with their own money, they've committed record amounts of shareholders' money to prop up stock prices this year," said David Santschi, Director of Liquidity Research at TrimTabs. There are many benign reasons for insider selling including diversification, liquidity needs and tax planning. But would the volume of selling be at record levels if the outlook for economic growth and corporate earnings is as strong as forecast? If nothing else, the record selling by insiders is certainly another red flag for equity investors to be aware of as the S&P 500 has not had a negative performance year since 2008.

Wealth Management Corner

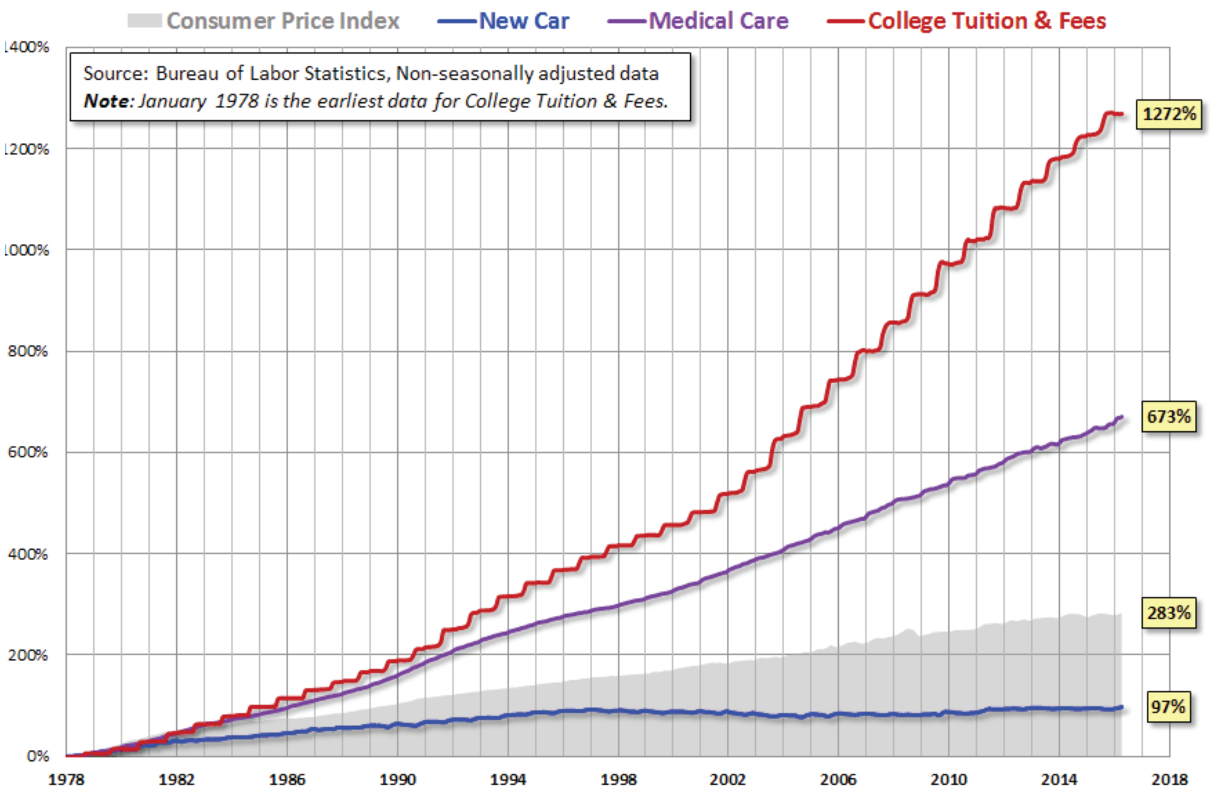
David Batchelder, CFA, CFP
Senior Investment Officer

When did college become so expensive? Well, according to the chart on the next page with data provided by the Bureau of Labor Statistics, the cost of tuition and related fees have risen almost twice as much as medical care since 1978, with the majority of the increase coming since the year 2000. Per the College Board, Trends in College 2017, the average cost of a year at a public college for year 2017/2018 is $25,290, while a private college is $50,900 per year.

The real question becomes, how are burgeoning adults and their families going to be able to afford this costly endeavor? There are several education specific vehicles available. What we want to touch on are a few of the most popular options to save for a child's education. Contributions to these vehicles are also seen as great gifting tools for parents and grandparents. The options we will touch on include 529 plans, Education Savings Accounts and Uniform Transfers to Minors Act (UTMA) accounts:

529 Plan is probably the most famous of the savings vehicles. Yet this could be the most confusing option of the bunch. Every state plus the District of Columbia sponsors a plan. Individuals are not required to open an account in their state of residence. A few, high level positives of these

INTERESTING INFLATION COMPARISONS
Consumer Price Index in Gray



plans are that they grow tax-free, they generally don't have any income or age limitations, and contribution rates are high. It should be noted that distributions from these vehicles are primarily tax-free and penalty-free only if they are used for qualified expenses. You can also change the beneficiary within the family in case one family member does not attend college. Even though investors are not required to invest in the plan in their state of residence, it may make sense to do so since some states offer 529 plan tax deductions for residents. Importantly and new in 2018, $10,000 of a 529 account's balance can now be used to cover private education expenses for kindergarten through grade 12.

Education Savings Accounts (ESA) are a second popular option, formerly known as Coverdell ESAs. ESA has some big differences with a 529 plan. For one, the ESA only allows $2,000 in contributions per child, per year. Even though the contribution amounts are limited, the funds grow tax-free and can be withdrawn tax-free for most school related expenses, no matter the grade. Also, importantly for some that like to invest on their own, the account's investment options are not limited as they would be in a 529 plan. This account needs to be spent by the beneficiary's age of 30, while there is no age requirement on needing to spend the 529.

UTMAs are oftentimes considered the third leg of the college savings stool. The big difference between these accounts and the two above is that these accounts are not just designed for education savings. This particular account is held in the name of the child until they turn generally either 18 or 21, depending on the state of residency. At the state appropriate age, the account turns over to the control of the child. These accounts can be used for pretty much anything. Paying college expenses with the account is not required. This may scare some parents as the beneficiary cannot be changed after the account is opened and funded.

To summarize, there are many ways to save for college on top of the three mentioned. More than the three common ones mentioned here. The key is to start early and, if at all possible, set up an automatic investment plan. Starting as soon as you have a new child's social security number is a great idea. Unfortunately, the meteoric rise in tuition costs does not look to be slowing down soon. If you would like to discuss a plan to start saving for that special child in your life, please reach out to one of our Financial Planners. We are ready to help.

Our Portfolio Strategy & Allocation Outlook

We made several changes to our managed accounts during the quarter. We sold our position in the SPDR Gold ETF across the portfolios. After logging a gain in 2017, we saw much of the gain evaporate this year as markets have been more favorable to risk assets. In addition, with short-term interest rates on the rise, this helps to strengthen the value of the U.S. dollar, which historically is a negative for gold. As the Federal Reserve is likely to continue their current campaign of interest hikes well into 2019, we decided to step aside from the gold position for now. We certainly may look to re-enter a gold position in the future as we still believes it offers valuable diversification benefits and more safety during volatile periods for stocks. We also added a position across the portfolios in the Hartford Multifactor Developed Markets ex US ETF (RODM) in August to diversify from the market cap index further. The three factors underlying this strategy are low valuation (50% weighting), high momentum (30%) and high quality (20%). The strategy provides a broader market cap than the index. RODM includes mid/small caps, and holdings are sized at approximately 75 basis points each, with 2.5% range around the benchmark's sector weighting and 2% range around the benchmark's country weighting. The ETF rebalances twice a year. In terms of inception performance, the fund has shown less risk, higher alpha, lower beta and better upside/downside risk compared to the index ETF. This move allows us to tilt a bit more from the top-heavy, market cap weighted index.

The changes enacted this quarter were not completed at the same time and as a result the portfolios held a modest 7-8% in cash for several weeks while we finished up some final details regarding our research and trades. This prompted a few questions from clients as to why we were holding cash. Now might be a good time to explain our thoughts on the virtues of cash. First, we typically never have more than a token percentage held in cash. Most often, as was the case this quarter, the cash is a byproduct of trade decisions and there will be infrequent times where cash is allowed to accumulate in the portfolios. This is not a market timing decision. Second, we'll note that cash has beaten most fixed-income categories (without principal risk) in 2018. As we write this report in early Q4, market volatility has returned in dramatic fashion and we'd guess that most clients would appreciate some added cash in their portfolios. Third, thanks to recent action by the Fed, money market funds are now yielding a more respectable rate thus decreasing the opportunity cost to holding cash. In fact, 3 month T-bills (a risk-free asset) at quarter-end yielded approximately 2.25%, beating the dividend yield on the S&P 500 by nearly 50 basis points. Only two years ago, the same T-bills offered yields of just 0.3%. So cash is no longer trash and the asset class now represents real competition to risk assets for those investors who don't want to take on the equity risk. Finally, with cash paying a respectable yield today, it allows the investor some optionality as that cash on hand can be put quickly to work if an opportunity presents itself.

Finally, as Q3 has ended, it's time for our 12th annual recommended reading list. This year we present two books firmly "outside the box." The first highlighting perhaps today's most controversial investment topic: Bitcoin. The second challenging everything you thought you might have known about investing.

1. *Digital Gold: Bitcoin and the Inside Story of the Misfits and Millionaires Trying to Reinvent Money.* By Nathaniel Popper. Bitcoin? Blockchain? Cryptocurrencies? Have you heard these terms and wonder what they refer to? This book chronicles the beginning of Bitcoin and the personalities who've brought it into existence. Reading like a page-turner, and not a technical journal, this book will keep you engrossed and provide you with a basic understanding of this controversial new technology.

2. *How Do You Know?: A Guide to Clear Thinking About Wall Street, Investing & Life.* By Chris Mayer. The foreword to this book begins with the phrase "Nobody Knows Anything" and the subsequent pages make you realize the truth in that statement. For those of you who invest your own assets (or the professional investors reading this commentary), this is a book that makes you think about what you really know

and may alter how you approach the investing process.

Please let us know if you'd like to discuss your personal investing and financial planning needs.

Matthew H. McPhail, CFA
Chief Investment Officer

David Batchelder, CFA, CFP
Senior Investment Officer

Market Scoreboard

Index Returns (%)	Q3 2018	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	7.71	10.56	17.91	17.30	13.95	11.97
DJIA	9.63	8.83	20.76	20.49	14.57	12.23
NASDAQ	7.14	16.56	23.87	20.31	16.37	14.42
Russell 2000	3.58	11.51	15.24	17.12	11.07	11.11
MSCI ACWI Ex USA	0.71	-3.09	1.76	9.97	4.12	5.18
Barclays Aggregate Bond	0.02	-1.60	-1.22	1.31	2.16	3.77
Bloomberg Commodity TR	-2.02	-3.09	2.59	-0.11	-7.18	-6.24

Source: Morningstar

S&P 500 TR: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the large-cap segment of stock market.

Russell 2000 TR: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 7% of the Russell 3000 total market capitalization often used as a proxy for the small-cap segment of the stock market.

Barcap Aggregate Bond TR: The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S.

MSCI EAFE NR USD: Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes that collectively represent many of the major markets of the world.

DJ US Industrials TR USD: Computed by summing the prices of the stocks of 30 U.S. companies and then dividing that total by an adjusted value--one which has been adjusted over the years to account for the effects of stock splits on the prices of the 30 companies.

NASDAQ: Measures the performance of all issues listed in the Nasdaq Stock Market and is often used as a proxy for the large-cap technology segment of the U.S. stock market.

DJ/UBS Commodity: The DJ-UBSCI is composed of futures contracts on physical commodities and is often used as a proxy for broad-based exposure to the commodity markets.

Date of First Use: 10/30/2018 | QMR-062-10252018

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