GROVE STREET FIDUCIARY, LLC

WEALTH AND TRUST ADVISORS

*OCTOBER 2018*

# MARKET COMMENTARY & QUARTERLY MARKET REVIEW


**CARL A. JOHNSON**
MBA, CFP®, AIF®
*OWNER & CHIEF INVESTMENT STRATEGIST*



**HAZEL E. HENSEL**
CFP®
*MANAGING DIRECTOR*



**ELINE RUEDIGER**
CFP®
*FIDUCIARY ADVISOR*



**LISA A. CAREY**
*FINANCIAL OPERATIONS PROFESSIONAL*



**STEPHANIE SAMUELSON**
*FINANCIAL PARAPLANNER QUALIFIED PROFESSIONAL™*



**ERIN E. CODY**
*FINANCIAL PARAPLANNER QUALIFIED PROFESSIONAL™*

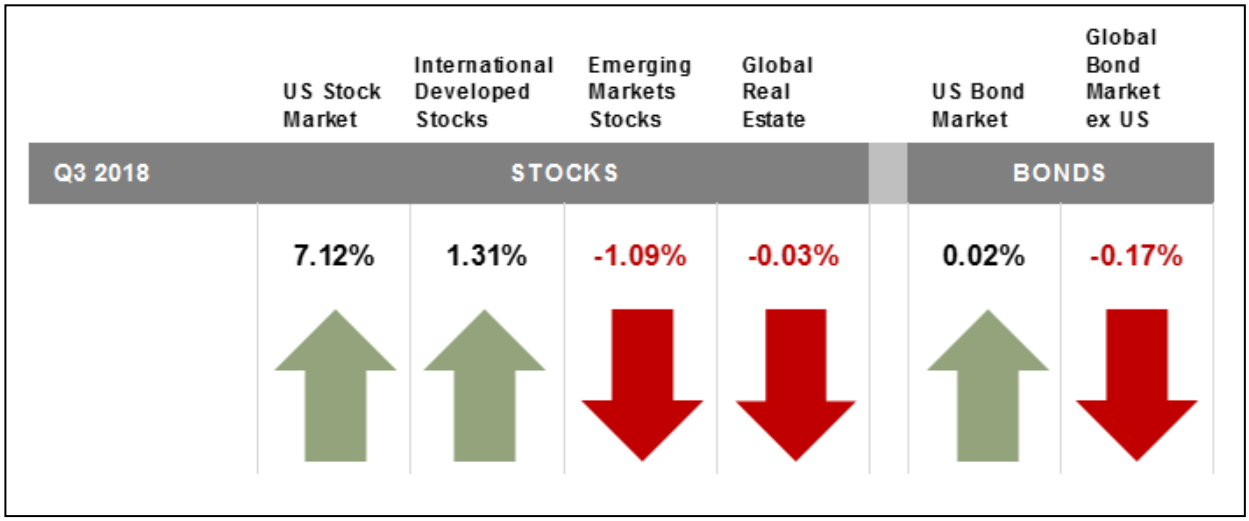


20 GROVE STREET
PETERBOROUGH, NH 03458
PHONE: 603.924.9939
WWW.GROVESTREETFIDUCIARY.COM

**Market Commentary: October 2018**

If you tuned into the market's ugly slide last week, it may be hard to believe that three weeks ago the U.S. market was setting new all-time highs. This downturn has been sudden, but is not particularly noteworthy — yet. The unfortunate reality of investing in stocks is that these types of market spasms are common. In fact, last Wednesday was the 20th time the S&P 500 has fallen 3% or more in a single day since the last bear market ended in 2009. What was the reason? The general belief among economists is that markets are beginning to realize the impacts of higher interest rates and the U.S./China trade disputes. Brexit and Italian debt concerns added to the selling pressure.

As the U.S. markets were making all-time highs, you might have wondered why your portfolio was not doing the same. *With a globally diversified portfolio, you are guaranteed never to be the biggest winner. Fortunately, a globally diversified portfolio is guaranteed never to be the biggest loser either.* One's surprise at not achieving a high rate of return will be pleasantly offset by not achieving a very negative return later. The best surprise however, is the one that happens over time – the amazing growth from the consistent compounding of a balanced return. Beyond having a smoother investment experience, your portfolio has a tremendous advantage over one that is highly concentrated in a single asset class. Before I get to that advantage, let's review the returns for the quarter.




The arrows above (also found on page 2) reveal that the markets had mixed results for the quarter, but the news was focused primarily on the superior returns for U.S. stocks. The S&P 500, an index of the largest stocks in the U.S., had its best quarter in five years. The opposite was true of Emerging Market stocks as they continued their decline that began about nine months ago. U.S. and International bonds were flat for the quarter.

In contrast to 2017, when global stocks rose broadly in every month of the year, the synchronized global growth story ended in 2018. *The divergence between the U.S. and Emerging Market stocks recently hit its most extreme level in 14 years*. For a global investor, this is a clear rebalancing opportunity. Systematically, we are working with you to adjust your investments for opportunities like this while at the same time reducing your risk. Herein lies the tremendous advantage of a diversified global portfolio: flexibility.

As fiduciaries, our recommendations are based first upon your needs and second upon proven principles. Diversity reduces risk, but it also provides for flexibility. We know that in any negotiation, the party with the most choices, the most patience, and the least need, will inevitably win. Having investments in at least five major asset classes, your portfolio is positioned to win any market negotiation. *You are not forced to sell and you are able to buy whatever "sale" the market presents.* Without this flexibility, you would not be able to take advantage of asset classes that have gone on sale relative to others. We have extensively studied investment mistakes – and we know how to avoid them. Having a diverse and flexible investment portfolio is critical. We also know the best investment opportunities often present themselves in disguise. [For an extended discussion on this, see the attached *Wall Street Journal* article at the end of this commentary, Jason Zweig's "The 'Dumb' Money Is Bailing on U.S. Stocks."]

Market corrections and recessions separate the prepared investor from the haphazard one. Our guidance is designed to make your portfolio a little more valuable each quarter. Together, we will discuss and assess the best steps forward as global markets create risk and opportunities. It may be cost reductions, tax planning and tax reductions, or selective rebalancing. In the end, the long run is made up of many short runs. We are very honored to be helping you at every turn.

Year-end note: From now to the end of December, we want to shape your tax picture to take advantage of opportunities to reduce taxes, make your portfolio more tax efficient, review your gifting plans, and more. Please ensure we are aware of any special circumstances or desires you have.

*"A man who wants to lead the orchestra must turn his back on the crowd." – James Crook*

*"If passion drives, let reason hold the reins." – Benjamin Franklin*

Best regards,

Carl Amos Johnson, MBA, CFP®, AIF®
October 15, 2018


# Q3

## Quarterly Market Review

Third Quarter 2018

# Market Summary

## Index Returns


| | US Stock Market | International Developed Stocks | Emerging Markets Stocks | Global Real Estate | US Bond Market | Global Bond Market ex US |
|---|---|---|---|---|---|---|
| **Q3 2018** | **STOCKS** | | | | **BONDS** | |
| | **7.12%** | **1.31%** | **-1.09%** | **-0.03%** | **0.02%** | **-0.17%** |
| **Since Jan. 2001** | | | | | | |
| Avg. Quarterly Return | 2.0% | 1.5% | 2.9% | 2.6% | 1.1% | 1.1% |
| Best Quarter | 16.8% | 25.9% | 34.7% | 32.3% | 4.6% | 4.6% |
| | 2009 Q2 | 2009 Q2 | 2009 Q2 | 2009 Q3 | 2001 Q3 | 2008 Q4 |
| Worst Quarter | -22.8% | -21.2% | -27.6% | -36.1% | -3.0% | -2.7% |
| | 2008 Q4 | 2008 Q4 | 2008 Q4 | 2008 Q4 | 2016 Q4 | 2015 Q2 |

**Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]). 

# Market Summary

## Index Returns


| | US Stock Market | International Developed Stocks | Emerging Markets Stocks | Global Real Estate | US Bond Market | Global Bond Market ex US |
|---|---|---|---|---|---|---|
| **Q2 2018** | **STOCKS** | | | | **BONDS** | |
| | **3.89%** | **-0.75%** | **-7.96%** | **6.05%** | **-0.16%** | **0.48%** |
| **Since Jan. 2001** | | | | | | |
| Avg. Quarterly Return | 2.0% | 1.5% | 3.0% | 2.6% | 1.1% | 1.1% |
| Best Quarter | 16.8% | 25.9% | 34.7% | 32.3% | 4.6% | 4.6% |
| | Q2 2009 | Q2 2009 | Q2 2009 | Q3 2009 | Q3 2001 | Q4 2008 |
| Worst Quarter | -22.8% | -21.2% | -27.6% | -36.1% | -3.0% | -2.7% |
| | Q4 2008 | Q4 2008 | Q4 2008 | Q4 2008 | Q4 2016 | Q2 2015 |

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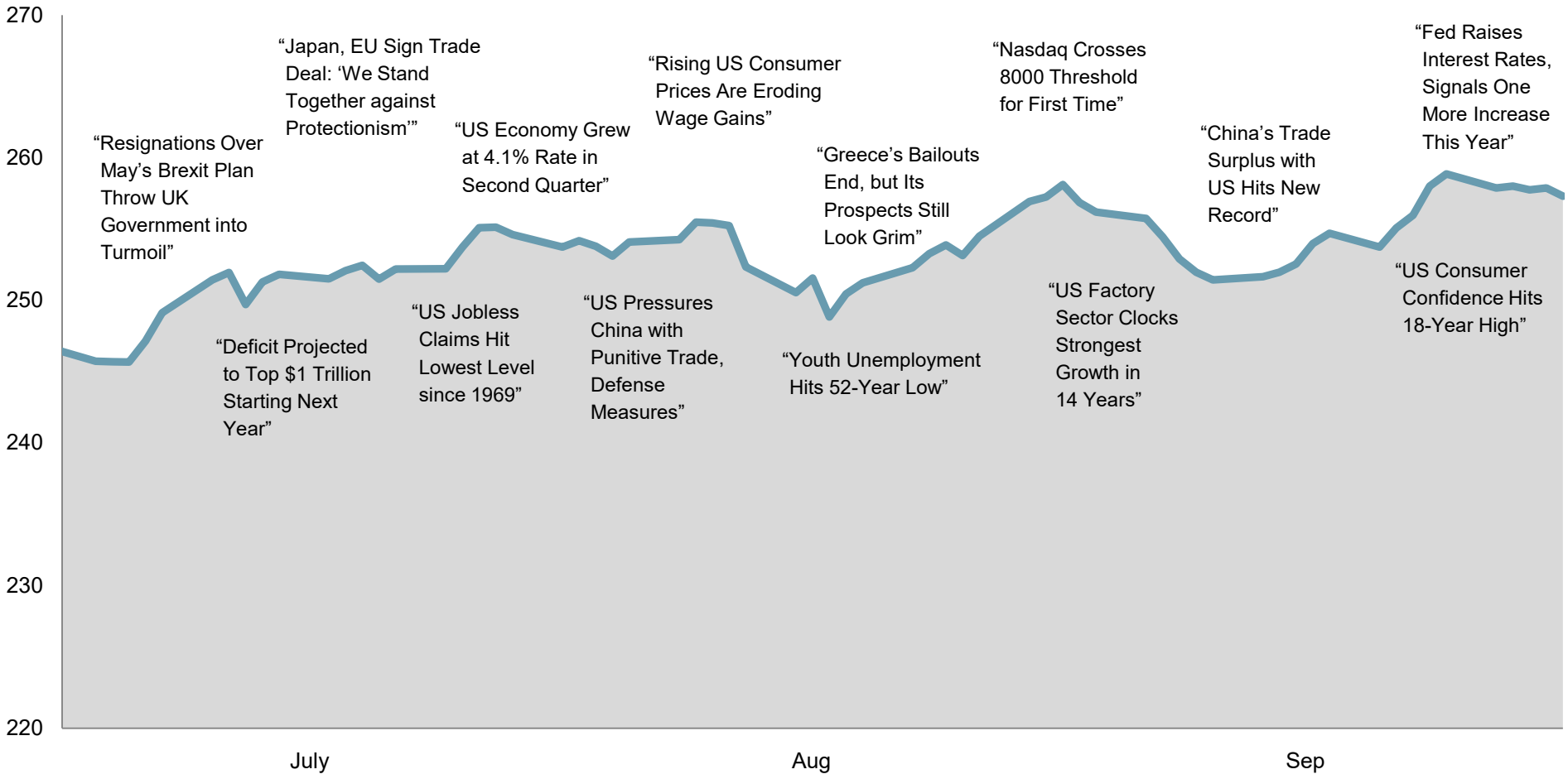
# World Stock Market Performance

## MSCI All Country World Index with selected headlines from Q3 2018

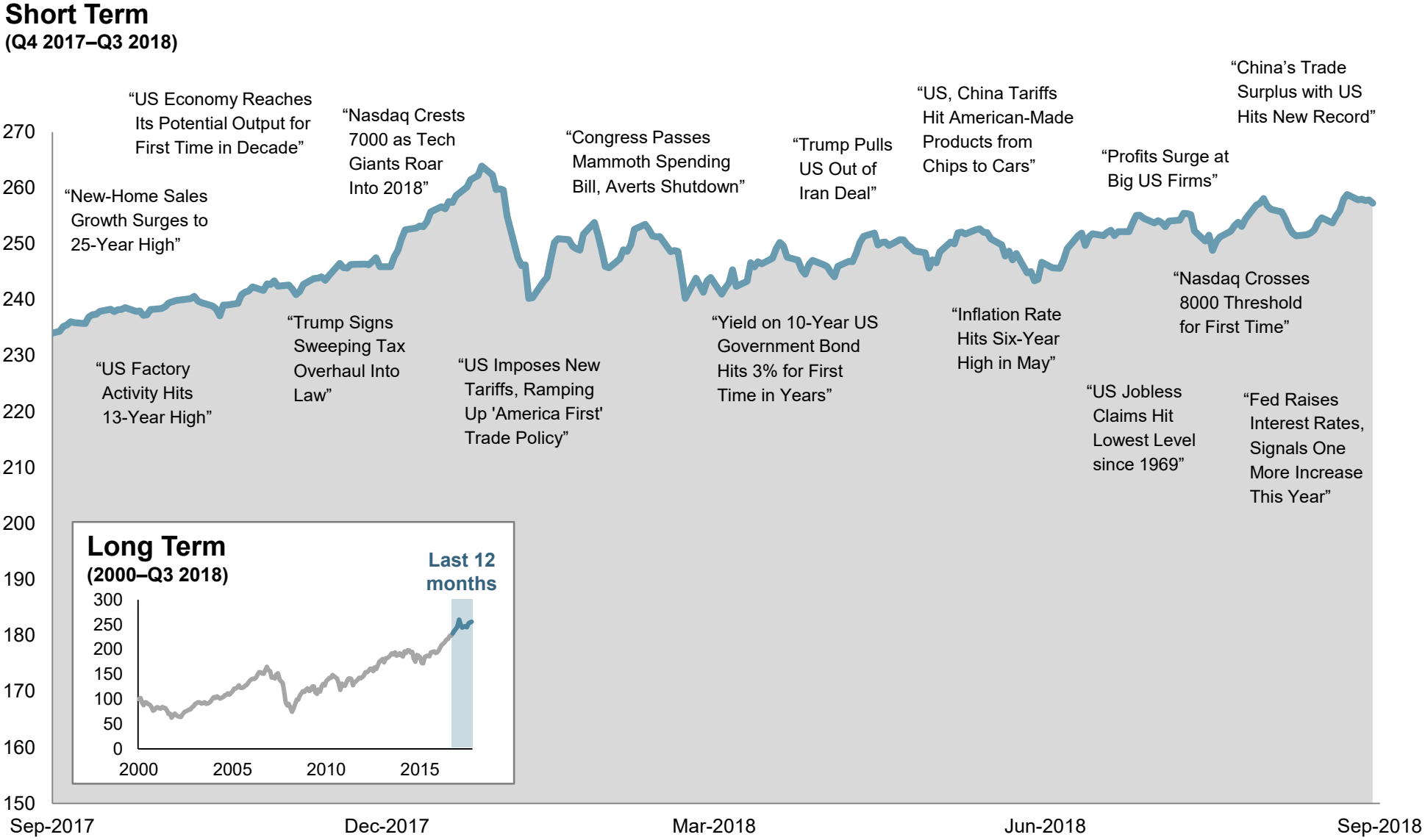



These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

Graph Source: MSCI ACWI Index [net div.]. 
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results**.

# World Stock Market Performance

## MSCI All Country World Index with selected headlines from past 12 months

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Graph Source: MSCI ACWI Index [net div.]. 
It is not possible to invest directly in an index. Performance does not reflect the expenses associated with management of an actual portfolio. **Past performance is not a guarantee of future results**.

# US Stocks

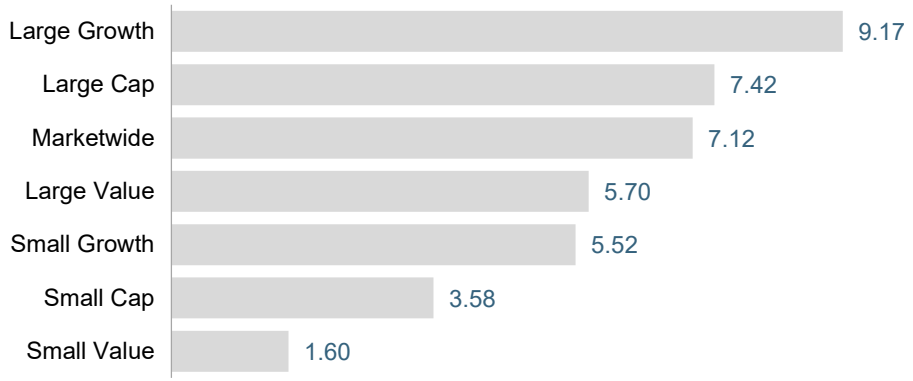
## Third Quarter 2018 Index Returns


The US equity market posted a positive return, outperforming both non-US developed and emerging markets.

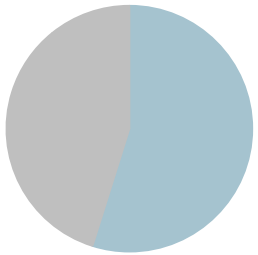
Value underperformed growth in the US across large and small cap stocks.

Small caps underperformed large caps in the US.

### Ranked Returns for the Quarter (%)




### World Market Capitalization—US



55%

**US Market**
$29.7 trillion

### Period Returns (%)

** Annualized*

| Asset Class | YTD | 1 Year | 3 Years* | 5 Years* | 10 Years* |
|---|---|---|---|---|---|
| Large Growth | 17.09 | 26.30 | 20.55 | 16.58 | 14.31 |
| Small Growth | 15.76 | 21.06 | 17.98 | 12.14 | 12.65 |
| Small Cap | 11.51 | 15.24 | 17.12 | 11.07 | 11.11 |
| Marketwide | 10.57 | 17.58 | 17.07 | 13.46 | 12.01 |
| Large Cap | 10.49 | 17.76 | 17.07 | 13.67 | 12.09 |
| Small Value | 7.14 | 9.33 | 16.12 | 9.91 | 9.52 |
| Large Value | 3.92 | 9.45 | 13.55 | 10.72 | 9.79 |

**Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: Marketwide (Russell 3000 Index), Large Cap (Russell 1000 Index), Large Cap Value (Russell 1000 Value Index), Large Cap Growth (Russell 1000 Growth Index), Small Cap (Russell 2000 Index), Small Cap Value (Russell 2000 Value Index), and Small Cap Growth (Russell 2000 Growth Index). World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. Russell 3000 Index is used as the proxy for the US market. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2018, all rights reserved.

# International Developed Stocks

## Third Quarter 2018 Index Returns

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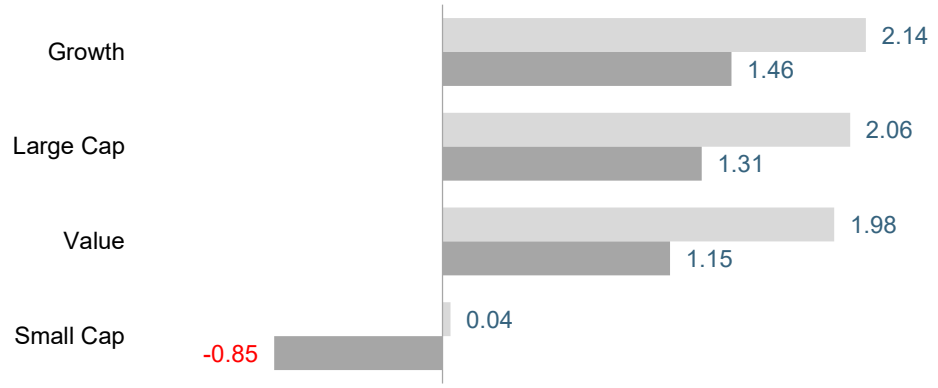
In US dollar terms, developed markets outside the US underperformed the US but outperformed emerging markets during the quarter.

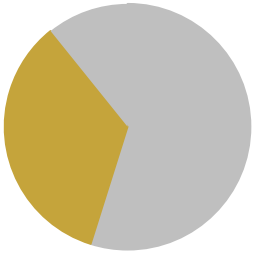
Large cap value stocks underperformed large cap growth stocks in non-US developed markets; however, small cap value outperformed small cap growth.

Small caps underperformed large caps in non-US developed markets.

### Ranked Returns (%)




### World Market Capitalization—International Developed



**34%**

**International Developed Market**
$18.6 trillion

### Period Returns (%)

** Annualized*

| Asset Class | YTD | 1 Year | 3 Years* | 5 Years* | 10 Years* |
|---|---|---|---|---|---|
| Growth | 0.39 | 5.47 | 9.91 | 5.37 | 5.78 |
| Large Cap | -1.50 | 2.67 | 9.32 | 4.24 | 5.18 |
| Small Cap | -2.28 | 3.42 | 12.23 | 7.07 | 9.04 |
| Value | -3.43 | -0.13 | 8.65 | 3.05 | 4.51 |

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# Emerging Markets Stocks

## Third Quarter 2018 Index Returns

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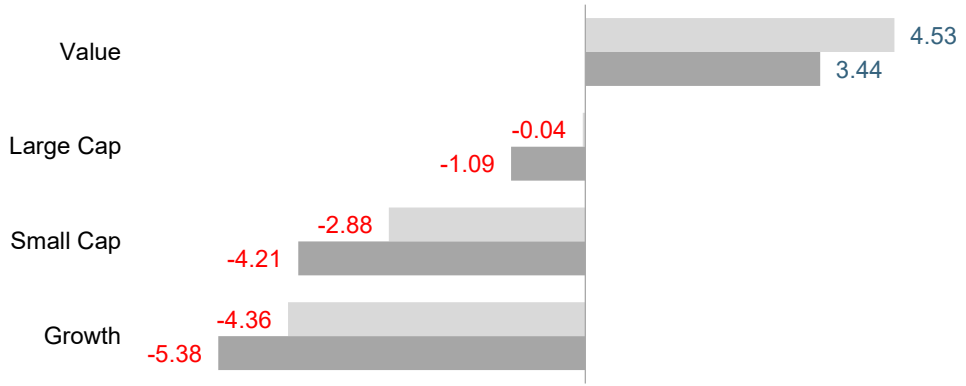
In US dollar terms, emerging markets posted negative returns for the quarter, underperforming developed markets including the US.

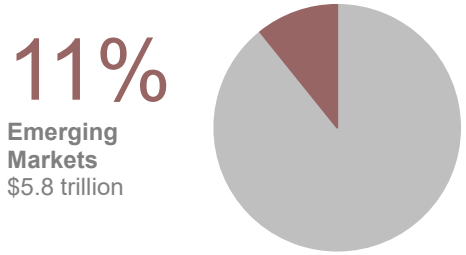
The value effect was positive, particularly in large caps in emerging markets.

Small caps underperformed large caps.

### Ranked Returns (%)




### World Market Capitalization—Emerging Markets




### Period Returns (%)

** Annualized*

| Asset Class | YTD | 1 Year | 3 Years* | 5 Years* | 10 Years* |
|---|---|---|---|---|---|
| Value | -4.28 | 2.27 | 11.55 | 2.04 | 4.53 |
| Large Cap | -7.68 | -0.81 | 12.36 | 3.61 | 5.40 |
| Growth | -10.94 | -3.89 | 13.03 | 5.08 | 6.18 |
| Small Cap | -12.30 | -4.20 | 7.43 | 2.72 | 7.43 |

**Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: Large Cap (MSCI Emerging Markets Index), Small Cap (MSCI Emerging Markets Small Cap Index), Value (MSCI Emerging Markets Value Index), and Growth (MSCI Emerging Markets Growth Index). All index returns are net of withholding tax on dividends. World Market Cap represented by Russell 3000 Index, MSCI World ex USA IMI Index, and MSCI Emerging Markets IMI Index. MSCI Emerging Markets IMI Index used as the proxy for the emerging market portion of the market. 

# Real Estate Investment Trusts (REITs)

## Third Quarter 2018 Index Returns

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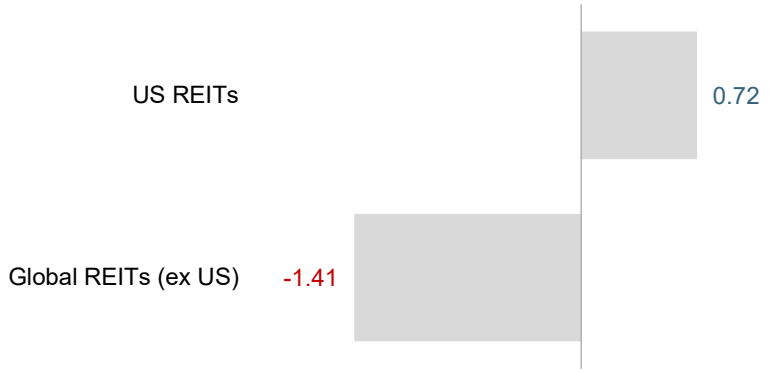
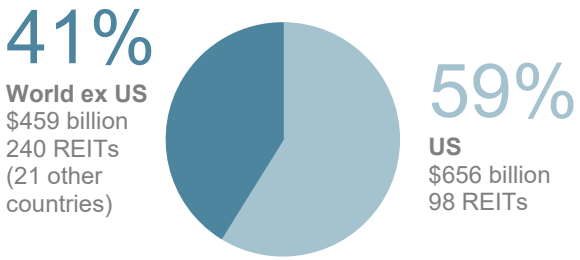
US real estate investment trusts outperformed non-US REITs in US dollar terms.

### Ranked Returns (%)




### Total Value of REIT Stocks




### Period Returns (%)

** Annualized*

| Asset Class | YTD | 1 Year | 3 Years* | 5 Years* | 10 Years* |
|---|---|---|---|---|---|
| Dow Jones US Select REIT Index | 2.56 | 4.59 | 6.88 | 9.14 | 7.21 |
| S&P Global ex US REIT Index (net div.) | -2.88 | 3.39 | 5.66 | 4.18 | 5.40 |

**Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Number of REIT stocks and total value based on the two indices. All index returns are net of withholding tax on dividends. Total value of REIT stocks represented by Dow Jones US Select REIT Index and the S&P Global ex US REIT Index. Dow Jones US Select REIT Index used as proxy for the US market, and S&P Global ex US REIT Index used as proxy for the World ex US market. 

# Commodities

## Third Quarter 2018 Index Returns


The Bloomberg Commodity Index Total Return declined 2.02% in the third quarter.

The energy complex led performance. Heating oil gained 5.63%, and Brent oil returned 5.21%.

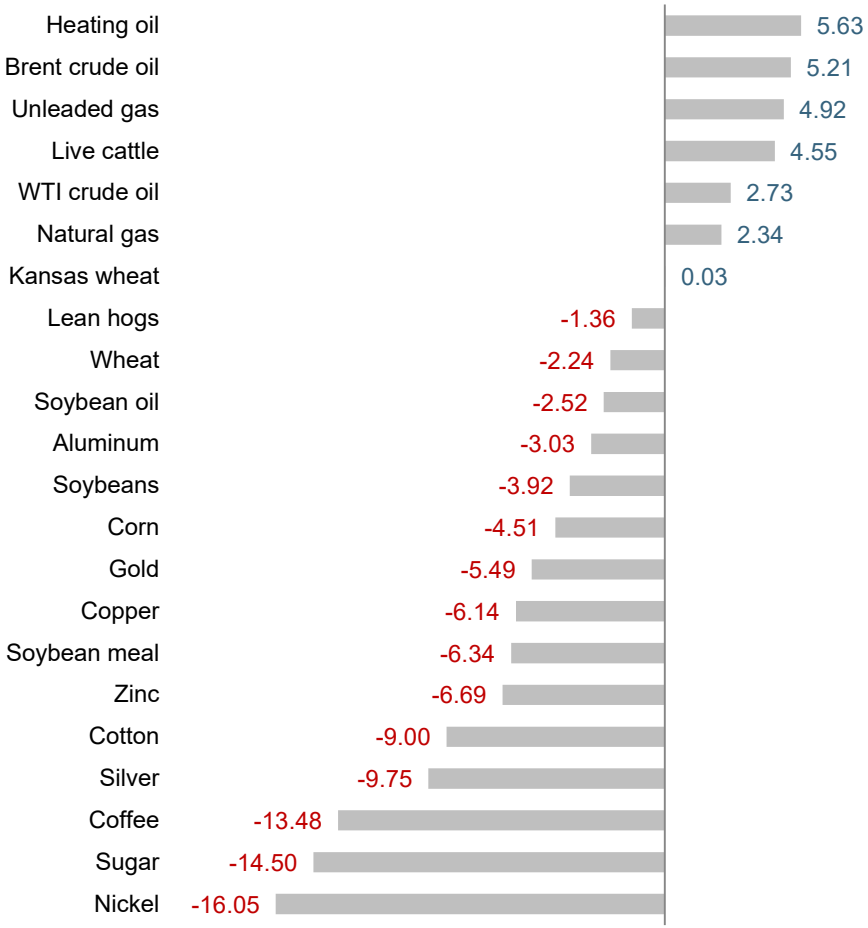
Nickel, the worst-performing commodity, declined 16.05%. Sugar lost 14.50%, and coffee fell 13.48%.

### Period Returns (%)

** Annualized*

| Asset Class | QTR | YTD | 1 Year | 3 Years* | 5 Years* | 10 Years* |
|---|---|---|---|---|---|---|
| Commodities | -2.02 | -2.03 | 2.59 | -0.11 | -7.18 | -6.24 |

### Ranked Returns for Individual Commodities (%)




**Past performance is not a guarantee of future results. Index is not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.**
Commodities returns represent the return of the Bloomberg Commodity Total Return Index. Individual commodities are sub-index values of the Bloomberg Commodity Total Return Index. Data provided by Bloomberg.

# Fixed Income

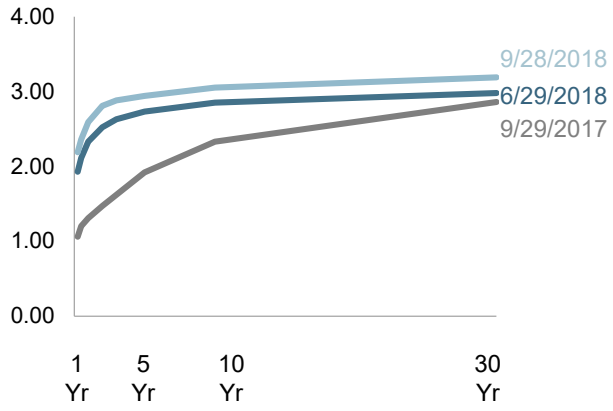
## Third Quarter 2018 Index Returns


Interest rates increased in the US during the third quarter. The yield on the 5-year Treasury note rose 21 basis points (bps), ending at 2.94%. The yield on the 10-year Treasury note increased 20 bps to 3.05%. The 30-year Treasury bond yield rose 21 bps to 3.19%.

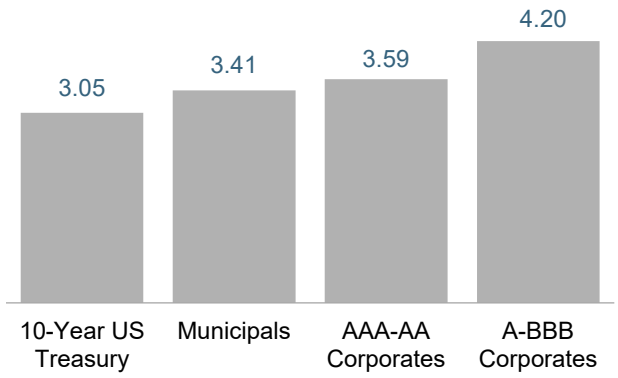
On the short end of the yield curve, the 1-month Treasury bill yield increased 35 bps to 2.12%, while the 1-year Treasury bill yield rose 26 bps to 2.59%. The 2-year Treasury note yield finished at 2.81% after an increase of 29 bps.

In terms of total return, short-term corporate bonds gained 0.71%, while intermediate-term corporates returned 0.80%. Short-term municipal bonds declined 0.11%, while intermediate-term munis dipped 0.06%. Revenue bonds (–0.16%) performed in line with general obligation bonds (–0.14%).

### US Treasury Yield Curve (%)




### Bond Yields across Issuers (%)




Period Returns (%) *Annualized

| Asset Class | QTR | YTD | 1 Year | 3 Years* | 5 Years* | 10 Years* |
|---|---|---|---|---|---|---|
| Bloomberg Barclays US High Yield Corporate Bond Index | 2.40 | 2.57 | 3.05 | 8.15 | 5.54 | 9.46 |
| ICE BofAML US 3-Month Treasury Bill Index | 0.49 | 1.30 | 1.59 | 0.84 | 0.52 | 0.34 |
| ICE BofAML 1-Year US Treasury Note Index | 0.41 | 1.07 | 1.08 | 0.74 | 0.55 | 0.71 |
| FTSE World Government Bond Index 1-5 Years (hedged to USD) | 0.17 | 0.58 | 0.64 | 1.04 | 1.26 | 1.90 |
| Bloomberg Barclays US Aggregate Bond Index | 0.02 | -1.60 | -1.22 | 1.31 | 2.16 | 3.77 |
| Bloomberg Barclays Municipal Bond Index | -0.15 | -0.40 | 0.35 | 2.24 | 3.54 | 4.75 |
| FTSE World Government Bond Index 1-5 Years | -0.63 | -1.68 | -1.39 | 0.84 | -1.16 | 0.88 |
| Bloomberg Barclays US TIPS Index | -0.82 | -0.84 | 0.41 | 2.04 | 1.37 | 3.32 |
| Bloomberg Barclays US Government Bond Index Long | -2.82 | -5.71 | -3.50 | 0.78 | 4.41 | 5.45 |

One basis point equals 0.01%. **Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Yield curve data from Federal Reserve. State and local bonds are from the S&P National AMT-Free Municipal Bond Index. AAA-AA Corporates represent the Bank of America Merrill Lynch US Corporates, AA-AAA rated. A-BBB Corporates represent the Bank of America Merrill Lynch US Corporates, BBB-A rated. Bloomberg Barclays data provided by Bloomberg. US long-term bonds, bills, inflation, and fixed income factor data © Stocks, Bonds, Bills, and Inflation (SBBI) Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). FTSE fixed income indices © 2018 FTSE Fixed Income LLC, all rights reserved. ICE BofAML index data © 2018 ICE Data Indices, LLC.

# Total Cost of Ownership

## Third Quarter 2018

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Costs matter. Whether you're buying a car or selecting an investment strategy, the costs you expect to pay are likely to be an important factor in making any major financial decision.

People rely on a lot of different information about costs to help inform these decisions. When you buy a car, for example, the sticker price indicates approximately how much you can expect to pay for the car itself. But the costs of car ownership do not end there. Taxes, insurance, fuel, routine maintenance, and unexpected repairs are also important considerations in the overall cost of a car. Some of these costs are easily observed, while others are more difficult to assess. Similarly, when investing in mutual funds, different variables need to be considered to evaluate how cost-effective a strategy may be for a particular investor.

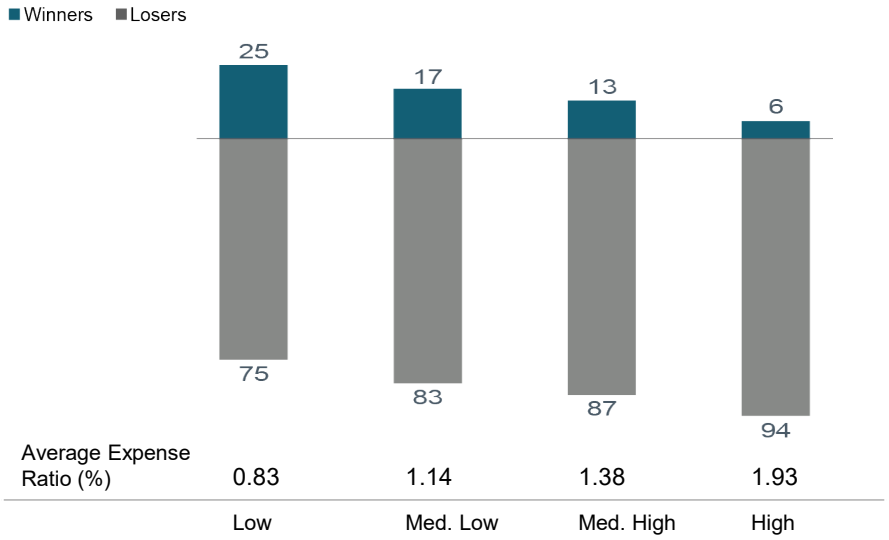
### EXPENSE RATIOS

Mutual funds have many costs, all of which affect the net return to investors. One easily observable cost is the expense ratio. Like the sticker price of a car, the expense ratio tells you a lot about what you can expect to pay for an investment strategy. Expense ratios strongly influence fund selection for many investors, and it's easy to see why.

**Exhibit 1** illustrates the outperformance rate, or the percentage of funds that beat their category index, for active equity mutual funds over the 15-year period ending December 31, 2017. To see the link between expense ratio and performance, outperformance rates are shown for quartiles of funds sorted by their expense ratio. As the chart shows, while active funds have mostly lagged indices across the board, the outperformance rate has been inversely related to expense ratio. Just 6% of funds in the highest expense ratio quartile beat their index, compared to 25% for the lowest expense ratio group.

This data indicates that a high expense ratio presents a challenging hurdle for funds to overcome, especially over longer time horizons. From the investor's point of view, an expense ratio of 0.25% vs. 1.25% means savings of $10,000 per year on every $1 million invested. As **Exhibit 2** helps to illustrate, those dollars can really add up over time.

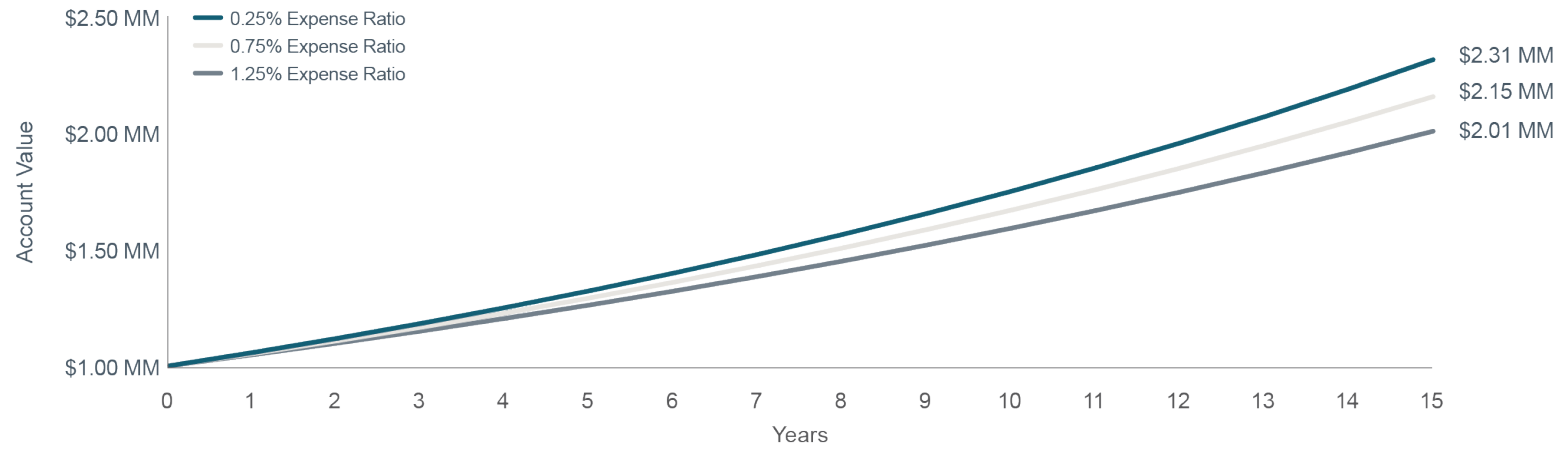
Exhibit 1. High Costs Can Reduce Performance, Equity Fund Winners and Losers Based on Expense Ratios (%)




*The sample includes funds at the beginning of the 15-year period ending December 31, 2017. Funds are sorted into quartiles within their category based on average expense ratio over the sample period. The chart shows the percentage of winner and loser funds by expense ratio quartile; winners are funds that survived and outperformed their respective Morningstar category benchmark, and losers are funds that either did not survive or did not outperform their respective Morningstar category benchmark. US-domiciled open-end mutual fund data is from Morningstar and Center for Research in Security Prices (CRSP) from the University of Chicago. Equity fund sample includes the Morningstar historical categories: Diversified Emerging Markets, Europe Stock, Foreign Large Blend, Foreign Large Growth, Foreign Large Value, Foreign Small/Mid Blend, Foreign Small/Mid Growth, Foreign Small/Mid Value, Japan Stock, Large Blend, Large Growth, Large Value, Mid-Cap Blend, Mid-Cap Value, Miscellaneous Region, Pacific/Asia ex-Japan Stock, Small Blend, Small Growth, Small Value, and World Stock. For additional information regarding the Morningstar historical categories, please see "The Morningstar Category Classifications" at morningstardirect.morningstar.com/clientcomm/Morningstar_Categories_US_April_2016.pdf. Index funds and fund-of-funds are excluded from the sample. The return, expense ratio, and turnover for funds with multiple share classes are taken as the asset-weighted average of the individual share class observations. For additional methodology, please refer to Dimensional Fund Advisors' brochure, Mutual Fund Landscape 2018. Past performance is no guarantee of future results.*

# Total Cost of Ownership

(continued from page 12)




*For illustrative purposes only and not representative of an actual investment. This hypothetical illustration is intended to show the potential impact of higher expense ratios and does not represent any investor's actual experience. Assumes a starting account balance of $1 million and a 6% compound annual growth rate less expense ratios of 0.25%, 0.75%, and 1.25% applied over a 15-year time horizon. Performance of a hypothetical investment does not reflect transaction costs, taxes, other potential costs, or returns that any investor would have actually attained and may not reflect the true costs, including management fees of an actual portfolio. Actual results may vary significantly. Changing the assumptions would result in different outcomes. For example, the savings and difference between the ending account balances would be lower if the starting investment amount were lower.*

## GOING BEYOND THE EXPENSE RATIO

The poor track record of mutual funds with high expense ratios has led many investors to select mutual funds based on expense ratio alone. However, as with a car's sticker price, an expense ratio is not an all-encompassing measure of the cost of ownership. Take, for example, index funds, which often rank near the bottom of their peers on expense ratio.

Index funds are designed to track or match the components of an index formed by an index provider, such as Russell or MSCI. Important decisions in the investment process, such as which securities to include in the index, are outsourced to an index provider and are not within the fund manager's discretion. For example, the prescribed reconstitution schedule for an index, which is the process of deleting or adding certain stocks to the index, may cause index funds to buy stocks when buy demand is high and sell stocks when buy demand is low. This price-insensitive buying and selling may be required so that the index fund can stay true to its investment mandate of tracking an underlying index. This can result in suboptimal transaction prices for the index fund and diminished overall returns. In other words, for a given amount of trading (or turnover), the cost per unit of trading may be higher for such a strictly regimented approach to investing. Moreover, this cost will not appear explicitly to investors assessing such a fund on expense ratio alone. Further, because indices are reconstituted infrequently (typically once per year), funds seeking to

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track them may also be forced to buy and sell holdings based on stale eligibility criteria. For example, the characteristics of a stock considered a value stock[1] as of the last reconstitution date may change over time, but between reconstitution dates, those changes would not affect that stock's inclusion or weighting in a value index. That means incoming cash flows to a value index fund could actually be used to purchase stocks that currently look more like growth stocks[2] and vice versa. Metaphorically, these managers' attention may be more focused on the rear-view mirror than on the road ahead for investors.

For active approaches like stock picking, both the total amount of trading and the cost per trade may be high. If a manager trades excessively or inefficiently, costs like commissions and price impact from trading can eat away at returns. Viewed through the lens of our car analogy, this impact is like the toll on your vehicle from incessantly jamming the brakes or accelerating quickly. Subjecting the car to such treatment may result in added wear and tear and greater fuel consumption, increasing your total cost of ownership. Similarly, excessive trading can lead to negative tax consequences for a fund, which can increase the cost of ownership for investors holding funds in taxable accounts. Such trading costs can be reduced by avoiding unnecessary turnover and seeking to minimize the cost per trade.

In contrast to both highly regimented indexing and high-turnover active strategies, employing a flexible investment approach that reduces the need for immediacy, and thus enables opportunistic execution, is one way to potentially reduce implicit costs. Keeping turnover low, remaining flexible, and transacting only when the potential benefits of a trade outweigh the costs can help keep overall trading costs down and help reduce the total cost of ownership.

## CONCLUSION

The total cost of ownership of a mutual fund can be difficult to assess and requires a thorough understanding of costs beyond what an expense ratio can tell investors on its own. We believe investors should look beyond any one cost metric and instead evaluate the total cost of ownership of an investment solution.

1. A stock trading at a low price relative to a measure of fundamental value, such as book value or earnings.
2. A stock trading at a high price relative to a measure of fundamental value, such as book value or earnings.

Source: Dimensional Fund Advisors LP.

# The 'Dumb' Money Is Bailing on U.S. Stocks. That's Smart.

## Now more than ever, investors need to consider investing in overseas stock markets

*By Jason Zweig – WSJ 9/29/2018*

Does it make sense to invest anywhere but in the U.S.?

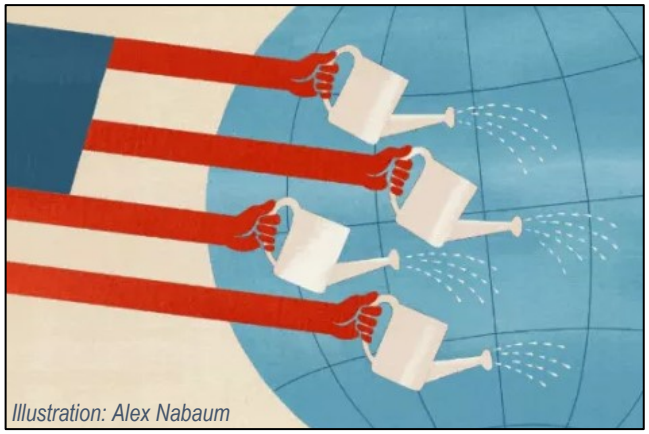


Illustration: Alex Nabaum

While the S&P 500 is within 1% of its all-time high, European markets are flat, Chinese stocks are in a deep slump and the Japanese market—after a huge recent run-up—has finally clawed its way back to where it was 27 years ago.

Through August 31st, the S&P 500 has outperformed international stocks, as measured by the MSCI World ex USA Index, over the past one, three, five, 10, 15, 20, 25, 30, 35, 40 and 45 years, according to AJO, an institutional investment manager in Philadelphia. Had you put $10,000 in each in 1973 and reinvested all your dividends, your U.S. holdings would be worth $1.06 million; your international stocks, $356,000.

All those numbers seem to indicate you'd be crazy to diversify internationally. But, in fact, all they signify is that numbers can play tricks on you. It still makes sense to add international stocks to a U.S. portfolio, probably more so than ever.

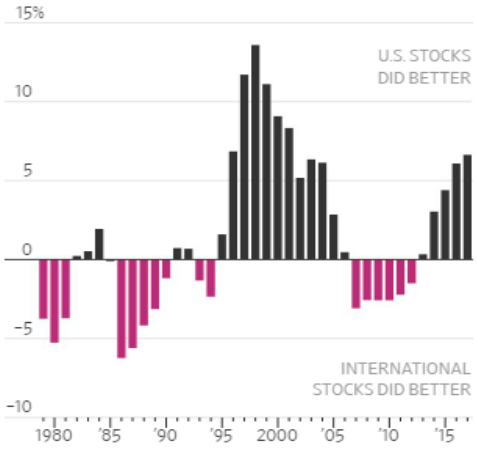
Looking back in time from today, U.S. stocks seem to have dominated over the long run only because they have done so extraordinarily well over the past few years.

Lofted by a strong currency and trillions of dollars of fiscal and monetary stimulus, U.S. stocks rose so swiftly out of the financial crisis that they left the rest of the world behind. That spectacular recovery has obscured the historical record.

**Who's the Greatest?**

While the U.S. stock market has outperformed international markets in recent years, the opposite has often been true for long periods.

**Annualized percentage by which U.S. stocks have outperformed international stocks over the preceding 10 years**




U.S. is S&P 500, with dividends. International is MSCI World ex USA Index, with dividends

Source: Dimensional Fund Advisors

The U.S. was among the worst-performing stock markets worldwide in the 1970s and the 2000s; it also earned lower returns than the average international market in the 1980s.

Over the 10 years ended in December 1986, international stocks outperformed the U.S. by an average of 6.2 percentage points annually; even over the decade through December 2007, U.S. stocks lagged the rest of the world by an annualized average of 3.1 percentage points.

No one can say when that might happen again. Chances are it will.

Markets tend to lose their dominance right around the time it seems most irresistible. The Japanese stock market rose 22-fold over the 20 years through the end of 1989, making it the world's best major performer.

If you were Japanese, that pinnacle of local outperformance marked the perfect time to diversify outside the country. The Nikkei 225 index, which hit its all-time high of 38915.87 on the last trading day of 1989, remains below 24000 as of this week.

“There have been many historical examples of countries that have risen and then fallen, either their economies or their markets or both,” says Marlena Lee, co-head of research at Dimensional Fund Advisors of Austin, TX, which manages approximately $528 billion.

That’s far from saying that the U.S. will become the next Japan. “There’s no reason to believe that might happen here,” says Ms. Lee, “but you don’t have to make that call.” If U.S. growth merely slows relative to other economies, stock markets elsewhere in the world are likely to catch up to or surpass the S&P 500.

Stocks in the U.S. may be more vulnerable than usual to such a reversal, given how expensive they are. Compared with the rest of the world, U.S. stocks are at their highest valuations on record, according to Bank of America Merrill Lynch—trading for twice as much, as measured by price to net worth, as international shares.

The rest of the world’s markets are less dominated, on average, by technology stocks than the U.S. and more focused on cheaper industrial and financial stocks, says Toby Thompson, a multi-asset portfolio manager at T. Rowe Price Group Inc. in Baltimore, which runs $1.1 trillion. The prices of such stocks outside the U.S. are “a lot more compelling,” he says.

What about the common objection that you can globalize your portfolio simply by holding such multinational U.S. companies as Coca-Cola Company or Intel Corporation?

Because such firms tend to hedge their exposures to foreign currencies, “what the U.S. economy and stock market are doing tend to overwhelm whatever benefits the companies get from being global,” says Mr. Thompson. Although they are multinational businesses, they still behave like U.S. stocks.

The biggest surprise is that individual investors have not abandoned global diversification during this recent period of disappointment.

Over the past 10 years, even as U.S. stocks hugely outperformed, mutual-fund and exchange-traded-fund investors took $34 billion out of U.S. funds and added $1.02 trillion to international, according to Fran Kinniry, an investment strategist at Vanguard Group.

Historically, investors have chased good returns and run away from bad performance, so “these numbers are kind of crazy,” says Mr. Kinniry. “This is incredibly contrarian compared to what we have seen in the past.”

Individual investors and their financial advisers, say Mr. Kinniry and other fund executives, seem to be adding money to international stocks as a systematic way of taking some money off the table as U.S. shares keep rising.

Sooner or later, that’s likely to make the so-called dumb money look smart.