SLOCUM, GORDON & CO. LLP

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When I first started my career at the First National Bank of Boston in 1973, the world of investments was generally framed by the hours of business of the New York Stock Exchange, 10AM to 4PM. There were no extended hours, no futures trading, and certainly no round-the-clock coverage of every stock move, earnings report, or tweet from management. Fundamental research won the day, and analysts who worked hard, digested the numbers correctly, interviewed corporate managements, and expressed cogent long-term opinions on a particular investment were rewarded by an annual ranking in *Institutional Investor* magazine. For fiduciaries, benchmark performance comparisons were less cut-throat, and the long view always prevailed over short-term trading.

Jumping ahead to 2019, it is readily apparent that everything has changed from those simpler market dynamics in their more analog world. In the most fundamental way, the predominance of trading (nearly 90%) on the New York Stock Exchange is now done by machines (algorithms), and markets in one form or another are available 24 hours-a-day. Following a more traditional buy-and-hold strategy has been tested recently with increased levels of volatility caused in large part by program trading across all asset categories.

So while we do not profess to do the same extensive fundamental research in our firm that the larger Wall Street firms offer, we have always found that measuring and mapping elements of the market itself can be extremely productive when defining an evolving investment strategy. Take a look at the accompanying chart below. The various colors represent all the essential asset classes, and notice how, from one year to the next, the ranking of relative performance can vary so widely. Given the disparity of annual asset returns, it is notable that money flows are

extremely transient and totally unrelated to long-term investment goals, but they do tell a story of the collective wisdom of the market that no single analyst is able to forecast.

For the last year or so we have been expressing a cautionary stance with respect to our investment strategy. Perhaps it is the longer perspective we have developed having been in business for 40 years, but measuring and mapping the markets with an overlay of the Federal Reserve Bank's rein on the supply of money in the system generally can help define the macro picture from which specific investment choices within various asset classes can be made for portfolio construction. Of primary significance to our current view is the fact that the global economy was thrown into existential turbulence in 2008 from which we are all still trying to recover. The Federal Reserve, more than any other single factor, has been the source of influence to global markets, particularly with their experimental zero-interest rate policy concurrent with acquiring an enormous volume of government, agency, and mortgage-backed bonds for their own portfolio.

2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
EM 39.8%	HG Bnd 5.2%	EM 79.0%	REIT 28.0%	REIT 8.3%	REIT 19.7%	Sm Cap 38.8%	REIT 28.0%	REIT 2.8%	Sm Cap 21.3%	EM 37.8%	Cash 2.0%
Int'l Stk 11.6%	Cash 1.4%	HY Bnd 57.5%	Sm Cap 26.9%	HG Bnd 7.8%	EM 18.6%	Lg Cap 32.4%	Lg Cap 13.7%	Lg Cap 1.4%	HY Bnd 17.5%	Int'l 25.6%	HG Bnd 0.0%
AA 7.6%	AA -22.4%	Int'l Stk 32.5%	EM 19.2%	HY Bnd 4.4%	Int'l Stk 17.9%	Int'l Stk 23.3%	AA 6.9%	HG Bnd 0.6%	Lg Cap 12.0%	Lg Cap 21.8%	HY Bnd -2.3%
HG Bnd 7.0%	HY Bnd -26.4%	REIT 28.0%	HY Bnd 15.2%	Lg Cap 2.1%	Sm Cap 16.4%	AA 11.5%	HG Bnd 6.0%	Cash 0.1%	EM 11.6%	Sm Cap 14.7%	REIT -4.0%
Lg Cap 5.5%	Sm Cap -33.8%	Sm Cap 27.2%	Lg Cap 15.1%	AA 0.3%	Lg Cap 16.0%	HY Bnd 7.4%	Sm Cap 4.9%	Int'l Stk -0.4%	REIT 8.6%	AA 14.6%	Lg Cap -4.4%
Cash 4.4%	Lg Cap -37.0%	Lg Cap 26.5%	AA 13.5%	Cash 0.1%	HY Bnd 15.6%	REIT 2.9%	HY Bnd 2.5%	AA -1.3%	AA 7.2%	REIT 8.7%	AA -5.6%
HY Bnd 2.2%	REIT -37.7%	AA 24.6%	Int'l Stk 8.2%	Sm Cap -4.2%	AA 12.2%	Cash 0.1%	Cash 0.0%	Sm Cap -4.4%	HG Bnd 2.7%	HY Bnd 7.5%	Sm Cap -11.0%
Sm Cap -1.6%	Int'l Stk -43.1%	HG Bnd 5.9%	HG Bnd 6.5%	Int'l Stk -11.7%	HG Bnd 4.2%	HG Bnd -2.0%	EM -1.8%	HY Bnd -4.6%	Int'l Stk 1.5%	HG Bnd 3.5%	Int'l Stk -13.4%
REIT -15.7%	EM -53.2%	Cash 0.2%	Cash 0.2%	EM -18.2%	Cash 0.1%	EM -2.3%	Int'l Stk -4.5%	EM -14.6%	Cash 0.3%	Cash 1.0%	EM -14.3%

Stock markets around the world basked in the glow of this "free" money, and valuations went wild as they typically do when proper risk analysis gets thrown to the wind. When the Fed changed course and began raising rates and selling off their bloated balance sheet of bonds in 2015, the game changed at the margins, and we opined at the time that what had been an enormous tailwind from the Fed's largess was now morphing into a headwind. These tectonic shifts are slow to be recognized, but after a lag time their effects begin to bite. We said in January 2018, *the more recent Fed intention of*

short term interest rates while simultaneously reducing its bloated balance sheet of bonds is without precedent in history, and it remains to be seen how that can be accomplished with minimal impact on the wider economy and stock market.

Later in April 2018, we wrote: *we think we may be near an inflection point in the markets. Our view on returns at this point in the investment cycle is defined by our desire to minimize risk and not chase over-extended valuations. Our focus generally remains on dividend paying stocks along with a healthy dose of bonds and significantly increased cash reserves*.

As 2018 evolved, there were three 10% "corrections" in stocks, unique in recent memory. Our bias of reducing equities and increasing short term bonds and cash reserves, while somewhat early, has made sense, as illustrated in the previously–noted asset class chart highlighting that the best performers of 2018 were cash and high grade bonds. Given the overwhelming influence of machine trading on the stock exchanges, we preferred to be early rather than late in order to avoid wild swings when they occurred.

So we enter 2019 with caution, despite the early January bounce from a deeply oversold market at year-end. We think there are long term factors at play here that will keep a lid on returns in the near future, and our strategy will be to retain higher levels of liquidity, seek high quality stocks that can increase dividends over time, and maintain a level of high-grade bonds to mitigate volatility in stocks. Our overarching mission as defined in our brochure is *a commitment to protect and enhance our clients' capital over time in a conservative and prudent manner. Our objective is to achieve these results without taking excessive risk. We are especially anxious to preserve capital in those periods when the markets are declining.*

One very satisfying note to share, Peter Hatfield who joined the firm in 2015 has been made a Partner as of January 1, 2019. Peter has been a wonderful addition to the firm, and I know that his commitment to our mission will be enjoyed by all of us here on Mill Street as well as our clients around the country for years to come.

With our best wishes for a prosperous New Year.

Jeff Gordon
Managing Partner

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