2018 First Quarter

Market Review & Outlook
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Executive Summary

> After a lengthy snooze, market volatility resurfaced in Q1. In the end, the ups and downs roughly balanced out. The Total US Stock Market finished down 0.7% for the quarter. International stocks fell 0.3% and the US Aggregate Bond market lost 1.5%.

> The return of volatility can feel jarring after two years of hibernation. But ups and downs in equity investing are normal and healthy. Volatility creates valuable opportunities for tax minimization and unleashes the true power of rebalancing. It also reiterates the need for a strategic asset allocation.

> In recent weeks, solid economic fundamentals and corporate earnings growth have played tug-of-war with fears of Fed rate hikes and protectionist policies. Neither the US or China wants a trade war, but only time will tell if the process can be managed without escalating into something truly damaging.

> New Fed Chairman Jerome Powell stuck to the existing playbook and raised the target federal funds rate 0.25% to a range of 1.5% - 1.75%. His unprepared comments in testimony to Congress could be interpreted as having a more hawkish view.

> There is nothing exciting about owning bonds at prevailing interest rates, but they continue to generate income and provide diversification from stocks. We view much of the fear around fixed income as excessive.

> Bitcoin lost roughly half of its value in the first quarter, finishing at $6,735.

> Personal Capital introduced the Socially Responsible Personal Strategy. It features all the core benefits of Personal Capital wealth management and is built using companies with high Environmental, Social and Governance scores within US stocks.

> Stumbles from major technology leaders in the second half of Q1 have some questioning if the party for the sector is over, or just taking a brief pause. Public perception may be important to support already lofty valuations.
Market Review & Outlook

After a lengthy snooze, market volatility resurfaced in Q1. The year started off hot. US stocks rose 5.2% in January and extended the S&P 500’s all-time record for consecutive positive months to 15. But February began with a sharp drop that barely dipped into 10% correction territory. In the end, the ups and downs roughly balanced out. The Total US Stock Market finished down 0.7% for the quarter. International stocks fared slightly better, down just 0.3%. The US Aggregate Bond market lost 1.5%, marking a rough quarter for bonds but not nearly as painful as was sometimes portrayed in the media.

It is hard to pinpoint a single culprit for the abrupt end to the market’s “Goldilocks” phase. Initial declines began with news of stronger than expected economic data, which is usually a positive for stock prices. This time, it stoked fears of higher interest rates and/or inflation. Market losses then accelerated rapidly when a number of similarly positioned hedge and quant funds were forced to reduce bets for continued low volatility. Not surprisingly, stocks initially bounced back from this temporary pressure, but have remained choppy ever since.

The return of volatility can feel jarring after two years of hibernation, but ups and downs in equity investing are normal and healthy. Without short-term risk, the critical long-term wealth creation from stocks would not be possible.

The most important thing Personal Capital does for our clients is help them obtain a data-driven financial plan and execute it efficiently. Slowly rising markets are enjoyable, but volatility creates valuable opportunities for tax minimization and unleashes the true power of rebalancing. It also reiterates the need for a strategic asset allocation tailored to cash flow goals and risk tolerance.

In recent weeks, solid economic fundamentals and corporate earnings growth are playing tug-of-war with fears of Fed rate hikes and protectionist policies. President Trump’s tariffs and the sudden departures of economic advisor Gary Cohn and Secretary of State Rex Tillerson make for great headlines of trade wars to come. Maybe. But Trump takes pride in his negotiating skills and it is difficult to differentiate between what is real and what is simply posturing. It is not uncommon for the current administration to start with an extreme position and then compromise back toward the middle. Widespread protectionism could be serious, but what has been enacted so far is not big enough to dent the global economy.
China abuses intellectual property rights and actively blocks many US technology and financial firms from operating there, so a US response is appropriate. Wars start with battles, but not all battles turn into wars. Neither side wants a trade war and the response so far from China has been measured. Only time will tell if the process can be managed without escalating into something truly damaging.

**SOURCE:**
1 Xignite / Indices represented by VTI, VEU, AGG, VNQ, IAU, DBC (total return)
2 Xignite / Indices represented by VTI, EFA, VWO (total return)
Looking Ahead

Stock valuations remain high by historical standards, but not excessive. The trailing PE ratio of the S&P 500 is around 25, but robust earnings growth in Q1 coupled with a slightly down market leaves multiples below the range for most of last year. Analysts expect earnings growth in the double digits for each of the next two years. If that proves accurate and interest rates stay low, it will go a long way to support higher stock prices.

| S&P 500 Change in Forward 12-Month EPS vs. Change in Price: 10 Years |

![Graph showing S&P 500 Change in Forward 12-Month EPS vs. Change in Price: 10 Years]

SOURCE: Factset
Sentiment is a mixed bag. Big down days in February shook off the cobwebs of complacency. So far, we haven’t seen the kind of greed and unrealistic expectations that were rampant in the late ’90s. However, things like Bitcoin’s meteoric rise and the FAANG acronym becoming a household term suggest high level sentiment has shifted from fear of losing money to fear of missing out.

The global economy continues to power ahead. US GDP growth has hovered around 3% for the last few quarters while growth overseas is accelerating toward 3%, according to World Bank forecasts. Stocks don’t necessarily wait for changes to show up in the data to reverse course, but a solid fundamental backdrop is a favorable environment for the bull to keep running, if it chooses.

Putting it all together, now is not the time to be greedy. It is also not the time to panic. Stocks go up more often than they go down. Those with a thoughtful long-term investment strategy should feel confident regardless of short-term gyrations. Timing the market remains extremely difficult to get right and is quite dangerous to retirement outcomes.

The increase in volatility should serve as a reminder that markets are risky. Four times in the last hundred years, US stocks have dropped by more than 50%. Statistically, that indicates such a decline is unlikely in the coming years, but is highly likely in the coming decades. Longer-term investors should expect to go through several more big bull and bear markets. Stocks are a blessing when it comes to creating wealth over time and should be the core of most portfolios, but the allocation should be strategic. This long bull market has steered many toward heavy stock allocations and big concentrations in large-cap technology stocks. If your portfolio is taking bigger bets than you are comfortable with or need, it is a perfectly reasonable time to transition into a more appropriate and diversified approach.

SOURCE: * Ibbotson
Bonds and Interest Rates

New Fed Chairman Jerome Powell stuck to the existing playbook and raised the target federal funds rate 0.25% to a range of 1.5% - 1.75%. His unprepared comments in testimony to Congress revealed a refreshing clarity, but could also be interpreted as a more hawkish view than the Fed has articulated in a long time. His responses indicate four rate hikes may be on the table this year and that the economy has strengthened in recent months. He also said he believes the tax cut will stimulate growth.

Most bonds fell as a result, but February and March demonstrated the stabilizing role bonds play in portfolios. While the US Aggregate Bond market lost 1.5% for the quarter, inflation protected, short-term, high yield corporate, and international bonds all fared better. This allowed those with a diversified bond portfolio to stay close to flat while blunting the ups and downs of stocks.

The Fed has significant control over short-term rates, but far less so over longer-term rates. Interestingly, long rates have tended to decline immediately following recent rate hikes. The single most common question we’ve heard over the last seven years has been how to react to rising interest rates – and yet for most of that period rates stayed flat or declined. While it is likely the Fed will carry on with its current projections of two more hikes for 2018, this is far from certain. It can be a big mistake to be overconfident in interest rate predictions. There is nothing exciting about owning bonds at prevailing interest rates, but they continue to generate income and provide diversification from stocks. We view much of the fear around fixed income as excessive as long as holdings are diversified and duration is managed.

| US Treasury Yield Curve |

Yield Curve as of 3/31/2018  Yield Curve as of 12/31/2017

SOURCE: U.S. Treasury
Cryptocurrency

Bitcoin lost roughly half of its value in the first quarter, finishing at $6,735. The leading cryptocurrency remains significantly above price levels from most of 2017, but the volatility and recent losses have called its long-term viability into question.

We caution that cryptocurrencies are not backed by physical assets and don’t pay dividends or interest. This makes them worth whatever someone else is willing to pay that day. That’s why we don’t have a Bitcoin forecast and do not consider it to be a legitimate asset class for long-term investors. If you are a speculator, wild price swings may be what you are looking for and a rebound remains possible. Even if major cryptocurrencies stabilize, we’d expect only a small handful will survive with meaningful value.
Socially Responsible Personal Strategy

The first quarter marked an important milestone at Personal Capital: the official launch of our Socially Responsible Personal Strategy. In addition to being something many of our clients wanted, it is a natural adaptation to the world we live in today. Whether it’s increasing awareness of the environment, disparities in the workplace, or other socially conscious issues, there is a growing sense of urgency to do better by the planet and our fellow human beings.

Historically, this hasn’t been easy to do in investing. Until recently, one of the few ways you could incorporate these issues into your portfolio was by excluding companies or categories you don’t want to own, like tobacco. This remains important, and extensive customization is part of what Personal Capital has always offered to our clients. But our new Socially Responsible Personal Strategy goes further. Instead of simply excluding specific stocks or categories, we seek out companies doing a better job managing Environmental, Social and Governance issues – an investment methodology referred to as “ESG.” It is through these high-level categories that a company’s “social responsibility” is assessed.

- **Environmental**
  - Climate Change
  - Renewable Energy
  - Sustainability

- **Social**
  - Diversity
  - Labor Relations
  - Conflict Minerals

- **Governance**
  - Management Structure
  - Board Independence
  - Executive Compensation
There is no global standard on how to evaluate these metrics, but a handful of third-party companies have established robust research and ranking methodologies. Personal Capital has selected Sustainalytics, a global leader in ESG and Corporate Governance research, as our partner. Using their independent ratings, we employ a “best in class” approach within the US equity component of the portfolio. The result is that on average, companies in the portfolio have an overall ESG ranking in the 90th percentile relative to their domestic peer groups.

We believe this strategy is truly unique. There aren’t many socially responsible offerings in the market right now and most have material shortcomings such as high cost or extreme sector concentrations.

The Socially Responsible Personal Strategy maintains the core benefits of Personal Capital and infuses high ESG rankings along with them. As always, our strategies are customizable* and are data driven based on your big-picture financial goals and retirement objectives. Within US stocks, ESG strategies incorporate our Smart Weighting methodology to better diversify at the sector, size, and style levels while avoiding unwanted excessive bets in any one part of the market. Using individual stocks allows more precision, as well as far greater opportunities for tax loss harvesting and tax allocation. More on our methodology can be found here.

Performance Expectations

Performance is a common concern for someone considering a socially responsible investment portfolio. There are numerous studies going back in time attempting to quantify the impact. We find it inconclusive whether socially responsible investing should be expected to generate any outperformance, but most studies indicate it can at least match performance of the broader market.

A recent study by MSCI produced some interesting results around companies with higher ESG rankings:

> Higher ranked ESG companies tended to be more profitable and paid higher dividends than lower ranked firms.
> Higher ESG rated firms showed lower incidence of idiosyncratic risk as measured by large stock drawdowns (i.e., lower tail risks).
> Higher ESG rated companies exhibited less earnings volatility and less systemic volatility.

In the end it is a personal choice as to whether socially responsible investing is right for you. For those interested, the hope is that by voting with their investment dollars they’re able to promote the change they want to see in the world, while still saving for retirement and achieving financial dreams. If you’d like to learn more, please contact us.

* The ability to customize varies by service tiers.
Speed Bump for Tech

Ten years ago, prevailing industry wisdom was that value stocks were “better” than growth stocks and small-cap stocks were “better” than large-cap stocks. So maybe it shouldn’t be surprising that the long bull market has been dominated by large-cap growth stocks, and technology in particular. As of January, the momentum of this trend seemed to be only gaining speed.

But, as is often the case with stocks, what goes up the most tends to fall the most when the music stops. Stumbles from technology leaders in the second half of Q1 have some questioning if the party is over, or just taking a brief pause.

In March, Facebook came under scrutiny on news that data on 50 million users inappropriately ended up in the hands of a company working for the Trump campaign. Attention then turned to Amazon after President Trump tweeted negative comments suggesting the retail behemoth is bad for the US Postal System and puts retailers out of business. Shares of both stocks were punished in March, but perhaps more importantly, the issues seem to be causing some to question whether technology’s lofty valuations are warranted.

Technology stocks gained 34% in 2017, but about half of that was due to higher valuations as opposed to actual earnings growth. They got more expensive.

The sector has enjoyed strong operating results and fabulously well-managed public perception. As the mega-tech companies become ever more important in our daily lives, there will be a deeper look by investors and regulators at how they impact society. Smart phones and social media aren’t going away, but with more oversight may come lower growth. Even if growth isn’t impacted, if their shiny veneer starts to tarnish, investors may not be willing to pay a premium.

Timing markets is so difficult because it is human nature to be drawn toward what has done well in the recent past. This is actually a known psychological trap called “recency bias”. But factors like sector leadership, growth/value, and US/international are always cyclical. We continue to believe the best approach is to remain diversified and be disciplined about rebalancing. It’s the best recipe we know to sell high and buy low.
There are two main things we’d like to highlight.

First, Utilities has outperformed Technology over the full period – something many find hard to believe. Second, and more important, is that there are big swings in both directions. But by owning both and rebalancing in a disciplined way, the outcome in this case is better than either sector and comes with less volatility along the way. Guessing sector leadership is hard, but diversification works.
Thank you for your interest.

Sincerely,

Bill Harris, Craig Birk, and Kyle Ryan

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