

2017

ANNUAL MARKET REVIEW

HFG | TRUST

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MARKET REVIEW

Fourth Quarter 2017

Each quarter we attempt to provide some meaningful commentary as it relates to investing and the economy. Our objective is to educate, but not forecast the near term. I also try to frame my thoughts through what clients have shared with me. Many of you will tell me, “I want to know what you are thinking about.” OK, I’ll let you in on what consumes me. My primary mental focus is on market valuations. I’m a firm believer that Price Determines Return. However, there are limits to the usefulness of knowing or studying market valuations. For one, market valuations tell us nothing about near term returns. In fact, I’ve found no indicator to predict market returns over a short time period, nor have I found any person that can forecast next year returns either. You might ask what is the usefulness of valuations? The answer lies in time. Valuations are a good predictor of decade returns. We’ll discuss this more on the next page.

My Beef: I find it interesting to read other firm’s market commentary or watch the pundits in the media attempt to inform the public their opinion where the stock market is going. It should be understood the media is there to inform us, however, there isn’t much that we need to know on a daily basis as it relates to investing. I think this is why you don’t hear from Warren Buffet except once per year when he writes his annual report. What we need to know is our individual financial objectives and how the different investment tools are likely to help us achieve the results we are looking for. *Short-term forecasting is non-sense and I encourage you to view anyone’s opinion on this subject only as entertainment.*

OVERVIEW

Commentary

Market Summary

World Asset Classes

US Stocks

International Developed Stocks

Emerging Markets Stocks

Real Estate Investment Trusts (REITs)

Fixed Income

Impact of Diversification

MARKET REVIEW

Fourth Quarter 2017

The Past Year

2017 was a strong year for all risk based asset classes with the exception of US REITs. US Stocks as measured by the Russell 3000 had returns over 21% while MSCI World ex USA and MSCI Emerging Markets had returns of 24% and 37% respectively. US government bond yields in the 1-5 year range fluctuated between 1.5%-2% for the year.

Perspective on Company Earnings and Stock Prices







As the year ended, we have been on one of the longest sustained bull markets in US stock market history. Unlike the early 1980s Bull Market when stock valuations were low, we've had significantly above-average stock valuations since 2010. Today, the Shiller p/e ratio stands at 33. This means investors are paying 33 times earnings to own a dollar of corporate profits (S&P500) compared to 13 times earnings at the bottom of the market in March of 2009, 10 times earnings in 1983* or 16-18 times earnings on average since 1887. (*Note: my career started in 1983) Let's put things into perspective. The investment proposition to owning stocks is for investors to reap growing dividends. As the economy expands, corporate sales and profits should grow as well. How fast can the market grow? Prior to 2008, it was expected the US economy would grow 4% or more per year as measured by GDP. Thus, one could extrapolate that corporate sales and profits would average 4% growth as well. Since 12/31/11 the earnings on the S&P 500 has changed from \$88/share to \$107/share. This comes to a 23% increase over 6 years, or less than 4% growth per-year. However, the S&P 500 price index has gone from 1243 in 12/31/11 to 2664 on 12/31/17. This comes to a 13.55% average growth or price increase per year. Thus, investors got a 13-14% price return on the S&P 500 in a business cycle where profits increased by less than 4%. This is an illustration of the disconnect between the underlying fundamentals of the S&P 500 and its market price. US Stock prices in our opinion have gotten ahead of their intrinsic value.

Valuations

You might be wondering if we are forecasting or predicting a market correction this year because of valuations. No, we do not forecast market results year to year. There is a strong correlation of valuations and returns over a decade. However, there is no reasonable correlation of valuations and returns year to year. We use market valuations to make asset allocation decisions in developing your portfolio. Today, when we examine US vs. International equities, it is clear to us that International valuations are far more attractive. Again, this doesn't mean International markets will have better returns in 2018. *We think it means there is a significantly higher probability that International markets will have higher returns over the next decade as compared to US markets.* As you examine the rest of this report and see the different returns for each asset class, understand there is NO information in the most recent return as it relates to the next year. We believe investment management principles of owning attractively priced assets coupled with a well diversified mix of asset classes is the most prudent formula for building and sustainable wealth. In closing, if you have any questions about your portfolio I encourage you to contact your advisor.

MARKET SUMMARY

Index Returns

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate		US Bond Market	Global Bond Market ex US
2017	STOCKS					BONDS	
	21.13%	24.21%	37.28%	7.41%		3.54%	2.06%
							
Since Jan. 2001							
Avg. Annual Return	8.4%	7.0%	14.8%	11.0%		4.8%	4.5%
Best Year	33.6% 2013	39.4% 2003	78.5% 2009	37.4% 2006		10.3% 2002	9.8% 2014
Worst Year	-37.3% 2008	-43.6% 2008	-53.3% 2008	-45.7% 2008		-2.0% 2013	1.4% 2013

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 ex US Market (Citi WGBI ex USA 1-30 Years [Hedged to USD]). The S&P data are provided by Standard & Poor's Index Services Group. 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. Bloomberg Barclays data provided by Bloomberg. Citi fixed income indices © 2018 by Citigroup.

US STOCKS

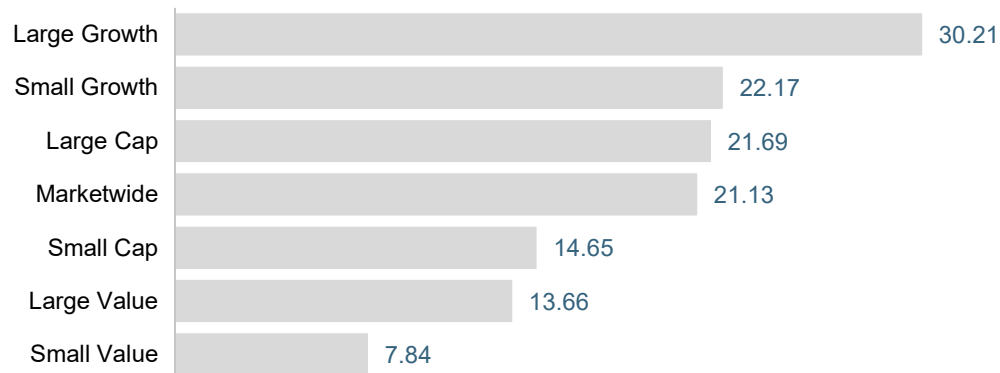
2017 Index Returns

The US equity market posted positive returns for 2017 but underperformed non-US developed and emerging markets.

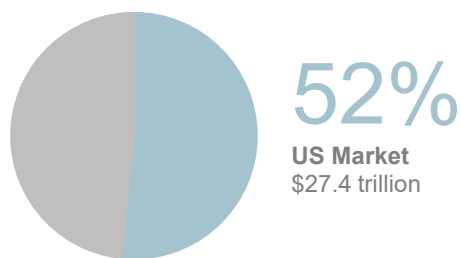
Value underperformed growth in the US across large and small cap indices.

Small caps underperformed large caps in the US.

Ranked Returns for 2017 (%)



World Market Capitalization—US



Period Returns (%)

Asset Class	* Annualized			
	1 Year	3 Years*	5 Years*	10 Years*
Large Growth	30.21	13.79	17.33	10.00
Small Growth	22.17	10.28	15.21	9.19
Large Cap	21.69	11.23	15.71	8.59
Marketwide	21.13	11.12	15.58	8.60
Small Cap	14.65	9.96	14.12	8.71
Large Value	13.66	8.65	14.04	7.10
Small Value	7.84	9.55	13.01	8.17

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

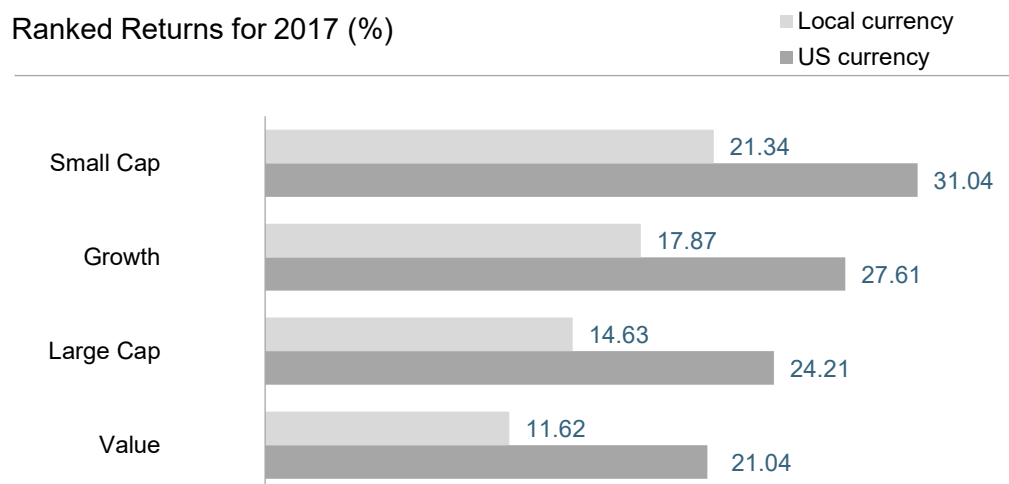
2017 Index Returns

In US dollar terms, non-US developed markets outperformed the US market but underperformed emerging markets during 2017.

Looking at broad market indices, the value effect was negative.

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

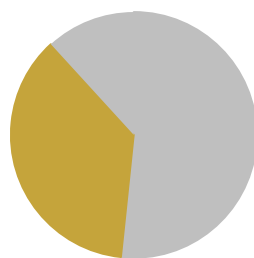
Ranked Returns for 2017 (%)



World Market Capitalization—International Developed

37%

International Developed Market
\$19.4 trillion



Period Returns (%)

Asset Class	* Annualized			
	1 Year	3 Years*	5 Years*	10 Years*
Small Cap	31.04	12.96	11.37	5.16
Growth	27.61	8.38	8.22	2.36
Large Cap	24.21	7.36	7.46	1.87
Value	21.04	6.26	6.64	1.32

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EMERGING MARKETS STOCKS

2017 Index Returns

In US dollar terms, emerging markets outperformed the US and non-US developed markets for the year.

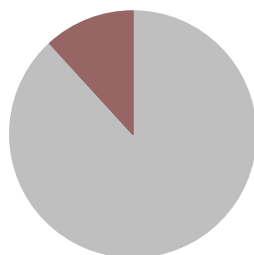
Across the large cap and mid cap space, the value effect was negative; however, in the small cap space, the effect was positive.

Overall, small caps underperformed large caps in emerging markets.

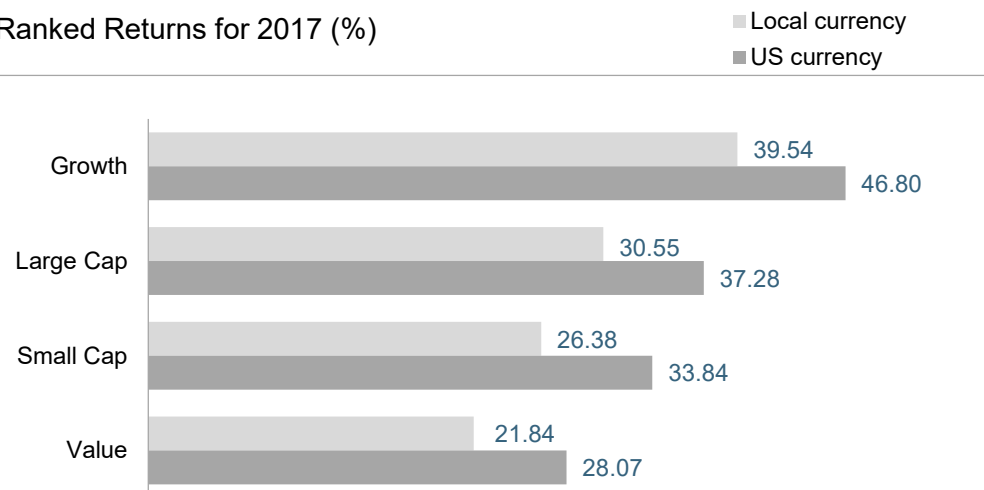
World Market Capitalization—Emerging Markets

12%

Emerging Markets
\$6.2 trillion



Ranked Returns for 2017 (%)



Period Returns (%)

* Annualized

Asset Class	1 Year	3 Years*	5 Years*	10 Years*
Growth	46.80	11.88	6.85	2.35
Large Cap	37.28	9.10	4.35	1.68
Small Cap	33.84	8.44	5.41	2.78
Value	28.07	6.21	1.75	0.91

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. MSCI data © MSCI 2018, all rights reserved.

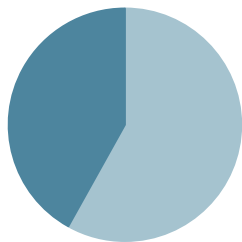
REAL ESTATE INVESTMENT TRUSTS (REITs)

2017 Index Returns

Non-US real estate investment trusts outperformed US REITs in 2017. However, US REITs have outperformed Non-US REITs by 5% over the last decade. Generally, over performance during a decade is an indicator of overvaluation.

42%

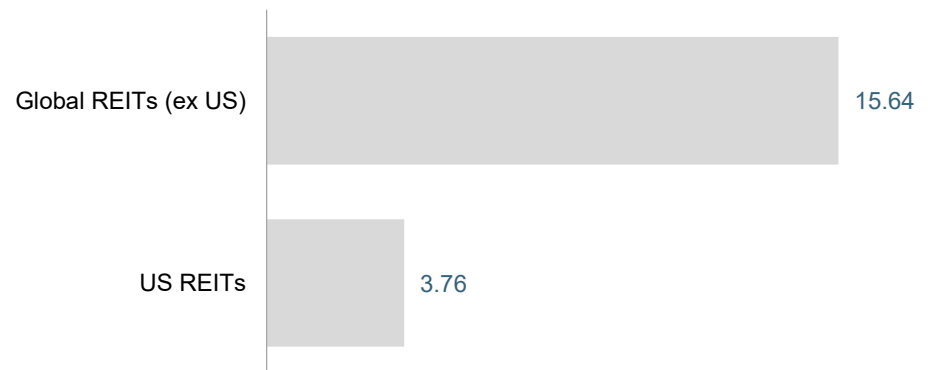
World ex US
\$485 billion
251 REITs
(23 other countries)



58%

US
\$672 billion
101 REITs

Ranked Returns for 2017 (%)



Period Returns (%)

* Annualized

Asset Class	1 Year	3 Years*	5 Years*	10 Years*
Global REITs (ex US)	15.64	4.78	5.49	2.05
US REITs	3.76	4.97	9.09	7.07

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. Dow Jones US Select REIT Index data provided by Dow Jones ©. S&P Global ex US REIT Index data provided by Standard and Poor's Index Services Group © 2018.

FIXED INCOME

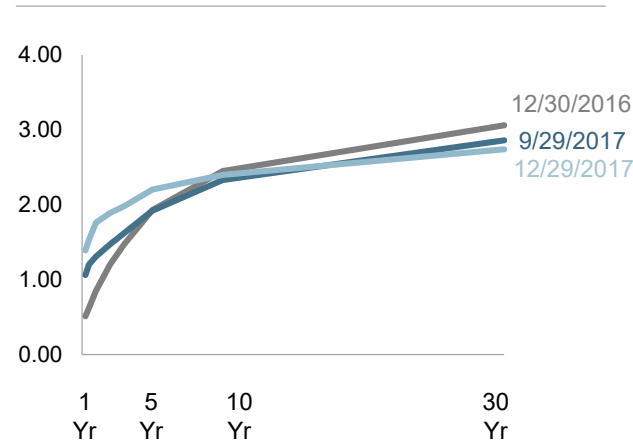
2017 Index Returns

Interest rate changes across the US fixed income market were mixed during the fourth quarter. The yield on the 5-year Treasury note rose 28 basis points (bps), ending at 2.20%. The yield on the 10-year Treasury note increased 7 bps to 2.40%. The 30-year Treasury bond yield decreased 12 bps to finish at 2.74%.

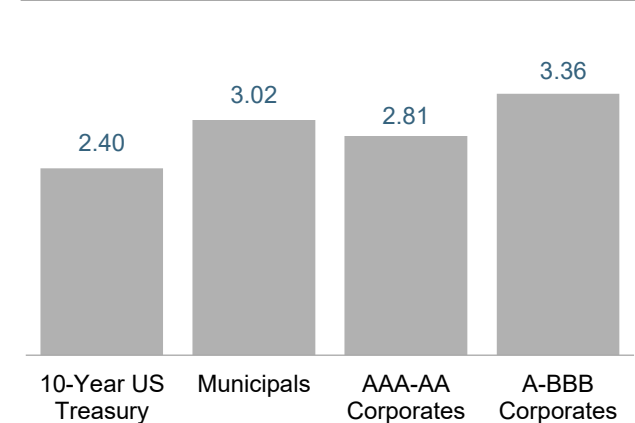
In terms of total returns, short-term corporate bonds increased 1.85% for the year. Intermediate-term corporate bonds gained 3.92% for the year.

The total returns for short-term municipal bonds were 1.61% for the year. Intermediate-term municipal bonds gained 4.70% for the year.

US Treasury Yield Curve (%)



Bond Yields across Issuers (%)



Period Returns (%)

Asset Class	* Annualized			
	1 Year	3 Years*	5 Years*	10 Years*
Bloomberg Barclays Long US Government Bond Index	8.53	2.85	3.49	6.49
Bloomberg Barclays US Corporate High Yield Index	7.50	6.35	5.78	8.03
Bloomberg Barclays Municipal Bond Index	5.45	2.98	3.02	4.46
Bloomberg Barclays US Aggregate Bond Index	3.54	2.24	2.10	4.01
Bloomberg Barclays US TIPS Index	3.01	2.05	0.13	3.53
Citi World Government Bond Index 1-5 Years (hedged to USD)	1.13	1.21	1.23	2.13
ICE BofAML 3-Month US Treasury Bill Index	0.86	0.41	0.27	0.39
ICE BofAML 1-Year US Treasury Note Index	0.57	0.49	0.38	0.90

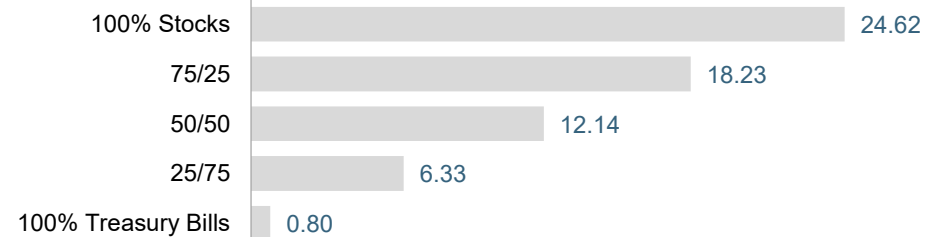
One basis point equals 0.01%. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio. Yield curve data from Federal Reserve. State and local bonds are 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 (SBBBI) Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefeld). Citi fixed income indices © 2018 by Citigroup. ICE BofAML index data © 2018 ICE Data Indices, LLC. The S&P data are provided by Standard & Poor's Index Services Group.

IMPACT OF DIVERSIFICATION

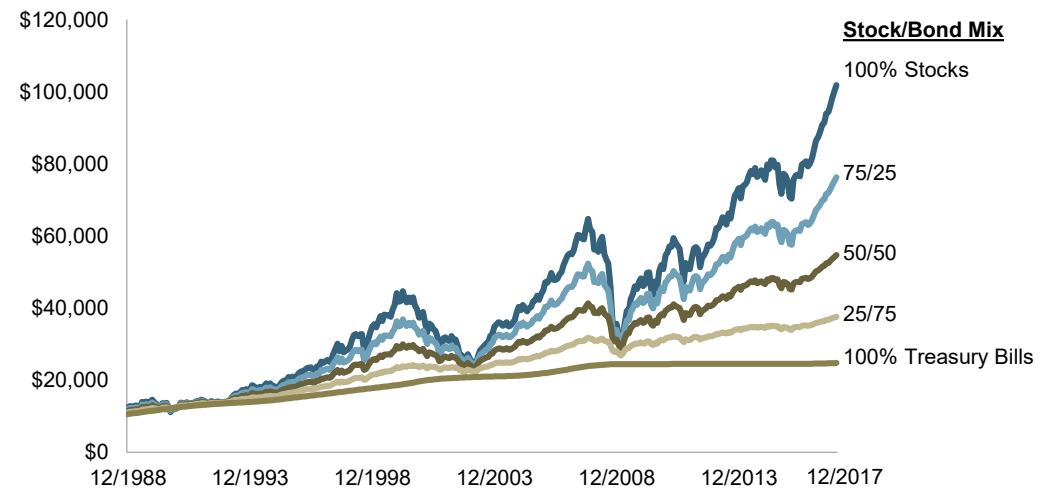
2017 Index Returns

These portfolios illustrate the performance of different global stock/bond mixes. Mixes with larger allocations to stocks are considered riskier but have higher expected returns over time.

Ranked Returns for 2017 (%)



Growth of Wealth: The Relationship between Risk and Return



Period Returns (%)

* Annualized

Asset Class	1 Year	3 Years*	5 Years*	10 Years*	10-Year STDEV ¹
100% Stocks	24.62	9.89	11.40	5.22	16.80
75/25	18.23	7.54	8.59	4.26	12.59
50/50	12.14	5.15	5.79	3.11	8.38
25/75	6.33	2.75	3.00	1.78	4.18
100% Treasury Bills	0.80	0.34	0.21	0.30	0.16

1. STDEV (standard deviation) is a measure of the variation or dispersion of a set of data points. Standard deviations are often used to quantify the historical return volatility of a security or portfolio. Diversification does not eliminate the risk of market loss. Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect expenses associated with the management of an actual portfolio. Asset allocations and the hypothetical index portfolio returns are for illustrative purposes only and do not represent actual performance. Global Stocks represented by MSCI All Country World Index (gross div.) and Treasury Bills represented by US One-Month Treasury Bills. Globally diversified allocations rebalanced monthly, no withdrawals. Data © MSCI 2018, all rights reserved. Treasury bills © Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefeld).