

MARKET REVIEW

› 3RD QUARTER 2018

▶ EXECUTIVE SUMMARY

- › US Markets maintain momentum through September but experience pullback in October
- › 10 Year Treasury rates rise 28bps in 60 days as rising yields create uncertainty for US Stocks moving forward
- › Foreign Markets remain the most attractive investment as measured by fundamental valuation metrics
- › Trade War with China negatively impacts tech giants with manufacturing facilities overseas

Overview

- Market Summary
- World Stock Market Performance
- World Asset Classes
- US Stocks
- International Developed Stocks
- Emerging Markets Stocks
- Real Estate Investment Trusts (REITs)
- Fixed Income
- Impact of Diversification
- Quarterly Topic: Total Cost of Fund Ownership

Quarterly Market Review

Third Quarter 2018

While the third quarter remained relatively steady, the beginning of the fourth offered quite a stark contrast to the first nine months of the year. We published a *'State of the Markets Summary'* in the beginning of October in hopes of providing perspective on the recent market turbulence. The tone of the message was to center around the core strategy of buying assets at attractive prices and ignoring the outside noise circulating in the daily media.

Over the last three months, US stocks were up 7.12% and International Developed Markets a modest 1.31%. Emerging Markets and Global Real Estate both ended on the wrong side of the performance line with -1.09% and -0.03%, respectively. As this Market Review is being published, the market has experienced a decline and you are probably wondering: What sparked the recent price fall? Financial Advisors and Investment Professionals are quick to provide analysis and theories when the reality is simple – no one really knows. This is not what investors want to hear, but I do have some good news. History has shown there is little to no relationship between correctly forecasting economic narrative and sustainable investment returns.

So what is happening today? There are a number of factors to consider as there has been nervousness brewing for quite some time amongst analysts. First, interest yields on closely watched government bonds have reached a seven-year high as the 10-year treasury note climbed above 3.25% for the first time since May 2011. Why is this significant? This rate directly impacts the pricing on every financial asset in the world, from the fixed-rate mortgage to how corporations access capital to grow their businesses. For the last 4 years, we have written about the overvaluation of US stocks while naysayers would ask: Why does it keep going up? Although it was difficult to point to one reason, our short answer was there are no alternatives for an investor to go. Fixed Income assets were providing minimal rewards and foreign market's were underwhelming, so it delayed rational asset pricing in the US Market. As rates continue to increase, we might be seeing investors re-evaluate why they own risk-assets with little to no growth potential, which is always a by product from overpaying to own them.

One particular sector feeling the brunt of the pain is the technology sector. Companies like Amazon, Microsoft and Apple might be impacted by a trade war with China as our government continues its tough stance on foreign supply-chain disruption. These tech companies have been market darlings for years and somewhere along the way became speculative and overpriced. It would have been futile to tell an Amazon stockholder 60 days ago that they were playing Russian Roulette with a fully loaded pistol as hindsight often provides clarity. Regardless of what strategy an investor implements, it is important to understand the journey will not always be smooth – 100 years of data has confirmed that fact. At the end of the day, history has shown that investors have the best chance of making rational decisions with their portfolio when they understand valuations and follow the evidence.

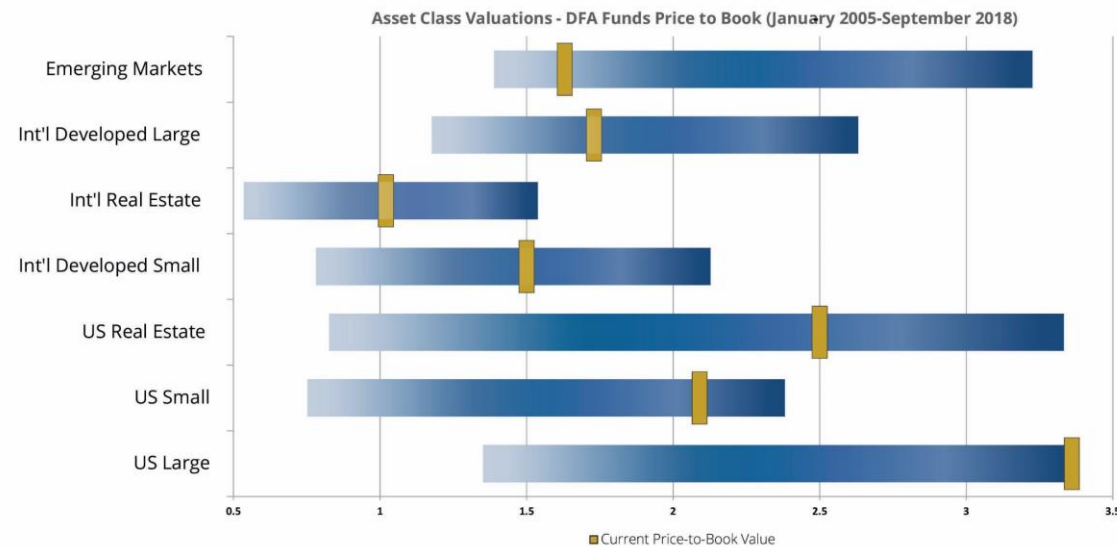


William Wang

President, HFG Trust







Valuations

During times of market turbulence, we encourage investors to look at the comparative attractiveness of the various asset classes across the world for perspective. The academic work of Eugene Fama and Kenneth French confirmed the usefulness of the valuation metric, Price-to-Book. Similar to the concept of Price-to-Square Foot for Real Estate, this metric captures the relative value an investor is paying to own an asset because it compares a common denominator. In Real Estate it is the square feet of a property and in business it can be the net worth of the investment. The metric is calculated as the combined asset class price (numerator) divided by the asset classes' combined net worth (denominator). For example, US large cap stocks has a price to book ratio of 3.4. This means investors are paying 3.4 times the actual net worth (assets minus liabilities) of the company. The chart below illustrates that since 2005, that ratio has ranged from 1.4 to its present mark of 3.4. If we look at equity markets in another region of the world, Emerging Markets, we find a much more attractively priced asset class. Emerging Markets have had a similar range of valuation to US Large Cap stocks over the aforementioned time period. However, currently Emerging Markets are priced at about 1.6 times book value. The lower the ratio, the more attractive the investment, as academic research has shown stronger long-term returns occur when assets are purchased at discounted prices. The balance of this chart illustrates the range of the asset classes we have followed since January 2005 and where they stand as of September 2018.



Market Summary-3Q Returns

Index Returns

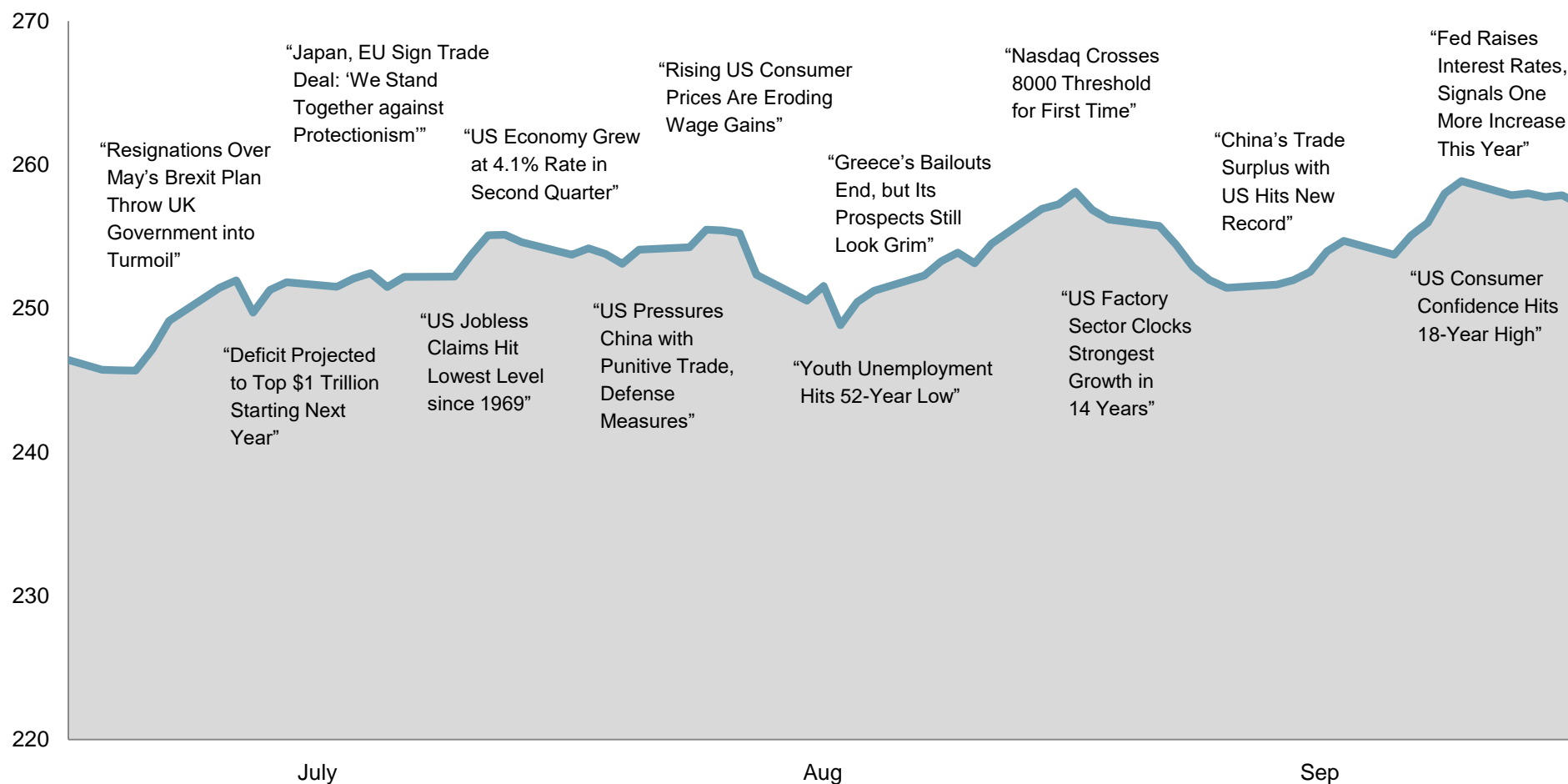
	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q3 2018	STOCKS				BONDS	
	7.12%	1.31%	-1.09%	-0.03%	0.02%	-0.17%
						

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]). S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. 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. FTSE fixed income © 2018 FTSE Fixed Income LLC, all rights reserved.

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.], MSCI data © MSCI 2018, all rights reserved.

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.

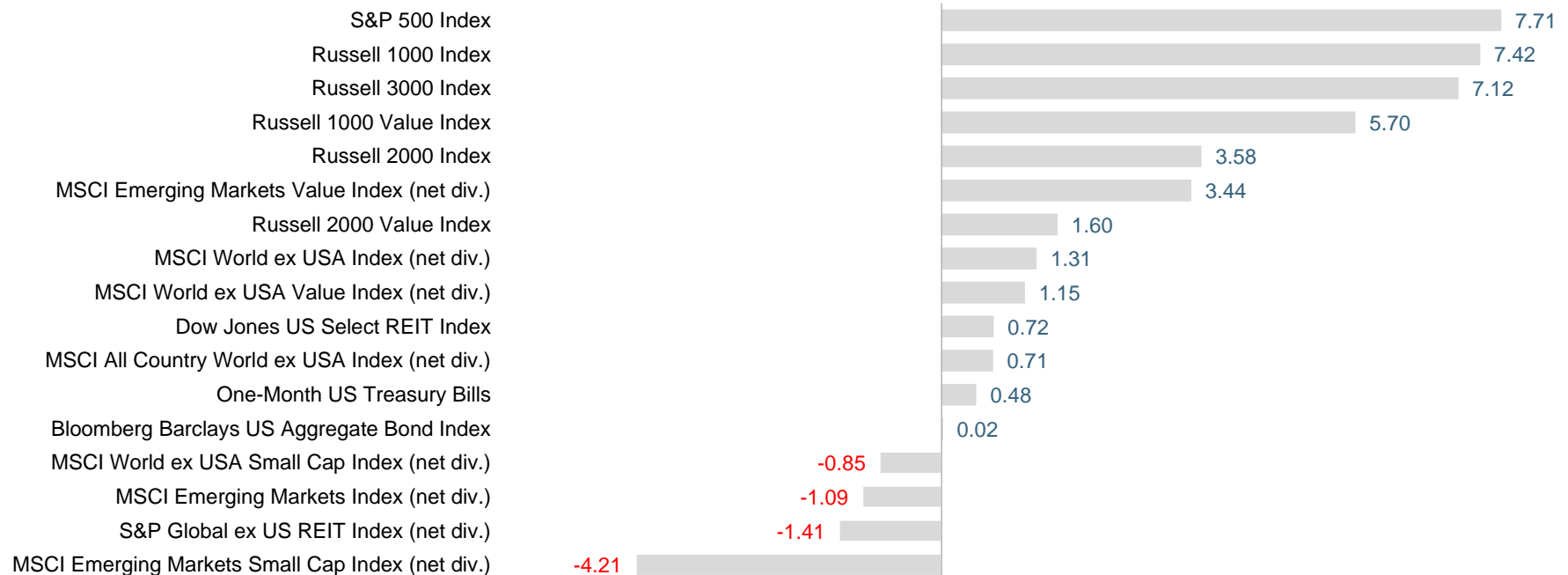
World Asset Classes-3Q Returns

Third Quarter 2018 Index Returns (%)

Looking at broad market indices, the US outperformed non-US developed and emerging markets during the quarter.

Small caps underperformed large caps in the US, non-US developed, and emerging markets. The value effect was positive in emerging markets but negative in the US and non-US developed markets.

REIT indices underperformed equity market indices in both the US and non-US developed markets.



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US Stocks

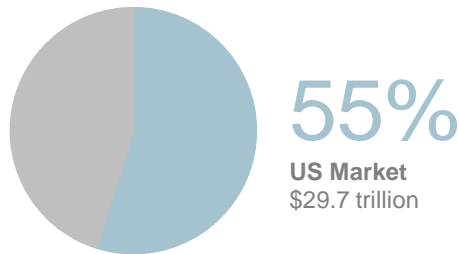
Third Quarter 2018 Index Returns

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

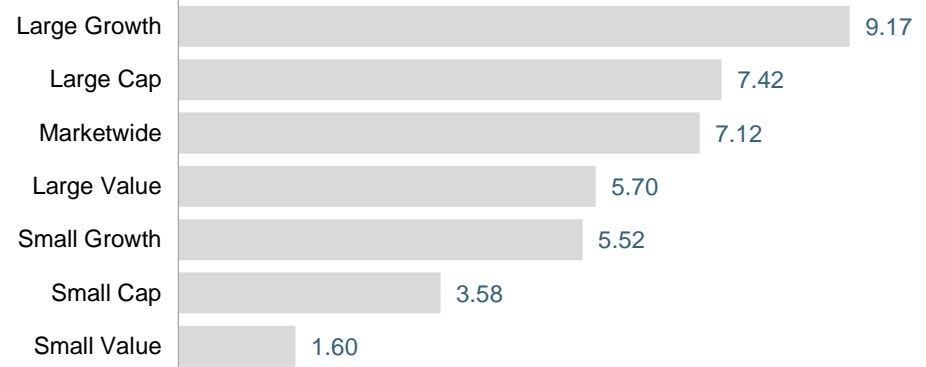
Value underperformed growth in the US across large and small cap stocks.

Small caps underperformed large caps in the US.

World Market Capitalization—US



Ranked Returns for the Quarter (%)



Period Returns (%)

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

* Annualized

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International Developed Stocks

Third Quarter 2018 Index Returns

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

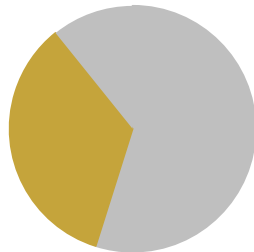
Large cap value stocks underperformed large cap growth stocks in non-US developed markets; however, small cap value outperformed small cap growth.

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

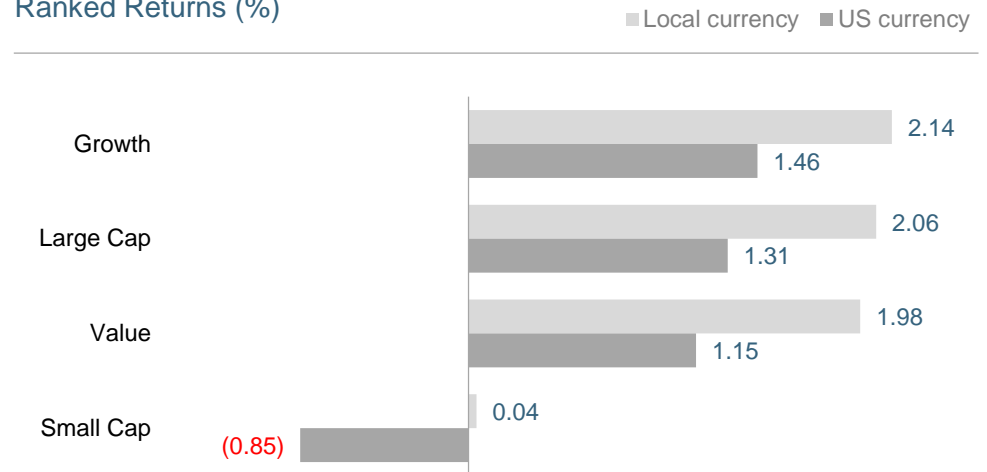
World Market Capitalization—International Developed

34%

International
Developed
Market
\$18.6 trillion



Ranked Returns (%)



Period Returns (%)

Asset Class	YTD	1 Year	* Annualized		
			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

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

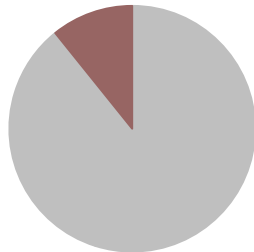
The value effect was positive, particularly in large caps in emerging markets.

Small caps underperformed large caps.

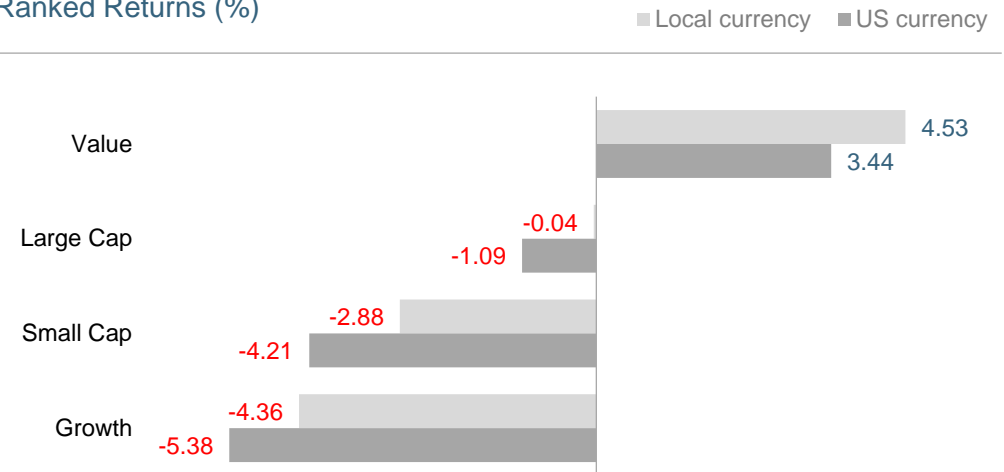
World Market Capitalization—Emerging Markets

11%

Emerging Markets
\$5.8 trillion



Ranked Returns (%)



Period Returns (%)

Asset Class	YTD	1 Year	* Annualized		
			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

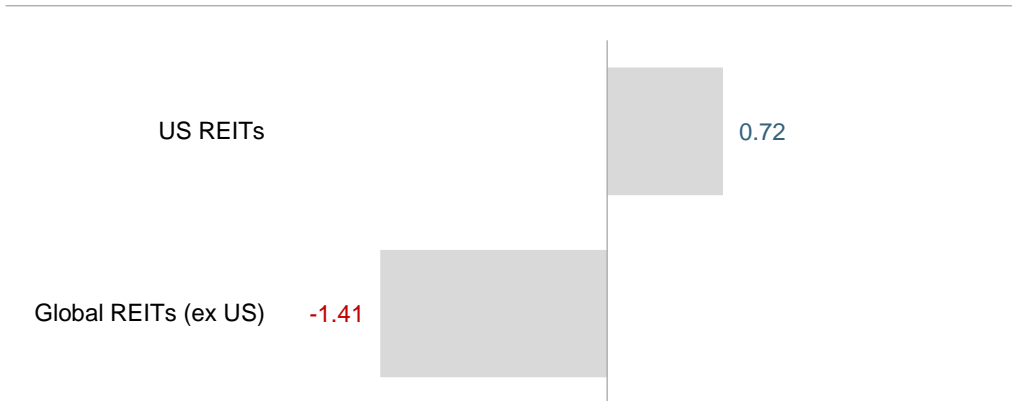
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Real Estate Investment Trusts (REITs)

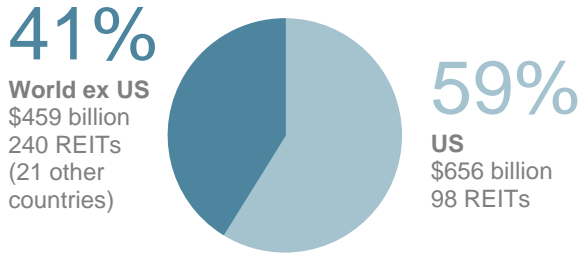
Third Quarter 2018 Index Returns

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

Ranked Returns (%)



Total Value of REIT Stocks



Period Returns (%)

Asset Class	* Annualized				
	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. Dow Jones data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. S&P data © 2018 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved.

Fixed Income

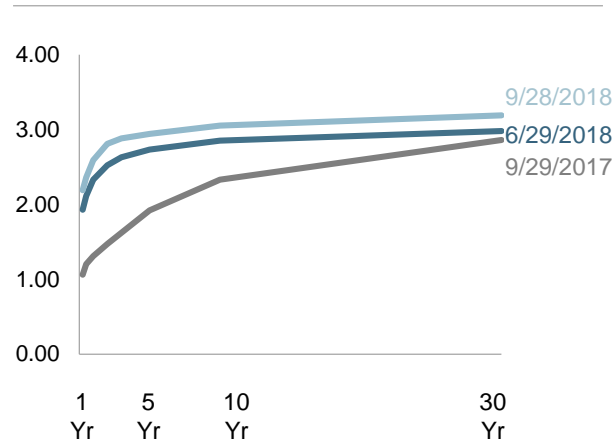
Third Quarter 2018 Index Returns

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%.

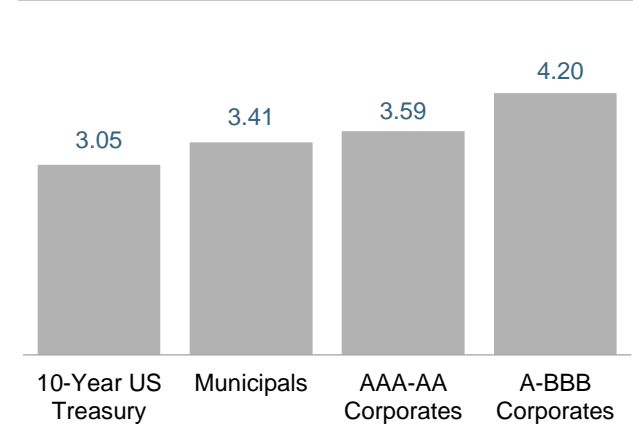
On the short end of the yield curve, the 1-month Treasury bill yield increased 35 bps to 2.12%, while the 1-year Treasury bill yield rose 26 bps to 2.59%. The 2-year Treasury note yield finished at 2.81% after an increase of 29 bps.

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 (%)

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

*Annualized

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). FTSE fixed income indices © 2018 FTSE Fixed Income LLC, all rights reserved. ICE BofAML index data © 2018 ICE Data Indices, LLC.

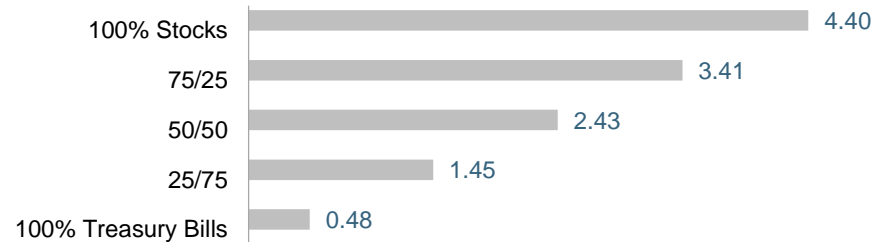
Impact of Diversification

Third Quarter 2018 Index Returns

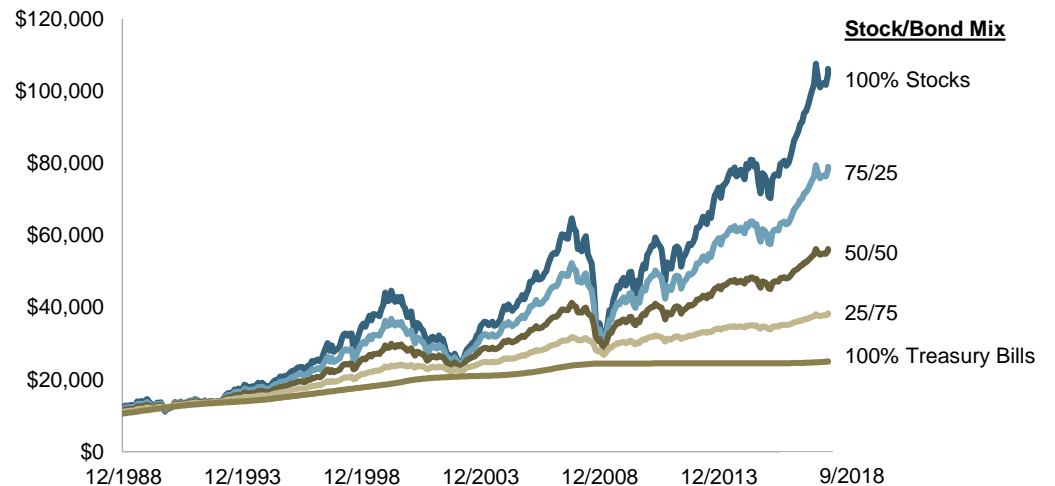
These portfolios illustrate the performance of different global stock/bond mixes and highlight the benefits of diversification. Mixes with larger allocations to stocks are considered riskier but have higher expected returns over time.

Period Returns (%)							* Annualized
Asset Class	YTD	1 Year	3 Years*	5 Years*	10 Years*	10-Year STDEV	
100% Stocks	4.26	10.35	14.02	9.25	8.77	15.83	
75/25	3.56	8.14	10.64	7.08	6.85	11.87	
50/50	2.82	5.93	7.31	4.89	4.78	7.91	
25/75	2.05	3.71	4.01	2.68	2.58	3.95	
100% Treasury Bills	1.24	1.50	0.75	0.45	0.27	0.14	

Ranked Returns (%)



Growth of Wealth: The Relationship between Risk and Return



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).