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THIRD QUARTER 2018

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Q2 Market Update

(values as of 6/30/2018; % changes for Q2, not YTD)

U.S. Stock Indices

S&P 500	2,718 (+2.93%)
Dow Jones	24,271 (+0.70%)
Nasdaq	7,510 (+6.33%)
Russell 2000	1,643 (+7.43%)

Global Stock Indices

FTSE (London)	7,637 (+8.22%)
DAX (Germany)	12,306 (+1.73%)
CAC (France)	5,324 (+3.02%)
Nikkei (Japan)	22,305 (+3.96%)
Emerging Mkts	1,069.52 (-8.66%)

Bond Indices (Bloomberg)

U.S. Gov't.	2,175.13 (+0.10%)
U.S. Corporate	2,806.89 (-0.98%)
U.S. Hi-Yield	1,953.09 (+1.03%)
Eurozone	254.28 (-0.85%)
Emerging Mkts	1,054.02 (-2.40%)

Commodities

Gold (per oz)	1,253 (-5.44%)
Silver (per oz)	16.06 (-1.68%)
Oil (WTI, barrel)	74.13 (+14.27%)

Fixed Income Yields

U.S. 2-Year Treasury	2.52%
U.S. 10-Year Treasury	2.85%
U.S. 30-Year Treasury	2.98%
U.S. High-Yield Index	6.44%

Currency Exchange Rates

Euro/Dollar	1.17
Pound/Dollar	1.32
Dollar/Yen	110.68

What is "passive investing"?

Over the last several years, the ongoing debate over the relative merits of "passive" versus "active" investing has picked up steam, with the passive camp steadily gaining ground against the more traditional active portfolio managers. Lured by the simplicity and low cost of an ever-increasing number of passively-managed index funds (both mutual funds and ETFs), investors have begun to shift a significant amount of assets into passive investments, leading many industry players to begin wondering about the future of the money management industry, the structure of equity markets, and even the viability of publicly listing new stocks for sale via initial public offerings (IPOs) in an increasingly passively-managed world.

Perhaps lost amid the sometimes-hysterical conversations and debates is a simple but important point: as passive investing has grown, the lines between passive and active investing have actually begun to blur, and the distinctions between the strategies are no longer so clear. Given the confusion that remains, we thought it might be useful to define the relevant terms, to clarify the recent changes in the marketplace, and to give our view of the future of financial markets and products.

The passive vs. active debate

At its basic core, "passive" investing can essentially be defined as simply "index" investing—instead of trying to "beat" the market via active strategies (either concentrating in individual stocks, timing entry/exit points via market-timing, or other more sophisticated hedging strategies), passive investing instead simply tries to mimic the return of a benchmark index, like the S&P 500. Because index compositions are publicly known and relatively consistent, passive investing is simple and cheap for fund managers to offer, since it is basically just a basic "buy and hold" strategy—buy a basket of stocks that mimics the target index, make sure that the balance of holdings remains correct, and there is no further need for investment analysis or decisions. As a result, passive managers (like Vanguard, long the industry champion of passive investing) are able to offer their funds with much lower management fees, since no specialized manager expertise is required.

The benefits to investors have been palpable, particularly as index fund managers have become increasingly more efficient (with an assist from computerized technology), to the point that many passive funds are offered at a fraction of the cost of their actively-managed competitors—while many active funds still charge north of 1% per year in management fees, some of the leading passive funds charge less than 0.10%, and as low as 0.03%. Given that industry research has consistently shown that active management strategies, on average, provide no demonstrable or repeatable market-beating expertise, minimizing fees is one of the most reliable ways in which to enhance long-term investment returns.

Since index investing can also offer improved tax efficiency, it should come as little surprise that a global shift from active to passive investing has occurred. According to Bloomberg data, passively

Passively Managed Funds Gained $700 Billion in New-Money Inflows in 2017 Alone

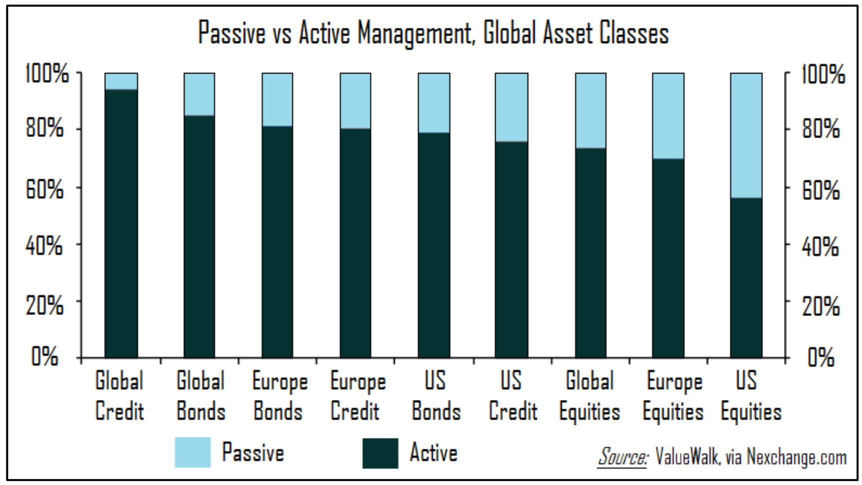
managed mutual funds and ETFs saw nearly $700 billion in new-money inflows in 2017 alone, whereas actively managed funds actually lost $45 billion in assets due to withdrawals. That shift continued a decade-long trend: globally, 21.6% of investments are now passively managed, as compared to just 16.5% five years ago. If that trend continues, many industry analysts expect passive investments to outnumber active investments by 2025 at the latest.

For some, that shift comes with significant concerns: without active managers, who will be buying stocks in a market downturn? Will future bear markets become more severe as a result? And if everybody is invested in index funds, who will be left to buy a newly-listed stock that isn't a part of an index yet? Will the entire IPO market collapse under the weight of the new passive investing behemoth?

<u>*Cutting through the hysteria*</u>

While the shift in investor preferences has been notable, we would argue that the importance of the passive surge is probably overstated, if only because the distinction between "passive" and "active" has become blurred. As passive strategies have gained popularity, the number of indexes being tracked has exploded—recent research from the Index Industry Association (IIA) finds that there are now more than 3 million recognized stock indexes in the world, as compared to only about 40,000 publicly traded companies. In a sense, then, the choice of an *index* is now a more "active" management decision (about 70 times more "active") than simply picking a stock or a basket of stocks. Not all index funds are created equal, and the specific choice of index or indexes could have a larger impact on portfolio returns than a decision to use "passive" or "active" funds.

With the broadest and best-known indexes, fund choice isn't much of an issue—S&P 500 index funds are mostly interchangeable, and the index is easy to track. That said, fund size could still matter, since some funds will be able to provide more liquidity than others in a volatile market. But in other asset classes—especially fixed income and international assets that are used to add diversification to a portfolio—the composition of the index fund matters a great deal. As just one example, "emerging markets" funds vary greatly, if only because South Korea is sometimes included as an "emerging" economy, and sometimes not. Since it is one of the world's dozen largest economies, its inclusion (or omission) will have a great impact on subsequent investment returns. Similar dynamics occur in real estate funds, sector-specific funds, and international or "global" funds in which there is no one "standard" index benchmark. When including exposure to those asset classes, then, even the choice of a "passive" fund that tracks an index is a very "active" decision—do you choose a highly concentrated fund with 40% or more of assets in the top 2 or 3 holdings? Is the size of the fund important? What is the fund manager's approach to rebalancing, if (and when) changes are made in the target index?



At Cypress, while we embrace the use of passive funds when constructing client portfolios, we recognize that in today's environment, there is no such thing as purely passive portfolio management. Our fund selection process remains, at least in part, an "active" management decision, as does the risk "glide path" that we use for our clients as they age. We also make frequent tactical decisions about the relative weights of different asset classes, including the types (and maturities) of fixed income investments to include, and whether or not to incorporate currency hedges on our international holdings. Passive funds have made constructing a diversified portfolio easier and cheaper than ever before, but "active" management will never (and can never) actually disappear from the equation.

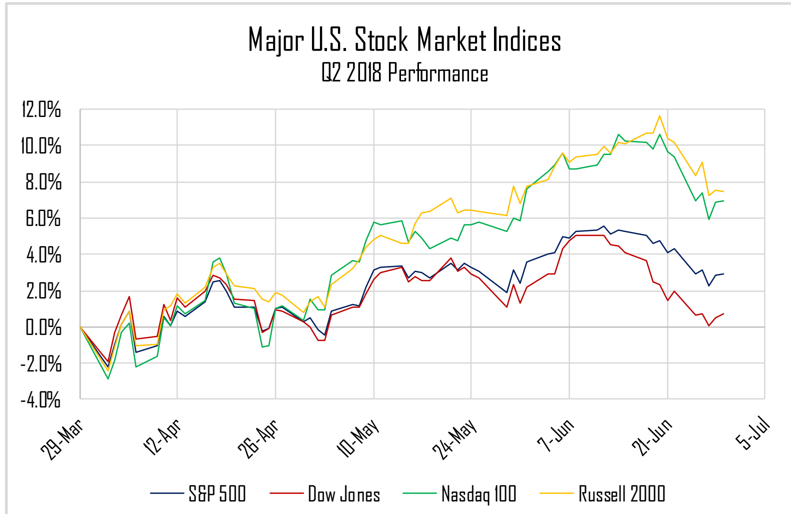
Markets Recovered In Q2, But Some Indexes Gained More Than Others

Equity Overview – Domestic Equity Markets

Compared to the manic first quarter—in which U.S. stocks gained nearly 6% in a month only to give it all back and then some in less than a week—Q2 was calm and laidback, with a gradual return to normalcy that saw the major indexes climb back into positive territory for the year, with all but the Dow Jones ending the quarter in positive territory for 2018. Not even a dramatic increase in protectionist rhetoric from Washington could derail the market recovery, though it must be noted that the recovery has yet to break out to new market highs, as the entirety of the second quarter was spent in "range-bound" trading, between the highs and lows that were established in the first quarter.

What was perhaps most notable about the performance of U.S. equities in the second quarter was the divergence between the major indexes—while all four indexes we track (the broad-based S&P 500, the "blue-chip" Dow Jones, the tech-heavy Nasdaq, and the small-cap Russell 2000) ended the quarter in positive territory, the spread between the best and worst performer was significant.

The Dow Jones was only able to eke out a fractional gain of 0.7%, while the small-cap Russell gained more than 7%, with the Nasdaq nipping right at its heels.



The S&P 500, meanwhile, landed between the two extremes, gaining roughly 3% for the quarter. The spread can largely be explained by budding trade wars with China and other nations, which will likely have varying impacts on the different types of companies that comprise the indexes. We'll have more on that dynamic in the final section of our newsletter.

The Ten-Year Yield Meets the 3% Barrier – Fixed Income

As equity markets struggled to find their footing in the spring months, one of the more closely watched subplots in the markets was the trend in U.S interest rates, which continued to climb higher after an unprecedented extended period of near-zero short-term interest rates. Many economists and market analysts felt that a level of 3% in the Ten-Year Treasury Yield marked a vital "line in the sand"—that a breakout in rates above that 3% mark would spell doom for the bond market specifically, and for the American economy more generally. Rates had peaked at exactly that level in 2014 before quickly reversing, so when they again tested the level in early 2018, fears of a broader bond market meltdown began to spread.

So far, though, the 3% level seems once again prepared to hold as a high point for intermediate-term bond rates, at least for now. That's good news for companies who rely on debt financing to fund their capital projects, but it's similarly good news for bond investors who have recently seen their fixed-income holdings struggle against the backdrop of rising interest rates.

While the Federal Reserve continues to forecast future rate increases on the short end, the longer maturities may finally have found their footing in Q2.

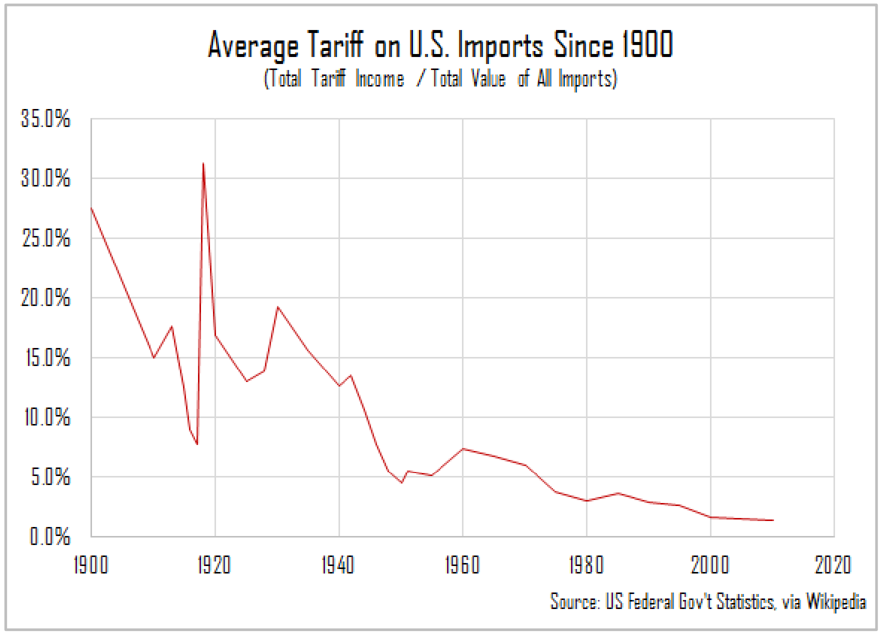
TARIFFS ARE ON THE RISE, BUT REMAIN AT HISTORICALLY LOW LEVELS

The Trump Trade War Kicks Into High Gear – Global Economy

In early 2018, President Trump announced his first new tariffs since taking office the year before, imposing a relatively narrow tariff on solar panels and washing machines. As it turns out, that minor move was a precursor to a much more major move, one that could theoretically reshape a number of global trade agreements over the coming months and years. In March, the Trump administration announced large tariffs on imports of steel and aluminum, while also promising to impose tariffs on $50 billion of Chinese-imported goods. The measures were consistent with the chief executive's famous Twitter pronouncement that "trade wars are good, and easy to win". While China was the obvious target of most of the tariffs, the steel and aluminum measures were later expanded to include Canada, Mexico, and the European Union.

Not surprisingly, the tariff announcements sparked a wide range of negative responses and retaliatory measures from America's major trading partners, including a promise by China to place a 25% tariff on U.S. imports of soybeans. The Chinese retaliation was enough to send U.S. soybean prices into a freefall, plunging nearly 20% in the space of a month to match a decade-low level. For soybean farmers who have increased their production by more than 40% in the last five years (making it the nation's second most-produced crop behind corn), that price hit will have a significant impact on profits in the short term.

And while it's still too early to know what the full extent of the feared "trade war" might be, some context is definitely in order. The current administration's rhetoric on trade may seem ill-conceived and unnecessary, and its lack of details or "master plan" clarity certainly helps fuel a general sense of uneasiness among manufacturers and investors alike. But two facts remain undeniably true, and are important in order to understand the potential economic impact of the tariffs: 1) the U.S. still has among the lowest tariffs in the world, and 2) with average tariffs below 10%, current global tariff rates are at their lowest levels in decades, if not ever.



To be sure, the overall level of international trade has also surged in recent decades, so even a small increase in average tariffs could have an outsized impact on certain industries, as compared to 50 years ago. As a result, in the short term, there will be significant winners and losers from any trade disruptions, a fact that Q2 market returns made clear: the export-heavy Dow Jones barely managed positive returns, while the less-exposed small-cap and technology indexes posted large gains (emerging markets stocks, of course, plunged, since China is the world's largest emerging economy).

But the resilience and resourcefulness of the global economy should not be overlooked; while it will take some time for trade arrangements (between firms and countries alike) to be reworked, the net impact on economic growth is likely to be muted and manageable, regardless of the headline hysteria. As with most macro scares of the last few years (see: Brexit), we think investor attention is best focused elsewhere, away from the noise.

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