MP McShane Partners

October 2019 Insights

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

During the first eight months of the year, asset class correlations exhibited perplexing behavior with fixed income (i.e., bonds) and equities increasing simultaneously. Normally, there has been an *inverse relationship* between bonds and equities, and, historically, when this longstanding relationship is challenged, there is eventually a correction in one of the asset classes. For this reason, the Investment Team deferred asset allocation decisions through the first part of 2019 due to the uncertainties and associated risks inherent in timing a correction in either bonds or equities.

After coincident increases of **+7.3%** and **+17.2%**, respectively, for the Bloomberg Barclays U.S. Aggregate Bond Index and the S&P 500® Index year-to-date ("YTD") in 2019, September 4th seemed to mark the beginning of the anticipated 'normalization' in the bond-equity relationship, with the Bloomberg Barclays U.S. Aggregate Bond Index declining **-1.11%** and the S&P 500® Index rallying **+1.33%** through the end of the month on the back of falling interest rate expectations, stabilizing trade talks, and a rotation into cyclical stocks. As this staid relationship between bonds and equities continues to 'normalize' and revert to historical trends, the near-term outlook for both asset classes remains mired in the relative uncertainties associated with mixed economic data and unconventional monetary policy.

Continued on next page

Wealth Advisory Overview

The Importance of Having a Financial Plan

As market volatility continues to increase, having a comprehensive financial plan in place as a baseline to assure clients they will be able to retire and/or live comfortably in retirement is paramount. According to the 2013 Household Financial Planning Survey conducted by the Certified Financial Planner Board of Standards, only 31% of financial decision makers say they have a comprehensive written financial plan. The Board defines a comprehensive financial plan as one that covers savings and investments; planning for retirement, education, emergencies, major purchases, and other financial goals; insurance needs, as well as having an effective estate plan in place.

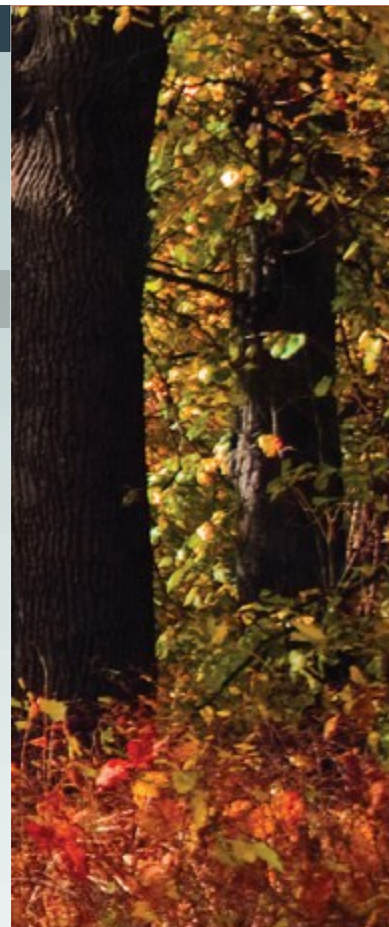
Creating a financial plan helps you see the big picture and set long and short-term life goals, a crucial step in mapping out your financial future. When you have a financial plan, it is easier to make financial decisions and stay on track to meet your goals, as well as feel secure in knowing you have a plan in place no matter what is transpiring in the stock market.

Top Reasons to Have a Financial Plan

1. ***It will help you define your financial goals.***

   We always begin building your financial plan by asking you what your financial goals are. For some individuals this is the first time they have actually written down their financial goals, while for couples this exercise can provide a venue to get on the same page.

Continued on page 7



Investment Team

Daniele Donahoe, CFA
Chief Investment Officer
Elliott Van Ness, CFA
Director of Research | Portfolio Manager
Thomas Mack
Research Analyst

Wealth Advisory Team

Sandy Carlson, CFP®, CPA, CDFA™
President | Wealth Advisor
Rebecca Hoover, CPA
Director of Tax | Wealth Advisor
Lorri Tomlin, FPQP™
Wealth Advisor
Ryan Vaudrin, CFP®
Wealth Advisor
Daniel Hudspeth
Wealth Associate
Corey Meyer
Wealth Associate
Lesley Burke
Client Service Associate

Points of Interest

- Monthly Index Review
- Stock & Strategy Spotlight
- Around McShane Partners

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

The aforementioned malfunction in correlations made navigating financial markets precarious when adhering to traditional portfolio management principles and empirical models, with strategic shifts in asset allocation appearing reckless given the lack of directional visibility. Correlations between traditional asset classes (e.g., bonds vs. equities) have broken down as a result of the unprecedented amount of *quantitative easing* ("QE") injected into capital markets over the past decade, with financial market performance conditioned to accommodative monetary policy and dependent on the trajectory of interest rates, which have become hostage to partisan politics and are increasingly disconnected from underlying economic fundamentals.

"In this game, the market has to keep pitching, but you don't have to swing. You can stand there with the bat on your shoulder for six months until you get a fat pitch."

- Warren Buffett

Correlation Analysis

Correlation analysis identifies relationships between assets, enabling portfolio managers to use long-term performance trends across various assets, such as bonds and equities, to construct 'optimal' investment portfolios capable of mitigating risk and performance volatility through diversification, as different assets should behave differently depending on the market environment, with the ultimate objective of diminishing the portfolio-level impact of a sharp decline in a singular asset class. Understanding correlations across different asset classes, investment strategies, sectors, and industries is critical to optimizing portfolio-level allocations and properly positioning portfolios over a full market cycle in order to achieve long-term return objectives and facilitate consistent cash flow requirements.

While the simultaneous rise in equities and bonds has been a welcome performance tailwind for diversified investment portfolios over the past **±12 months**, the Investment Team does not subscribe to the "this-time-is-different" mantra or the theory that traditional relationships and correlations between asset classes have been permanently altered in some fundamental way. Conversely, it is more likely a short-term anomaly that is beginning to revert to the long-term, historical mean.

As illustrated in Chart I (*next page*), the price-level relationship between equities (represented by the S&P 500® Index) and bonds (represented by the Bloomberg Barclays U.S. Aggregate Index) has been *significantly negatively correlated* during the **±9 years** since the last recession: the *correlation coefficient* between the U.S. equity-bond performance relationship was approximately **-0.72**, indicative of a strong, *negatively correlated* (i.e., *inverse*) relationship between equities and bonds. Over the past **±9 months**, however, that relationship between the price-level performance of equities and bonds has become *positively correlated*, exhibiting a correlation coefficient of approximately **+0.71**, as illustrated in Chart II (*next page*), which tracks the 2019 YTD performance of equities and bonds through month-end.

Continued on next page

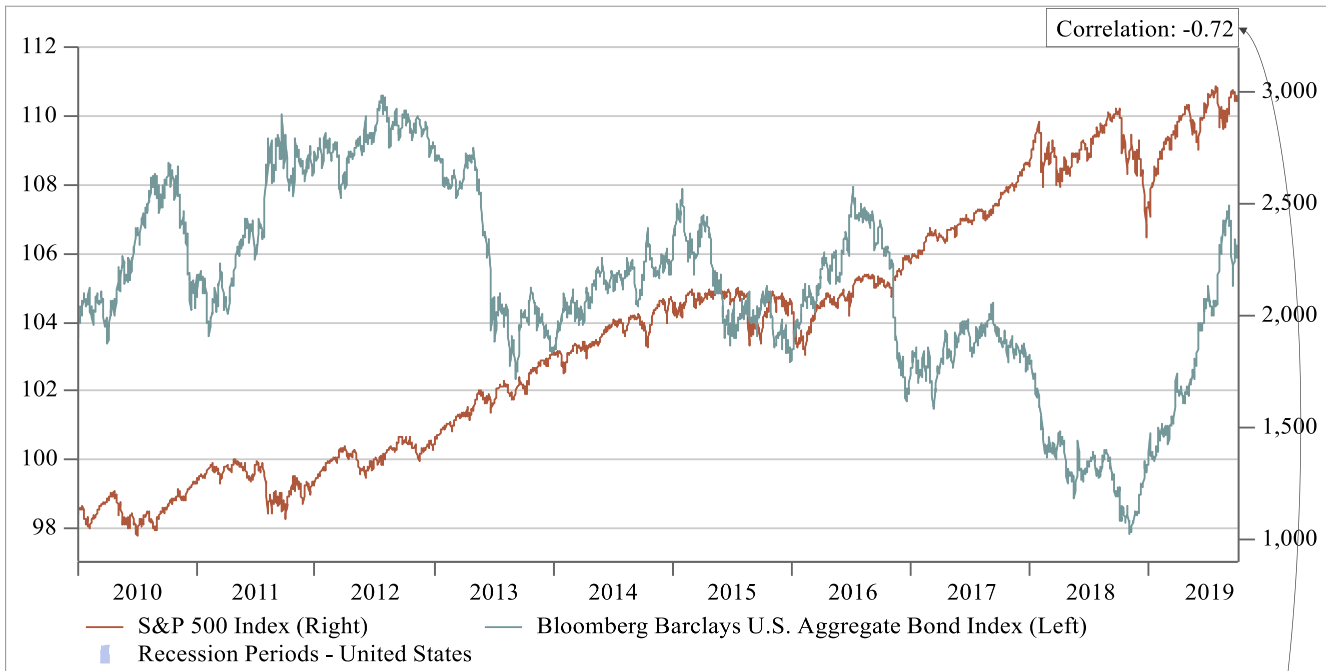
Monthly Index Review
USD Total Return

Data as of September 30th 2019	September 2019	2019 YTD	2018	2017
S&P 500®	+1.87%	+20.55%	-4.38%	+21.83%
Dow Jones Industrial Average	+2.05%	+17.51%	-3.48%	+28.11%
NASDAQ Composite	+0.54%	**+21.54%**	-2.84%	+29.64%
Russell 2000	+2.08%	+14.18%	-11.01%	**+14.65%**
MSCI Emerging Markets	+1.94%	+6.22%	**-14.24%**	+37.75%
MSCI EAFE	**+2.92%**	+13.35%	-13.36%	+25.62%
Bloomberg Barclays U.S. Aggregate Bond Index	**-0.53%**	+8.52%	**+0.01%**	+3.54%

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

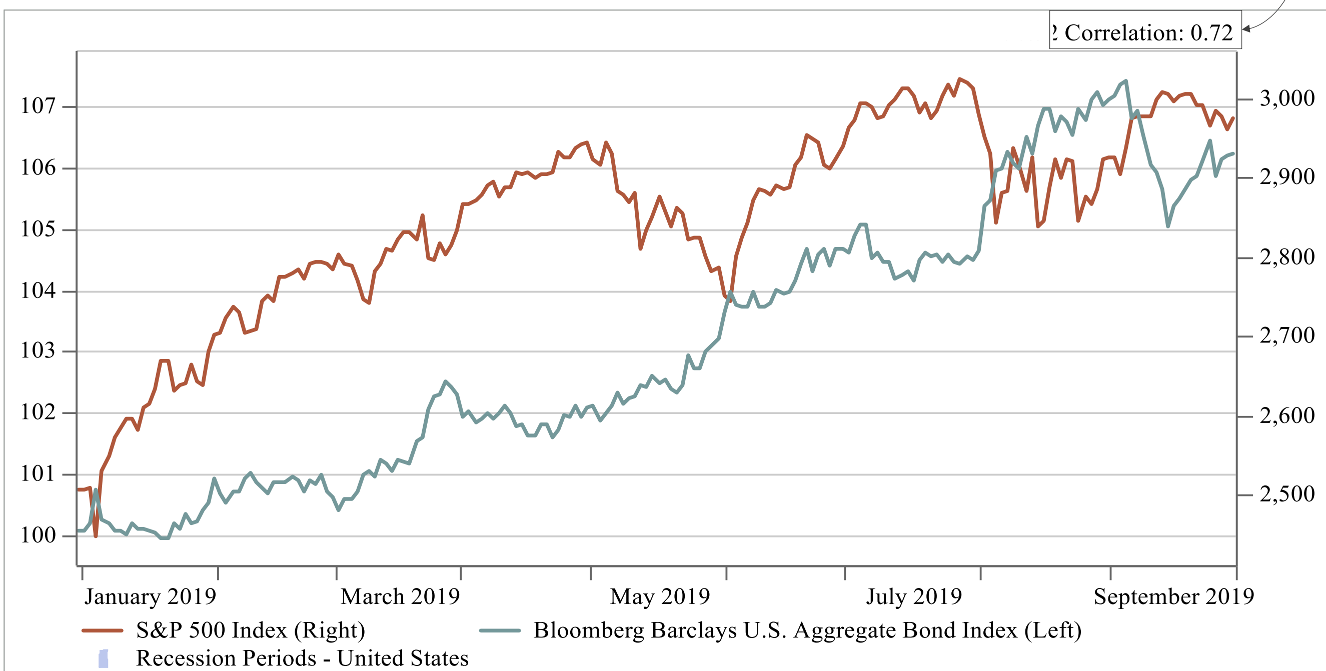
Chart I: Equities vs. Bonds - Correlations (January 2010 - September 2019)



Source: McShane Partners - FactSet Research Systems, Inc.

Despite the longer-term history of negative correlations evident in Chart I, Chart II shows a temporary, short-term positive correlation between bonds and equities

Chart II: Equities vs. Bonds - Correlations (2019 YTD Through September 30th 2019)



Source: McShane Partners - FactSet Research Systems, Inc.

Continued on next page

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

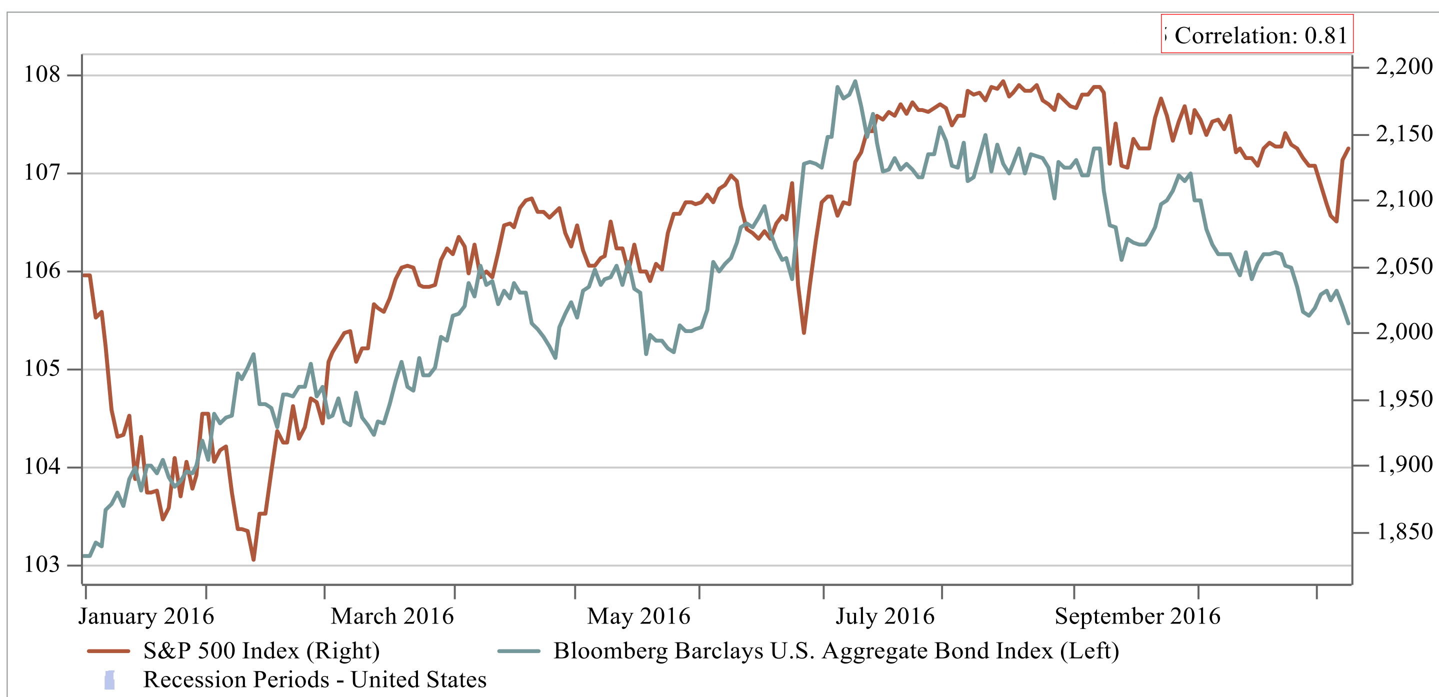
A similar scenario occurred during the first **±10 months** of 2016 leading up to the U.S. presidential election on Tuesday, November 8th 2016, as shown in Chart III (*see page 4*). Throughout most of the first half of 2016 ("1H16") and into the third quarter, both bonds and equities enjoyed relatively consistent, steady gains alongside one another, with the S&P 500® Index and the Bloomberg Barclays U.S. Aggregate Index returning **+7.66%** and **+5.98%**, respectively, through July 31st 2016. In the final weeks and months before the election, both equities and bonds began to stall and trend incrementally lower, effectively setting the stage for a divergence in relative performance between the two asset classes. While not shown in Chart III, following the relatively surprising outcome of the 2016 U.S. presidential election, equities quickly rallied and continued to trade higher through year-end, while bonds declined dramatically and continued to trade lower, thereby resuming their 'normal' inverse relationship to each other and conforming to the historical equity-bond correlation.

While it may be premature to add to Fixed Income allocations, as the 'correction' in bonds thus far has been nominal, and the trajectory for interest rates remains volatile and subject to exogenous shocks, the Investment Team is closely monitoring several key metrics across bond markets for incremental signals and leading indications that have historically been reliable predictors of potential near-/intermediate-term performance for bonds. For example, as previously discussed in a recent newsletter (August 2019 INSIGHTS), the Investment Team believes that the slope and shape of the U.S. Treasury bond yield curve deserves continued scrutiny over the coming weeks and months, as a prolonged period of *inversion* (i.e., short-term yields *greater than* long-term yields) at key levels could potentially warrant an increase in portfolio-level Fixed Income allocations. The recent inversion appears to have corrected for the time being and may be more accurately characterized as a "false positive" due to the short-term impact on financial conditions, as interest rates have adjusted *lower* in response to changes in monetary policy expectations and global economic growth forecasts/projections.

Cash levels remain elevated across investment portfolios, as the aforementioned correlation conundrum and positive equity-bond relationship has reinforced a reluctance to add to Fixed Income allocations, with the Bloomberg Barclays U.S. Aggregate Bond Index hitting near-term highs as recently as September 4th.

Continued on next page

Chart III: Equities vs. Bonds - Correlations (2016 YTD Through November 8th 2016)



Source: McShane Partners - FactSet Research Systems, Inc.

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

Bond Market 'Correction' Yields Long-Term Opportunities

The benchmark 10-Year U.S. Treasury bond appears to have established a near-term cyclical trough, bottoming at **±1.46%** on September 4th: this represents a decline of approximately **-177 basis points** ("bps") over the past year after hitting a near-term cyclical peak of **±3.23%** on October 5th 2018. During this period of falling interest rates, the Bloomberg Barclays U.S. Aggregate Bond Index returned **+12.23%** vs. a comparable return of **+3.73%** for the S&P 500® Index.

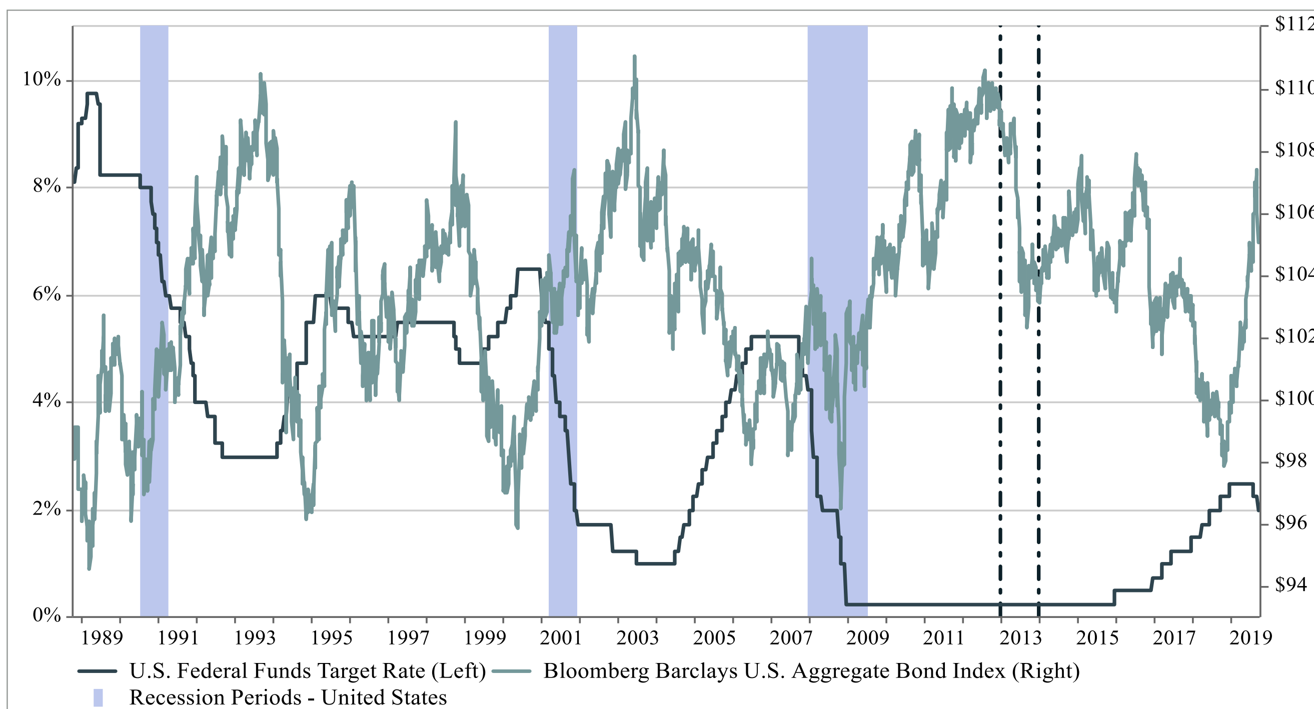
As illustrated below in Chart IV, following similar periods of dramatic declines in benchmark interest rates over the past **±20-30 years**, excluding U.S. recessionary periods, bonds have tended to *underperform* equities, largely in response to a broad-based stabilization in interest rates and a reversion in the cyclical trajectory of short-term interest rates as they begin to climb from trough levels. Based on an analysis of historical interest rate cycles and prior episodes of bond performance following periods of declining interest rates, the Investment Team estimates the potential worst-case drawdown in broader bond market benchmarks ranges from approximately **-6.0%** to **-12.0%**.

Municipal Bond Credit Quality

As the Investment Team has discussed in prior publications, these short-term corrections across broader bond markets have historically created tactical asset allocation opportunities for long-term investors willing to buy high-quality municipal bonds trading at excessively discounted prices as a result of the segment being out of favor due to the timing of the interest rate cycle. Given current debt levels across major credit sectors (e.g., corporate, treasury/sovereign, etc.), municipal bonds appear to offer the highest-quality value proposition in a debt-laden economy at this point in the market cycle. Table I (next page) summarizes the positive credit attributes and compelling investment characteristics of the municipal bond market.

Continued on next page

Chart IV: Fed Funds Target Rate vs. Bloomberg Barclays U.S. Aggregate Bond Index



Source: McShane Partners - FactSet Research Systems, Inc.

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

Table I: Municipal Bond Market Overview	
Market Attributes	**Details**
Credit Quality	As of July 2019, municipal payment defaults were approximately ±\$900 million, only about ±0.02% of the ±\$3.8 trillion municipal bond market. The 2019 YTD default rate is on a slower pace than comparable 2018 YTD municipal defaults of ±\$2.3 billion and is on pace to fall short of the 10-year average annualized default rate of ±\$2.5 billion. Additionally, underlying credit quality of individual municipal bonds has seen significant upgrades: in 2017, there were 774 credit upgrades vs. 461 downgrades; in 2018, there were 480 upgrades vs. 392 downgrades.
Issuance	From 2018 to 2019 YTD, new capital issuance has picked up its proportional share of municipal bond issuance against refunding vs. 15-year historical averages. In 2018, new capital outpaced the 15-year average of ±\$210.0 billion by ±\$10.0 billion, reaching highest new capital issuance since 2010, and 2019 new capital issuance is on pace to match last year's numbers. Moreover, in this decade, refunding issuance has made up a slight majority of total municipal bond issuance on an annualized basis, but 2018 and 2019 reversed that trend: with new capital issuance exceeding refunding issuance, the net impact on municipal bond markets should be incrementally positive, as market and investor demand for high-quality municipal bonds has consistently outpaced readily-available supply, and a reversal in that supply-demand dynamic should enhance market liquidity and generate more attractive investment opportunities for actively managed municipal bond strategies.
Balance Sheet	Through 2018, state revenues saw quarterly revenue growth in the mid-to-high single digits YoY with fiscal 2018 revenue growth of ±7.0%, boosted by tax reform in late 2017. This revenue strength has continued into 2019, as 1Q19 local property tax revenues were up ±6.8% YoY, and 1Q19 state revenues were up ±4.6% YoY. According to the National Association of State Budget Officers, through 1Q19, no state has needed to cut spending due to budget shortfalls and 28 states have reported revenues exceeding projections. Furthermore, revenues for fiscal year 2020 are projected to grow at ±4.0%. **With U.S. government debt to GDP ratio of ±106% at the end of 2018, municipal bonds are more strongly positioned vs. U.S. Treasuries to combat economic uncertainty.**
Tax Policy Projections	One feature of the 2017 tax reform was the \$10,000 cap on state & local tax ("SALT") deductions when paying federal taxes. A consequence of this legislation is a surge in fund flows into state-specific municipal bond strategies with state tax-exempt dividends. During the first five months of 2019, there was ±\$6.6 billion net new cash inflows into state funds versus \$34.0 billion of net flows into national funds; this accounts for ±19.0% of the ±\$40.6 billion total net new cash flows. Contrasting this rotation against 2017 and 2018 fund flows, national funds had net inflows while state funds recorded net outflows. Furthermore, in 2015 and 2016 state funds only captured about ±8.0% of net inflows versus the aforementioned ±19.0% YTD number.

Source: Nuveen Asset Management, LLC

Continued on next page

Investment Overview

Correlations 'Normalize' as Bond Markets 'Correct'

Stock & Strategy Spotlight

Name	Ticker	2019 YTD
Activision Blizzard, Inc.	ATVI	+14.43%

Description & Investment Thesis

Activision Blizzard, Inc. ("ATVI") is a leading game publisher for consoles, mobile devices, personal computers ("PCs"), and online, benefitting from the migration towards gaming and away from other forms of traditional media, which the Investment Team believes should remain a secular, multi-year tailwind for shares of ATVI. The Investment Team views the recent pullback in ATVI as an opportunity to build a position in one of the leading gaming software vendors at a reasonable price ahead of identifiable near-term catalysts. The stock has pulled back due to the general, sector-level malaise across Information Technology and Communication Services stocks, but the gaming software vendors have been particularly hard hit. Furthermore, ATVI has had idiosyncratic hurdles in the form of waning content throughout 2019. The confluence of these factors contributed to a **-38.5%** decline in the stock price from its near-term peak roughly a year ago. The gaming sector experienced a downshift going into the fourth quarter of last year ("4Q18"), as many popular titles/games simultaneously matured across multiple platforms. After experiencing two years of extreme positive investor sentiment and momentum, these stocks became expensive and experienced a corresponding multiple reset, as the market began to question the long-term growth prospects of the industry given changing dynamics (e.g., console cannibalization, move to digital, in-game purchases, changing revenue models, etc). This cautious outlook for the industry and growth-investor rotation out of this once extremely popular and crowded group of stocks combined with a difficult year-over-year ("YoY") comparison in 2019 for ATVI's major titles *Destiny*, *Heartstone*, and *Overwatch*, which benefited from new releases in 2017-2018 but are now slowing. This issue first manifested itself in a weak third quarter 2018 ("3Q18"), so the company is set to anniversary that particularly troublesome quarter in November, creating a more forgiving YoY comparison for the company in 3Q19, which could potentially show a resumption in growth or at least a stabilization in the corresponding decline. A favorable quarterly earnings report in 3Q19, combined with the highly anticipated October 25th 2019 release of *Call of Duty: Modern Warfare*, should propel shares of ATVI higher, with implied and forward-looking valuation multiples expanding towards the multiple assumed and incorporated into the Investment Team's price target

Wealth Advisory Overview

The Importance of Having a Financial Plan

2. ***It will help you see whether your goals are realistic, especially for your timeline.***

   After taking a look at your goals, it is important to determine if they are realistic? Are they attainable? Most of us have more goals than financial resources and usually it is not that the goal is unattainable, it is that it is not attainable in the timeline we are afforded.

3. ***It will help you see what action items are needed to help you achieve your goals.***

   Once you know where you want to go and how long it will take to get you there, we can determine how much you need to save, where you should save it and what types of investments need to be made.

4. ***It will allow you to measure your progress towards your goals.***

   Once the plan is in place, we can set up measurable goals, such as regularly contributing a specific amount toward savings or debt repayment. Annual reviews can provide measurable results to determine whether you are on track or if adjustments need to be made.

5. ***It will help you find new ways to maximize your money.***

   Having a financial plan might reveal opportunities to save money that you had not thought about such as maximizing a company 401(k) match or fully funding a Health Savings Account.

Continued on next page

Wealth Advisory Overview

The Importance of Having a Financial Plan

6. It will help identify risks.

Part of a comprehensive financial plan includes looking at risk capacity. What is your risk of becoming disabled and being unable to support yourself or your family, or dying early and leaving your family with unmanageable debt? Once the risks are identified, it can help to provide alternatives for addressing these risks.

7. It will help you build wealth and live more comfortably.

The CFP Board survey showed that those with a written financial plan have more money saved and are more likely to say they are living comfortably. They are more confident, more engaged with their wealth, and demonstrate more positive saving and investing behaviors than average Americans .

Only 15% of high-net-worth individuals (i.e., those with $1.0 million or more in investable assets) have a written financial plan that is updated annually.

Benefits of Using a Financial Planner

Most individuals do not have the expertise, the time or the desire to actively plan and manage certain financial aspects of their life. Some reasons for having professional financial planning guidance might include:

- ✓ Making sure your money will last during retirement
- ✓ Handling the inheritance of a large sum of money or other unexpected financial windfall
- ✓ Preparing for a marriage or divorce
- ✓ Planning for the birth or adoption of a child
- ✓ Facing a financial crisis such as a serious illness or displacement from employment
- ✓ Caring for aging parents or a disabled child
- ✓ Coping financially with the death of a spouse or close family member
- ✓ Funding education
- ✓ Buying, selling or passing on a family business

"If you don't have time to do it right, when will you have time to do it over?" - John Wooden

---

Procrastination is the greatest enemy of financial independence, and using a financial planner will keep you on track to meet your goals. Financial planning is a process, not a product. It is the long-term method of wisely managing your finances so you can achieve your goals, while at the same time assisting you with navigating the financial barriers that inevitably arise in every stage of life. At McShane Partners, we are committed to making sure that every client has a written comprehensive financial plan that is reviewed and adjusted on an annual basis to ensure that you have a roadmap to attain your life goals .

Around McShane Partners

Dress for Success® Charlotte The Ultimate Power Luncheon

McShane Partners and friends attended "The Ultimate Power Lunch" for Dress for Success® Charlotte. The luncheon was held at the Fillmore Charlotte Music Factory on Tuesday, September 24th.

Included in the photo are Elliott Van Ness and Corey Meyer who each participated in the "Stiletto Swagger" earlier this year. A champion of upward mobility for 19 years, Dress for Success® Charlotte provides services to more than 800 women who are seeking employment as a means to achieve economic independence and strengthen their families.

Walk for an IC Cure!

On September 14th, McShane Partners supported the inaugural walk in Charlotte, NC to raise awareness and support for the Interstitial Cystitis Association ("ICA").

The ICA is the only nonprofit charitable organization dedicated solely to improving the quality of healthcare and lives of people living with interstitial cystitis ("IC").

One Night Wonder - Discovery Place

Our own Corey Meyer had a chance to dive into the future of how we will live, work, and play at Discovery Place's annual celebration of innovation in science and technology.

McShane Partners Supports Fashion & Compassion

Fashion & Compassion creates empowerment communities where vulnerable women connect with God, one another and resources as their lives are transformed.

Fashion & Compassion runs programs in Charlotte, North Carolina and partners with Artisan projects in six other countries. F&C teaches women to make jewelry and other crafts. These products provide supplemental income to the women and an income stream for the organization.

Mint Museum Auxiliary Fall Membership Meeting

McShane Partners is proud to once again sponsor the Mint Museum Auxiliary. Organized in 1956, the Auxiliary supports the Mint Museum by raising money to support educational offerings for the community and fund acquisitions for the Museum's permanent collection.

Daniele Donahoe introduced guest speaker, Cathy Kincaid, at the Fall Membership meeting for the Mint Auxiliary. Charlotte was Cathy's first stop her book tour, *The Well Adorned Home: Making Luxury Livable*. Cathy Kincaid's enviable sense of color and intricate design detail has established her as one of the country's top designers and an editorial favorite whose work is published internationally. For more than 30 years, Kincaid has designed houses for her clients that are as individual as they are.

McShane Partners

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

521 East Morehead Street | Suite 580
Charlotte, NC 28202
Phone: (980) 585-3373
Fax: (980) 265-1274
Email: mcshane@mcshanepartners.com

Information provided in this newsletter should not be considered or interpreted as advice for your particular financial situation. Please consult a professional advisor for advice regarding your specific financial needs.

CIRCULAR 230 NOTICE: To comply with requirements imposed by the United States Treasury Department, any information regarding any U.S. federal tax matters contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, as advice for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

This newsletter is for discussion purposes only and represents the opinions of McShane Partners.

McShane Partners is a Registered Investment Advisor.