COLORADO FINANCIAL MANAGEMENT®

February 2019

"I wanted a perfect ending. Now I've learned, the hard way, that some poems don't rhyme, and some stories don't have a clear beginning, middle, and end. Life is about not knowing, having to change, taking the moment and making the best of it, without knowing what's going to happen next. Delicious Ambiguity."
— **Gilda Radner**

SUMMARY:

2018 was up, down, up, down. At the end, equities were down (5% - 15%). Better in the U.S., worse internationally.

2018 fundamentals were good for the economy and corporate earnings.

One pressure on markets in 2018 was the Fed raising interest rates. They have indicated they are unlikely to raise rates in 2019.

We may surpass the modern record for economic growth longevity in 2019.

There are so many geo -political risks in the world today we are likely to have negative surprises from time to time.

We are positioned conservatively at the current time, but cautiously optimistic we'll be fully invested before long.

As Of 1/31/19 (annual returns)	1 Year	5 Years	10 Years
60/40 Balanced World Index	-3.7%	5.0%	9.0%
World Equity Index (ACWI)	-7.7%	6.6%	11.6%
U.S. Equities (Wilshire 5000)	-2.2%	10.6%	15.1%
Foreign Equities (ACWI-ex U.S.)	-12.6%	3.1%	8.4%
U.S. Bonds (Barclays AGG)	2.3%	2.4%	3.7%
Global Bond Index (Global AGG)	-1.4%	1.1%	2.9%
HFRI Fund of Funds Composite	-2.4%	2.3%	3.5%

Dear Clients and Friends,

Once I asked my Mom if she had read my newsletter. She replied something to the effect that she had to be ready to concentrate before sitting down to read it. I don't think that was a compliment. I apologize if it's too dense but grab a cup of coffee (or something stronger if you prefer) and we'll try and describe last year and look forward to what might happen in 2019.

Going back to the beginning of 2018, you'll remember January began with a bang. Stock markets everywhere were up over 5%, but then suffered a sharp correction of 10% in February. From March until May, both U.S. and foreign stocks drifted sideways. Beginning in May, foreign markets declined and the U.S. stock market rose through September. As we all know, there was a vicious decline in the 4th quarter of nearly 20% in stocks globally. Nonetheless, as shown above the 5 and 10 year returns for equity markets have been spectacular. Remember though that trailing returns can be deceiving. They can be heavily influenced by big returns at the beginning or ending of the period. In this case, the beginning point is right after the Financial Crisis and 50% decline in stocks.

Economically, things were good in 2018, and this will likely be the longest economic expansion in modern U.S. history. The previous record was set in the 1990s at 120 months. We will break that record in July if there is no downturn beforehand.

Corrections Are Normal

Standard & Poor's 500 Composite Index (1948-2017)

	-5% or more	-10% or more	-15% or more	-20% or more
Average frequency	About 3 times a year	About once a year	About once every 3.5 years	About once every 6.3 years
Length (days)	46 days	117 days	275 days	425 days

Sources: RIMES, Standard & Poor's. Assumes 50% recovery of lost value. Length measures market high to market low.

The unemployment rate ended the year at 3.7%, inflation is 2% or lower, interest rates remain low, and oil and gasoline prices were modest. Just in case you think a recession is inevitable, it is worth noting that Australia has not had a recession in 27 years. We may not match their record, but it does suggest we could have a much longer expansion than people think.

As we have reported before, U.S. corporate earnings had a terrific year in 2018 primarily due to the tax cuts. S&P 500 earnings were up 25%. Combined with the 4th quarter correction valuations are much better today than a year ago. In January 2018, stocks were trading at 21.5x trailing earnings. In January 2019, they were only at 16x trailing earnings.

As we look forward, we think economic growth will slow, but not enter a recession in 2019. One of the primary risks, rising interest rates, has been taken off the table – at least temporarily. The Federal Reserve has made multiple statements signaling they will be 'patient'. The futures market is now pricing in no rate increases in 2019. This could change, but it is our base case assumption.

With unemployment still at historic lows and an economy that is primarily related to consumer spending, recession risks are low. On the other hand, growth is likely to slow as tax cut benefits fade and businesses slow their capital spending plans. Trade concerns and slowing growth around the globe are also reasons to expect slower growth.

Geo-political risks are increasingly concerning to us as economic risks. The government shutdown (and possible redux), BREXIT, trade wars, looming debt ceiling battle, investigations, and pockets of upheaval around the world are likely to lead to slowing economic growth. At a minimum, periodic surprises will lead to increased market volatility. We do not expect any meaningful legislation this year in the U.S.

Sometimes Annual Secular Summit

In January our investment and advisory teams met for an off-site meeting to discuss longer term trends affecting the economy and the markets. Topics included artificial intelligence, demographics, autonomous driving, China, electric vehicles, Russian aggression, 5G internet, climate change, politics, energy, and government debt. The presentations were excellent and provide us some background for interpreting near term events. Look for a special report on the summit in coming weeks, and following are some excerpts.

For example, while Russia is currently in the news for influencing the last election, here's a short list of other recent Russian activities:

- Clashes with Georgia in 2006 & 2008
- Stakes claim to the Arctic in 2007
- 2007 Russia withdraws from 1990 Arms Treaty
- Russia performs naval exercises in Atlantic and Mediterranean in 2008
- Russia halts gas to Ukraine in 2009
- Backs Al Assad in Syrian civil war

- Invades Ukraine in 2014. Shoots down Malaysian airline killing 298
- 2016 interferes with U.S. presidential election

Clearly, we should expect Russia to continue stirring the pot.

We discussed demographics and technology and their potential to affect our labor markets. On the one hand, the labor force is growing at the slowest pace in 50 years. In the next seven years, the baby-boomers will be between 62 and 80 years old. As they leave the labor force, economic growth will likely slow.

On the other hand, technology has the potential to transform our economy, and will likely do so in ways we don't yet understand. According to Forrester Research, robots and artificial intelligence will create digital workers for 40% of companies this year, and roughly 10% of U.S. jobs could be eliminated by automation. At the same time, they predict automation will be responsible for creating new jobs - the equivalent of 3% of today's jobs.

Taking just one more technology example, we explored autonomous driving and electric vehicles. These changes will affect businesses as diverse as auto repair, taxis, energy, and insurance.

While it will almost certainly be disruptive, it would appear the productivity gains from technology have the potential to offset the slowing effects from demographics.

Climate change will lead to more and more problems. Hurricanes, fires, and floods will increase in severity and frequency. There will be increased costs to society (aka taxpayers). While there is an economic benefit in the rebuilding process, it is still an economic drag on balance. We see energy costs being lower for longer. The increased production in the U.S. from shale is shifting the supply curve.

China is a wildcard both in the near and long term. They have emerged from sleeper to superpower in a short time. Their government strives to keep a billion people employed, and they have a demographic problem similar to the rest of the world. Their monetary and economic policies will continue growing in importance to the world. It is inevitable there will be clashes with the West in general, and the U.S. in particular from time to time.

All these issues: Russia, climate change, technology, and the others lead us to expect an increased level of volatility in financial markets in the coming years.

Finally, a concern of ours for many years has been the level of government debt. I found a quote from Mike Sargent in our newsletter written in January 1992. He said, "The final wild card is how we in the United States deal with our huge debt burden. Getting out of this mess without creating financial chaos will be a miracle. Continued build up of larger and larger government debt levels reminds me of a giant Ponzi scheme." Total public debt outstanding was $3.8 trillion in 1992 and it is $16.1 trillion today.

Our point is not that the debt doesn't matter, but it has not had the negative impact we and many others worry about. There are a number of reasons for this. Probably the most important is that the U.S. dollar is the world's reserve currency, and we remain the world's largest economy. We have a level of flexibility with our debt that smaller nations do not have. We worry that our politicians have given up any semblance of fiscal responsibility; but in the near term our conclusion is that this is not likely to result in a market disruption.

Strategy

At our All Client ICM in Boulder this year we described our two approaches to asset allocation: Strategic and Tactical. You can watch a video replay of the presentation by going to our website www.colofinancial.com

In our Strategic Portfolios, we only attempt to change the asset allocation targets when we believe we are in for a longer or deeper bear market. As we wrote in our November 2018 Bear Market Playbook newsletter, the problem is that every 20% or greater bear market begins with a

Colorado Financial Management Composite Returns As Of 12/31/18

	2018	5 Yrs	10 Yrs	15 Yrs
CFM 60/40 Balanced	-5.6%	3.4%	7.2%	5.1%
Avg. Asset Allocation Fund	*-6.3%*	*2.9%*	*7.2%*	*4.4%*
60/40 ACWI/AGG	*-6.0%*	*3.5%*	*7.6%*	*5.5%*
CFM Global Equity	-8.3%	5.5%	11.2%	6.7%
MSCI All Country World Index (ACWI)	*-10.1%*	*4.2%*	*9.7%*	*6.4%*
CFM Core U.S. Equity	-2.6%	8.0%	13.2%	8.7%
S&P 500	*-4.4%*	*8.5%*	*13.1%*	*7.8%*
CFM Fixed Income	-0.2%	2.2%	3.2%	3.5%
CFM Alternative Strategies	-0.3%	3.3%	5.9%	4.5%
Bloomberg Barclays Aggregate Bond Index	*0.0%*	*2.5%*	*3.5%*	*3.9%*

10% correction. You can't know, after that first 10% move, whether the next move is up or down.

The recent market action is a case in point. The global equity index ACWI and the S&P 500 both fell 19% last year from their highs to their lows set on Christmas eve; but both are now up over 13% from those lows. The speed of these market moves makes it very difficult to time, so we will only make changes to strategic portfolios when we think the fundamentals will not recover in the near term. This usually means we expect an economic or earnings recession, or valuation is at an extreme, or we believe the inflation and interest rate environments are deteriorating. In December we were worried enough to reduce our equity targets by about 10%. For example, if your target was 60/40 we reduced the allocation of equities to about 55%.

For clients in our Tactical Portfolios, we attempt to make changes more quickly and to a greater degree. Using both advice and recommendations from outside research sources, and from our internal fundamental and technical analysis, we reduced those portfolios to a 40% weight in December.

Because the equity markets rebounded in January this strategy has underperformed. Were we wrong? The short answer is yes, at least for January. The more nuanced answer is maybe. We view this strategy, and the clients that choose it, as being more risk averse. The strategy is meant to reduce equity allocation more aggressively in the event we have another 2000 or 2008 type of bear market where stocks fell 50%. In order to protect against that downside there will be times where we get whipsawed.

Further underscoring the maybe verdict is the possibility of another down-leg in the market. Technical analysis (chart below) suggests stocks will fall in the next month or two and retest the

Chart courtesy StockCharts.com and RBC Wealth Management lows set December 24th. We hope it won't happen, but history suggests it will. Both our Strategic and Tactical Portfolios remain defensive (to varying degrees) until the facts change.

In conclusion, we believe the fundamentals remain largely intact. The economy is growing (no recession), earnings will grow, valuations are reasonable, inflation and interest rates will remain steady. Sentiment and the news will be volatile and create both risks and opportunities this year. We thank you for the confidence you give us and we strive every day to deserve it.

Brad Bickham, CFA, CFP®
Partner | Chief Investment Officer

The Last Word

Our financial planning team is busy. We are working on more than 35 different projects right now, covering a wide range of topics including estate planning reviews, family meetings, and IRA withdrawal strategies. Seven projects are first time financial plans. Everyone who works with our firm ought to aim to have a financial plan in place. This tool is indispensable for both of us, and an essential piece of thinking to lean on when you are handling a life event, considering an investment opportunity, or want to make an important gift or loan. If you are interested in putting together a financial plan, mention it to your advisor. We are eager to help you with this work.

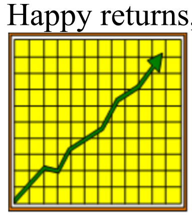
In a few weeks Patty Meneley will be leaving our company. To be a bit more accurate, she has decided to quit her day job and enjoy time and travel with husband Doug, and her "grown up" kids. Patty will continue to be an owner and partner in the firm. Patty was employee #3 of our company. She has been a part of CFM (prior to the merger it was Sargent Bickham Lagudis) for 25 years. While Mike, Gary, and Brad, and later others, built the company with new relationships, it was Patty who built the operations and compliance processes and structure. Many of the people who will read this newsletter have known Patty for years, and I know you will join us in wishing her well in retirement, and thanking her for the huge contribution she has made to this firm. Hats off to you, Patty!

During the last several weeks we held our annual "All Client Investment Committee Meetings" in Loveland and Boulder. Brad, Josh and David each gave presentations on the economy, the stock and bond markets, the outlook for 2019, and how those things affect our various portfolio management approaches. We are planning one more of these sessions in a location convenient to our Denver area clients. We will do this on February 26th at 9:00am, location will be in the Tech Center area. If you are interested in attending, please send a note to Bekah Pickerell at bekahpickerell@colofinancial.com. We welcome the chance to meet with you. If you won't be able to attend any of these meetings, and want to see what these are all about, we have put a recording of the Boulder meeting on our website. Have a look, and we would love to have you attend next time.

I hope you enjoyed reading Brad's note. It is amazing how many important, complicated, and conflict filled things are going on in the world, and I always welcome a chance to understand a little more and think through what that could mean to our markets and investments. Thank you for taking the time to read our newsletter, and thank you for working with Colorado Financial Management.

Rick Lawrence
President & CEO

Happy returns,



Your Colorado Financial Management Team

Index Definitions & Disclosures:

Standard and Poor's Index

- **S&P 500:** The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization

Morgan Stanley Capital International (MSCI)

- **MSCI All Country World Index:** The MSCI ACWI Index is designed to represent performance of the full opportunity set of large- and mid-cap stocks across 23 developed and 24 emerging markets. As of September 2018, it covers more than 2,700 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market. The index is often used as a benchmark for global equity portfolios. Investments in international and emerging markets include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability.
- **MSCI All Country World Index Ex US:** The All Country World Index Ex-U.S. (MSCI ACWI Ex-U.S.) is a market-capitalization-weighted. It is designed to provide a broad measure of stock performance throughout the world, apart from U.S.-based companies. The MSCI All Country World Index Ex-U.S. includes both developed and emerging markets. For investors who benchmark their U.S. and international stocks separately, this index provides a way to monitor international exposure apart from U.S. investments.

Bloomberg Barclays Indices

- **Bloomberg Barclays Global-Aggregate Total Return Index (Hedged):** The Bloomberg Barclays Global Aggregate Index is a flagship measure of global investment grade debt from twenty-four local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.
- **Bloomberg Barclays U.S. Aggregate Bond Index:** The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS (agency and non-agency).
- **Wilshire 5000:** The Wilshire 5000 Total Market Index is widely accepted as the definitive benchmark for the U.S. equity market, and measures performance of all U.S. equity securities with readily available price data.
- **HFRI Fund of Funds Composite Index:** This index is a composite made up of multiple hedge funds via funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio.

Performance Calculation Disclosures: a) Time weighted returns are used; b) Cash and equivalents are included in the balanced composite, but not in the equity or fixed income composite; c) Gross figures do not reflect the deduction of investment advisory fees for all clients. Therefore the return would be reduced by the advisory fees in some cases. d) Returns are not GIPS compliant; e) Total return includes the reinvestment of dividends and capital gains.

Past performance is not to be construed as a guarantee of future performance. Returns are presented for the period shown and may differ for future time periods. Composite is a broad reflection of performance. Prospective clients should recognize that each client's account is customized and performance can vary widely.

References to specific investments should not be construed as a recommendation by Colorado Financial Management to buy or sell securities.

Past performance is not an indication of future results, and as is the case with all investment advisors that concentrate on equity investments, future performance may result in a loss. Portfolio holdings and weightings are subject to change at any time due to ongoing portfolio management. Portfolio returns given are after trading costs but not after fees. Returns do not reflect the holding of cash in the account, if any. This report is for informational purposes only.

Colorado Financial Management, LLC (CFM) succeeds registration as Sargent Bickham Lagudis, LLC. Sargent Bickham Lagudis, LLC (SBL) succeeds registration as Sargent and Company. SBL's registration was effective March 8, 1999. Sargent & Company's registration was effective in 1988. Sargent Bickham Lagudis merged with Colorado Financial Management effective January 1st, 2016. For the year 2016 and after, the composite performance will include both firm's households for each asset class. For returns before 2016, only returns from legacy Sargent Bickham Lagudis will be included in the composite.

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