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Economic Memorandum

October 2018, Issue 73

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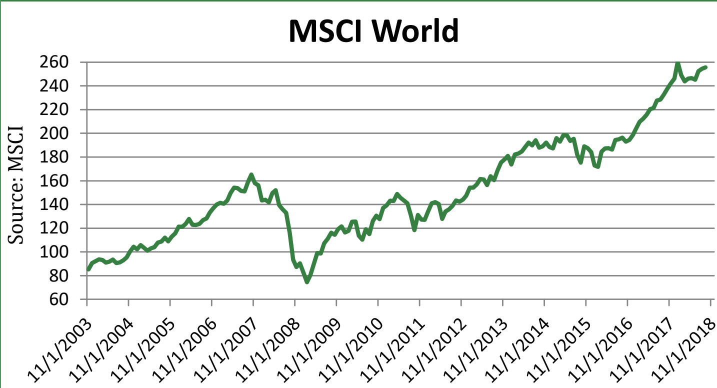
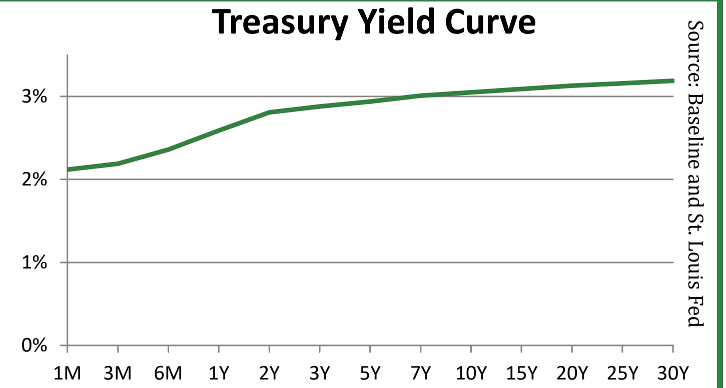
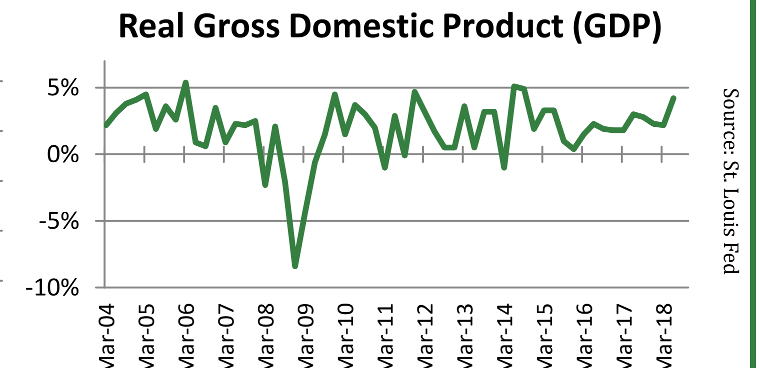




The Federal Reserve continues to raise short-term interest rates.



Unemployment reached a new cycle low as GDP growth pierced 4%.

The Risk Of Investing In One Asset Class

By: Justin W. McNichols, CFA

In this article: We explain the present risks of investing in one asset class – domestic equities.

For many decades, the best risk-adjusted returns were found using a multi-asset class investing approach. Historically this discipline, used by most of the top performing large foundations and endowments, enabled investors to achieve equity-like returns with far less risk and far less downside in difficult markets. A once-in-a-generation credit bubble and subsequent crisis altered the way these asset classes worked together. Due to record low interest rates, low inflation, and the U.S. dollar appreciating by over 30%, the number of asset classes that are performing near their long-term norms has dwindled to one – U.S. equities. The side effect of this is too many investors have piled into a single asset class, leaving many others trading at extremely compelling levels. The "piling" is reaching a crescendo as many of the reasons for the outperformance (low valuation, high earnings growth, low inflation, strong dollar) appear close to reversing. As seen in the table below, since 2010, domestic equities have strongly outperformed their long-term average annual return. Conversely, every other asset class has underperformed the long-term average – by a substantial margin in some cases.

Asset Class Return Divergence From The Long-Term Average

	12/31/10-9/30/18 Return	12/31/77-9/30/18 Return	Return Difference
Domestic Equities	13.4	11.6	**1.8**
Foreign Equities	4.6	9.9	**(5.3)**
Natural Resources	(4.9)	6.3	**(11.2)**
Real Estate	7.9	10.8	**(2.9)**
Alternatives	4.3	5.5	**(1.2)**
Fixed Income	2.4	7.0	**(4.6)**
Equal Weighted Portfolio	4.6	8.5	**(3.9)**

Source: OPCM

Please note: an investor cannot invest directly in an index. Please see the end of the article for more information regarding this table.

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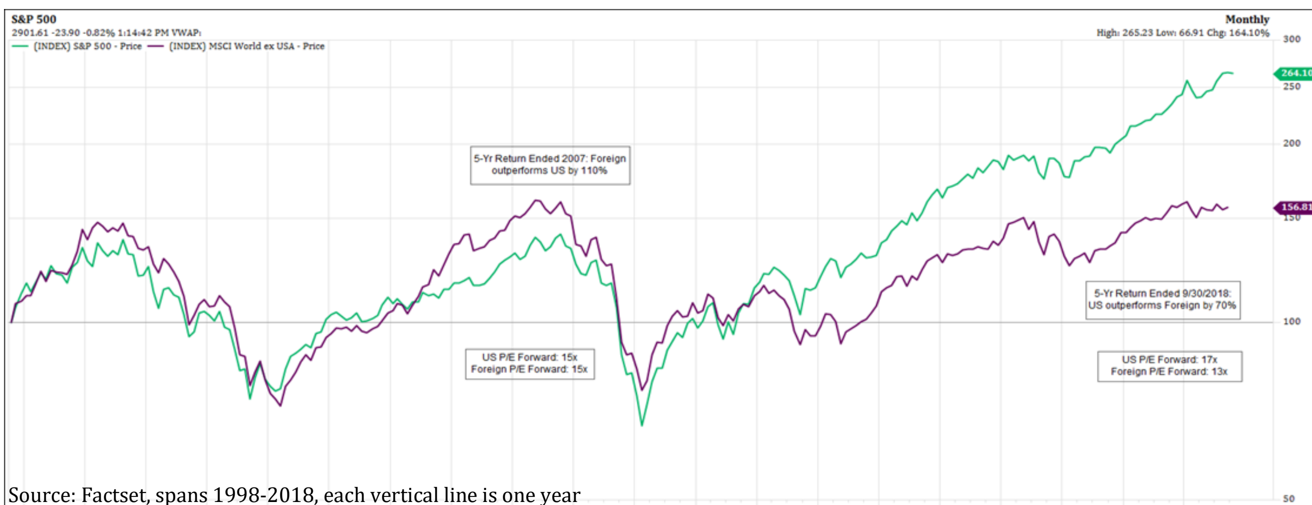
The Risk Of Investing In One Asset Class

Generally the transition for one asset class to outperform another progresses in three stages. First, the difference in returns becomes extreme. Next, the valuation differential dramatically widens. Finally, the fundamentals reverse. Let's examine how close the different asset classes are to achieving all three of these stages versus U.S. equities.

First by almost any measure, the return of U.S. equities versus all other asset classes has reached at least a decade extreme. The performance difference with natural resources is basically unprecedented. U.S. equities typically outperform natural resources by about 5% a year (while natural resources trounce the U.S. in inflationary and weak dollar periods). However, since 2010 U.S. equities have outperformed by over 18% per year. Next, for many decades, U.S. and foreign equities both returned about 10% annually with one outperforming the other during stretches. Since 2010 the U.S. has outperformed foreign by almost 9% per year! The chart below shows the returns over the last 20 years.



Source: Factset, spans 1998-2018, each vertical line is one year

While at the end of 2007, foreign equities had outperformed the U.S. by over 100% in the previous five years, the U.S. has now outperformed foreign equities by over 70% during the last five years. These extremes in each direction usually reverse when the performance spread becomes too compelling for astute investors like today.

Second, we analyze the relative valuation of other asset classes versus U.S. equities. The following table shows the long-term valuation range between foreign equities, emerging markets equities, REITs, and fixed income versus the S&P 500. While the relative valuation between fixed income and REITs versus the S&P 500 is essentially at fair value, huge extremes are seen within foreign equities and natural resources.

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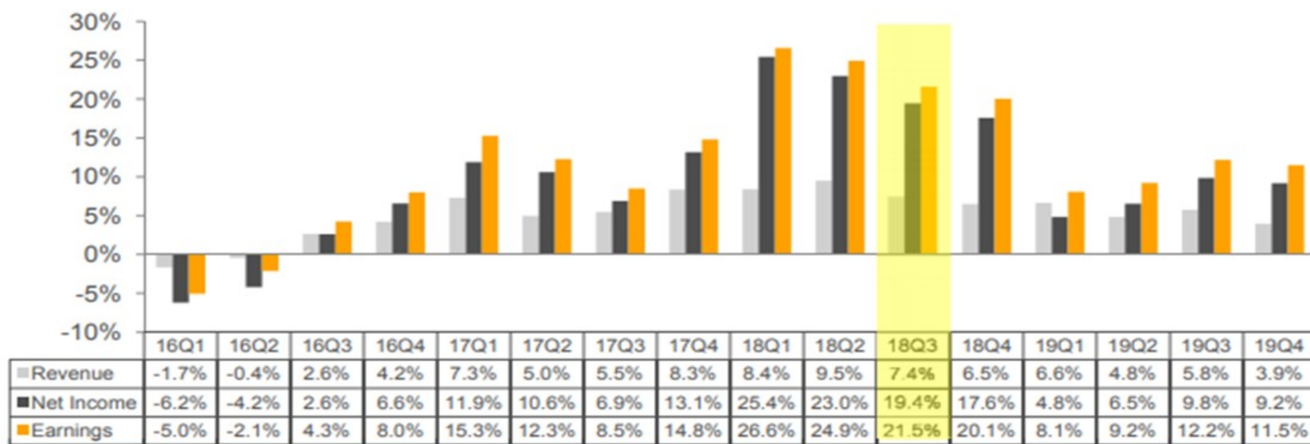
The Risk Of Investing In One Asset Class

	HIGH	MIDPOINT	LOW		TODAY		METRIC
All Foreign Equities	1.10x	0.90x	0.65x		0.72x		MSCI ACWI P/E versus S&P 500 P/E
Emerging Markets	1.20x	0.85x	0.55x		0.62x		MSCI Emerging Mkts P/E versus S&P 500 P/E
Natural Resources	104	91	78		97		U.S. dollar 30 year range (ex-2000 & 2008)
REIT's	1.60x	1.10x	0.70x		1.00x		REITs P/E versus S&P 500 P/E
Fixed Income	+2.00%	-2.00%	-6.00%		0.00		S&P 500 dividend yield versus 2-yr Treasury

Source: OPCM, date range: 1998-2018

To summarize the table, foreign equities as a whole trade at a P/E on next 12-months of earnings of 0.72x versus the U.S. – meaning a 28% discount (1.00-0.72). They are within 10% of reaching a long-term relative valuation low. The same phenomenon is seen with emerging markets. Natural resources are affected by the dollar and inflation. As the table shows, the dollar strength is within 10% of the high of 104. Once the dollar stops rising, natural resources experience a tailwind. Looking at REITs and fixed income, the opportunities are not as strong on a relative valuation basis. This is one of the reasons we are generally underweight both of these asset classes.

Finally, a look at fundamentals. Clearly the U.S. earnings growth rate has been superior to other regions and asset classes recently. However, as U.S. interest rates continue to rise, inflation moves higher, and the earnings comparisons become difficult in 2019, investors could piece together these metrics, along with relative returns and relative valuation, and decide the risk/reward is superior in other asset classes.



	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Revenue	-1.7%	-0.4%	2.6%	4.2%	7.3%	5.0%	5.5%	8.3%	8.4%	9.5%	7.4%	6.5%	6.6%	4.8%	5.8%	3.9%
Net Income	-6.2%	-4.2%	2.6%	6.6%	11.9%	10.6%	6.9%	13.1%	25.4%	23.0%	19.4%	17.6%	4.8%	6.5%	9.8%	9.2%
Earnings	-5.0%	-2.1%	4.3%	8.0%	15.3%	12.3%	8.5%	14.8%	26.6%	24.9%	21.5%	20.1%	8.1%	9.2%	12.2%	11.5%

Source: I/B/E/S by Refinitiv

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The Risk Of Investing In One Asset Class

The previous table shows the revenue, net income, and earnings growth rates for the S&P 500 from 2016 through estimated 2019. The non-existent earnings growth of 2016, gave way to 12% growth in 2017, then this year's spike to up 22%. However, the table indicates the first quarter of 2018 was the growth peak at an unsustainable 26.6%. The fourth quarter will be the third quarter in a row of slower, but strong, earnings growth. 2019's earnings growth estimate is now under 10%, which puts the S&P 500 earnings growth on par with the 10% estimate for foreign equities, and less than the 12% growth estimate for emerging markets. If these growth rates come to fruition, foreign equities trading at a little over 12x earnings are positioned well to potentially outperform the S&P 500 trading over 17x earnings.

With a major performance extreme in place, along with a major relative valuation disconnect, and fundamentals beginning to turn in favor of other asset classes, many investors will learn the perpetual lesson of why investing in one asset class, or majorly overweighting an asset class can be dangerous, especially at valuation and performance extremes. ■

In the OPCM Performance Comparison Table, (page 2) the following benchmarks are used to represent each asset class: Fixed Income – Barclays US Aggregate Bond Index (1977-1999), Barclays US Govt/Credit Interm Bond Index (2000-2018); Domestic Equities – S&P 500; Foreign Equities – MSCI EAFE (1977-2000), MSCI World ACWI ex US (2001-2018); Natural Resources – GSCI (1977-1991), Bloomberg Commodity (1992-2018); Real Estate – NAREIT (1977-2004), NAREIT Global (2005-2018); Alternatives – Hennessee Market Hedge Fund Index (1987-1999), HFRI Fund Weighted Index (2000-2007), HFRI Asset Weighted Index (2008-2018). The Equal Weighted Portfolio represents a hypothetical portfolio equally weighted in each asset class of the corresponding benchmark.

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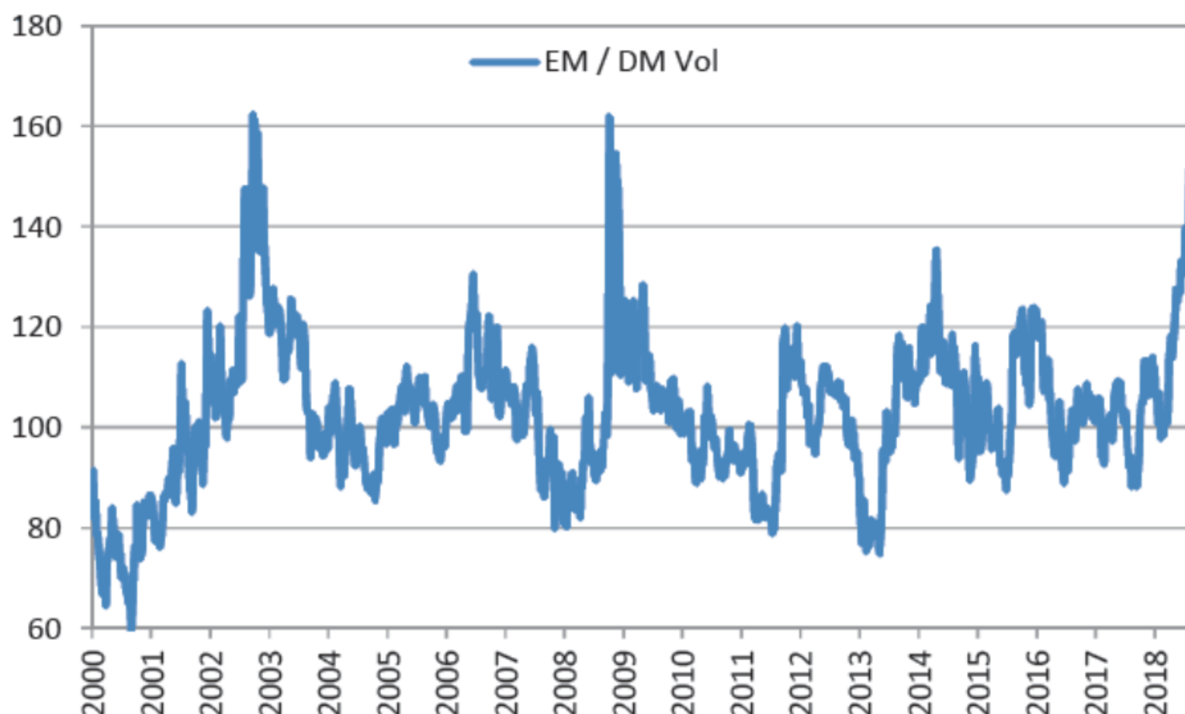
Foreign Currency Conundrum

By: Jay M. Skaalen, CFA

In this article: It is important to be cognizant of currency risk when investing outside of U.S. equities.

On August 13th, 2018 a headline in the International Business Times read, "Turkey facing currency meltdown and credit crunch fears". The "meltdown" the article was referencing was a three day, 30% decline in the value of Turkey's currency, the Lira. Normally, headlines like this are rare, especially for a country that is home to nearly 80 million people and has been considered for inclusion in the European Union. Yet in 2018, headlines like this have felt all too common. In fact, 2018 has been the most volatile year for emerging market currencies since 2008 when the U.S. was going through the worst recession since the Great Depression and economies across the globe were sputtering. But it is not just emerging market currencies that have had a turbulent year. Nearly every major currency across the globe, including the Euro, the Pound and the Yen has lost value versus the U.S. Dollar this year. In this article we will take a look at what has been causing this volatility, the impact it has on client portfolios, and what is likely to happen next.

(The chart below shows the volatility of emerging market currencies relative to their developed market peers over the last 18 years)



Source: JPMorgan

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Foreign Currency Conundrum

The fireworks that we have seen in global currency markets this year have been driven by several main factors. First, interest rates in the U.S. have marched higher as the Federal Reserve continues to distance itself from other major global central banks, most of whom are still holding interest rates near 0% (or below). Higher interest rates tend to increase demand for currencies which has provided support for the dollar and been a drag on others. Second, protectionist trade policies in the U.S. have weakened the currencies with which the U.S. has had trade disputes. Specifically, we saw the Mexican Peso, the Canadian Dollar and the Euro weaken while the U.S. attempted to re-write long standing trade agreements. China, with whom the U.S. is still in a fierce trade standoff, has seen its currency fall by roughly 5% so far, year to date. Another factor that has contributed to the hysteria this year is a handful of isolated events in countries like Turkey and Argentina. As previously mentioned, the value of Turkey's currency has been ravaged this year, down over 35% from the start of the year. Turkey's volatile political environment, outsized government debt and runaway inflation all contributed to the sharp deterioration in the local currency. Argentina, a country with a long history of financial problems, has seen an even steeper decline in its currency with the Peso down nearly 50% year to date versus the U.S. Dollar. Like Turkey, Argentina's bloated government debt and rampant inflation are primary drivers of the Argentine Peso's collapse. The issues that are plaguing Turkey and Argentina have been mostly confined to those two countries but we have seen some spillover effect into other emerging markets that are perceived to be more vulnerable by financial markets.

Source: Factset, 2018. Argentina Peso purple. Turkish Lira green.

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Foreign Currency Conundrum

Now that we have explored a few reasons why we have seen strength in the U.S. Dollar this year, the next logical question is – what impact does this have on my portfolio? As a general rule, any time you see outsized strength in the U.S. Dollar, the area most likely to be negatively impacted is foreign equities (natural resources too but we'll save that for another article). Because foreign equities are denominated in their respective local currencies, the return that U.S. investors receive is a function of: the stock's total return in local currency + any fluctuation in the local currency. As an example, the main foreign equity benchmark, the MSCI All Country World Ex-US Index was up 0.7% year to date through September when measured in local currencies. But when you factor in the currency movements we saw in the first nine months of the year the index was down 2.7%. A more glaring example is in Brazil where local equity markets were up 5.9% through the first three quarters of the year but due to declines in the Brazilian Real were down 12.1% in U.S. Dollar terms. For most investors, a country's currency often is an after-thought, but if you are investing in a region that is susceptible to significant volatility it is important to be cognizant of this added element of risk not present when investing in U.S. equities.

While currency swings can be aggravating for investors, it is worthwhile to keep a couple things in mind during periods of heightened volatility. First, at OPCM, we have taken a proactive stance to mitigate the impact of foreign currency volatility by holding a long position in the U.S. Dollar. In effect, any negative impact that the dollar's appreciation could have in client portfolios is partially mitigated by the return via our U.S. Dollar hedge. Second, we have seen this year that currency movements can have substantial impacts on performance, but underlying company fundamentals are a more important variable, and over time will be a more significant determinant of future performance. At the moment, fundamentals in markets outside the U.S. and, in particular, the regions where OPCM has a larger tactical exposure (India, Brazil, Germany, etc.), continue to be attractive and could lead to continued gains over time. Lastly, currency fluctuations have tended to be a smaller variable in performance over longer time frames as the movements usually act to offset each other. As an example, in 2017, foreign currency added 9% to the return of the MSCI All Country World Index Ex-US as most international currencies gained ground against the dollar.

Our team currently believes that the rally in the U.S. Dollar is somewhat long in the tooth and, as such, our expectation is that currency will likely shift from a headwind to a potential tailwind as we exit 2018 and head into the New Year. Going forward, the team at OPCM will continue to be proactive in looking for additional ways to protect client portfolios from currency volatility, while simultaneously positioning your portfolio to take advantage of the rapidly changing global economic landscape. ■

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Credit Markets: Another Rate Hike

By: Charles J. Else

In this article: There is a large degree of complacency in the bond market.

The third quarter saw yet another interest rate hike by the Federal Reserve. On September 26th, Fed Chairman Powell announced the Fed Funds target would increase another .25% to a range of 2.0-2.25% and officially removed the term "accommodative" in relation to current monetary policy. With the jobless rate at 3.9% and inflation running right at the Fed's 2% target, Powell stated that the U.S. economy has a "remarkably positive outlook" at this point.

In the week following the rate hike, further strong economic data has caused longer-term rates to move up significantly, while spreads between shorter-term and longer-term bonds have widened. Prior to the rate hike, the benchmark 10-year Treasury was yielding 3.06% and as of this writing, the 10-year is yielding 3.20%. Over the same period, the spread between the 10-year and the 2-year Treasury has widened from .23% to .31%, indicating the bond market's expectation of continued strong economic performance and further tightening of monetary policy. The Fed is widely expected to raise rates again at their December meeting.

For the quarter, junk bonds were up while most other issues were generally flat to slightly positive. In fact, CCC-rated bonds (the junk of the junk) are up 6.4% this year, while long-term investment grade bonds are down 6.6% - a whopping 1300 basis point difference. This indicates there is a large degree of complacency in the bond market at present.

We continue to maintain our positioning in the 3-6 year maturity range, although opportunities to lock in higher rates with slightly longer maturities may develop as the Fed continues raising rates into 2019. ■

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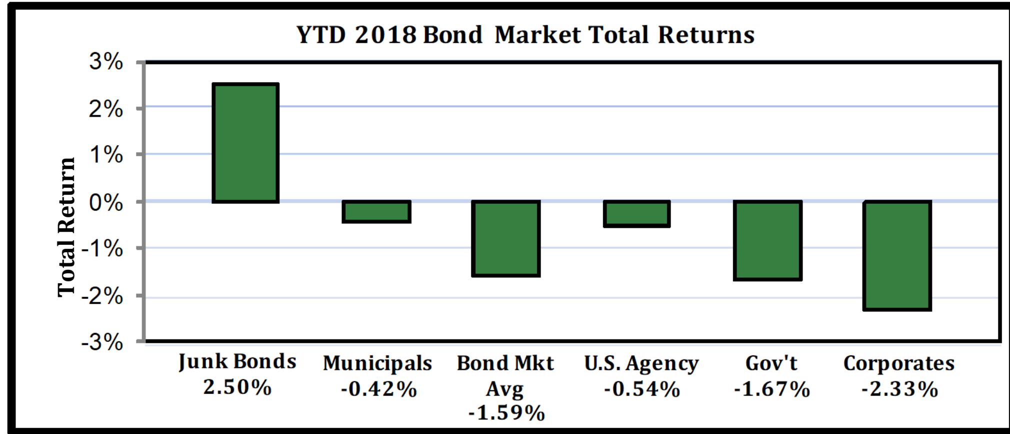
Credit Markets: Another Rate Hike



Source: Wall Street Journal

Bond Market Yields 9/30/2018			
Average Money Market Fund	0.47%	10 Yr. AAA Muni Bond	2.62%
5 Yr. AAA Muni Bond	2.23%	10 Yr. AA Corporate Bond—Long Term	3.77%
5 Yr. AA Corporate Bond—Intermediate	3.38%	10 Yr. U.S. Treasury	3.06%
		30 Yr. Fixed Rate Mortgage (Conforming)	4.92%

Source: Bankrate.com

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11 Tips to Trim Taxes, Increase Cash Flow, or Save Time

By: Karen J. McMillan, CFP®

In this article: Tax & Time; 11 Tips For the Next 70 Days

The Tax Cuts and Jobs Act was signed into legislation last December, and this upcoming 2018 tax filing will be our introduction to how the changes affect us personally. As Q3 comes to a close, we have been thinking about what steps can be taken over the remaining 70 days with the goal of reducing tax liability, improving cash flow, or saving time.

Many of the recommendations are familiar and repeated annually, but each year almost always contains a twist that requires us to consider our strategy anew. This year is no different, with changed tax brackets and reduced Schedule A deductions in particular.

1. Determine if you are going to file a Schedule A or take the standard deduction. In 2017, approximately 30% of all tax filers itemized. Given the extremely restricted allowable deductions (e.g.: no more unreimbursed business expenses, accounting or portfolio management fees, moving expenses, personal casualty losses[i]), and considering the increased standard deduction amounts, it is estimated that only 10% of filers will now itemize deductions on a Schedule A. This year, the maximum amount that can be deducted for state and property tax combined is $10,000. Add to that the amount of applicable mortgage or HELOC (Home Equity Line of Credit) acquisition interest paid (with limitations, see below), and you will have your base deductions. On top of this number, the addition of medical expenses in excess of 7.5% of AGI, and charitable donation amounts will either bring you over the standard deduction floor - or not.

Married Filing Jointly / Qualifying widower	Single / Married filing separately	Head of Household
$24,000	$12,000	$18,000

2. Review your charitable gifting. If you are under the standard deduction floor even when including deductible charitable gifting, there are still ways to enhance gifting financially as well as emotionally:

a) If possible, use highly appreciated stock to make charitable donations. The charity receives the shares at current market value, but you do not have to pay tax on the capital

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gain, and the capital gain does not add to your AGI (adjusted gross income), or impact calculations that use your AGI.

b) You could set up a Donor Advised Fund and donate a few years' worth of donations all at once to increase the current year itemized deduction, then take the standard deduction in the following years.

c) If you are 70.5 or more years old, deliver all or part of the IRA RMD (Required Minimum Distribution) directly to a qualified charitable institution (up to $100,000). RMD amounts donated directly to a charity are not included in your taxable income, therefore reducing your AGI, which favorably impacts other calculations that use your AGI number. This is commonly referred to as a Qualified Charitable Distribution.

d) Forego the tax deduction, and in doing so leave behind the need to keep track of the value of the dinner, or the gift, or the silent auction item vs the charitable donation.

3) Arrange for investment management fees of IRA and other tax-deferred accounts to be paid from the tax-deferred account directly with pre-tax dollars. This is an allowable expense.

4) Review mortgage and HELOC deductibility. Interest on a HELOCs is still tax-deductible provided it was used to buy, construct, or improve the residence. If the interest expense is insufficient to itemize, calculate the tax, portfolio and cash-flow ramifications of paying off the mortgage and/or HELOC debt.

5) As always, it is useful to **review portfolios for any meaningful tax-loss** harvesting to improve a tax position. The $3,000 capital loss deduction is still allowed. However, it is equally important to **review capital gain positions**, to ascertain whether there is room in the tax bracket to take some capital gains at favorable tax rates. This is especially useful in lower income years, such as those after retirement, and before Social Security and IRA withdrawals add to taxable income. The lower tax brackets of the Tax Cuts and Jobs Act legislation may have opened up some cost basis step-up opportunities.

6) If you are a member of an employer sponsored retirement plan (401(k), 403(b), 457, Simple IRA), verify that you will reach the maximum contribution ($18,500 + age 50 and over catch-up amount of $6,000; or $12,500 + age 50 and over catch-up of $3,000 for a Simple IRA) by the end of

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11 Tips to Trim Taxes, Increase Cash Flow, or Save Time

the year. If not, consider increasing your remaining deferral amounts to reach the maximum and supplementing your cash flow from other investments.

7) Check that wage withholdings and any estimated tax payments made to date in 2018 reflect the new tax regime with the lower tax brackets and increased standard deductions. It may be that your withholdings can be reduced, or that a fourth installment of estimated taxes will not be required. The IRS released an updated calculator that can be used. https://www.irs.gov/individuals/irs-withholding-calculator

8) Don't forget that now is **open enrollment** for many health insurance plans, including Medicare. Make full use of the tax deduction and tax deferred growth of a HSA account if the insurance coverage is appropriate, and make maximum use of the ability to pay certain medical, child care, and transportation expenses using pre-tax FSA money if possible.

9) If you have vested **Incentive Stock Options (ISOs)**, request a tax projection to determine whether some of the ISOs can be exercised without adverse AMT consequences. The expanded AMT tax exemption amounts combined with the limited Schedule A deductions could create a favorable ISO exercise environment.

10) Fund 529 Education Plans using all or part of your individual annual gift tax exclusion amount of $15,000.

11) Review withdrawals from Survivor and Bypass trusts. The increase in the Estate Tax Exemption amount to $11.2 million per person has switched the focus from estate tax avoidance to the protection of cost basis step-up. It may now be more efficacious to spend down accounts that will not receive a step-up of assets on death.

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11 Tips to Trim Taxes, Increase Cash Flow, or Save Time

The new tax legislation also contained significant changes for business entities, sole proprietorships, partnerships, LLCs, S and C Corps, but for reasons of complexity we did not include any recommendations pertaining to those. As always, please consult with your tax advisor for specific tax related questions.

We would be happy to talk with you about these tips and other last-quarter strategies that can be employed to enhance your overall financial situation, and look forward to working together. ■

[i] *Moving expenses are allowed as a deduction for active-duty members of the U.S. Armed Forces whose moves relate to a military-ordered permanent change of station. Also, to the loss of personal casualty losses, The Act did retain a deduction for qualified disaster-related personal casualty losses if the loss occurs in a presidentially declared disaster area and is a result of the disaster.*

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OPCM Profile: Kathie Celestina — Client Service Specialist

After 17 years with Osborne Partners and previously Woodside, Kathie Celestina is heading to the sandy beaches of Florida for retirement in December. Kathie worked closely with Bob Beim and Morgan White at Woodside Asset Management for over 5 years and came to Osborne Partners 12 years ago. Since then she's done an excellent job on our client service team in our Silicon Valley office. She's gotten to know many clients very well, always remembering dogs' names and the latest milestones in clients' lives. She is best known for being a happy and friendly co-worker, knowing how to fight for what's right for the client, being extremely efficient, and always a great help getting quarterly statements out to clients. Keeping track of annual gifting requests and RMDs is Kathie's forte. While we are happy for her and believe that her career has been a remarkable one, we will greatly miss having her on our team. Over the next couple of months she'll be busy training her successor for a seamless transition. Kathie – you will be missed!

Facts about Kathie:

- Grew up in Staten Island, New York
- Yorkie Terrier dog's name: Lucy
- Avid SF Giants Baseball fan
- Lived in the Bay Area for 40 years
- Most looking forward to during retirement: "Not having the alarm go off at 4:40am; taking more golf and Tai Chi lessons; volunteering; spending more time with my sister"
- Favorite part about working at OPCM: "Love every client I've worked with; it has been such a blessing working for a truly amazing company!"

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