Sentinel Trust
Together, families prosper℠

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Dear Friends of Sentinel Trust,

Before diving into a recap of 2019 and our 2020 market overview, I want to thank each of you who has taken the time to meet with me over the past four months. It has been extremely helpful to understand the families we are serving and to hear firsthand your thoughts and honest feedback on your experiences with Sentinel Trust. For those of you I have not yet met, I look forward to doing so. Please know that I am happy to speak with you or meet at any time to discuss your portfolio, the markets or any other concern.

One of the cornerstones of Sentinel Trust's culture that attracted me to the Firm is the paramount focus on service and fiduciary duty, and I am committed to ensuring that every investment decision is guided by these principles. Now, I'll address the markets.

2019 Recap

In 2019, geopolitical risk reached a 20-year high, with headlines dominated by US-China trade negotiations, Brexit, impeachment, drone attacks and protests from Hong Kong to Argentina. Business confidence fell to 10-year lows and global trade declined from a year earlier. The yield curve – the difference between short- and long-term interest rates – inverted or turned negative. Economists predicted there was a one in three chance we would enter a recession, and U.S. companies indeed entered an earnings recession with two straight quarters of earnings decline from a year earlier.

But unlike 2018, when nearly every asset class except cash delivered negative returns, 2019 was an exceptional year for almost every asset class. Cash was the laggard, giving investors roughly 2% if they held Treasury bills. Bonds, as measured by the Barclays Aggregate Index, gained over 8%. U.S. stocks jumped a little over 30%, while international stocks gained just over 21%. Real estate stocks climbed 20%, and even gold rallied 18%. Most remarkable, perhaps, was that despite all the geopolitical uncertainty, volatility remained low. U.S. stocks never fell more than 7% and registered one of their longest streaks of days without a +1% or -1% return.

So, what happened? How could such negative news and economic activity deliver such exceptional returns? We tend to believe that three powerful forces drove markets higher in 2019. First, central banks the world over reduced interest rates, initiated quantitative easing programs and lowered reserve requirements, all of which increased liquidity available for investment. Next, the U.S. consumer (responsible for 17% of the global economy) remained resilient due to 50-year lows in unemployment, meaningful boosts in wages and reduced interest rates. Finally, heading into 2019 on the heels of a year-end decline, stocks became relatively cheap, with the S&P 500 trading at just 14 times next years' expected earnings (a level not seen since 2014 and below its 25-year average).

2020 Outlook

Because forecasting one-year returns is very difficult and error-prone, we'll address our long-term views and how they impact our current asset-class positioning. While many of the hot-button 2019 geopolitical issues have cooled, 2020 is already shaping up to be just as uncertain from a global perspective. If January's headlines – of the coronavirus, impeachment hearings, primary campaigns and the US-Iran exchange – are any indication, then elevated geopolitical risk is likely

to remain a theme for the remainder of the year. These concerns, along with a recognition that the post-2008 recovery has been uneven (leaving many low-income consumers concerned about the future), will keep the Federal Reserve and global central bankers accommodative for continued expansion.

Cash & Bonds

We believe that interest rates, especially short-dated cash-like rates, will remain low and below inflation. While we recognize the feeling of comfort in holding cash in the face of heightened geopolitical risk, we know with certainty that both pre- and post-tax returns on cash are not keeping pace with current inflation rates. Holding low-yield assets creates a drag on long-term portfolio value. Longer dated bonds are not providing much more compensation than cash against inflation, but will provide better returns should stocks decline. As such, we plan to lower our negative yielding (relative to inflation) exposure by reducing our overweight in cash and adding to bonds on weakness.

U.S. Stocks

Turning to equity markets, U.S. stocks are not as cheaply valued as they were heading into 2019. We now stand closer to 18 times next year's expected earnings, which we think will deliver below average, forward-looking returns over the longer term. Unlike last year when stocks fell just 7% intra-year, we expect there to be a typical correction of 10% at some point during 2020, consistent with historical norms. Over the past 40 years, the S&P 500 has averaged a roughly 14% intra-year decline despite still compounding at 8.9% per year. We expect to add to equities during these bouts of volatility as we believe the below-average returns from stocks will still outpace the negative real returns from cash. We are likely to remain in passive, index-replicating strategies for the foreseeable future as the vast majority of active managers have failed to outpace the highly efficient U.S. markets.

International Stocks

Outside of the U.S., stocks appear relatively cheap. However, we think there are a host of good reasons why international stocks should trade cheaply relative to their domestic counterparts. The valuation gap between the two has grown so wide that we do think international stocks can play some catch up in the near-term and will remain near our long-term international targets. Over the long-term, expect us to tilt a little more toward the U.S., where we see several distinct advantages that warrant higher valuations. Within international markets where we see greater inefficiencies, we are likely to be more active and are working now to reduce our manager count to our highest conviction ideas.

Hedge Funds

We plan to extend this culling initiative into our hedge fund strategy. Hedge funds, as a group in general, have failed to deliver returns justifying their higher fees and reduced liquidity. For some historical context, in 1990 there were just 530 hedge funds managing a relatively small pool of capital. These funds outpaced the S&P 500 in 6 of the next 10 years by considerable margins. By 2010, 7,200 hedge funds managed over $1.5 trillion in assets. Since then, the group as a whole has failed to match the returns of the S&P 500 in each year and often by considerable margins.

Our Firm's track record in hedge funds has been strong due to our focus on high-quality managers. We continue to see hedge funds as a valuable tool in constructing diversified portfolios, but we intend to reduce our exposure to the asset class and focus the allocation on

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compelling hedge funds with expertise in specific niches (those operating an “inch wide and a mile deep”).

Private Equity

Given the lack of relative returns from hedge funds, one might expect similar results from private equity, where higher fees and even more illiquidity are the norm. However, private equity as an asset class has continued to deliver returns that are commensurate with the added fees and illiquidity and we are more optimistic on the space. As the number of publicly traded companies in the U.S. has shrunk considerably, the number of private companies and the value created by them has accelerated. We don’t see this trend abating any time soon and want to maintain our commitment to the space.

We consider the commitments we make to private equity funds with the seriousness of marriage in light of the long-term holding periods. In fact, we reviewed over 200 funds in 2019 and made commitments to just 12 of them. While we are cognizant of the amount of capital flowing into private equity and the high valuations paid for companies that are unprofitable in many cases, we will continue using our smaller size and nimble structure to make commitments to firms we are aligned with philosophically to continue our success in this asset class.

Real Assets

Turning finally to real assets – real estate, gold and commodity-related assets – like many observers (including the Federal Reserve), we have been surprised by the lack of inflation in the face of record unemployment, rising U.S. deficits and mounting debts. While we are not anticipating runaway inflation any time soon, we do think there are accelerants that could eventually lead to higher inflation and a weaker U.S. dollar. Accordingly, we continue to commit to real estate funds that can generate tax-efficient, predictable cash-flow streams in normal times, with upside protection should inflation accelerate.

We also are watching closely energy-related assets and pure commodities because they one of the few assets trading at historically cheap levels. We are cognizant of potential rising regulatory risk and are considering managers who are deft to the regulatory regime and flexible to change course if needed.

Conclusion

In 2019, markets climbed a wall of worry in the face of heightened geopolitical risk as they have largely done over time. Although geopolitical risk remains elevated as we head into 2020, events that appeared to be catastrophic at the time have generally been buying opportunities for long-term investors. Over the past 70 years, a diversified portfolio has rarely delivered returns below that of cash. Although we expect increased volatility and lower expected returns moving further into 2020, we generally will be looking to add to risk when other investors are fearful and to move closer to our long-term targets.

We expect to prepare similar communications on a regular basis or more frequently as markets dictate. We’ve also prepared a more detailed presentation diving more deeply into the themes discussed if you are interested. As always, we welcome the opportunity to discuss these market themes, your portfolio and any other topics with you.

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Our entire Sentinel Trust team values your family and your business. For myself, I am humbled by the confidence you have placed in me and do not take that responsibility lightly. I look forward to continuing to earn your trust over this next year and beyond.

Yours truly,

Todd A. Burchett, CFA, FRM, CAIA
Chief Investment Officer

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