3rd Quarter 2016 – Investment Commentary

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Market and Portfolio Performance:

Summary:

- **The year so far gives a resounding argument for diversification—and against market timing.** After the first 9 months of 2016, nearly a third of the stocks in the S&P 500 are in negative territory. Yet the S&P 500 index overall is up 7.8% for the year. Put another way--if you had chosen just one stock out of the S&P 500, you had a 32% chance of ending up with a loser. We don't like those odds! We much prefer an indexing approach, which allows us to benefit from the performance of a diversified index. Not only do we avoid the issue of picking a winner or a loser, we also avoid the problem of timing. With index funds, you do not have to decide when is the 'right' time to buy or sell an individual stock.
- **Investors are waking up after a sleepy summer.** The third quarter was relatively calm until September. During prolonged periods of low trading activity, pretty much any news can make markets move, regardless of how important it actually is. Deutsche Bank's woes at the end of the quarter had the power to move markets, despite being just one single stock! Deutsche stock was down almost -7% on September 29 based on news of the company's potential $14 billion settlement payment to the U.S. Justice Department to settle mortgage-backed securities cases. Then the very next day, Deutsche stock was up 14% on news that the penalty might be lessened to 'just' $5.4 billion. These break-neck speed of these price movements highlights the folly of individual stock selection– even among industry 'giants' like Deutsche Bank. We use a value-based, enhanced index approach along with a low-volatility version of certain funds to protect you during uncertain climates.
- **Low economic growth and a return to normal levels of volatility highlight the importance of proper diversification.** Q2 GDP growth was only 1.4% annualized (despite forecasts of around 2.5%), and bond yields are so low that there is little cushion for volatility. Being exposed to a proper mix of equities, bonds, alternatives, and global investments is how we prepare for the fact that different asset classes outperform at different times—as they have this quarter. During times of low volatility, it appears that markets are looking for anything at all to determine their direction – whether it's a headline, Deutsche Bank, Twitter potentially being bought, or oil prices moving. During times of high volatility, investors often have a herd mentality – pouring in and out of asset classes, sectors or individual holdings based on the fear du jour. Looking at markets overall, volatility is picking up for the first time since Brexit-related turbulence at the end of June. This is not surprising as fall often brings greater volatility. This year we have a national election cycle to stir the pot even more!

Equities:

- **Strong quarter for all equity asset classes. For the quarter, growth outperformed value.** Cash-healthy companies should be more resilient during a rising-rate environment, so it is prudent to favor them in this type of environment. Value indexes tend to have higher exposure to financial services companies, so their performance recently was held back by the Wells Fargo scandal and concerns over Deutsche Bank's financial stability. We do still favor value over growth during a low growth cycle like we are in now and during periods of political uncertainty because of their relative stability compared to their growth counterparts.
- **Developed international stocks had weak numbers YTD, but regained strength in the last quarter.** Around the world, other countries are continuing or even increasing their 'easy money' policies. Loose monetary conditions are intended to boost stock markets. At the same time, the U.S. is (very slowly) trying to tighten monetary policy. This may be a contributing factor to strength in developed international stocks, as well as some of the initial Brexit fears abating. Do not be surprised, though, if we see a second Brexit shock when the split begins to be implemented in early 2017.
- **Minimum volatility funds continue to show their worth.** 2016 was expected to have increased volatility compared to recent years, so we have taken steps to include minimum volatility funds within specific asset classes. This has been a prudent move, especially earlier in the year when expected volatility hit hard—these funds outperformed broad markets significantly in Q1 and Q2. However, with little volatility and little trading volume in Q3, "min vol" delivered more muted performance. They are designed to mitigate risk during times of high volatility. Both minimum volatility funds we utilize have phenomenal year-to-date numbers.
- **Emerging markets saw a boost from higher oil prices.** Oil prices surged this summer after an OPEC agreement to limit production, touching $50 per barrel in August for the first time since November 2015. Emerging market

economies are very dependent on natural commodities so this is likely why the emerging market sector is up so significantly for the year-to-date, leading all other equity asset classes. This is great news, but remember not to fall head over heels for any particular asset class… upward and downward trends for any particular area can turn on a dime, so we maintain a diversified strategy to benefit from upside and mitigate the downside.

Alternatives:

- **Trimming back REIT fund exposure.** Your REIT fund is doing phenomenally—up 11.27% for the year-to-date, and up 2.95% for the quarter despite REITs overall being down a fraction of a percent. However, this outperformance is unusual—and likely unsustainable--given the low risk profile of the fund compared to other REITs. We are cutting back exposure to this fund, but certainly not eliminating it. Our underlying reasons for using the fund have not changed (including diversification, providing a buffer to low bond interest rates), but we are making a strategic adjustment to take some profits off the table.

Bonds:

- **Flat quarter for bonds – amazing risk-adjusted YTD performance.** Bond markets treaded water for much of the third quarter as investors awaited the results of the September Fed meeting, delivering muted returns for the quarter. Once it was announced there would be no Fed hike, bonds regained some strength and have delivered strong numbers across the board for the YTD.
- **Emerging market (EM) bonds soared and high yield bonds regained strength!** EM bonds have delivered wonderful quarter and YTD returns, benefitting from strength in commodities like oil. High-yield bonds did not see as extreme of a leap, but they are also highly tied to energy prices so have really delivered strong returns.
- **No inflation? Think again!** Despite an apparently lack of inflation, inflation protected bond funds have delivered solid returns for the YTD. This shows that although it has seemed like there has been almost no inflation in recent years, it is not completely stagnant. Of course, too much inflation is bad but we are glad to see a small amount of movement. Some of this is also likely advance movement in anticipation of likely Fed tightening.

Expectations and Perceptions for the Future:

Equities:

- **Election, election, election.** The outcome of the Presidential election will have an impact on taxes, estate planning, and other aspects of your financial life—and that's not even taking into account the potential volatility in the markets leading up to November 8. But regardless of who wins, your fundamental strategy is designed to weather change. As we have been mentioning, election years can be rocky, so we are preparing for short-term volatility.
- **Don't let short-term moves sway you from your long-term strategy**. In the next few months we will see a lot of predictions--the 3rd quarter earnings reports will start to come out for different stocks, and financial writers' outlooks for 2017 will start to appear in the media. As silly as it sounds, these things do tend to move markets – especially if the comments come from a media-savvy financial pundit.
- **"The end of the world" is greatly exaggerated in hindsight.** Remember January, when we had the worst 5-day start for equities in history? There were massive outflows from equities into bonds during the first quarter as stock markets appeared to be in freefall through the middle of February. With the benefit of hindsight, we can see how silly it was for investors to panic based on the movements of just 1.5 short months. How about the Brexit vote when it seemed the entire European Union was going to collapse? These events seemed catastrophic at the time, yet investors quickly get over these shocks and move on—to the tune of U.S. equities being up over 7% year-to-date. Even just a few months ago this seemed unlikely. We still anticipate a volatile market ahead, so be prepared. Although it can be difficult in the moment, investors would do well to maintain perspective whenever the next market shock occurs.
- **China's financial system to become more open.** China's Yuan will be included in the International Monetary Fund's basket of reserve currencies, starting in October. One of the conditions of this inclusion was for China to open their financial system further and implement additional reforms. It remains to be seen what the impact of this will be longer term, but the goal was to support the growth and stability of China by implementing a more robust monetary and financial system. China is a large part of the global economy, so a more open system could be a boost for the global economy over the longer term.

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- **Taxes driving markets?** We keep tax efficiency in focus at all times, and manage your portfolio in a way that minimizes short-term gains and other investment-related tax issues throughout the year. However, many other investors don't pay much attention to taxes until the end of the year. These investors then take reactive steps like sales for large losses, or they get nasty surprises from tax-inefficient mutual funds making large distributions. Remember also that the outcome of the election could also dramatically affect tax policy – and this may cause investors to react before the end of the year, even if new tax policies will not take effect quickly. So be aware that in the fourth quarter, all of these factors could cause increased market volatility. While we are careful not to 'let the tax tail wag the investment dog', we must pay very careful attention to what the future tax landscape will look like, and how this could affect investor sentiment.

Bonds:

- **The Federal Reserve did not raise rates in September.** However, there is speculation that a 0.25% rate hike may now be likely by year-end, announced at the December Fed meeting. Whenever the Fed does act, the move is likely to be so small and measured that it should not cause much issue for bond markets. However, we are prepared for markets to react as if this is a very dramatic event! Your bond portfolio is extremely diversified and has been designed to tolerate changes in interest rates for some time now. But regardless of any short-term volatility, over the long term we want rates to rise to reward patient savers like you.
- **Inflation HAS been low, but not nonexistent, so we maintain a strategy to handle rising rates and rising inflation over time.** The Fed's inflation target was 2%, and currently inflation is very close, at 1.7%, so it should not surprise us too much if the Fed moves closer to a less accommodative policy stance. In some ways, the Fed has stuck to what they have said very closely, but with so many moving parts, it is impossible to predict their future movements with certainty.
- **With that being said – avoid market timing for bonds too!** You are already aware of the folly of stock market timing and the negative impact it can have on your portfolio. It is vitally important to avoid market timing strategies for bonds too. This means you should maintain allocations to a variety of durations and qualities of bonds, and avoid jumping in and out of bond asset classes based on Fed-watching. It is an impossible sport with a high probability of losses!

Please do not hesitate to reach out with any questions about your investments in the current market environment. We are always happy to talk to you, and we wish you a very happy fall season!