HalpernFinancial

Second Quarter 2017 Market Review

Portfolio Principles in Action

It would be hard to ask for a better first half of 2017 in the markets. For Q2 and the year to date, we are pleased to bring you positive returns in every single fund we hold in your portfolio, with the exception of your TIPS fund, which ended Q2 very slightly negative, but was offset by gains in Q1 to provide a positive YTD number.

We always like to see gains in the portfolio, but some may wonder if they should be worried. After all, "what goes up must come down." This is true to some extent over short-term time horizons. Yet your portfolio has performed well on a risk-adjusted basis over the varying market trends of the past quarter, 6 months, and even the past 18 months. Much of this is due to the simple portfolio principles that we bring up every quarter in these commentaries. Some market factors are out of anyone's control, but there are certain things we *can* control to build your wealth over the long term. Recent performance shows these portfolio principles in vivid action.

- **Cost savings:** We are always searching for ways to optimize investment expenses, and this past quarter brought the opportunity to provide our clients with lower costs than ever before. We have always provided the lowest cost fund share class available because low investment costs are a primary driver of performance, but previously, not all clients were able to use Institutional share classes ("bulk pricing"). Typically, Institutional shares have prohibitively high minimums (as much as $5 million per fund). Now we are able to use them across the board regardless of account size.

  To give an example of the impact, let's look at a very common fund, the Fidelity S&P500 Index Fund. The institutional share class has an expense ratio of just 0.035%. That's more than 60% lower than the cost you would pay to buy the same fund as an individual retail investor (0.09%), and 22% lower than the cost of the (already low, and exclusive) Premium shares that were available to our clients until this point with an expense ratio of 0.045%. Depending on the individual fund, our clients will save 3.6% to 42.6% on expense ratios! Low investment costs are among the most reliable predictors of performance because "you get what you don't pay for."

- **Diversification:** Going into 2017, markets faced a lot of uncertainty…just as they do every day. No one knows what the next day in the markets will bring, so we diversify to benefit from movements in all asset classes, allocated according to each client's individual growth needs and risk tolerance. When one investment zigs, another zags and the idea is to offset losses with gains. We implement a strategy which aims to maximize growth within a custom risk spectrum for each client. Over the past 6 months, it was all gains—and we'll take that too! In comparison, active stock picking (the opposite of a diversified strategy) performed terribly this year, with 40 stocks in the S&P 500 losing 20% or more, further highlighting the benefits of a more passive strategy within certain asset classes.

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- **Risk-adjusted returns:** One example of how we mitigated risk while preserving the potential for gain was incorporating a minimum volatility "smart beta" fund. This fund automatically screens for stocks with lower volatility relative to the broader U.S. equity market. Given that high volatility was expected due to changing fiscal and monetary policies, this position helped to smooth out some bumps and dips.

- **Strategic opportunities:** While we are not active day traders, we are not sticking our heads in the sand with a blind "buy and hold" strategy either. Given our slowly rising interest rate environment, we want the flexibility to "float" the rate of interest your portfolio earns as the Fed adjusts its rates. We invest in bond funds with shorter durations within each class, which provide the ability to float as rates change. This means we are not locked in to lower-interest bonds as higher-yielding ones become available.

  On the equity side, we also saw an opportunity to focus on high quality stocks for consistency during uncertain outcomes, such as potential regulatory changes and a rising interest rate environment. Investing in high quality stocks, and those with strong balance sheets and consistent dividends via diversified mutual funds and ETFs gives you the ability to weather potential volatility much better than aggressive growth funds and overvalued stocks.

  Our strategy is designed to help guard against currency risks. Because the U.S. dollar is the global currency reserve, U.S. investors need to be cognizant of how rising rates in the U.S. interact with negative rates in much of the rest of the world.

- **Rebalancing**: Emerging markets and international stocks have rebounded strongly this year after a period of negative performance. Rebalancing really amplifies moves like this because when a portion of the portfolio is losing value, we add to it to bring the position back in proportion to your recommended allocation. That means that we aim to buy low and sell high. This system also avoids reactionary or emotional movements to market dips or climbs—we buy when assets are "on sale." It feels counterintuitive to buy a "loser," but you can see in your portfolio the benefits of rebalancing, provided it is done in a systematic, unbiased way.

Opportunities Ahead

"From financial history and from my own experience, I long ago concluded that regression to the mean is the most powerful law in financial physics: Periods of above-average performance are inevitably followed by below-average returns, and bad times inevitably set the stage for surprisingly good performance."

– Jason Zwieg

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When markets are doing well, I see people suddenly become a lot more interested in adding to their savings. According to the Investment Company Institute, both bonds and equities have seen positive inflows for the past 5 weeks. Adding to savings is a positive thing, but with a caveat.

No matter what the market is doing, it is always a good time to save, increase your net worth, and put your money to work for your future. But investors must understand the concept of reversion to the mean. After a healthy stretch of bullish activity, and a recent quarter where all asset classes moved in the same direction, the probability is that the next 18 months may not be so overwhelmingly positive. Performance generally adjusts to the average between extremes. This year is particularly unusual, with all asset classes moving in the same direction at the same time. After a stretch like this, future performance may not be so uniformly bullish. Recency bias plays a role too—just because we have seen good performance lately has no effect on whether it will continue tomorrow. Of course, no one has a crystal ball, and market trends are one of those factors out of our control. This is why we employ the fundamental investment principles described above.

This is not meant to sound pessimistic. Rather, this gives me confidence in our approach. We are prepared for tomorrow, no matter what it brings.

We are pleased to see markets faring well. The Fed has moved rates higher twice this year without much reaction at all and markets are pricing in loosened regulations and potentially lower taxes. However, it is precisely times like these where you must be prepared for market winds to change. That is why we have these processes in place and in action every day!

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