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Our News

3rd Qtr. 2015

The last quarter will be a time for year-end planning for our clients. We will be reviewing required minimum distributions, looking at tax information, deciding if gains or losses should be taken before the end of the year, considering charitable contributions, reviewing qualified plan contributions, and looking at your overall allocation for rebalancing purposes.

The last quarter is also when we have the opportunity to attend conferences. This year, Stephanie attended a conference put on by the Financial Planning Association (FPA). The education sessions are strong and it is a great opportunity to network with other advisors from all parts of the country and even the world. Marty will be going to the Schwab IMPACT conference in November in Boston. These annual conferences provide us with fresh ideas and new concepts. It is a good time to reflect on our current practices and consider new approaches.

We hope you are enjoying the fall. With the holidays approaching, we know this will be a busy time for you and your families. As we approach Thanksgiving, we reflect on the gratitude we have for our clients we have the privilege to work with and help every day. Thank you for your continued trust in us.

Key Takeaways

Increasing concern about China's economy, accompanied by a surprise albeit modest devaluation of the yuan currency, helped trigger a sharp drop in global equity markets in late August, with the S&P 500 falling 12% from its high reached just a month earlier. The S&P 500 then bounced briefly from its August 25 low but dropped an additional 2.5% in September, ending the quarter down 6.5%. This marks the first negative quarterly return for the index since 2012.

Developed international stocks, as measured by the Vanguard FTSE Developed Markets ETF, also dropped 12% intraquarter, from high to low. For the quarter as a whole, they were down 9.7%. European stocks did a bit better, losing 8.5% in dollar terms and 7% in local-currency terms.

Emerging-markets stocks fared the worst, dropping 21% from their intraquarter high in early July to their low on August 24. For the quarter, the emerging-markets stock index was down 18%. That return includes several percentage points of losses to dollar-based investors from the continued depreciation of emerging-markets currencies against the U.S. dollar.

Given the broad negative environment for global stocks, let alone that much of the angst was driven by disappointing developments in China, it's not surprising emerging-markets stocks had the worst downside performance. While we have viewed (and continue to view) emerging-markets stocks as attractive over our five-year and longer investment horizons, we have also assumed they are riskier than developed market equities and will suffer larger short-term losses in a negative macro scenario for various reasons (e.g., due to concerns about slowing global growth).

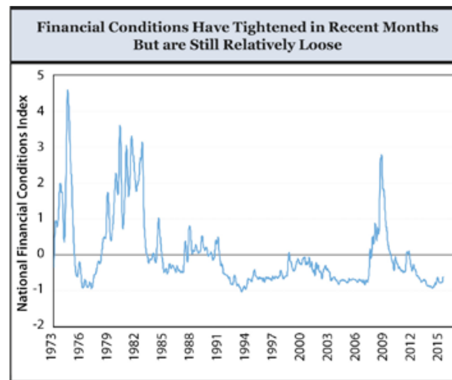
Moving on to the fixed-income markets, the core bond index gained about 1% during the U.S. stock market's 12% intraquarter drop. While this was strong *relative* outperformance versus most other (riskier) asset classes, with yields on core bonds so low (around 2.3%), their potential to generate strong absolute/positive returns over any meaningful time frame is very limited, as we have frequently discussed. This is true not only over our five-year tactical horizon, but also over shorter periods. Our floating-rate loan funds lost approximately 1% during the stock market correction and were roughly flat for the quarter as a whole.

We believe that part of successful investing involves riding out these nervous markets, where prices are driven by short-term news and investor cycles of emotion, and staying focused on long-term fundamentals. We have positioned our broadly diversified portfolios to withstand a wide range of scenarios, and were satisfied to see the various elements of our balanced portfolios working as expected through the market downturn.

Investment Commentary

Given the market's historical pattern of corrections, we've mentioned the potential for a market decline in each of our last three quarterly investment commentaries. So we weren't surprised by the volatility witnessed in the third quarter. But that's not to say we were predicting it would happen or what the triggers or catalyst might be. Short-term market predictions are a fool's errand, and history doesn't exactly repeat. But, knowledge of market history and cycles is useful for putting the present moment into context and thinking through different potential scenarios, risks, and investment opportunities. We will discuss the impact of the recent market turbulence on our asset class views and portfolio positioning later in this commentary, but first we will spend a bit of time discussing the proverbial elephant in the room: the Federal Reserve.

The big question looming for the markets over the quarter was whether the Federal Reserve was going to raise interest rates for the first time in more than six years. Ultimately, the Fed decided to hold off on a rate hike, citing that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." Fed Chair Janet Yellen pointed specifically to the recent developments in China and emerging markets as factors that gave them pause. She also noted the "tightening of financial conditions" due to stock market declines, a stronger dollar, and wider credit spreads since the FOMC's last meeting. Thirteen out of the 17 Fed policymakers indicated they expect to raise rates at least once this year, with six of the 13 expressing a preference for two rate hikes. So on to the October 28 FOMC meeting, when we can go through this all over again!



Source: Federal Reserve Bank of Chicago. Data as of 9/18/2015.

Impact of Market Volatility on our Asset Class Views and Portfolio Positioning

U.S. Stocks: While the market decline made future returns for U.S. stocks look incrementally better, the price drop was not large enough to lead us to increase our U.S. stock exposure. Our analysis still indicates that over a broad range of scenarios, expected returns for U.S. stocks over the next five years remain unattractive. Valuations are still stretched and earnings are well above normalized levels for a variety of reasons (e.g., due to unsustainably high profit margins). Earnings estimates also continue to decline. So we see a substantial risk of earnings disappointment and valuation multiple contraction, implying subpar returns.

Developed International Stocks: We continue to have a positive view of European stocks. We believe European stock valuations are much more attractive than those of U.S. stocks, while European corporate earnings are well below normal (unlike in the U.S. where earnings are well-above their long-term trend). As such, in our base case and more optimistic scenarios, we see potential for both improved earnings growth as well as some multiple expansion, implying significant outperformance for European stocks compared to the U.S. market over our five-year outlook.

Emerging Markets: After recent declines in emerging-markets stocks, we now view them as more attractive, to varying degrees, than U.S. and European stocks. Specifically, using what we believe are quite conservative earnings growth and valuation assumptions for emerging markets, we now estimate returns are comparable to what we expect from U.S. stocks in our optimistic scenario and from European stocks in our base case scenario. This means we believe the risk/reward of adding to emerging-markets stocks is now attractive, and as such, we will be modestly increasing our emerging-markets exposure. Importantly, we think our assumptions adequately capture the risks stemming from a slowdown of growth in China and other emerging-market countries.

Investment-Grade Bonds: The events of the latter part of the third quarter did not lead to any material changes in our fixed-income asset class views. Our expected returns for core bonds are very low looking out over the next several years in almost any reasonably likely macro scenario. This is why we have invested a large portion of our fixed-income allocation in more flexible bond strategies. Based on our analysis of each fund's strategy and our strong positive assessment of the managers' strengths, we think these funds have the potential to generate returns above the core bond index over the next five years, across a broad range of macro scenarios. Nevertheless, we still maintain exposure to core bonds in our more conservative portfolios because of the risk management role they play—smoothing overall portfolio volatility and mitigating some of the downside risk of owning stocks in the

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event of a global growth scare, recession, or worse.

Floating-Rate Loans: In our view, the fundamentals for floating-rate loans remain healthy, as interest coverage levels and overall leverage levels are reasonable, while the amount of debt maturing over the next couple of years is extremely benign. At current price levels, which are below par, our view is that floating-rate loans offer attractive return potential over our investment horizon. We continue to own an allocation to the asset class via positions in diversified, high-quality floating-rate loan funds that emphasize liquidity in order to benefit from and protect against rising short-term rates and unexpected inflation.

Alternatives: We continue to see long-term value—in terms of diversification benefits and expected contribution to overall portfolio risk-adjusted return—from exposure to a highly select group of alternative strategy managers. The alternative strategies we own and will be purchasing, managed futures and arbitrage, are intended to generate long-term returns that are better than core bonds, with much lower downside risk and volatility than stocks and relatively low or no correlation to stock and bond market indexes.

Concluding Comments: The reality of owning stocks is that occasionally, inevitably, we will experience bear market losses. This underscores the importance of our risk management, in which we seek to reduce our balanced portfolios' vulnerability to stock market downturns through strategies that include owning "insurance" assets such as bonds and lower-risk alternatives. Another key ingredient in managing through bear markets is helping our clients accurately assess their risk tolerances and investment objectives. If you are in an appropriately structured portfolio, there is no benefit to selling in a market downturn. In fact, by doing so, you risk selling nearer to the bottom and then missing the subsequent recovery. This is based on our tactical asset allocation approach that centers on analyzing long-term fundamentals and valuations, while remaining sensitive to shorter-term portfolio risks.

Market Data

(From various sources. Data as of September 30, 2015.)

Index	*September 2015*	*3rd Qtr.*	*12 Mos.*	*5 Yrs.**
Dow Jones Industrial Average TR	-1.40%	-6.90%	-2.20%	11.20%
S&P 500	-2.47%	-6.44%	-0.61%	13.34%
Russell 2000	-4.91%	-11.92%	1.25%	13.25%
Barclays US Agg. Bond	0.68%	1.23%	2.94%	3.11%

***Annualized**

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