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4th Qtr. 2015

Our News

Happy New Year! In regards to the markets, 2016 is off to a rough start. During these volatile and uncomfortable times, it is important to remember the planning work we have done together, the risk tolerance work and discussions, and the long-term framework we are working within. When it comes to investing, emotionally-timed decisions often do not equate to wise decisions.

We have moved! Well…a little bit. Treybourne Wealth Planners now occupies a separate space in our building. So when you come in our front door, you will go left to find us (Suite B) and right to find Sherman & Armbruster (Suite A). Both of our companies, within the S&A Group, work hard together to service the diverse needs of our clients. From an operational and service standpoint, nothing has changed.

Marty is heading to Las Vegas for the Advanced Personal Financial Planning Conference. This conference is of added benefit to him now because of his membership in the All Star Financial Group as they meet before the start of the conference. Marty will come back energized with lots of good information.

We hope 2016, although off to a rough start, will prove to be a prosperous year for you.

Key Takeaways

2015 was a poor year for financial markets across the globe and across asset classes (stocks, bonds, commodities, etc.). Among the major global stock markets, the United States was the best performer, but that's faint praise given the S&P 500's 1.4% return. What's more, it was a market in which a handful of large tech/Internet companies (e.g., Facebook, Amazon.com, Netflix, and Google) generated huge gains and helped propel the index into positive territory, while the equal-weighted S&P 500 index actually *fell* 2.2% for the year.

One striking feature of last year's investment environment was the difference in the direction of the U.S. economy and U.S. monetary policy versus other major global economies. In December, the U.S. Federal Reserve was sufficiently comfortable with the outlook for economic growth and the potential for inflation to eventually normalize that it made its first increase in rates in nearly a decade.

Outside the United States, regaining more normal economic growth and inflation has remained more challenging. Sharply lower commodity prices (most notably oil), Middle East tensions, and China's slower economic growth all weighed on foreign stock market returns. Developed international stocks ended the year down 0.4% while emerging markets fared worse, falling 15.8%.

As in 2014, the strength of the dollar exacerbated foreign markets' underperformance for dollar-based investors, detracting 9% from emerging-markets stocks and 6% from developed international stocks compared to their local-currency returns. Currency effects will always be a shorter-term wild card when investing in non-U.S. assets, but on a fundamental, longer-term basis we believe currency movements may be a tailwind to dollar-based returns going forward after having been a drag on returns the past few years.

The worst-performing areas of the markets were commodity-related asset classes. Commodity indexes were crushed, down on the order of 25%–30% as oil prices hit an 11-year low in December and fell 30% for the year, after plunging 50% in 2014. Energy MLPs, an increasingly popular vehicle for yield seekers (and yield chasers), dropped 35%–40%, wiping out the previous four years' worth of gains.

Fixed-income offered little respite, with the core bond index gaining just 0.3%. High-yield bonds fared worse, down close to 5%, while floating-rate loans lost 0.7%. Investment-grade municipal bonds were a *relative* bright spot, with the national muni bond index up nearly 3% on the year.

Investment Commentary

Overall, 2015 was a challenging year for the financial markets in general, and for our portfolios more specifically. In this month's commentary, we thought it would be instructive to break the portfolio down into four categories of investments that highlight their different roles: longer-term return generators; shorter-term risk reducers; hybrid investments, which have elements of both return generators and risk reducers; and diversifying alternative strategies. Understanding how we employ the various types of investments we own in our client portfolios should help in setting reasonable expectations of how they will perform.

Longer-Term Return Generators: These are investments or asset classes that we own because of their ability to generate longer-term growth of capital, well in excess of inflation. U.S., developed international, and emerging-markets stocks are our portfolios' primary long-term return generators. However, we expect them to have higher shorter-term volatility and significant downside risk.

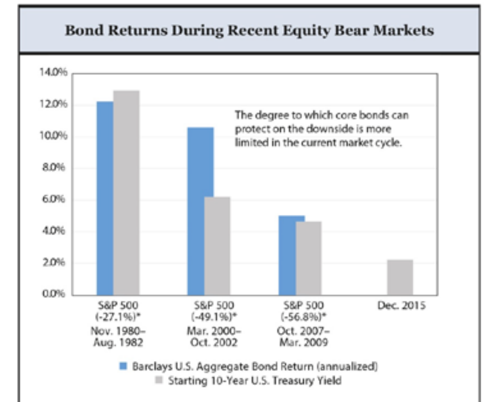
With prospective returns in the low double digits in our base case five-year scenario for European stocks, and comparable or higher return estimates for emerging-markets stocks, we believe we are being well compensated for their risk and that exposure to these markets will pay off over time. Hence our decision to modestly increase our allocations to both in 2015.

Our investment thesis for European and emerging-markets stocks has not changed materially. In a nutshell, our analysis suggests both markets are undervalued relative to their normalized earnings potential looking out five or so years. Therefore, we expect to benefit from both stronger-than-expected earnings growth and some valuation (P/E multiple) expansion, generating the double-digit type of expected returns noted above. We are confident we will get paid (with outsized returns) for our current allocations to European and emerging-markets stocks.

Conversely, when it comes to U.S. stocks, our tactical outlook over the coming five years is much less positive compared to emerging-markets stocks and European stocks. Unlike in those markets, our analysis suggests U.S. valuations are high. And with U.S. corporate profit margins also well above normal, we see potential for disappointing earnings growth and valuation multiple contraction. Our base case scenario results in low single digit expected returns for the S&P 500. While that return may exceed that of low-risk core bonds, it is well below the upper-single-digit-type returns we are looking for, at a minimum, from our long-term return generators.

Shorter-Term Risk Reducers: To mitigate the shorter-term uncertainty, volatility, and downside risk that comes from owning stocks, our balanced portfolios also have dedicated exposure to core investment-grade bonds. If there is a recession or economic shock that leads to increased risk aversion among investors, core bonds have historically performed well in absolute terms (generating solid gains) and very well relative to riskier assets like stocks that may be down 20%–30% or more. We'd expect a similar performance pattern this time around if and when stocks fall into a bear market. So core bonds have a very important risk-management role, particularly in our more conservative portfolios, where our 12-month downside risk thresholds are lower.

However, given the very low current yield and our expectation for returns in the 0% to 2% range over the next five years, the degree to which core bonds can limit the downside during the current market cycle has been significantly reduced. This past year was a good example of this, with core bonds barely positive while global stocks were negative. That is a high price to pay (in terms of low longer-term returns) for the risk-reduction benefits of core bonds.



*Source: Morningstar Direct. Data as of 12/31/2015. *Cumulative price return during the period.*

So we are in a situation where our two primary asset classes, U.S. stocks and U.S. core bonds, look unattractive relative to their respective return-generation and risk-reduction roles in our portfolios. This has been the case for the past several years and led us to research and invest in other asset classes and strategies that we think are more compelling on a risk/return basis.

Hybrid Investments: Part Risk Reduction, Part Return Generation: As the primary examples of what we consider hybrid investments, we have allocated a meaningful portion of our portfolios to a diversified group of fixed-income funds representing a variety of investment categories: multisector, absolute-return-oriented, and unconstrained. We are also invested in floating-rate loan funds. We believe these investments have the potential to generate returns over the next five years that are several percentage points above the core bond index and in line with or better than our base case return expectations for U.S. stocks. Importantly, these funds should have much less volatility and downside risk than stocks. However, in most scenarios, these funds will have higher volatility and short-term downside risk than core bonds, due to their below-investment-grade and/or non-dollar currency exposure.

Alternative Strategies/Portfolio Diversifiers: The final piece of our portfolio is allocated to alternative strategies. These investments also play a dual role of return generator and portfolio risk diversifier. Within our alternative strategies allocation we own two types of strategies: arbitrage/event-driven strategies and managed futures strategies. Broadly speaking we believe these investments will both add valuable diversification benefits and will also be additive to our balanced portfolio returns over the next five years.

Our risk and return expectations for the arbitrage funds are roughly similar to our expectations for the hybrid funds discussed above: better returns than core bonds over the long term but with somewhat higher risk, and comparable returns to U.S. stocks over our five-year tactical horizon but with much less risk.

We expect the managed futures funds we own to generate attractive long-term returns relative to their volatility as well as compared to a comparable mix of stocks and bonds, with a performance pattern that is very different from the other pieces of our portfolio. Our ownership period for managed futures has been extremely short, but so far their performance is consistent with our expectations.

Concluding Comments

We would have liked to have experienced better overall performance in 2015. However, we'd reiterate that it is in the nature of our long-term, fundamental, valuation-driven investment approach to go through periods of subpar performance. It is exactly during these challenging periods that it is *most* critical, but also most difficult, for an investor to stick with their approach and remain disciplined in order to ultimately harvest the long-term rewards.

We believe our portfolios are well positioned to generate solid returns over our five-year horizon, but we think it is prudent to be prepared for potentially increased market volatility and downside risk (as well as positive returns) over the shorter-term. We may even get the opportunity to add to our undervalued positions or establish some others before this market cycle turns. In other words, we believe the key to successful investing ahead is to maintain the healthy patience, perspective, and discipline necessary for long-term investment and financial success.

Market Data

(From various sources. Data as of December 31, 2015.)

Index	*December 2015*	*4th Qtr.*	*12 Mos.*	*5 Yrs.**
Dow Jones Industrial Average TR	-1.60%	7.60%	0.10%	11.10%
S&P 500	-1.60%	7.00%	1.40%	12.60%
Russell 2000	-5.02%	3.59%	-4.41%	9.19%
Barclays US Agg. Bond	-0.32%	-0.57%	0.55%	3.25%

***Annualized**

Past performance is no guarantee of future results. Indexes are not available for direct investment.

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