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Our News

2nd Qtr. 2016

Hope you are enjoying the summer. This quarter we had much to celebrate as Stephanie and her family officially welcomed another little one, Steven. Adoption day was at the end of April and it was a great day for all. Jessica passed her Series 65 exam and has started taking courses to prepare her for taking the CFP® exam, likely next year. We are proud of the progress she is making.

As we write this, market record highs are being set. In non-technical terms, in many ways the markets seem weird. On July 5, the day after the United States' 240th birthday, the yield on the 10-year Treasury debt fell below 1.4% for the first time in the nation's history. Measured before inflation, rates have never been so low in so much of the world. Meanwhile central-bank policies have failed to produce inflation. Stocks have soared to all-time highs. Brexit occurs and a steep drop follows and lasts…for a couple of days. Many political and economic risks linger. Understanding your aptitude for volatility or risk, setting your expectation of future returns, and the ability to remain disciplined are important.

Enjoy the rest of the summer! At least one person in our office is already thinking about football season.

Key Takeaways

U.S. markets were initially range-bound for most of the quarter until June, when the relative calm in global stock markets came to an abrupt end. Upending most forecasts and taking world financial markets by surprise, the United Kingdom voted to leave the European Union on June 23. In the wake of the vote, British pound sterling fell 11% overnight against the U.S. dollar, its lowest level since 1985. The euro fell 2.4% to 1.10 versus the dollar. Global equities plummeted.

Then in the week following Britain's historic vote, global equities rallied, despite still significant uncertainty regarding the economic, political, and financial market implications of Brexit. When the dust had settled, developed international and European stocks remained in the red, while U.S. stocks edged into positive territory. The big winners in the quarter were emerging-markets stocks, which gained 4.9% and are now up 8.6% year to date.

Before the Brexit vote, the big story in financial markets had been bonds, specifically negative yields on government bonds across the globe. By month's end, the amount of government debt sporting negative yields had soared by nearly $1 trillion. Falling yields have been driven by economic growth concerns; central banks' interest rate policies and intervention in bond markets; and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact.

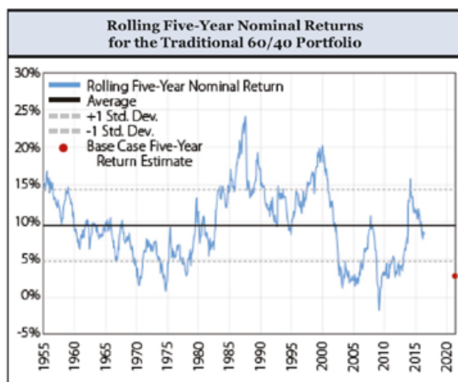
While we do not expect a sharp rise in interest rates any time soon, at such low starting yields, expected returns for core bonds are extremely low. Investors are earning very little (or actually *paying* via negative yields) for the safety of holding government bonds.

Given current yields, valuations, and earnings fundamentals, we continue to view the return prospects of a "traditional" portfolio split 60/40 between stocks and bonds as poor. We believe the diversified portfolios we've assembled for our clients are well positioned to outperform ones that only feature traditional assets. We saw strong performance for our flexible fixed-income strategies during the volatile quarter, with most of them beating the core bond index. Our alternative strategies positions also performed in-line with our expectations, fulfilling their role as important ballasts to our diversified portfolios when stock and bond markets overshoot.

The quarter's market upheaval was yet another reminder that successful investing requires patience and the understanding that investing is part of a process, not a one-off decision, toward achieving your long-term financial goals. There will be inevitable and unpredictable shorter-term market ups and downs along the way, and through these periods, it is our job to remain focused on the long-term objectives of our clients, maintaining a consistent investment discipline to guide our decisions over time.

Investment Commentary

No matter how you slice it, looking out over the next five years, the return prospects are poor for a hypothetical portfolio split 60/40 between stocks and bonds.



Source: Morningstar Direct. Data as of 5/31/2016.

We looked at rolling five-year annualized nominal returns for the traditional 60/40 portfolio (60% S&P 500 index and 40% core bond index), starting in 1950. We assumed annual rebalancing back to the 60/40 weights. Over that period, the average annual return was 9.5%. As shown in the chart, our base case return estimate for the 60/40 of roughly 2.5%–3% is derived from our current estimate of roughly a 4% return for the S&P 500 and a 1% return for core bonds over the next five years. Yet, looking at the history, a 3% annualized five-year return would be among the worst historical returns for the 60/40 portfolio. Of the 738 rolling five-year periods since 1950, *only 67* have had a return less than 3%. The results are much the same on a "real return" (net of inflation) basis.

Assuming our return expectations play out, investors in a traditional 60/40 portfolio will barely stay ahead of inflation. And they will earn around 6.5% less per year than the historical average 60/40 return, or 37% less cumulatively over the entire five years.

The historical data also show the 60/40 portfolio has generated above-average returns over the past several years. A key driver has been the impact of quantitative easing (purchases of government debt in an effort to add liquidity to bond markets) and other aggressive central bank policies, which have helped push down interest rates. This has meant higher bond prices and capital appreciation for the core bond index in addition to its paltry income yield.

Central bank policies also contributed to the meaningful increase in stock market valuations. In more recent years, a significant majority of the S&P 500's return has come from P/E multiple expansion rather than earnings growth. For the five years ending March 31, 2016, the S&P 500 gained 73%, but 46 percentage points of that total return came from P/E expansion.

The 12-month trailing P/E of the S&P 500 is currently around 23x, compared to its median since 1950 of roughly 17x. As long as interest rates remain at extremely low levels, P/E multiples may remain higher than normal. If current interest rate levels are not sustainable—and we don't think they are—then it is likely the valuation multiple will drop toward more normal historical levels. Our base case scenario for U.S. stocks assumes a 17x multiple for the S&P 500, and we look at different scenarios across a range of multiples around that one.

Yes, Stocks Should Still Return More Than Core Bonds . . . So What? While we have subpar return expectations for stocks, we do believe they are likely to generate higher returns than core bonds over our five-year horizon (absent a deflation/depression scenario) of roughly a 3% annualized return premium in our base case. However, stocks have *significantly* higher volatility, higher downside risk, and greater risk of permanent capital loss than core bonds. You should *always* be compensated with a higher expected return from stocks.

In addition to the *relative* return premium you should get from owning stocks versus core bonds, we also believe there is a minimum *absolute* equity return in order to fully compensate for equity risk and be "fully allocated" to equities. (For clients whose risk tolerance is appropriate for a 60/40 portfolio, "full" equity exposure is 60%). Our absolute-return hurdle for the U.S. stock market is an upper single-digit return. If expected returns are in that ballpark, we consider the stock market to be within its "fair value range," and all else being equal, we will be fully allocated to stocks in our balanced portfolios.

Since our current analysis suggests expected returns for U.S. stocks as well as core bonds are unattractive, we are invested in a mix of asset classes that we believe has a much more attractive return potential. These, along with some exposure to U.S. stocks and core bonds, can be combined in a well-diversified, risk-managed portfolio with comparable risk to a traditional 60/40

portfolio, but with a much better five-year expected return.

Putting It All Together
This more diversified 60/40 portfolio is still not expected to generate returns as high as the long-term historical average, even with the additional return margin coming from our ability to tactically allocate to more attractive asset classes and strategies.

Volatile markets, which we also expect, will likely challenge investors' convictions and emotions. Remaining focused on the *long-term* objective is key, as is maintaining a consistent investment discipline. Our valuation-driven discipline means we can use short-term market volatility to our long-term benefit—managing risk while taking advantage of the investment opportunities created by other market participants' *lack* of discipline, patience, and flexibility.

Market Data

(From various sources. Data as of June 30, 2016.)

Index	*June 2016*	*2nd Qtr.*	*12 Mos.*	*5 Yrs.**
Dow Jones Industrial Average TR	0.9%	2.0%	4.4%	10.2%
S&P 500	0.26%	2.46%	3.99%	12.10%
Russell 2000	-0.06%	3.79%	-6.73%	8.35%
Barclays US Govt/Credit Bond	2.20%	2.67%	6.70%	4.11%

***Annualized**

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

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