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Our News

4th Qtr 2016

Happy New Year! We hope the year is off to a good start for you. As we are writing this letter, we are nearing the inauguration of the 45th President of the United States of America. Some investment firsts already with this President – we were reading about an app that warns investors when Donald Trump tweets about companies. There was also recently an article in the Wall Street Journal titled "How to Trade a Donald Trump Tweet." Not going to incorporate into our long-term investment strategy, but interesting nonetheless. We are reading and researching and listening to ideas about how to invest with President Trump as our leader.

We are looking ahead to what we plan on being a good tax season. We will get to see some of you in our office during this time. Schwab has indicated that 1099s for most accounts will be mailed out mid to late February. We also receive a copy of your Schwab tax documents from Schwab via the Schwab Advisor website we use.

We wish for you another happy, healthy, and prosperous year. We are grateful to be a part of your lives and value the trust you continue to place in Treybourne Wealth Planners.

Key Takeaways

Global stocks performed well both in absolute terms and relative to core bonds this year, with U.S. stocks again taking the lead. Large-cap stocks gained 11.8% and small-cap stocks surged 21.6%. This marked the eighth straight year the large-cap S&P 500 Index had a positive return. While streaks of this length have occurred twice before, the market has never had a nine-year winning streak.

Emerging-market stocks were also strong performers, gaining 12.2% for the year. Developed international stocks were the big laggards. They returned just 2.7% in U.S.-dollar terms. European stocks did worse, falling 0.4% in dollar terms, although they gained 7.2% in local-currency terms. For the third straight year, dollar appreciation was a drag on European stock returns. The major currency decliner was the British pound. It plunged 16% versus the U.S. dollar, triggered by June's Brexit vote. The euro fell 3% on the year. Overall, the U.S. dollar index rose around 4% against a basket of developed-market currencies.

For the year, core bonds produced a 2.5% gain, slightly above our longer-term (five-year) expected return outlook for them. Investment-grade municipal bond returns were slightly negative on the year. Though core bond prices got off to a strong start with the 10-year Treasury yield dropping to an all-time low of 1.37% in early July, yields then reversed course, rising to 2.5% by year-end. In the fourth quarter, the core bond index fell 3.2%—its worst quarterly performance in *35 years*—due to rising interest rates.

While 2016 wound up being a poor year for Treasurys and core bonds, it was a good year for riskier fixed-income sectors. Fixed-income sectors with more credit risk (and less interest rate risk), such as high-yield bonds and floating-rate loans, performed very strongly, gaining 17.5% and 10.2%, respectively.

Alternative strategies turned in mixed performance. Managed futures, which are volatile and have a much wider range of potential returns in any given year, struggled. While one of the three funds we use had a positive return for the year, the category suffered a loss in aggregate.

In our year-end investment commentary, we look back at 2016 as well as ahead to 2017. Several trend reversals occurred in 2016 that leave us hopeful the portfolios we manage will outperform in the coming years. Our analysis leads us to stay the course, maintaining a focus on our investment discipline, as opposed to trying to forecast economic or political outcomes, which we believe are inherently unpredictable.

Investment Commentary

As we look back at 2016 and ahead to 2017 and beyond, we'll leave the political discourse and analysis to others and focus our comments on the financial markets. In this commentary, we recap portfolio performance, before speaking to client concerns regarding our investments in foreign stocks.

Fixed-Income: In our balanced portfolios, roughly half of our fixed-income exposure is in non-core bond funds, including actively managed absolute-return-oriented, flexible multisector, and floating-rate loan funds. These positions benefited greatly from rising interest rates and added significant value compared to core bonds. Gains were in the 8% to 11% range versus 2.5% for the core bond index. Looking ahead to 2017, floating-rate loan funds should again meaningfully outperform core bonds, although 2016's double-digit returns will not repeat.

Larger-Cap U.S. Stocks: Our underweight to U.S. stocks in favor of non-U.S. stocks and alternative strategies was again a headwind to performance this year (we provide more details on this in the following sections).

Smaller-Cap U.S. Stocks: Having benefited from a multiyear period of small-cap underperformance, we unwound our relative underweight to smaller-cap U.S. stocks versus larger-cap U.S. stocks in the second quarter. We subsequently profited from small caps' strong rebound during the remainder of the year.

Developed International Stocks: Given our modest tactical overweight to Europe, we were hurt by U.S. stocks' continued outperformance versus other regions. This marked the fourth straight calendar year and the sixth in the past seven that the S&P 500 beat the global ex-U.S. index. Since 2008, this is one of the longest stretches of U.S. outperformance on record. U.S. stocks also meaningfully outperformed European stocks.

Emerging-Market Stocks: We were pleased to see emerging-market stocks rebound in 2016. Through the end of October, emerging-market stocks were up 18% on the year (versus larger-cap U.S. stocks' 6% rise), though they did give back some gains following the presidential election.

Alternative Strategies: Our lower-risk alternative strategies (such as arbitrage and event-driven) met their performance objectives this year (mid-single digits) but were no match for the double-digit return of U.S. stocks.

Meanwhile, despite some short periods of very strong performance when equity markets dropped sharply early in the year and again right after Brexit, managed futures had a tough year. We certainly aren't happy about their performance. Unfortunately, it is entirely consistent with our *shorter-term* return expectations for these strategies (i.e., returns can range widely from very negative to very positive in any given year, particularly in a year with so many sharp market reversals). That said, our view of the long-term strategic benefits from investing in managed futures strategies as part of a diversified portfolio has not changed.

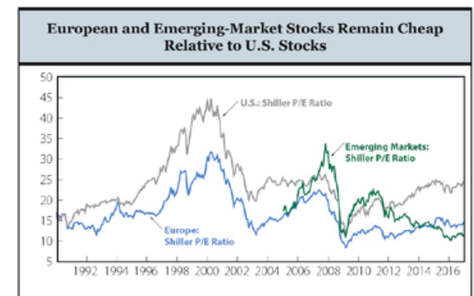
Why Do We Still Own Foreign Stocks?

Since the end of 2009, the S&P 500 has returned a cumulative 131%. In contrast, developed international stocks have gained 32% and emerging-market stocks a measly 1.3% in dollar terms. Because of their globally diversified long-term equity allocation, our portfolios have lagged compared to a purely U.S. stock portfolio. While foreign stocks' underperformance is trying, we continue to believe, supported by our analysis, in maintaining large strategic allocations to foreign stocks *particularly* after this prolonged period of underperformance.

Our analysis implies that from current price levels, both European and emerging-market stocks are likely to generate much higher returns than U.S. stocks over our tactical time horizon of five years. In our base case scenario, we estimate low double-digit potential returns from European and emerging-market stocks, driven largely by improving earnings growth from still very depressed levels. This compares to our base case of low-single-digit expected returns for the S&P 500.

While our analysis indicates we are being reasonably compensated for equity risk in Europe and emerging markets, U.S. stocks appear overvalued, with a lot of optimism baked into current prices. This accelerated post-election and makes them particularly vulnerable to a negative surprise. We expect the market price-to-earnings multiple to decline in our base case, consistent with U.S. market history, dragging down expected returns. History and investment logic also tell us that *high starting-point valuations are a strong predictor of low future returns* over a five-to-10-plus-year horizon. It is this horizon upon which we base tactical decisions. So on a relative and absolute basis, we are moderately overweight to non-U.S. stocks and underweight to U.S. stocks.

Though there are risks to our European and emerging-market equity positions, current valuations suggest these are pretty well—though not *fully*—discounted. News flow regarding political uncertainties from rising nationalism in Europe and related economic/breakup risks facing the Eurozone, or the negative ramifications for emerging markets of China's huge public debt build-up (to name a few big ones), has contributed to their poor stock market performance in recent years. With investors discounting lots of risks and bad news, the news must only be "less bad" for sentiment and stock prices to improve. That typically happens when the market least expects it.



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We believe the key earnings growth and valuation assumptions that underlie our base case five-year scenarios for these markets are reasonably conservative. These markets still face potential *shorter-term* cyclical downside risk. We do consider more bearish scenarios and outcomes in our analysis, which is why we don't have larger tactical positions to these markets. However, we believe the overall risk/reward, the combination of the *likelihood* of certain scenarios playing out and the *magnitude* of gains or losses across those scenarios, continues to support a modest tactical overweight. Unless or until our analysis suggests making an allocation change, we will remain patient and confident we will be rewarded, as has been the case historically for long-term value-driven strategies.

As Warren Buffett wonderfully and concisely put it, "A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful." Much easier said than done.

Looking Ahead to 2017

Expert predictions of the future are usually no better than guesses. When it comes to economies and financial markets, there are way too many complex, adaptive, and interactive variables—most of which are consistently unpredictable—to confidently forecast outcomes, at least over the shorter term.

Even if one could know in advance the outcome of many of the important individual variables (such as election results, central bank policy decisions, and currency movements), one would still be likely to make many inaccurate *market* forecasts. For example, how many experts would have predicted gold would drop and stock markets would rally in the days and weeks after an unexpected Donald Trump election victory?

We don't bother guessing what financial markets will do next year. An important part of our portfolio risk management process *does* analyze the impact of 12-month stress-test scenarios. But those are neither forecasts nor predictions. If we had to make a forecast for next year, or any year, it would be this: Expect the unexpected. Prepare to be surprised. Stock markets will be volatile; they will go up and down—probably *a lot*.

Market Data

(From various sources. Data as of December 31, 2016.)

Index	Dec 2016	4th Qtr	12 Mos	5 Yrs*
Dow Jones Industrial Average TR	3.4%	8.6%	16.3%	12.7%
S&P 500	2.0%	3.8%	12.0%	14.7%
Russell 2000	0.0%	13.3%	37.9%	14.0%
Barclays US Govt/Credit Bond (GVI)	0.0%	-2.1%	1.9%	1.6%

***Annualized**

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

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