



Portfolio Strategy

May 4, 2017

Geo-Jitters, Again

Volatility returned to the financial markets in April. Geo-political concerns were focused on rising tensions in North Korea, French elections, bombing in Syria, and the souring of the Putin/Trump bromance. Domestically, there was the threat of a government shutdown and uncertainty around the prospects for a Trump tax plan. The VIX index, often described as the market's fear gauge, reached its highest post-election levels in mid-April before finishing the month at new lows. Safe-haven assets performed well, as gold added 1.4% and long-term bond prices improved.

<i>Index (% Total Return)</i>	<i>Apr</i>	<i>YTD</i>	<i>Last 12 Mos.</i>
MSCI All-World Equity	1.6	8.6	14.7
75% U.S. Stocks/25% Foreign Stocks*	1.4	7.9	16.5
S&P 500 (U.S. Large-Cap Stocks)	1.0	7.2	17.9
Russell U.S. Mid-Cap Stocks	0.8	6.0	16.7
Russell 2000 U.S. Small-Cap	1.1	3.6	25.6
MSCI EAFE (Euro, Australasia, Far East)	2.6	10.2	11.8
MSCI Emerging Markets	2.2	13.9	19.1
Barclays Aggregate U.S. Bond	0.8	1.6	0.8
Barclays Long-Term Treasury Bonds	1.5	3.0	3.1
SPDR: DJ Global REIT ETF (Real Estate)	0.6	1.6	1.2
DJ-Bloomberg Commodity ETF	1.9	4.8	2.3

Sources: FactSet, Interactive Data Corporation. *Red indicates negative return.*

*75% MSCI USA Std Index (Large/Mid); 25% MSCI All-World ex U.S. Index (Large/Mid)

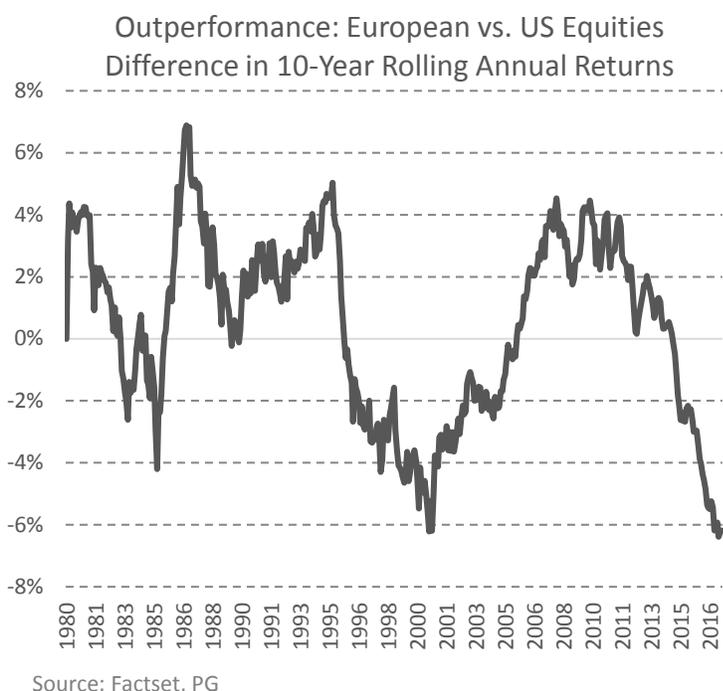
In the end, investors breathed easier as potential crises abated. Congress avoided a government shutdown, warships were redirected, and political results in France, along with prospects for holding together the euro, were encouraging. The past year was marked by politically-driven anxiety around the globe. The financial markets reacted with short-term bouts of instability, but remained resilient.

While geo-political noise dominated the headlines, Q1 earnings were steadily beating expectations. With 58% of the companies in the S&P 500 reporting, 77% beat analysts' estimates. That puts earnings up 12.5% versus last year and on track to be the best quarter since Q3 of 2011. Supported by positive earnings, the S&P 500 added 1% in April and is now up 7.2% this year, including dividends. Foreign stocks continued to outperform, with developed markets returning 2.6% and emerging markets adding 2.2%, respectively.

Going and Staying Global

We have previously noted the challenges of diversifying internationally, especially when the U.S. markets have been the primary driver of global returns for several years. The most recent 10-year period has proven especially difficult for international diversification as European markets have underperformed the U.S. market by over 6% per year. That's the difference between \$100 growing to \$193 versus \$108. In hindsight, Europe has struggled

with the sovereign debt crises since 2011 while the U.S. economy benefitted from more aggressive central bank policies. Of course, this is all perfectly clear looking through the rear-view mirror.



Valuations matter in the long run, and currently, the price per dollar of earnings is lower outside the U.S. stock market. The CAPE ratio, which measures long run valuations, suggests investors in European stocks are paying about 63% of what they are paying for U.S. earnings. Valuation measures are unreliable as near-term guides, and Europe still faces numerous political challenges. But over the next decade, the tides of greed and fear will likely recede, leading to a convergence in relative performance. In the past, when European stocks have underperformed U.S. stocks to these extremes, they have gone on to outperform for the subsequent 10 years.¹

What We Are Doing

Non-U.S. equities represent 46.8% of the FTSE Global All-Cap Stock Index. For U.S. dollar-based investors, the optimal allocation to foreign stocks (highest Sharpe Ratio) over the past 40 years has been 25%. Due to Europe's problems and the stronger U.S. recovery, we have allocated from 15% to 20% to non-U.S. stocks in our models. We recently started the process of raising our foreign stock allocation back to our long-term target of 25%.

In bond portfolios, we are adding a 10% allocation to investment-grade mortgage-backed securities. In addition to higher income yields relative to traditional corporate bonds, mortgages offer manageable durations and diversifies exposure to credit spread risk.

After a year where stocks significantly outpaced bonds, equity allocations are out of balance. In addition to changes to our allocations, we are also rebalancing portfolios back to target weights for stocks and bonds. Rebalancing is important for controlling and managing risk in a portfolio. For taxable accounts, allocation changes and rebalancing create gains that will be reported and taxed next April. While paying taxes is never a pleasant experience, it is important to keep the bigger economic picture in mind.

¹ Michael Batnick, CFA. *Investing in Europe: Where's the Return*, CFA Institute Enterprising Investor, April 28, 2017.

What It All Means

Over time, returns are the reward for bearing certain risks, and those risks are the primary driver of investment returns. Developed in the 1960s, the Capital Asset Pricing Model, or CAPM, was the first factor-based investing model. It suggested that one factor, the market portfolio, determined asset risk premiums. In the 70s, the index fund was born, giving investors an efficient method of accessing the equity market risk premium through exposure to the whole stock market.

The idea of moving beyond the single market factor was conceived in the 1970s but not widely employed in investing for another 20 years until additional empirical research more clearly identified and validated multiple sources of risk, or factors. Now, low-cost exchange-traded funds (ETFs) provide access to multiple factors diversified across asset classes and geographic regions. Investors can cheaply harvest multiple risk premiums for value versus growth, small-cap versus large, higher quality stocks, momentum investing, credit exposure, and volatility.

A focus on proven risk factors can generate excess returns and help investors avoid behavioral pitfalls that often waylay both amateur and professional investors. These risk factors are the fundamental building blocks of effectively diversified portfolios. Carefully combining risks that meet your individual needs, and suit your investment style and personality, are the keys to creating a successful long-term investment strategy – a portfolio that you can stick with.

Sticking to a well-grounded strategy during tough times is the closest thing to an investing superpower. It can be difficult to stay invested in stocks when domestic and international politics can, at times, seem so uncertain. It is no coincidence that the cheapness of country markets tends to line-up with political instability. In the long run, political noise becomes less important and returns for stocks are driven by economic growth and the ebb and flow of investor sentiment. A well-diversified strategy, geared towards growth and customized to meet specific needs will help you survive and prosper, regardless of the financial market's ups and downs.

As always, please contact us with individual questions or concerns.

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