Q4 2016
Investment Perspectives

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- **STOCKS RISE; BONDS FALL:** After Donald Trump defied the predictions of most pollsters and defeated Hillary Clinton in the November election, US stock indices rallied as hopes of fiscal stimulus, corporate tax reform and a more relaxed regulatory environment buoyed investor risk appetite. Conversely, yields on core bonds rose rapidly, leading to declines across most fixed income indices. Bond investors began to discount higher inflation and growth expectations.
- **FED RAISES RATES:** At their December meeting, the Fed elected to raise rates by 0.25%, citing a tightening labor market and increased inflationary pressures in the economy. Markets fully expected the rate hike and hardly reacted to the news.
- **OIL AND USD CATCH A BID:** Crude oil prices concluded the year with a rally toward $55 per barrel after OPEC announced a deal to curb production. The US dollar also rallied into year-end as the Fed continued to be the only major, global central bank moving toward rate normalization.

Market Recap

The election and the subsequent market reaction was undeniably the theme of the quarter. For investors who are solely "Dow watchers," the dispersion of returns within diversified portfolios may come as a surprise. There was a significant bifurcation that occurred after November 8 as investors decidedly favored US risk assets—equities and high yield—at the expense of core fixed income and global risk assets.

MARKETS REACT TO THE TRUMP VICTORY

Within a 24-hour period starting on the evening of election day, investors swung from a temporary state of panic to a state of optimism. As it became increasingly clear that Donald Trump would be the next president and Republicans would retain Congress, US stock futures sold off significantly (down 5% before selling was effectively halted) and Treasury rates plummeted. After Trump gave what most viewed as a conciliatory victory speech later that

FIXED INCOME

INDEX	USD Total Return (%) Q4	USD Total Return (%) YTD
Barclays 1-10 Yr Muni	-2.6%	-0.1%
Barclays US Agg. Bond	-3.0%	2.7%
BofA/ML HY Master II	1.9%	17.5%

EQUITIES

INDEX	USD Total Return (%) Q4	USD Total Return (%) YTD
Russell 3000	4.2%	12.7%
S&P 500	3.8%	12.0%
Russell 2000	8.8%	21.3%
MSCI All Country World	1.2%	7.9%
MSCI EAFE	-0.7%	1.0%
MSCI Emerging Mkts	-4.2%	11.2%

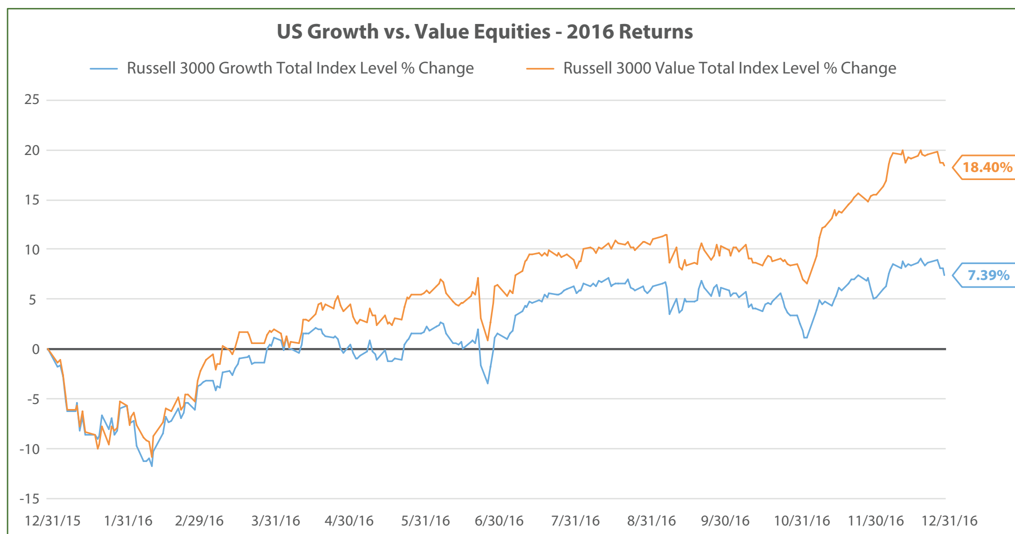
night, investor sentiment began improving. By the time the markets opened the following morning, US equities had trimmed most of their losses and interest rates started moving higher. Ultimately, US markets closed up on the day and bond yields experienced their biggest daily increase since 2013, marking the start of a multi-week rally for US stocks and decline for core fixed income.

TRENDS BEGIN TO EMERGE

Following the immediate market reaction post-election, a few trends asserted themselves over the subsequent weeks:

- **Bonds sell off.** Interest rates on core bonds rapidly rose as the specter of increased fiscal stimulus and higher inflation led investors to demand higher yields.

- **Cyclical stocks outperform.** Sectors such as financials, energy and industrials—the largest constituents of value indices—were the leading performers in Q4. A more benign regulatory environment and the potential for infrastructure spending were among the reasons for their outperformance. This phenomenon manifested itself in the wide performance gap between value and growth stocks during 2016—as illustrated by the chart below:



- **Defensive stocks underperform.** The relative leaders earlier in the year—utilities, staples and telecom—lagged during the post-election rally, largely owing to their interest rate sensitivity.

- **US outperforms non-US.** Developed international and emerging markets stocks finished Q4 lower, while US stock indices were broadly higher for the quarter.

For market observers solely tracking large cap US stocks, it may come as a surprise that diversified portfolios likely struggled to post gains during the quarter. Consider that the Morningstar Moderate Risk Index (representing a 60% global equity and 40% global fixed income allocation) was only up 0.38% in Q4, whereas the Dow Jones Industrials—a widely followed US equity index—posted an 8.66% gain. The chart on the next page illustrates the dispersion of returns across five major equity indices.

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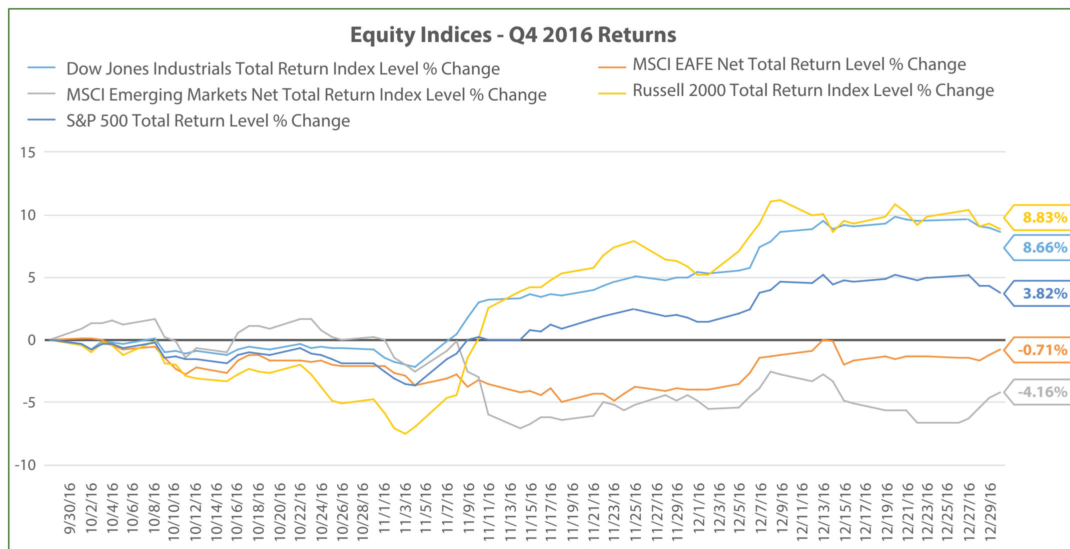


Within fixed income, a broad measure of investment grade bonds—the Barclays Aggregate Bond Index—declined 3.0% during the quarter. Rising yields negatively impacted bond prices, and investors were anticipating the Fed's move to increase rates by 0.25% at their December meeting. Conversely, credit performed quite well during the period as investors showed an increased appetite for riskier and higher yielding fixed income. The BofA/ML High Yield Master II Index advanced 1.9%, finishing the year among the top-performing asset classes with a return of 17.5% for 2016.

OPEC STRIKES A DEAL

In early December, after a number of negotiations gone awry, OPEC and non-OPEC members finally agreed to cut oil production by roughly 1.8MM barrels per day—or nearly 2% of global production. The cut was the first since 2008 and sent crude prices above $50 per barrel after trading below $45 per barrel during November. The move came as budgetary pressures continued to mount in a number of member countries and is generally being viewed as positive for US shale producers that have decreased their cost structures during the downturn. What remains to be seen is how well OPEC and non-OPEC members will comply with the agreed upon output quotas, and ultimately, how crude prices will respond to production data—particularly against the backdrop of a strengthening US dollar.

SPEAKING OF DOLLAR STRENGTH…

The trade-weighted US dollar index advanced 4.5% after the election, continuing its move higher throughout the latter half of the year. For all of 2016, the Dollar Index increased 3.7%, but was up 8.2% after Q1. The greenback has seen significant flows as central banks outside of the US continue to pursue easing measures as a means of fighting deflationary pressures and low growth. The Fed, on the other hand, has clearly signaled that it is embarking on a hiking cycle, and the consensus is that these growing rate differentials will continue to drive dollar strength throughout 2017.

THE ITALIAN REFERENDUM—OR "REFERENZI"

What was initially billed as a potentially destabilizing event for the euro zone, the Italian constitutional referendum championed by then-Prime Minister, Matteo Renzi, was handily defeated in early December. The market response was muted as Renzi fulfilled his promise to resign if the measure was defeated. Much like the Fed rate hike, the "Referenzi" proved to be a nonevent—at least for the time being.

The First 100 Days

While the incoming administration and Republican Congress have a long, ambitious list of policy goals, what remains to be seen is how their agenda will be prioritized—particularly over the first 100 days. While market participants have clearly been receptive to the pro-growth rhetoric, little has been offered in the way of details, leaving policy uncertainty elevated.

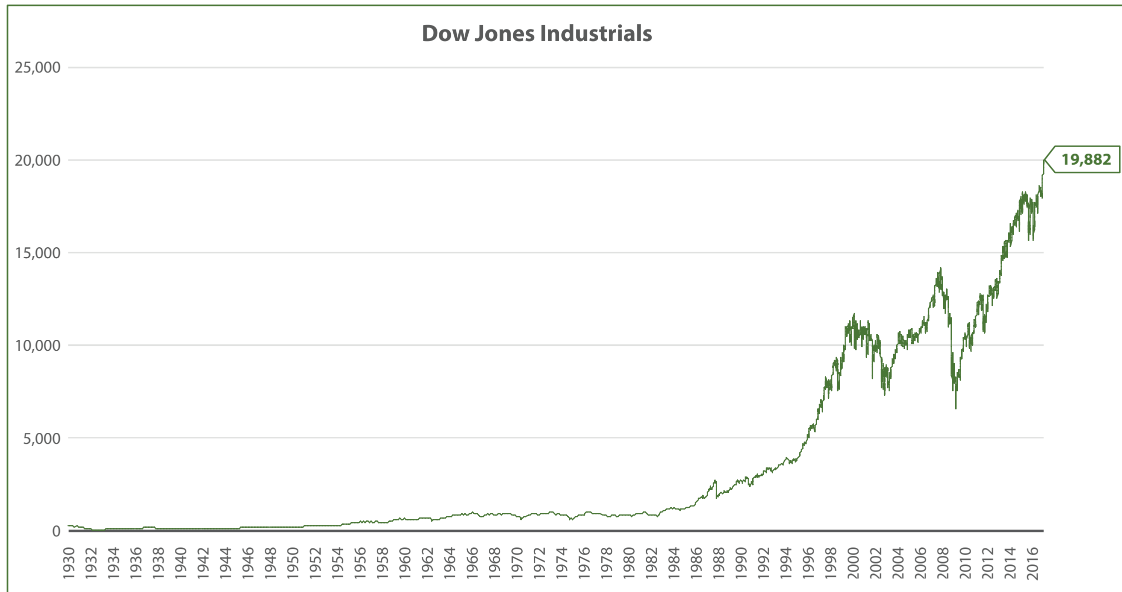
WINNERS AND LOSERS

Consensus forecasts have identified a handful of distinct winners and losers based on Trump's victory. Generally speaking, the winners are expected to benefit from some combination of regulatory rollback, infrastructure spending and tax reform, while the losers are expected to suffer due to a combination of rising interest rates, immigration reform and unfavorable trade conditions.

WINNERS	LOSERS
Energy	Core fixed income
Financials	Tech
Materials	Interest rate-sensitive equities (e.g., utilities, telecom, staples)
Small caps	Asian equities and emerging markets more broadly

A word on the Dow Jones Industrial Average...

The Dow Jones Industrial Average (DJIA) is widely cited by the popular media as *the* measure of stock market performance. The fascination with the 131-year-old index often reaches a fever pitch as it approaches round number milestones—like 20,000.



Unfortunately, the index is not a particularly useful measure of US stock market performance due to two key flaws in its construction methodology:

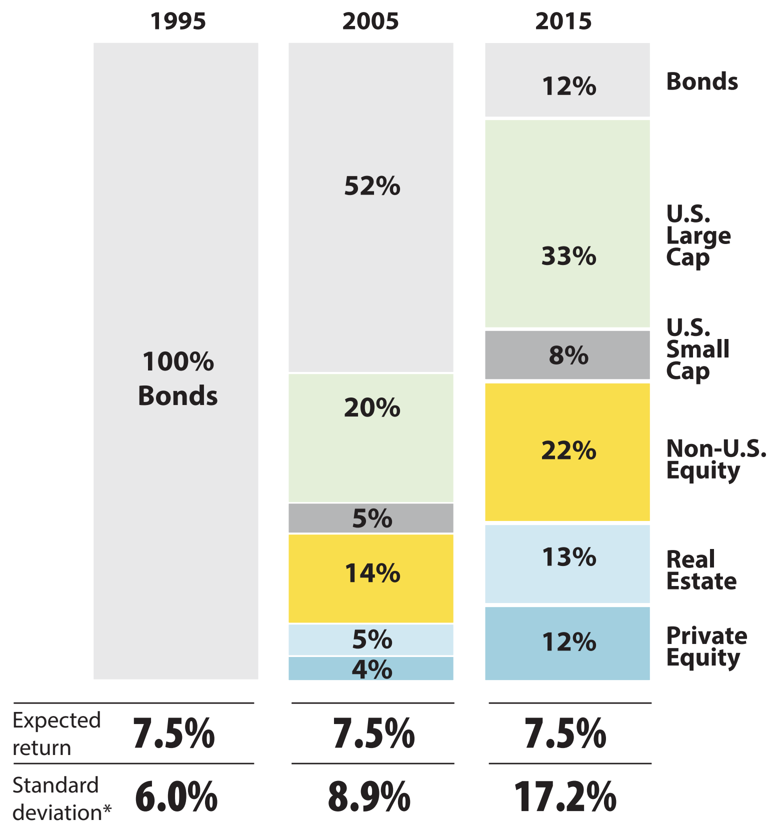
1) **30 companies.** The DJIA is a highly concentrated index, containing only 30 companies. The index constituents are chosen in a discretionary manner by a committee. Their stated goal is "to reflect the market in just 30 stocks (minus transportations and utilities)." Due to its limited scope, the "Dow 30" only represents roughly 30% of the total US stock market capitalization and omits massive companies like Alphabet (Google), Berkshire Hathaway, Facebook and Amazon. For perspective, the S&P 500 represents nearly 80% of the total US stock market capitalization. The DJIA also has a substantially different sector weighting relative to the S&P 500 and lacks diversification within those sectors.

2) **Price-weighted index.** The most egregious flaw is that the DJIA is what's known as a "price-weighted" index, meaning that the index's level is determined by the share prices of the constituent companies rather than their market capitalizations. In the 1890s, this methodology was necessary to simplify the calculation of the index, and they have kept the practice in place since that time. As an example of how this works, consider that Goldman Sachs is currently the biggest weighting in the DJIA at 8.3%. This is a function of its ~$240 share price. Cisco Systems, on the other hand, is a 1.0% weight in the DJIA due to its ~$30 share price. Goldman Sachs' market capitalization is ~$100B whereas Cisco's market capitalization is ~$150B. So, despite being two-thirds the size of Cisco, Goldman Sachs receives eight times the weighting in the index. It's pretty illogical. The S&P 500 solves this issue by weighting companies by their market capitalization; Cisco is 0.78% of the S&P 500 and Goldman Sachs is 0.46%.

While we won't besmirch investors who want to reference the Dow for a quick look at how the US market is performing, just don't mistake it for a truly comprehensive measure of US equity performance.

Chart of the Quarter

Our Chart of the Quarter comes courtesy of the *Wall Street Journal* and Callan Associates. As you can see, the investing landscape has materially changed since 1995 when an investor could reasonably expect to earn a 7.5% return solely by owning low volatility fixed income investments. Fast forward 20 years to 2015, and investors have to own a broadly diversified portfolio of risk assets in order to achieve the same 7.5% returns due to the prevailing interest rate environment. The rub lies in the fact that in order to achieve this same return, investors expose their portfolios to much higher levels of volatility—or standard deviation—and the potential for market declines.



Source: Wall Street Journal

Further, broadly diversified portfolios can pose unique challenges based on investor psychology. Brian Portnoy from Virtus Investment Partners coined the phrase "Diversification means always having to say you're sorry" to describe the concept that diversified portfolios generally hold a few lousy investments during any year, quarter, etc.—regardless of how skilled the portfolio manager is. It's just the nature of diversification. No one knows exactly what is going to happen in the future, so you spread your bets around. Each observation period will most likely contain some winners and some losers. It can be hard for investors to stay disciplined and resist the urge to sell underperforming asset classes at what is often the wrong time (let alone add to them) or trim their winners under the mistaken belief that they will continue to go up in perpetuity.

Moving forward...

Putting the market's recent exuberance aside, the investing landscape continues to be populated with assets that appear to be somewhere between fully valued and expensive. Constructing a portfolio of high-conviction ideas has become increasingly difficult. Despite the challenges, the following tried and true investing principles will continue to serve investors well.

FOCUS ON FUNDAMENTALS

Ben Graham, the father of modern value investing, once said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." The reality of investment performance is that changes in asset values on a day-to-day, week-to-week, or even quarter-to-quarter basis are due to a complex group of factors which may or may not be related to the real, intrinsic value of the asset. Over time, these oscillations tend to work themselves out and asset prices generally converge on fair value. In other words, fundamentals win out in the end. Know what you own and why you own it.

FIGHT COMPLACENCY

Another investing axiom—investments can be very safe or very popular, but never both at the same time—is important for investors to consider going forward. Assets often advance higher in an orderly fashion, but trades often unwind in a quick, *disorderly* fashion. Fighting the complacency that can occur during a benign market is a crucial part of making sure portfolios are prepared for a bout of volatility or a larger shift in sentiment.

Rebalancing is key. When allocations are off kilter, consider trimming from investments that have come "too far, too fast," and evaluate unloved or under-owned asset classes for potential opportunities—even when recent returns have been uninspiring. Tax implications should always be a factor, but as the saying goes, you cannot go broke taking a profit.

TRUST THE PROCESS

There will always be variables outside of investors' control, and decisions are made within the context of an inherently unknowable future. Therefore, it is imperative to practice disciplined, process-oriented thinking. Have a plan and be proactive; that is the backbone of generating consistent results over time.

WISHING YOU A HAPPY, HEALTHY AND PROSPEROUS 2017!

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