Quarter One Newsletter 2016

Quarter in Review

First quarter market volatility presented our portfolios with a real-world stress-test scenario. It began with the worst start to a year in Wall Street history, as major equity markets dropped 10% to 16%, oil prices plunged, and fears of a global recession grew. Then beginning around mid-February, everything changed (though as is often the case, there was no clear catalyst for the turnaround). Oil prices spiked higher, stock markets rallied, and the dollar declined (serving as a tailwind for foreign equity returns). In a welcome change for our portfolios versus recent years, emerging-markets stocks were among the highest-returning asset classes. Core bonds, which had rallied strongly in the first half of the quarter, fell and the 10-year Treasury yield moved higher.

This sort of extreme market turmoil vividly illustrates why we construct diversified investment portfolios for our clients. It also points out the unpredictability of short-term market movements. Our approach is to carefully analyze long-term risk and return potential and build portfolios that balance these considerations and are resilient across a variety of market scenarios.

During the first half of the quarter, our defensive positions in core bonds and diversifying allocations to alternative strategies helped offset the dramatic equity market declines, with one of our managed futures funds up as much as 10% at February's market low point.

As the market rebounded, our flexible and absolute-return-oriented bond funds were rewarded, while on the equity side, our allocations to emerging-markets and U.S. stocks boosted performance as each asset class ended in positive territory for the quarter (5.9% and 1.3%, respectively). Developed international stocks also rebounded dramatically off their mid-quarter lows, but trailed for the quarter, down just under 2%. The turn in the markets also favored many of our value-oriented active fund managers that lagged in 2015.

Portfolio Review and Positioning

We believe that part of successful investing involves riding out these nervous markets in which prices are driven by short-term news and investor cycles of emotion, staying focused on long-term fundamentals, and remaining committed to a disciplined risk-management process. The quarter's market volatility seemed to reflect a recognition by investors of some of the macroeconomic concerns we have expressed over the last few years, including the uncertainty created by unprecedented monetary policies (which have resulted in ultra-low and even negative interest rates) and the potential effects of an economic slowdown in China on global markets. Our assessment of these risks has not materially changed, and we have factored them into our asset allocation decisions.

Based on our analysis (and supported by a variety of commonly used valuation metrics), the U.S. stock market is overvalued and company earnings have declined from peak levels. Returns over the next five years are likely to be low not only in absolute terms, but also relative to the outsized gains we've seen in the post-2008 period. This assessment has been key in supporting our relatively conservative allocation to U.S. stocks in our portfolios.

On the other hand, the attractiveness of foreign markets is almost a mirror image of the U.S. market. We see the potential for faster earnings growth from current below-normal levels and valuation levels we believe will expand somewhat as earnings improve. To the valuation point, foreign stocks have seen very steep declines of 24%–35% from their April 2015 highs, bringing prices to recession-like levels even though it isn't at all clear that we are either in or at imminent risk of a recession. In other words, foreign stocks, having discounted a lot of negative news, are set up for a potential rebound should markets realize things aren't as bad as prices suggest. Our tilt toward foreign stocks has so far been a headwind for our portfolios. However, the performance of emerging-markets stocks versus U.S. stocks since the quarter's turnaround may be hinting at a possible turn in the cycle that, if realized, could result in further gains for our equity holdings.

Our diversified bond allocations reflect our assessment that in the current ultra-low rate environment, allocating to fixed-income calls for greater ingenuity than in a more normal environment. And while our core bond positions provide useful risk-management qualities—as illustrated during the downturn early this year—their longer-term upside potential is limited. As such, we are looking to our flexible and absolute-return-oriented bond funds to provide greater upside over the longer term, as they are better equipped to navigate a rising interest rate environment. We also believe we'll continue to see positive return contributions from our tactical positions in floating-rate loans as was the case when rates ticked up during the second half of the quarter.

The final piece of our portfolios is our allocation to managed futures and arbitrage/event-driven funds. We view these investments as alternative strategies because they should have different return drivers and risk exposures than traditional stock and bond funds. We believe these investments will also be additive to our balanced portfolio returns over the next five years.

Looking Ahead

Markets are cyclical, and for the past several years our portfolios have been facing some meaningful cyclical performance headwinds given our long-term, active, valuation-driven investment approach (We will be sending you our *First Quarter Investment Commentary* for more in-depth discussion of these market trends). While the sharp reversal in the markets beginning in the middle of the first quarter may indicate the pendulum is starting to swing in our favor, we realize it is impossible to time these short-term shifts and reversals. As always, patience, discipline, and fortitude remain key to achieving one's long-term investment goals and avoiding being swept away by the market's unceasing swings.

As always, we appreciate your confidence and welcome questions about your individual situation.

Best regards,
Deborah Wiggin