WFS Investment Letter

Wiggin Financial Services **Second Quarter 2016**

Second Quarter 2016 *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.

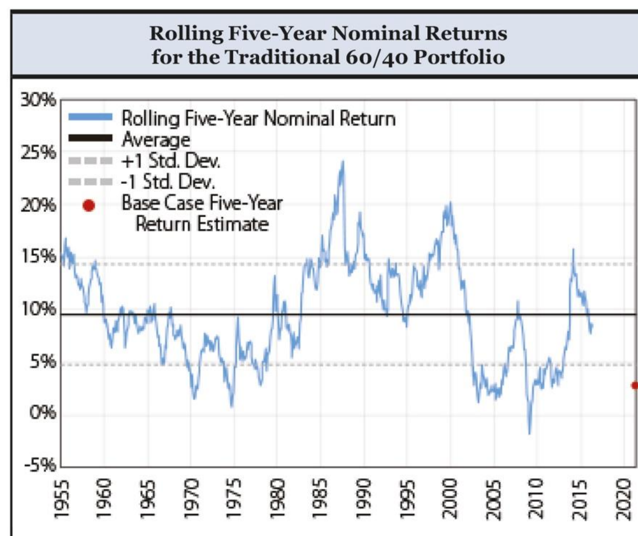
Given current yields, valuations, and earnings fundamentals, we continue to view the return prospects of a "traditional" portfolio split 60/40 between stocks and bonds as poor. We believe the diversified portfolios we've assembled for our clients are well positioned to outperform ones that only feature 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.

Second Quarter 2016 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.

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.



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

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.

Portfolio Positioning

We are underweight to U.S. stocks, in favor of a mix of developed European and emerging-markets equities. Our analysis and modeling suggests both these broad markets offer attractive five-year return potential, driven by improving earnings growth and expanding valuation multiples. We believe we are being fully compensated for taking on the near-term risks, higher potential downside, and volatility, with low double-digit expected returns in our base case.

Part of our underweight to U.S. stocks in our balanced portfolios is also allocated to liquid alternatives, such as managed futures. With these investments, we generally expect to get returns comparable to or better than U.S. stocks but with much less downside risk.

We are underweight core bonds in favor of actively managed, flexible, unconstrained, and/or opportunistic fixed-income funds. We expect to earn a meaningful return premium relative to the core bond index over the next several years. The trade-off is that we are taking on more credit risk and they won't hold up as well if there is deflation or a short-term shock that pushes Treasury bond yields lower. However, these funds have less sensitivity to negative price impacts from rising Treasury rates, playing a valuable risk-management role in our more conservative, fixed-income-heavy portfolios.

We also have a tactical position in floating-rate loan funds in place of some of our core bond allocation. These do expose us to some credit risk, but they also offer attractive five-year expected annual returns and provide a hedge against inflation and interest rate increases.

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. Our base case expected annualized five-year return for our 60/40 portfolio, is in the 5.5%–6% range. That is still meaningfully higher than the approximate 2.5%–3% return we expect for a traditional 60/40 portfolio. There are no guarantees. But we view our base case as being the most likely, and our asset class assumptions as reasonably conservative.

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.—*Debbie Wiggin (7/16)*