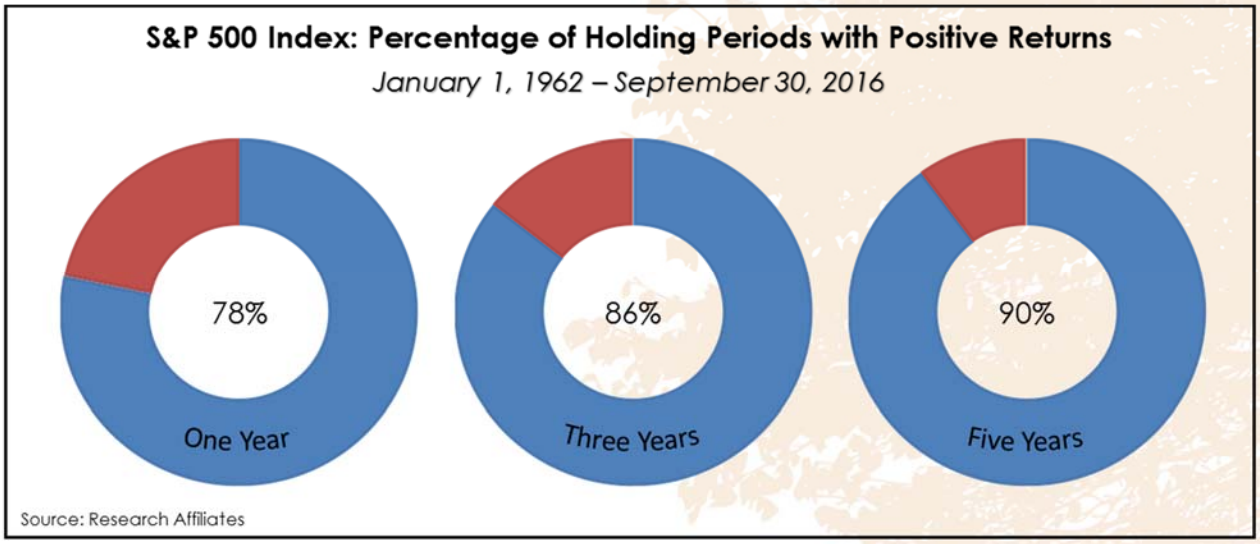
Quarterly Newsletter

October 2016

CAPITAL MARKETS UPDATE | Equity markets posted strong returns in the third quarter as investors moved past the surprise vote by the United Kingdom to leave the European Union (Brexit vote) and applauded continued accommodation by the world's central banks (expectations that short-term interest rates will be lower for longer). U.S. Small Cap (+9.1%) led the way followed by Emerging Markets (+9.0%), International (+6.4%) and U.S. Large Cap (+3.9%). Real Estate (-1.4%) and the U.S. bond market (+0.5%) took a breather with near break-even returns as the U.S. 10-Year Treasury yield edged higher.

THE EQUITY MARKET'S BATTING AVERAGE | With the Major League Baseball playoffs in progress and the World Series on deck, it is timely to talk batting averages. For a baseball player, a batting average measures the percentage of the time you get a hit (number of hits divided by number of at bats). For equity investors, we may think of our batting average as how frequently we earn a positive return over a given holding period. Historical perspective is helpful, since market turbulence will inevitably test our confidence, convictions and commitment to staying invested. In fact, the last fifty plus years of market history show that long-term investors have been rewarded over appropriate investment horizons.



The chart below uses monthly return data for the S&P 500 Index (an equity index weighted by the market value of 500 large U.S. companies) since January, 1962 (as far back as available) to compute how frequently investors earned a positive return over various holding periods. As the data suggests, "staying invested" has a high batting average.

One-year holding periods have delivered positive returns 78% of the time. This batting average intuitively seems high, perhaps because it is human nature to remember acute downdrafts more vividly than the sharp recoveries that follow. If we extend the holding period to three and five years, the batting average has been even stronger at 86% and 90%, respectively.

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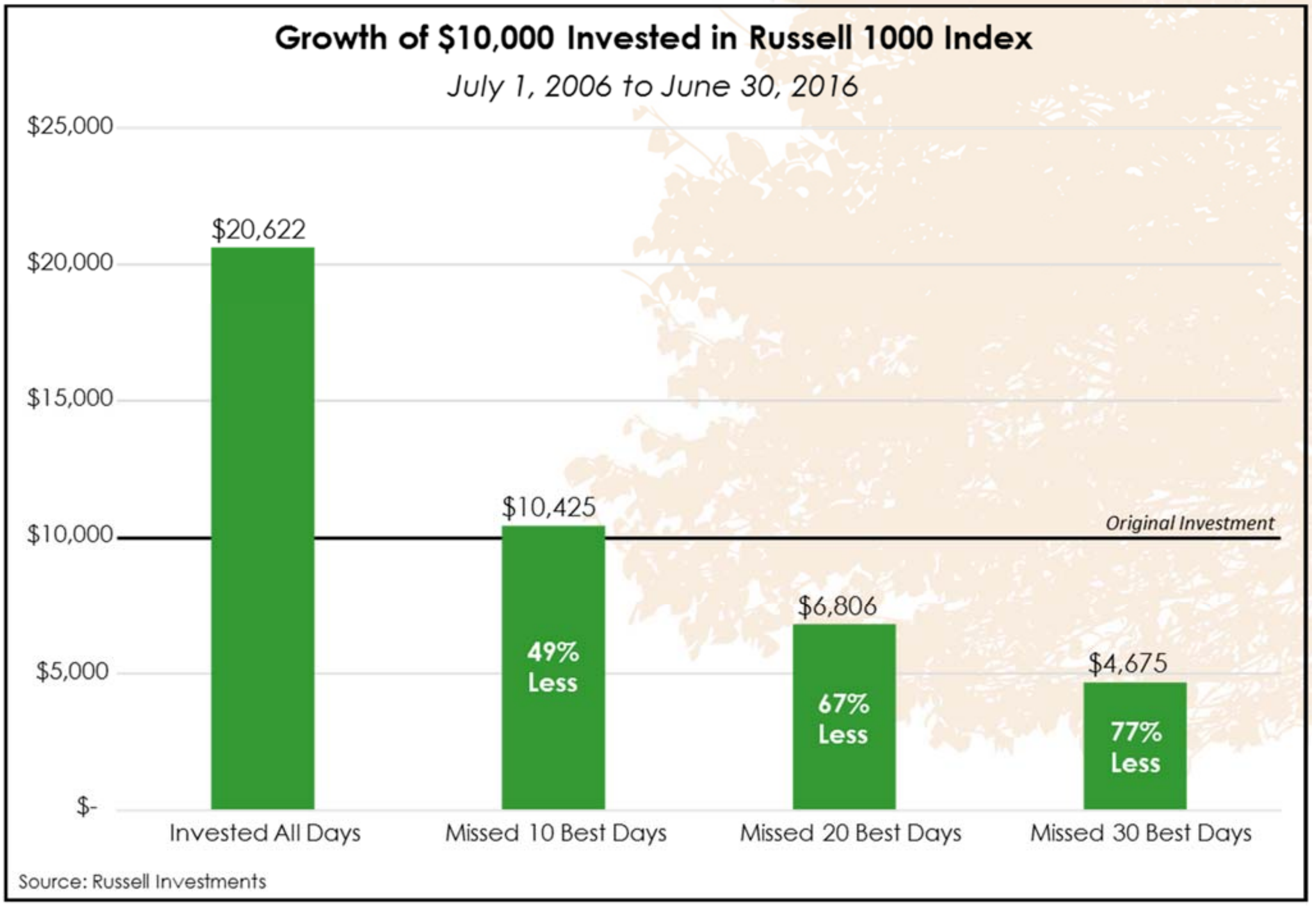
DON'T STRIKE OUT | It has always been tempting for investors to try to time the market: sell in anticipation of market declines and buy back in at a lower price. The recent volatility around the shocking Brexit vote was a prime example. The S&P 500 Index plunged over 5% in the two days after the surprise June 23rd vote, prompting some to sell and wait for markets to calm down. As Research Affiliates' Robert Arnott has observed: "The market doesn't reward comfort. It rewards discomfort." It only took eight trading days for the market to claim new highs. Those that did not stay invested were penalized.

Brexit was a mild test. The last ten years have been a stern test with eight intra-year double digit declines averaging 19%. The peak to trough decline during the Global Financial Crisis exceeded 50%. While this period was emotionally jarring, it eventually rewarded investors' discomfort: by staying invested, you doubled your money (an annualized return of 7.5% as measured by the Russell 1000 Index, an equity index of the 1,000 largest U.S. companies by market value). The chart below quantifies the cost of missing a small amount of the days with the best returns.



Amazingly, the ending portfolio value is nearly cut in half by only missing the ten best days. For perspective, there were over 2,500 trading days during this ten year period. Missing ten days means you were invested over 99% of the time yet missed nearly all of the profit! What about missing the twenty best days (still invested over 99% of the time)? The ending value is 2/3 less than staying fully invested. Only thirty days? The portfolio lost more than half the original investment. Market timing can be costly.

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DISCIPLINE IS KEY | History offers many examples of unexpected events that have incited abrupt declines in the equity markets: election results, Fed policy decisions and acts of terrorism to name a few. Market history also affirms that setting an appropriate risk budget, diversifying broadly, maintaining discipline and strategically rebalancing to target allocations has rewarded long-term investors. Attempts to time the markets most often result in higher risk and lower returns as market reversals (up or down) usually trigger emotional reactions and hasty, irrational decisions. The best path is a disciplined path.

YEAR-END REMINDERS | As year-end is fast approaching, please let us know if we can help with any charitable giving—from either an IRA or a taxable account. As a reminder, individuals age 70½ and older may transfer up to $100,000 per year from an IRA to a qualifying charitable organization. These transfers (Qualified Charitable Distributions or QCDs) may be excluded from taxable income and count toward meeting the Required Minimum Distribution (RMD). Our goal is to complete all QCDs by mid-November to ensure these gifts are processed correctly.

All clients are eligible to gift appreciated securities to a charity from taxable accounts. Our experience is that many charitable organizations are not fully staffed in late December, which makes it challenging to coordinate transfers and verify receipt of these important gifts. Our objective is to submit all signed forms for in-kind asset gifts by early December to ensure a smooth and timely accounting of your contribution.

Please consult your tax advisor to see what option (or combination of options) may be most advantageous for you. We look forward to helping you with your charitable giving and will provide a year-end summary of your QCDs and/or stock gifts.