Quarter in Review

As we look back on the last three months, what stands out is how quiet financial markets were during the summer, and yet as September rolled around and market fluctuations increased, how much it paid to be diversified. Broader financial market returns have been positive—large-cap U.S. stocks were up nearly 4% for the quarter and close to 8% year to date. Small-cap U.S. stocks, emerging-market stocks, and European stocks outperformed larger-cap U.S. stocks for the quarter. In fixed-income, high-yield bonds and floating-rate loans outperformed core investment-grade bonds.

Asset Class	*3Q*	*1 Year*	*5 Years*
U.S. Large-Cap	*3.82%*	*15.27%*	*16.20%*
U.S. Large Growth	*4.53%*	*13.65%*	*16.35%*
U.S. Large Value	*3.45%*	*15.97%*	*15.89%*
U.S. Small Blend	*8.92%*	*15.53%*	*15.86%*
Developed Int'l Stocks	*6.31%*	*8.07%*	*8.21%*
Emerging-Markets Stocks	*8.14%*	*16.66%*	*4.10%*
REITs	*-1.49%*	*19.53%*	*15.54%*
Investment-Grade Bonds	*-0.28%*	*4.09%*	*2.37%*
Municipal Bonds	*0.39%*	*5.21%*	*2.89%*
High-Yield Bonds	*5.49%*	*12.82%*	*8.24%*
Global Bonds	*0.30%*	*9.71%*	*0.77%*

Central bank actions and inaction, along with the fear surrounding both, drove financial market swings during the quarter. Against a backdrop of soft economic growth and weak corporate earnings, extremely low interest rates have driven investors to bid up the prices of financial assets, distorting markets in the process. Any sign this "easy money" interlude is nearing an end has triggered gyrations in stocks and bond markets.

In viewing recent market performance, we keep coming back to one of our fundamental principles, that successful long-term investing is a marathon, not a sprint. Focusing on how all the pieces of your portfolio contribute to performance and less on what a specific investment is doing in any given quarter is the best way to avoid overreacting to temporary market declines. Investors should be extra cognizant of this as the U.S. presidential election passes, and the transfer of power to the new administration begins. We are prepared for more financial market fluctuations going into year-end, but we do not view that as a rationale to make tactical changes to our portfolios. Uncertainty can lead to rash, poorly timed decisions that negatively impact results. Maintaining diversified portfolios, managing risk, and riding out periods of uncertainty, however uncomfortable, are key to successful investing.

As we focus on this bigger picture, we acknowledge short-term successes and challenges. During the past quarter, emerging-markets performed well, continuing a turnaround that began during the second quarter of this year. Its year-to-date double-digit gains outpaced those of nearly every other investment category. Additionally, other areas of the portfolio such as European stocks and non-core bonds added value. While performance was mixed for our alternative investments during the quarter, these investments continue to fulfill their longer-term role as portfolio diversifiers. Given a current investment environment that features high uncertainty, and one that we view as offering lower than historical returns, we believe the diversified portfolios we've assembled for clients are both resilient and well-positioned for long-term outperformance on a risk-adjusted basis.

Perception versus Reality: Managing Risk

While we spend time analyzing each individual position and holding in managing client portfolios, the whole is much more than simply the sum of its parts. By definition, a well-diversified portfolio *(i.e., one with investments that do not all move together in the same direction)* will contain some laggards during any given time-frame, but particularly over shorter time-frames. More importantly, we focus on the overall portfolio; how the pieces fit together and perform relative to each other and whether that performance is consistent with the original rationale for owning them.

Successfully managing portfolios also requires the discipline to resist trading on emotion, rather than on long-term fundamentals such as valuations, yield, and earnings growth. Even in an advanced economy such as the United States, the stock market has fallen by at least 10% every 16 months on average since 1950. Bear markets (20% or greater declines) in the United States have happened about every seven years on average. In most cases you can't predict what the exact cause of the volatility will be or exactly when it will hit. Even if you could successfully call it, you'd need to also successfully time your re-entry so as not to miss out on the subsequent gains—and do so consistently and repeatedly over an investment lifetime. That is not realistic, which is why our tactical investment approach is based on a range of potential outcomes and a longer-term time frame.

Along with the U.S. presidential election, central banks' policies *(particularly the Fed's)* remain a key near-term wildcard for financial markets. At its September 21st meeting, the Fed remained on hold but signaled it is on course to raise rates later this year, likely in December. It also lowered its longer-term forecast of rate hikes yet again. It now forecasts just two in 2017, down from the three forecasted at the June meeting and the four forecasted at the March meeting. Financial markets responded positively.

Investors are effectively being forced out of low-risk, extremely low-yielding, core bonds into riskier assets that offer higher current yields (still quite low compared to historical levels). Many investors appear to be "reaching for yield" as well as *perceived* safety in traditionally "defensive" yield-oriented sectors of the stock market, such as utilities, telecoms, consumer staples, and REITs. Valuations have soared. But these trades can unwind quickly and momentum can work in reverse. It certainly seems "defensive" plays are vulnerable to any hint of interest rate increases and are potentially higher-risk right now than the broad stock market, not to mention bonds.

To the extent the "buy 'bond-like' and dividend-yield stocks" theme remains in play, it will likely be a headwind for our actively managed U.S. stock funds overall. When that trend reverses, our managers and portfolios should benefit. We saw that happen in the third quarter, as the yield on the 10-year Treasury bottomed at 1.37% on July 5 and closed at 1.56%

Putting It All Together

Our decision-making is anchored in our long-term fundamental and valuation-driven approach. We and our clients need to be psychologically and financially prepared for periods of market stress and able to ride them out on the path to achieving long-term investment and financial goals. Investors who can't stomach a given level of volatility or downside risk should reallocate into a portfolio with a lower targeted risk level. The time to do so is *before* a period of volatility, not during or right after it when they would be selling their riskier assets at lower prices and buying more defensive assets at higher prices.

We structure our balanced portfolios across a well-diversified mix of investments, each with a distinct role. We expect them to be resilient and to perform at least reasonably well across a wide range of outcomes, balancing our objective of long-term capital appreciation with shorter-term downside risk management appropriate for each client's risk tolerance.

While July and August were unusually calm months for the markets, volatility picked up in early September. We're prepared for more of it heading into (and potentially coming out of) the November election, as well as on increased likelihood of a Fed rate hike in December.

-We thank you for your continued support!