Quarter & Year in Review

As we look back at 2016 and ahead to 2017 and beyond, we'll leave the political discourse and analysis to others and focus our comments on the financial markets. Our expertise is in our objective analysis of investment opportunities and risks; the application of our analytical insights to the construction and management of diversified portfolios; and the disciplined execution of our investment process over the long term. So, whether one is personally happy or horrified—or somewhere in between—with the outcome of the recent U.S. presidential election, our focus as investment analysts, portfolio managers, and fiduciaries is unchanged

Global stocks performed well both in absolute terms and relative to core bonds this year, with U.S. stocks again taking the lead. Large-cap stocks (S&P 500) gained 11.8% and small-cap stocks (Russell 2000) surged 21.6%. This marked the eighth straight year the large-cap S&P 500 Index had a positive return. This ties the streak from 1982–1989 and only the period from 1991–1999 saw a longer streak, at nine years. Developed international stocks were the big laggards. They returned 2.7% in U.S.-dollar terms.

Asset Class	*4Q*	*1 Year*	*5 Years*
U.S. Large-Cap	*3.8%*	*11.82%*	*14.49%*
U.S. Large Growth	*-0.45%*	*5.99%*	*13.91%*
U.S. Large Value	*7.50%*	*16.75%*	*14.85%*
U.S. Small Cap	*6.08%*	*18.17%*	*14.68%*
Developed Int'l Stocks	*-1.52%*	*2.67%*	*6.79%*
Emerging-Markets Stocks	*-4.46%*	*12.21%*	*1.36%*
REITs	*-3.04%*	*8.34%*	*11.63%*
Investment-Grade Bonds	*-3.19%*	*2.50%*	*2.03%*
Municipal Bonds	*-3.67%*	*-0.50%*	*2.55%*
High-Yield Bonds	*1.88%*	*17.49%*	*7.35%*
Global Bonds	*-6.09%*	*1.60%*	*2.99%*

Though core bonds got off to a strong start with the 10-year Treasury yield dropping to an all-time low in early July, yields reversed course, rising to 2.5% by year-end. In the fourth quarter, the core bond index (Barclays Aggregate Bond) fell 3.2%—its worst quarterly performance in 35 years—due to rising interest rates. For the year, core bonds produced a 2.5% gain, slightly above our longer-term (five-year) expected return outlook for them. Investment-grade municipal bond returns (Barclays Intermediate-Term Tax-Exempt) were slightly negative on the year.

We also witnessed a number of sharp reversals in market trends and consensus views during the course of the year. We often make the point that markets are prone to both momentum (continuation of a trend) in the shorter term and cyclical behavior (reversion to the mean) in the longer term. We don't think anyone can consistently time markets—buying in just before an upswing, riding the momentum, and then selling at the top. To the contrary, there is a mound of evidence (academic and industry studies, as well as our own observations and experience) that suggests most investors destroy value over time due to perversely bad timing of buys and sells. They are repeatedly whipsawed by shorter-term price volatility—driven into and out of asset classes and funds by emotional reactions, performance-chasing, risk-aversion, and the lack of a fundamentally sound, long-term investment discipline to guide their decisions. If 2016 is a harbinger of what's to come, that lack of investment discipline may cause permanent financial harm.

Looking Ahead

As we consider investment opportunities and risks going forward, we'll focus on two key questions:

1) Why do we still own foreign stocks?

Since the end of 2009, the large-cap S&P 500 has returned a cumulative 131%. In contrast, developed international stocks have gained 32% and emerging-market stocks a measly 1.3%. Because our portfolios' long-term, strategic equity allocation is diversified globally, they have obviously lagged compared to a purely U.S. stock portfolio.

We know the underperformance of foreign stocks can be trying on an investor's patience. It tries our own, at times, as well. However, we continue to believe, and our analysis supports, maintaining foreign stocks as a part of any well-diversified portfolio.

Some key points and rationale for this include:

- *Equity markets and asset classes go through cycles*
- *Most importantly, by owning a globally diversified equity portfolio, we gain access to a much broader investment opportunity set—more than twice as large as that available through investing in U.S. stocks alone.*
- *Because markets move in cycles, by definition you will always own some assets that are lagging while others are outperforming. Prudent investors diversify because they know they can't consistently predict which asset classes will outperform when.*

2) What if we are facing a macroeconomic "regime shift"—a cyclical change from monetary to fiscal policy, from deflation to inflation, from falling interest rates to rising rates?

In the weeks since Donald Trump's election, we've observed an increasing number of investment strategists refer to a so-called regime shift. (We may nominate regime shift as our investment buzzword of the year for 2017.) The gist is that the U.S. economy is poised to undergo a number of significant transitions:

- *from the dominance of monetary policy since the 2008 financial crisis to an increased emphasis on fiscal policy stimulus,*
- *from a disinflationary/deflationary trend to a reflationary/inflationary trend, and*
- *from a 35-year trend of declining interest rates to rising rates.*

This is certainly one plausible scenario. But there is tremendous uncertainty in terms of what policies the Trump administration and Congress will actually implement, the timing of those policies, the magnitude of the economic impact, and finally, how (and when) financial markets will react to and discount those potential impacts—not to mention how the financial markets' reaction can in turn impact the policies themselves. In any case, the consensus narrative at the moment seems to be the Trump administration and Republican-controlled Congress will implement fiscal stimulus via both increased infrastructure spending and reduced corporate and individual tax rates. Potential deregulation across many industries is further stoking market optimism that dormant "animal spirits" (and corporate profits) will soon be revived.

More importantly, economics in the real world is never as clean and simple as it is in the textbooks. There are numerous other variables that impact growth and inflation. The direction of interest rates and the U.S. dollar are two big ones. In theory, these policies, if implemented, should drive both U.S. interest rates and the dollar higher.

While the initial rise in interest rates would reflect optimism about stronger U.S. economic growth, at some point higher rates become headwinds to such growth. Higher rates and yields mean higher mortgage rates, which would hurt the housing market and ancillary industries. Higher rates for consumer and business loans depress demand and spending. Higher rates and expanding government budget deficits from fiscal stimulus also pose risks given the already-high levels of government debt—by raising the nation's debt servicing costs.

Concluding Comments

Expert predictions of the future are usually no better than guesses. Sometimes they are right, often they are wrong. And the experts who are right one year are often wrong the next. When it comes to economies and financial markets, there are way too many complex, adaptive, and interactive variables—most of which themselves are consistently unpredictable—to confidently forecast outcomes, at least over the shorter term.

Even if one had a crystal ball and could know in advance the outcome of many of the important individual variables (e.g., election results, central bank policy decisions, currency movements), one would still be likely to make many inaccurate market forecasts. For example, how many experts would have predicted gold would drop and stock markets would rally in the days and weeks after an unexpected Donald Trump election victory?

We don't bother guessing what the markets will do next year. An important part of our portfolio risk management process does analyze the impact of various short-term (12-month) stress-test scenarios. But those are neither forecasts nor predictions. If we had to make a forecast for the financial markets next year, or for any year, it would be this: Expect the unexpected. Prepare to be surprised. Stock markets will be volatile; they will go up and down—probably a lot.

We'll end with a quote from one expert whose long-term investment record is truly impressive:

We've long felt that the only value of stock forecasters is to make fortunetellers look good. Charlie and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.

—Warren Buffett (1992 Berkshire Hathaway shareholder letter)