Virginia Capital Strategies

STEPHEN J. BOWERY, PRESIDENT

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Year-End 2015 Investment Commentary

In this commentary we highlight some key market developments from the fourth quarter and recap 2015 performance for the key asset classes we invest in. We follow with a discussion of the types of investments we own in order to highlight the different roles they play within a client's overall portfolio. Understanding how we employ these strategies in our portfolios should help in setting reasonable expectations of how they will perform, particularly during periods of challenging performance. A discussion of 2016 market events is included as well.

December Benchmark Returns (Preliminary)			
Large Cap Benchmarks	**Dec**	**4Q**	**YTD**
Vanguard 500 Index	-1.6%	7.0%	1.2%
iShares Russell 1000	-1.9%	6.5%	0.8%
iShares Russell 1000 Growth	-1.5%	7.4%	5.5%
iShares Russell 1000 Value	-2.2%	5.6%	-4.0%
Mid-Cap Benchmarks			
iShares Russell Midcap	-2.8%	3.5%	-2.6%
iShares Russell Midcap Growth	-2.3%	4.1%	-0.5%
iShares Russell Midcap Value	-3.2%	3.1%	-5.0%
Small-Cap Benchmarks			
iShares Russell 2000	-5.0%	3.6%	-4.5%
iShares Russell 2000 Growth	-4.8%	4.3%	-1.3%
iShares Russell 2000 Value	-5.4%	2.8%	-7.7%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-2.1%	3.7%	-0.4%
MSCI World ex USA Index	-1.8%	4.0%	-2.6%
Vanguard FTSE Europe ETF	-2.6%	1.8%	-1.9%
Vanguard FTSE Emerging Markets ETF	-3.4%	-0.7%	-15.8%
Vanguard REIT Index	1.8%	7.0%	2.2%
Vanguard Total Bond Market Index	-0.4%	-0.6%	0.3%
BofA Merrill Lynch U.S. High Yield Cash Pay	-2.6%	-2.2%	-4.6%
Vanguard Int. Term Tax-Exempt Fund	0.7%	1.3%	2.9%
S&P/LSTA Leveraged Loan Index	-1.1%	-2.1%	-0.7%
Citigroup World Gov't Bond Index	0.9%	-1.2%	-3.6%

Markets in Review

As we look back on the financial markets in 2015, what really stands out is how poor returns were across the globe and across asset classes (stocks, bonds, commodities, etc.). Among the major global stock markets, the United States was the best performer, but that's faint praise given the S&P 500's flat return. What's more, it was a market in which a handful of large tech/Internet companies (e.g., Facebook, Amazon.com, Netflix, and Google) generated huge gains and helped propel the index slightly into positive territory, while the equal-weighted S&P 500 index actually *fell* 2.2% for the year.

Specific market segments performed particularly poorly. Large-cap value stocks lost 4%, and mid and small-cap value stocks declined 5% and 7.7%, respectively. Emerging markets stocks fell almost 16%. World bonds declined 3.6%.

Value stocks suffered primarily due to a lack of breadth in the market. The growth index benefited from its large weighting in the strongest-performing market sectors—technology, health care, and consumer stocks—as well as from its minimal allocation to the bottom-dwelling energy sector, which plunged nearly 25% on the year.

Over the long term, value has outperformed growth by a meaningful margin, but the opposite has been true over the past several years (and actually going back to mid-2006).

The worst-performing areas of the markets were commodity-related asset classes. Commodity indexes were crushed, down on the order of 25%–30% as oil prices hit an 11-year low in December and fell 30% for the year, after plunging 50% in 2014. Energy MLPs, an increasingly popular vehicle for yield seekers (and yield chasers), dropped 35%–40%, wiping out the previous four years' worth of gains.

It wasn't much better on the fixed-income side, as bonds offered little respite, with the US core bond index gaining just 0.3%. High-yield bonds fared worse, down close to 5%, only the fifth negative year in the asset class's 30-year history. Aside from 2013, when the Fed's "taper tantrum" led to a 2% decline, this was the worst performance for US core bonds since 1999 (down 0.8%) and the fourth worst year since the index's inception 40 years ago.

Foreign stocks were a challenging asset class again. One striking feature of last year's investment environment was the difference in the direction of the U.S. economy and U.S. monetary policy versus other major global economies. In December, the U.S. Federal Reserve was sufficiently comfortable with the outlook for economic growth and the potential for inflation to eventually normalize that it made its first increase in rates in nearly a decade. Outside the United States, regaining more normal economic growth and inflation has remained more challenging in the face of downward pressures such as sharply lower commodity prices (most notably oil), Middle East tensions, and China's slower economic growth. Year-end foreign stock returns reflect this bifurcation, with developed international stocks down 0.4% and emerging-markets stocks falling 15.8%. As in 2014, the strength of the dollar exacerbated foreign markets' underperformance for dollar-based investors, detracting 9% from emerging-markets stocks and 6% from developed international stocks compared to their local-currency returns.

So clearly, 2015 was a disappointment with respect to virtually all investable asset classes. And 2016 has gotten off to a rough start as well.

Present Market Activity

In fact, in just 10 trading days, US equity markets have recorded their worst start to a year on record, with a loss of over 8%. Worries about China, a dislocation in the energy complex, recent Fed actions, disappointing earnings and the possibility of a worldwide recession are the primary drivers. Of these, the possibility of a worldwide recession is the most ominous threat and the key issue to follow.

As we mentioned in our previous commentary, it is very difficult to predict recessions. For what it's worth, the consensus expectation continues to be positive, albeit modest world economic activity. Goldman Sachs current outlook on the risk of a recession is no higher than a 1 in 5 chance. Oxford Economics expects advanced economy global growth to average 2% annually over the next 10 years.

The direction of the world economy is very important as a worldwide recession would likely lead to a bear market for stocks, with losses of greater than 20%. However, if it appears that worldwide growth will remain muted, but positive, the current sell-off may be only a correction; a loss of 10% or so. Approximately 8% has been lost in US stocks already. So if a correction is in the cards, and we feel this is the most likely scenario, much of the medicine has already been taken by investors. And as we've mentioned before, corrections are a common occurrence, as one happens every 1.5 years on average. US investors went over 4 years without one, and now there have been two almost back-to-back.

Corrections are often short-lived. Corrections can be frightening, but please realize that corrections are a necessary phenomenon and are actually positive in that they slow-down frothy markets and build bases for future advances.

We understand the risk tolerances of our clients, as well as their goals and objectives. The asset allocations we maintain are appropriate. We need to move forward and not sell in a panicked fashion, as the current correction should soon run its course.

Portfolio Review and Positioning

As you can imagine, our portfolios generally lost money during 2015, although losses were very small on a percentage basis. Given the challenges of the past year, we think it is particularly important to reiterate our rationale for our portfolio positions and review how we arrive at our assessments.

Why do we invest 5-10% of portfolios into foreign investments such as American Funds EuroPacific, Dodge and Cox Intl Stock and American Funds New World? Our positions in foreign funds are not based on a short-term view of the market, or a prediction that a drop in U.S. stocks is imminent, or even that U.S. stocks will necessarily trail non-U.S. stocks in 2016 (although it is very tempting to say they are due!). Financial market history is a history of cycles (or like the swings of a pendulum), moving from one extreme to another. Market history teaches us that undervalued assets can fall further, and overvalued markets can overshoot even further on the upside. We need only look back to the tech bubble to see one recent example of this. It is simply the reality that comes with being a long-term equity investor.

Our investment philosophy is based on the belief that fundamentals ultimately drive investment returns. This gets down to the economics of the investment. Specifically, whether we're evaluating stocks, bonds, real estate, or another asset class, the value of an investment is generally determined by the cash flows the investment or investment market generates over time. This type of valuation, unfortunately, is a very poor short-term market indicator. But over the longer term and over full market cycles (five to 10-plus years), history has shown that valuation is a powerful driver of returns. Buying undervalued assets pays off over time, but you need to withstand the discomfort that typically accompanies it as you wait for markets to turn in your favor.

The US equity market, and funds such as BlackRock Equity Dividend Inv A, Jensen Fund J, and Vanguard Strategic Equity Fund have had a very strong run over the past few years. However, by most valuation measures, the US stock market has become somewhat stretched. After six years of generally rising stock prices, investors may be complacent about the potential risk. Those risks may or may not be imminent, but we believe the reversal of this current cycle may not be long in coming given the relative attractiveness of foreign stock market valuations and the potential for foreign company earnings to improve from currently depressed levels.

We are confident we will be rewarded (with outsize returns) for our current allocations to European and emerging-markets stocks. But we also know that we don't know precisely *when* those markets will turn around. As the old saying goes, "They don't ring a bell at the bottom of the market" (or the top for that matter). It requires patience—another core element of our investment philosophy—to hold onto (and potentially add more to) these longer-term return generators during the periods when they seem only to be *downside-risk* generators.

On the bond side, with interest rates having begun what the Fed has said will be a gradual upward climb, our conviction in our diverse fixed-income lineup is stronger than ever. Our investments in flexible and absolute-return-oriented bond funds, such as Weitz Short Intermediate Income, Templeton Global Bond, and Osterweis Strategic Income are designed to generate higher returns and better manage interest-rate sensitivity versus the US core bond index in a rising rate environment. And while US core bond funds, such as Dodge and Cox Income and PIMCO Total Return may still mitigate some of the shorter-term downside risk from stocks in our portfolios, the degree to which they can do so is more limited in the current market cycle. This past year was a good example of this, with US core bonds barely positive while global stocks were negative.

Finally, given our cautious outlook for U.S. stocks and bonds, we continue to find value in owning alternative strategies that can generate attractive long-term returns and provide powerful portfolio diversification benefits. We currently have some allocation to merger and arbitrage stock products in our clients' portfolios; the Merger Fund and the Arbitrage Fund.

Looking Ahead

We believe our portfolios are well positioned to generate solid returns over our five-year horizon, but we think it is prudent to be prepared for potentially increased market volatility and downside risk (as well as positive returns) over the shorter-term. We may even get the opportunity to add to our undervalued positions or establish some others before this market cycle turns. In other words, we believe the key to successful investing ahead is to maintain the healthy patience, perspective, and discipline necessary for long-term investment and financial success.

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

Sincerely,

Stephen J. Bowery, CFA, CFP

110 W. Church Avenue, Suite 401 • Roanoke, Virginia 24011 • Phone 540.527.3700 • Fax 540.527.3702 • www.vacapstrategies.com