October 2015

Third Quarter 2015 Investment Commentary

Quarter in Review and VCS Strategy

The correction we've been anticipating finally occurred! As we noted in our previous commentary, corrections (10% declines in stock prices) occur every 12-18 months, and it had been almost 4 years since we'd experienced one (There have only been two longer stretches without a correction, in the early to mid-1990s and the mid-2000s.) Increasing concern about China's economy, accompanied by a surprise albeit modest devaluation of the yuan currency, were the triggers. From early August until the end of September, the S&P 500 fell roughly 12%. The S&P 500 has had a 10%-plus correction 52 times since the end of World War II. They are not unusual. Investors should be prepared to experience such drops repeatedly over their investment lifetime.

September Benchmark Returns (Preliminary)			
Large Cap Benchmarks	**Sep**	**3Q**	**YTD**
Vanguard 500 Index	-2.5%	-6.5%	-5.4%
iShares Russell 1000	-2.8%	-6.9%	-5.3%
iShares Russell 1000 Growth	-2.6%	-5.4%	-1.7%
iShares Russell 1000 Value	-3.1%	-8.4%	-9.1%
Mid-Cap Benchmarks			
iShares Russell Midcap	-3.6%	-8.0%	-5.9%
iShares Russell Midcap Growth	-3.9%	-8.1%	-4.3%
iShares Russell Midcap Value	-3.4%	-8.2%	-7.8%
Small-Cap Benchmarks			
iShares Russell 2000	-4.9%	-11.9%	-7.8%
iShares Russell 2000 Growth	-6.3%	-13.0%	-5.4%
iShares Russell 2000 Value	-3.5%	-10.8%	-10.2%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-4.1%	-9.7%	-3.9%
MSCI World ex USA Index	-5.0%	-10.5%	-6.3%
Vanguard FTSE Europe ETF	-4.1%	-8.5%	-3.7%
Vanguard FTSE Emerging Markets ETF	-2.9%	-17.9%	-15.2%
Vanguard REIT Index	3.0%	2.0%	-4.5%
Vanguard Total Bond Market Index	0.8%	1.2%	0.9%
BofA Merrill Lynch U.S. High Yield Cash Pay	-2.6%	-4.9%	-2.5%
Vanguard Int. Term Tax-Exempt Fund	0.7%	1.6%	1.5%
S&P/LSTA Leveraged Loan Index	-0.6%	-1.4%	1.4%
Citigroup World Gov't Bond Index	0.8%	1.7%	-2.4%

It's also worth noting in this context that, based on our analysis, since 1950 the S&P 500 has suffered a 20%-plus decline nine times—the common definition of a bear market. Put differently, bear markets have historically happened about once every five years on average. The current market advance has gone for more than six-and-a-half years. The longest stretch without a 20%-plus decline was the 12-plus years ending with the bursting of the tech stock bubble in 2000.

Large-cap US stocks: During the third quarter, the S&P 500 lost 6.5%. This marks the first negative quarterly return for the index since 2012; again, an unusually long span of positivity. However, other market categories performed much worse. Developed international stocks, as measured by the Vanguard FTSE Developed Markets ETF, dropped 9.7%. European stocks did a bit better, losing 8.5% in dollar terms and 7% in local-currency terms. We've had a neutral exposure to US stocks and plan to continue such an approach. In general, while the market decline made future returns for U.S. stocks look incrementally better, the price drop was not large enough to lead us to increase our U.S. stock exposure in most cases.

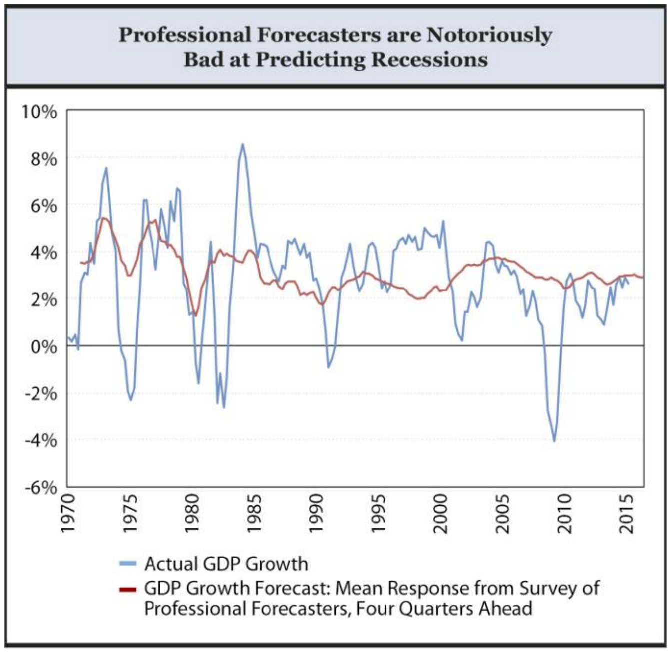
Foreign stocks: Despite the recent poor performance of international stocks, we continue to have a positive view of established-economy foreign stocks, European stocks in particular. We believe European stock valuations are much more attractive than those of U.S. stocks, while European corporate earnings are well below normal (unlike in the United States where earnings are well above their long-term trend). As such, in our base case and more optimistic scenarios, we see potential for both improved earnings growth as well as some multiple-expansion, implying significant outperformance for European stocks compared to the U.S. market over our five-year outlook. We will continue to have a significant weighting in this space.

Emerging-markets stocks: This category performed very poorly during Q3, dropping 18%. That return includes several percentage points of losses to dollar-based investors from the continued depreciation of emerging-markets currencies against the U.S. dollar. Given the broad negative environment for global stocks, let alone that much of the angst was driven by disappointing developments in China, it's not surprising emerging-markets stocks had the worst downside performance. While we have viewed (and continue to view) emerging-markets stocks as attractive over our five-year and longer investment horizons, we have also assumed they are riskier (higher beta) than developed market equities and will suffer larger short-term losses in a negative macro scenario for various reasons (e.g., due to concerns about slowing global growth). We plan to maintain our current exposure to this category, and may increase exposure at some point down the road.

Fixed income: The performance of the fixed-income markets, particularly the performance of core bonds was a bit out of character. The core bond index gained only 1% during the U.S. stock markets 6.5% swoon. We'd typically expect core bonds to generate stronger relative returns during a risk-off or risk-averse period due to fears about slowing global growth. Strangely, it was a very modest gain for bonds. Moreover, core bonds actually had a slightly negative total return for the month of August. Due to the very low level of interest rates, the potential for bonds to generate strong absolute/positive returns over any meaningful time frame now seems limited. Our analysis indicates the 10-year Treasury yield would need to fall a full percentage point (to around 1%) for core bonds to generate even a 6% total return over the next 12 months. We view that as an outlier scenario and assume that if it does happen stock markets will likely be in bear market territory. And if interest rates finally trend higher, core bonds will suffer losses.

Consequently, we'll continue to limit core bonds to approximately 50% of our fixed income allocation, and we'll utilize flexible and defensive strategies, such as short-term and credit-sensitive and short-term world bonds to round out our bond portfolios. Flexible bond funds have the potential to generate returns several percentage points above the core bond index over the next five years, across a broad range of macro scenarios. Nevertheless, we still maintain exposure to core bonds in our more conservative portfolios because of the risk management role they play—smoothing overall portfolio volatility and mitigating some of the downside risk of owning stocks in the event of a global growth scare, recession, or worse.

Alternatives: Alternative approaches, such as the merger and arbitrage funds we utilize, provided some recent benefit as they remained flat whereas stocks and other risky assets declined. We are currently analyzing a number of vehicles in this space and may add exposure to these types of investments.



Source: U.S. Bureau of Economic Analysis/Federal Reserve Bank of Philadelphia. Data as of 8/14/2015.

The Federal Reserve

When discussing bond yields these days, the elephant in the room is the Federal Reserve. The timing of the Fed's first move—whether made in October or December, or next January or March—will make little economic difference, although it is interesting to watch. The pace and magnitude of subsequent rate hikes is much more important. How investors interpret and react to the Fed's first moves or their timing is an unknown, although a number of noted strategists suggest a sense of relief will occur once the event takes place and the uncertainty is removed. Clearly, the Fed is taking more of a worldwide view than it has in the past.

What's Ahead for Global Stock Markets?

In the opening section of our commentary, we provided a brief overview of the frequency of U.S. stock market corrections and bear markets since World War II, the point being that 10%-plus declines are very common and even 20%-plus drops have occurred every five years, on average. There is another interesting historical fact that we see frequently mentioned by market commentators, which is that stock market corrections typically (though not always) only turn into bear markets when the economy is nearing or in a recession. Recessions are associated with sharp declines in corporate earnings and investor risk aversion, so a linkage between falling stock prices and recessions certainly makes sense (although it's also the case that not every recession has been associated with a bear market).

After making the historical point about bear markets and recessions, the market commentator will then typically point out that based on various economic indicators, there is little risk of an impending recession in the United States. Therefore, they conclude the risk of the current market correction turning into a bear market decline is low.

There is a comforting logic to such arguments, and indeed there seem to be few signs of recession (at least in the United States; the story is different in the emerging markets, with Russia and Brazil already in recession). However, we need to point out one fly in the ointment: economists and market strategists are notoriously bad at predicting recessions! The chart on the prior page shows the consensus forecast has never predicted one going back to the 1970s.

Our gut feel is that we're not entering a global recession, and our current forecast suggests we're experiencing a correction and not a bear market. However, we humbly admit we don't have any skill in forecasting recessions either, which is why we don't bother trying to do it, nor base our investment decisions on such predictions.

Instead, as part of our scenario analysis we think about the risks of a recession or an economic shock and the implications for asset class returns. We also try to have some sense of where we may be in the economic and financial market cycles. But no two cycles across history are identical, and there are countless, ever-changing micro- and macroeconomic variables that impact the duration and magnitude of these cycles. So, we also think about what may be different this time around compared to the past—for example, the impact of emerging markets, and China in particular given its importance in the global economy and markets.

The reality of owning stocks is that occasionally, inevitably, we will experience bear market losses. This underscores the importance of our risk management, in which we seek to reduce our balanced portfolios' vulnerability to stock market downturns through strategies that include owning "insurance" assets such as bonds and lower-risk alternatives. Another key ingredient in managing through bear markets is helping our clients accurately assess their risk tolerances and investment objectives.

Our job as your investment manager is to manage your portfolio in the appropriate manner based on your risk profile, age and other factors. Please contact us if your situation has changed, or if you have questions regarding the strategies and level of risk we've employed for you. As always, we appreciate you allowing us to manage your investments.

Sincerely,

Steve Bowery, CFA, CFP