Virginia Capital Strategies

STEPHEN J. BOWERY, PRESIDENT

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Second Quarter 2016 Investment Commentary

Quarter in Review

Compared to Quarter 1, Quarter 2 offered investors some degree of calm with modest returns in a generally range-bound manner. That was until June 23, when the relative calm came to an abrupt end with the United Kingdom voting to leave the European Union.

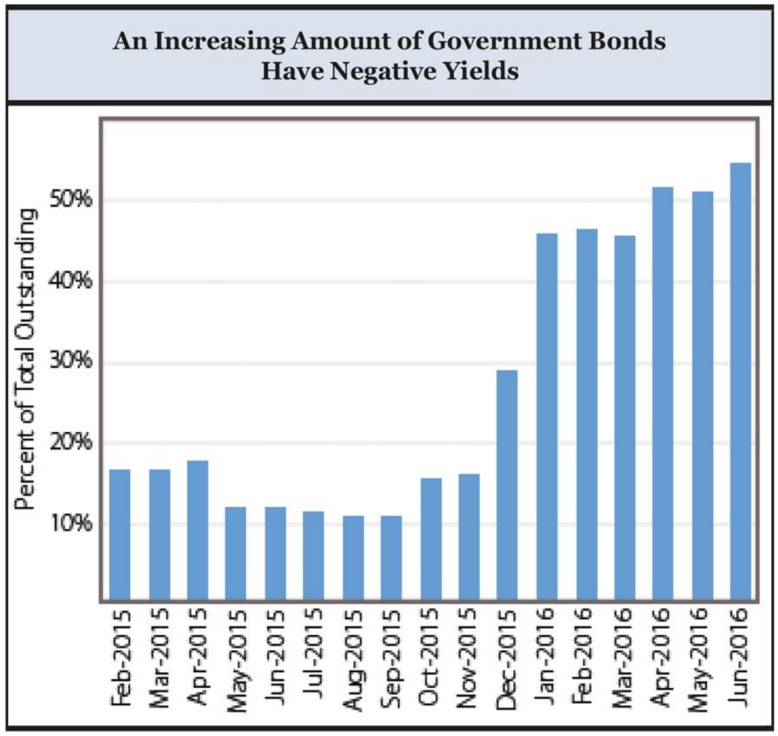
In the wake of the vote, the British prime minister resigned. Overnight, British pound sterling fell 11% to 1.33 against the U.S. dollar, its lowest level since 1985. The euro fell 2.4% to 1.10 versus the dollar. U.S., developed international, and emerging-markets equities all plummeted. The S&P 500 fell by 3.6%, while the FTSE 100 dropped by 8.7%. Financial stocks were the hardest hit, while defensive dividend-paying utility and telecommunications sectors saw strong buying. Away from equities, investors fled to "safe haven" investments: gold, Treasury bonds, and certain currencies, such as the Swiss franc, Japanese yen, and U.S. dollar. Days later, ratings agency Standard & Poor's stripped the United Kingdom of its triple-A credit rating and downgraded the European Union's rating. Fitch and Moody's, the other major ratings agencies, also cut their U.K. ratings.

June Benchmark Returns (Preliminary)

Large Cap Benchmarks	Jun	2Q	YTD
Vanguard 500 Index	0.2%	2.4%	3.8%
iShares Russell 1000	0.3%	2.5%	3.7%
iShares Russell 1000 Growth	-0.4%	0.6%	1.3%
iShares Russell 1000 Value	0.8%	4.5%	6.1%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	0.5%	3.2%	5.5%
iShares Russell Mid-Cap Growth	0.0%	1.5%	2.1%
iShares Russell Mid-Cap Value	0.9%	4.7%	8.8%
Small-Cap Benchmarks			
iShares Russell 2000	0.0%	3.9%	2.4%
iShares Russell 2000 Growth	-0.4%	3.4%	-1.3%
iShares Russell 2000 Value	0.4%	4.4%	6.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-2.0%	-0.1%	-1.9%
MSCI World ex USA Index	-3.0%	-0.8%	-2.6%
Vanguard FTSE Europe ETF	-4.0%	-1.9%	-4.0%
Vanguard FTSE Emerging Markets ETF	4.9%	2.6%	8.6%
Vanguard REIT Index	6.9%	6.8%	13.4%
Vanguard Total Bond Mkt Index	1.9%	2.3%	5.5%
BofA Merrill Lynch U.S. High Yield Cash Pay	1.1%	5.9%	9.3%
Vanguard Intermediate-Term Tax-Exempt	1.4%	2.1%	3.8%
S&P/LSTA Leveraged Loan Index	0.0%	2.9%	4.5%
Citigroup World Govt. Bond Index	3.7%	3.4%	10.7%

However, in the week following Britain's historic vote, global equities markets rallied as the quarter ended, despite still significant uncertainty regarding the economic, political, and financial market implications of Brexit. When the dust settled, the Vanguard FTSE Developed Markets ETF was down just a slight 0.1% for the quarter and down 1.9% year to date, while large-cap U.S. stocks, as represented by the S&P 500, ended the quarter and year-to-date with gains of 2.4% and 3.8%, respectively. Emerging markets stocks, laggards for some time, actually returned almost 5% during quarter 2.

During this very uncertain environment, bonds rallied as yields fell to unprecedented levels. At the end of June, the amount of government debt (mainly eurozone and Japan) sporting negative yields had soared by nearly $1 trillion, to reach an astonishing $11 trillion! While not (yet) negative, the yields on U.K. 10-year gilts breached the 1% level, falling to 0.87% by June 30. U.S. 10-year Treasurys ended the quarter with a yield of 1.48%, close to their low-water mark reached in July 2012. Falling yields have been driven by economic growth concerns; central banks' ongoing low/negative interest rate policies, including government intervention (buying) in bond markets; and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact. They have been joined by expectations of imminent rate cuts from the Bank of England, potential additional bond buying by the European Central Bank, and a growing consensus that the Federal Reserve will further delay raising U.S. rates.

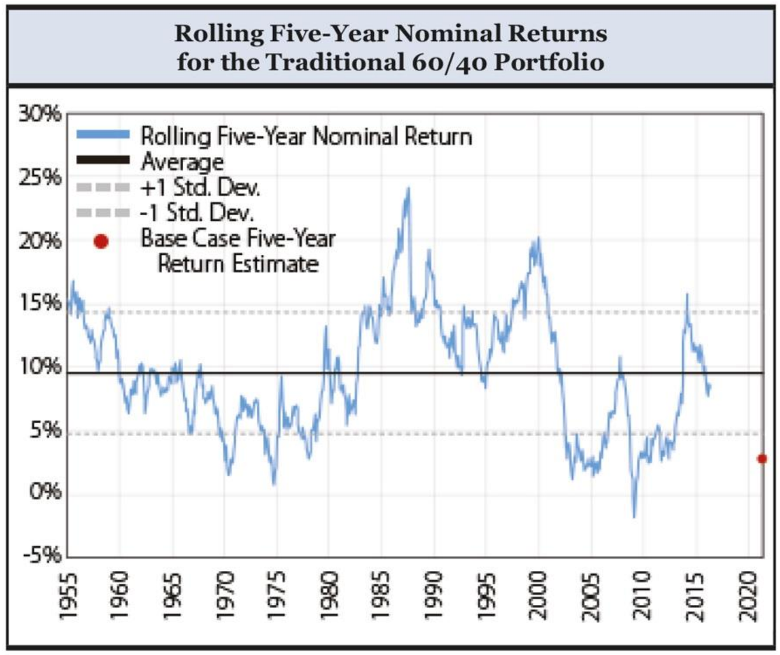


Source: © BCA Research 2016. Includes the government bonds of 18 developed countries.

A Traditional 60/40 Portfolio Has Unattractive Expected Returns

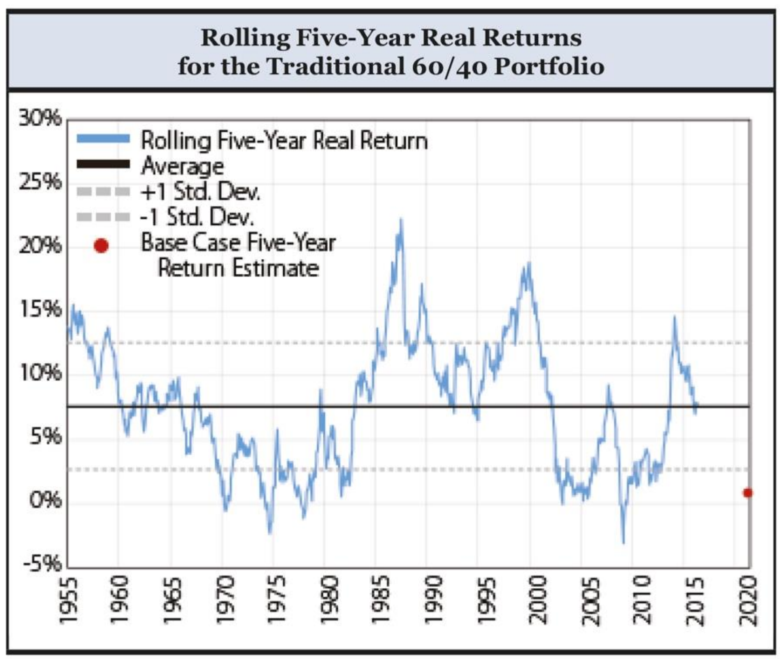
Recently, a client asked me why we don't manage assets in a traditional 60/40 manner. I replied such an approach is generally undiversified, but moreover, such an approach is particularly unattractive at the present time. No matter how you slice it—in nominal or real terms, in absolute terms or relative to historical performance—looking out over the next five years, the return prospects of a traditional 60/40 portfolio are poor.

Looking at some history, the chart at right shows rolling five-year annualized nominal returns for the traditional 60/40 portfolio (60% S&P 500 index and 40% core bond index), starting in 1950. We have assumed annual rebalancing back to the 60/40 weights. Over that period, the average annual return was 9.5%. The red dot in the chart signifies our base case return estimate for the 60/40 of roughly 2.5%–3%. This is derived from our current estimate of roughly a 4% return for the S&P 500 and a 1% return for core bonds over the next five years. As can be seen from the chart, a 3% annualized five-year return would be among the worst historical returns for the 60/40 portfolio. Of the 738 rolling five-year periods since 1950, *only 67* have had a return less than 3%.



Source: Morningstar Direct. Data as of 5/31/2016.

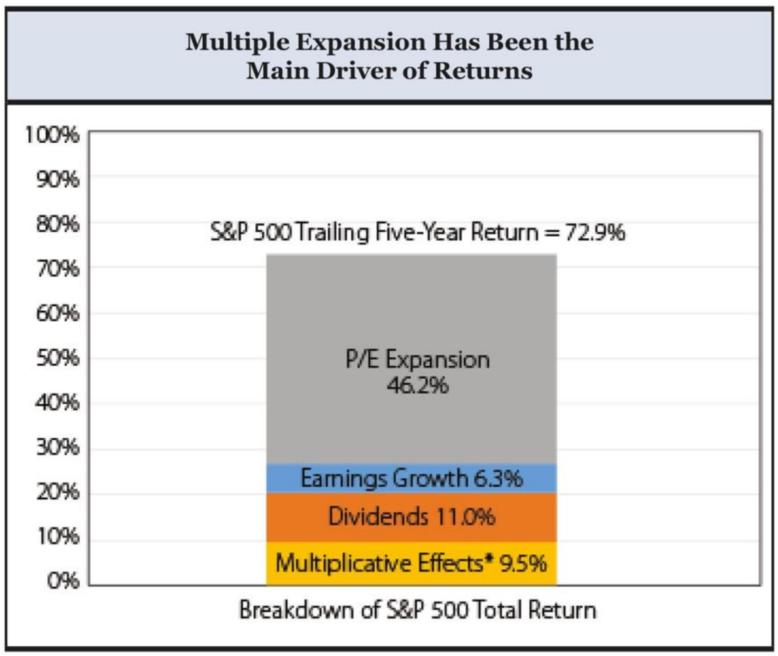
The results are much the same if we look at things in “real return” terms (net of inflation), as shown in the following chart. The historical average annual real return (i.e., each rolling five-year nominal return reduced by the inflation rate over that same five-year period) was 7.6%. In contrast, our base case expected real return is roughly 0.5%–1% (assuming 2% expected inflation). Of the 738 rolling five-year real return periods since 1950, *only 53* have seen returns lower than 1%. Assuming our return expectations play out, investors in a traditional 60/40 portfolio will barely stay ahead of inflation. And they will earn around 6.5% less per year than the historical average 60/40 return, or 37% less cumulatively over the entire five years.



Source: Morningstar Direct. Data as of 5/31/2016.

The historical charts also show the 60/40 portfolio has generated above-average returns over the past several years. A key driver of this strong performance has been the impact of quantitative easing (purchases of government debt in an effort to add liquidity to bond markets) and other aggressive central bank policies, which have helped push down interest rates. This has meant higher bond prices and capital appreciation for the core bond index in addition to its paltry income yield. Central bank policies also contributed to the meaningful increase in stock market valuations. This was one of former Fed Chair Ben Bernanke's explicit objectives when the Fed undertook multiple bond purchase programs in the years following the financial crisis. Although there was a sharp V-shaped rebound in S&P 500 earnings off the extreme lows of the 2008–2009 financial crisis, which supported a rebound in stock prices, the hoped-for stimulative "wealth effect" for the actual economy barely materialized.

In more recent years, a significant majority of the S&P 500's return has come from P/E multiple expansion rather than actual earnings growth. For example, for the five years ending March 31, 2016, the S&P 500 gained 73%, but 46 percentage points of that total return came from P/E expansion. Meanwhile, total earnings per share growth was just 6% over the entire period (i.e., 1.2% annualized). Dividends accounted for roughly 11%.



**The multiplicative effect accounts for the difference between summing the three return components instead of multiplying them to get to the total return number.*
Source: Standard & Poor's. Data as of 3/31/2016.

The 12-month trailing P/E of the S&P 500 is currently around 23x, compared to its median since 1950 of roughly 17x. As long as interest rates remain at extremely low levels, P/E multiples may remain higher than normal. If current interest rate levels are not sustainable—and we don't think they are—then it is likely the valuation multiple will drop toward more normal historical levels. (If rates do stay at such depressed levels for the next five years, it likely means economic and earnings growth have remained quite depressed as well, which is unlikely to be bullish for stock market valuations.) Our base case scenario for U.S. stocks assumes a 17x multiple for the S&P 500, and we look at different scenarios and sensitivities across a range of multiples around that.

A Better Approach

A 2.5% - 3% annualized 5-year return would barely exceed inflation, and is an unacceptable outcome for many investors. So what is the answer? We feel our global, multi-asset class approach will provide more meaningful returns over the next five years for our clients. In fact, for our clients with a 60% risk exposure, our expectation is a more tolerable return level of 5.5% - 6%. Clients with less exposure to risk would have a somewhat lesser level of both risk and return.

For example, we expect stronger relative performance from our flexible fixed income strategies and expect most if not all of them to outperform the core bond index, which represents the "40" in a traditional 60/40 approach. Weitz Short Intermediate Income Fund, Templeton Global Bond Fund and Osterweis Strategic Income could easily generate 3%+ annual returns, versus the 1% annual return we anticipate from core bonds. In exchange for the higher expected returns, we know we are taking on more credit risk and that these investments won't hold up as well as core bonds in the event of deflation or a flight-to-safety event that pushes Treasury bond yields even lower. However, these flexible fixed-income funds have less sensitivity to negative price impacts from rising Treasury rates. Therefore, in addition to positive expected excess returns, these investments play a valuable risk-management role in our portfolios.

Another example is the outperformance we expect from our key large cap US funds, versus the S&P 500. Jensen Quality Growth has outperformed the S&P 500 by 6.2% over the last 12 months. Blackrock Equity Dividend has also outperformed the S&P 500 over the last 12 months and also outperformed its category (large value) by over 5.2%. These funds heavily emphasize quality, and we feel quality will be a major driver over the next five years, as companies struggle to expand earnings in a very challenging economic environment.

We continue to advocate exposure to foreign stock investments. Our analysis indicates that developed European and emerging markets equities offer attractive five-year return potential, driven by improving earnings growth and expanding valuation multiples. As noted earlier, emerging markets stocks returned almost 5% during the second quarter. American Funds New World, Dodge and Cox International Stock and American Funds Euro Pacific Growth will supplement the exposure we have to Jensen Quality Growth and Blackrock Equity Dividend and will be a key strategy in achieving the 5.5%-6% return levels we are forecasting.

We've also become more constructive on US small/mid-cap stocks. After a multiyear period of significant underperformance verses larger-cap stocks, we no longer view smaller caps as being significantly overvalued. Vanguard Strategic Equity is our lead fund in this space.

Closing Comments

We believe patience, discipline, and the tactical flexibility and expertise to invest across a broad opportunity set will be important attributes for navigating the next five years. We doubt investors will be able to simply rely on the U.S. market tailwinds of declining interest rates and rising P/E multiples that have boosted returns for core bonds and stocks over the past several decades.

Volatile markets, which we also expect, will likely challenge investors' convictions and emotions. As always, it is critical to do an honest self-assessment to understand your temperament, risk tolerance, and objectives, and to invest in a portfolio that is managed in a manner that is consistent with those attributes *before* market volatility strikes rather than in the heat of it, when emotions are likely to cloud judgment and lead to poor investment decision-making.

Successful investing requires patience and the understanding that investing is a part of a *process*, not a one-off decision, toward achieving your long-term financial goals; there will be inevitable and consistently unpredictable shorter-term market ups and downs along the way. Remaining focused on the *long-term* objective is key, as is maintaining a consistent investment discipline to guide your decisions over time. Our valuation-driven discipline means we can use short-term market volatility to our long-term benefit—managing risk while taking advantage of the investment opportunities created by other market participants' *lack* of discipline, patience, and flexibility.

Sincerely,

Stephen J. Bowery, CFA, CFP