Virginia Capital Strategies

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Third Quarter 2016 Investment Commentary

Quarter 3 Review

The 3rd quarter of 2016 witnessed populism gain ground in Europe, the installation of a new government in the United Kingdom after the Brexit vote, an unsuccessful coup attempt in Turkey, and a U.S. presidential campaign that continued to unfold as the most unconventional in recent memory. As the slide to the right shows, the financial markets handled these uncertainties very well; returns were robust and volatility remained at extremely low levels through July and August. However, September seemed to usher in a change in tone. During this month, investors registered high anxiety, with stocks rising and falling sharply in response to any oil-related headlines and any suggestion of interest rate hikes by central banks. As described below, bonds experienced heightened volatility in September as well.

September Benchmark Returns (Preliminary)			
Large Cap Benchmarks	**Sept**	**3Q**	**YTD**
Vanguard 500 Index	0.0%	3.8%	7.7%
iShares Russell 1000	0.1%	4.0%	7.9%
iShares Russell 1000 Growth	0.3%	4.5%	5.8%
iShares Russell 1000 Value	-0.2%	3.4%	9.8%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	0.2%	4.4%	10.2%
iShares Russell Mid-Cap Growth	0.0%	4.5%	6.8%
iShares Russell Mid-Cap Value	0.4%	4.3%	13.5%
Small-Cap Benchmarks			
iShares Russell 2000	1.1%	8.9%	11.5%
iShares Russell 2000 Growth	1.4%	9.1%	7.7%
iShares Russell 2000 Value	0.7%	8.7%	15.5%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	1.6%	6.3%	4.3%
MSCI World ex USA Index	1.3%	6.4%	3.6%
Vanguard FTSE Europe ETF	0.8%	5.0%	0.8%
Vanguard FTSE Emerging Markets ETF	2.1%	8.1%	17.4%
Vanguard REIT Index	-1.8%	-1.5%	11.7%
Vanguard Total Bond Mkt Index	-0.1%	0.4%	5.9%
BofA Merrill Lynch U.S. High Yield Cash Pay	0.6%	5.5%	15.3%
Vanguard Intermediate-Term Tax-Exempt	-0.4%	-0.3%	3.5%
S&P/LSTA Leveraged Loan Index	0.9%	3.1%	7.7%
Citigroup World Govt. Bond Index	0.7%	0.3%	11.1%

Yields on U.S. 10-year Treasury notes ended the quarter at 1.56%, up from 1.44% as of July 1, as investors braced for an interest rate hike by the Federal Reserve that didn't come (bond prices fall as rates rise). However, those looking only at starting and ending levels would have missed the big mid-September move. Yields briefly backed up to 1.75% on worries over central bank policies. The Fed's decision not to raise interest rates in September soothed markets. But a December rise is potentially still on the table. Financial markets remain keenly attuned to this possibility. For now, flows into core bonds (such as those owned in our preferred approach, the Dodge & Cox Income Fund) are strong, the buyer base is broad, and central banks across the developed world remain hesitant to either spook the markets or hinder a still fragile economic recovery by doing more than just paying lip service to a move away from their easy monetary policies. When all was said and done, the core bond index gained just 0.4% for the quarter.

On the following pages, we will recap our current views on relevant asset classes, before discussing other important issues we'd like to bring to your attention.

Performance and Portfolio Positioning

US Stocks

The Vanguard 500's near 4% gain in Q3 occurred in the context of a market that saw sharp intraday drops followed by swift reversals, as well as strong rotation into and out of sectors perceived to be "safe," such as utilities, telecoms, and consumer staples, although such sectors ended the quarter on a down note. Financials continued to be pressured by low interest rates, a challenging regulatory environment, and negative investor sentiment—headlines surrounding Deutsche Bank and Wells Fargo didn't help either. Overall, we continue to view the U.S. stock market as relatively expensive, thus, we're not increasing exposure to this asset class. We feel investors chasing US stock returns will ultimately be disappointed.

We're pleased that our preferred approaches in this space, Jensen Quality Growth and BlackRock Equity Dividend continued to outperform during the quarter – Jensen is up over 10% so far in 2016!

US Core Bond

Although core bonds offered little in the way of performance during Q3, no one can argue with the stellar performance of core bonds from a 2016 perspective. Year-to-date, the Vanguard Total Bond Market Index gained almost 6%, which roughly parallels the returns of many riskier asset types, such as US growth stocks. Analysts have been calling for the end of the US core bond bull market for years, however, the asset class continues to notch solid returns. Our preferred choice, Dodge & Cox Income has achieved a return of over 6.6% thus far in 2016. As mentioned in previous commentaries, our strategy is to maintain a diversified portfolio of both US core bonds and flexible fixed-income funds (discussed on next page) in order to maintain a maximum level of diversification in this asset class.

Developed International Stocks

European stocks outperformed the Vanguard 500 after the Brexit low and for the third quarter. But they still trail U.S. stocks for the year (both in dollar-hedged and unhedged currency terms). We continue to believe European stocks are cheap relative to U.S. stocks, based on normalized earnings power, and offer attractive relative returns in our base case scenario. While U.S. stocks are no longer overearning as they were one to two years ago, we believe European stocks continue to significantly under earn compared to their normalized earnings power.

There are any number of known and unknown catalysts that could result in an earnings recovery. Earnings may recover due to the European Central Bank's continued efforts to keep borrowing costs down as a way to stimulate lending and investment spending. The ECB recently started buying investment-grade corporate bonds as part of its quantitative easing program. According to research firm GaveKal, since the program was announced in March, the average yield on eligible bonds has fallen from 1.45% to almost 0.5%. That significant decline may spur investment and lead to better economic growth. Or, it may spur financial engineering, with companies using the proceeds from issuing debt to buy back their stock and boost earnings per share, as we have seen in the United States. Either outcome would bode well for future profits and stock prices.

Brexit, along with the rise of many right-wing political parties, may serve as a wake-up call to European authorities that they need to generate better growth in the economic bloc soon. As a result, they may become more open to loosening the fiscal purse strings to assist the ECB's reflation efforts.

The exact timing is highly uncertain. It's possible nothing much gets done on the fiscal stimulus front until major elections are completed over the next year, meaning the ECB continues to do what it can and Europe continues to muddle along. In our modeling, we assume normalization will take place in roughly five years.

American Funds Europacific Growth, Dodge & Cox International and Templeton Foreign are our favorite international stock funds.

Emerging-Market Stocks

Emerging-market stock returns have been particularly striking, building upon their sharp rebound and outperformance versus other markets that began in late January. Emerging-market stocks are now up 17% for the year (versus almost 8% for the Vanguard 500) and up 32% from their January low (versus 17% for the Vanguard 500). We are glad to see such strong returns but note they have been driven primarily by expanding P/E multiples rather than a strong upturn in earnings growth, which is not (yet) apparent in the market-level data we follow. However, the market clearly expects emerging-market earnings growth to rebound over the next six to 12 months.

We have remained committed to emerging-market stocks as our analysis suggests their expected returns over the next five years are attractive compared to the expected returns for U.S. stocks. We believe we are using reasonably conservative five-year earnings growth and valuation assumptions in our modeling. Our preferred emerging-market fund, American Funds New World, is very conservative in nature, and tends to offer its strongest relative performance during flat and down markets. Nevertheless, we're not overly disappointed with a 2016 return of over 10%, particularly when considering the lack of performance from this category during the last 7-10 years.

Flexible Fixed-Income Funds

Our portfolios also benefited last quarter from our significant position in flexible fixed-income funds, which had very strong absolute and relative performance compared to core bonds. These funds—Weitz Short-Intermediate Income, Templeton Global Bond and Osterweis Strategic Income offered very meaningful returns in the third quarter, while the core bond index was basically flat (up 0.4%). After trailing core bonds earlier in the year, these funds, especially Osterweis stepped-up to the plate in the third quarter and now offer very competitive 2016 performance – Osterweis is up almost 10%.

Our non-core bond holdings do have more risk than core bonds in certain macroeconomic scenarios—namely, a recession, a deflationary environment, or any flight-to-safety macro shock. However, we believe the added credit risk is more than offset by our underweight to U.S. stocks (in our balanced portfolios where we hold fixed-income). From a longer-term return perspective, these positions should meaningfully outperform core bonds in either a flat or rising rate environment.

Portfolio Management: The Key to Managing Risk

On a regular basis, I get questions from clients regarding why we hold certain underperforming investments as opposed to simply swapping such investments into categories that seem to be performing better at that time. When asked, I attempt to describe the role of portfolio management and my key role as portfolio manager. As many of you know, I hold the prestigious CFA credential, and the emphasis of the CFA program has always been and will always be portfolio management. While we spend time analyzing each of our individual positions and holdings, when it comes to portfolio management, the whole is very much more than simply the sum of its parts (Harry Markowitz won a Nobel Prize in 1990 for this insight). By definition, a well-diversified portfolio of assets (i.e., a portfolio of investments that do not all move together in the same direction) will contain some laggards during any given measurement period, particularly over shorter-term periods. But it's at least as important to focus on the overall portfolio and how the pieces fit together and complement one another—how they are performing 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 based on emotion (fear and greed), rather than on long-term return drivers such as valuations, yield, and earnings growth. Even in an advanced economy like the United States, the stock market has had at least a 10% decline 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. The catch is that 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 did successfully call the bear market, you'd need to also successfully time your re-entry so as not to miss out on the subsequent gains. And you'd need to do this consistently and repeatedly over an investment lifetime. That is simply not realistic, which is why our tactical investment approach is based on a range of potential outcomes and a longer-term time frame. In our view, making investment decisions based on short-term market forecasts (guesses) is a losing game and we have no confidence that this approach can be successfully executed over time.

Putting It All Together

Our decision-making is anchored in our long-term fundamental and valuation-driven approach. Given our 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 our 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. And the time to do that is *before* a period of volatility strikes, not during or right after it when they would be selling their riskier assets at lower prices and buying more defensive or safer assets at higher prices.

We structure our balanced portfolios across a well-diversified mix of investments, each with a distinct role to play within the overall portfolio (e.g., return-generation, risk-reduction, and hybrid/alternative). We expect our portfolios 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.

Changes to Performance Checker

As many of you know, Virginia Capital Strategies invented an analytical model called Performance Checker over 15 years ago. Performance Checker assists us in choosing the best mutual funds for our clients. The model uses various metrics to evaluate funds, and scores of "A", "B", "C", "D" and "F" are assigned based on relative performance, relative risk, manager tenure and other factors. In the past, funds were evaluated primarily on 1, 3 and 5-year time frames. Beginning on October 1, we will incorporate 10-year data into the model as well. We feel doing so will give us a more comprehensive evaluation of mutual funds. Please give us a call and we'd be glad to discuss Performance Checker in more detail with you.

Closing Comments

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 market swings related to the increased likelihood of a Fed rate hike in December.

In addition to our tactical positioning and portfolio tilts, we remain diversified across multiple asset classes and strategies with diverse risk exposures and return drivers. This diversification should smooth out the overall portfolio ride over time. Finally, we remain alert to new investment opportunities as well as new risks we will need to manage against.

Sincerely,

Steve Bowery, CFA, CFP