Virginia Capital Strategies

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Year-End 2016 Investment Commentary

2016 Market Review

Global stocks performed well both in absolute terms and relative to core bonds in 2016, with U.S. stocks again leading the way. Large-cap U.S. stocks (Vanguard 500 Index) gained 11.8% and small-cap stocks (iShares Russell 2000 ETF) surged 21.6%. (This marked the eighth straight year the large-cap S&P 500 Index had a positive return. While streaks of this length have occurred twice before, the market has never had a nine-year winning streak.) Emerging-market stocks (Vanguard FTSE Emerging Markets ETF) were also strong performers, gaining 12.2% for the year. Developed international stocks (Vanguard FTSE Developed Markets ETF) were the big laggards. They returned just 2.7% in U.S.-dollar terms.

December Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	**Dec**	**4Q**	**YTD**
Vanguard 500 Index	2.0%	3.8%	11.8%
iShares Russell 1000	1.9%	3.9%	12.0%
iShares Russell 1000 Growth	1.3%	1.1%	7.0%
iShares Russell 1000 Value	2.6%	6.8%	17.3%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	1.2%	3.2%	13.7%
iShares Russell Mid-Cap Growth	0.3%	0.4%	7.2%
iShares Russell Mid-Cap Value	1.8%	5.5%	19.8%
Small-Cap Benchmarks			
iShares Russell 2000	2.9%	9.0%	21.6%
iShares Russell 2000 Growth	1.4%	3.7%	11.7%
iShares Russell 2000 Value	4.2%	14.2%	32.0%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	2.5%	-1.5%	2.7%
MSCI World ex USA Index	3.3%	-0.3%	3.3%
Vanguard FTSE Europe ETF	4.9%	-1.2%	-0.4%
Vanguard FTSE Emerging Markets ETF	-0.7%	-4.5%	12.2%
Vanguard REIT Index	4.7%	-3.0%	8.3%
Vanguard Total Bond Mkt Index	0.2%	-3.2%	2.5%
BofA Merrill Lynch U.S. High Yield Cash Pay	2.0%	1.9%	17.5%
Vanguard Intermediate-Term Tax-Exempt	1.0%	-3.3%	0.1%
S&P/LSTA Leveraged Loan Index	1.2%	2.3%	10.2%
Citigroup World Govt. Bond Index	-0.7%	-8.5%	1.6%

Though core bond prices got off to a strong start with the 10-year Treasury yield dropping to an all-time low of 1.37% in early July, yields then reversed course, rising to 2.5% by year-end. In the fourth quarter, the core bond index (Vanguard Total Bond Market Index) 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. While 2016 wound up being a poor year for Treasurys and core bonds, it was a good year for riskier fixed-income sectors. Fixed-income sectors with more credit risk (and less interest rate risk), such as high-yield bonds (BofA Merrill Lynch U.S. High Yield Cash Pay Index) performed very strongly, gaining 17.5%. As you'll soon learn, Virginia Capital Strategies performed very well in the fixed income markets in 2016.

Alternative strategies turned in a mixed performance. The lower-risk, diversified arbitrage strategies we use had decent absolute returns, ranging from 3% to 5%. Managed futures, which are volatile and have a much wider range of potential returns in any given year, struggled. We're not currently investing in managed futures, although we're considering use of the approach in the future.

We also witnessed a number of sharp reversals in market trends and consensus views during the course of the year. For instance, value and cyclical stocks beat growth names (for the first time in several years). And in the commodity markets, crude oil prices rebounded sharply, doubling from their February lows and reversing a dramatic two-year slide. That pattern was true for commodity prices in general, with the Bloomberg Commodity Index gaining 20% from its January low (up 11% for the year). The reversal in interest rates, as noted earlier, was also significant. Just as with the U.S. presidential election and the Brexit vote results, very few "experts" predicted these reversals. The consensus was surprised and wrong at the inflection points, as it usually is.

2016 will be remembered as a year of dramatic reversals, as shown below:

Performance Reversals in 2016

Since:	Previous Two-Year Return	Return Since
Emerging Markets Low in January		
Emerging-Market Stocks	-25.5%	28.2%
Oil (WTI)	-68.7%	82.4%
U.S. Market Low in February		
U.S. Small-Cap Stocks vs. U.S. Large-Cap Stocks	-18.0%	19.5%
U.S. Value Stocks vs. U.S. Growth Stocks	-7.7%	10.8%
U.S. Value Stocks vs. U.S. Momentum Stocks	-11.2%	14.1%
10-Year U.S. Treasury Yield Low in July		
U.S. Core Bonds	9.1%	-3.3%
U.S. Treasurys (7–10 Year Index)	14.8%	-7.0%
U.S. Presidential Election in November		
Consumer Staples Stocks vs. S&P 500	6.3%	-6.2%
Utilities Stocks vs. S&P 500	4.3%	-5.2%
Energy Stocks vs. S&P 500	-25.5%	4.0%
Financial Stocks vs. S&P 500	-3.4%	11.8%

Source: Morningstar. Returns through 12/31/16. Two-year returns are cumulative.

Related to this, 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. Virginia Capital Strategies follows a disciplined approach and helps clients from making these mistakes.

Portfolio Performance

Our portfolios benefited from many of 2016's trend reversals.

Bonds: In our balanced portfolios, roughly half of our fixed-income exposure is in non-core bond funds, including flexible multisector funds, both short term domestic and world bond products and shorter-term high yield vehicles. We've spoken about these – Templeton Global Bond, Weitz Short Intermediate, Osterweis – a number of times in past commentaries. These positions added significant value compared to core bonds, with gains in the 5% to 12% range versus 2.5% for the bond index. Equally importantly, the core product we use (Dodge & Cox Income) gained 5.69% for 2016! Assuming an account had 15% invested in Dodge & Cox Income last year (as opposed to a core product earning 2.5%), an overall portfolio outperformance of over 50 basis points took place.

Emerging-market stocks: We continue to favor exposure to emerging-market stocks. We were therefore pleased to see emerging-market stocks rebound in 2016. However, they gave back some of those gains following the presidential election amid worries the Trump administration may impose protectionist trade policies and tariffs as well as negative effects from further U.S. dollar appreciation and emerging-market currency depreciation.

Smaller-cap stocks: The Vanguard Strategic Equity Fund cranked out a 17.92% return in 2016. Small cap stocks skyrocketed after the election, and this fund was among the top performers in the category.

Large cap U.S. funds: Our active large-cap U.S. equity managers, in aggregate, outperformed the market index. Jensen Quality Growth and Blackrock Equity Dividend returned 12.01% and 16.21%, respectively, each outperforming the S&P 500 return of 11.8%.

Developed international stocks: 2016 marked the fourth straight calendar year and the sixth in the past seven that the S&P 500 has beaten the global ex-U.S. index. Going back to 2008, this is one of the longest stretches of U.S. outperformance on record. Fortunately, our largest position, Dodge and Cox International, gained 8.26% and far outpaced the 2.7% return of the developed foreign market index.

Alternatives: As previously mentioned, our lower-risk alternative strategies (such as arbitrage funds) returned 3% to 5% in 2016.

Looking Ahead to 2017

As we consider investment opportunities and risks in the context of how our portfolios are currently positioned, we'll focus on two key questions we've been hearing from clients:

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% (in dollar terms). Virginia Capital Strategies maintains a modest exposure to these categories, resulting in slightly diminished portfolio returns.

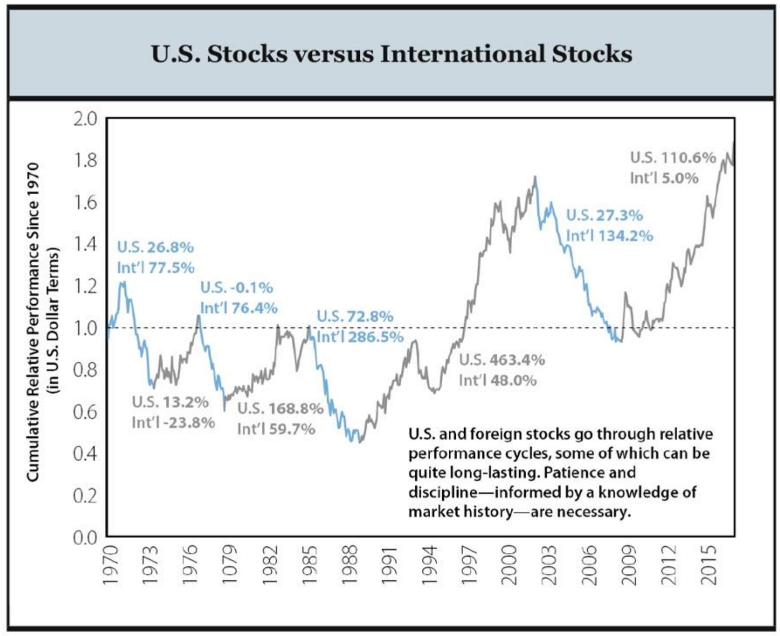
We know the underperformance of foreign stocks is trying some clients' patience. It tries our own, at times, as well. However, we continue to believe, and our analysis supports, maintaining some exposure to these categories.

In terms of the strategic rationale, here are the key supporting points:

- Equity markets and asset classes go through cycles, meaning it is unwise to extrapolate recent/past performance trends far into the future.
- People are generally overconfident in their ability to predict changes in trends and cycles and are therefore poor at timing their buying and selling.
- 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.

- 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. Many of the most attractive companies and equity market returns are located outside the United States.

As analysts, we are continually digesting new data, information, and news relevant to our asset class analysis. While there were certainly plenty of headlines over the past year, our fundamental tactical views on developed economy foreign stocks and emerging-market stocks have not materially changed. Our analysis implies that from current price levels, both markets are likely to generate much higher returns than U.S. stocks over the next five years (our tactical time horizon). In our base case scenario, we estimate low double-digit potential returns from developed foreign and emerging-market stocks, driven largely by improving earnings growth from still very depressed levels. This compares to the mid single-digit expected returns for the S&P 500 in our base case.



Source: Morningstar Direct. Data as of 12/31/16. International stocks are represented by the MSCI World ex USA Index from 1970 to 1988 and the MSCI ACWI ex USA Index from 1988 onward.

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. It is a series of continuous, interactive feedback loops, which is what makes predicting the results so difficult. In her press conference following the Federal Open Market Committee meeting on December 20, Federal Reserve chair Janet Yellen summed it all up as "a cloud of uncertainty."

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.

On the monetary policy front, as the markets expected, the Fed raised the federal funds rate 25 basis points in December (to roughly 0.625%). The Fed also signaled it expects to raise rates three more times in 2017 and another three times in 2018. The Fed has been woefully inaccurate in prior years’ forecasts of rate hikes. A year ago it thought it would raise rates four times in 2016 but did so only once. If it is finally at least in the ballpark for 2017, this would clearly represent a shift from the highly accommodative and unprecedented policies in place since 2008.

Economics in the real world is never as clean and simple as it is in textbooks, so much can change as we look at all of this from a global perspective and digest the effects of a rising dollar, possibly higher budget deficits and higher interest rates (and the accompanying effects on consumers and businesses), among other things.

With that being said, we’ve recently made a number of minor changes in order to adjust to these changing conditions. We’ve recently reviewed portfolios, and have reduced our core bond exposure to no more than 15%, and have reinvested proceeds into additional shorter-term and flexible bond products. We’ve also eliminated a fund, PIMCO Total Return Bond Fund, a product that seems overly sensitive to rising interest rates among other issues.

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*.

Sincerely,

Steve Bowery, CFA, CFP’