Virginia Capital Strategies

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First Quarter 2017 Investment Commentary

Market Recap

March Benchmark Returns (Preliminary)	Mar	Q1	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	0.1%	6.0%	6.0%
iShares Russell 1000 ETF	0.1%	5.9%	5.9%
iShares Russell 1000 Growth ETF	1.2%	8.8%	8.8%
iShares Russell 1000 Value ETF	-1.0%	3.1%	3.1%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	0.0%	2.2%	2.2%
iShares Russell 2000 Growth ETF	1.1%	5.2%	5.2%
iShares Russell 2000 Value ETF	-0.8%	-0.3%	-0.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	3.1%	8.0%	8.0%
Vanguard FTSE Europe ETF	4.4%	8.2%	8.2%
Vanguard FTSE Emerging Markets ETF	2.8%	11.2%	11.2%
Vanguard REIT Index	-2.4%	1.0%	1.0%
Vanguard Total Bond Market Index	-0.1%	0.9%	0.9%
Vanguard Intermediate-Term Tax-Exempt	0.3%	1.4%	1.4%
BofA Merrill Lynch U.S. High Yield Cash Pay Index	-0.2%	2.7%	2.7%
S&P/LSTA Leveraged Loan Index	0.1%	1.1%	1.1%

Global equities greeted the new year with the same degree of enthusiasm as was witnessed during the 4th quarter of 2016. Emerging-market stocks led the way with a double-digit return, followed closely by developed international and U.S. stocks (Vanguard FTSE Emerging Markets ETF up 11.2%, Vanguard FTSE Developed International ETF up 8%, and Vanguard 500 Index up 6%).

Investors took the Federal Reserve's widely anticipated 0.25% increase in the federal funds rate in stride, treating it as another indicator of the U.S. economy's return to form. As Fed Chair Janet Yellen stated, "The simple message is the economy is doing well." The Bureau of Economic Analysis just released a revised GDP figure of 2.1% for the fourth quarter of 2016 versus an earlier estimate of 1.9%. It's widely assumed two additional rate increases will occur during the remainder of 2017. U.S. stocks rallied on the prospect of better economic conditions, improved consumer and business confidence and the likelihood of a significant tax-reform bill during 2017.

Internationally, stock gains seemed to reflect a combination of bullish investor sentiment and positive economic data, including rising corporate earnings. Upward revisions to corporate earnings forecasts, GDP growth that far outstrips that of developed economies, and valuations that are still cheap compared with developed-market stocks all helped drive the strong gains in emerging-market stocks. We continue to like foreign and emerging markets stocks, and will discuss our strategy in these categories during the Portfolio Positioning and Outlook portion of this commentary.

Fixed income securities turned in mixed results. U.S. Treasury securities rallied after the Fed's March 15 announcement, thus the core bond index made up some ground during the latter half of March. Such a recovery still wasn't enough for core bonds to outpace the quarterly gains of the specialty (foreign, flexible) bond funds we also own, which will be discussed later in this commentary. Specialty bond funds delivered gains of 1.5%–4.5% versus the core bond fund's 0.9% return (Vanguard Total Bond Market Index), although we're pleased our primary core bond product, Dodge & Cox Income, outperformed the index again, with a return of 1.2%

The Investment Environment

For the first time in recent memory, global economic growth is in sync and improving. A quick survey of the economic landscape suggests the environment should remain supportive of stocks and other risk assets, at least over the next six to 12 months or so. As we'll discuss later, we continue to believe high current valuations will be a major headwind to U.S. stock market returns looking out longer term (i.e., the next five years). We also remain concerned about the unresolved risks stemming from the global debt build-up and unprecedented central bank policies. But for the time being at least, the global macroeconomic backdrop offers reason for optimism that many of the reflationary trends that have benefited our portfolios in recent quarters can continue.

Across a wide range of measures, the global economy is in its best shape in many years. Economic growth in most countries and industries is in sync and has been accelerating, albeit modestly. Leading economic indicators suggest this trend can continue, and many of the respected economic research firms we follow agree. Capital Economics expects world GDP growth to be at least 3% this year, up from 2.5% in 2016. In its March 16 cover article titled, "On the Up: The World Economy's Surprising Rise," *The Economist* noted that across the United States, Europe, Asia, and emerging markets, "all the burners are firing at once, for the first time since a brief rebound in 2010."

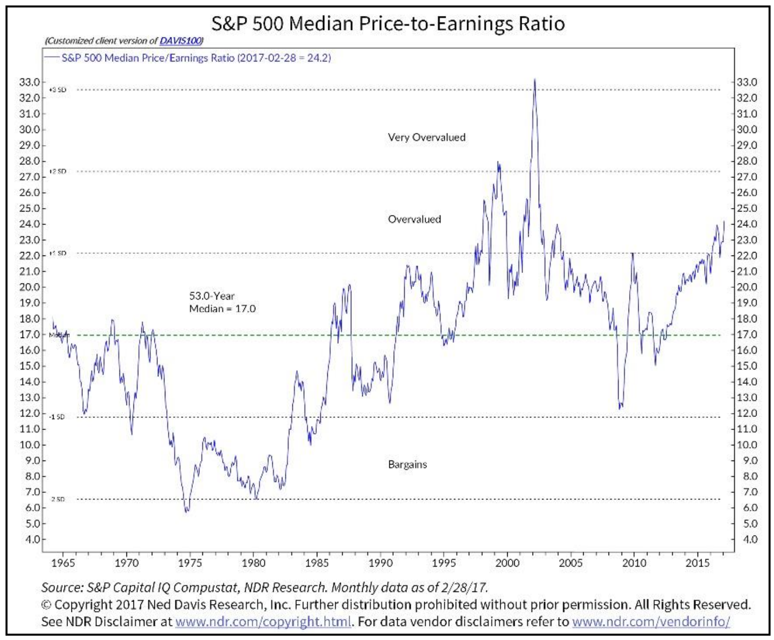
While unexpected macro shocks can occur at any time, causing at least a short-term flight from risk assets, the likelihood of an incipient U.S. or global economic recession appears low. Without a recession, history suggests a bear market in stocks is unlikely. Macroeconomic fundamentals appear reasonably solid and are improving from cyclically depressed levels in many regions outside the United States. But financial markets respond to *new* data, information, and events that differ from the consensus expectations already discounted in prices. In other words, markets react to surprises. The Citi Economic Surprise Indexes are meant to capture whether and to what extent new economic data points are exceeding or disappointing consensus expectations. This index and others have rebounded sharply over the past year. In fact, the Surprise indexes for Europe and emerging markets both recently hit seven-year highs. So, please note much of the good news is *already* reflected in the prices of stocks.

Portfolio Positioning and Outlook

U.S. Stocks

Over the longer term, our analysis continues to indicate the U.S. stock market is broadly overvalued. Specifically, our estimate of the expected annualized total return for U.S. stocks (including dividends) in our base case scenario is in the low to middle single digits over the next five years. For U.S. stocks to be priced in what we consider to be a "fair value" range, that is, to at a minimum compensate investors for the risks they incur owning public equities, their expected return would be at least in the upper single digits. Since we are below that hurdle rate in our base case scenario, we will remain cautious with our U.S. stock position, and consequently, don't plan to add to our current level of exposure. As in the past, we continue to favor Blackrock Equity Dividend Growth, Jensen Quality Growth and Vanguard Strategic Equity.

As the valuation chart to the right indicates, the U.S. stock market is as expensive as it has *ever* been in the past 50 years, with one exception: the dot-com stock market bubble of the late 1990s, from which the S&P 500 Index plunged nearly 50%. We don't believe this time is different. We do believe valuation matters. When stock market valuations are high, the odds are your *future* market returns will be low. So, we won't chase U.S. equities, and instead will focus on (1) foreign stocks with much better return prospects and (2) select specialty fixed income strategies we believe offer at least as attractive returns as U.S. stocks do, with much less risk.



Foreign Stocks

Our portfolios have a meaningful exposure to developed international markets. These positions added value to our portfolios in the first quarter, and we continue to be confident foreign stocks will outperform their U.S. counterparts over the next several years. And as you may have recently witnessed, we further added to this space during the first quarter; primarily through purchases of either the American Funds Europacific Stock Fund or the Dodge & Cox International Fund. We expect these investments to appreciate by 10% or more annually over the next five years or so.

Primarily due to the onset of a regional debt crisis in 2011, foreign corporate earnings have barely grown since the 2008–2009 financial crisis. Fiscal and monetary policies have not been accommodative enough to offset this stagnation, but more accommodative moves are now being made outside the U.S. Meanwhile, accommodative fiscal and monetary policies have helped U.S. company earnings grow strongly, and earnings have exceeded prior cyclical highs due to historically high profit margins, stock buybacks, and low interest expenses. This divergence in earnings trends is the key reason we view foreign stocks as more attractive looking forward. Clearly, there is dry powder internationally to stimulate growth, whereas accommodation has already taken place in the U.S. and it's in the process of being wound down.

Consequently, we estimate that over the next five years' foreign companies will likely grow earnings at a much faster rate than their U.S. counterparts; this should lead to outperformance by foreign stocks. Simply stated, we believe foreign stock earnings are cyclically depressed, while U.S. earnings are near cyclical highs. Further, we do not believe this condition is adequately reflected in their respective valuations. We don't know the precise timing or exactly what catalyst will lead investors to close the gap. This is especially true now, with high political uncertainty in Europe. Yet, there are reasons for optimism the market will finally start to take notice.

Regarding Europe, last year, for the first time since the 2008–2009 financial crisis, Europe's economy grew faster than that of the United States. Improving economic growth is a good sign as it ultimately leads to better sales growth and gets consumers and corporations to borrow and spend, furthering the growth cycle. According to the Bank Credit Analyst, private sector credit growth in Europe is up at the fastest rate since the financial crisis. Asia is witnessing much improved conditions as well.

Unsurprisingly, the European Central Bank is expressing greater confidence in its economic outlook, and has revised upward both its inflation and growth projections for 2017–2018. We are also finally seeing better earnings from foreign companies.

Emerging-Market Stocks

Our analysis continues to indicate that emerging-market stocks are particularly attractive. Emerging-market company earnings are *cyclically* depressed relative to earnings of U.S. companies, yet investors are essentially pricing that in as a *permanent* condition. Using what we believe are very conservative normalized earnings estimates, our analysis indicates emerging-market stocks in aggregate are trading at a price-to-earnings multiple well below their historical averages. Using Robert Shiller's valuation methodology—another way of normalizing earnings, or smoothing out their cycles—emerging-market stocks are trading at around half the multiple of their U.S. counterparts. As emerging-market earnings growth comes through, we expect investors to bid up their prices and valuations, generating low double-digit annualized returns or better.

Of course, there are risks investing in emerging markets. Among the new worries investors have is Trump's protectionist stance on international trade. There remains considerable uncertainty as to whether his stated policies on border taxes, import tariffs, etc., will be implemented in the manner he has proposed. There is a good chance they may not be. Even assuming they will be, while they would be a near-term negative for some emerging-market countries, we argue they may be worse for larger U.S. companies. That is because, among other things, Trump's protectionist policies would likely disrupt global supply chains for U.S. multinationals. This ability to conduct sourcing on a global basis has driven down multinationals' operating costs and has been important in pushing U.S. corporate margins higher for the past decade-plus.

Emerging markets are better positioned today to weather protectionism, higher U.S. interest rates, and a rising dollar than they were a few years ago. Many countries are implementing reforms and undergoing political change that could be positive longer term. For example, Michael Kass, portfolio manager of Baron Emerging Markets, cites the approval of a "national sales tax" in India that's aimed at creating a single unified market and reducing bureaucracy there. In Latin America, Kass is optimistic recent political regime shifts and renewed fiscal constraint in Brazil and Argentina could increase foreign capital and investment, helping the region recover from its economic stagnation. In China, much needed supply-side reforms seem to be happening.

The above developments are not sufficient in and of themselves to drive growth and outperformance in emerging markets. But when we start to see such actions occur at a time when earnings are historically depressed *and* valuations are attractive, we think there are good reasons to be optimistic about investing in emerging markets.

Our preferred fund in this space is the American Funds New World Fund.

Fixed-Income

As previously noted, our specialty fixed-income funds outperformed the core benchmark, continuing the trend from 2016. And we're pleased the core fund we do use (Dodge & Cox Income) outperformed the core index too. Our fixed-income exposure is diversified and encompasses what we believe is a prudent amount of credit risk along with modest interest-rate risk. Our blended strategy also offers a meaningful yield and expected-return advantage versus the core bond index. We continue to believe that over the next several years the most likely direction for U.S. interest rates is higher, although it will likely be a *bumpy* path. That would be consistent with the evidence of global economic reflation as discussed above. In such a scenario, core bond index annualized returns will be relatively low. In contrast, we believe our actively managed flexible bond funds can generate mid-single-digit-type annualized returns. We continue to favor the Templeton Global Bond Fund, Osterweis Strategic Income Fund and Weitz Short-Intermediate Income Fund.

Putting it All Together

Despite a high level of volatility emanating from U.S. politics in recent months, U.S. stock market volatility has remained very low. That is unlikely to last. Although economic conditions have clearly improved, our portfolios are prepared for greater oscillations, particularly downside risk to U.S. stocks. As noted, we won't add to this category as valuations are very extended. However, foreign and emerging markets stocks and some specialty fixed income categories are attractive. We remain confident in our positioning and in our investment process, both of which allow us to look past periods of uncertainty and keep our focus where it should be: on prudently managing our diversified portfolios to achieve long-term, risk-adjusted returns.

Sincerely,

Steve Bowery, CFA, CFP