Virginia Capital Strategies

STEPHEN J. BOWERY, PRESIDENT

Third Quarter 2017 Overview

September Benchmark Returns (Preliminary)			
	Sept	Q3	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	2.1%	4.4%	14.1%
iShares Russell 1000 ETF	2.1%	4.3%	13.9%
iShares Russell 1000 Growth ETF	1.2%	5.8%	20.4%
iShares Russell 1000 Value ETF	2.9%	3.0%	7.6%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	6.3%	5.9%	11.0%
iShares Russell 2000 Growth ETF	5.5%	6.4%	16.9%
iShares Russell 2000 Value ETF	7.2%	5.3%	5.6%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	2.5%	5.5%	21.2%
Vanguard FTSE Europe ETF	3.2%	6.2%	24.6%
Vanguard FTSE Emerging Markets ETF	-0.5%	8.0%	24.2%
Vanguard REIT Index	-0.1%	0.8%	3.4%
Vanguard Total Bond Market Index	-0.5%	0.7%	3.1%
Vanguard Intermediate-Term Tax-Exempt	-0.4%	1.0%	4.3%
BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.9%	2.0%	7.0%
S&P/LSTA Leveraged Loan Index	0.4%	1.0%	3.0%

Despite its reputation as the worst seasonal period for stocks, the U.S. market delivered strong returns in the third quarter, extending its winning streak to eight consecutive quarters and a remarkable 18 out of the last 19 quarters. The S&P 500 Index closed at an all-time high, gaining 4.5%. But foreign markets did even better, led by emerging markets, which surged 8%. More broadly, developed international stocks rose 5.5%. For the third consecutive quarter, the U.S. dollar depreciated against foreign currencies, boosting dollar-based investor returns in these markets.

Within the U.S. market, larger-cap growth stocks—technology stocks in particular—continued their year-to-date dominance over smaller-cap and value stocks, a sharp reversal from what occurred in 2016. Larger-cap growth stocks are up more than 20% this year, while smaller-cap value stocks have gained 5.6%. The Vanguard 500 is up 14.1% for the year, while the Russell 2000 has gained 11% (helped by a 6.3% surge in September). Looking at industry sectors, energy stocks had a big rebound in September (up 10%) as oil prices rose above $50. But for the year, the sector is still *down* 6.6%, while technology and health care have soared 27% and 20%, respectively.

After spiking briefly in August on geopolitical concerns (North Korea), the VIX volatility index dropped back below 10 by quarter-end, near its all-time low. Another indicator of how calm the stock market has been this year is that its largest decline (drawdown) has been a loss of 2.8% (from March 1 to April 13). Going back to 1929, there has been only *one* calendar year when the largest drawdown was smaller than that (in 1995, with a 2.5% intra-year decline), according to Ned Davis Research.

Moving to the fixed-income markets, core investment-grade bonds inched up 0.7% for the quarter. Core bond prices peaked in early September, with the benchmark 10-year Treasury yield (which moves inversely to bond prices) bottoming at 2.06% on a confluence of flight-to-safety fears around tensions with North Korea, catastrophic hurricanes in Texas and Florida, and a potential U.S. debt ceiling crisis/government shutdown. But the yield shot up into month-end, closing the quarter at 2.3%—right about where it stood three months earlier. Credit-sensitive (higher-risk) sectors of the fixed-income market outperformed core bonds for the quarter, with the high-yield bond index gaining 2%.

Portfolio Performance Summary and Investment Outlook

Our client portfolios continued to benefit from meaningful exposure to foreign stocks. And for the quarter, our balanced portfolios generated attractive returns as all the major asset classes registered gains for the period. VCS portfolios particularly benefited from increased exposure to emerging-market and developed market foreign stocks, both of which had strong absolute returns and beat

U.S. stocks, as noted above. For the year to date, emerging markets' 24.2% return has beaten the S&P 500 Index by ten percentage points. Developed market foreign stocks are beating the U.S. market by more than 7 percentage points on the year, helped by the depreciation of the dollar.

After a multiyear period of severe underperformance by foreign stocks versus U.S. stocks, we are pleased by this turn of events. Given their attractive relative valuations and earnings fundamentals, we are also not surprised. While the precise catalyst or timing of these types of cyclical market turns are unpredictable, we still see plenty of runway for additional outperformance over our five-year tactical horizon.

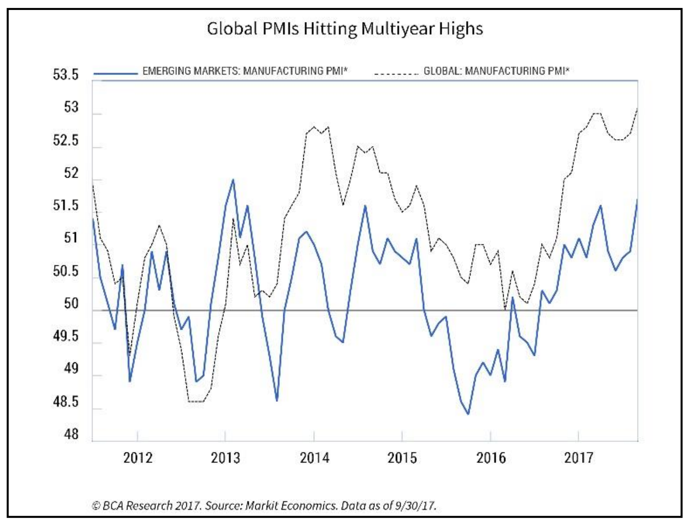
Within the fixed-income portion of our balanced portfolios, our long-established positions in several flexible bond funds, added value again for the quarter. This didn't look to be the case coming into the early part of September, as macro risk-aversion drove core bond prices higher (Treasury yields lower). But as Treasury yields rose later in the month, our flexible bond positions, which are less interest-rate-sensitive, outperformed. These funds are also ahead of the core bond index for the year.

All-in-all, our results during the third quarter and for 2017 have been outstanding. Due to the success of tactical measures we have taken, even conservatively managed portfolios are experiencing high-single digit returns over the last nine and twelve months.

In recent client meetings, we've been asked to explain what is driving the markets higher, and in a year that was supposed to be sub-par or worse. We see three primary factors pushing the markets to record levels:

1. THE GLOBAL ECONOMY REMAINS ROBUST

In August, the Global Manufacturing PMI hit its highest level in over six years. The Eurozone PMI also hit a new six-year high, while the Emerging Market PMI rose to its highest level since January 2013.



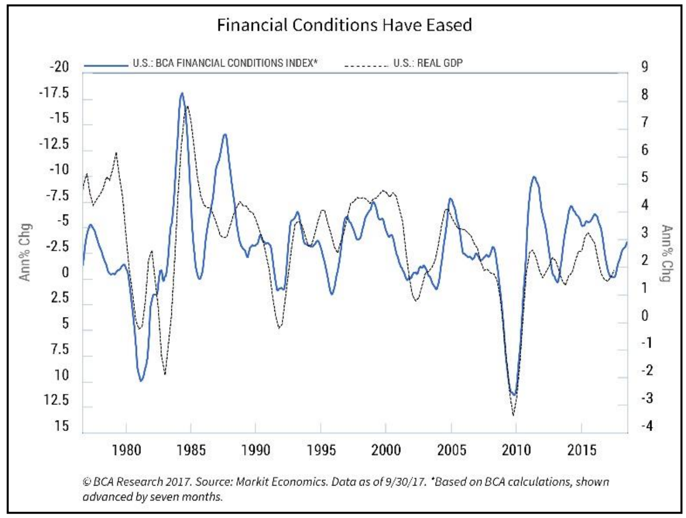
Meanwhile, easing inflationary pressures in emerging markets have allowed numerous emerging-market central banks to lower interest rates this year (including Brazil, Russia, India, and South Africa). Lower inflation and lower central bank policy rates are typically positive for local stock markets, and they can also help offset the impact of policy tightening by the Fed on emerging markets.

For the first time in a decade, the world's major economies are growing in sync. All 45 countries tracked by the Organization for Economic Cooperation and Development are on track to grow this year, and 33 of them are poised to accelerate from a year ago, according to the OECD. It is the first time since 2007 that all are growing and the most acceleration since 2010, when many nations enjoyed a fleeting snapback from the global financial crisis.

The International Monetary Fund in July projected global economic output would grow 3.5% this year and 3.6% in 2018, up from 3.2% in 2016.

In the past 50 years, simultaneous growth among all the OECD-tracked countries has been rare. In addition to happening last decade, it has only happened in the late 1980's, and a few years before the 1973 oil crisis.

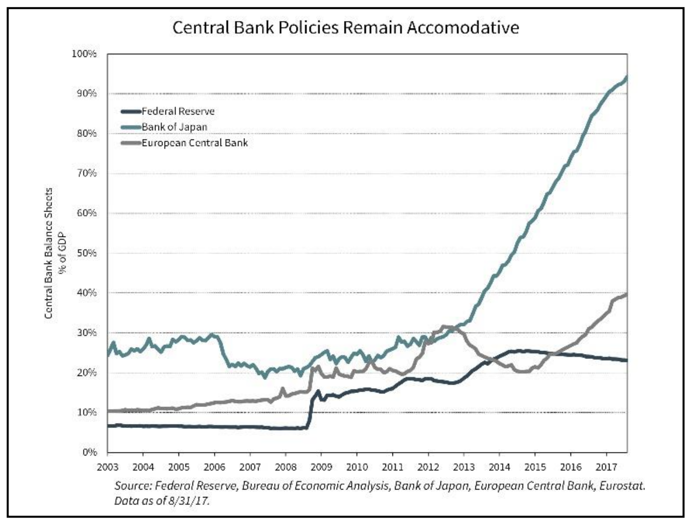
2. U.S. GDP GROWTH GRINDING ALONG



Turning to the U.S. economy, real GDP growth remains subpar by historical standards but continues to grind along at around a 2% annual rate. Looking ahead, a positive sign for the economy is that financial conditions have eased (become looser) over the past year—despite the three Fed rate hikes—due to factors such as the declining dollar, higher stock prices, narrower corporate bond spreads, and lower Treasury bond yields. This could bode well for economic growth over the next few quarters at least, as shown in the chart to the right.

Job and wage growth appears to be accelerating as unemployed workers begin to reenter the workforce, as evidenced by recent improvements (although small) in the labor force participation rate. Factory orders and numerous consumer confidence indicators are on the rise. Clearly, baseline growth the U.S. economy appears to be improving.

3. GLOBAL CENTRAL BANK POLICY REMAINS ACCOMMODATIVE AND STIMULATIVE



Real (net-of-inflation) policy rates remain in negative territory across all the major developed economies, and the European Central Bank and Bank of Japan continue purchasing assets via quantitative easing (see chart to the right).

In contrast to Europe and Japan, the Fed continues to very gradually tighten, reflecting that the United States is further along in its economic and market cycles. As expected, at its September 19 meeting, the Fed left its policy rate (federal funds rate) unchanged at a range of 1% to 1.25%, but it kept a potential December rate hike on the table and detailed its plan to begin shrinking its $4.5 trillion (quantitative easing) portfolio of Treasury and mortgage-backed bonds. Starting in October, the Fed will allow $10 billion worth of bonds to mature and roll off their balance sheet each month, increasing the total roll-off by $10 billion each quarter until it reaches $50 billion per month. The financial markets took the Fed announcements largely in stride, although the dollar bumped up a bit versus the euro and yen.

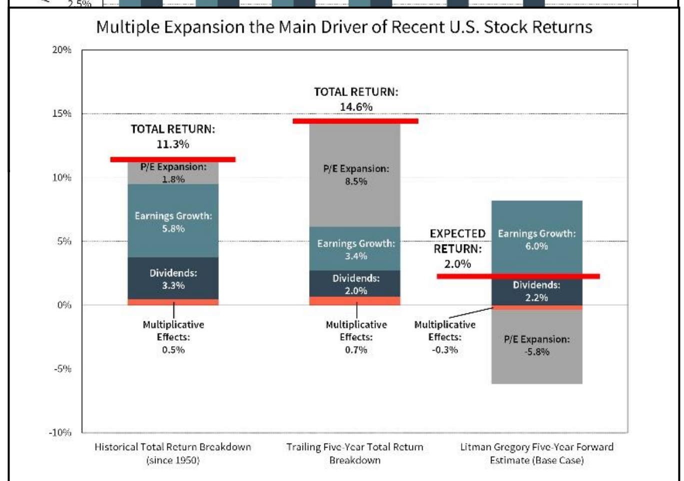
Clearly, central bank policy worldwide remains accommodative, even when considering recent U.S. Fed actions.

So Why Not Buy Additional U.S. Stocks?

A stock's total return can be decomposed into an earnings growth contribution, a dividend yield contribution, and a change-in-valuation (price-to-earnings ratio) component. Historically and over the long term, it is dividends and earnings growth that drive total returns. They are the fundamentals we so frequently refer to. And over long-term periods, they have been fairly predictable, at least within a reasonable range. S&P 500 earnings per share have grown at roughly a 6% annualized rate over the past 65 or so years, and that is our base case earnings growth assumption (see the chart "Multiple Expansion the Main Driver …" on next page).

In contrast, the market's P/E multiple (whether on a trailing-12-month or a multiyear normalized basis) has fluctuated across a very wide range over time. But the evidence is clear that over longer-term periods (e.g., five to 10 years or more), when starting valuation multiples are in the upper end of their historical range, as they are now, realized returns are likely to be poor if not downright terrible. Of course, there is no *certainty* of that outcome this time around. But successful investing is about weighing the probabilities and magnitudes of various outcomes.

Litman Gregory Analytics expects the market P/E multiple to decline toward historical norms over the next several years. If this happens, it will be a meaningful drag on total market returns. As shown in the chart to the right in the third column, it would cut 5.8% per year from the five-year annualized return. Effectively, this would reverse some (but not all) of the large positive impact the sharp P/E multiple expansion has had on market returns over the *past* five years (the 8.5% annual return contribution shown in the second column of the chart.



Source: Litman Gregory Analytics, Standard & Poor's, and Robert Shiller. Data as of 6/30/17.

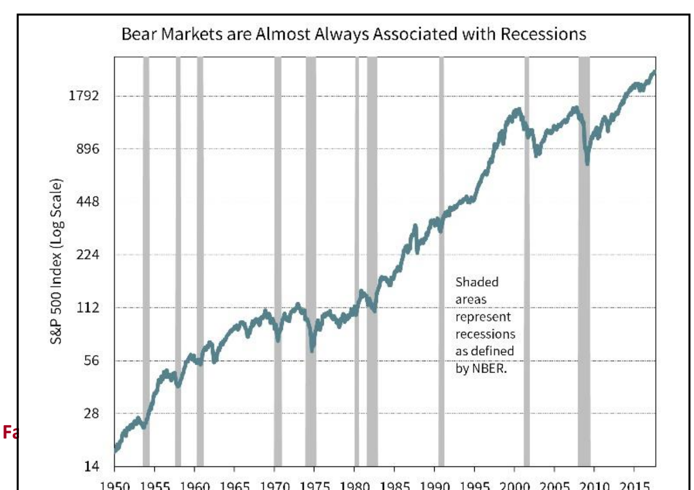
We agree with Litman Gregory Analytics that this argues for caution when it comes to U.S. stocks, looking out over the next five-plus years. That is why we plan to maintain U.S. stocks at current levels, despite what may continue to be a supportive macro backdrop for them over at least the next few quarters.

At some point, especially if U.S. stocks accelerate to much higher levels, we may begin trimming exposure. However, it is our intent to continue to hold foreign and emerging markets stocks, and we may even add further to these categories. We are comfortable with our current fixed income strategy.

Closing Comments

Despite the U.S. economy's rather healthy economic indicators, it's worth noting that a typical 5% to 10%-plus stock market correction can happen at any time, triggered by any number of unpredictable and/or unexpected events. Historically, the U.S. market has dropped at least 5% roughly *three times a year* and declined 10% or more about once a year. We are at 330 days and counting since the last 5% drop; this is the longest such streak in *26 years*. Given that historical reference, the U.S. market seems long overdue for a correction.

However, a true bear market in U.S. stocks (a sustained 20%-plus decline) is almost always associated with an economic recession. Absent a recession, a bear market is unlikely. Recessions, in turn, are typically caused by excessive Fed tightening (reflected in an inverted yield curve), usually in response to inflationary pressures, an overheating economy, or financial market excesses, none of which *seem* imminent in the U.S. or global economy. So, although this is now the third-longest economic expansion and second-longest bull market in U.S. history, neither appears ready to die of old age just yet.



Source: The National Bureau of Economic Research, Yahoo! Finance. Data as of 8/31/17.

It's also important to remember that the next bear market will surely create some table-pounding tactical investment opportunities, as many risky asset classes will get excessively beaten down in price relative to their longer-term fundamentals. Given our positioning in lower-risk asset classes, we expect to be able to take advantage of such opportunities.

In the meantime, we have built balanced portfolios that are resilient across a range of scenarios; diversified across investment strategies, asset classes, and risk exposures; and with meaningful exposure to the areas our analysis indicates currently have the most attractive risk/return profiles, such as established economy foreign stocks, emerging-market stocks, and flexible bond funds.

Thank you for your continued confidence and trust.

Sincerely,

Stephen J. Bowery, CFA, CFP