Virginia Capital Strategies

STEPHEN J. BOWERY, PRESIDENT

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First Quarter 2018 Investment Commentary

Market Recap

March Benchmark Returns (Preliminary)	Mar	Q1	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	-2.6%	-0.8%	-0.8%
iShares Russell 1000 ETF	-2.2%	-0.8%	-0.8%
iShares Russell 1000 Growth ETF	-2.7%	1.3%	1.3%
iShares Russell 1000 Value ETF	-1.8%	-3.0%	-3.0%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	1.2%	-0.2%	-0.2%
iShares Russell 2000 Growth ETF	1.3%	2.2%	2.2%
iShares Russell 2000 Value ETF	1.1%	-2.7%	-2.7%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-0.4%	-1.0%	-1.0%
Vanguard FTSE Europe ETF	-0.4%	-1.2%	-1.2%
Vanguard FTSE Emerging Markets ETF	-0.2%	2.5%	2.5%
Vanguard REIT Index	3.8%	-8.1%	-8.1%
Vanguard Total Bond Market Index	0.6%	-1.5%	-1.5%
Vanguard Intermediate-Term Tax-Exempt	0.2%	-1.1%	-1.1%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	-0.6%	-0.9%	-0.9%
S&P/LSTA Leveraged Loan Index	0.3%	1.4%	1.4%

Volatility, which was almost non-existent last year returned in a big way to the financial markets in the first quarter. Equity investors had a particularly bumpy ride—an experience we'd suggest getting used to for the months and years ahead. U.S. stocks surged out of the gates in January, with larger-cap U.S. stocks up nearly 8% at the market high on January 26. This was followed by a short but sharp market correction, which dropped the market 10% over the next nine trading days. The VIX volatility index had its biggest one-day move *ever*, spiking more than 100% on February 5. U.S. stocks then rebounded into mid-March, clawing back much of their losses, before dipping again into quarter-end, buffeted by fears of a potential trade war with China and a Facebook data scandal. When the dust settled, large caps ended down about 1% for the quarter.

Foreign stocks also got off to a strong start to the year, before suffering similar losses to U.S. stocks during the sharp correction in early February. They made up ground relative to U.S. stocks in March but also ended the quarter down 1%. Emerging-market stocks held true to their higher-volatility reputation, shooting up 11% to start the year, falling 12% during the mid-quarter correction, and then once again outgaining U.S. and international stocks to finish the quarter with a 2.5% return.

Core bonds didn't play their typical "safe-haven" role in the first quarter. They posted losses during the sharp stock market correction in February and delivered a 1.5% loss for the quarter overall, as Treasury yields rose across the maturity curve. Our specialty fixed-income funds outperformed the core bond index for the period; we will discuss our fixed income approach in some detail in the next section.

First Quarter Portfolio Performance & Key Performance Drivers

Our clients know we don't invest based on three-month time horizons or short-term expected outcomes. To the contrary, we strongly believe that a critical element of our investment process is the ability to maintain a longer-term (multiyear) perspective while other market participants over-react to short-term performance swings, daily news flow, and other emotional/behavioral triggers—much to their longer-term financial detriment. Yet, many clients are also naturally curious to know "what worked and what didn't" in any given period. So, with that in mind, we typically provide shorter-term updates on the key drivers of our portfolios' performance.

EQUITIES

Overall, our U.S. equity investments performed in-line to their benchmarks, led by our recommended growth product, Jensen Quality Growth and our preferred value products, Blackrock Equity Dividend and Dodge & Cox Stock. Our favorite foreign stock funds, Dodge & Cox International and American Funds Europacific Growth were at or slightly ahead of their benchmarks in the first quarter. The American Funds New World Fund, our emerging markets choice basically performed in-line with its benchmark. Vanguard Strategic Equity, our favorite small and mid-cap product, had a gain of 0.5% for the quarter, slightly ahead of its benchmark.

In summary, all stock categories (foreign and domestic, growth and value and small and large) had little or no gains during the period. The only outlier was REITS, and this category saw a sizable loss, primarily due to the rise in interest rates which took place. Cohen & Steers Realty Shares was down over 6%. Due to the outperformance of technology stocks, growth outperformed value by a fairly significant level.

FIXED-INCOME

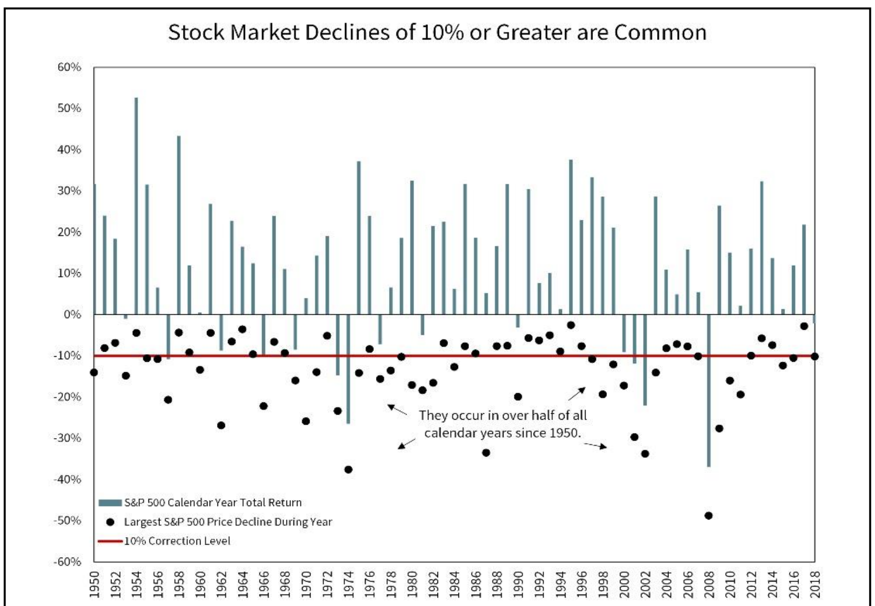
As noted earlier, core fixed-income funds, especially those with a large Treasury exposure had a tough time during the quarter (down over 1.5%), due to the rise in yields which took place. Fortunately, our preferred choice, Dodge & Cox Income, was down only 0.9%, as the fund is primarily invested in corporate investments and this approach outperformed funds more heavily invested in Treasury securities. Furthermore, our specialty fixed income investments offered very solid performance relative to core fixed income funds. Templeton Global Bond, Weitz Short-Intermediate Income and Osterweis Strategic Income returned 1.38%, -0.28% and 0.28%, respectively.

All combined, our fixed income approach was only slightly negative for the quarter versus a loss of 1.5% for Vanguard Total Bond Market Index. This level of outperformance is significant, when considering many of our client portfolios have 50% or more invested in fixed income.

ALTERNATIVES

Finally, the performance of our liquid alternative strategies was mixed. The Merger Fund gained 2.5% for the quarter and the Arbitrage Fund was flat. Most of our clients own both of these funds, so all-in-all, these products added value to portfolios during the quarter.

The Return of Stock Market Volatility (aka Stocks Can Go Down as Well as Up)



In our 2017 year-end commentary, we noted that by some measures U.S. stock market volatility was the lowest it had ever been in 90 years of market history. Of course, most experienced investors knew that was unsustainable. We also knew the exact timing, magnitude, and catalyst of a market disruption couldn't be predicted with any precision. We highlighted central bank policy tightening as a potential or likely trigger, along with the ever-popular and all-purpose "unexpected geopolitical shock."

As it turned out, the catalyst was an economic data point in early February showing higher-than-expected U.S. wage inflation. It unnerved markets to think that overall inflation may be rising more rapidly, thereby suggesting the Federal Reserve would tighten policy (raise interest rates) more aggressively than the consensus had been expecting. Selling then begat more selling, as short-term traders (the speculative herd) rushed to unwind their misplaced bets that the very low market volatility regime *would* continue.

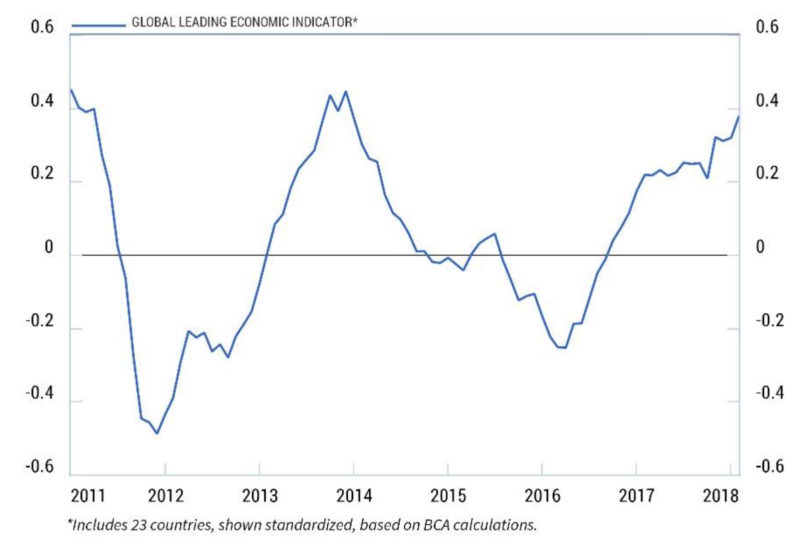
Although the 10% market correction proved to be very short-lived, it may still have provided a nice reality check for some investors in terms of testing their *true* risk tolerance as compared to a hypothetical risk estimation by our Finametrica questionnaire. To the extent you were paying attention to the markets and your portfolio during that nine-day period: how did it feel to see the value drop by that magnitude? If it was starting to cause heavy discomfort or stress, that's probably a sign you are not in a portfolio with the right risk level. Stock market corrections of 10% or more in any given year are very *normal*. Historically, they've happened more than half the time. (A 5% decline has happened in more than 90% of years.) We think this is a reasonable expectation for the future as well. That is why stocks are called "risky assets." In exchange for their higher long-term expected returns, you must be willing and able to ride through their inevitable periods of decline.

From our perspective, as the market correction unfolded we were starting to view it as potentially creating an opportunity to reallocate some capital back into stocks. But the selloff ultimately didn't go nearly far enough (i.e., stocks didn't get cheap enough) for us to see an expected benefit from making any portfolio changes, so we basically maintained our positions.

Please let us know if you feel your portfolio is out of line with your ability to weather risk.

The Market Correction was not Caused by Deteriorating Economic Fundamentals

The Global Economy Still Looks Solid



*Includes 23 countries, shown standardized, based on BCA calculations.

Source: BCA Research. Data as of 1/31/18.

Another observation about the market correction in February is that it was caused *not* by indications of an economic slowdown or recession, but by fears the economy may be getting a bit too *strong*, with a tight labor market finally causing rising wage growth and broader inflationary pressures. Fundamentally, even after the correction, the U.S. economy and global economy still look solid. Global growth may no longer be accelerating, but it remains at above-trend levels and the likelihood of a recession over the next year or so still appears low (absent a macro/geopolitical shock). The global economic and corporate earnings growth outlook has not materially changed from what it was earlier in the year. The near-term macro backdrop is still supportive for riskier assets such as global stocks, even though the U.S. economic recovery is getting long in the tooth.

Where Do We Go from Here? Shorter-Term Paths vs. Our Five-Year Outlook

A positive near-term economic view doesn't mean we are at all bullish on stocks looking out over our five-year tactical investment horizon. Our analysis remains the same as we outlined most recently in our year-end commentary, the key driver being that the valuation of the S&P 500 Index is well above our estimate of its fair-value range on a normalized (longer-term) basis. As the valuation multiple comes down, it will be a significant drag on the total return of the market index. We estimate a mid-single digit annualized five-year return for U.S. stocks in our base case scenario, which we think is the most likely outcome. Such a return is approximately one-half of what investors typically receive in stocks. But there is a wide range around that base case, incorporating bearish and bullish scenarios.

Spenser Jakab recently wrote an interesting column in the Heard on the Street section of the Wall Street Journal called "Stocks' Value Still Isn't Right". Jakab points to a Crestmont Research study that illustrates the importance of valuation, relative to any other stock market indicator. The Crestmont study looked at stock U.S. stock market returns between 1919 and 2017, and sliced them into deciles from worst to best over 20-year periods. The worst periods had annualized returns averaging around 5% and the best approximately 15%. That is a huge difference, basically turning $10,000 into either $28,000 or $175,000. The main difference between the two was starting and ending valuation – specifically the cyclically-adjusted price/earnings ratio that measures the past 10 years of inflation-adjusted earnings popularized by economist Robert Shiller. The lowest-return periods had an average starting cyclically-adjusted P/E of 18.2 but ended at 9.2. The best periods started at 10.1 times on average but ended at 28.2 times. The Shiller P/E, currently at 31, sits firmly in the most expensive decile historically!

However, our base case five-year expected return estimates are meaningfully higher for foreign and emerging-market stocks—possibly in the mid- to upper single digits, largely due to their lower current valuations. We view these as *relatively* attractive returns compared to U.S. stocks but not table-pounding in an absolute-return sense given the downside risks inherent in owning equities. We do not plan to reduce exposure to foreign and emerging markets stocks. We have made multiple purchases in these two spaces over the last year or so, and now have exposure to the levels we feel are appropriate.

We agree with Jakab and Crestmont Research and emphasize a five-year or longer time horizon as the basis for our expected-returns analysis because valuation (what you pay for an investment relative to its future cash flows) has been the strongest predictor of returns over longer-term periods. By contrast, over the shorter term, markets are driven by innumerable and often random factors that are impossible to consistently predict (although that doesn't stop lots of people from trying).

If we experience a short-term bounce in U.S. stocks, one that will push the markets back to their January 26 highs, we will use such a rebound as an opportunity to modestly reduce U.S. stocks in many of our portfolios, especially those with equities at the high end of their ranges.

We plan to maintain our diversified fixed income approach with monies split equally between core bond and specialty bond products.

Concluding Comments

Managing money over short time horizons is very difficult. We believe that acknowledging and internalizing the inherent uncertainty in this endeavor is extremely beneficial. It can help us and our clients from over-reacting to short-term events—particularly unpleasant ones—and restrain our natural human inclination to "do something" in response to pain and discomfort. In the real world this human inclination to action is beneficial—thanks to our ancestors it's why we are all here (and weren't eaten by lions). But when it comes to the investment world, it leads most investors to undisciplined performance-chasing and other detrimental portfolio moves. Numerous reputable studies have quantified this. As Vanguard founder Jack Bogle put it, "Investors are their own worst enemy." Or as Walt Kelley's *Pogo* more famously said: "We have met the enemy and he is us."

The best defense against that enemy is a sound, fundamentally grounded investment process that an investor has confidence in and is therefore able to stick with for the long term—through the ups and downs of market cycles, economic cycles, political cycles, and daily news cycles.

As always, we thank you for your continued confidence and trust.

Sincerely,

Steve Bowery, CFA