Virginia Capital Strategies

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Second Quarter 2018 Investment Commentary

Market Recap

US stocks rose to the top of asset class performance charts with solid returns in the second quarter. Larger-cap US stocks gained 3.4%, but were outdone by smaller-cap stocks, which jumped 7.9%. The smaller-cap outperformance was driven by the market narrative du jour that smaller companies are more domestically focused and therefore not as exposed to a strengthening US dollar or potential trade wars, both of which are assumed to be detrimental to larger-cap (multinational) company profits.

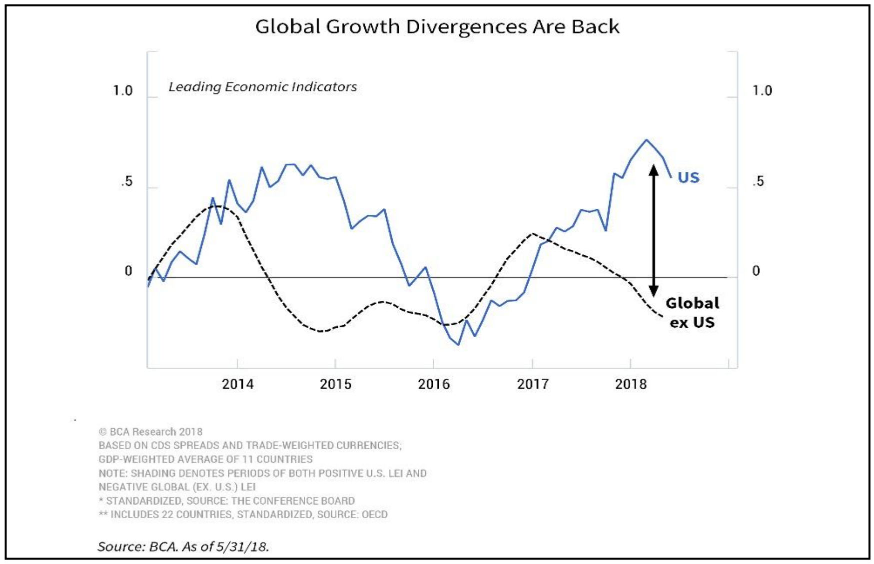
June Benchmark Returns	MTD	QTD	YTD
EQUITY BENCHMARKS			
Vanguard 500 Index	0.6%	3.4%	2.6%
iShares Russell 1000 ETF	0.6%	3.5%	2.7%
iShares Russell 1000 Value ETF	0.3%	1.2%	-1.8%
iShares Russell 1000 Growth ETF	1.0%	5.7%	7.1%
iShares Russell 2000 ETF	0.6%	7.9%	7.7%
Vanguard REIT	4.1%	8.8%	-0.1%
iShares MSCI ACWI ETF	-0.6%	0.3%	-0.3%
Vanguard FTSE Developed Markets ETF	-1.7%	-1.8%	-2.8%
Vanguard FTSE Europe ETF	-1.3%	-1.6%	-2.8%
Vanguard FTSE Emerging Markets ETF	-4.8%	-9.6%	-7.3%
FIXED-INCOME BENCHMARKS			
Vanguard Total Bond Market Index	0.0%	-0.2%	-1.7%
Vanguard Intermediate-Term Tax-Exempt	0.1%	0.8%	-0.3%
iShares TIPS Bond ETF	0.7%	0.9%	-0.0%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.4%	1.0%	0.1%
S&P/LSTA Leveraged Loan Index	0.1%	0.7%	2.2%
ALTERNATIVE BENCHMARKS			
HFRX Global Hedge Fund Index	-0.2%	0.2%	-0.9%
Bloomberg Commodity Index	-3.5%	0.4%	0.0%
SG Trend Index	1.1%	-1.3%	-5.2%
3-Month LIBOR	0.2%	0.6%	0.9%

The US dollar rebounded 5% against a basket of its peers and ended the second quarter at an 11-month high. The dollar's appreciation translated into a meaningful headwind to returns for dollar-based investors in foreign securities, as foreign currencies depreciated against the dollar. Developed international stocks fell 1.8% for the period. Emerging-market (EM) stocks fared the worst, dropping 9.6% in dollar terms. The global stock index (iShares MSCI ACWI ETF), which combines US, international, and emerging stock markets, gained just 0.3% for the quarter and is slightly negative for the year.

In addition to the currency effects, EM stocks were buffeted by on-again, off-again (and back on-again) trade tensions between the United States and Europe, Mexico, Canada, Japan, and China—in other words, all its major trading partners. Fears of a trade war with China and the European Union escalated into quarter-end, with the entities engaged in vigorous trading of threats and counter-threats. In light of the sharp underperformance of EM stocks in the quarter, we'll revisit our investment thesis and outlook for them later in this commentary. We'll also address the global trade threat and how we incorporate such macro uncertainties into our overall portfolio management approach.

Moving on to the bond markets, in May, the benchmark 10-year Treasury yield pierced the 3% level, hitting a seven-year high. Yields then fell back, ending the quarter at 2.85%, an 11-basis-point increase from the prior quarter-end. As such, the core bond index had a slightly negative return (bond yields and bond prices move inversely to each other). Once again, shorter-term and credit-sensitive investments (specialty bond strategies) outperformed core bonds and generated flat or modestly positive returns. For the year, the core bond index is down nearly 2%, whereas our specialty bond strategies are flat or modestly positive, resulting in overall fixed income performance significantly higher than the core bond index. Moreover, our core bond product, Dodge & Cox Income, continued to outperform most core bond approaches as well as the Barclays U.S. Bond Aggregate.

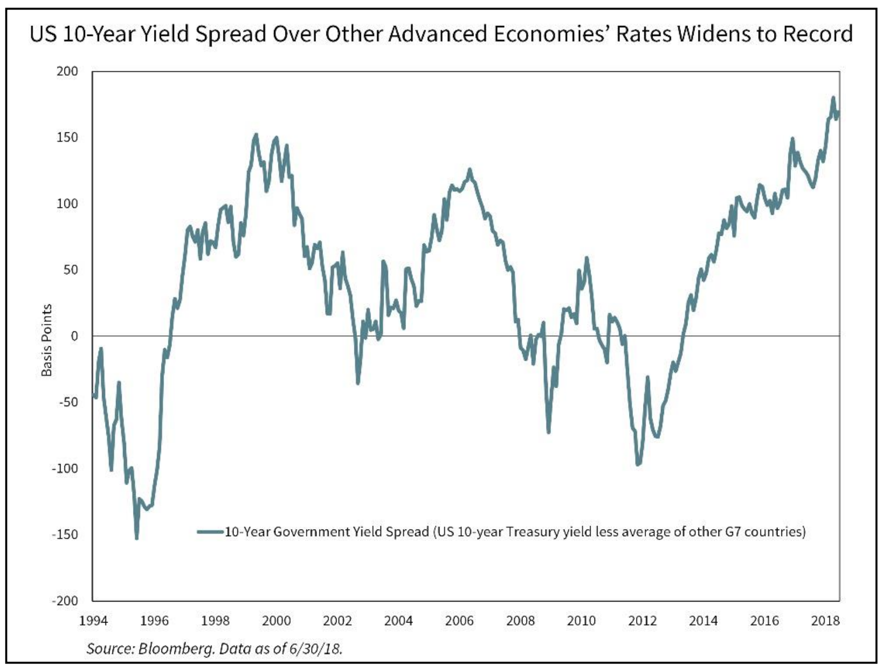
While there are always multiple, diverse factors impacting bond yields on a day-to-day basis, a primary underlying driver is Federal Reserve monetary policy (and the market's *expectations* about such). Fed policy in turn is driven by the Fed's assessment of the US economy, and specifically its twin objectives ("dual mandate") of price stability and full employment. To this end, with the economy growing above trend and the labor market tight—the unemployment rate fell to an 18-year low in May—the Fed continued its gradual path of tightening monetary policy. In June, as expected, it hiked the federal funds policy rate another 25 basis points to a range of 1.75%–2%. It also forecasted a slightly accelerated path of hikes over the next two years, which, if it comes to pass, would bring the Fed funds rate to a range of 3%–3.25% by the end of 2019. Whether the economy can withstand that degree of tightening remains to be seen.



Source: BCA. As of 5/31/18.

In other central bank news, the European Central Bank said it would conclude its quantitative easing/asset-purchasing program by the end of this year. But the ECB also sent a more dovish message, saying it doesn't plan to begin raising its benchmark refinancing rate (currently sitting at 0%) until at least September 2019. The ECB also has no plans to start shrinking its balance sheet any time soon, unlike the Fed, which is in the process of allowing up to $50 billion per month of its QE assets to mature without reinvesting the proceeds.

Beyond the strength of the US economy, the global economy remains in pretty good shape, with real GDP growth expected to be above trend again this year (the consensus forecast seems to be in the 3.5%–4% range). However, last year's highly synchronized growth has decelerated and may have peaked for this cycle. This loss of momentum can be seen in measures such as the Citigroup Economic Surprise Indexes, which early in the year dropped sharply into negative territory for the eurozone, Japan, and the United Kingdom. The US economy's stronger relative growth along with a further widening of the yield gap between US and foreign bonds (i.e., diverging central bank policies) have been reflected in the rebound in the US dollar, described earlier.



Source: Bloomberg. Data as of 6/30/18.

The recent dollar-strength trend may continue for a while as currency momentum can take on a life of its own. But there are fundamental reasons to expect the dollar may weaken looking a bit further out: the prospect of a ballooning US federal budget deficit in the coming years, a large US trade deficit, and the eventual convergence of central bank monetary policies—as other central banks start to raise interest rates, thereby shrinking the yield gap versus the United States. The Trump administration also seems to prefer a weaker dollar.

Regardless, from a portfolio management perspective, we remain tactically agnostic on the dollar—we don't have a high-conviction view relative to the currency markets that we would want to reflect in our portfolios. Instead, we maintain our strategic (long-term) diversified approach of having both dollar and non-dollar exposure—with the latter coming primarily from our foreign and EM stock funds and our exposure to the Templeton Global Bond Fund.

Quarterly Portfolio Performance, Key Drivers, and Positioning Recap

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 and edge is our discipline 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. We try to minimize the harmful impact of "myopic loss aversion" on our investment decision-making that can come from paying too much attention to short-term results. 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 provide the following update on the key drivers of our portfolios' recent quarterly performance.

EQUITIES

All of our globally diversified portfolios have meaningful strategic allocations to developed international and EM stocks. This positioning was beneficial in 2017, as foreign markets outperformed US markets (in dollar terms). But it has been a drag on returns this year, driven by the sharp performance divergence among these markets in the second quarter.

In a nutshell, our key equity market views and positioning remain unchanged. On a tactical (five-year) basis, US stocks are increasingly looking expensive, offering below-average expected returns across the macro scenarios we think are most likely. Put differently, at current prices and valuations we don't believe we are being sufficiently compensated for US stocks' downside risk. On the other hand, foreign and EM stocks currently offer a meaningful expected return premium over US stocks across most scenarios, and at least sufficient (although not table-pounding) absolute returns to compensate us for their shorter-term risks. We clearly are in the latter-stages of a bull market for U.S. stocks.

Please be aware of our plans to reduce U.S. stock exposure, and our current plan is to do so once the U.S. markets return to their January 26 highs. Clients significantly above their target level of equity exposure, may see reductions of 10-15%. Other clients, especially ones closer to their target risk level will see reductions of only 5-10%. Proceeds will be directed to absolute-return-oriented strategies and specialty bond approaches. Although it may be down the road, the ultimate conclusion to the current cycle will be a bear market, and it will likely unfold in advance of an economic recession, which is likely to be caused by central bank policy tightening or some unexpected macro or policy shock. We will maintain our current level of exposure to both foreign and EM stocks.

FIXED-INCOME

Our balanced portfolios have a large allocation to actively specialty bond funds and these funds contributed positively to quarterly portfolio returns and outperformed the core investment-grade bond index, as has been the case over the past several years. We expect our fixed income strategy will outperform over the next several years, particularly if interest rates continue to rise. As previously noted, the performance of our actively managed core investment-grade fund (Dodge & Cox Income) was modestly better than the index for the quarter. We hold core bond funds largely as risk mitigators in the event of recession or some other shorter-term "risk-off" scenario. These funds, particularly Dodge & Cox Income have also outperformed their index over longer-term holding periods.

ALTERNATIVE INVESTMENTS

We hold modest levels of liquid alternative strategies funds that we believe improve our balanced portfolios' long-term risk-adjusted return potential. These strategies have different risk and return drivers from traditional stock and bond funds. We find these alternatives particularly attractive from a tactical perspective, given our current expectation of relatively low returns for US stocks and core bonds. In the second quarter, the performance of these alternatives was modestly additive to our portfolios, as our lower-risk arbitrage strategy funds produced modest gains, outperforming core bonds and foreign stock markets but trailing US stocks.

Concluding Comments

As I write this commentary, fears of a global trade war are rattling the financial markets. The resolution of the current trade tensions is a meaningful uncertainty (a "known unknown"), with the potential to seriously disrupt the global economy at least over the shorter to medium term. (The potential for a positive surprise also exists.) President Trump's unconventional negotiating approach adds an additional wildcard dimension. The process is likely prone to several more twists and turns before things become any clearer. (For a recent example: how many experts predicted the 180-degree flip this year in the relationship between President Trump and North Korea's dictator—from name-calling and nuclear threats to grinning BFFs?) The bottom line is that nobody knows how it will all play out.

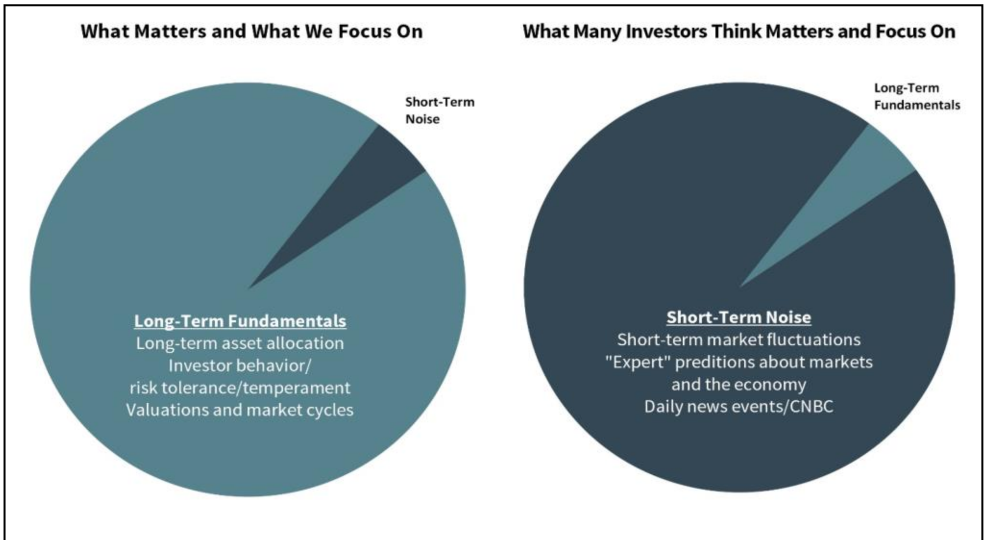
It is in the best interest of both the United States and China to negotiate a resolution and prevent trade skirmishes from becoming an all-out trade war. However, the potential for a severely negative shorter-term shock to the global economy and risk assets (not just emerging markets) can't be dismissed. Even absent an actual trade war, the negative impact on business and consumer confidence from the uncertainty and fear of a trade war is a risk in itself.

Therefore, we file this under the heading: "There are *always* risks and uncertainties when investing in equities that have the potential to cause significant shorter-term price declines." Whether it is a trade war, a geopolitical event, an unexpected economic shock, a monetary policy mistake, or innumerable other factors, stocks can deliver big losses, at least over shorter-term (one- to three-year) periods. Market corrections and bear markets happen. An investor must be able to withstand these drops, stay the course, and stick to their long-term plan (assuming it was well-designed and aligned with their financial objectives to begin with, and we feel our portfolios are in-sync with client objectives).

We do our best to reposition assets at the margin in order to more fully participate on the upside and protect on the downside, but this is clearly not an exact science. No one can consistently and accurately predict the timing, outcome, and market reactions of these types of macro/geopolitical uncertainties. A corollary, therefore, is that people who try to do so, and do so aggressively are very likely to detract more value than they add over time. They're more likely to get whipsawed by the daily news headlines and changing "expert" opinions amid market ups and downs. While they may feel better in the moment of their action, they end up with a worse outcome than if they had remained disciplined in their investment approach. We believe it is far better to stick with one's long-term strategic asset allocation (with disciplined rebalancing). Or, to only make portfolio changes away from your strategic allocation when you have high confidence (based on strong evidence and analysis) that you have an edge. This is possible if you understand what the market is discounting in current prices, why you think the market is wrong, and why the odds are stacked in your favor that you are likely to ultimately be proven right. Even then, of course, there is no guarantee you will be right every time. In fact, it is guaranteed you *won't* be right every time. That's why portfolio diversification, scenario analysis, and risk management are also critical elements.

As mentioned earlier, one of the key elements of the edge we think Virginia Capital Strategies brings to the table is "time arbitrage"—our willingness and ability to take a longer-term analytical view and maintain a longer-term investment horizon than other market participants. We don't have to respond to all the short-term market noise, and we don't play the short-term trading (guessing) game.

We borrowed the following visual representation from the "Behavioural Investment" blog, written by Joe Wiggins. It illustrates how what most investors spend time on doesn't really matter and can often cause them to act in ways detrimental to their long-term investment goals. We try to focus on the things that do matter most, such as asset allocation, investor behavior and risk tolerance, valuations, and market cycles.



Based on a concept by Joe Wiggins, featured in the "Behavioural Investment" blog.

Our globally diversified portfolios are positioned to perform well over the long term and to be resilient across a range of potential scenarios. Should the current trade tensions get resolved, and the global economic recovery continues, we expect to generate good overall returns, with outperformance from our foreign and EM equities positions, active equity managers, and flexible bond funds. Alternatively, should a bear market strike, our portfolios will have "dry powder" in the form of lower-risk fixed-income and alternative investments that should hold up much better than equities. We'd then expect to put this capital to work more aggressively by, for example, reallocating to US equities at lower prices and higher expected returns sufficient to compensate us for their risks.

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

Sincerely,

Stephen J. Bowery, CFA, CFP