INDEPENDENT WEALTH MANAGEMENT

# Market & Economic Review

IWM

A Quarterly Publication | Historical Perspectives | 2nd Quarter 2016

## 2Q16 Benchmark Returns

| | 2Q | YTD |
|---|---|---|
| **Equities** | | |
| S&P 500 Total Return Index | 2.5% | 3.8% |
| Russell Index 1000 w/Dividend | 2.5% | 3.7% |
| Russell Index 2000 w/Dividend | 3.8% | 2.2% |
| Russell Index 3000 w/Dividend | 2.6% | 3.6% |
| MSCI Developed EAFE (USD) | -2.6% | -6.3% |
| MSCI Emerging Markets (USD) | -0.3% | 5.0% |
| **Alternatives** | | |
| Credit Suisse Hedge Fund Index | 0.7% | -1.5% |
| DJ Wilshire Global REIT Index | 3.0% | 8.2% |
| Credit Suisse Hedge Mgd Fut Index | -6.1% | -2.1% |
| S&P GSSI Natural Resources Index | 12.5% | 19.6% |
| Barclays High Yield Bond Index | 5.5% | 9.1% |
| **Fixed Income** | | |
| 90 Day Treasury Bill | 0.1% | 0.1% |
| Barclays Muni Bond Index | 2.6% | 4.3% |
| Barclays Aggregate Bond Index | 2.2% | 5.3% |
| Barclays Global Bond Index | 4.8% | 14.1% |

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## Second Quarter / Key Takeaways

**U.S. markets were initially range-bound for most of the quarter until June, when the relative calm in global stock markets came to an abrupt end. Upending most forecasts and taking world financial markets by surprise, the United Kingdom voted to leave the European Union on June 23. In the wake of the vote, British pound sterling fell 11% overnight against the U.S. dollar, its lowest level since 1985. The euro fell 2.4% to 1.10 versus the dollar. Global equities plummeted.**

**Then in the week following Britain's historic vote, global equities rallied, despite still significant uncertainty regarding the economic, political, and financial market implications of Brexit. When the dust had settled, developed international and European stocks remained in the red, while U.S. stocks edged into positive territory. The big winners in the quarter were emerging-markets stocks, which gained 4.9% and are now up 8.6% year to date.**

**Before the Brexit vote, the big story in financial markets had been bonds, specifically negative yields on government bonds across the globe. By month's end, the amount of government debt sporting negative yields had soared by nearly $1 trillion. Falling yields have been driven by economic growth concerns; central banks' interest rate policies and intervention in bond markets; and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact.**

**It is not expected that there will be a sharp rise in interest rates any time soon. At such low starting yields, expected returns for core bonds are extremely low. Investors are earning very little (or actually paying via negative yields) for the safety of holding government bonds.**

**The quarter's market upheaval was yet another reminder that successful investing requires patience and the understanding that investing is part of a process, not a one-off decision, toward achieving your long-term financial goals. There will be inevitable and unpredictable shorter-term market ups and downs along the way, and through these periods, it is our job to remain focused on the long-term objectives of our clients, maintaining a consistent investment discipline to guide our decisions over time.**

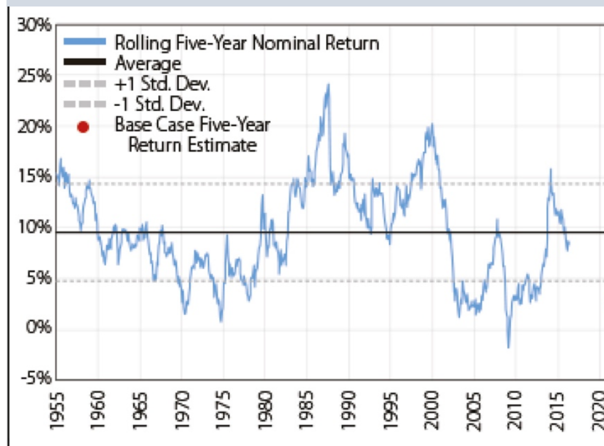
## Second Quarter 2016 Investment Commentary:

### Ahead—Projected Lower Returns and Volatile Markets will Challenge Investors' Convictions and Emotions

No matter how you slice it, looking out over the next five years, the return prospects are poor for both stocks and bonds. Below is an analysis by one of our favorite research sources and the source for a

lot of this newsletter, Littman Gregory, of the returns, both past and their projected future, of a hypothetical portfolio split 60/40 between stocks and bonds.

**Rolling Five-Year Nominal Returns for the Traditional 60/40 Portfolio**




Source: Morningstar Direct. Data as of 5/31/2016.

*We looked at rolling five-year annualized nominal returns for the traditional 60/40 portfolio (60% S&P 500 index and 40% core bond index), starting in 1950. We assumed annual rebalancing back to the 60/40 weights. Over that period, the average annual return was 9.5%. As shown in the chart, our base case return estimate for the 60/40 of roughly 2.5%–3% is derived from our current estimate of roughly a 4% return for the S&P 500 and a 1% return for core bonds over the next five years. Yet, looking at the history, a 3% annualized five-year return would be among the worst historical returns for the 60/40 portfolio. Of the 738 rolling five-year periods since 1950, only 67 have had a return less than 3%. The results are much the same on a "real return" (net of inflation) basis.*

*Assuming our return expectations play out, investors in a traditional 60/40 portfolio will barely stay ahead of inflation. And they will earn around 6.5% less per year than the historical average 60/40 return, or 37% less cumulatively over the entire five years.*

*The historical data also show the 60/40 portfolio has generated above-average returns over the past several years. A key driver has been the impact of quantitative easing (purchases of government debt in an effort to add liquidity to bond markets) and other aggressive central bank policies, which have helped push down interest rates. This has meant higher bond prices and capital appreciation for the core bond index in addition to its paltry income yield.*

*Central bank policies also contributed to the meaningful increase in stock market valuations. In more recent years, a significant majority of the S&P 500's return has come from P/E multiple expansion rather than earnings growth. For the five years ending March 31, 2016, the S&P 500 gained 73%, but 46 percentage points of that total return came from P/E expansion.*

*The 12-month trailing P/E of the S&P 500 is currently around 23x, compared to its median since 1950 of roughly 17x. As long as interest rates remain at extremely low levels, P/E multiples may remain higher than normal. If current interest rate levels are not sustainable, then it is likely the valuation multiple will drop toward more normal historical levels.*

## Yes, Stocks Should Still Return More Than Core Bonds… —So What?

While we have subpar return expectations for stocks, we do believe they are likely to generate higher returns than core bonds over the medium to long-term (i.e. 5+ years) (absent a deflation/depression scenario). However, stocks have *significantly* higher volatility, higher downside risk, and greater risk of permanent capital loss than core bonds. You should *always* be compensated with a higher expected return from stocks.

In addition to the *relative* return premium you should get from owning stocks versus core bonds, we also believe there is a minimum *absolute* equity return in order to fully compensate for equity risk and be "fully allocated" to equities.

## Putting It All Together

Projected lower returns and volatile markets, which we also expect, will likely challenge investors' convictions and emotions. We encourage investors to remaining focused on the *long-term* objective, maintaining a consistent investment discipline. Investors should be managing risk while taking advantage of the investment opportunities created by other market participants' *lack* of discipline, patience, and flexibility.

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