INDEPENDENT WEALTH MANAGEMENT

Market & Economic Review

IWM

A Quarterly Publication | Historical Perspectives | 4th Quarter 2016

4Q16 Benchmark Returns

	4Q	YTD
Equities		
S&P 500 Total Return Index	3.8%	12.0%
Russell Index 1000 w/Dividend	3.8%	12.1%
Russell Index 2000 w/Dividend	8.8%	21.3%
Russell Index 3000 w/Dividend	4.2%	12.7%
MSCI Developed EAFE (USD)	-1.0%	-1.9%
MSCI Emerging Markets (USD)	-4.6%	8.6%
Alternatives		
Credit Suisse Hedge Fund Index	0.2%	0.3%
DJ Wilshire Global REIT Index	-5.2%	1.5%
Credit Suisse Hedge Mgd Fut Index	-5.8%	-7.0%
S&P GSSI Natural Resources Index	5.0%	30.9%
Barclays High Yield Bond Index	1.8%	17.1%
Fixed Income		
90 Day Treasury Bill	0.1%	0.%
Barclays Muni Bond Index	-3.6%	0.2%
Barclays Aggregate Bond Index	-3.0%	2.6%
Barclays Global Bond Index	-11.3%	1.9%

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Fourth Quarter / Key Takeaways

Global stocks performed well both in absolute terms and relative to core bonds this year, with U.S. stocks again taking the lead.

Emerging-market stocks were also strong performers, gaining 12.2% for the year. Developed international stocks were the big laggards. They returned just 2.7% in U.S.-dollar terms.

For the year, core bonds produced a 2.5% gain. Investment-grade municipal bond returns were slightly negative on the year.

While 2016 wound up being a poor year for Treasurys and core bonds, it was a good year for riskier fixed-income sectors.

Year-End 2016 Investment Commentary:

Forecast: Expect the Unexpected, Prepare to be Surprised

U.S. Stocks: Large-cap stocks gained 11.8% and small-cap stocks surged 21.6%. This marked the eighth straight year the large-cap S&P 500 Index had a positive return. While streaks of this length have occurred twice before, the market has never had a nine-year winning streak.

European Stocks: European stocks did worse, falling 0.4% in dollar terms, although they gained 7.2% in local-currency terms. For the third straight year, dollar appreciation was a drag on European stock returns.

Currencies: The major currency decliner was the British pound. It plunged 16% versus the U.S. dollar, triggered by June's Brexit vote. The euro fell 3% on the year. Overall, the U.S. dollar index rose around 4% against a basket of developed-market currencies.

Developed International Stocks: This marked the fourth straight calendar year and the sixth in the past seven that the S&P 500 beat the global ex-U.S. index. Since 2008, this is one of the longest stretches of U.S. outperformance on record. U.S. stocks also meaningfully outperformed European stocks.

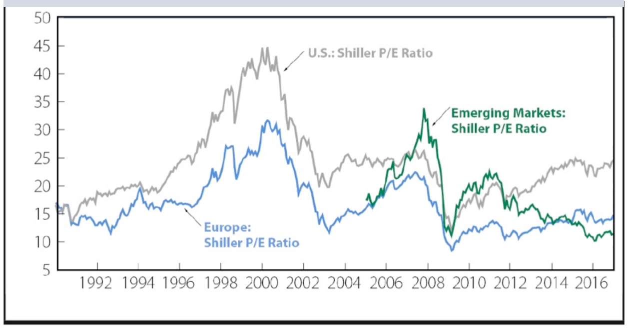
Emerging-Market Stocks: Emerging-market stocks rebounded in 2016. Through the end of October, emerging-market stocks were up 18% on the year (versus larger-cap U.S. stocks' 6% rise), though they did give back some gains following the presidential election.

Fixed-Income Securities: Though core bond prices got off to a strong start with the 10-year Treasury yield dropping to an all-time low of 1.37% in early July, yields then reversed course, rising to 2.5% by year-end. In the fourth quarter, the core bond index fell 3.2%—its worst quarterly performance *in 35 years*—due to rising interest rates. Fixed-income sectors with more credit risk (and less interest rate risk), such as high-yield bonds and floating-rate loans, performed very strongly, gaining 17.5% and 10.2%, respectively.

Why Do We Still Own Foreign Stocks?

Since the end of 2009, the S&P 500 has returned a cumulative 131%. In contrast, developed international stocks have gained 32% and emerging-market stocks a measly 1.3% in dollar terms. Because of their globally diversified long-term equity allocation, portfolios have lagged compared to a purely U.S. stock portfolio. While foreign stocks' underperformance is trying, we continue to believe in maintaining allocations to foreign stocks *particularly* after this prolonged period of underperformance.

European and Emerging-Market Stocks Remain Cheap Relative to U.S. Stocks



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We believe that investors are reasonably compensated for equity risk in Europe and emerging markets. However, U.S. stocks appear overvalued, with a lot of optimism baked into current prices. Potentially, this makes them particularly vulnerable to a negative surprise. History tells us that *high starting-point valuations are a strong predictor of low future returns* over a five-to-10-plus-year horizon.

News flow regarding political uncertainties from rising nationalism in Europe and related economic/breakup risks facing the eurozone, or the negative ramifications for emerging markets of China's huge public debt build-up (to name a few big ones), has contributed to their poor stock market performance in recent years. With investors discounting lots of risks and bad news, the news must only be "less bad" for sentiment and stock prices to improve. That typically happens when the market least expects it.

As Warren Buffett wonderfully and concisely put it, "A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful." Much easier said than done.

Looking Ahead to 2017

Expert predictions of the future are usually no better than guesses. When it comes to economies and financial markets, there are way too many complex, adaptive, and interactive variables—most of which are consistently unpredictable—to confidently forecast outcomes, at least over the shorter term.

Even if one could know in advance the outcome of many of the important individual variables (such as election results, central bank policy decisions, and currency movements), one would still be likely to make many inaccurate *market* forecasts. For example, how many experts would have predicted gold would drop and stock markets would rally in the days and weeks after an unexpected Donald Trump election victory?

We don't bother guessing what financial markets will do next year. An important part of our portfolio risk management process *does* analyze the impact of 12-month stress-test scenarios. But those are neither forecasts nor predictions. If we had to make a forecast for next year, or any year, it would be this: Expect the unexpected. Prepare to be surprised. Stock markets will be volatile; they will go up and down—*probably a lot*. Our analysis leads us to stay the course, maintaining a focus on our investment discipline, as opposed to trying to forecast economic or political outcomes, which we believe are inherently unpredictable.

As always, we thank you for your continued trust and confidence as we work together to achieve your financial goals.

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