rebalance IRA

Market Review

Winter 2016

There's no doubt about it. Since last fall, the financial markets have gone from calm to nervous, and then to outright jumpy. As portfolios have steadily risen for the last six years, market watchers have wondered when the music would stop. Finally, in 2015, diversified portfolios clocked small single digit losses, followed by a 9% decline in global markets the first two weeks of 2016, echoing the dark days of the financial crisis. The "fear" or volatility index, which measures the price of buying downside protection on stocks, jumped 33% from its 4-year average as 2016 began. And the speed of the 2016 decline once again proves that it is impossible to consistently predict drops or rises in the stock market; they happen too fast, and usually from surprising catalysts.

Falling oil prices are today's catalyst, driving fear into almost every asset class. While cheaper oil saves everyday Americans money on gas and airline tickets, other economic players suffer. Lower oil prices translate into lower revenue for smaller oil producers, who then incur a higher risk of default on their bonds, roiling the overall high yield bond market. Banks and financial institutions that have lent into the energy sector are under increased scrutiny from investors.

Then there is China, a massive economy in the midst of dramatic change. For the last 25 years, exports and highway and skyscraper construction drove China's growth. Now China will shift to a more "first-world" economy based upon consumer products and services sold to a growing middle class. That means less demand for oil. Then, add more oil supply from the lifting of sanctions to Iran and voilà, oil has gone from too much demand and not enough supply, to the opposite.

If China and falling oil prices weren't enough, the Fed intensified these dynamics by raising interest rates for the first time in almost a decade, moving the patient (the U.S. economy) off the pain-killers and giving her withdrawal pains in the process.

Against this backdrop, the **Rebalance IRA** Investment Committee conducted its 2016 winter meeting in New York in mid-January. We carefully reviewed these factors in the context of our clients' long-term retirement portfolios and unanimously decided that no changes were necessary.

"How could that be?" you might ask. *"Certainly you should be doing something, based upon these macro conditions. Everyone else seems to be frantically buying and selling. Shouldn't we sell, let this pass and then get back in?"*

Our answer, for our retirement investor client base, is an emphatic but highly informed '*no.*' Decades of financial research supports this position.

Here is a metaphor that might be helpful–you probably own a home in a great neighborhood where you plan to live for at least 5 more years. You probably notice recent sales in your neighborhood, but only casually. If you owned the home during 2008, your home likely decreased in value. That didn't feel great, but you didn't do anything about it because you needed a place to live and it was home. You didn't feel that you lost money in 2008, and recently, as home prices have risen, you probably didn't feel that you *made it back*.

Assuming that your home is well located with no imminent threats to its long-term value, you will stay in your home and enjoy it. You will feel little or no emotion about your home's value, because you have no plans to move. Unlike your stock portfolio, your home's value is not valued every day. There are no national headlines on 24-hour news channels saying: "Homes in Carmel, Indiana, down 0.4% today on light trading."

But, for the homebuilder who is building a spec home down the street, it is very different. He bought the land and is risking money to build a home that hopefully someone will want to purchase. He pays close attention to neighborhood sales because a sudden decline in home values could wipe out his profits. Should a sudden decline occur, he might *have to do something*. It would be rational.

Institutional stock market traders who are "doing something" now have salaries and jobs dependent upon how well their portfolios perform this month or quarter. They have the disadvantage of the short-view. And that requires action in market meltdowns.

Rebalance IRA clients do not have such a handicap. Knowing that we cannot control the stock market, our clients' portfolios are highly diversified, "all-weather vehicle" retirement portfolios built in anticipation

of today's market storms; built to both recover and grow. We are experts in the complexities of how to "diversify" a retirement portfolio for you, our clients.

As **Rebalance IRA** Investment Committee member Professor Burton Malkiel said in his *Wall Street Journal* op-ed, December 30, 2015:

> *"Broad diversification remains the surest method to minimize investment risks. This means that U.S. investors need to overcome their home-country bias and put money into international securities. Domestic markets often behave differently than international ones, and broad equity portfolios tend to be more stable over time than narrow ones. Fixed-income securities ... need to be included to anchor your portfolio despite their low current yields. And real-estate returns, which have historically experienced close to a zero correlation with bond returns, provide excellent diversification."*

The positive news is this: downdrafts give those saving for retirement an opportunity to add to their portfolios at lower prices. Those in retirement can easily withdraw in a disciplined way, in small amounts and rebalance their portfolios in the process.

The **Rebalance IRA** Investment Committee works with two broad asset classes for the basic building blocks of our clients' retirement portfolios: Growth and Income. During 2015, these asset classes performed as follows:

Growth Asset Classes*	Q1 2015 Returns	Q2 2015 Returns	Q3 2015 Returns	Q4 2015 Returns	2015 Returns
U.S. Total Market (VTI)	1.7%	0.2%	-7.9%	6.0%	**0.4%**
U.S. Small Cap (IJR)	3.5%	0.5%	-9.7%	4.2%	**-1.4%**
Emerging Markets (VWO)	2.3%	1.0%	-17.9%	-1.0%	**-14.8%**
Foreign Developed (VEA)	5.6%	0.8%	-10.3%	3.4%	**0.1%**
International Small Cap (VSS)	4.2%	3.4%	-10.7%	3.4%	**-0.1%**
U.S. Real Estate (VNQ)	4.7%	-10.5%	0.5%	6.5%	**0.9%**

Income Asset Classes*	Q1 2015 Returns	Q2 2015 Returns	Q3 2015 Returns	Q4 2015 Returns	2015 Returns
High-Yield Dividend Equities (VYM)	0.0%	-0.6%	-6.8%	7.6%	**0.3%**
US Corporate Bonds (VCIT)	2.4%	-2.0%	1.3%	-0.6%	**0.3%**
High-Yield Corporate Bonds (HYG)	2.0%	-0.7%	-5.0%	-0.7%	**-5.0%**
Emerging Market Bonds (EMB)	2.9%	-0.9%	-2.4%	1.5%	**1.4%**

*Returns displayed representing the major asset classes of **Rebalance IRA** portfolios include dividends as measured using the ETFs shown in parenthesis.

Growth Asset Classes

U.S. Stocks. U.S. equities held steady for most of 2015, correcting sharply at the end of the summer before recovering and holding its ground until nearly the last trading days of the year. This winter's correction has been similar in scope to the earlier, late summer declines and linked primarily to uncertainty over China and a long-awaited, if small, rise in U.S. benchmark interest rates. Both of these factors, however, are transitory events against a backdrop of greatly improved employment and steady, if slow, U.S. economic growth.

The attractiveness of the U.S. economy has also led to higher valuations on stocks. A useful metric to assess valuations is the cyclically adjusted price-earnings multiple (CAPE). As of the end of 2015, CAPE stands at over 26 for the U.S. market, well above its long-run average. The CAPE is 20 for Japan, 15 for Europe and under 10 for emerging markets, below their long-run averages.

Small-cap stocks. Smaller company stocks enjoyed a solid fourth quarter in 2015, rebounding from the weaker previous quarter. Over the long periods of typical retirement plans, small-cap stocks have better growth characteristics compared to large firms. The great companies of today – yes, Apple – were all small-cap stocks many years ago. The price of that performance, however, is less predictable, quarter-by-quarter, results. Owning these companies through an index fund is the key to reducing risk; since no one knows which of hundreds of small firms will prosper, a broad investment in the "biggest of the small" through an index fund provides our clients with a solid portfolio return.

Real Estate Stocks. Owning real estate in a retirement portfolio once again proved prescient, giving our clients a shot of strength in a generally slower quarter for traditional growth assets, stocks. Being able to counterbalance stock performance is a feature of portfolio investing. Adding to growth by

outpacing stocks is an even better outcome, which was the experience of **Rebalance IRA** clients in the final quarter of the year.

Large European, Japanese & Asian Stocks. Foreign large-company stocks rescued themselves from weaker mid-year numbers due to overall better corporate earnings, coupled with a sense of having turned the corner on several dark years of malaise over lingering public debts. Beginning in 2016, Europe had a decline in investor confidence, rooted in short-term thinking. We rely on broad index funds precisely in order to avoid participating in such reactionary trading activity.

Emerging Market Stocks. Led downward by a slowing China, emerging market and international small-cap stocks were the biggest decliners among **Rebalance IRA** retirement portfolio holdings in 2015. Young, growing populations represent an opportunity to buy the world's future growth at a discount, giving our client portfolios added return with relatively modest increased risk. The price of that growth is volatility, as nervous traders pulled back at the first sign of trouble.

The ripple effect of China's painful transition from export economy to consumer economy could be felt for some time to come, but we remain engaged in this sector because of its long-term promise: faster growth compared to developed markets, better portfolio returns, and today, historically depressed prices.

Income Asset Class

The broad bond market, as measured by the Barclays Aggregate Bond Index, steadily lost ground in 2015, yet our client portfolio holdings generally held up, with the notable exception of high-yield corporate debt. Positions in dividend stocks and emerging market debt, however, worked to offset what many observers saw as an emotional overselling of corporate bonds, a perfect example of how owning a portfolio reduces overall investment volatility.

U.S. Corporate Bonds. After many quarters of taking advantage of extraordinarily low interest rates to refinance debt and clean up balance sheets, the tide finally turned for corporate borrowers. Seven years of nearly free money did what it was supposed to do — give breathing room to strapped companies. But, as with all good things, it had to come to an end. The Federal Reserve's long-telegraphed path towards higher interest rates finally started in earnest, catching some investors off guard. We repositioned away from Treasuries in 2014 and into high-grade corporate bonds, giving our clients a hedge against rising interest rates. Thus, this asset class rose slightly in 2015.

High Yield Dividend Equities. Owning dividend-paying stocks once again paid off as investors fled parts of the market deemed "risky" and parked cash in dividend stocks during the final quarter

of 2015. Being stocks, they took a hit at the beginning of the year, but the declines were modest in comparison to all stocks and their ongoing dividend income is reinvested, rebalanced or taken by **Rebalance IRA** investors seeking income. Our Investment Committee continues to view high-yield dividend stocks as a prudent risk-management tool and a good income asset class for retirement investors.

Emerging Market Bonds. As corporate lenders took it on the chin, emerging market debt rose sharply in the quarter, solid evidence of the power of diversification. As the world turns toward higher interest rates, led by the U.S. Federal Reserve, the rising cost of debt means increased interest in owning bonds issued by smaller economies around the world.

High-Yield Corporate Bonds. The end of the year was full of headlines warning of a "bubble" in the junk bond market. Naturally, that led to some selling and a self-fulfilling prophecy of sorts. A more sober view of the problem is that energy companies got hit by the global decline in oil prices, leading investors to reevaluate the ability of those companies to borrow sustainably. The **Rebalance IRA** Investment Committee has reviewed the index fund for this asset class, HYG, and remains satisfied with the position here. High-yield corporate bonds remain a powerful diversifier in the fixed-income portion of our clients' portfolios.

The Rebalance IRA Investment Process

Rebalance IRA portfolios are diversified into thousands of stocks and bonds in the United States and over 45 foreign countries. Market cycles will continue. Research going back decades, much of it done by members of the **Rebalance IRA** Investment Committee, shows that using those cycles in a prudent manner is the most effective long-term strategy for retirement investing.

By systematically rebalancing our clients' portfolios, we are able to take advantage of market gyrations. Trimming what has gotten rich, and adding to what has soured, enables us to take advantage of market ups and downs, rather than becoming paralyzed by it. **Rebalance IRA** proprietary portfolios rely on multiple ways to deliver returns to our clients that are commensurate with the risk taken.

The **Rebalance IRA** Investment Committee has created a vigilant and disciplined rebalancing process that assures that our client portfolios are managed using the best practices of sophisticated endowments and pension funds. We will alert you when we are about to trim winning asset classes, and buy more of the losing asset classes, so that you can better understand how we are managing your money.

Your portfolio is premised on the dialogue that we have with you to understand your situation, risk tolerance and liquidity needs. Our goal: to help you reach your retirement investing goals with the lowest assumed risk possible.

We value your trust and look forward to many years of prudent and profitable investing. And, if at any time you would like to talk, please feel free to send us an email or give us a phone call.

Very truly yours,

Your **Rebalance IRA** Team

The Rebalance IRA Investment Committee

Burton Malkiel, Charles Ellis and Jay Vivian comprise the **Rebalance IRA** Investment Committee. They are renowned for creating and implementing sophisticated investment methods used today by elite pensions and endowments. The Investment Committee actively develops, oversees and sets policies for the portfolios offered to **Rebalance IRA** clients. Their core ideas include diversification across multiple types of assets on a global basis and disciplined portfolio rebalancing. They also advocate techniques for keeping investment fees low.

Professor Malkiel is an emeritus Princeton University economics professor, a former board member of The Vanguard Group, and the author of the investment classic *A Random Walk Down Wall Street*.

Dr. Ellis was for three decades the managing partner of Greenwich Associates, the leading investment advisor to large pools of institutional capital around the world. He was Chairman of the Investment Committee of the famed Yale Endowment, and he has served on the governing boards of The Vanguard Group, Yale, Harvard, NYU Stern, Exeter, the Whitehead Institute, and the Robert Wood Johnson Foundation.

Jay Vivian is the former Managing Director of the IBM Retirement Funds, responsible for over $100 billion in IBM investment funds for more than 400,000 employees worldwide.