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Market Review

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Rebalance IRA's Chief Investment Officer, Mitch Tuchman, along with Sally Brandon, Vice President of Client Services, present the Fall 2016 *Market Review Conference Call*. Listen In!

Fall 2016

Steady Investing in a Chaotic Political Year

One of our clients called in early September and said, *"If Donald Trump is elected, sell my entire portfolio. I'm going to wait until things settle out and then I'll tell you when to get back in."* Of course, we attempted to convince him not to try and time the market based upon his "gut feel." We directed him to Professor Burt Malkiel's video warning against market timing and to our recent MarketWatch article demonstrating that, historically, there is little correlation between who wins the presidential election and short-term stock market performance. Hopefully, this client will stay the course through this election and resist the temptation to respond to admittedly nerve-wracking political events.

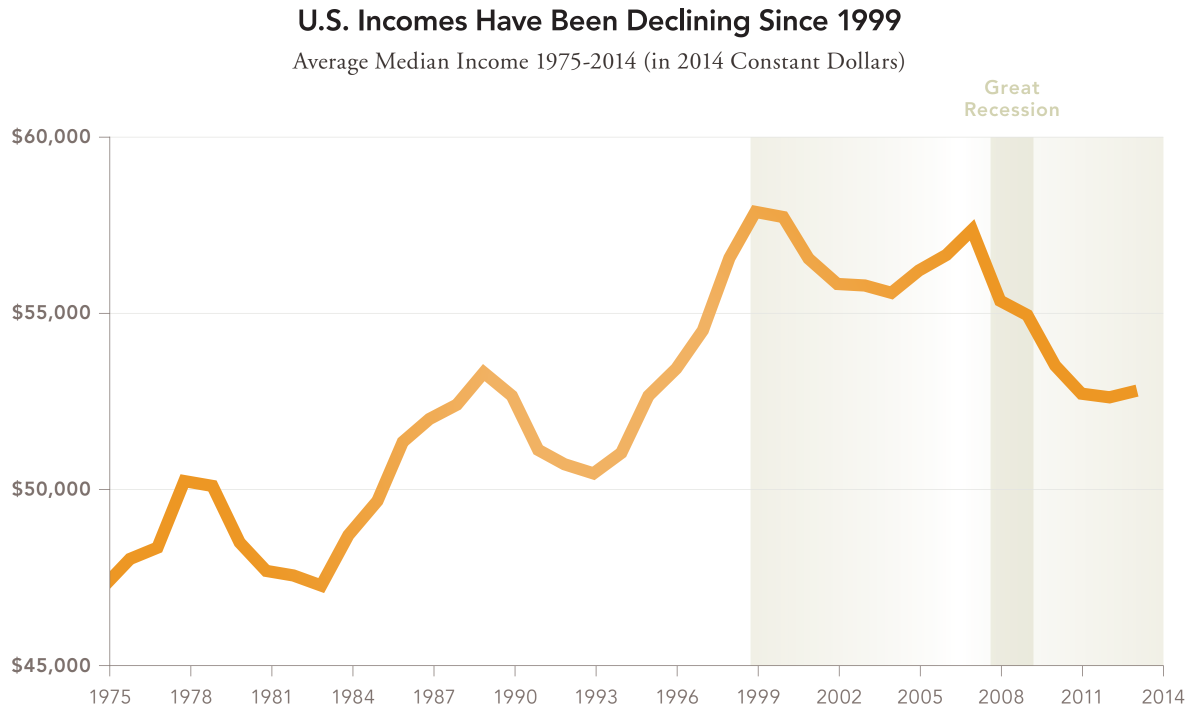
Given that we are in a significant election cycle, we wanted to share what is important in our view for retirement investors, namely, growth in U.S. corporate earnings, growth which in turn drives stock market returns for you, our clients. Higher returns mean more compounding of your investments and more money for your retirement.

When it comes to your retirement investments, history suggests that the profound decision of Clinton vs. Trump will not effect long-term stock market returns. Rather, we are concerned with how the eventual winner will tackle the issues at the heart of our country's economic problems, which is that U.S. growth has slowed. There is no better way to frame our concerns than to summarize what Harvard professors Michael Porter, Jan Rivkin and Mihir Desai wrote in a September 2016 report titled "Problems Unsolved and a Nation Divided."

The authors attribute American uncertainty to "divisive and partisan" dialogue, which "has confused the public on many issues." The study points out that the candidates' "solutions offered are emotionally appealing but simplistic and deeply misguided." Their primary message is: "The nation's political system has now become America's greatest competitive weakness, and that the situation continues to deteriorate."

The lengthy study goes on to detail three key issues:

1. Incomes have been falling since 1999. America's ability to compete globally has been on the decline for 16 years and is the main reason for our sluggish economic performance since 2008. The link between prosperity and productivity is often misunderstood. "Productivity" simply means that if you can do more in the same amount of time (make more widgets, serve more meals, help more patients), you make more money. When America's productivity rises, so do our salaries, the value of our companies, the stock market, and our nation's prosperity. Americans have prospered from rising productivity for decades; we have continually figured out how to produce more with less. But since 1999, U.S. productivity has declined, and thus so have incomes. When incomes decline, there is more pressure on the political system. severe market downturns, have always been positive. In fact, there has never been a five-year period during the last 65 years where a balanced portfolio has lost money. So, while "think long term" may be a cliché, the evidence demonstrates that even after tough times the stock markets have found their way to positive returns irrespective of random events.



2. Prosperity must be shared. The study's second point is that the right strategy for the United States must include "shared prosperity," a model where everyone benefits. Incomes have fallen overall, yet the top income brackets have grown while those in the lower- and middle-income brackets have suffered disproportionate declines. This dynamic has afflicted business as well. Large corporations have grown while smaller businesses have not, and the number of small business formations has declined.

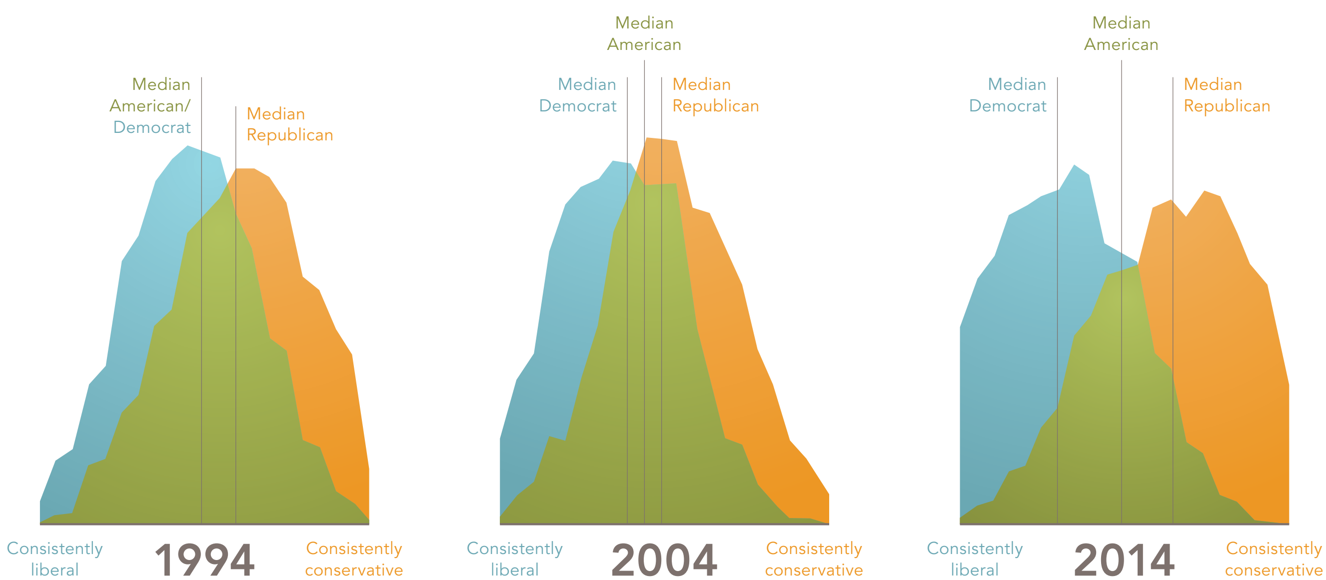
The professors note:

> "The lack of shared prosperity in America has become a major economic, social, and political challenge. More importantly, it endangers our nation's unity and security, and it compromises a longstanding bedrock promise of America."

As income growth between the wealthy and the lower and middle classes has diverged, so has American political life. Gallup's party affiliation poll finds that the percentage of Americans who identify themselves as Independents has grown from 27% in 2004 to 42% today, making unaffiliated voters the largest group, overtaking both the Democrats and Republicans in size.

3. A dysfunctional political system is America's most important problem — socially and economically. In 2012, the professors outlined an eight-point bipartisan plan to restore America's world-leading status. Those recommendations include lowering the 39% corporate tax rate, highest among advanced economies; making immigration to the United States easier for highly skilled workers; improving infrastructure; and lowering trade barriers. Several years later, none of these changes has been implemented.

Americans Have Become More Polarized



Distribution of Democrats and Republicans based on 10 political value questions

Why? The study concludes that American leaders simply cannot legislate nor compromise; for the country to prosper our current political system must evolve. The study does not provide more specific answers on how but implies that we must address the way our federal government elects our leaders, how campaigns are financed, and the terms and privileges bestowed upon our lawmakers. Only then can critical structural changes be enacted. Yet a polarized America — one full of blame, hostility, and inability to compromise — is now the fragile "platform" upon which our economy rests.

Observing the dynamics here in America, events such as Brexit in Europe, and the rapid advances being made in India clarifies how critical it is that your **Rebalance IRA** retirement portfolio is invested *globally*. The relative competitiveness of nations changes continually. The combinations of political systems, demographics, tax structures, work ethic, and economic policies are unique to each country.

Will America move past our polarized government and make changes that will help the economy, and if so, how long will that take? How will the younger working-age populations in India and China impact America's ability to compete?

These global forces are impossible to use to predict stock prices over time. That's why the best and safest way to grow wealth and protect your retirement savings is to keep expenses low by using index funds. **Rebalance IRA** clients own stocks in thousands of businesses all over the globe via low-cost index funds, carefully calibrated to be the right asset mix for individual goals.

The **Rebalance IRA** Investment Committee works with two broad asset classes for the basic building blocks of our client's retirement portfolios: Growth and Income. During the second quarter of 2016, these asset classes performed as follows:

Growth Asset Classes*	**Q1 2016 Returns**	**Q2 2016 Returns**	**Q3 2016 Returns**	**Q4 2016 Returns**	**2016 Returns**
U.S. Total Market (VTI)	1.0%	2.7%	3.6%	--	**7.4%**
U.S. Small Cap (IJR)	2.6%	3.8%	6.0%	--	**12.7%**
Emerging Markets (VWO)	5.9%	2.6%	7.4%	--	**16.7%**
Foreign Developed (VEA)	-1.9%	0.0%	5.6%	--	**3.6%**
International Small Cap (VSS)	0.6%	0.6%	6.8%	--	**8.1%**
U.S. Real Estate (VNQ)	6.3%	6.8%	-0.8%	--	**12.6%**

Income Asset Classes*	Q1 2016 Returns	Q2 2016 Returns	Q3 2016 Returns	Q4 2016 Returns	2016 Returns
High-Yield Dividend Equities (VYM)	4.2%	4.4%	1.0%	--	**9.8%**
US Corporate Bonds (VCIT)	3.9%	3.7%	1.1%	--	**9.0%**
High-Yield Corporate Bonds (HYG)	2.4%	5.2%	4.0%	--	**12.0%**
Emerging Market Bonds (EMB)	5.2%	5.6%	2.8%	--	**14.2%**

*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. Investors enjoyed another strong quarter after a weak start to the year. Stock traders seemed to have "priced in" the eventuality of an increase in the U.S. interest rate with little effect on buying. Naturally, many Americans are nervous given this unique presidential election, but as we have said in previous communications, it is rare for politics to have a lasting effect on the underlying strength or weakness of any stock market. A Wells Fargo scandal and a higher than expected court judgment against Deutsche Bank created a mini-panic with financial stocks and concerns of contagion.

Small Cap Stocks. Small companies roared again in the third quarter, putting on 6% to push the year-to-date figure to 12.7%. It is not unusual for small-cap stocks to outpace the larger companies in the stock market. Over the long term, small stocks grow faster than more established firms and thus offer investors better returns. But their volatility adds to risk, so we add higher allocations of this asset class only for investors with long time horizons.

Emerging Market Stocks. This asset class has outrun all others so far in 2016, returning 16.7% year to date and putting on a very strong third quarter after a respectable first-half performance. Political disruption in Brazil seems to have died down, while oil and commodity prices have stabilized, helping Latin America and Russia. China's growth has slowed, but it is still growing steadily at nearly 7% and has stabilized. These economies are growing 3% faster than developed nations and earnings also have stabilized. The U.S. Federal Reserve becoming more dovish on interest rates has boosted these currencies as well, up 3% against the dollar.

Real Estate Stocks. After multiple quarters of great results, real estate stocks in the third quarter took a breather. Overheated condo markets in cities such as New York and Miami and a rollicking rise in home prices in most metros had to slow down at some point. The prospect of an eventual increase in interest rates also cooled investor interest. Nevertheless, an Associated Press analysis found that ordinary investors enjoyed better returns from real estate investment trusts (REITs) than any other investment type over the past 10 years. There is little doubt that investors will continue to rely on real estate in the years to come.

Large European, Japanese & Asian Stocks. Great Britain continued to wrestle with the political and economic implications of the vote to leave the EU, known as "Brexit." Yet nothing has happened concretely with regard to the actual exit process, nor is there any indication that it will happen soon. The perfect storm of unusually low interest rates abroad and falling securities prices thus led to an unsurprising rally in foreign developed-country shares after two uninspiring previous quarters.

Income Asset Class

U.S. Corporate Bonds. Lower inflation expectations led investors to buy longer-dated U.S. government bonds, a trend which in turn put pressure on corporate debt. Institutional investors prefer the security of government bonds and had been using quality corporate bonds as a substitute. While the move away from corporate debt meant a lower return for this portion of our portfolios, it does not signal deterioration in the quality of company-issued bonds.

High Yield Corporate Bonds. Junk bonds notched another solid quarter, while analysts foresee a strengthening year for high-yield debt in 2017 thanks to firming oil prices. Some drilling companies were forced into bankruptcy by the collapse of oil earlier this year, so higher prices for crude should alleviate financing pressure in the oil patch. Retailers are having a hard time dealing with the slow recovery, while some are simply unable to transform their business model to the highly competitive world of online selling.

Emerging Market Bonds. The prospect of rising U.S. interest rates is real, yet investors kept up the hunt for yield abroad. Despite a lackluster third quarter, emerging market bonds led our income portfolio in returns year to date. Our firm's rebalancing process allows **Rebalance IRA** clients to realize the lion's share of those gains while keeping risk at a minimum.

High Yield Dividend Equities. The investment world seems to have joined our Investment Committee's decision to add high-dividend equities as an income substitute, bringing valuations to higher levels. We continue to use this investment class to offset bond risk. But the prospect of a rising

U.S. interest rate by the end of this year has begun to hit dividend-paying stocks. Nevertheless, the Federal Reserve has not taken any kind of action, nor is it the case that dividend stocks are cutting that income flow unilaterally.

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

Burt Malkiel

Charley Ellis

Jay Vivian

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.