Market Review

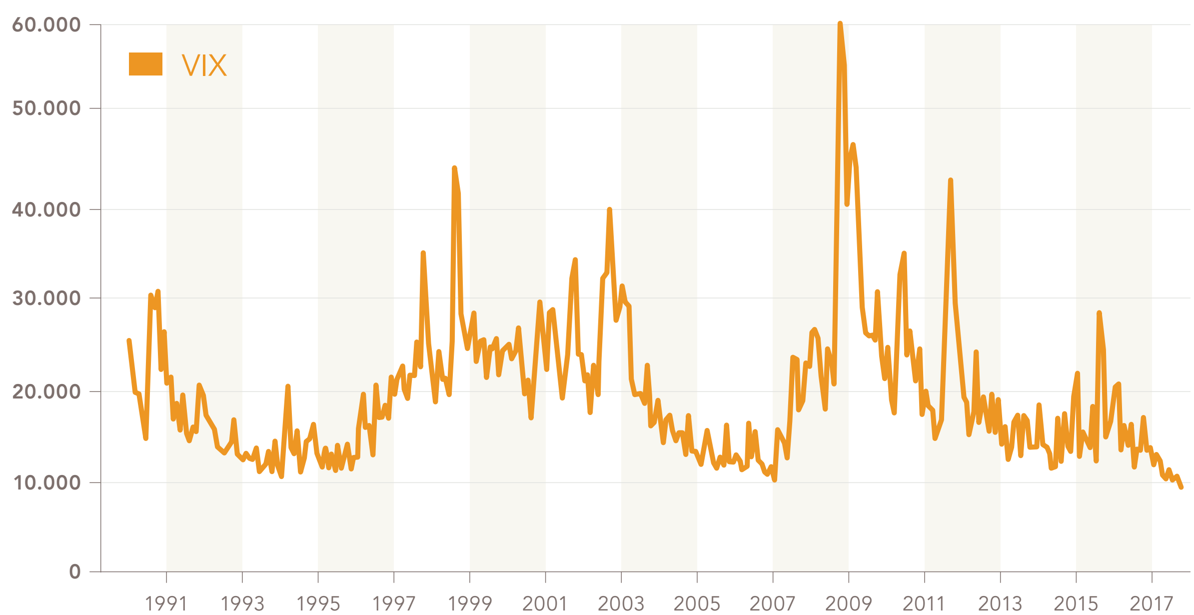
Fall 2017

Staying Safe

Rebalance IRA clients invested in our firm's portfolios over the last two years have enjoyed a great run. Proven back-testing methodology (not actual client accounts), shows that our most widely used **Rebalance IRA** portfolios were up by more than 10% in 2016 and this year (through September 2017) in the 12% to 14% range. Through the end of September, international stocks dramatically outpaced the U.S. stock market, up 22% compared to 14% for domestic shares.

With such a great increase comes concern over a correction — when and how much? Events such as bellicose talk with North Korea, the Trump presidency in general and hurricanes, plus valuations approaching peaks seen before the last financial crisis, has added to investor nervousness. But ironically, the Chicago Board Options Exchange Volatility (VIX) Index, which measures investor fear, has trended toward a recent historic low.

As Markets Go Up Fear Goes Down – the "VIX"



This chart shows the VIX Index since 1991. Note recent investor panics, such as the Asian financial crisis in 1997, the tech bubble 2000-2003, and the financial crisis of 2008-2009, where the VIX peaked at 60 vs the current low below 10.

There's No Wizard of Oz

So something has got to give and soon, right? As investment advisors, we are often asked: *"How will you protect me when the markets go down?"*

It's a natural question, especially when billions in advertising dollars from the financial services industry bombard investors with this implied message:

> *"Our firm employs the smartest, most educated investment managers, people who understand and can predict the direction of the markets! Let us handle your money and we will keep you safe by getting you out before the big declines and back in to participate in the run-up."*

In truth, there is no Wizard of Oz. No professional investor can consistently predict the market's direction. Those who claim they can "position" portfolios based upon their macroeconomic forecasts are selling nothing more than snake oil. Most often, in fact, those who claim they can forecast a down market are instead beaten by the market itself! Meanwhile, the data show that individual investors, because they overreact, do far worse than the market over time.

At **Rebalance IRA**, we never provide a forecast on stock market direction. Like all financial forecasts, it could not possibly be accurate and not even be an educated guess. It would simply be a guess.

Nevertheless, smart investors can and do stay protected in a fundamental ways. There is a real science behind proper portfolio construction that ensures investments recover with the markets. The **Rebalance IRA** Investment Committee, all of them seasoned professionals, seeks to protect our clients from permanent loss of capital. For example, we focus on defining appropriate asset classes. Client portfolios do not contain precious metals nor sector "bets" such as technology shares or specific foreign country funds.

And we understand which indexes to use when selecting optimal ETFs for our clients. For instance, for small U.S. companies we use the S&P Small Cap 600 Index instead of the more popular Russell 2000 Index. Like a strong bridge built to withstand extreme weather and weight, **Rebalance IRA** portfolios are over-engineered to manage market corrections and to safely capture long-term market returns.

Second, our firm's unemotional, systematic rebalancing process protects clients by continually managing risk. As an example, U.S. stocks rose to a greater proportion of our client portfolios over the last few years. Accordingly, we trimmed this asset class and used the proceeds to purchase more international stocks — which had declined. Our own Professor Malkiel, writing in a December 2015 Op-Ed in the *Wall Street Journal*, urged investors to add international stocks to their portfolios. True to the **Rebalance IRA** investment discipline, international stocks have driven returns for the last two years. Our clients have profited for their patience.

Unfortunately, we at **Rebalance IRA** can only do so much to keep you safe. Clients must help the investment process by staying the course during rough patches. We all have a tug-of-war between our analytical brains and our emotions. Our brains evolved to help us survive harsh, predatory environments. But those same instincts almost always work against us as an investor, and they force us to make mistakes that cost us dearly.

Last month, Professor Richard Thaler of the University of Chicago was awarded the Nobel Prize for his work in behavioral economics. In this new field, researchers have identified certain tendencies that drive us to act in ways that harm our returns.

Here are some examples of these common behaviors:

Hindsight. "I knew that would happen." Who hasn't said or heard that at some point in their lifetime? While the know-it-all who reminds people of his or her forecasting prowess can be annoying, having a hindsight tendency can have detrimental effects on one's finances. Data shows that we tend to overestimate the accuracy of our predictions. This can be costly. We can get a false sense of security when making investment decisions, which can lead to excessive risk-taking behaviors that put one's investments in jeopardy.

Loss aversion. We often feel the pain of loss more than the joy of gains. Loss aversion takes hold when people recall investment portfolio declines more vividly than gains, sometimes even when the gains are greater. People will remember 2008 forever but seem unable to recall the years when they made 30 percent annual gains! That is why at **Rebalance IRA** we have discussions with our clients about market expectations and how to manage emotions during downturns.

Confirmation. People are often drawn to information or ideas that validate their existing beliefs and opinions. For example, many TV viewers prefer a news channel that represents their own political views, avoiding those featuring commentators offering different perspectives.

People do the same when it comes to finance. An investor who has a belief about market conditions will gravitate toward information sources that confirm that belief. When we attach an emphasis to the outcomes we desire, we make mistakes.

Recency. Investors tend to chase investment performance, often piling into an asset class just as it is peaking and about to reverse and decline. Because the investment has been climbing higher recently, investors believe that this will remain the case. Unfortunately, research has shown that it is essentially impossible to predict which asset class, sector or geographic region will be the top performer in any given year. Past performance can be a strong driver, as few people want to feel left behind.

The best way to stay safe, assuming fees are low and portfolios are well-constructed and periodically rebalanced, is to hold investments long term. Becoming aware of your own natural human tendencies that work against prudent investing is important, so take no offense if your advisor points them out to you! At **Rebalance IRA**, preserving and growing your wealth is our biggest concern. Those who have been in the process for many years know that time heals all wounds, smooth seas follow rough, and compounding is akin to magic.

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 third quarter of 2017, these asset classes performed as follows:

Growth Asset Classes*	**Q1 2017 Returns**	**Q2 2017 Returns**	**Q3 2017 Returns**	**Q4 2017 Returns**	**2017 Returns**
U.S. Total Market (VTI)	5.7%	3.1%	4.5%	--	**13.8%**
U.S. Small Cap (IJR)	0.9%	1.4%	6.2%	--	**8.6%**
Emerging Markets (VWO)	11.2%	4.6%	8.0%	--	**24.2%**
Foreign Developed (VEA)	8.0%	6.4%	5.5%	--	**21.2%**
International Small Cap (VSS)	9.3%	6.1%	6.7%	--	**23.8%**
U.S. Real Estate (VNQ)	0.8%	1.7%	0.9%	--	**3.5%**

Income Asset Classes*	**Q1 2017 Returns**	**Q2 2017 Returns**	**Q3 2017 Returns**	**Q4 2017 Returns**	**2017 Returns**
High-Yield Dividend Equities (VYM)	3.2%	1.2%	4.5%	--	**9.4%**
US Corporate Bonds (VCIT)	1.3%	2.3%	1.4%	--	**4.9%**
High-Yield Corporate Bonds (HYG)	2.3%	2.0%	1.7%	--	**6.1%**
US Preferred Stocks (PFF)	5.1%	2.4%	0.4%	--	**8.3%**
Emerging Market Bonds (EMB)	4.0%	1.8%	3.0%	--	**9.0%**

*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. Better-than-forecasted earnings across a strong majority of major U.S. stocks fueled a sustained rally and pushed the Dow Jones Industrial past 23,000 points for the first time ever. Industrial manufacturing data beat expectations by a wide margin, while investors shrugged off the specter of a rise in interest rates as simply the price of success as the U.S. economy finally starts to fire on all cylinders. Some of this enthusiasm comes from Wall Street betting on tax reform by the year's end.

Small Cap Stocks. Investors rushed into small cap stocks on the expectation that small companies would benefit most from the tax reform plan. Many large cap stocks pay taxes abroad or hold profits overseas to avoid taxation; homegrown small cap firms cannot avoid taxes as easily. Sensing a decision to lower corporate rates by a significant margin, buyers outgunned sellers in this area of the market.

Real Estate Stocks. Housing starts have been on a tear since bottoming out in 2009 but over the last 12 months they took a breather. The sudden slack in demand stems from a variety of sources, but it follows a double-digit, three-year run for real estate. The strengthening of U.S. stocks and blossoming demand for foreign shares naturally led to a sell-off to generate cash for buying stocks.

Large European, Japanese & Asian Stocks. Foreign developed stocks got a firm boost, thanks to improving U.S. demand and a continuation of relatively easy financing in Europe and Japan. While trailing the U.S. market and even emerging stocks, the uptick in large foreign firms is a welcome turnaround after a weaker run over the past 12 and 36-month periods. Nevertheless, the theme of "synchronized expansion" across the globe is a powerful narrative. The curse of low inflation in Europe and Japan still looms, albeit not as much over the corporate landscape.

Emerging Market Stocks. Foreign shares in emerging market economies (and small cap stocks everywhere outside the U.S.) did the best this quarter, surprising experienced money managers who expected to "leg into" the sector over several quarters. Rising commodity prices helped in countries such as Brazil, Chile and Peru. Russia was aided by firming higher oil prices. Additionally, China posted strong GDP numbers, down from blistering growth in years past but a convincing result nevertheless.

Income Asset Classes

U.S. Corporate Bonds. The Federal Reserve decision to unwind its $4.5 trillion balance sheet has begun to dampen enthusiasm for corporate bond issues. Bond traders are concerned that the "roll off" of government debt will build a solid floor under interest rates. Coupled with a Fed already interested in raising the benchmark rate, such a trend could trigger losses for big bond portfolios priced against the previous reality of a limitlessly easy Fed. While there are no signs of panic, the pressure from policymakers could keep a lid on this asset class for some time to come. Still, a year-to-date return for corporate debt of 4.9% outclasses Treasury debt returns by a wide margin.

High Yield Corporate Bonds. High yielding bonds also felt the heat from the Fed's moves. After a solid run in 2016, this asset class has maintained a return commensurate with the income it provides. Rebalancing in a timely fashion helps **Rebalance IRA** clients realize the gains that become available. Meanwhile, we work to diversify in order to blunt the impact of any downward moves.

Emerging Market Bonds. The global recovery story is likely to help emerging market debt regain luster after a weak second quarter. As companies in emerging countries move onto a more solid footing, their debt becomes more attractive from a risk perspective. Investors looking to pick up additive sources of income and price appreciation may selectively move cash into these areas of the world in the coming quarters. Naturally, **Rebalance IRA** clients are already there, thanks to our firm's commitment to global diversification.

High Yield Dividend Equities. Stock market volatility remains a distant memory for most U.S. investors, leading many to pad their income portfolios with high-yields stocks. We are not immune to the attractiveness of stocks that pay a 5% return in a world of low inflation and low bond rates. While we remained invested in this asset class, we also remain realistic. Maintaining a reasonable target percentage in our client portfolios is the best course to balance risk and return, especially if the stock market turns rocky.

Preferred Stocks. Preferred stock shares, a hybrid investment that has features of both stocks and bonds, slowed in the third quarter after strong gains in the first half of the year. Despite the meager 0.4% gain in the most recent quarter the year-to-date gain remains a solid 9%. Adding this asset class to **Rebalance IRA** portfolios lowers risk and provides solid income over the long run.

The Rebalance IRA Investment Process

Rebalance IRA portfolios are diversified into thousands of stocks and bonds in the United States and more than 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**'s 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 possible risk.

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 strategic advisor and consultant to large institutional investors 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.