Market Review

Summer 2016

Investing, Speculating, and Brexit

In 1973, Professor Burton Malkiel, a member of the **Rebalance IRA** Investment Committee, wrote what is arguably the most influential book on investing — ever. It is still required reading for most college finance courses. *A Random Walk Down Wall Street*, now in its 11th edition, has sold more than 1.5 million copies, extraordinary for even a romance novel let alone an academically grounded investing guidebook.

A Random Walk provided John Bogle with academic support that helped him start Vanguard and its core innovation, the index fund. Forty years later, Vanguard is the world's largest fund company with $3.5 trillion (that's trillion!) under management and the index fund is considered one of the greatest inventions of the 20th century.

The “random walk” in the book’s title is a metaphor for the stock market. Future “steps” or events in stocks cannot be predicted; they are random. Thus, the past is of no use in predicting the short-term future movement of stocks. The next “thing” to happen is random. *Therefore, in the short-term, no one can accurately and continuously* ***predict*** *the movement of stock or bond prices because their movement is* ***random****.*

Professor Malkiel through his work has debunked many of the methods used by investors to make short-term stock predictions. But, four decades later, the predicting continues. Many pundits on CNBC, investment newsletter authors, and investment radio talk show hosts predict without shame. For those selling financial services it is highly profitable to make bold predictions that stoke investor fear or greed. Investor activity (buying and selling) drives profits on Wall Street. But Professor Malkiel’s work is irrefutable: Those who make short-term predictions in a random world are not even making “educated guesses.” Instead, they are fortune-tellers in Brooks Brothers suits.

Last month’s “Brexit” event exemplifies the wisdom of *A Random Walk*. A truly random step in the market, the referendum vote by Britain to leave the European Union, turned out to be a complete surprise to both odds makers and to the global markets. Stocks moved downward for several days — until the markets digested the event and concluded that, with respect to global stock prices, Brexit was a non-event. For bonds, it signaled that Central Banks were hamstrung and that negative rates might proliferate. Ten-year U.S. Treasuries dropped to historic lows, another impact of a random event.

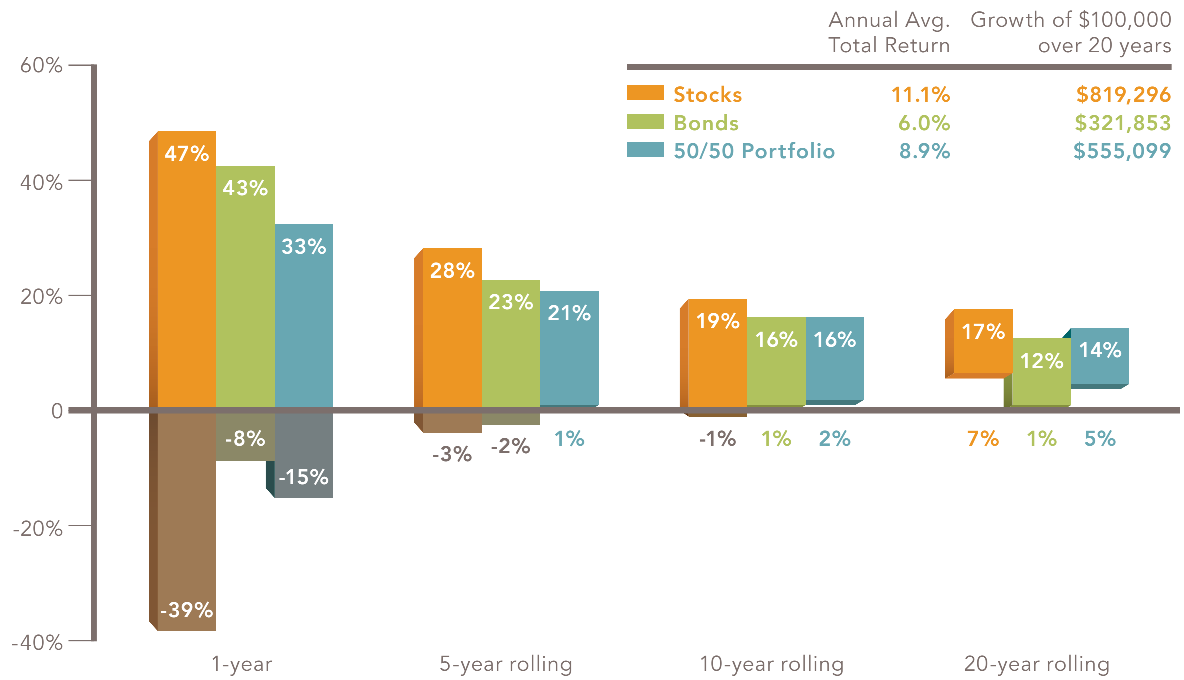
Last summer’s random event was slowing growth rates in China — an occurrence that surprised the world and brought down emerging market stocks by nearly 15% during 2015. This year, emerging markets are up nearly 12%, over twice that of US stocks, marking a nearly complete recovery.

Professor Malkiel explains that investors should purchase assets in order to receive dividends, interest, rents and, hopefully, some appreciation. What distinguishes investing knowledge from speculation is the time period. *A Random Walk* details a prudent process for long-term investors that largely ignores short-term stock price movements. We have integrated this method into our process for managing **Rebalance IRA** client retirement portfolios.

Once one invests for periods of five years or greater, returns become very predictable. The chart below (see next page) demonstrates that balanced portfolios for five-year periods and greater, including many 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.

Range of Stock, Bond and Blended Total Returns

Annual Total Returns (1950-2015)



Source: Barclays, FactSet, Federal Reserve, Robert Shiller, Strategas/Ibbotson, J.P. Morgan Asset Management. Returns shown are based on calendar year returns from 1950 to 2015. Stocks represent the S&P 500 Shiller Composite and Bonds represent Strategas/Ibbotson for periods from 1950 to 1980 and Barclays Aggregate after index inception in 1980. Growth of $100,000 is based on annual average total returns from 1950 to 2015. Guide to the Markets – U.S. Data are as of June 30, 2016.

While it might be fun to ponder which countries or companies might be winners or losers from Brexit, our job as the stewards of our clients' retirement savings is neither to opine nor invest in random events. Rather, the **Rebalance IRA** Investment Committee has engineered portfolios to survive such events, protect our clients from inflation and prosper in a world where central banks have driven interest rates nearly to zero.

By following the time-tested investment process, prescribed in *A Random Walk* more than 40 years ago, we continue to grow our client retirement savings in the fastest and safest way possible to help them retire with more. We admit, compared to CNBC's Jim Cramer, our **Rebalance IRA** commentary can be very boring. But, in return for tolerating our lack of entertainment value, you have an investment firm with a steady hand on the rudder and an unwavering belief in our investment process as well as a seasoned team of financial advisors ready to give you consistent and prudent retirement investing advice.

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**	**YTD 2016 Returns**
U.S. Total Market (VTI)	1.0%	2.7%	3.7%
U.S. Small Cap (IJR)	2.6%	3.3%	6.3%
Emerging Markets (VWO)	5.9%	2.5%	8.6%
Foreign Developed (VEA)	-1.9%	-0.1%	-1.9%
International Small Cap (VSS)	0.6%	0.7%	1.1%
U.S. Real Estate (VNQ)	6.3%	6.8%	13.4%

Income Asset Classes*			
High-Yield Dividend Equities (VYM)	4.2%	4.4%	8.7%
US Corporate Bonds (VCIT)	3.9%	3.7%	7.8%
High-Yield Corporate Bonds (HYG)	2.4%	4.4%	7.2%
Emerging Market Bonds (EMB)	5.2%	5.2%	10.6%

*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. The value of U.S. companies is determined by earnings growth over the long term, which is what we really care about. In the short term, of course, any number of factors can test investor faith. The political chaos following the surprise vote by Britain to leave the European Union was a surprise, and yet the actual "leaving" process will take months or years and change little about how U.S. companies perform. While U.S. stocks might benefit from the headline risk of events in Europe short term, this only makes foreign stocks a greater bargain in the longer term.

Small Cap Stocks. During the first quarter, many investors swooned for small-cap growth stocks in a bid to offset concern that large blue-chip stocks would flounder on a slow U.S. recovery. That trend held up during the second quarter, losing only a little steam. As the shakeup abroad plays out, it seems likely that investors looking for extra return will continue to favor small U.S. stocks, even if they become more fully priced as new investors pile on.

Real Estate Stocks. Investments in construction for housing and commercial use were among the better performers of the quarter and year-to-date in our client portfolios. The financial crisis of 2008 — now eight years in the rear-view mirror — put building projects around the nation into a deep freeze. The thaw has taken time, resulting in a newfound rush to build housing in areas generating employment demand. Retail follows rooftops, so it's likely that commercial construction will keep the party going over the medium term.

Large European, Japanese & Asian Stocks. Things will be a mess in Europe as the full weight of the British decision to leave the EU drags down investors caught by surprise. But the actual process of the so-called "Brexit" will take much longer, and there is likely to be little in the way of concrete decisions until the UK forms a new government. While "Brexit" will take months, if not years, reverberations across the EU will continue to be intense as some weaker EU economies toy with the idea of following Britain out the door. Uncertainty is the new normal for foreign stocks, a big reason **Rebalance IRA** investors own the world via broad, index-style investments, rather than trying to pick winners and losers. Using index funds, our clients will own both.

Emerging Market Stocks. Russia is a basket case because of low oil prices. China continues to dither over a debt load nobody seems to be able to quantify. Brazil impeached its president in a massive corruption scandal. Nevertheless, emerging market stocks were big winners for **Rebalance IRA** clients during the first half of the year and the best performing equities duringthe second quarter. The case for rebalancing and holding investments for the long term could not be clearer: Few would have recommended emerging stocks this year based on the "facts" before them. Yet here we are, reaping the benefits just the same.

Income Asset Class

U.S. Corporate Bonds. Corporate bonds continued to rise responding in part to fears of Brexit and expectations that the U.S. Federal Reserve is bound in time to move interest rates higher. It appears that the pace of that rise will be slower than forecast, however, driving yields down and bond prices up.

High Yield Corporate Bonds. The rebound for high-yielding corporate bonds in the first quarter continued into the second. This was largely in response to oil prices rising and less concern over defaults in the small portion of bonds issued by energy producers in the high-yield bond fund.

Emerging Market Bonds. Emerging market bonds continued their strong rebound this quarter. The unfolding of a government collapse in Venezuela shows the wisdom of index funds that avoid concentration in any one country. Investors get the generally higher yields of developing-country debt while reducing the absolute risk of default. We continue to like these dollar-denominated sovereign country bonds because they pay great yields over 4% and diversify risk in **Rebalance IRA** portfolios.

High Yield Dividend Equities. Total return, the combination of rising stock prices plus dividends, is a powerful argument for owning stocks in the first place. We put this asset class in our income portfolios, however, because our Investment Committee believes that high-yielding stocks are an effective tool for offsetting bond market risk. Market prognosticators talk about lowered expectations from both bonds and stocks in the years ahead, making the added power of reinvested dividend income all the more attractive for our client 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.