rebalance IRA

Market Review

Spring 2017

Are You the House, or the Drunken Guest?

Most of us are saving money to travel, buy things we want, help the charities and people we love, send kids to college, stop working, or just plain relax.

If that's you, you may want to refrain from consulting your favorite stockbroker, buying that "5 star" mutual fund, or becoming a stock picker yourself. No matter what, when you try to beat the stock market, the odds are very high that within 20 years you will say goodbye to a staggering one-third of your money — and many of those dreams.

How could this be true?

Most people confuse investing with gambling. Gamblers try to "beat the house." Investors want to be "the house." Let's examine MGM, one of the largest casinos in Las Vegas. Like all casinos, MGM offers all kinds of gaming options — blackjack, poker, roulette, craps, slots — along with great food, entertainment, and well-appointed rooms.

Guests have a lot of fun at MGM. They frankly enjoy the excitement of gambling, the thrill of winning and losing. Some come in with various "systems," statistical models or card counting, to try to beat MGM. Poker players have their favorite seat. Some talk to God.

Stories at MGM get passed down over generations. There was the grandma who dropped a quarter into a slot machine and immediately won $250,000. Another person who had never played blackjack hit 21 with his first hand, made $50,000, then proposed and married his girlfriend, all in one great evening. It's fun being at MGM — just look at the posters and marketing brochures.

A game that's hard to win
But most guests don't play, win, and leave. They continue to play, and that's what MGM counts on. Like all casinos, it has special "house" odds. Sooner or later, MGM will win more money than it will lose due to human nature and basic statistics.

Year after year, gamblers try to beat the house, something that's impossible to do by design over the long run. Research from the University of Las Vegas Nevada puts the house edge anywhere from slightly negative (say, if you are an expert card counter) to as high as 27% (lottery games like keno). Yet virtually all games give the house an advantage, so that the longer you play, the more you will lose. What's more, the higher the house advantage, the faster you lose. Really, all MGM needs to do is to keep you at the table.

Here lies the cold, hard difference between the investor and the gambler. Investors care about one thing only: making money. They are not concerned with having fun or discussing that night they had the "hot dice" at the craps table. They could not care less if they ever hear the ka-ching of a winning pull at a slot machine. They just want to know they will make money year after year.

MGM never knows from night to night when and where they will make their money, but because of house advantage they know they will not lose. Some nights they host a guest with a streak of luck at the craps table and lose money there. That same night, MGM made back that money and more on blackjack and slots — or vice versa.

Like MGM, true investors are "the house." By spreading the risk around several "games" and not getting caught up in greed and other emotions, investors make more money by being the house rather than trying to beat the house. It's a statistical fact that easy to forget, but impossible to ignore.

Retirement Investing with House Odds
So why do people treat their own retirement money as if they were gamblers instead of investors?

Wall Street is very good at turning investing into a literal casino. Instead of betting on blackjack or roulette, the siren song of Wall Street encourages investors to attempt to "beat the house" of the world's investing markets — U.S. stocks, bonds, real estate, foreign stocks, and emerging market stocks.

Like the casino, Wall Street earns money through frenzied trading activity – fundamentally, betting. When individuals pick stocks on their own, or give their money to a broker they believe is a good "stock picker," or when they invest in a mutual fund that has a "great" track record, it is not different from betting on games in a casino. And the house always has better odds.

House Advantages for Popular Casino Games

Game	House Advantage
Roulette (double-zero)	5.3%
Craps (pass/come)	1.4%
Blackjack (single deck, basic strategy*)	0.0%
Three Card Poker*	3.4%
Slots	5.0% – 10.0%
Keno (average)	27.0%

**optimal strategy*

It Pays To Be The House not the Guest

Since April 2009, the "bottom" of the Great Recession, MGM stock has risen about 9 times - from \$3 to \$27 per share. Those returns came from the pockets of their guests.

Just like in a casino, the cost of trying to beat the house in the stock and bond markets is steep. Reams of studies confirm that investors do worse because of the money they lose trying to "win" by beating the markets. For instance, many investors pay on average 2% of their total assets per year in the pockets of their "trusted advisers" in the form of fees (explicit and hidden). On top of that, because buying and selling stocks creates taxable income, many also pay unnecessary income taxes. Over time, the mathematics of compounding returns (and compounding fees) cause those investors to steadily lose over 33% of their money over 20 years — just like the gambler over at MGM.

On the contrary, **Rebalance IRA** clients invest with "the house." Instead of trying to select just the winning stocks, we buy every stock and we buy every type of bond. We let other "guests" do all of the trading while our clients profit from the entire market. A well-constructed portfolio of index funds allows our clients to own all of the world markets. The mutual funds and stock pickers of the world try to beat those odds, while we are happy to take house returns. Our firm calls it "portfolio indexing."

For every $100,000 invested, **Rebalance IRA** clients pay roughly $650 in yearly fees, compared to $2,000 in fees others pay to money managers, financial advisers, and in broker commissions. We set the risk levels of a given portfolio to whatever level matches our clients' 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 first quarter of 2017, these asset classes performed as follows:

Growth Asset Classes*	**Q1 2017 Returns**
U.S. Total Market (VTI)	5.7%
U.S. Small Cap (IJR)	0.9%
Emerging Markets (VWO)	11.2%
Foreign Developed (VEA)	8.6%
International Small Cap (VSS)	9.3%
U.S. Real Estate (VNQ)	0.8%

Income Asset Classes*	**Q1 2017 Returns**
High-Yield Dividend Equities (VYM)	3.2%
Government and Corporate Bonds (BND)	1.3%
High-Yield Corporate Bonds (HYG)	2.3%
US Preferred Stock (PFF)	5.1%
Emerging Market Bonds (EMB)	4.0%

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

Growth Asset Classes

U.S. Stocks. U.S. stocks rose 5.7% as investors remained convinced of U.S. corporate growth from expectations of tax reform and lower regulations from the Trump administration – even after a failed attempt to reform healthcare. The Federal Reserve continued to telegraph slowly rising interest rates. That in itself was plenty of cause to believe that the economy has finally pulled out of the long shadow of the 2008 crisis and is now growing independently of the stimulus from low borrowing costs. Steady home prices, cheaper energy, low unemployment and rising business spending all point toward a continuation of the same. Congress remains a wild card, while tax policy discussions over the summer will bear on sentiment for sure.

Small Cap Stocks. After a steady sequence of high quarterly returns in 2016, small caps took a big break in 2017. Part of the reason for relatively lackluster gains in the small cap arena is the movement by investors toward international stocks, which represented a bigger opportunity in the medium term thanks falling prices for those stocks over the past several years. It finally became too much too ignore, so investors choose to rebalance away from small caps and toward relative bargains abroad.

Real Estate Stocks. Real estate equities essentially had a flat quarter. Home prices have remained steady or rising on lack of supply. Homebuilders are only now dusting off old plans halted by the 2008 housing crisis. Meanwhile, the rising cost of borrowing is being slowly translated into higher mortgage costs. While still historically low, rising rates were a signal to some investors to take profits in real estate and put money to work elsewhere in their portfolios.

Large European, Japanese & Asian Stocks. Outpacing the U.S. stock market this quarter, foreign developed country stocks were up 8.6%. Europe's rebound continued at a brisk pace, fed in part by stronger corporate earnings and improved business sentiment. Consumer confidence is back. Various contested elections generated headlines but little serious movement toward a breakup of the European Union, as some had feared. The same cannot be said for the UK, where the Brexit referendum appears to be setting the stage for rupture and renegotiation. Japan continues to muddle through, with good macroeconomic numbers but a still-strong yen that hurt exports.

Emerging Market Stocks. After a dip in the final quarter of 2016, emerging country stocks rebounded with vigor as the winning asset class, up 11.2%. Institutional investors finally decided that a bottom had been reached. Fears that America would turn its back on trade and erect barriers to growth were ignored, leading investors back into places such as China and Brazil, where valuations were at historic lows.

Income Asset Classes

U.S. Corporate Bonds. Long-term interest rates remained largely unchanged in the quarter. The 10-year U.S. Treasury was at 2.4% at the end of the quarter, down slightly from the quarter ending Dec. 31, 2016. Shorter term interest rates followed the Federal Reserve's rate hike in March. Interest rates have already doubled from the post Brexit lows, from 1.36% on July 8, 2016 to a peak of 2.6% on March 13, 2017 for the 10-year U.S. Treasury Bond. Some forecasters believe that the 10-year Treasury will hit, or come close to 3% by the end of 2017. Investors thus have been moving carefully toward a shift in their bond portfolios in order to increase safety and capture that rising yield.

High Yield Corporate Bonds. Defaults in commodity-sensitive sectors of the high-yield bond market drove the high-yield default rate up to its 2016 peak of 3.82% in May 2016, but the default rate has since fallen back down to 1.90% (0.64% excluding the energy and metals/mining sectors). This is well inside the long-term average default rate of 3.3%. The low default rate is reflective of the relatively sound financial condition of most companies and the strong backdrop of a healthy macroeconomic environment.

Emerging Market Bonds. The debt of emerging nations saw the same dip and recovery as did their equity counterparts in the first part of this year compared to the end of 2016. It's just this kind of "headline risk" from temporary spates of bad news that can trigger emotional selling and unnecessary losses. Emerging market bonds turned in a solid start to the year, so we remain in this asset class on behalf of our clients.

High Yield Dividend Equities. We approach dividend-paying equities as a form of income investing. Naturally, this is the more volatile section of any income portfolio. The past several years of high dividend generating stocks from this asset class has been an essential component of income returns. Owning this asset class has helped keep **Rebalance IRA** income investors ahead of the pack without unnecessarily increasing their long-term investment risk.

Preferred Stocks. While a stock investment, preferred issuances function somewhere in between bonds and stocks for an income portfolio. The PFF fund primarily includes large bank issues such as Wells Fargo, Citibank, GMAC Capital, Barclays and JP Morgan. After considerable analysis and deliberation, the **Rebalance IRA** Investment Committee decided to add this asset class to add diversity and enhance income. The current SEC 30-day yield of the preferred stock asset class is over 5%.

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** 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.