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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 Winter 2018 *Market Review Conference Call*. Listen In!

Winter 2018

Broken Crystal Balls

At the beginning of 2017, many money managers and analysts predicted that the financial markets would not repeat their strong returns from 2016. Some cited the uncertain global economy, political turmoil in the U.S., implementation of Brexit, conflicts in the Middle East, North Korea's weapons buildup, or other factors. The global equity markets defied their predictions, with major equity indices in the U.S., Europe, Japan, Asia, and emerging markets posting strong returns for the year.

In fact, each January, *Barron's*, a well-known financial publication, invites a group of experienced investment professionals to New York for a lengthy roundtable discussion of the investment outlook for the year ahead. The nine panelists have spent their careers studying companies and poring over economic statistics all over the globe.

Ahead of 2017, the authors were struck by the "remarkably cohesive consensus" among the members of the group, who often have much to disagree about. Not one expert expressed strong enthusiasm for U.S. stocks in the year ahead; two expected returns to be negative for the year; and the most optimistic forecast was for a total return of 7%. The panelists also found little to like in global markets, citing "gigantic geopolitical issues," including a Chinese "debt bubble" and a "crisis" in the Italian banking system.

Summarizing the panel's outlook Barron's presented a less than optimistic view of the year ahead in January 2017:

> *"This could be the year when the movie runs backwards: Inflation awakens. Bond yields reboot. Stocks stumble. Active management rules. And we haven't even touched on the coming regime change in Washington."*

How accurate were these predictions? 0 for 4!

Stocks moved broadly higher around the world, in some cases dramatically. Twenty out of 47 countries tracked by the largest index firm achieved total stock market returns in excess of 30%.

The *Barron's* panel was no aberration. Among 15 prominent investment strategists polled by USA TODAY, the average prediction for U.S. stocks for 2017 was 4.4%, while the most optimistic was 10.4%.

Turn Off the News

Here are some counterintuitive "surprises" from 2017 that reinforce the challenge of directly linking positive or negative events in the world to positive or negative returns in the stock market.

- Question: What do you get when you combine a tumultuous year for a new U.S. president and divisive political trends in many global markets? Answer: *A new record.* For the first time since 1897, the total return for the U.S. stock market was positive in every single month of the year. During the year, a great deal of media coverage was focused on markets at all-time highs, and some investors braced themselves for a sharp drop in stock prices. Not only did the much anticipated "correction" never occur, financial markets remained remarkably calm. Out of 254 trading days in 2017, the total return of the S&P 500 Index rose or fell over 1% only eight times. By comparison, in a more rambunctious year such as 1999 it did so 92 times.

- North Korea issued threats of a nuclear missile strike throughout the year and boasted that even mainland U.S. cities were vulnerable to its newest warheads. Next-door neighbor South Korea would seem to have the most to lose if such a catastrophe occurred, but Korean stocks were among the top performers in 2017, with a total return of 46.0% in U.S. dollar terms.

- To many experienced researchers, Chinese stocks appeared alarmingly vulnerable. A gloomy November 2016 article in *Barron*'s warned that "China's debt addiction could lead to a financial crisis."

In the article, a prominent Wall Street strategist observed: *"It's scary that China seems to be continuing its debt binge to achieve its unrealistic growth targets."* And a global fund manager noted: *"We are the most underweighted in China than we have been since launching the fund over years ago."*

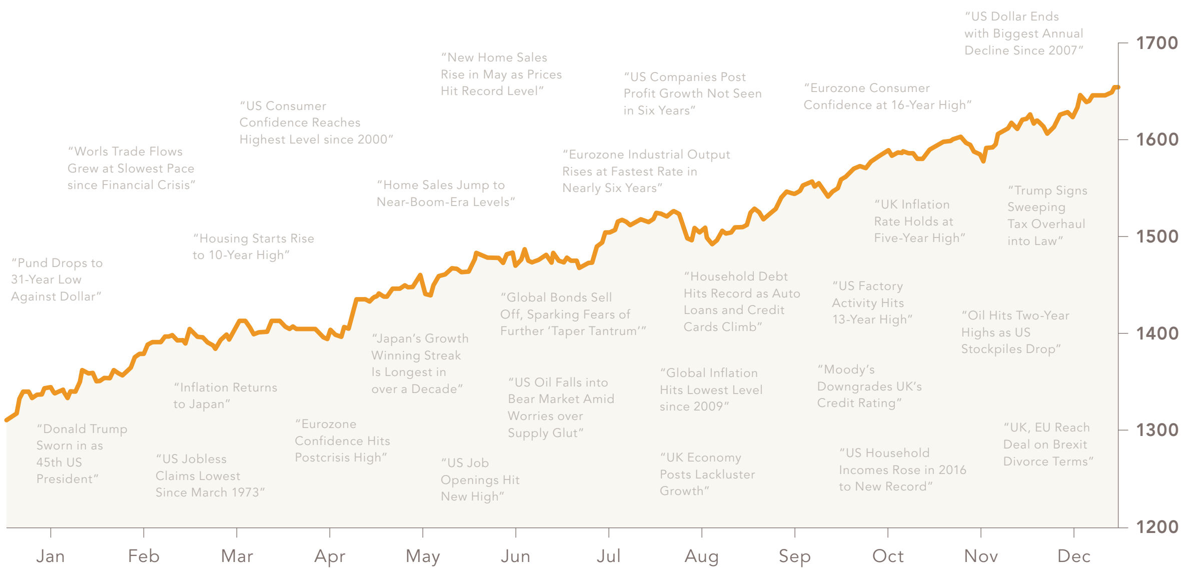
The outcome: China was the third best-performing stock market in 2017 with a total return of 51.6% in local currency and 50.7% in U.S. dollar terms.

- The seven-year string of increasing U.S. auto sales finally ended in 2017. Domestic sales fell 1% at Ford Motor, 1.3% at General Motors, and 10.7% at Fiat Chrysler. Anticipating the sales slump, a *Wall Street Journal* columnist warned investors in January 2017 to avoid the stocks. Good advice? Ford Motor had a total return of 8.7%, General Motors returned 22.5%, and Fiat Chrysler's total return came in at an impressive 96.3%, even with a 10% drop in sales.

The chart on the next page highlights some of the year's prominent headlines in the context of global stock market performance as measured against the common global market index. These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

World Stock Market Performance

MSCI All Country World Index (IMI) with selected headlines from 2017



Source: MSCI. Part performance is not a guarantee of future results. In US dollars, net dividends. Index is not available for direct investment. Performance does not reflect the expense associated with management of an actual portfolio.

Surprising all experts, global equity markets posted another positive year of returns in 2017. The U.S. Stock Market recorded a 21.1% total return and returns among foreign stock markets were even higher. The index that reflects the Foreign Developed markets logged a 24.2% return, and Emerging Markets a 37.3% return, making this the fifth-highest return in the index history.

The U.S. ranked in the bottom half of all countries for the year, placing 35th out of the 47 countries. Worldwide, 45 out of the 47 countries posted positive returns. Country level returns were dispersed even among those with positive returns. In developed markets, returns ranged from +10.4% in Israel to +51.4% in Austria. In emerging markets, returns ranged from -24.8% in Pakistan to +53.6% in Poland—a spread of almost 80%.

This broad global advance underscores the importance of following an investment approach based on diversification and discipline, rather than prediction and timing. Attempting to predict markets requires investors to not only accurately forecast future events, but also predict how markets will react to those events. The 2017 markets were a good reminder that there is little evidence suggesting either of these objectives can be accomplished on a consistent basis. And yet, an entire industry of media pundits and active money managers rely upon the investing public believing and acting on their outlooks and forecasts.

The Million Dollar Bet

To make somewhat accurate predictions, one only needs to look out 10 years and use the enduring and somewhat consistent returns of the overall stock market. Last year saw the conclusion of a 10-year wager between Warren Buffett, chairman of Berkshire Hathaway Inc., and Ted Seides, a New York hedge fund consultant. Seides responded to a public challenge issued by Buffett in 2007 regarding the merits of hedge funds relative to low-cost funds index funds. The two men agreed to bet $1 million on the outcome of their respective investment strategies over the 10-year period from January 1, 2008, through December 31, 2017. Buffett selected the S&P 500 Index, Seides selected five hedge funds, and the stakes were earmarked for the winner's preferred charity.

The 10-year period included years of dramatic decline for the S&P 500 Index (–37.0% in 2008) as well as some with above-average gains (+32.4% in 2013), so there was ample opportunity for clever managers to attempt to outperform a buy-and-hold strategy through successful timing.

If anyone should be able to predict or forecast the direction of markets, it should be hedge fund companies. They are paid an average of 2% of the assets under management each year and 20% of the profits. They are considered the best of the best.

For fans of hedge funds, however, the results were not encouraging. For the nine-year period from January 1, 2008, through December 31, 2016, the average of the five funds achieved a total cumulative return of 22.0% compared to 85.5% for the S&P 500 Index.

Having fallen far behind after nine years, Seides graciously conceded defeat in mid-2017. But he pointed out in a May 2017 Bloomberg article that in the first 14 months of the bet, the S&P 500 Index declined roughly 50% while his basket of hedge funds declined less than half as much. He suggested that many investors bailed out of their S&P 500-type strategies in 2008 and never participated in the recovery. Hedge fund participants, he argued, "stood a much better chance of staying the course."

Seides makes a valid point—long run returns don't matter if the strategy is abandoned along the way. And there is ample evidence that some mutual fund investors sold in late 2008 and missed out on substantial subsequent gains. But do actively managed portfolios offer the best solution to this problem? We know they do not.

Where To Go From Here

As **Rebalance IRA** Investment Committee member Professor Burt Malkiel reminds us in a recent *Wall Street Journal* Op-Ed, when asset classes appear overpriced, no valuation metric has ever reliably forecasted the future. Malkiel reinforces the importance of a broadly diversified portfolio: *"By holding a wide variety of asset classes, investors have historically enjoyed smoother gains during bull markets and gentler losses during bear markets."*

Professor Malkiel also advises our firm to rebalance portfolios regularly and to keep **Rebalance IRA** fees low. *"The less I pay to the purveyor of an investment service, the more there will be for me."*

Rebalance IRA continues to directly follow Professor Malkiel's advice.

While the firm has enjoyed the outpouring of "thank you" emails and notes from our clients, it should be noted that **Rebalance IRA** did not generate these returns – the markets did. Our firm, however, will take credit for properly positioning **Rebalance IRA** client portfolios so that when a year like 2017 comes along our clients participate in the growth of the markets. Our Investment Committee and the investing team know that tuning out the headlines and "noise" and sticking to our rigorous process will work over many years. While lean times will come at some point, years such as 2017 build portfolio "headroom." And, along the way, on behalf of our clients, we continue to add to the losing asset classes and trim the winners through our firm's disciplined rebalancing procedures.

Rebalance IRA portfolios are premised on the dialogue that our financial advisors have with clients to better help understand their life situations, risk tolerance and liquidity needs. Our firm's goal: to help clients reach their 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 call.

Very truly yours,

Your **Rebalance IRA** Team

Asset Class Performance

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 fourth 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%	6.5%	**21.2%**
U.S. Small Cap (IJR)	0.9%	1.7%	6.2%	3.9%	**13.2%**
Emerging Markets (VWO)	11.2%	3.4%	8.0%	5.9%	**31.5%**
Foreign Developed (VEA)	8.0%	6.4%	5.5%	4.4%	**26.4%**
International Small Cap (VSS)	9.2%	6.1%	6.7%	5.5%	**30.6%**
U.S. Real Estate (VNQ)	0.8%	1.7%	0.9%	1.5%	**5.0%**
Foreign Developed/Emerging (VEU)	8.6%	5.7%	6.0%	4.7%	**27.4%**

Income Asset Classes*	Q1 2017 Returns	Q2 2017 Returns	Q3 2017 Returns	Q4 2017 Returns	2017 Returns
High-Yield Dividend Equities (VYM)	3.2%	1.4%	4.5%	6.4%	**16.4%**
US Corporate Bonds (VCIT)	1.3%	2.2%	1.4%	0.4%	**5.3%**
High-Yield Corporate Bonds (HYG)	2.3%	2.0%	1.7%	0.0%	**6.1%**
US Preferred Stocks (PFF)	5.1%	2.7%	0.4%	-0.2%	**8.1%**
Emerging Market Bonds (EMB)	4.0%	1.8%	3.0%	1.2%	**10.3%**

*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. Strong earnings and solid job numbers seem to support the stock market's early-2018 dash to record highs across the major indexes. The VIX, the so-called "fear gauge" of stock investor sentiment, remains relatively low despite an uptick as stocks touch new highs. The corporate tax cut has generated revised earnings projections, and the market has been readjusting prices to reflect these higher earnings.

Small Cap Stocks. Typically, smaller companies beat their large-cap peers on performance, thanks to their relative room to grow market share compared to larger, fully established firms. The coming tax cuts, too, should bolster the case for small cap investing, since taxes figure more significantly into small-company bottom lines. Analysts nevertheless point out that investor inflows into small caps have lagged compared to large-cap stocks, suggesting that investors will eventually turn back toward small caps and begin buying again to make up lost ground.

Real Estate Stocks. The imminent rise in interest rates should drive the return on real estate stocks lower. It seems clear, however, that the pace of rate increases will not change dramatically following the assumption of the new Federal Reserve chairman, the recently confirmed Jerome Powell. Nor will investors necessarily flee from real estate if the U.S. central bank sticks to its long-held strategy of telegraphing rate hikes well in advance. Meanwhile, home prices are still headed skyward as demand continues to outstrip supply.

Large European, Japanese & Asian Stocks. Foreign stocks in developed countries benefited from the same tailwinds that helped U.S. stocks hit higher highs: Solid corporate earnings and money that remains historically cheap. Inflation is muted and rumblings of a trade reset with the United States remain a distant concern for the moment. Stocks in Asia seem to be following Wall Street's lead as investors reacted to strong earnings by plowing more cash into equities there.

Emerging Market Stocks. Big research firms remain bullish on foreign stocks as an antidote to slowing growth in the United States. It's all relative, of course. U.S. stocks will continue to rise as the underlying economy continues its mature growth; it's just that many emerging country stock markets offer better returns thanks to younger populations and faster growth prospects. Additionally, these economies continue to benefit from a weaker U.S. dollar.

Income Asset Classes

U.S. Corporate Bonds. U.S. corporate borrowers hit the brakes in early 2018, posting the slowest start to the year in terms of investment grade borrowing since 2015. The amount of high-grade debt available fell by 38%. This should come as no surprise, given the implications of tax cuts coming to U.S. corporations, plus a rising interest rate. There's less reason to borrow and, in some cases, too much cash on the balance sheet for big U.S. firms.

High Yield Corporate Bonds. Low interest rates over the past several years have allowed many companies that issue high-yield debt to refinance, improving their risk ratings. That in turn has shored up the market for junk bonds by increasing the supply by enough to meet demand for better returns compared to the low payouts expected from high-grade corporates and government-issued debt. Until the economy takes a decisive turn for the worse — an outcome not necessarily in the immediate future — high-yield investing remains a solid asset class portfolio performer.

Emerging Market Bonds. Not too many years ago a selloff in one part of the emerging world's debt markets meant "contagion" as investors assumed the worst and abandoned other emerging countries — even among distant capitals with no direct financial or trade connection. Since then, the negative link between countries seems to have eroded, leading investors to stick with solid economies while discounting the occasional basket case. Interestingly, this is the compelling logic for diversification in a nutshell: Own the world, and one bad headline won't ruin your day.

High Yield Dividend Equities. For a very long time, low interest rates on safer government-issued bonds fed a cycle of demand that benefited high-yield dividend stocks. After all, why settle for a 2% interest coupon when you can get a 5.5% dividend from a blue-chip U.S. stock? As interest rates steadily rise, however, expect that trade to unwind. It is difficult, of course, to forecast the end of the high-yield cycle. That is why it is prudent to hold such investments as a portfolio diversifier rather than as the bulk of your income portfolio.

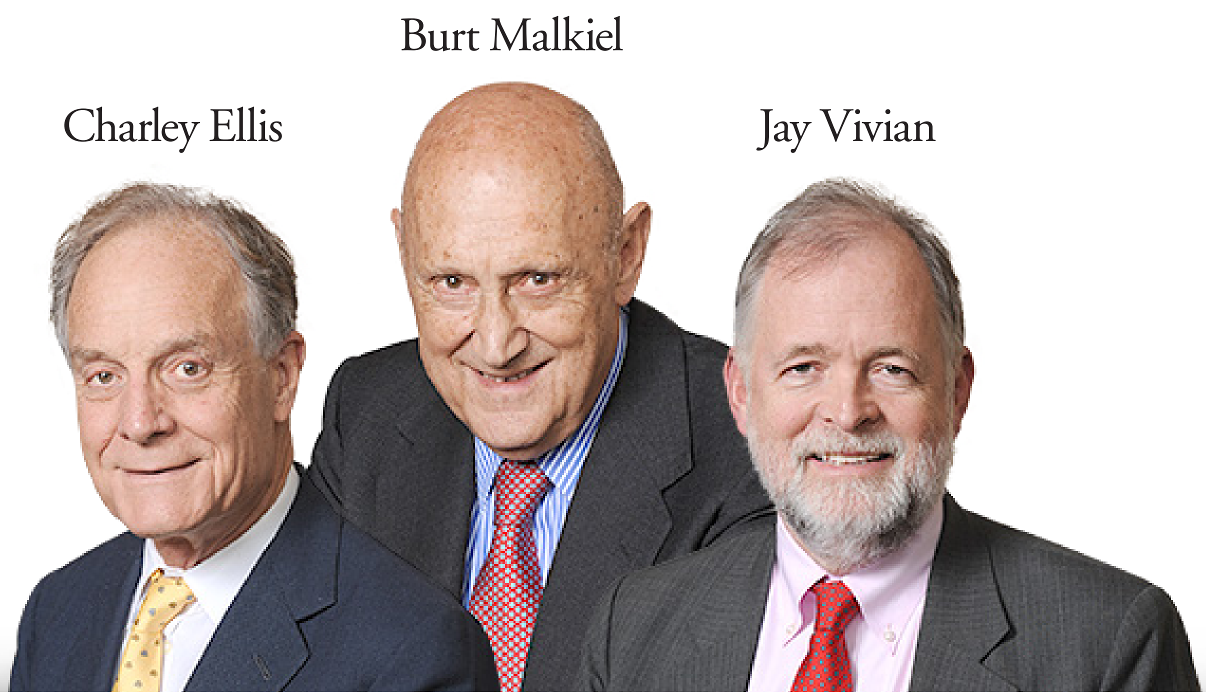
Preferred Stocks. As the income portion of portfolios across the market adjust to the uncertainty of a changing bond market, we continue to like our Investment Committee's recent decision to move deeper into preferred stocks. This hybrid holding offers additional income, a hedge against rising interest rates, and the upside benefits of equity ownership.

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.



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.