rebalance IRA

Market Review

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Rebalance IRA's Chief Investment Officer, Mitch Tuchman, along with Sally Brandon, Senior Vice President of Client Service & Advice, present the Spring 2018 *Market Review Conference Call*. Listen In!

Spring 2018

Ignore the Siren Song

Odysseus, the wandering protagonist of Homer's *The Odyssey*, had a healthy fear of temptation. In Greek mythology, Sirens, creatures who sang a beautiful and irresistible song, lured sailors to their deaths. Entranced by the song, sailors steered toward the music only to be dashed to pieces on the rocks.

In order to avoid this fate, Odysseus ordered his crew to plug their ears with beeswax and to tie him firmly to the ship's mast. Upon hearing the Sirens' song, Odysseus himself could not resist and begged to be untied, but since he had instructed his crew to ignore him they refused his pleas.

Thus the ship was able to sail safely past danger, but only because Odysseus was smart enough to appreciate the power of temptation.

Investing is a long-term endeavor. There are siren songs played at every turn. Indeed, we spend decades pursuing our financial goals, so being an investor can be complicated, challenging, frustrating, and sometimes frightening. This is exactly why it is critical to have an investment philosophy and process you can stick with, one that will help you stay the course.

Over our lifetimes, we face many decisions, prompted by events that are both within and outside of our control. Without an enduring philosophy to inform our choices, we potentially can suffer unnecessary anxiety that leads to poor decisions and outcomes that damage our long-term financial well-being.

When some investors don't get the results they want they blame things outside of their control. These investors may point a finger at the government, the president, central banks, stock markets, or the economy. Unfortunately, the majority will not do the most beneficial exercise — evaluating and reflecting on their own responses to events and taking responsibility for their decisions.

The **Rebalance** investment philosophy is enduring, built on solid principles backed by decades of empirical academic evidence regarding how the stock market operates and the returns that it generates. We distinguish between investing and speculating; we rely on the power of diversification to manage risk and increase the reliability of returns; we periodically rebalance portfolios; and we benchmark our client progress against their own realistic long-term investment goals.

Combined, these principles help prudent investors react better to stock market events, even when those events are globally significant or when, as some might suggest, a paradigm shift has occurred, leading to claims that "It's different this time." Adhering to the aforementioned principles also help investors resist the siren call of investment fads or worse, outright scams.

Those of us with an enduring investment philosophy are able to maintain discipline through bull markets, bear markets, political strife, economic instability, or whatever crisis du jour threatens the progress toward one's investment goals.

Tying Ourselves to the Mast

Successful investors focus on influencing outcomes by controlling one's reactions to events, rather than the events themselves. Simply put, this means an outcome — either positive or negative — is the result of how you respond to an event, not the result of the event itself.

For instance, a major political surprise, such as Brexit, may cause a market to fall (event). In a panicked response, one potentially fueled by gloomy media speculation over the resulting uncertainty, an investor sells some or all of his or her investment (response). Lacking a long-term perspective and reacting to the short-term news, this investor misses out on the subsequent market recovery and suffers anxiety about when, or if, to get back in, leading to suboptimal investment returns (outcome).

To understand the same example from a different perspective, imagine the following a surprise event causes stock markets to fall suddenly. Based on an enduring philosophy, an investor understands the long-term nature of returns and the short-term nature of stock market volatility around news events. Thus, the investor can control his or her emotions and maintain investment discipline, leading to a better chance of a successful long-term outcome.

This example reveals why having an investment philosophy and process is so important. By understanding how markets work and maintaining a long-term perspective on past events, investors can focus on ensuring that their responses to events are consistent with their long-term investing plan.

The Guiding Hand of Our Investment Committee

One overarching event that has been of great concern to the **Rebalance** Investment Committee is sometimes called "financial repression." Prior to 2008, investors who did not want stock market risk could opt for 4% to 5% interest on a 10-year Treasury Bond. This is often referred to as "coupon-clipping." Every month, one's interest check would come in the mail and life was smooth.

As U.S. deficits soared after the 2008 financial crisis, central governments flooded the markets with liquidity and artificially suppressed interest rates. Interest rates dropped to as low as 1.5% on 10-year Treasury Bonds, making it impossible for an investor to get a positive return after taxes and inflation. Traditionally, bonds are used in an investment portfolio to lower risk. Ironically, because interest rates were at historically low levels, our firm's Investment Committee concluded that U.S. Treasury bonds could actually add risk to a portfolio!

This external dynamic caused the **Rebalance** Investment Committee to revisit the traditional "rules of thumb" in constructing fixed-income portfolios for our clients.

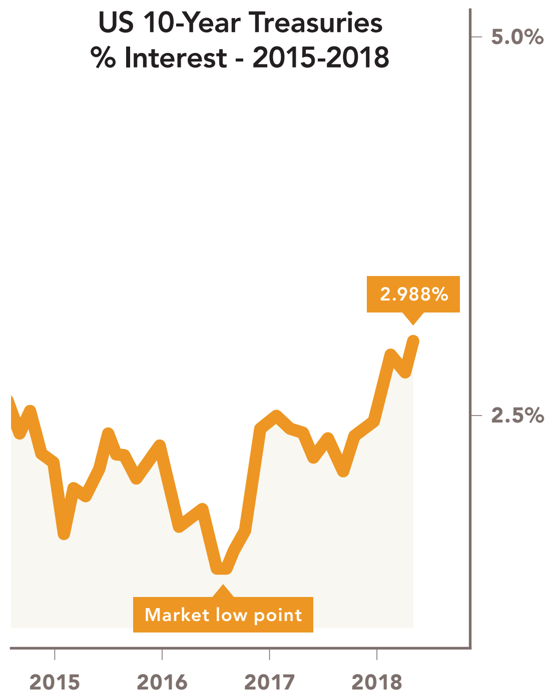
In general, our firm's investment philosophy assumes that markets usually are efficient. However, when normal market forces of supply and demand were not setting interest rates accurately, we had to adjust our process accordingly.

With interest rates being held artificially low, the **Rebalance** Investment Committee addressed this inefficiency by adding alternative types of income-producing asset classes. In early 2012, the Investment Committee designed an income portfolio that included a variety of alternative bonds as well as a stock fund that generated high dividend income.

In hindsight, we responded insightfully to this unusual sequence of events. Over five years (from 2013 to 2018), the **Rebalance** Income Portfolio returned an average yearly return of 5.2% versus a global bond index of 2.3% (see back-testing methodology).

Additionally, the Investment Committee's discipline dictates that this critical decision systematically be revisited and analyzed. At the March 2018 Investment Committee meeting in New York, in light of rising interest rates, the decision was made to move toward a more traditional fixed-income

US 10-Year Treasuries - % Interest - Last 30 Years



portfolio. **Rebalance** added inflation-protected Treasury Bonds to client Income portfolios, removed High Dividend Stocks and added a High Grade Corporate Bond fund. On April 24, 2018, the 10-Year Treasury reached 3% from a low of about 1.5%.

The Danger of Going It Alone

Without education and training, sometimes gained from a bitter experience, it is hard for non-investment professionals to develop and stick with a coherent investment philosophy. Even the most self-aware investors find it hard to manage their responses to events. That is why the **Rebalance** process includes a group of world-renowned financial experts who make decisions together and who review client portfolios on a disciplined and systematic basis. This is where we hope to be invaluable to our clients, by providing the foundation of an investment philosophy and by acting as experienced counselors.

Rebalance has a proven investment philosophy. We trust in the power of stock markets to deliver reliable returns over time and focus our efforts on managing risk and helping clients benefit from as much of the market return as possible. We like to think that our firm's process and philosophy is second to none, adapted from the leading institutional investors in the world.

Investing always will be both alluring and, at times, scary. With a smart and prudent approach to investing combined with **Rebalance**'s seasoned guidance, you can stay the course through challenging times. We continue to provide an objective view and help our clients separate emotions from investment decisions. Moreover, we continue to educate, communicate, and help **Rebalance** clients deal with their responses even to the most extreme of stock market events.

Very truly yours,

Your **Rebalance** Team

Asset Class Performance

The Rebalance 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 2018, these asset classes performed as follows:

Growth Asset Classes*	**Q1 2018 Returns**	**Q2 2018 Returns**	**Q3 2018 Returns**	**Q4 2018 Returns**	**2018 Returns**
U.S. Total Market (VTI)	-0.7%	–	–	–	**-07%**
U.S. Small Cap (IJR)	0.6%	–	–	–	**0.6%**
Emerging Markets (VWO)	2.5%	–	–	–	**2.5%**
Foreign Developed (VEA)	-1.0%	–	–	–	**-1.0%**
International Small Cap (VSS)	0.0%	–	–	–	**0.0%**
U.S. Real Estate (VNQ)	-8.2%	–	–	–	**-8.2%**

Income Asset Classes*	**Q1 2018 Returns**	**Q2 2018 Returns**	**Q3 2018 Returns**	**Q4 2018 Returns**	**2018 Returns**
High-Yield Dividend Equities (VYM)	-3.0%	–	–	–	**-3.0%**
US Corporate Bonds (VCIT)	-2.4%	–	–	–	**-2.4%**
High-Yield Corporate Bonds (HYG)	-1.0%	–	–	–	**-1.0%**
US Preferred Stocks (PFF)	-0.4%	–	–	–	**-0.4%**
Emerging Market Bonds (EMB)	-2.3%	–	–	–	**-2.3%**

*Returns displayed represent the major asset classes of **Rebalance** portfolios, including dividends measured via the ETFs shown in parenthesis.

Growth Asset Classes

U.S. Stocks. The U.S. expansion continued in the first quarter, but stocks wobbled on renewed volatility. Rising interest rates seemed to spook investors despite a long-telegraphed return to sustainable bond payouts. Fears of asset repricing and a potential spat over U.S. tariffs were offset by the impact of deep corporate tax cuts, full employment and continued economic expansion abroad. While sobering, the long-anticipated first quarter correction did not mushroom into anything larger, giving stock buyers a second wind as the quarter wound down.

Small Cap Stocks. Investors peeled money out of large caps during the first three months, giving smaller company shares the windfall. Tax cuts, which aid smaller companies in a more impactful way, were a factor. Small company earnings were strong, with some analysts predicting more to come. Crystal balls aside, much of what drives stock prices higher is nothing more than investors seeking to take profits in other parts of a portfolio then choosing the relative "loser" to soak up the spoils. This time around, that phenomenon turned out to benefit small-cap stocks.

Real Estate Stocks. Higher interest rates had a negative effect on real estate stocks in the first quarter, as investors took money from income-oriented plays and put money instead into the relative safety of bonds. While other factors supported real estate, such as low unemployment, low inflation, strong demand and housing starts, pressure from the Federal Reserve is hard to deny. Over extended periods, the data show that real estate outpaces stocks. In a rising interest rate environment, however, the flight to investment-grade debt is a difficult tide to swim against.

Large European, Japanese & Asian Stocks. Stocks of large foreign companies took a breather in the first quarter after making a solid run over the previous 12 months, posting double-digit gains. The strong 2017 performance seemed to coast to a halt in early 2018 as political noise about trade deals took over. So far, there seems to have been more wind than weight behind the trade-war headlines, but investors did not need much prompting to trim holdings anyway. A tech-stock reckoning at home and abroad, following years of outperformance, also had an impact.

Emerging Market Stocks. When big economies sneeze the rest of the world catches the cold, per usual. Yet the underlying strength of growing global economies could not keep emerging stocks down for long. They finished the quarter positive; just not in the superior return position of the last few quarters. Volatility is the name of the game with emerging-country shares, so a step backward might be the pause the refreshes, assuming that global growth stays in track into the rest of 2018.

Income Asset Classes

U.S. Corporate Bonds. Rising interest rates has created a situation where debt buyers increasingly seek bonds with longer maturities. That shift, however reasonable, implies a decline in the value of existing bonds. This is another reason why steady rebalancing helps investors smooth out what can be the jarring experience of trying to predict investment outcomes — a virtual impossibility.

High Yield Corporate Bonds. If risk is on the rise among investment-grade bonds, then high-yield, or so-called "junk" bonds, are that much more of a target for traders nervous about long-dated bonds issued by companies under earnings pressure. Companies that issue high-yield debt are generally higher risk anyway, so adding in interest-rate risk only amps up the pressure to get out. That's why diversification in a low-cost index fund is fundamental to prudent investing. Owning many different investments in an asset class dampens the volatility in good times and bad.

Emerging Market Bonds. After a solid year-plus of good global growth, the increase in developed-market volatility had the highly predictable knock-on effect of pressuring emerging market debt. Broadly, we buy this asset class for our clients because emerging countries pay more to borrow but also because emerging nations are the storehouse of long-run global growth. Lending to emerging markets is always a risk — just consider Venezuela for a moment — but the case for the asset class remains solid, despite choppiness in the short run.

High Yield Dividend Equities. Interest rates truly are the tide against which most all investments must swim, for better or worse. The years-long movement into high-paying dividend stocks was a great strategy in a world defined by artificially low bond yields. Now the wind is against dividend stocks, though the trend may take years to unwind. The thing about dividends, though, is that falling stock prices can push up yields, so steady rebalancing over time will push your portfolio in the right direction, even if the short run isn't inspiring.

Preferred Stocks. A roiled bond market is no picnic. It's ultimately impossible to say if the Federal Reserve will stick to its plan of steady, predictable interest rate hikes. Whatever happens, the sheer size of the debt market means small shifts can result in large movements of money toward or away from specific investments. We find preferred stocks to be somewhat insulated, given their hybrid nature, and a good place to find diversification as the larger bond market shakes out.

The Rebalance Investment Process

Rebalance 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** 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**'s proprietary portfolios rely on multiple ways to deliver returns to our clients that are commensurate with the risk taken.

The **Rebalance** 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 Investment Committee

Burton Malkiel, Charles Ellis and Jay Vivian comprise the **Rebalance** 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** 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.