Market Review

Summer 2018

Do Without Doing

"We aren't paid to be busy. We are paid simply to be right." - Charles Munger (Warren Buffett's partner)

The path to success in many areas of life, including most of our careers, is paved with continual hard work, intense activity, and a day-to-day focus on results. However, many investors who adopt this approach to managing their wealth end up surprised and disappointed at sub-optimal returns.

The Chinese philosophy of Taoism has a phrase: "wu-wei." In English, this translates into "do without doing." It means that in some areas of life, such as investing, greater activity does not necessarily translate into better results. In Taoism, students are taught to let go of what they cannot control. To use an analogy, when you plant a tree, you choose a sunny spot with good soil and water. Apart from regular pruning, you let the tree grow. One cannot actively pursue wu wei. It manifests as a result of cultivation.

A bit less loosely translated, Wu-wei describes not forcing things as a way of life. It's about spending less time trying to manipulate situations, people, and environments to satisfy your desires, and spending more time aligning yourself to the natural flow of things. This philosophy is about avoiding the paralyzing effects of overanalysis, stress, and everything that comes with a general need to control events and people. Quite simply, wu-wei is an approach to existence that advocates an acceptance of what is out of our control, a willingness to go along for the ride, and a readiness to act in the few instances where action will truly add value.

But that last part—acting in the few instances where action will truly add value. That is the difficult part: knowing the difference between the few situations where some small action will add real value and the many situations where we feel anxious to act, but those actions will get us nowhere.

Not About Laziness and Complacency

This doesn't mean that you should never take action, rather be strategic when you do. Insights from financial science suggest that you should direct your investment efforts to the things that you can control. These include taking account of your own preferences and sensitivities when choosing investment strategies, diversifying your allocation to moderate the ups and downs, being mindful of the impact of fees, and exercising discipline when emotions threaten to blow you off course.

Successful investing requires taking actions that can have a positive impact on the outcome. For instance, to maintain a desired asset allocation, investors should regularly rebalance their portfolio by reallocating money away from strongly performing assets.

Rebalancing is a disciplined, premeditated activity based on each person's circumstances. It contrasts with the "busyness" of reflexively following investment trends and chasing past returns promoted through financial media. Look at the person who fitfully watches business TV or who sits up at night researching stock tips. That sort of activity is usually counter-productive and very likely adds cost without any associated benefit. With investing, constantly tinkering with an allocation does not perfectly correlate with success.

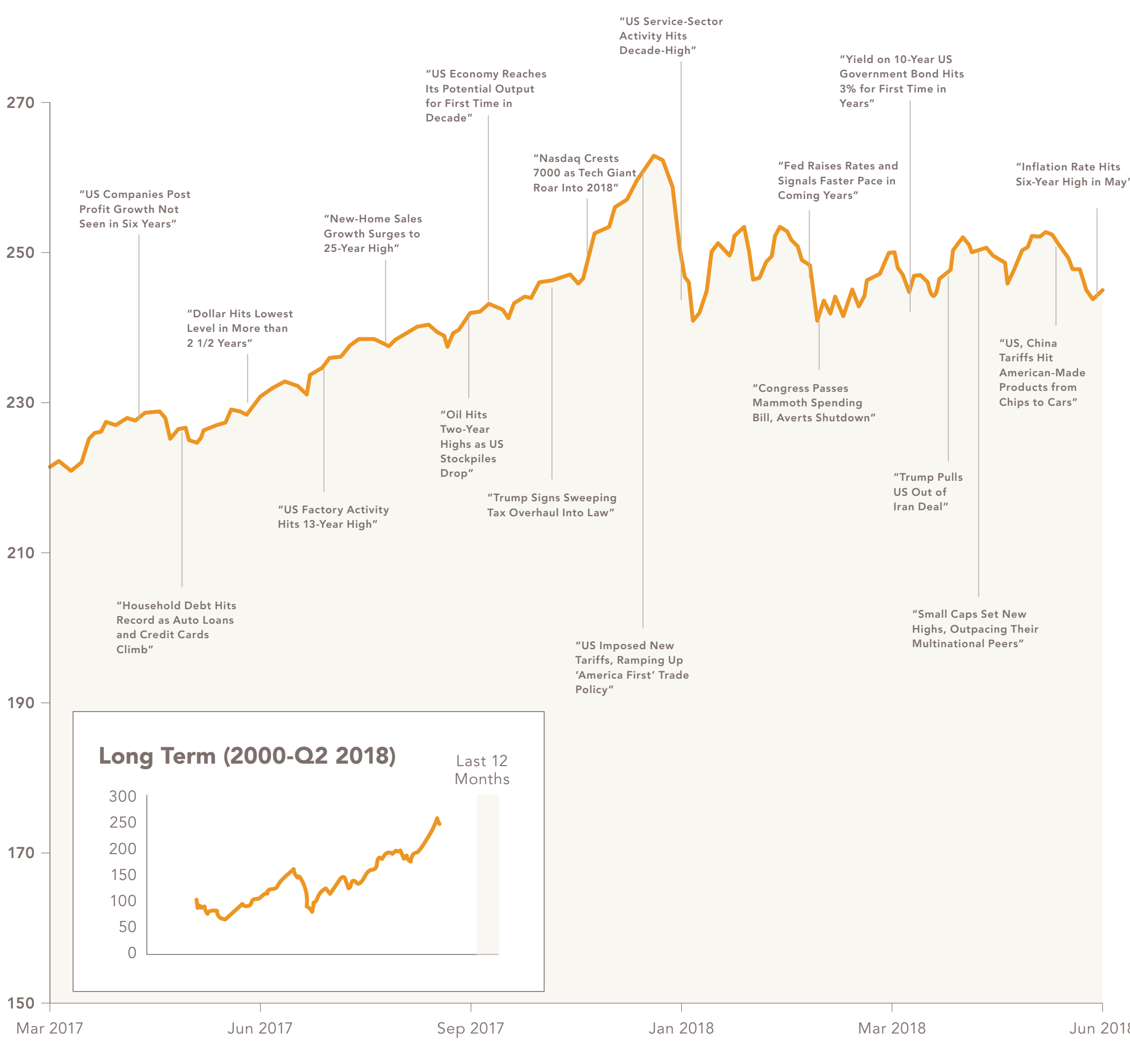
Now, while that makes sense, many struggle to apply those simple long-term investing principles.

Because the media is compensated by looking at investing through a different lens, it encourages viewers to focus on today's news (which is already priced into stocks and bonds) or on speculating about tomorrow. The chart below illustrates the counter-productive impact of major headlines and stock market values. Guesswork can be interesting and add to ratings, but, is it relevant to your personal long-term plan? Probably not.

World Events and the Global Stock Markets

World Stock Market Performance

MSCI All Country World Index with selected headlines from past 12 months



People caught up in the day-to-day may constantly switch money managers based on past performance, or attempt tactical changes in their allocation, or respond in a knee-jerk way to news events that turn out to be noise.

Again, the assumption underlying this media-influenced approach is that if you just put more effort into understanding the external factors and adjust your position constantly, you will get better results.

Making reactive investment decisions based on emotion more times than less leads to disastrous results. Investors often end up earning lower long-term returns from trading too much, chasing past performers, attempting to time the market, or altering their portfolio based upon current events (for example, today's trade tariffs).

Ultimately, the noise of the financial media should serve as a reminder of the potential benefits available to disciplined investors who stay focused on what they can control.

As the ancient Chinese proverb says: "By letting it go, it all gets done. Those who let it go win the world. But when you try and try, the world is beyond the winning."

Very truly yours,

Your **Rebalance** Team

Asset Class Performance

Q2 2018 Index Results*

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2018	**Stocks**				**Bonds**	
	3.89%	-0.75%	-7.96%	6.05%	-0.16%	0.48%
Since Jan 2001						
Avg. Quarterly Return	2.0%	1.5%	3.0%	2.6%	1.1%	1.1%
Best Quarter	16.8% Q2 2009	25.9% Q2 2009	34.7% Q2 2009	32.3% Q3 2009	4.6% Q3 2001	4.6% Q4 2008
Worst Quarter	-22.8% Q4 2008	-21.2% Q4 2008	-27.6% Q4 2008	-36.1% Q4 2008	-3.0% Q4 2016	-2.7% Q2 2015

***Past performance is not a guarantee of future results. Indices are not available for direct investment. Index performance does not reflect the expenses associated with the management of an actual portfolio.** Market segment (index representation) as follows: US Stock Market (Russell 3000 Index), International Developed Stocks (MSCI World ex USA Index [net div.]), Emerging Markets (MSCI Emerging Markets Index [net div.]), Global Real Estate (S&P Global REIT Index [net div.]), US Bond Market (Bloomberg Barclays US Aggregate Bond Index), and Global Bond Market ex US (Bloomberg Barclays Global Aggregate ex-USD Bond Index [hedged to USD]).

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 second quarter of 2018 these asset classes performed as follows:

Growth Asset Classes

U.S. Stocks. Information technology, real estate, energy and consumer discretionary stocks drove the U.S. stock market higher in the second quarter, rebounding from a slightly negative performance in the first three months of the year. While broad-based — seven out of 11 sectors were positive — the stock market was nevertheless volatile as interest rates rose and global tensions over trade put pressure on investors who might otherwise prefer to stay in large-cap stocks.

Small Cap Stocks. Our firm accentuates smaller public companies because their long-term growth performance historically has been higher than larger companies. Several studies have shown that, despite higher volatility, small caps are the growth engines of many investment portfolios.

That truism turned out to be a fundamental driver of the **Rebalance** portfolios in the second quarter, in part thanks to the ongoing impact of corporate tax cuts passed in December last year. Big tax cuts help small companies more than large ones because larger companies typically have strategies in place to lower their tax burden while small companies often do not. The tax cut thus disproportionately helped small stocks report better earnings, pushing up valuations.

Real Estate Stocks. The housing industry has been struggling over the past few months to keep up with huge demand for homes and apartments. That drives up rents and increases the profitability of real estate investment trusts (REITs). While a rising interest rate environment is a negative for real estate firms, which borrow to build, if revenue rises faster REITs become more, not less, attractive as investments. The upward tilt on our real estate holdings reflects this quick turnaround, going from sharply negative in the first quarter to sharply positive in the second.

Large European, Japanese & Asian Stocks. It is easy to chalk up foreign slowdowns to the recent White House campaign to rewrite trade rules or at least renegotiate longstanding agreements. That is part of the concern for major European and Asian stocks. However, it is less about direct trade than it is about U.S. trade with China. The current administration recently decided to kiss and make up with European trade chiefs, but business leaders on the Continent fear that U.S. trade threats might still be carried out against China. Given the global nature of supply chains, a move against Beijing could set off a series of cost increases that would affect exporters around the globe. Business sentiment in Japan and Germany has dipped as a result, even as U.S. business leaders remain upbeat.

Emerging Market Stocks. After a solid first quarter and double-digit growth in 2017, emerging markets took a beating in the second quarter. Talk of recession in Brazil, political and military conflicts in the Middle East, higher energy costs and a strong U.S. dollar all combined to punish earnings down. A strong dollar drives up borrowing costs for emerging countries, while higher U.S. interest rates draws home capital that might otherwise seek a return abroad. Trade disputes are not helping, and small countries are increasingly bound up in global supply chains. Disruption from bigger economies has a multiplier effect on small ones. When elephants fight, the ants lose the most.

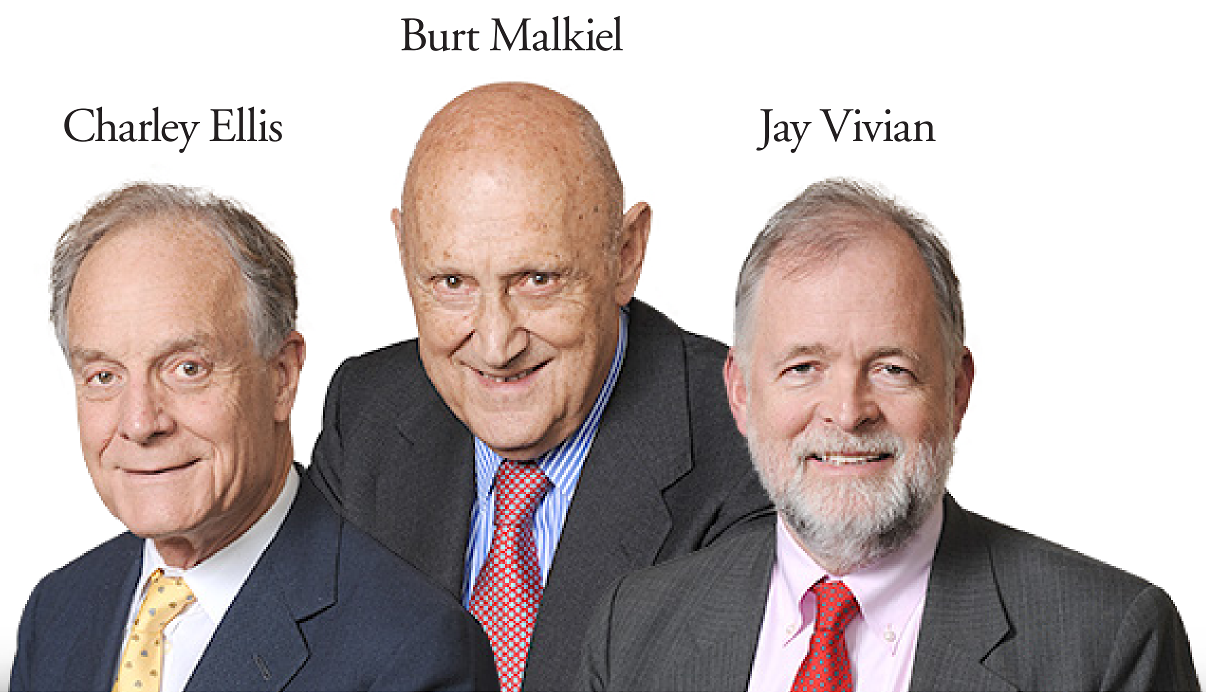
Income Asset Classes

U.S. Corporate Bonds. The shift into lower interest rate government bond investments comes at a cost for corporate lenders who are used to being the cleanest dirty shirt in the pile for those seeking yield in a yield-starved world. Corporations that had been happy to distribute the windfall from lower tax rates to investors might instead have to increase their payouts to their own lenders. While we are nowhere near bond rates of years ago, it's enough of a change to rattle corporate finance departments that had grown accustomed to rock-bottom debt costs.

High Yield Corporate Bonds. So-called "junk" bonds appear to be in a temporary sweet spot. Their yields remain attractive to investors despite pressure from a rising rate environment. Investors flocked to high-yield investments even as they exited higher grade corporate bonds. As the benchmark U.S. lending rate bumps up against 3% however, the ability for lower-quality borrowers to repay could be strained. Default rates could edge higher, pushing investors out of high-yield as risk increases but yields stay the same.

Emerging Market Bonds. A broad move in the United States and in China to tighten monetary policy could have a strong secondary effect on emerging countries and their ability to secure financing for their own debt. Solid, double-digit growth stories are turning into a negative year-to-date performance for emerging country debt issuers. "Active" bond fund managers will try to cherry pick the few winners here. **Rebalance** takes the view that diversification and rebalancing are more powerful ways to offset risk while still participating in the positive long-term performance of small country bond issuance.

Preferred Stocks. Preferred stocks benefited in the same way as high-yield corporate bonds in the second quarter, though with slightly less "oomph." The higher payout from preferred stock, which has features of both stocks and bonds, was more attractive to investors vs. just owning corporate bonds or short-term U.S. bonds.



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.