rebalance

Spring 2019
What's Hot Becomes What's Not

When our team begins to speak with a prospective client, we ask for a copy of their current portfolio so that we can look for ways to improve it. We often discover expensive actively managed funds in their portfolio, which presents an opportunity to reduce fees and risk. In a recent conversation, a prospective client told us that his advisor preferred actively managed funds over indexed funds because "in a down market someone needs to be adjusting positions as conditions change."

And isn't that the crux of it?

While "adjusting positions as conditions change" may sound smart, it makes little sense. Wouldn't it be better to construct a portfolio that presumes a variety of conditions and is set up to survive them? In California, earthquakes happen suddenly and with very little warning. The state's building codes include seismic design to live through unexpected earthquakes of various levels. Like global markets, there is no time to react when an earthquake happens — it is too late. When markets shift, what knowledge could any individual possibly have that would inform rational judgements about when the shift will begin and end? We believe this to be an impossible task.

This concept of attempting to "outsmart" the stock market also leads to promoting a yearly parade of investment fads, tempting investors with the latest and greatest opportunities. These approaches are wide-ranging. For example, capitalizing on developments such as the perceived relative strength of particular geographic regions, technological changes in the economy, or the popularity of different natural resources. However, smart investors understand that letting short-term trends influence their investment approach is a loser's game. As Nobel laureate Eugene Fama said, *"There's one robust new idea in finance that has investment implications maybe every 10 or 15 years, but there's a marketing idea every week."*

Decades of Fads

Looking back at some investment fads over recent decades can illustrate just how often trendy investment themes come and go:

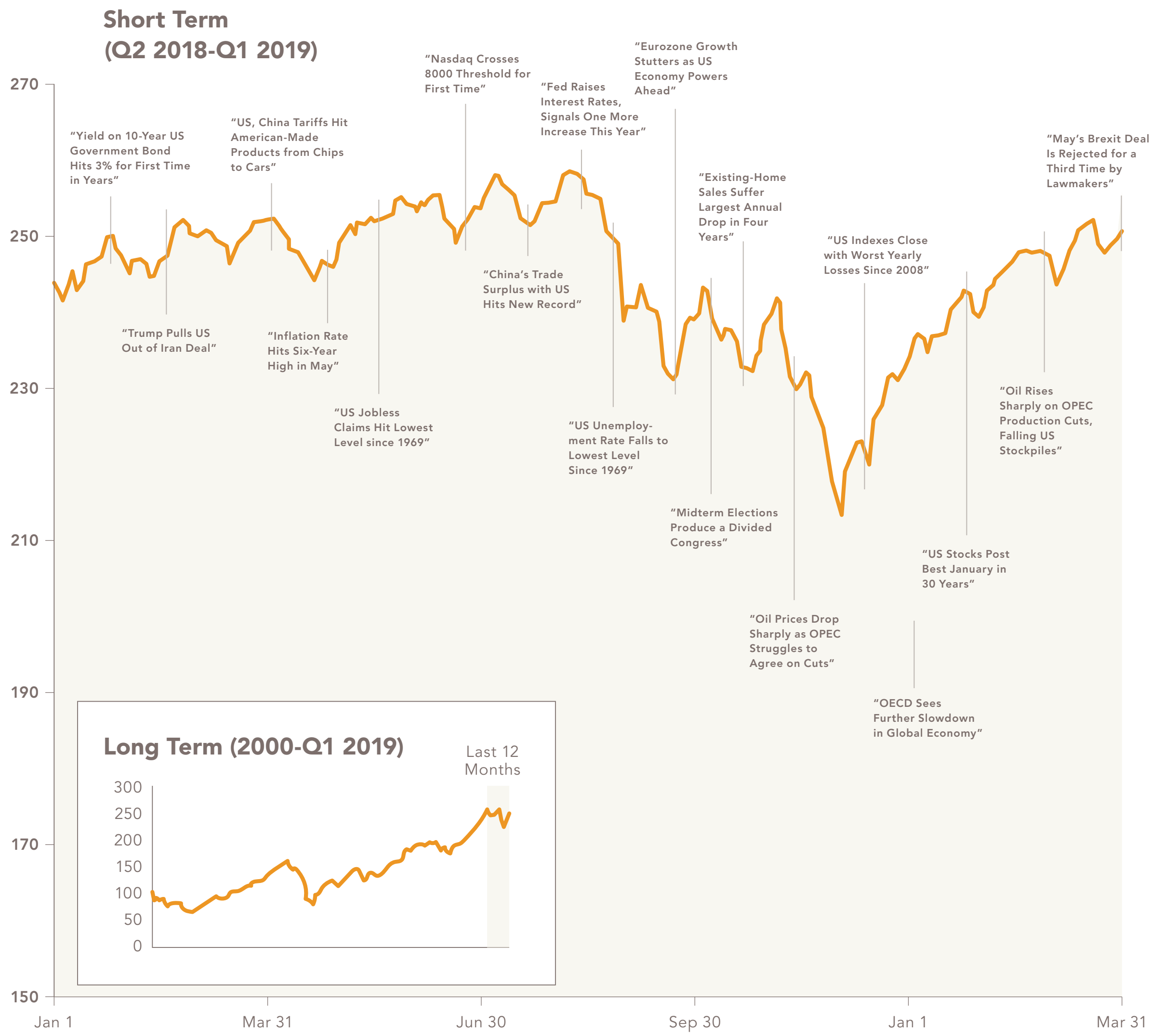
- In the 1950s, the "Nifty Fifty" were all the rage.
- In the 1960s, "go-go" stocks and funds piqued investor interest.
- In the early 1990s, attention turned to the rising "Asian Tigers" of Hong Kong, Singapore, South Korea, and Taiwan.
- In the 2000s, much was written about the emergence of the "BRIC" countries of Brazil, Russia, India, and China and their new place in global markets.
- During the 2000s, 130/30 funds, which used leverage to sell short certain stocks while going long others, became increasingly popular.
- In the wake of the 2008 financial crisis, "Black Swan" funds, "tail-risk-hedging" strategies, and "liquid alternatives" abounded.
- Since 2010, investors have reached for yield in a low interest rate environment. Accordingly, funds have sprung up that claimed to offer increased income generation, and new strategies such as unconstrained bond funds have proliferated.

Today's popular strategies focus on peer-to-peer lending, Bitcoin, cryptocurrencies, and even cannabis cultivation and private space exploration. In this environment, so-called "FAANG" stocks and concentrated exchange-traded funds with catchy ticker symbols also have garnered attention among investors.

Fads tend to play off the stock market concerns of the day. During the last quarter of 2018, the fad was "downside protection," funds that could supposedly "get you out of the way before a large

World Stock Market Performance

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



market meltdown." And of course, right when you do that, the stock market roars back, as it did in the first quarter of this year.

The Fund Graveyard

Unsurprisingly, numerous funds across the investment landscape were launched over the years only to subsequently close and fade from investor memory. While economic, demographic, technological, and environmental trends shape the world we live in, public stock markets aggregate a vast amount of dispersed information and drive it into security prices. Any individual trying to outguess the stock market by constantly trading in and out of what's hot is competing against the extraordinary collective wisdom of millions of buyers and sellers around the world.

With the benefit of hindsight, it is easy to point out the fortune one could have amassed by making the right call on a specific industry, region, or individual security over a specific period. While these anecdotes can be entertaining, there is a wealth of compelling evidence that highlights the futility of attempting to identify undervalued stocks in advance and profit from it.

It is important to remember that many investing fads, and indeed, most mutual funds, do not stand the test of time. A large proportion of funds fail to survive over the long term. Of the 1,622 fixed income (bond) mutual funds in existence at the beginning of 2004, only 55% still existed at the end of 2018. Similarly, among equity (stock) mutual funds, only 51% of the 2,786 funds available to U.S.-based investors at the beginning of 2004 endured.

What Am I Really Getting?

When confronted with choices about whether to add additional types of assets or strategies to a portfolio, it may be helpful to ask the following questions:

1. What is this strategy claiming to provide that is not already in my portfolio?
2. If it is not in my portfolio, can I reasonably expect that including it or focusing on it will increase expected returns, reduce expected risk and/or help me achieve my investment goal?
3. Am I comfortable with the range of potential outcomes?

If you are left with doubts after asking any of these questions, it may be wise to use caution before proceeding. Within stocks, for example, a broad-based portfolio like one our firm employs gives you ownership in thousands of companies doing business around the world and broad diversification across industries, sectors, and countries. While there can be good reasons to deviate from a market portfolio, investors should understand the potential benefits and risks of doing so.

Fashionable investment approaches will come and go, but investors should remember that the long-term, disciplined investment approach based on robust research and implementation is the most reliable path to success in the global capital markets.

Long-Term Market Summary

Index Returns*

Q1 2019	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
	Stocks				Bonds	
	14.04%	10.45%	9.92%	14.07%	2.94%	2.96%

Since Jan 2001	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Avg. Quarterly Return	2.0%	1.4%	2.9%	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 as the basic building blocks of our client portfolios: Growth and Income. During the first quarter of 2019 these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks had their highest first-quarter return since 1998 amid easing global trade tensions and accommodative central bank policies. In January, the end of the longest government shutdown in U.S. history also provided investors with relief. The Standard & Poor's 500 Index gained 14% in the quarter and has risen more than 20% since its recent low in late December.

Small U.S. Stocks. A misplaced panic over the U.S. economy in the final month of 2018 drove markets down sharply, setting the stage for an 11.7% surge in those shares in the first three months of the year. Over multi-year periods, small stocks offer investors a clear growth "edge" compared to large U.S. company shares.

International Developed Stocks; European stocks rose in concert with a global market rally despite ongoing signs of slowing economic growth in the 19-member eurozone. Stocks moved higher even as political leaders in the United Kingdom repeatedly failed to approve a long-awaited plan to leave the European Union, forcing Brexit negotiations to continue past a key March 29th deadline. Overall, the MSCI Europe Index gained 12%.

The U.K.'s Brexit plan was defeated in the British Parliament for a third time on March 29th, losing by a vote of 286 to 344 and leaving the political process in turmoil. U.K. lawmakers continued to pursue alternative measures, which include a modified withdrawal plan, a new nationwide Brexit referendum, or potentially no exit at all, among other options. U.K. stocks finished the quarter with a 9% gain, lagging the overall market, and the British pound rose 2% against the dollar.

Asia-Pacific markets rebounded sharply. Most Asia-Pacific markets fared well. Australian stocks rose 10%, reversing an 8% fourth-quarter decline. Hong Kong shares rose 16% versus a 4% drop in the fourth quarter, and New Zealand stocks advanced 15%, reversing an 8% decline. Japanese stocks rebounded in the first quarter despite signs of an economic slowdown. The MSCI Japan Index rose 8% on a local currency basis after dropping 17% in the prior quarter. Japan's economy showed more signs of stress. Exports dropped for a third consecutive month in February, hurt by lower Asian demand.

Emerging Markets Stocks rebounded, lifted by progress in the U.S.-China trade dispute and news that the U.S. Federal Reserve expects to slow its pace of interest rate hikes. Chinese stocks soared on hopes that the U.S. and China could avert a major trade war. Constructive negotiations and cheaper valuations following last year's sell-off lured investors despite China's slowing economy.

Indian equities shot up in March after lagging most emerging markets in January and February. With its handling of a terrorist attack in the Kashmir region, Prime Minister Narendra Modi's party regained some momentum ahead of general elections taking place in April and May. Plans by opposition parties to create a strong nationwide alliance against Modi also have not panned out.

Real Estate rallied on improved confidence that interest rates will stay lower for longer, removing a common source of concern for the group in recent years. The Fed's dampened forecast for hikes also subdued investor fear that rates will move appreciably higher in future periods. This news overshadowed generally underwhelming earnings guidance from property companies, pushing all sectors higher. The best performance came from the industrial, office, and shopping center sectors, driven by solid guidance and/or improved trade headlines. Conversely, regional mall owners and storage lagged, given weak guidance, with malls also hit by elevated store closing activity to start the year.

Income Asset Classes

High Grade Corporate Bonds and other fixed income asset classes followed equity returns higher. The major bond index ended the quarter at 2.94%, buoyed by both lower yields and tighter credit spreads. The 10-year Treasury yield ended the quarter at 2.41%, down about 0.25%. The Federal Reserve kept the fed funds rate at 2.5% at its January and March meetings and said it expected no further increases for the rest of 2019. Corporate bonds rallied, with investment-grade bonds gaining 5.1%.

High-Yield Corporate Bonds. Owning high-yield corporate debt is higher risk compared to investment-grade bonds but also provides higher yields to compensate for the added risk. Positive economic talk from the Fed goosed investor demand, pushing high-yield to a more stock-like 7.6% gain in the quarter. Solid economic numbers also prompted many investors to buy into high-yield in search of extra income.

Emerging Market Bonds recorded solid returns, helped by comments from major central banks favoring low interest rates to help support the global economy. Dollar bonds in Brazil, Indonesia, and Mexico all gained more than 5%. A number of countries completed debt offerings, riding on renewed appetite for emerging markets sovereign issues. Qatar sold $12 billion in dollar bonds and Saudi Arabia sold $7.5 billion. Elsewhere, Mexico completed a $2 billion sale and the Philippines raised $1.5 billion.

Preferred Stocks. Preferred stocks saw an outsized relative gain in the first three months, posting a 7.8% return that exceeded its 10-year performance and nearly doubled the 20-year return of 3.8%.

Like any income investment, preferreds are sensitive to higher interest rates. The removal of the risk of an increase in interest rates motivated income-hungry investors to move big into this asset class in the period.

Treasury Inflation Protected Bonds (TIPS). The U.S. government backs TIPS. They provide ultra-low volatility and an inflation hedge. TIPS tend to behave differently from other types of investments with a low correlation to stocks and bonds, making TIPS a valuable portfolio diversifier.

The Rebalance Investment Committee

The **Rebalance** Investment Committee meets several times a year to review our client portfolio options, asset class selections, and overall economic factors. The Committee's goal is to curate client portfolios that generate the most investment return for the least amount of risk.

The Rebalance Investment Committee meeting in New York, April 2019. (from left to right: Scott Puritz, Charley Ellis, Jay Vivian, Burton Malkiel, Mitch Tuchman, Sally Brandon)

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.

Burton Malkiel, Charles Ellis and Jay Vivian comprise the core of the **Rebalance** Investment Committee. They are renowned for creating and implementing sophisticated investment methods used today by elite pensions and endowments.

Rebalance, and its clients, are fortunate to have such respected and savvy financial experts guiding key investment decisions.

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.

We thank them for their input and wisdom.

Very truly yours,

Your **Rebalance** Team