rebalance

Fall 2019
TNSTAAFL

On the first day of Economics 101, the professor shuffled into the classroom holding white chalk in hand and wrote random characters on the board. He asked, "Who knows what this means?"

TNSTAAFL

It was fall 1974 at Brandeis College in Waltham, Massachusetts.

My friend Jeff rolled his eyes. I bet he was thinking, "This professor is nuts!" No one guessed the answer and the professor filled in the acronym:

There's **N**o **S**uch **T**hing **A**s **A** **F**ree **L**unch

The free lunch in the saying refers to the 19th-century practice in American bars of offering a "free lunch" to entice drinking customers. The professor went on to communicate the notion that it is impossible to get something for nothing.

TNSTAAFL would remain the centerpiece concept of the entire semester.

It's hard to deny the allure of a free lunch or anything free. Free rewards are frequently a positive and potent emotional trigger for most people, even though ultimately we know there's a price for every pleasure. It's a basic life lesson. As Jane Fonda would bellow in her aerobic workout videos, "No pain, no gain."

Many investors, however, don't understand that this life lesson applies to investing.

Some prospective clients say they need 6% returns to achieve their retirement goals but also tell us that they cannot tolerate market volatility. And, when clients don't get the answer they want, we simply say, "Sorry."

Who wants a free lunch?

Unfortunately, most financial services advisors won't be truthful or say, "Sorry." Wall Street brokerage firms, active mutual funds, and a multitude of other investment firms sell "free lunches." They emphasize high returns while keeping the risks in the fine print.

Here are some recent pitches we've seen, paraphrased:

- *As an income investor, you want 100% downside protection but 2% interest on bonds just isn't enough. Structured notes give you market returns with no downside risk. Market is up — you win. Market is down; you can't lose.*
- *We invest in only the best high-dividend paying stocks. You'll always earn a good income even when the stock market is going up and down.*
- *The recession is coming soon and with it a catastrophic loss from which you may never recover. Our portfolios have built-in protection with stop-losses, options and other strategies.*
- *Our variable annuity will give you safe, protected income for the rest of your life — no more worrying about the ups and downs of the stock market.*
- *You can now have access to better returns with alternative investments, hedge funds, private equity, and managed futures previously only available to the uber-rich.*
- *With the new tax laws, investors can now defer and even lower taxes through real estate Opportunity Zones. Our fund focuses on these zones so you'll get a great real estate investment with fantastic tax breaks.*

These pitches are seductive, particularly when delivered by erudite, well-educated financial professionals working in established institutions and armed with glossy presentation materials.

A few years back, master limited partnerships (MLPs) that own oil and gas pipelines attracted income investors with high-dividend yields, historically stable cash flows, and perceived protection from swings in oil and gas prices. Soon, however, many MLPs announced distribution cuts. Their stock prices tumbled and the “warts” began to surface.

When it sounds too good to be true, it usually is

Here’s a way to gauge “too good to be true.” In finance, a “risk-free yield” is the interest one can earn from a U.S. government-backed Treasury bond. Investors assume there is zero risk of default.

Today, this risk-free yield is slightly under 2% — barely enough to keep up with inflation.

Any investment return above 2% comes with risk. Want 4%, 6%, 8% or 10% returns? If so, you must take on more risk.

If you see 6% returns with no risk, then you do not understand what could go wrong. One of billionaire investor Warren Buffett’s most famous pieces of investment advice is “Rule #1: Never lose money. Rule #2: Never forget Rule #1.”

And beware the siren call! TNSTAAFL is alive and well in investing.

If and when those risks surface, it is usually too late. Returns collapse, investors are disappointed and money is lost forever.

The only free lunch in finance

All this to say, there is one exception. Diversification.

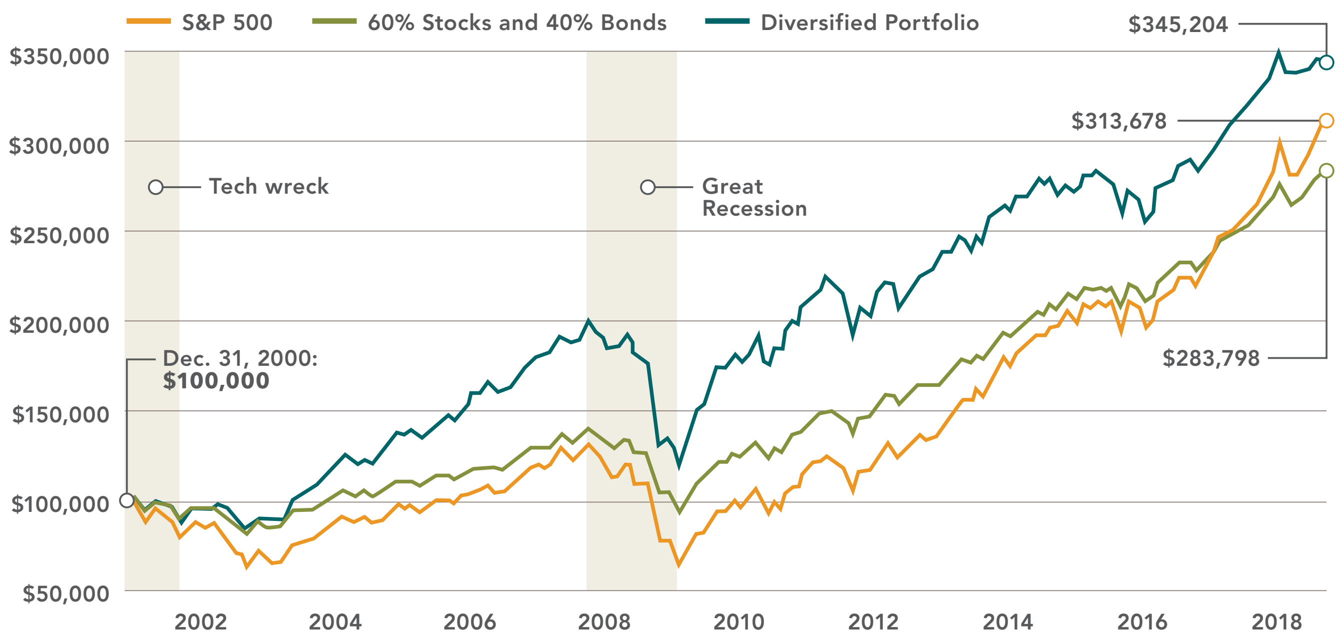
Harry Markowitz, an American economist, was awarded the 1990 Nobel Memorial Prize in Economic Sciences by developing the theory of portfolio choice, thus proving that diversification works.

By diversifying, portfolio risk is reduced at no loss in returns — a free lunch! And, there is a specific science to knowing how to diversify a portfolio to achieve this free lunch properly.

Proper diversification does not mean owning 50 stocks. Rather, it’s knowing the science of portfolio construction and diversifying into a range of geographical regions and by capitalization size, liquidity of assets and other factors.

Anthony Davidow at Charles Schwab recently re-examined Markowitz's theories and simulated the growth of $100,000 invested over the last 18 years in either of three distinct portfolios:

- 60% stocks and 40% bonds — all large U.S. companies = **$283,798**.
- 100% in the S&P 500 = **$313,678** with high market swings and volatility.
- 60% stocks and 40% bonds — fully globally diversified = **$345,204** with the least market up and down movement.



Source: Morningstar Direct and the Schwab Center for Financial Research. Data is from January 1, 2001 to September 30, 2018. Full research, assumptions and article "Why Global Diversification Matters"can be found here.

There is a free lunch available. The ability of the more diversified portfolio to cushion shocks and over time to recoup losses and grow is the basis of the **Rebalance** process. We believe this method is the smartest way to balance the amount of risk taken with a desired return.

Sadly, the rest is just dangerous marketing.

World Markets Review

Third Quarter 2019

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q3 2019	**Stocks**				**Bonds**	
	1.16%	-0.93%	-4.25%	5.72%	2.27%	2.83%
Since Jan 2001						
Avg. Quarterly Return	2.0%	1.4%	2.8%	2.6%	1.2%	1.2%
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	-21.1% 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]). S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. MSCI data © MSCI 2019, all rights reserved. Bloomberg Barclays data provided by Bloomberg.

The **Rebalance** Investment Committee works with two broad asset classes as the basic building blocks of our client portfolios: Growth and Income. During the third quarter of 2019, these asset classes performed as follows:

Growth Asset Classes

Large U.S. Stocks rose as accommodative central bank policies helped offset concerns that an escalating trade war with China and a U.S. yield curve inversion could lead to a recession. The Standard & Poor's 500 Index rose 21% year to date, its strongest return through three quarters since 1997. The growth concerns were most pronounced in August when the Federal Reserve's conservative messaging around its policy response underwhelmed investors. The Fed acted as expected by cutting rates by 25 basis points both in July and September but has not committed verbally to a more extended easing cycle. The U.S. yield curve inverted in the month, a phenomenon that often precedes a recession. Despite the ebb and flow of optimism over a trade war resolution, any concrete plans to remedy the ongoing U.S.-China dispute remain elusive. Increasing speculation over possible impeachment proceedings for President Trump further added to uncertainty.

Small U.S. Stocks finished the third quarter down slightly (-0.2%). However, the index is up 13.5% for the year, while underperforming the overall U.S. market, which is up nearly 20% in 2019. Small caps seem to be in a holding pattern where various sectors seem to outperform and then underperform within the group. In prior recessions, investors began moving away from smaller, riskier companies and into larger ones. Some investors believe this underperformance in small caps in 2019 is a signal of an upcoming recession.

International Developed Stocks rose modestly as investors welcomed a new round of monetary stimulus measures. Reacting to signs of weakening economic growth, the European Central Bank cut interest rates in September and announced a relaunch of its massive bond-buying program. Overall, the MSCI Europe Index gained 2% in local currency terms. However, those gains were mostly erased for U.S. dollar-based investors amid sharp currency moves. Japanese stocks advanced, buoyed by a sharp rally in September. The MSCI Japan Index rose 3% while the MSCI Pacific ex Japan Index lost 3%, largely driven by a 12% decline in Hong Kong stocks. The Japanese yen fell 0.3% against the U.S. dollar after strengthening amid market volatility in August.

Small International Stocks lost ground (-2.6%) in the third quarter but are up 9.2% for the year. International small-cap stocks are perceived as riskier than U.S. stocks and can be more volatile than large caps, so it might seem counterintuitive to think about investing in international small-caps with the stock market near its highs and with trade tensions ratcheting up. But after years of weak performance international small-caps have gotten so cheap that they represent a smaller risk than U.S. large caps. They have higher dividend yields, lower multiples, are more insulated from U.S. created trade tensions, and could be poised for relative outperformance over the next several years.

Emerging Markets Stocks were down as U.S.-China trade tensions escalated and concerns over global growth continued to mount. The MSCI Emerging Markets Index decreased in value and underperformed the MSCI World. Argentina was the weakest index market as surprise primary election results triggered a major sell-off in equities and its currency, the peso. Markets more sensitive to a stronger U.S. dollar came under pressure, notably South Africa but also Indonesia. Saudi Arabia and Colombia underperformed with crude oil price weakness as a headwind. China underperformed by a more modest margin.

Real Estate share prices for U.S. REITs grew in the third quarter for the third consecutive quarter of positive returns, finishing up 7.6%, 5.9 percentage points higher than the S&P 500's 1.7% return for the same period. For the year, REITs are up 28.2% and are the strongest performing asset class this year. The healthcare sector (hospitals and care facilities) continued to do the best. At the other end of the spectrum, the regional mall sector continued to decline, including Simon Property Group Inc., the largest mall REIT by market capitalization. The timber and hotel REIT sectors were also down for the quarter.

Income Asset Classes

High-Grade Corporate Bonds outperformed government bonds. They benefited from the decline in global yields and, more recently, an improvement in risk sentiment. Investment-grade corporate bonds outperformed the riskier high yield part of the market. The telecom and utility sectors performed well. Overall, this bond asset class is up 15.7% this year as a result of lower interest rates.

High-Yield Corporate Bonds, while up 11.3% for the year, only inched up 1.3% despite Fed rate increases, reflecting concerns that these issuers would have in a recession. While these bonds generally have more volatility than high-grade corporate bonds, they currently yield about 5.3% as compensation for the increased risk.

Emerging Market Bonds ssaw corporate debt and local-currency government debt make positive returns while emerging market currencies broadly weakened against the U.S. dollar. Many countries launched bond offerings as borrowing costs fell, with rate cuts from major central banks. Larger issues included those from South Africa, which sold $5 billion in Eurobonds, and Abu Dhabi, which sold $10 billion in bonds. Across emerging market bonds, the **Rebalance** emerging market bond fund was up 1.2% for the quarter and remained up 12.6% for the year.

Preferred Stocks are hybrid instruments that exhibit the characteristics of both equity and debt securities. Their unique credit quality, security structure, coupon type and volatility profiles can help them serve as an attractive diversifier in a multi-asset portfolio. Preferreds felt pressure from rising interest rates in 2018, but this year 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. These stocks are up 13.8% for the year and 3.2% in the second quarter.

Treasury Inflation-Protected Bond (TIPs) yields fell across the Treasury curve during the period, especially for longer maturity profiles. The 10-year Treasury yield ended 32 basis points lower at 1.68%. The Fed cut interest rates by 25 basis points in both July and September, citing weakening global growth and modest inflation. Falling yields led to positive results across most fixed income sectors.

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 (left to right: Scott Puritz, Charley Ellis, Jay Vivian, Burt Malkiel, Mitch Tuchman, and 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 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 more than $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