rebalance

Summer 2019

Where's That Magic Genie?

Over the course of a summer, it's not unusual for the stock market to be a topic of conversation at barbeques or other social gatherings.

A neighbor or relative might ask about which investments seem good at the moment, or tell of her recent success in owning a particular fund. The lure of getting in at the right time, or avoiding the next downturn, may tempt even disciplined long-term investors. The reality of successfully timing the stock market, however, isn't as straightforward as it sounds.

Getting in and out of individual stocks and funds or making changes at exactly the "right" time presents investors with at best substantial, and likely insurmountable, challenges. Markets are fiercely competitive and adept at processing information. During 2018, $462.8 billion in stocks traded each day around the world. Most of these trades were made by highly trained, computer-armed institutional investors who made use of all available information, from economic data to investor preferences and so on, and quickly incorporated it into market prices.

Trying to time the market based on an article from this morning's newspaper or advice at a summer gathering? That information is likely already reflected in prices by the time the typical investor can react to it.

Even professional investors have difficulty beating the market: Over the last 20 years, 77% of equity funds and 92% of fixed income funds failed to survive and outperform their benchmarks after costs.

Getting It Right Twice

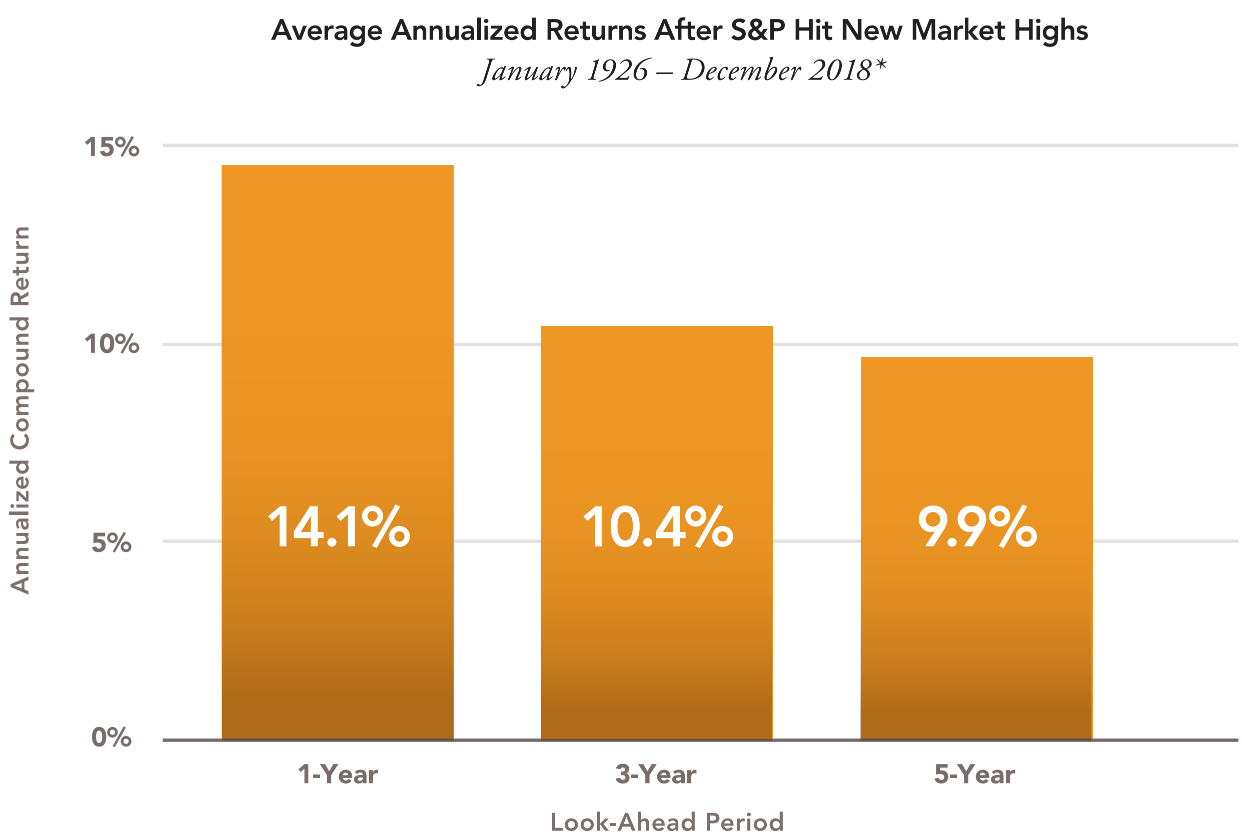
Further complicating matters, to have a shot at successfully timing the market you must make the call to buy or sell stocks correctly twice. Robert Merton, a Nobel Laureate, once said, "Suppose I could verify that I'm a .700 hitter in calling market turns. That's pretty good; you'd hire me right away. But to be a good market timer, you've got to do it twice. What if the chances of me getting it right were independent each time? They're not. But if they were, that's 0.7 times 0.7. That's less than 50-50. So, market timing is horribly difficult to do."

As Burt Malkiel of the **Rebalance** Investment Committee said, "Everyone wishes there was a magic genie that would tell them which way the market will go. But unfortunately I don't know anyone, nor do I know anyone who knows anyone, who has successfully timed the markets over various cycles and over a reasonable time period."

S&P 500 at All-Time High!

The prospect of market timing has come up in many client calls recently as the S&P 500 clocked an incredible decade. *Should we be "getting out" of U.S. stocks and moving into "safer" investments?* The chart below suggests that new market highs have not been a harbinger of negative returns to come. The S&P 500 went on to provide positive average annualized returns over one, three, and five years following new market highs.

If you think about it, markets should always be achieving new highs. That's what they have done for decades as companies continue to innovate, become more productive, and earn more per share for investors.



*In U.S. dollars. Past performance is no guarantee of future results. New market highs are defined as months ending with the market above all previous levels for the sample period. Annualized compound returns are computed for the relevant time periods subsequent to new market highs and averaged across all new market high observations. There were 1,115 observation months in the sample. January 1990–present: S&P 500 Total Returns Index. S&P data © 2019 S&P Dow Jones Indices LLC, a division of S&P Global. All rights reserved. January 1926–December 1989; S&P 500 Total Return Index, *Stocks, Bonds, Bills and Inflation Yearbook*™, Ibbotson Associates, Chicago. For illustrative purposes only. Index is not available for direct investment; therefore, its performance does not reflect the expenses associated with the management of an actual portfolio. There is always a risk that an investor may lose money.

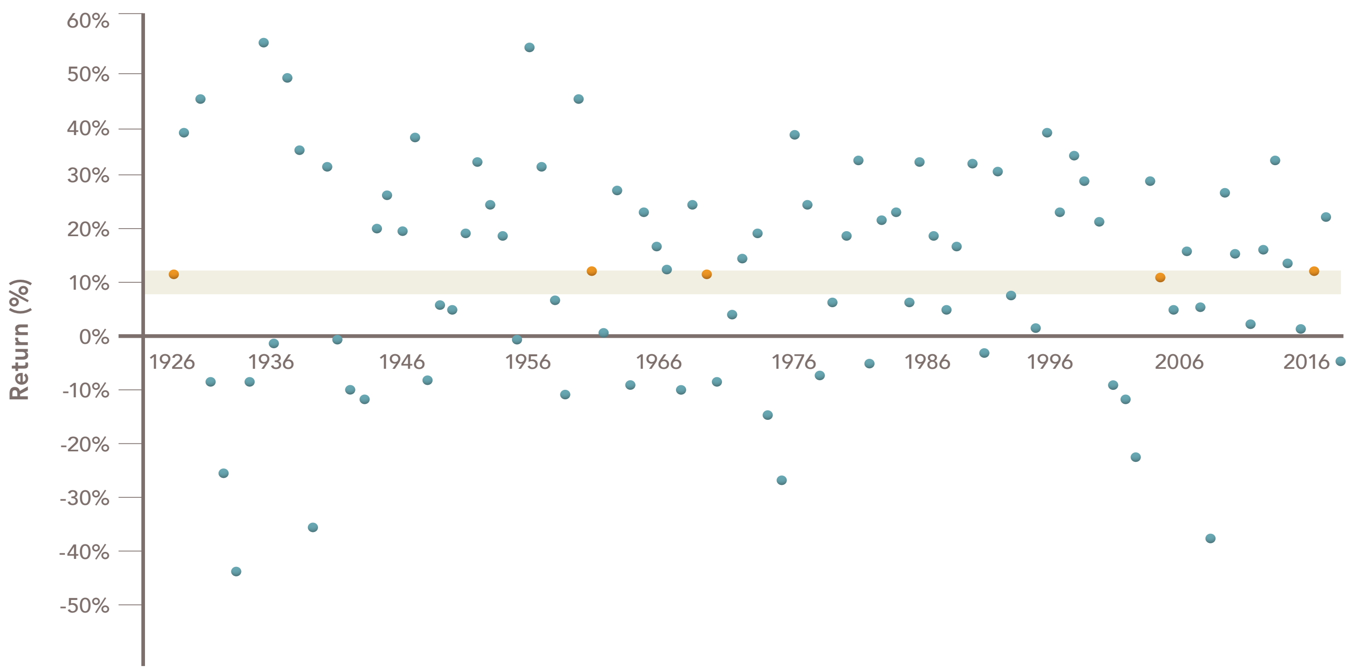
Trusting Capitalism

We know that "staying the course" is the most important way to have investment success — as long as you believe in and understand the course. The importance of having an investment philosophy, one that is robust and that you can stick with, cannot be overstated.

In years with above average returns it's usually easy to stay the course. But periods of disappointing results can test one's faith in equity markets. *What can help us endure the ups and downs?* While there is no silver bullet, understanding how markets work and trusting market prices are good starting points.

An asset allocation that aligns with personal risk tolerances and investment goals is also valuable. By thoughtfully considering these and other issues, investors can be better prepared to stay focused on their long-term goals during different market environments.

Also, being aware of the range of potential outcomes can help us all remain disciplined, which generally increases the odds of a successful investment experience. Consider these facts. The chart below shows calendar year returns for the S&P 500 Index since 1926. The shaded band marks the historical average of 10%, plus or minus two percentage points. The S&P 500 Index had a return within this range in only six of the past 93 calendar years. In most years, the index's return was outside of the range — often above or below by a wide margin — with no obvious pattern. But most every rolling five-year period showed a positive return.



In U.S. dollars. S&P data © S&P Dow Jones Indices LLC, a division of S&P Global. Indices are not available for direct investment. Index returns are not representative of actual portfolios and do not reflect costs and less associated with an actual investment. Past performance is no guarantee of future results. Actual returns may be lower.

Grand Irony

The view at **Rebalance** is that there is no need to time markets to have a good investment experience. That's because over time capital markets have rewarded investors who have taken a long-term perspective and remained disciplined in the face of short-term noise. By focusing on what we can control (such as having an appropriate asset allocation, diversification, and managing expenses, turnover, and taxes) we position ourselves to make the most of what capital markets have to offer. And as you can see from past years and decades, these ranges of returns are very satisfying and can fund a very successful retirement.

Long Term Market Summary

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:

	US Stock Market	International Developed Stocks	Emerging Markets Stocks	Global Real Estate	US Bond Market	Global Bond Market ex US
Q2 2019	**Stocks**				**Bonds**	
	4.10%	3.79%	0.61%	1.29%	3.08%	2.75%

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%	1.5%	2.9%	2.6%	1.2%	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]). 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.

Growth Asset Classes

Large U.S. Stocks touched new all-time highs, rising 4% for the quarter and 19% year to date. Elevated trade tensions with China rattled the stock market in May. Tensions calmed in June as a planned meeting between the leaders of the two countries at the G-20 summit raised optimism for an eventual resolution to the dispute. Investors also took comfort in the growing likelihood of an interest rate cut in the coming months. Economic data was mixed. The U.S. economy grew at a solid 3.1% annual rate in the first quarter, but the labor market showed signs of plateauing.

Small U.S. Stocks experienced a seesaw ride in the second quarter with lots of motion and little overall progress - a modest 1.8% positive return for the second quarter. Bullish months in April and June bookended a bearish May, likely a function of higher sensitivity to slowing economic growth. Growth equities outperformed value, with tech shares leading the growth segment while the slumping banking sector dragged down value stock indices. Banks have come under pressure as interest rates declined, which could negatively impact their lending margins.

International Developed Stocks in Europe rose on indications from the European Central Bank that it may cut interest rates in the months ahead. Stock prices advanced despite continuing political turmoil across Europe, including the announced resignation of U.K. Prime Minster Theresa May amid stalled Brexit negotiations. Overall, the MSCI Europe Index gained 4% for the quarter and 16% for the year to date. Japanese stocks fell modestly and trailed other major global markets as exports remained weak. The MSCI Japan Index lost 2% and the MSCI Pacific ex Japan Index rose 6%. Australia led the region's stock markets and gained 9%. Elsewhere, stocks rose 7% in Singapore, 6% in New Zealand and 1% in Hong Kong.

Small International Stocks have appreciated nearly 2% in the second quarter and 12.2% for the year thus far. Smaller companies could be poised to benefit from digital transformations across industries and are not subject to the regulatory scrutiny faced by some of the larger tech firms. Several large asset managers currently consider this asset class ripe for bargain hunting for relative value in the less richly priced value areas as the valuations are much lower than U.S. stocks.

Emerging Markets Stocks fluctuated due to bouts of volatility tied to U.S.- China trade talks, concerns over China's slowing economy, and election uncertainty in several countries. Many emerging market currencies gained against the dollar, boosting returns for local currency bonds. Overall, the MSCI Emerging Markets Investable Market Index finished essentially flat, putting its year-to-date gain at 10%. Chinese stocks declined after strong gains through April. Taiwanese stocks ended flat and Korean stocks edged lower. Both countries are major exporters and were affected at varying levels by trade tariffs stemming from global trade disputes. Indian stocks also finished near the breakeven line. India has been trading near record highs and stock valuations in India remain pricey relative to other developing markets. Brazil's economy has been sluggish since emerging from a long recession in 2017 but stocks there advanced on hopes their new President can overhaul Brazil's pension system.

Real Estate. U.S. real estate investment trusts (REITs) slowed down in the second quarter. Despite a sharp drop in share prices near the end of 2018, REIT stocks have soared throughout the past year, with the Vanguard REIT index recording second quarter return of 1.5% and a year to date return of 19.2%. Different types of real estate have performed in dramatically different ways. Regional mall REITS like Simon Properties were down nearly 13% last quarter, while Industrial and Self-storage properties were up nearly 10%.

Income Asset Classes

High-grade Corporate Bonds had another strong quarter. The Fed left interest rates unchanged at its June meeting and expressed a dovish tone that led yields to decline. The 10-year Treasury yield fell by 41 basis points to 2.00%, its lowest level since 2016. Returns were positive across bond sectors. Investment-grade corporates were among the best performers, advancing 4.5% for the quarter.

High-yield Corporate Bonds continued to perform well after a strong first quarter and delivered a total return of 2.2% in the second quarter and are up nearly 10% for the year. Reasonably strong economic data and accommodative signals from the Federal Reserve resulted in good performance for high yield bonds. High yield spreads remain over 4%. Consumer Goods and Media sectors were the primary detractors to relative performance during the quarter but these areas were partially offset by positive selection in the Energy and Financial Services sectors.

Emerging Market Bonds dollar-denominated and issued by sovereign nations posted solid returns as major central banks signaled plans to keep interest rates low to support global growth. Dollar bonds in Brazil, Russia and South Africa all gained at least 5%. Several countries sold new bonds, including Serbia, Croatia and Peru. Among corporate issues, oil giant Saudi Aramco raised $12 billion in its debut bond sale.

Preferred Stocks. These 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 10.2% for the year and 2.3% in the second quarter.

Treasury Inflation Protected Bonds (TIPs). The decline in the real cost of borrowing reflected end-of-Q2 market expectations that the Federal Reserve will cut interest rates at least 50 basis points during 2019. Ten-year Treasury bond yields ended the quarter below three-month Treasuries, inverting the yield curve. After a gradual multiyear rise, inflation pressure has broadly softened over the past year across labor and commodities markets, with relatively contained employment costs helping boost near-term productivity measures. Like with US Corporate Bonds, these dynamics helped to life TIPs 4.4% in the quarter and 10.1% so far this year.

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, 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