Perspectives on 2016 Capital Markets

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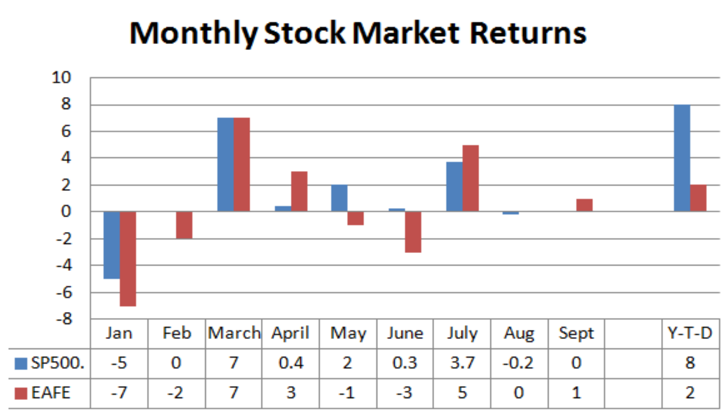
"There are no facts, only interpretations." — Friedrich Nietzsche

- Did September disappoint as usual? Yes and no, depending on your perspective.
- Is the 8-year stock market rally over? Is it a Sisyphus market?
- Which markets look attractive? We identify both momentum and reversals. Diversification outside U.S. stocks and bonds is working, for now.
- Is fundamental indexing bidding up some stocks beyond fair value?

Introduction

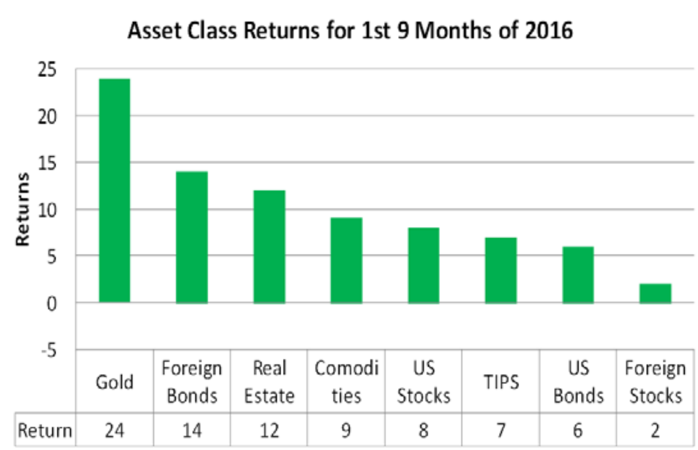
Did September, 2016 disappoint as Septembers are prone to do? The answer depends on your perspective. It disappointed by earning nothing, but it delighted by not losing its historical average -0.7%. So it is with many perspectives/interpretations of capital markets in 2016, as discussed in the following.



	Jan	Feb	March	April	May	June	July	Aug	Sept		Y-T-D
SP500.	-5	0	7	0.4	2	0.3	3.7	-0.2	0		8
EAFE	-7	-2	7	3	-1	-3	5	0	1		2

Source: PPCA Inc.

As we began the year many thought the 7-year rally had ended, but not so. Stock market investors breathed a sigh of relief in the first quarter as January losses were more than recovered in March, although foreign markets declined 3% in the quarter. Continuing into the second quarter, the S&P500 earned another 2.5%, but EAFE lost another 1. Then in the most recent quarter, the U.S. market earned 3.5% and foreign markets rebounded 6%. It would seem that the scare is over, or it could be that we're whistling past the graveyard being set up for an even bigger fall. Which is your perspective?



	Gold	Foreign Bonds	Real Estate	Comodities	US Stocks	TIPS	US Bonds	Foreign Stocks
Return	24	14	12	9	8	7	6	2

Source: The Capital Spectator

Bucking a 5 year trend, diversification has finally worked in the first nine months, with gold, real estate, foreign bonds and commodities performing quite well, better than stocks. This fact has a material impact on multi-asset portfolios, especially target date funds, as discussed in the next section where we introduce a new index. As for perspectives, the benefits of diversification are not always realized even though theory seems to suggest otherwise.

A New Index for Fiduciaries

In a breakthrough for evaluating target date funds, which now total more than a $trillion, the SMART Funds ® Target Date Index is the first and only index that is focused on Prudence, and performance expectations for prudent TDFs, a small but growing segment of the TDF marketplace. The index is specifically designed for fiduciaries because fiduciaries want to make prudent decisions. Prudent target date funds are characterized by the following:

- Low fees
- Broad diversification at long dates away from the target date
- Rigorous risk controls near the target date

Importantly, the index remedies a current serious problem, namely prudent TDFs have lost the performance horserace to less prudent competitors because prudent characteristics have been detrimental to performance. For example, until this year diversification beyond U.S. stocks and bonds had been penalized. The new index is a more pertinent standard that measures the intrinsic return to prudence.

Continuing our discussion on perspectives, we report on the details of U.S. and foreign stock market performances in 2016. As you'll see, most market segments came through okay, but some disappointed, depending on your perspective. It's been challenging.

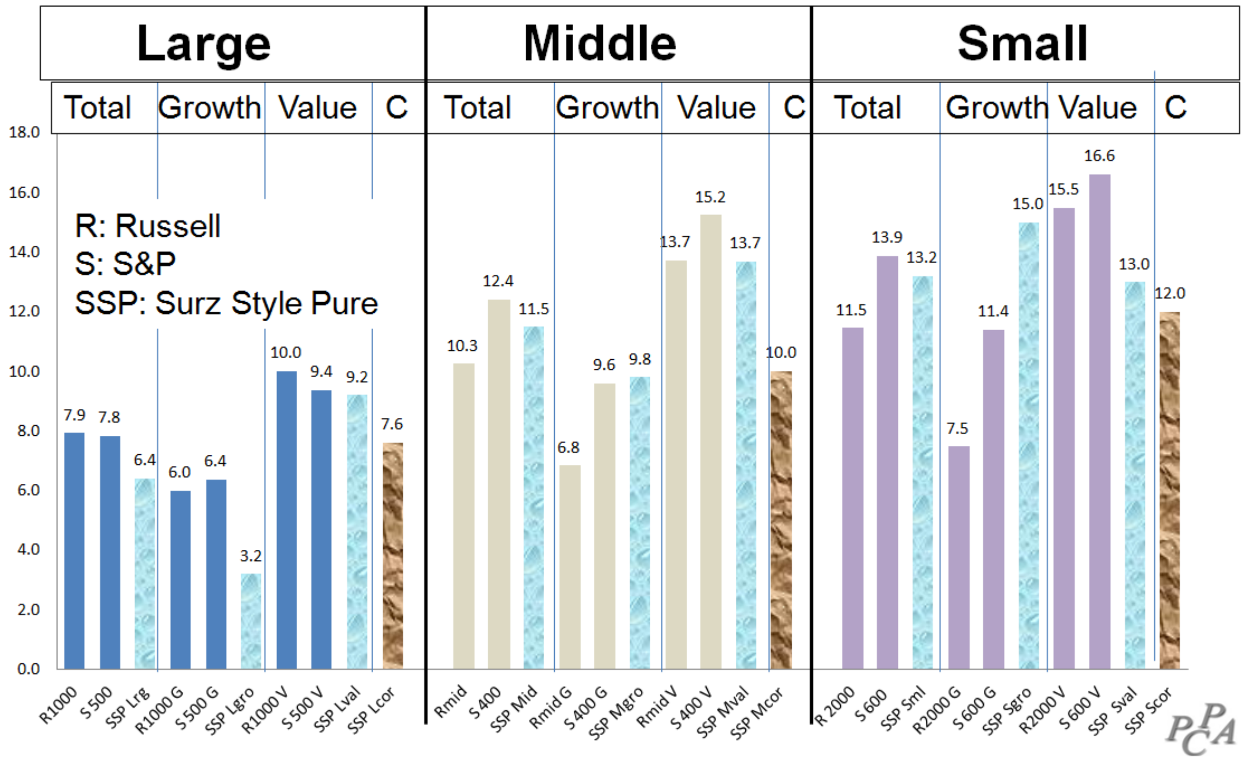
U.S. Stocks

Despite popular opinion to the contrary, style indexes are not created equal, so the following graph shows the popular S&P and Russell style indexes, plus a precursor to Morningstar style boxes called Surz Style Pure® indexes. What's your perspective? Which is your favorite? Why?

Core, defined as the stocks in the middle between value and growth, adds an important perspective; it is to Style what mid-cap is to Size. Core is shown as "C" in the graph.

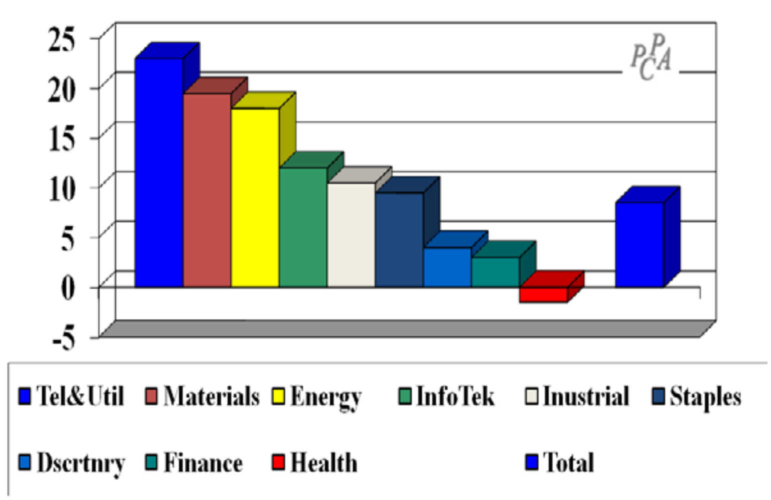
Small and mid-cap value stocks have led the way this year so far. The huge appetite for Fundamental Indexing ("Smart Beta") could be the reason for this success. Smart beta indexes tilt toward smaller company value stocks. What's your perspective? Have the lemmings overrun smart beta?

Style Returns for 1st 9 Months of of 2016



The performance range across sectors is even larger than the range across styles. Telephone-and-utility companies earned a substantial 23% return, while healthcare firms lost 1%. That's a 24% spread. Energy prices rebounded in the second quarter, so energy investors have enjoyed a positive 18% return for the year to date, as have investors in materials companies. Tech and industrials round out the list of sectors that have outperformed the broad market.

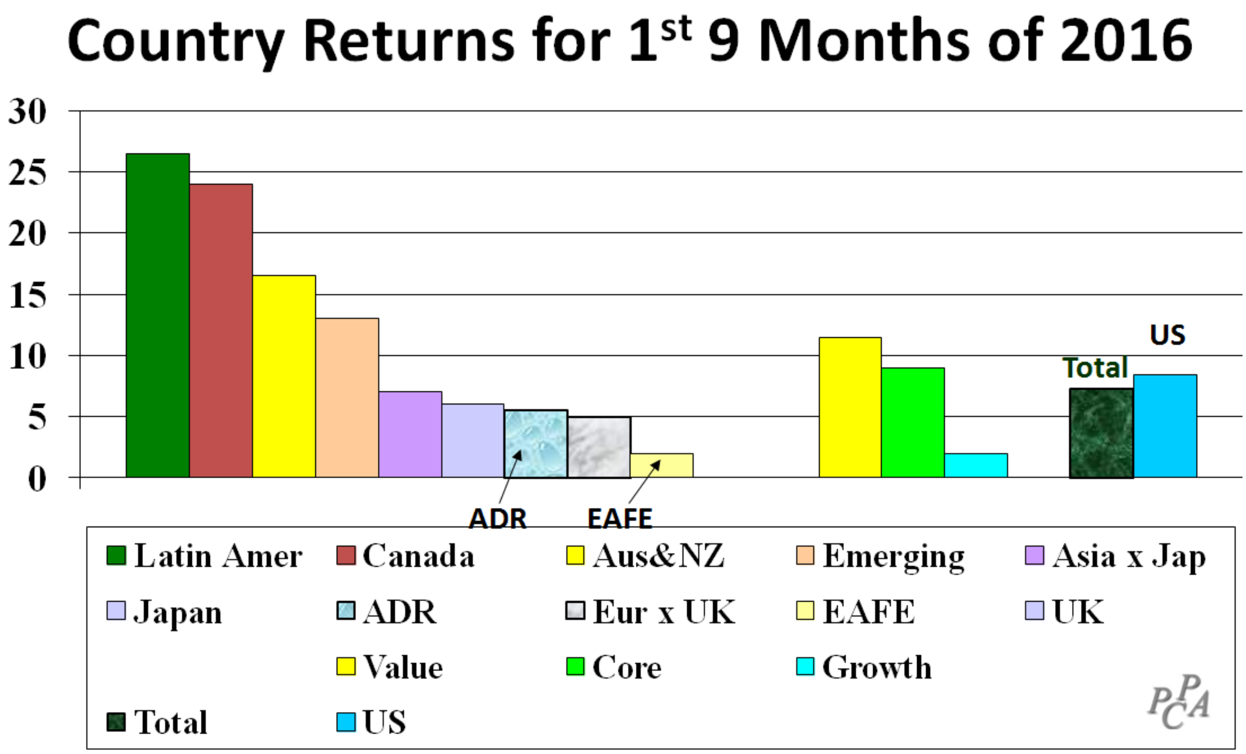
Sector Returns for 1st 9 Months of 2016



Foreign Stocks

Looking outside the US, foreign markets earned 7.3% in $U.S., lagging the U.S. stock market's 8.4% gain but exceeding EAFE's 2.2% return. Like the US smaller value companies have fared best, earning 13% while large growth companies earned only 3%. Fundamental indexing has had great success outside the U.S., as well as domestically, so it could be an explanation. Again, what is your perspective?

Latin America and Canada have left the rest of the world in their dust, earning double digit returns of 25%. From a global perspective EAFE has been very easy to beat because it has no allocation to Canada and Latin America, and it is weighted toward larger companies.



How to Use This Information

It just keeps getting better, until it doesn't. After 7 years of extraordinary growth, stock markets are starting to show signs of weakening. No one knows what lies ahead, but we all have outlooks on the economy and the stock market, and adjust our thinking as results roll in. I personally remain surprised and grateful that stocks have performed so well in the past 7 years, following the 2008-2009 meltdown; it's been a long-term reversal. We can use the information above to test our personal outlooks, to see which are unfolding as we think they should and which are not, with the intention to clear the haze from those crystal balls.

We can also use this information to evaluate our investment managers, and to put an end to the continuing disappointments from active investment managers. Success Scores can help.