MODERA
WEALTH MANAGEMENT

Investment Perspectives – Second Quarter 2017

What a difference a year makes. Brexit volatility in June 2016 mirrored Brexit issues in June 2017. There were equity valuation questions last year, and there are even more this quarter. A year ago, volatility in financial markets started to pick up. Many grew concerned about rising interest rates. Some worried that inflation was imminent and others thought a recession/deflation environment was just over the horizon. After one full circle around the sun, we've come completely full circle with the same concerns.

Looking further back, consider the difference ten years has made. The iPhone debuted in June 2007. An original CNET review of the first generation iPhone noted, "Is the iPhone pretty? Absolutely. Is it easy to use? Certainly. Does it live up to the stratospheric hype? Not so much." Few could have predicted the explosive impact the iPhone would have on society in such a short period of time. Ten years ago, equity markets were doing well, yet a "flash crash" in August 2007, the collapse of several hedge funds, and an inverted yield curve all foreshadowed the 2008 credit crisis.

Even as times have changed, they can still seem the same. In August of 1979, *Businessweek's* headline famously called for "The Death of Equities." Thirty-three years later in August 2012, former bond manager at PIMCO, Bill Gross, wrote, "The cult of equity is dying." How did those predictions work out?

	DJIA Value	Change in Price		
Aug-79	875	1979-2012	2012-2017	1979-2017
Aug-12	13,000	1386%		
Jun-17	21,350		64%	2340%
Price only: Dividends not included				

Eugene Fama, a Nobel Laureate and chief strategist at Dimensional Financial Advisors, is famous for stating, "I'd compare stock pickers to astrologers but I don't want to bad mouth astrologers."

Whether it is 2007, 2016, 2017 or any other year, investors face a flood of uncertainty and emotion as they wonder what the next day might bring. Investors have every right to be confused. The challenge is to cut through the "noise" and focus on the factors that we can indeed control. Both *Businessweek* and Mr. Gross' flawed predictions ignored the power and benefits of diversification, as well as the need to maintain long-term perspective. All we know with certainty is that uncertainty will be prevalent, whether it is one year or ten years from now. Hindsight makes it seem obvious what one should have done, but looking backward will never solve what happens in the future.

Echoing Fama, we are committed to the principles of diversification, maintaining multiple asset classes in portfolios, focusing on the long-term, and rebalancing to help mitigate risks. We strive to avoid noise and the temptation to predict the unknown. In addition to our comments on recent market performance, we ask a few questions: Is a bear market inevitable? Why not choose just the best performing asset classes and leave it at that? Why should we rebalance when things are looking so good?

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Market Performance

Many of the global themes from the first quarter of 2017 continued to prevail in the second. Equities, both domestic and international, continued their upward trajectory. Year to date through June 30, the S&P 500 index gained 9.3%, the MSCI EAFE index of developed international markets returned 14.2%, and the

MSCI Emerging Markets index led the way with an 18.6% increase. In a reversal from 2016, on a year-to-date basis growth stocks have outperformed value and large caps have outperformed small caps. Both value and small caps are still leading for the 12 months ending June 30.

Equity market strength was fueled by positive earnings growth, low volatility, a weaker U.S. dollar, stable energy markets, strong employment data, and gradual interest rate increases by the Federal Reserve Bank. Within the fixed income sector, corporate bonds and international bonds have been strong over the past year. This has been true despite the Fed's raising rates twice since January 1, along with expectations of one to two more rate increases before year end.

Data ending 6/30/2017 (not annualized if less than 1 year)

Indices	Q2 2017	YTD	1 year	3 years	5 years	10 years
Equities						
MSCI ACWI (All Country World)	4.5%	11.8%	19.4%	5.4%	11.1%	4.3%
S&P 500 (U.S. Large Cap)	3.1%	9.3%	17.9%	9.6%	14.6%	7.2%
Russell 2000 (U.S. Small Cap)	2.5%	5.0%	24.6%	7.4%	13.7%	6.9%
MSCI EAFE (International Developed)	6.4%	14.2%	20.8%	1.6%	9.2%	1.5%
MSCI EM Emerging Markets (International Emerging)	6.4%	18.6%	24.2%	1.4%	4.3%	2.3%
Fixed Income						
Citigroup World Government Bond (Global Bonds)	2.9%	4.5%	-4.1%	-1.0%	-0.2%	3.5%
Barclays U.S. Aggregate (U.S. Investment Grade Bonds)	1.5%	2.3%	-0.3%	2.5%	2.2%	4.5%
Barclays Municipal Bond 5Y (4 - 6) (Municipal Bonds)	1.3%	3.2%	0.4%	2.0%	2.1%	4.0%
Barclays U.S. Corporate High Yield (U.S. High Yield)	2.2%	4.9%	12.7%	4.5%	6.9%	7.7%
Other Indices						
S&P Developed REIT (Global Real Estate)	1.9%	3.5%	-1.5%	5.9%	8.9%	3.8%
HFRI FOF: Conservative Index (Diversifiers)	0.5%	1.7%	5.3%	1.5%	3.6%	0.8%

Modera's Perspectives

Where's the Bear?

Since the market lows of March 2009, equities have risen steadily, and many people feel that a "bear" market is inevitable. Let's take a closer look at this, since some things are not always as they seem. We'll define a bull market as one marked by such sustained and continued increases in market prices that investors feel the upward trend will continue in the long term. Unlike bear markets, which are defined as a drop of 20% or more from a market peak, bull markets do not typically have a percentage gain associated with them. One could say that being in a bull market is simply an observation.

Corrections during bull markets are common. Since 1949, there have been 11 bull markets, including the one we are experiencing now that started in 2009. While bear markets are rare, corrections are not. Even within these 11 bull markets, there have been 23 distinctive corrections that range from -10% to -20%. While US markets have had a strong run, there have been some ups and downs along the way.

Period	S&P 500 Price Return
April 23, 2010 - July 2, 2010	-16.0%
April 29, 2011 - October 3, 2011	-19.4%
May 21, 2015 - February 13, 2016	-14.2%
Entire period 4/23/10-2/13/16	**+50.0%**

Since 2009, you may be surprised to see three periods of significant market declines, averaging -16%, as shown in the above chart. However, the S&P 500 gained 50% over the full time period, not including dividends. While this is just the 2010-2016 period, similar patterns can be seen in many other time periods. One cannot look at a single market within a short period of time and then forecast what will happen in the future with any degree of certainty.

There has been significant discussion regarding whether or not the bull market will continue. There are many economic indicators signaling a bull market continuum, including earnings strength, low volatility, consumer confidence, low interest rates, capital expansion, stable energy prices, and expanding global economies. There are also supporting signs of a bear market such as valuations, a flattening yield curve, rising interest rates, tightening credit spreads, a weakening dollar, and geopolitical concerns. The reality is that all of the insights conveyed by the industry and media are inherently speculative.

Cutting through the Noise: Keep a Long-Term Perspective

It is important to focus on factors that you can control and not get caught up in the emotions that can lead to derailing a solid financial plan. History shows that the best performing asset class in any given year could be the worst performing asset class the next year, demonstrating that past performance cannot be used to accurately predict future results.

Let's look at the asset class category level by again reviewing one of our favorite charts on the following page. As you can see, there is no discernable pattern that presents itself when comparing the performance of individual asset classes from year to year. No one can truly know which asset class will outperform from year to year. By holding a globally diversified portfolio, we believe investors should be better positioned to generate returns whenever and wherever they occur.

As a point of reference, of the nine asset classes illustrated in the following chart, the top three best performers from 2002–2016 were real estate, emerging markets and high yield bonds.

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Comdty. 25.9%	EM Equity 56.3%	REITs 31.6%	EM Equity 34.5%	REITs 35.1%	EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%
Fixed Income 10.3%	Small Cap 47.3%	EM Equity 26.0%	Comdty. 21.4%	EM Equity 32.6%	Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%
High Yield 4.1%	DM Equity 39.2%	DM Equity 20.7%	DM Equity 14.0%	DM Equity 26.9%	DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%
REITs 3.8%	REITs 37.1%	Small Cap 18.3%	REITs 12.2%	Small Cap 18.4%	Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%
Cash 1.7%	High Yield 32.4%	High Yield 13.2%	Asset Alloc. 8.1%	Large Cap 15.8%	Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%
Asset Alloc. -5.9%	Large Cap 28.7%	Asset Alloc. 12.8%	Large Cap 4.9%	Asset Alloc. 16.3%	Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%
EM Equity -6.0%	Asset Alloc. 26.3%	Large Cap 10.9%	Small Cap 4.6%	High Yield 13.7%	Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%
DM Equity -15.7%	Comdty. 23.9%	Comdty. 9.1%	High Yield 3.6%	Cash 4.8%	High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%
Small Cap -20.5%	Fixed Income 4.1%	Fixed Income 4.3%	Cash 3.0%	Fixed Income 4.3%	Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%
Large Cap -22.1%	Cash 1.0%	Cash 1.2%	Fixed Income 2.4%	Comdty. 2.1%	REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%

Source: JPMorgan Guide to the Markets – U.S. Data are as of June 30, 2017. Barclays, Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management. Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Barclays Global HY Index, Fixed Income: Barclays US Aggregate, REITs: NAREIT Equity REIT Index. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Barclays US Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the Barclays Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period of 12/31/01 – 12/31/16. All data represents total return for stated period. Past performance is not indicative of future returns.

Diversification does not guarantee a profit or eliminate the risk of market loss. Investing wisely does not include making investment decisions based solely on prior performance.

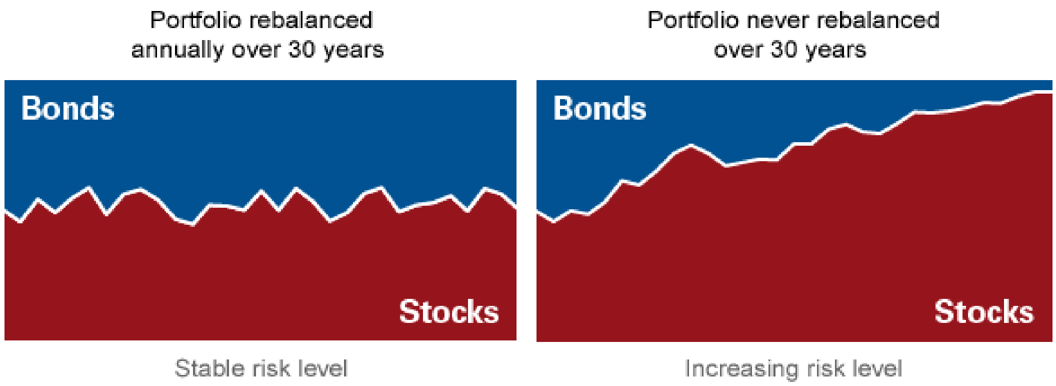
Why rebalance? Isn't rebalancing market timing in disguise?

There are two issues with this question. The first is that we presume to know that strong markets will continue. If we knew that for certain, there may not be a need to rebalance or diversify. The second is that rebalancing is as much about managing risk as it is about managing returns. Since we cannot confidently predict future returns of any given asset class, rebalancing and diversification are prudent investment principles.

While one can ask if rebalancing is a form of market timing, it is more important to ask if rebalancing a portfolio is warranted and when. Some investors try to time the market by frequently buying and selling, choosing only between a few investments, or holding cash. This type of market timing is not a winning strategy because it is influenced by emotion and a short-term perspective.

Rebalancing goes hand in hand with diversification, and its importance cannot be ignored. Rebalancing involves selling over-weighted positions and buying under-weighted positions to maintain the expected risk-and-return characteristics of the portfolio. As the following graphic illustrates, a portfolio which was never rebalanced resulted in riskier stock assets overwhelming a portfolio because of higher long-term returns. No one seems to mind upward volatility when markets rise. As equity markets gain in value though, the portfolio gets riskier and riskier over time.

Rebalancing back to target allocations forces one to follow the theories and fundamentals of investing with a goal of keeping the risk level of a portfolio in check. We seek to build portfolios with broadly diversified asset classes, paying attention not only to valuations but also to correlations among asset classes. Disciplined rebalancing can be counterintuitive to emotional investing. We review portfolios regularly and rebalance dynamically when appropriate to keep risk-and-return metrics in line with the clients' objectives while seeking to improve overall returns in each specific asset class.



Source: Vanguard Capital Markets Model® (VCMM). The projections or other information generated by the VCMM regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from the VCMM is derived from 10,000 simulations for each modeled asset class. Simulations as of December 31, 2014. Results from the model may vary with each use and over time. For both charts, the simulation represented is the VCMM simulation with the median return after 30 years. In one scenario, the portfolio is rebalanced at the end of each year; in the other scenario, it is never rebalanced. Stocks are represented by the MSCI AC World IMI Index. Bonds are represented by the Barclays Global Aggregate Bond Index (USD hedged). Portfolios are initially weighted 50% stocks/50% bonds.

Investing should not be based on emotion. But more often than not, emotions can get in the way. Our emotions may tell us to sell asset classes that have underperformed and to buy into those that are soaring, but chasing returns in this manner may actually result in more risk. Our emotions also may cause us to be fearful when we feel that a downturn is likely. We may think about the lost opportunities just as much about actual losses. By contrast, we believe discipline and a focus on risk management and downside protection should be essential components of any investment philosophy.

Corrections come and go. Yet we see that predictions and emotional market timing can cause investors to get burned time and again. One can just ask the CNET reviewers, *Businessweek* editors, or Bill Gross. We intend to continue to allocate for long-term trends while maintaining a disciplined, strategic approach. Most importantly, we will design clients' investment strategies to align with their planning goals. Next year will bring new issues and worries adding to the uncertainty. So what's the answer? Always keep perspective, keep looking ahead, and avoid the noise.

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Thank you for your continued confidence and trust in our services. We welcome your questions and comments.

Modera Wealth Management, LLC

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