# Investment Perspectives – 4th Quarter 2016

*"I try to avoid looking forward or backward, and try to keep looking upward." - Charlotte Bronte*

The quote above held true for 2016. As we finished 2015, the worldwide stock markets were weak, there were questions about the U.S. economy, overseas markets were struggling as energy and commodity prices declined, there were worries about China's economic growth, and the U.S. was facing a contentious presidential election. Many predicted that the Federal Reserve would raise interest rates multiple times in 2016, yet that only happened once (in December). Few predicted the Brexit vote in June or the election of Donald Trump, yet both occurred.

In the midst of this uncertainty and disruption, U.S. stocks closed near record highs and international equity markets rebounded during 2016. Lower rated bonds had a significant rally. Longer term trends that have favored value and small company stocks resurfaced in a meaningful manner.

In this end-of-year letter we offer our perspectives on the year just concluded and the year ahead. We also take a longer look at Modera's investment approach favoring small company and value stocks.

In 2016, client portfolios benefitted from a disciplined and consistent approach. You have our commitment that our emphases on diversification and rebalancing will remain the cornerstones of our philosophy and that we will strive to avoid the noise and temptation of predicting the unknown.

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## Performance Commentary

Asset class performance trends for the 4th quarter were similar to the entirety of 2016. Domestic markets outperformed both international developed and emerging markets. Real estate investment trusts (REITs) recorded negative returns for the quarter and lagged the domestic and emerging markets equities markets for the entire year. Throughout both periods the "value and small cap effects" were positive.

Data ending 12/31/2016 (not annualized if less than 1 year)

| Indices | 1-Qtr | 1 year | 3 years | 5 years | 10 years |
|---|---|---|---|---|---|
| **Equities** | | | | | |
| MSCI ACWI (All Country World) | 1.3% | 8.5% | 3.7% | 10.0% | 4.0% |
| S&P 500 (U.S. Large Cap) | 3.8% | 12.0% | 8.9% | 14.7% | 7.0% |
| Russell 2000 (U.S. Small Cap) | 8.8% | 21.3% | 6.8% | 14.5% | 7.1% |
| MSCI EAFE (International Developed) | -0.7% | 1.5% | -1.2% | 7.0% | 1.2% |
| MSCI EM Emerging Markets (International Emerging) | -4.1% | 11.6% | -2.2% | 1.6% | 2.2% |
| **Fixed Income** | | | | | |
| Citigroup World Government Bond (Global Bonds) | -8.5% | 1.6% | -0.8% | -1.0% | 3.0% |
| Barclays U.S. Aggregate (U.S. Investment Grade Bonds) | -3.0% | 2.7% | 3.0% | 2.2% | 4.3% |
| Barclays Municipal Bond 5Y (4 - 6) (Municipal Bonds) | -2.6% | -0.4% | 1.7% | 1.8% | 3.7% |
| Barclays U.S. Corporate High Yield (U.S. High Yield) | 1.8% | 17.1% | 4.7% | 7.4% | 7.5% |
| **Other Indices** | | | | | |
| S&P Developed REIT (Global Real Estate) | -4.8% | 6.9% | 10.1% | 11.2% | 3.3% |
| HFRI FOF: Conservative Index (Diversifiers) | 2.0% | 2.3% | 1.9% | 3.5% | 1.3% |

During the evening of Election Day, when it first appeared that Donald Trump could win the presidency, global equity futures markets fell precipitously (e.g., Dow Jones futures dropped almost 1,000 points at the low point) and those for U.S. Treasury bond prices rose, reflecting a “flight to quality.” Once trading commenced the following day, however, sentiment had shifted as U.S. equity prices rose, bond prices declined (as market interest rates spiked), and the U.S. dollar strengthened.

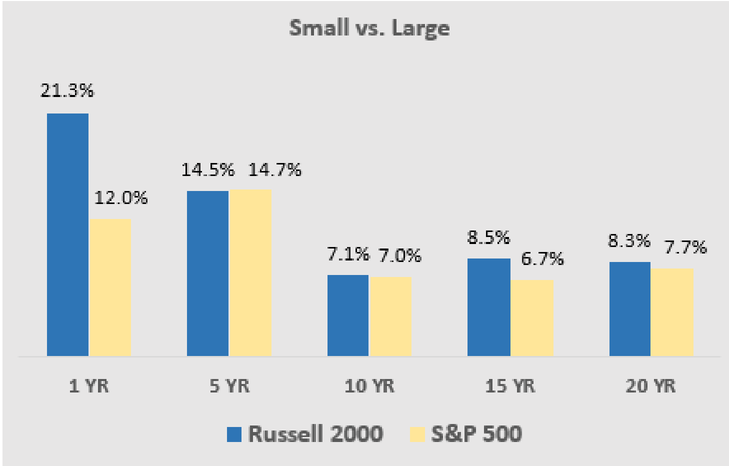
Despite uncertainty on what the new presidency will bring to tax laws, the securities markets have speculated that tax cuts and regulatory rollbacks are probable. These expectations fueled a strong increase in U.S. equity prices between Election Day and year-end, as well as a sharp rise in Treasury bond yields. Bond prices tend to move in the opposite direction of yields, and investment grade bond values retreated as 2016 came to a close. The Federal Reserve’s decision to raise short-term interest rates by 25 basis points in December contributed to demand for U.S. dollars from overseas buyers. On the other hand, Trump’s anti-free trade comments during the campaign led to fears of increased tariffs and even potential trade wars going forward, and this negatively impacted international equity markets.

In the face of uncertainty, U.S. equity asset class performance in the fourth quarter of 2016 was quite surprising. U.S. stocks performed very well. High-yield bonds (whose performance is driven more by economic considerations than by changes in market interest rates) essentially justified their risk by outperforming less risky debt. International equities and bonds lost ground (with the impact exacerbated by currency movements), while investment grade U.S. bonds endured a brutal quarter. Nonetheless, the table above illustrates that asset class performance for 2016 was almost uniformly positive. Clients’ broadly diversified accounts typically enjoyed positive calendar year gains although there was some dampening in portfolios with a higher percentage of tax-free municipal bonds. Unlike 2015, when many asset classes lost money, asset class performance in 2016 exhibited a much more traditional level of dispersion, with a meaningful difference between the best and worst performers.

**Modera’s Investment Approach: Small/Value Tilt**

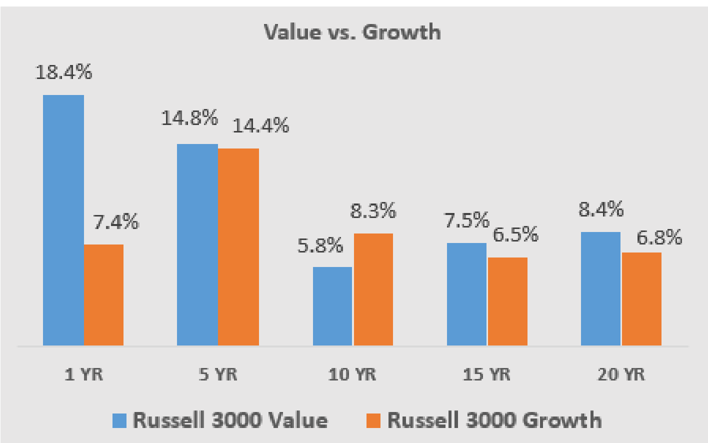
There have been some short and intermediate time periods when the stocks of larger companies outperformed the stocks of smaller companies, and other periods when smaller companies outperformed larger companies. Likewise, growth-oriented stocks and value-oriented stocks historically have exchanged leadership positions. These periods of out- or under-performance have lasted for months or even years. Over longer periods of time, however, research and historical returns have demonstrated that small cap and value stocks have tended to outperform their counterparts. At Modera, our consistent approach has been to invest in a broadly diversified mix of domestic and international equities with a tilt toward small cap and value.

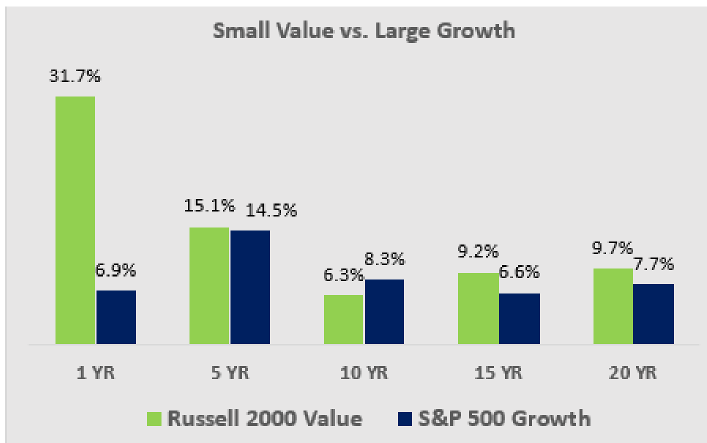
The first chart below compares the historical performance of small cap stocks (Russell 2000) against their large cap (S&P 500) peers. For the most recent 15 and 20-year trailing periods, small caps outperformed large caps. Over the more recent five-year period, however, large cap stocks slightly outperformed small caps. (This was even more pronounced during the previous three years.) It is these short and intermediate time periods that test investors’ conviction in staying the course. Investors who move away from small cap stocks after periods of short-term underperformance may miss the benefits of consistent exposure over the long term. In 2016, the superiority of small caps was quite dramatic.




Sources: Small – Russell 2000, Large – S&P 500. All time periods shown are though 12/31/2016.

The chart below on the left illustrates a similar pattern as above with value stocks having outperformed growth over the previous 15 and 20 years. Note that even the 10-year trailing period saw growth outperform value. If investors had allocated away from value, they would have missed out on the dramatic recovery of small and value dominance during 2016. The final chart below on the right combines the two factors, comparing small value equities to large growth equities.




Sources: Value – Russell 3000 Value, Growth – Russell 3000 Growth, Small Value – Russell 2000 Value, Large Growth – S&P 500 Growth All time periods shown are though 12/31/2016.

We recognize that the historical patterns of small cap and value have not persisted across all time periods and that in such periods our strategy may occasionally be questioned. Modera, however, is committed to staying true to our convictions and focusing on the long term.

As we begin a new year, it can be tempting to look back as we consider the future. 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. Focusing on risk management and downside protection are the key components of our investment philosophy. We intend to continue to allocate for long-term trends and diversify while maintaining a disciplined, strategic approach and aligning clients' investment strategies with their planning goals.

Modera focuses on factors we can control, and we are committed to low cost implementation for our clients. High expense ratios can erode returns, and due to the law of compounding the effect is magnified in the long run. We find it noteworthy to share that some of our investment managers have announced they are lowering their expense ratios for several of their funds effective January 1, 2017. This will affect the majority of our clients. Please contact your wealth manager for specifics on the changes.

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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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