JANICZEK® WEALTH MANAGEMENT

Portfolio Matters

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A SMOOTH RIDE IN Q2

But Don't Fall Asleep At The Wheel

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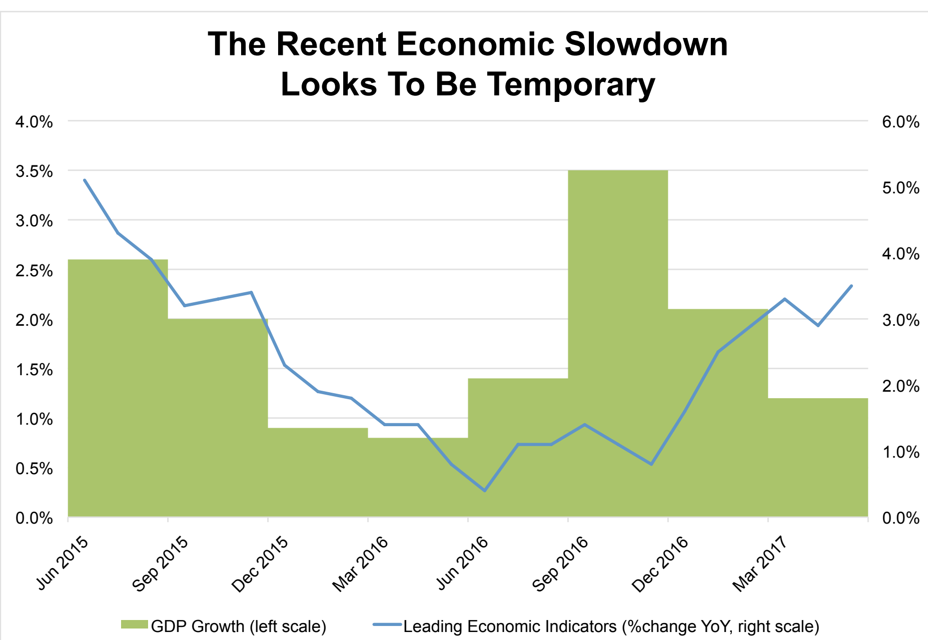
BOTTOM LINE

- The economy expanded despite the myriad of headlines and events
- Non-U.S. equities are taking center stage after years of lagging
- Bond yields are poised to go higher as central banks begin to unwind
- Amazon's 20th birthday offers some key investing lessons

On May 16th, there was a Wall Street Journal column by Jason Zweig that may have gone unnoticed, if not, underappreciated. The article discusses Amazon's 20th birthday as a publicly traded company. Since its IPO in 1997, Amazon generated a total return of nearly 49,000%, or over 36% annually for its shareholders.

No doubt that a performance number of 49,000% will make anyone stop dead in their tracks, either in amazement, disbelief, or both. But the rest of the article had some far more important points that may not have sunk in for most readers.

We'll return to this story later, but suffice is to say that the Amazon story was likely lost among the many negative stories that embodied the most recent quarter. In this issue of ***Portfolio Matters***, we'll discuss what all these moving parts mean for investor returns and, more importantly, the future for our clients and friends.



Source: Bloomberg

Economy

During the past quarter, we witnessed terror attacks in the UK, France, and Washington, D.C. We even saw a rare terrorist attack in Iran. Tensions in the Middle East escalated as Saudi Arabia and Qatar continue their disagreement. Elsewhere, investors were (yet again) surprised by election results in the UK, and these rekindled concerns over how Brexit will unfold. This overshadowed the Brazilian presidential investigations and North Korea's continued missile tests.

Focusing solely on the U.S., we only have to worry about things like infrastructure spending plans, tax reform, health care reform, deregulation and an obstruction of justice investigation in the White House(!) But beyond all these issues lie economic factors that offer a good backdrop for investors to make money.

Sticking with the recent pattern of weak first quarter growth, Q1 GDP clocked in at 1.2%. Second quarter growth (not due out until July 28th) is expected to come in around 1.5%, with recent data pointing towards even more of an acceleration of late. As such, we still see healthy prospects for economic growth in the second half of 2017. Notably, the concerns often discussed relate more to the equity markets and less on the economy, and we find this to be an important distinction.

We are currently in the longest economic expansion on record. This fact (which makes for great headlines) may imply the risk of a downturn on the horizon, but arriving at such a conclusion overlooks other important points. For example, this expansion is also one of the weakest on record. In other words, the risk of excesses such as leverage and inflation that are typically evident at this stage of the cycle are simply not prevalent today.

Inflation is an interesting study these days. After a pickup late last year, inflation seems to have stalled out recently. After hitting 2.7% in February, the consumer price index has declined for three months to its current 1.9% pace. The Fed has been trying to reflate the economy for years, yet we still seem to be tethered to the 2% mark. But this is not necessarily bad news, as we discuss below.

As unemployment is now down to 4.3%, the lowest in 16 years, one might expect wage pressure to lead to higher inflation, as has occurred in the past. But the data just doesn't show any such pressures, and we believe the role of technology and its impact on productivity are likely a headwind for higher wages. This isn't anything new, as automation has made many industries more efficient for decades. But it does have interesting implications for our economy and the Fed actions.

While the media would prefer to point to all the negative possibilities that come with more technology, we'll shine light on some of the positives. For example, what if the slow but positive economic expansion continues to benefit from technology within a fully employed labor market? What if the next recession is pushed out as growth continues but without the volatile excesses of leverage and accelerating inflation that's we've seen in past cycles? That doesn't sound like such a bad path forward (but won't grab many headlines!)

The U.S. economy is driven by the consumer, and we see plenty of good news here. Let's stop and consider the environment for the consumer: Higher real estate values and investment portfolios have created balance sheet wealth; low interest rates have allowed for a wave of refinancing to lower debt payments; and falling unemployment means more people with disposable income to spend.

By several measures, these are good days for the consumer. The data show that consumer spending is gaining strength, with recent upward revisions to both the March and April numbers. And consumers are increasingly confident, an important data point for current and potential spending. Historically, these levels of consumer sentiment have led to continued or increased spending.

Indeed, the Index of Leading Economic Indicators (chart, page 1) support a positive outlook. In fact, no recession has ever occurred without this index flashing a warning. While we are always wary of superlatives such as "never", we also seek to invest with the evidence on our side.

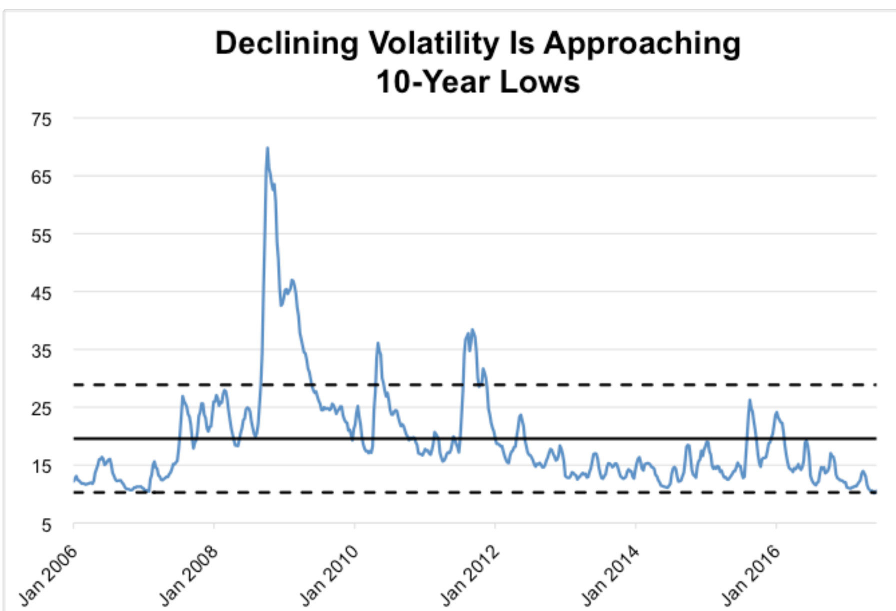
So, while the promise of the new administration drove the "soft data" higher (as discussed last quarter), some of the hard data is coming to fruition. To be sure, there are plenty of uncertainties that need resolution. But the economic environment today is one in which there may be more risks to the upside than the downside.

Asset Allocation

While investor concerns about the economy may be overdone, we do believe there is an underappreciation of risk in the investment market. That said, any market correction we experience is unlikely the start of the next recession.

We find it fascinating that all the headline risks didn't result in much volatility. In fact, quite the opposite: The second quarter saw a rather calm investment marketplace. The VIX Index (affectionately known as the "fear index") measures market volatility, and it remained rather low by historical standards, as seen in the chart below.

During the second quarter, and despite all the headlines mentioned above, the VIX broke below 10. This compares to its long-term average of 19.5 and marks the first time below 10 since 2006. Betting on a lower VIX worked well during the quarter as the markets grinded higher, but recent market data shows increasing wagers on a higher VIX (i.e., higher volatility) going forward. We'd agree.



Source: Bloomberg

We've seen big moves across various asset classes since the U.S. election, but this so-called "Trump trade" seems to be softening a bit. Small cap stocks have faded from their big rally, while emerging market equities have more than recovered from their post-election selloff. Overall, equities continue to climb higher, so let's assess a few other asset classes.

During the quarter, short term rates rose (driven by Fed expectations) while longer term yields fell (driven by inflation expectations). In other words, the yield curve flattened. Although the curve flattened, it remains upward sloping, and this is important. Past recessions have been signaled by an inverted (downward sloping) yield curve, as investors perceive growing risks and prefer to lock up their cash in long-term bonds.

We normally don't comment much on currencies, but recent action here warrants some attention. A strong U.S. dollar was hurting corporate profits a few years back, while the euro was all but left for dead. Today, the U.S. dollar has declined 6%, while the euro is up almost 8%. A cooler U.S. dollar and the absence of crashing energy prices means corporate profit growth has some tailwinds ahead of it.

Commodities have also turned lower. After spiking 6% to a January high, prices have drifted lower along with lower inflation expectations. While higher prices may indicate greater demand and overall economic activity, we've also experienced an explosion of supply in oil and natural gas. This was bad news back in 2014, with oil at $110. But we've seen mid-$40 oil for over two years now. With most of the economy having already adjusted to new realities, we'd have to look favorably at current commodities prices and friendly inflation within an expanding economy.

The challenge for investors these days is what to conclude from the recent softening after a year of strong gains across many asset classes. Buying opportunity? Next correction on the horizon? Next recession on the horizon? How do savers put new money to work, and how do retirees manage their recent gains?

For those looking for a detailed prediction of how markets will move over the short-term, I'm afraid I'm going to disappoint you. But there is an evidence-based way to tackle these questions. First, note that implied in these questions is a goal of achieving short-term success, i.e., having immediate gains from new money invested. On this note, we'd put forth some evidence against market timing.

A recent research report looked at 1-year returns in the S&P 500 since 1967 and found an average of 9.8% but a high of 32% and a low of negative 21%. To find your recent investments down 21% after 12 months is possible (and probably unsettling), but trying to time the market or predict its next 12-month move is not the best solution, in our view. Instead, a disciplined program of buying into the market at pre-determined periods alleviates risks, both real and perceived. Here's how.

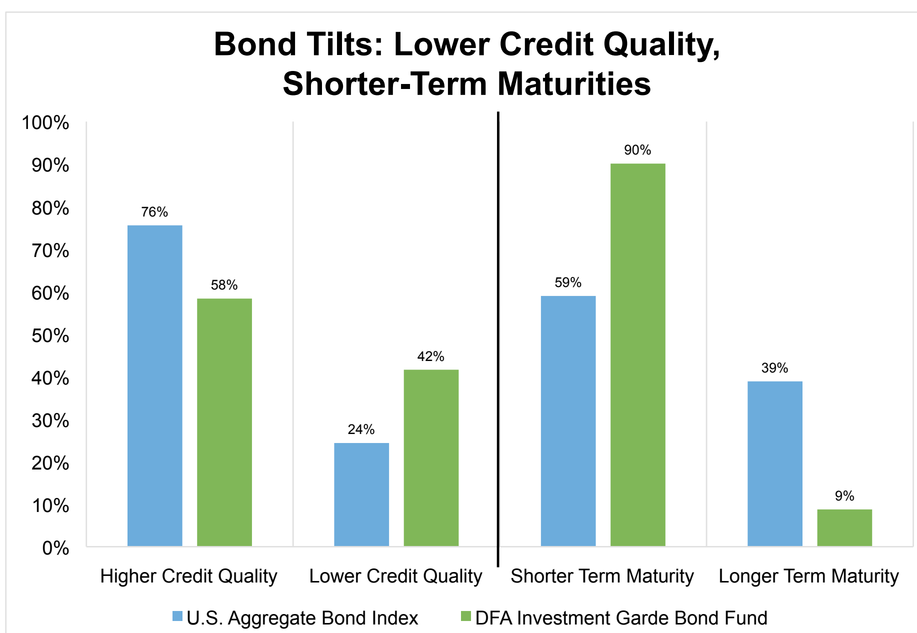
Investing equal amounts over fixed time periods, say, three, six, or twelve months removes the downside if the market turns south. The research showed that the risk of a 21% drop shrinks to 17% if buying over 3 months, 15% over 6 months, and 9% if over 12 months.

Of course, there is a trade-off. The same research indicates that, the more you lower your potential loss by averaging in, the more you give up in expected return. Specifically, the median 1-year return is cut from 9.8% to 7.2%.

Most importantly, we couldn't agree more with the report's conclusion. Put a plan in place that you can stick with, put it in writing, then execute the plan regardless of market conditions. After all, the whole point of averaging in is to avoid extremes … in both market prices and your emotions. So, "avoid the temptation to constantly re-evaluate each of your entry points with the swings of the market". And if you can't do it alone, don't. Find an advisor with a disciplined process who can help you get to where you're trying to go.

Fixed Income

Bond yields finished the quarter lower but remain significantly higher than last fall. The 10-year Treasury yield finished the second quarter at 2.30% after



Source, Morningstar (as of 5/31/2017), Bloomberg (as of 6/30/2017) ranging between 2.41% and 2.12%. A tempering of inflation expectations led to the general decline in bond yields, which peaked at 2.63% in December. While we still see the prospects for higher yields over time, we'd add a couple of additional points.

First, a slow and steady climb in yields would be the ideal scenario for investors. Our positioning would benefit most from such an environment, but our process allows for good results in other scenarios as well. Second, although the Fed was viewed as the driver of higher interest rates globally, it's completely possible that non-U.S. bond yields will drive global rates higher. Just looking at how quickly the outlook for the Eurozone has shifted, investors should pay some attention to non-U.S. bond markets going forward.

The Fed continues to tighten monetary policy, including the unwinding of its bloated balance sheet starting as early as next quarter. After raising rates in June, its third hike in the last 6 months, the Fed released a slightly revised forecast for the pace of future increases. As it has for some time now, the market disagrees with the Fed's outlook.

While the Fed forecasts still call for 3% short term interest rates by 2019, market traders still see a "lower for longer" environment. Why does this matter? Because the level of short term interest rates can impact longer term rates. The difference between short and long term interest rates is an important factor we seek to capitalize upon in our bond investments.

The educated investor prefers to capture the higher yields regardless of where they reside along the curve. If the market sells off the shorter end of the curve (and sends those yields higher), we'll capture that excess yield relative to longer maturities. This repositioning results in a process that regularly sells higher priced (lower yielding) bonds to buy lower priced (higher yielding) bonds.

And we'll deploy this process regardless of whether the Wall Street gurus are calling for a recession or an expansion. By pocketing these incremental yields regularly, we increase the returns at which we're compounding our clients' money over time.

We apply this same process when it comes to different credit ratings, too. It's the same concept: Buy lower quality bonds when they sell off, capturing the higher yield relative to higher quality bonds. When lower quality bonds are rich and offer unattractive yields, we trim exposure to reallocate to less pricey bonds.

Since February of 2016, the premium offered to lower credit quality bonds has been shrinking. So, while excess returns have been captured, the prospects for future returns have diminished. When the excess premiums are unattractive, our portfolio will, incrementally, shift into other bonds where excess yields have sprung up.

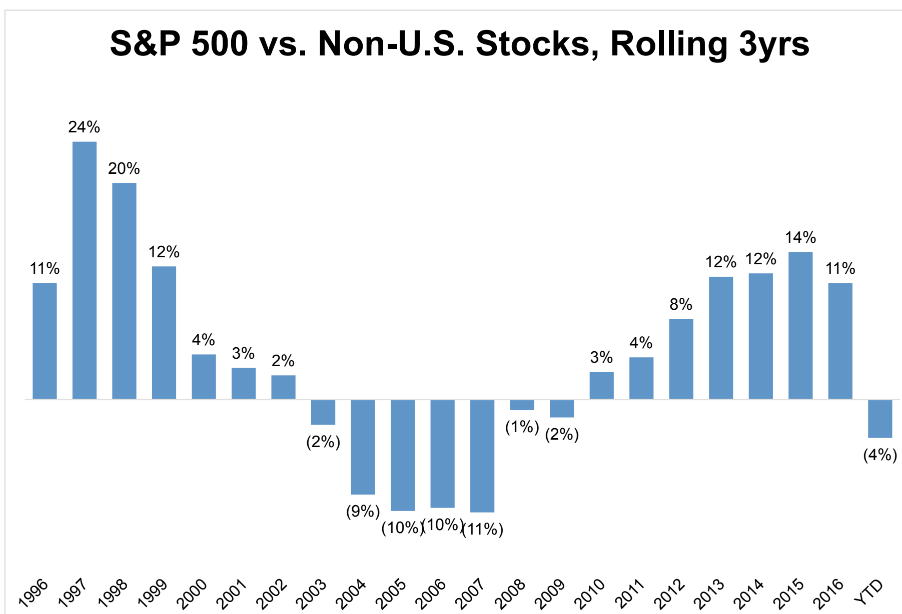
Much like the incremental returns offered in equities, the excess yields we seek in bonds don't produce results every quarter. But over time, these results compound handsomely. The only challenge for the average investor is to stay invested when the markets work test our commitment to this disciplined process.

Equities

Non-U.S. equities continued their strong year, besting U.S. stocks for the second straight quarter. Emerging markets led the world, returning a whopping 6.4% for the quarter, while developed markets gained 5.9%. In the U.S., the benchmark S&P 500 rose 3.0% while small cap stocks returned 2.5%.

Whereas the S&P 500 dominated global stock market returns since 2009 while non-U.S. stocks lagged, the recent strengths seen in non-U.S. stocks is welcome news. The U.S. has led the global stock market for years, and valuations here have become stretched. Since the 2009 lows, the S&P 500 is up 258% while non-U.S. equities are only up 106%. As such, the S&P 500's valuation dwarfs that of its non-U.S. counterparts.

Think about this: One year ago, Brexit was all the rage. One year later, the UK experienced yet another negative election surprise. These two events might be expected to conclude in a tough year for UK investors, no? Wrong. UK stocks have returned 16.9% in local currency and 14.6% in U.S. dollar terms over the last 12 months. Not quite as



Source: Bloomberg

good as the S&P's 17.8% return, but not nearly the Brexit disaster that was predicted by some last year.

After years of disappointing returns, emerging market stocks have come back to life. Over the last 3 years ending June 30th, emerging markets have eked out a 1.4% gain per year. They dropped after Trump won the election, but year to date they are leading the world, up 18.5%. And there's reason to think this run isn't over yet.

Emerging markets grabbed further headlines when MSCI, the keeper of many global equity indices, announced an increase in Chinese exposure from its current 27% to around 40% over time. Given the amount of money in passive funds that track these benchmarks, it's pretty clear that there will be increasing inflows into Chinese and emerging markets funds. And this makes sense once one remembers that we're talking about the second largest economy in the world.

Even after their recent gains, emerging market valuations remain quite attractive. While the domestic equity market sports price tags that are expensive by any measure, emerging markets have valuations that are half that of the S&P 500. Valuation is a powerful predictor of future results, and we seek to keep our globally diversified portfolio tilted towards attractive valuations.

Our clients know that, beginning this year, we made several changes to our equity holdings. As a result, our equity exposure was tilted away from what's typically found in the traditional indexes. Instead, we now have greater tilts towards equity characteristics, or factors, that have historically provided powerful enhancements to equity returns over time.

One example is "value". Value can be simplified as the less expensive stocks in the market, and its merit was made famous in the 1993 research of Eugene Fama & Kenneth French. Value stocks have been shown to outperform the market over time, but not all the time, and this is an important distinction.

Since 2007, value stocks have lagged their counterparts, a 10-year stretch that's not unprecedented but longer than historical norms. A recent article stated, "Goldman Sachs mulls the death of value investing." To financial historians, this may bring a smile. Why? Because it was an infamous magazine cover back in 1982 stating, "The Death Of Equities" that kicked off one of the strongest bull markets in history.

Those who do not know their history are doomed to repeat it, and value investors should pay attention here. Despite the past decade of lackluster returns, history offers some support. While value has outperformed only 63% of the time in any given year, the success rate rises to 85% over 10 years. In other words, short-term underperformance does not nullify the value premium. (Just ask the Amazon shareholders who sold out after lagging badly in 2001!)

Alternatives

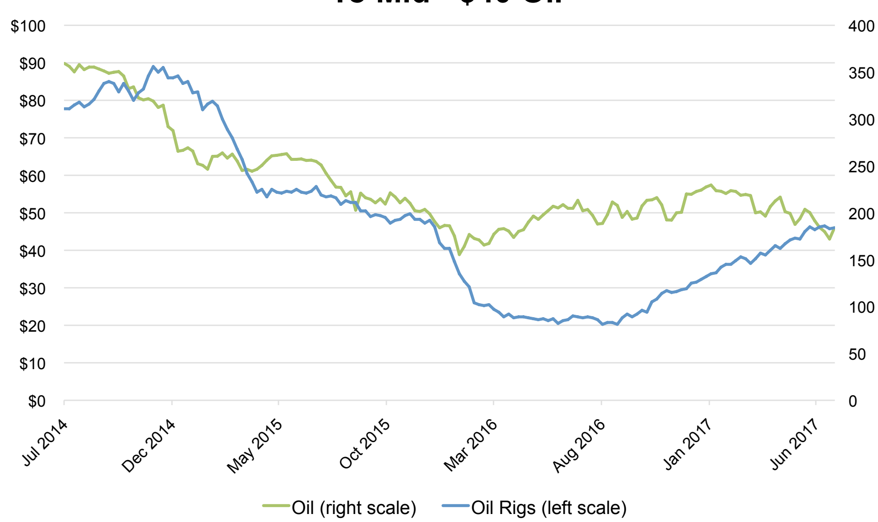
REITs booked a 1.6% quarterly return, while equity market neutral lost 0.8%. MLPs took a bit of a ride, falling nearly 13% before finishing the quarter down 6.3%. MLPs are down 2.6% for the year, and we'll focus our comments here.

The driver for MLP volatility should surprise no one: oil prices. Oil fell from $50 to $42 before returning to finish the quarter at $46 per barrel. But the reason we're not ruffled by a 16% quarterly swing in oil prices has less to do with our outlook for oil prices and more to do with why we're invested in MLPs.

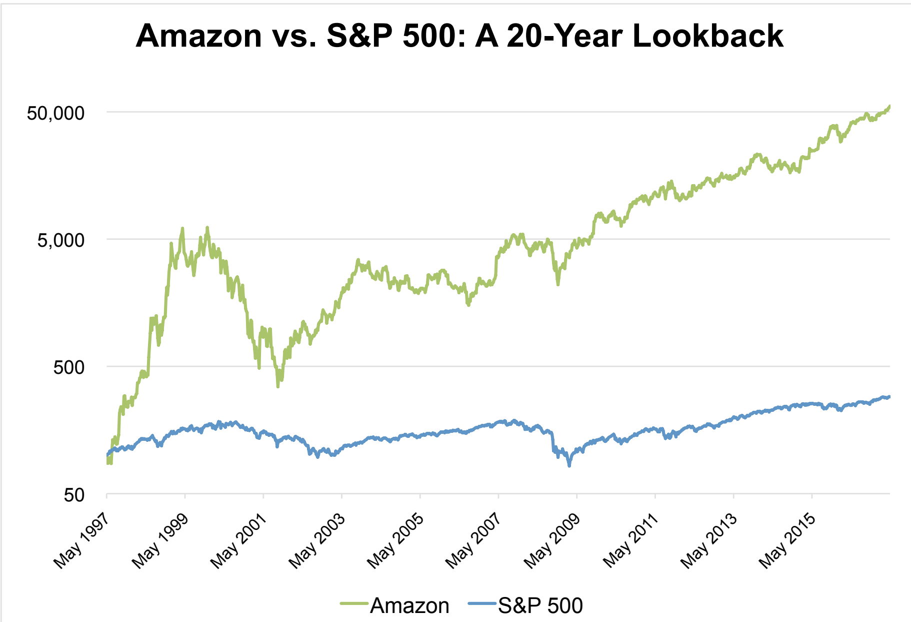
We won't provide our full MLP thesis here, only an update that should leave investors comforted. With oil having hovered in the mid $40s for over a year now, U.S. energy companies have right-sized their businesses and begun drilling again. Increased drilling (and the resulting volume flowing through the pipelines) could be driven by an accelerating economy.

But volume increases may occur regardless of the economy. Why? Because the lease terms that oil drillers signed years ago include required drilling activity over time. This creates a bit of a "heads I win a little, tails I win a lot" situation for MLP investors … all while getting paid over 7% tax-advantaged just to be patient.

U.S. Energy Industry Has Adjusted To Mid - $40 Oil



Source: Bloomberg



Source: Bloomberg

Conclusion

Returning to where we began brings us back to the story of Amazon's 20th birthday. The article had two other key angles that we'd like to highlight. First, most Amazon investors have sold out along the way, and not at the most opportunistic times. And as one writer noted, "You had to be some sort of sociopath, void of any human emotions, to [stay invested and] earn these monstrous gains."

Why? Well, remember that in 1997, Amazon was little more than an unprofitable online bookseller operating in a relatively new internet age. Its revenue in 1997 was $147 million (compared to $135 billion in 2016!) The stock has seen 16 instances in which it sold off 20% or more, including 8 times in which it lost at least 40% of its value. When the tech bubble burst, Amazon lost 95% of its value from 1999 through 2001. So, throwing in the towel is understandable, as is being called a sociopath for staying invested.

All investments have down periods, but most investors don't react well to these drawdowns. But think about it: If you like the company, and the stock is down significantly, you'd be a buyer. If you don't have any more money to put into the stock, you'd hold. The last thing you should do if you like the company is sell when the price goes down, but most of us are simply not hard-wired this way. We're merely human.

The second takeaway highlights the recent studies that show how few stocks account for the return of the overall stock market. From 1926 through 2016, only 30 stocks generated one-third of the entire 25,782 company stock market. Only 1.1% of all stocks in the entire market over that time generated 75% of the total return. And the top 1,000 companies (less than 4% of the total) account for all the stock market's return. As columnist Jason Zweig points out, "You could have matched the returns of all the other 96% of stocks combined by putting your money in one-month U.S. Treasury bills." (How does active stock-picking sound now?)

The takeaways here are important and timely. As Janiczek clients know, the typical peak-to-trough decline in the S&P 500 in any given year is almost 15%. Given the run we've had, it's quite possible the next correction, whenever it happens, could be 15%, 20%, or more. How we act during this correction will determine the future gains we achieve.

Debating whether the next correction happens in a month, a year, or three years makes for great financial entertainment. But just like with floods or blizzards, you're either prepared in advance or you're not. Buying insurance after a disaster is not going to help, but unfortunately, that's exactly what many people do.

When it comes to potential market drops, being prepared includes financial and emotional readiness. Financially, this includes having cash reserves in place and a financial plan with up-to-date cash flow expectations. Emotional readiness includes having a knowledge and understanding of market behavior and of the role that human emotions play during short-term swings.

Many folks wish they could go back in time and buy Amazon at its 1997 price of $1.50 per share. But you don't need a time machine to succeed in investing. A little historical perspective and a disciplined process will put you way ahead of the pack, especially when it matters most.

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