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Market Review

With U.S stock markets initially range-bound, for most of the quarter the big story in financial markets was bonds, specifically negative yields on government bonds. That was until June, when the relative calm in global stock markets came to an abrupt end. As the month unfolded, trading became increasingly influenced by shifts in sentiment and polls predicting the outcome of the United Kingdom's so-called Brexit referendum on continued European Union membership. Finally, upending most forecasts and taking world financial markets by surprise, the United Kingdom voted to leave the European Union on June 23.

In the wake of the vote, the British prime minister resigned. Overnight, British pound sterling fell 11% to 1.33 against the U.S. dollar, its lowest level since 1985. The euro fell 2.4% to 1.10 versus the dollar. U.S., developed international, and emerging-markets equities all plummeted. The S&P 500 fell by 3.6%, while the FTSE 100 dropped by 8.7%. Financial stocks were the hardest hit, while defensive dividend-paying utility and telecommunications sectors saw strong buying. Away from equities, investors fled to "safe haven" investments: gold, Treasury bonds, and certain currencies, such as the Swiss franc, Japanese yen, and U.S. dollar. Days later, ratings agency Standard & Poor's stripped the United Kingdom of its triple-A credit rating and downgraded the European Union's rating. Fitch and Moody's, the other major ratings agencies, also cut their U.K. ratings.

Index Returns *Through 06/30/2016*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	2.46%	3.84%	3.99%	11.66%	12.10%
Russell 2000	3.79%	2.22%	-6.73%	7.09%	8.35%
MSCI EAFE	-1.46%	-4.42%	-10.16%	2.06%	1.68%
MSCI All Country World Index	1.06%	1.35%	-3.90%	6.13%	5.42%
MSCI Emerging Markets Index	0.66%	6.41%	-12.06%	-1.56%	-3.78%
Barclay Capital US Aggregate Bond	2.21%	5.31%	6.00%	4.06%	3.76%
Barclay Capital Municipals	2.61%	4.33%	7.65%	5.58%	5.33%
Bloomberg Commodity Index	12.78%	13.25%	-13.32%	-10.55%	-10.82%
HFRI Fund of Funds Composite Index	0.61%	-2.56%	-5.38%	1.92%	1.64%

However, in the week following Britain's historic vote, global equities markets rallied as the quarter ended, despite still significant uncertainty regarding the economic, political, and financial market implications of Brexit. When the dust settled, the chart above shows the returns for the various benchmarks for the quarter and year to date.

By month's end, the amount of government debt (mainly Eurozone and Japan) sporting negative yields had soared by nearly $1 trillion, to reach an astonishing $11 trillion! While not (yet) negative, the yields on U.K. 10-year bonds breached the 1% level, falling to 0.87% by June 30. U.S. 10-year Treasury's ended the quarter with a yield of 1.48%, close to their low-water mark reached in July 2012. Falling yields have been driven by economic growth concerns; central banks' ongoing low/negative interest rate policies, including government intervention (buying) in bond markets; and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact. They have been joined by expectations of imminent rate cuts from the Bank of England, potential additional bond buying by the European Central Bank, and a growing consensus that the Federal Reserve will further delay raising U.S. rates.

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While we do not expect a sharp rise in interest rates any time soon, at such low starting yields, expected returns to core bonds are extremely low. Investors are earning very little (or actually paying via negative yields) for the safety of holding government bonds.

At the same time although equities started to rally less than a week after the Brexit vote, we haven't viewed that as an "all-clear" signal. We continue to asses to the short and long term impact, including the likelihood that central banks will intervene to support financial markets. We also expect potentially greater downside risk as investors, politicians, central bankers and a host of others digest recent events. We believe that the unprecedented nature of the vote is a reason why making knee-jerk predictions, and trading based on them, are really stumbling in the dark- which we will not do.

Though downside risks remain significant, we view the initial market reaction to Brexit as a short-term shock that does not change our longer-term five-year return expectations for European equities. For now, European equities have not fallen to the point where we see compelling reasons to add to our position; however, should further declines relative to the US markets occur, we may consider adding to our exposure. Accordingly, as we analyze the range of possible outcomes stemming from the British vote to exit the European Union, we will weigh potential changes to our views or positioning from that perspective, while incorporating the likelihood of increased shorter-term market volatility.

Low Yields Low Returns

Against the backdrop of extremely low bond yields that looks set to continue it is our expectation that we are also transitioning to an extended period of low returns for U.S. stocks.

Low, let alone negative, current bond yields imply very low five-year expected returns for core bonds. However, as we have seen frequently over the past several years, and again earlier this year, they don't preclude strong returns over shorter-term periods if bond prices are driven higher by investor fears, ongoing central bank bond purchases, and/or speculative short-term macro bets. Eventually though, the "bond math" catches up to you. In other words, you can't escape the gravitational pull of the starting bond yield in determining your total return as a bond investor.

Similarly, starting stock market valuations (e.g., price-to-earnings multiples) have a historically strong inverse relationship to future market returns. That is, the higher the current valuation, the lower the future realized return. Another way to see this is that the reciprocal of a P/E multiple is an earnings yield (e.g., a 20x P/E ratio implies a 5% earnings yield). So high valuation multiples are the flipside of low yields.

Unlike bonds, which have a defined stream of cash flows (interest payments) and a set maturity date, stock market returns are subject to a much wider range of potential outcomes due to uncertainty and variation in earnings growth and valuation multiples. Wall Street analysts, and investors in general, have a very poor track record of predicting near-term earnings—as can be seen by their constant revisions to their forecasts. Valuation multiples are impacted by earnings fundamentals but are also driven by investor sentiment (put simply, greed and fear) and herd behavior, at least in the shorter term, making them unpredictable. Consequently, we never invest based on short-term stock market forecasts. We view them as no better, and probably worse, than a coin toss.

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But even when looking out over longer-term (five- to 10-year) periods and market cycles—a period over which we believe fundamentals ultimately are reflected in market prices—we are very sensitive to the risk of "false precision" in estimating stock market returns. That is why we incorporate a range of plausible scenarios, assumptions, and potential outcomes in our analysis. Nevertheless, in looking at extended investment time horizons, it becomes clear: valuation matters. Higher valuations mean lower yields, which lead to lower expected returns.

In more recent years, a significant majority of the S&P 500's return has come from P/E multiple expansion rather than actual earnings growth. For example, for the five years ending March 31, 2016, over 60% of its total return came from P/E expansion. Meanwhile, total earnings per share growth was just 6% over the entire period (i.e., 1.2% annualized). Dividends accounted for roughly 11%.

The 12-month trailing P/E of the S&P 500 is currently around 23x, compared to its median since 1950 of roughly 17x. As long as interest rates remain at extremely low levels, P/E multiples may remain higher than normal. If current interest rate levels are not sustainable—and we don't think they are—then it is likely the valuation multiple will drop toward more normal historical levels. (If rates do stay at such depressed levels for the next five years, it likely means economic and earnings growth have remained quite depressed as well, which is unlikely to be bullish for stock market valuations.)

Yes, Stocks Should Still Return More Than Core Bonds . . . So What?

We constantly see market strategists point to very low bond yields as a reason to favor or overweight stocks versus bonds. While we have subpar return expectations for stocks, we also believe stocks are likely to generate higher returns than core bonds over our five-year horizon (absent a deflation/depression scenario). However, as we always point out, you shouldn't look at expected returns in a vacuum while ignoring the risk side of the equation. Stocks have significantly higher volatility, higher downside risk, and higher risk of permanent capital loss than core bonds. This seems like such an obvious point, but rarely do we hear these strategists make it. This being the case, you should always be compensated for this risk with a higher expected return from stocks compared to core investment-grade bonds. This is referred to as the equity risk premium. Of course, the fact that the expected return for stocks is higher doesn't mean the actual return over a given time period will turn out to be higher. But why would anyone buy stocks if the expected return from owning low-risk bonds was just as good?

The actual average annualized five-year excess return for stocks over core bonds was 4.6%, going back to 1950. However, the average equity return premium has fallen to 3.4% over the past 30 years. There have been several periods where the actual equity risk premium was negative—clearly not the market's expectation at the beginning of those periods!

Informed investors can reasonably disagree about whether the current expected excess return from owning stocks over bonds is sufficiently high to justify overweighting stocks versus bonds (or conversely whether it is too low and therefore favors bonds versus stocks). But to state that if you believe stocks are going to return more than bonds over the next year, you should therefore hold more stocks and less bonds than you normally would strikes us as overly simplistic and potentially dangerous to one's financial and mental well-being. Presumably, people who normally hold bonds in their portfolio are more sensitive to shorter-term market volatility and

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losses, and therefore own bonds to mitigate risk. It is not a simple comparison of which asset class is likely to return more, because the certainty of that outcome is nowhere near 100%, especially over shorter-term periods. Even over longer-term periods, where stocks are much more likely to beat bonds, the path to that long-term outcome will assuredly not be a smooth one. This creates the conditions for more conservative, risk-averse investors with too much stock exposure relative to their risk tolerance to harm their long-term returns by reducing their stock exposure at exactly the wrong times—during the inevitable market selloffs and cyclical scares. In the long run, a larger allocation to equities actually makes these types of investors worse off.

Putting It All Together

Given current yields, valuations, and earnings fundamentals, a globally diversified portfolio is not expected to generate returns as high as the long-term historical average, even with the additional return margin potentially coming from our ability to tactically allocate to what we believe are much more attractive asset classes and strategies. Of course, there are a wide range of potential returns, depending on what scenarios actually unfold over the next several years. But we view our base case as being the most likely, and we believe our asset class assumptions are reasonably conservative.

Another important message is that, as always, investors should have realistic return expectations as they look out over the next five or so years at least. These return expectations should be based on current valuations and starting yields, and they should encompass a range of reasonable economic, fundamental, and financial market scenarios. Similarly, investors should also be cautious in assuming returns, in the short run, will mirror their long-term averages. There is no economic law that says investors are owed an historical return each year, but rather should expect these returns over the longer term.

Closing Comments

We believe patience, discipline, and the tactical flexibility and expertise to invest across a broad opportunity set will be important attributes for navigating the next five years. We doubt investors will be able to simply rely on the U.S. market tailwinds of declining interest rates and rising P/E multiples that have boosted returns for core bonds and stocks over the past several decades.

Volatile markets, which we also expect, will likely challenge investors' convictions and emotions. As always, it is critical to do an honest self-assessment to understand your temperament, risk tolerance, and objectives, and to invest in a portfolio that is managed in a manner that is consistent with those attributes before market volatility strikes rather than in the heat of it, when emotions are likely to cloud judgment and lead to poor investment decision-making.

Successful investing requires patience and the understanding that investing is a part of a process, not a one-off decision, toward achieving your long-term financial goals; there will be inevitable and consistently unpredictable shorter-term market ups and downs along the way. Remaining focused on the long-term objective is key, as is maintaining a consistent investment discipline to guide your decisions over time. Our valuation-driven discipline means we can use short-term market volatility to our long-term benefit—managing risk while taking advantage of the investment opportunities created by other market participants' lack of discipline, patience, and flexibility.

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