

Market Update and Model Portfolio Reviews 10/31/2017

For the month of October, domestic large cap equities were up [2.33%](#), making it the 2nd strongest month-over-month return this year. Domestic investment grade bonds performed in a modestly positive manner at 0.06%. The 10-year Treasury moved up just under 5 basis points over the month. Hong Kong and Japanese Stocks continued their strong returns, booking returns of 32.44% and 21.72%, respectively, year-to-date (Hang Seng Index and Tokyo Price Index – Morningstar). The S&P 500 Total Return Index is having its second best year, dating back to full year 2000 when we ignore the two years that were recovery years (2009 – Financial Crisis Recovery and 2003 - Dot Com Bubble Recovery). It's important to note that we have not made it through the full year. On a long run historical average we are well above our average annualized returns relative to the index; but returns, of course, are not linear over time.

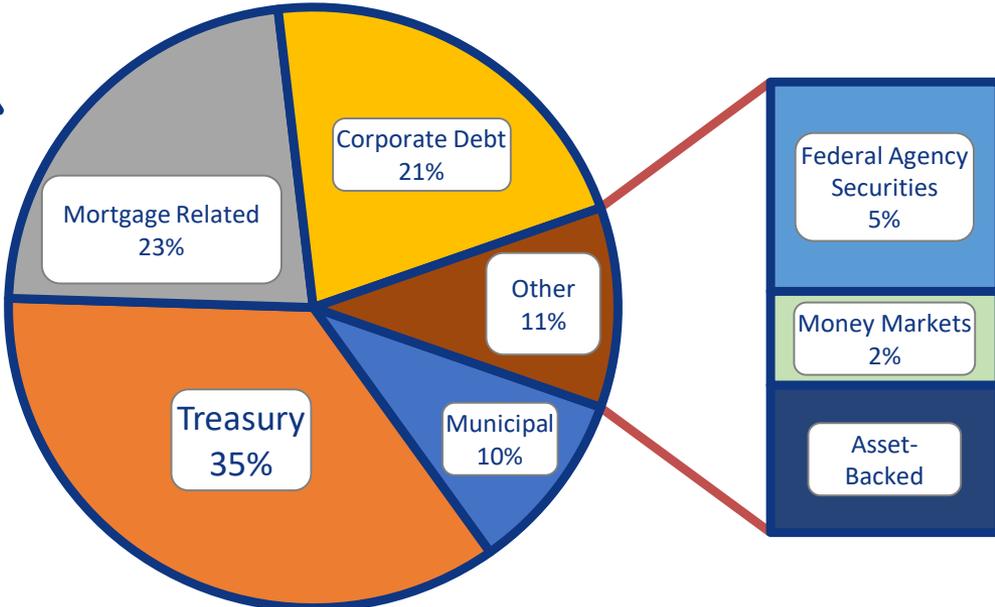
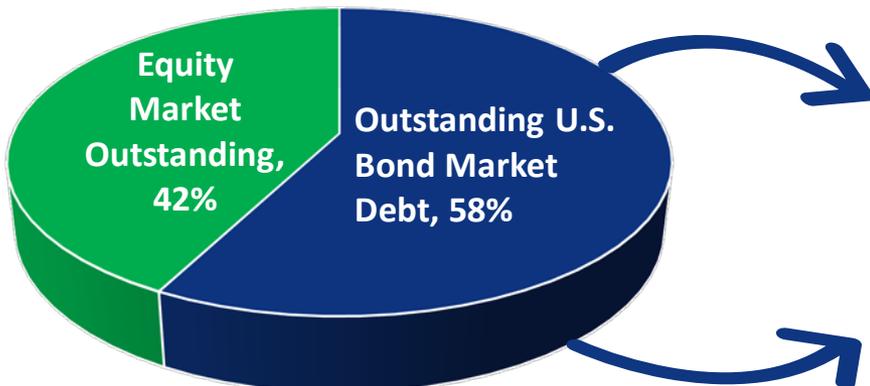
Almost 25% of the market capitalization of the S&P 500 Index was IT (Information Technology) at month-end. YTD, IT under GICS within the S&P 500 has returned [37.24%](#). If you back out both IT and Telecom (Telecommunication Services), then YTD Returns on the S&P 500 TR would fall from [16.91%](#) to [12.36%](#). Amazon is included in that 12.36% and as of month-end accounted for nearly 2% of the S&P 500 TR Index by market capitalization. Amazon is up by [47.4%](#) YTD, giving the S&P 500 almost 1% of the 16.91% year-to-date return. Bottom line: the top 5 largest companies by market cap in the S&P 500 TR index have all returned at least 30% YTD and are attributable for nearly 1/3rd of the total returns in the S&P 500 TR YTD.

We see risk in the yield curve for longer maturity fixed income instruments as lower than previously estimated. We remain mindful of interest rate risk (duration), but we would expect the yield curve to continue to flatten with short-term rates continuing to rise and longer maturity fixed income rates rising modestly at best. The exception to this expectation breaking down is outlined on the next page under the forward rate path expectations on the 10-Year Treasury Bond. We continue to benefit from rising short-term rates with our exposures to investment grade floating instruments and non investment grade floating instruments. A flat to negative yield curve has often led to recessions.

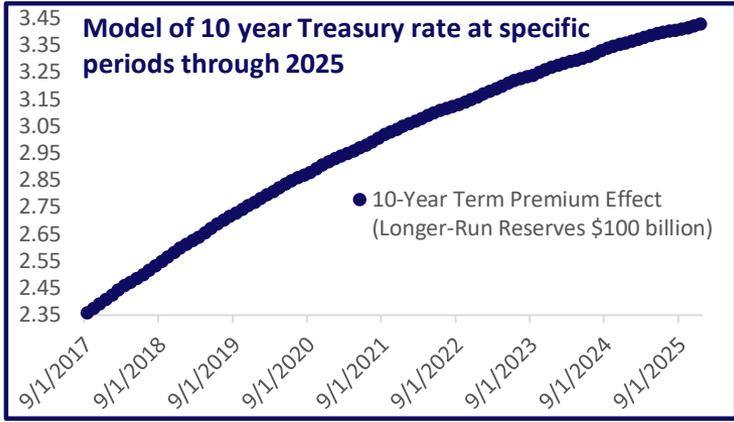
YTD 10/31/17 Net of Fees	% Return Strategy	% Return Benchmark	Relative Over (Under) Performance
Ultra Conservative	5.28%	5.04%	0.25%
Conservative	5.95%	6.38%	-0.43%
Moderate	7.06%	7.72%	-0.66%
Balanced	6.89%	9.06%	-2.17%
Growth and Income	7.48%	10.40%	-2.93%
Growth	9.03%	11.74%	-2.72%
Aggressive	9.35%	13.08%	-3.73%
Ultra Aggressive	11.56%	14.42%	-2.86%

MTD 10/31/17 Net of Fees	% Return Strategy	% Return Benchmark	Relative Over (Under) Performance
Ultra Conservative	-0.05%	0.46%	-0.51%
Conservative	0.02%	0.68%	-0.66%
Moderate	-0.03%	0.91%	-0.94%
Balanced	-0.04%	1.14%	-1.18%
Growth and Income	0.08%	1.36%	-1.28%
Growth	0.24%	1.59%	-1.34%
Aggressive	0.29%	1.81%	-1.52%
Ultra Aggressive	0.49%	2.04%	-1.54%

Month over month, five of the eight model portfolios yielded positive results net of fees, and all lagged their respective benchmarks when accounting for fees. The relative underperformance is attributed to the negative safe haven allocations (Gold and Long Yen to Dollar), Staples, spreads widening in sovereign debt, strengthening dollar and closed end fund premiums compressing and discounts widening. Positive attribution was lead again this month from our overweight to regional banks and thrifts. Our unhedged U.K. allocation was positive and still modestly outperformed our equity benchmark on a YTD basis, yet lagged this month due to relative strength of the dollar vs. sterling. Other asset class sleeves with positive attributions worth noting included exposures to Convertible Bonds, Mid Cap Equities and Large Cap Equities reweighted for lower volatility. The risk off strategies are intended to outperform in modestly positive, flat, and negative market environments. We expect relative underperformance if markets deliver average historical returns or strong bull market-like returns.



*US Capital Markets Deck 2017. (2017, September 18). Retrieved November 01, 2017, from <https://www.sifma.org/resources/research/us-capital-markets-deck-2017/>



What is bigger: the U.S. debt market or equity market? It may surprise you, given how much headlines focus on stocks. We spend a lot of time focusing on interest rates, which can admittedly be dry as a standalone topic. Let's put a few things in perspective regarding the U.S. capital markets (securitized debt & equity). As of the end of 2016, U.S. Bond Market Debt was approximately 38% larger than the entire U.S. Equity market.* When equity/investment analysts try to figure out how to price the value of an asset, they generally will look to estimate what the future free cash flow will be to the investor and then use a rate to discount (opposite of compounding rates) those cash flows to "today's" value. If an investor is going to accept any risk outside of treasuries, then they will demand that the rate is above the going rate of the treasury rate (as compensation for risk). The big point is that rates on treasury securities are generally the foundation of pricing of most other assets, even if we do not believe we can see it. If you are trying to value what a cash flow is 10 years from now, then you would mostly likely use the 10-year treasury rate as the minimum rate of required return plus the risk of the uncertainty of the cash flow (5-year cash flow would be rate on 5-year treasury).

Of the more commonly referenced benchmarks for pricing equities and 30 year mortgages is the 10-year Treasury Bond Yield (rate). With the financial crisis came multiple rounds of quantitative easing and now comes the time for "unwinding" the historical balance sheet that the Federal Reserve has built up. We are officially in Fed balance sheet unwind mode. To put this in perspective, the Federal Reserve had nearly \$4.5 trillion of assets on their balance sheet as of the end of 2016, which is equivalent to over 10% of the total outstanding U.S. Bond market.* 10% is a large number relative to the U.S. bond market and market participants naturally question as to how this "unwinding" would work. Selling supply back into the market when demand cannot meet it causes prices to fall and rates to rise (on Treasuries). This causes investors' required rates of returns to increase, and all else equal, is not positive for broad based equities, corporate bonds, and most of the other items listed above in the total U.S. Capital Markets Outstanding. [Late in September, the federal reserve provided an update to a well documented](#) (and for investment professionals reasonable inputs for modeling, see - [Model of 10 year Treasury rate at specific periods through 2025](#)) framework for how the "unwind" will take place. Using the September month end rate on the 10-Year Treasury Bond and the projections of the [SOMA](#) portfolio, [above is our forward rate path on the 10 Year Treasury Bond at various points of time](#). Although the guidance [highlights the limitations](#) of this approach, we want to highlight two timely topics: 1) with a new Fed Chair replacing Janet Yellen comes the opportunity to change course of the FOMC reinvestment policy; and 2) as we highlighted last month, larger than expected public deficit increases through Tax Reform would likely put additional supply of public debt (Treasuries) leading to added inflationary pressures and drive yields higher to offset fiscal stimulus. Those two aspects are the primary variables that would require the most recalibrating of the Term Premium Effect of the 10 Year Treasury Rate modelled above.

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The results do not represent actual trading and actual results may significantly differ from the theoretical results presented.