Investment Commentary: 8/2016

Investors shook off the global macro concerns of Brexit and a failed coup in Turkey, driving risk assets sharply higher for the month. Major U.S. equity indexes finished up for July, with the S&P 500 rising by 3.7%, and 7.7% for the year-to-date period. Gains were fairly broad-based across sectors, led by technology, materials and healthcare while defensive sectors such as consumer staples and utilities lagged.

Foreign developed market stocks pushed higher, with the MSCI EAFE gaining 5.1% and European stocks were up 3.5% as markets quickly recovered from Brexit-related worries. The British pound also firmed, ending the month at $1.32, virtually flat versus where it began, despite falling to as low as $1.29 during the early part of July. Emerging-markets stocks were strong performers in July, advancing 5.1%.

Core bonds, as benchmarked by the Barclays Aggregate Bond Index, registered a gain of 0.6% as a combination of central banks' policies and strong investor inflows (with the private sector now competing with central banks for limited supply) continued to drive down yields. Lower quality high-yield bonds benefited from the chase for yield and increasing risk appetite, gaining 2.7% for the month.

As of month-end July, U.S. quarterly earnings have come in ahead of already reduced expectations (with nearly two-thirds of companies having reported). Still, concerns about the economy's health resurfaced as second quarter GDP figures came in below expectations. The lackluster growth rate of 1.2% did beat the first quarter's 0.8% pace, though. Both contrast sharply with healthy consumer spending and continued strong employment numbers. The divergence has some questioning whether the Federal Reserve may once again hold off on raising rates—despite strong statements to the contrary from individual bank governors and last week's official policy statement that "near-term risks to the economic outlook have diminished."

The Science & Art of Asset Allocation

At the core of our investment philosophy and asset allocation strategy is a belief that valuation (the science) is the key determinant of *long-term* investment returns. We emphasize long-term because, as we've written many times, valuation isn't much help determining what an asset will return in the short-term. The reality is the valuation of an asset and its performance can be out of sync for years before reverting back to a more normal relationship. The danger of purchasing an asset just because it's cheap is buying too early and getting stuck in a "value-trap" that underperform for years before the value is recognized, or the flip-side, selling too soon based on valuation only to see the asset go to much higher levels. Both scenarios can be painful!

The "Art" of asset allocation is learning to recognize the cycles of financial markets and how to use them to your advantage. These cycles, we believe, are driven by natural human group or herd behavior.

The "Art" of asset allocation is learning to recognize the cycles of financial markets and how to use them to your advantage. These cycles, we believe, are driven by natural human group or herd behavior. And since we don't think *human* behavior is going to evolve much over the next few decades, we expect *markets* will continue to behave cyclically.

The existence of market cycles creates significant risks for investors who ignore them (i.e., the "this time is different" syndrome) and great opportunities for disciplined long-term investors. But while this time is *rarely* different when it comes to investing, neither do history and cycles repeat *exactly* in terms of timing, duration, or magnitude.

Investment Commentary: 8/2016

Howard Marks, a well-respected investor, often emphasizes the importance of understanding cycles in his writing. He uses the metaphor of a pendulum to describe market behavior, as summarized in the following excerpt from his 2011 book, *The Most Important Thing*.

Investment markets follow a pendulum-like swing:

- between euphoria and depression [greed and fear],
- between celebrating positive events and obsessing over negatives, and thus
- between overpriced and underpriced.
- This oscillation is one of the most dependable features of the investment world.

Marks notes that the oscillation of the investor pendulum is similar to the up-and-down fluctuation of economic and market cycles in that while the occurrence of the pendulum-like pattern is extremely dependable in most markets, one never knows exactly how far the pendulum will swing, how long it will stay at one extreme or another, or what might cause it to reverse.

It is impossible to consistently and accurately predict exactly when a cycle will turn or when the pendulum will start to swing back the other way or how far it will go at the extremes. But with our longer-term analytical framework and focus on valuation that is informed by and grounded in market history, we can position our portfolios to benefit from the cyclic swings of the pendulum. This requires having a long-term perspective and the discipline to stick to your process and consistently execute it over time, *especially* when the cycle and pendulum are swinging to extremes.

The four charts below tell a story of a pendulum that we believe has swung too far in the direction of U.S. stocks outperforming relative to foreign developed and emerging market stocks. We don't know when the cycle will change back into the favor of foreign assets(nor does anyone else!), however we think the valuation discount of foreign stocks relative to U.S. stocks is great enough that there is a high probability they will out-perform over the long-term (next five years). Investors should begin tilting their portfolios in this direction to capitalize on the next cycle.

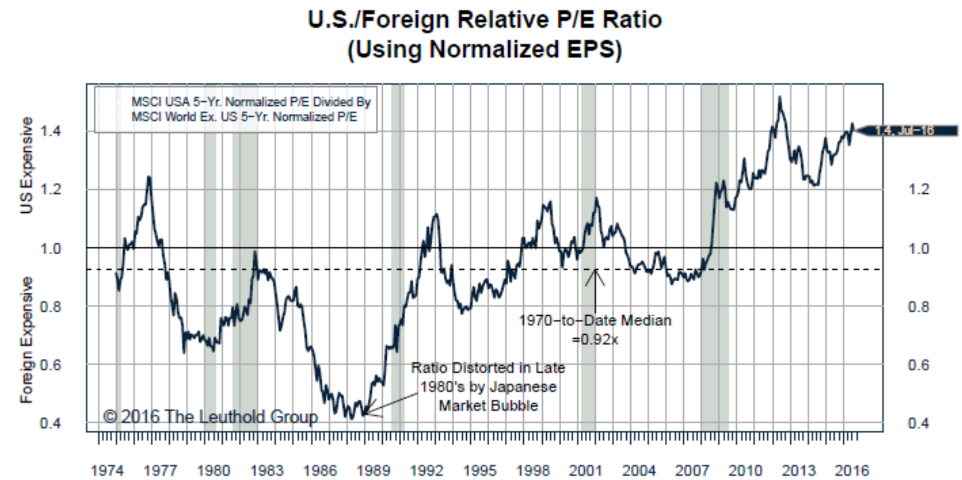


Chart 1- *The relative valuation of U.S. to foreign stocks is near all-time highs and well above the historical median:*

Investment Commentary: 8/2016

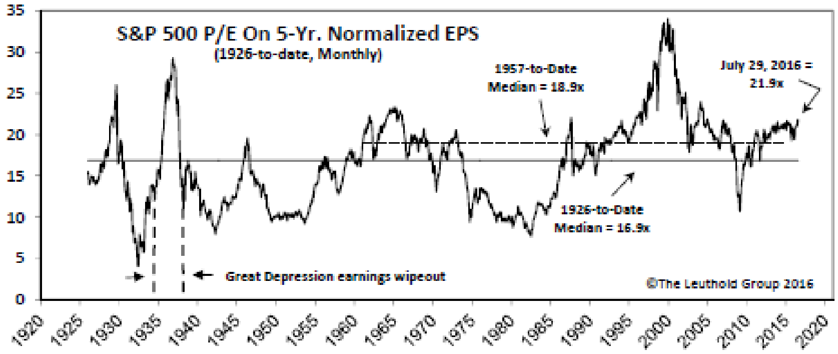
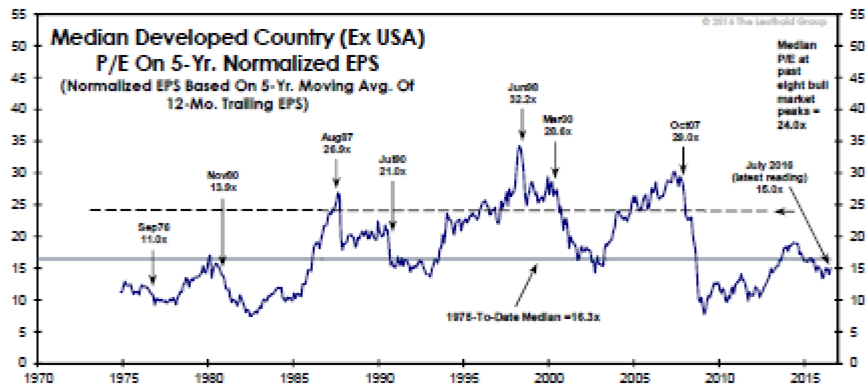


Chart 2- *The valuation of S&P 500 stocks are well above their historical median:*

Chart 3- *The valuation of foreign developed stocks are below their historical median:*



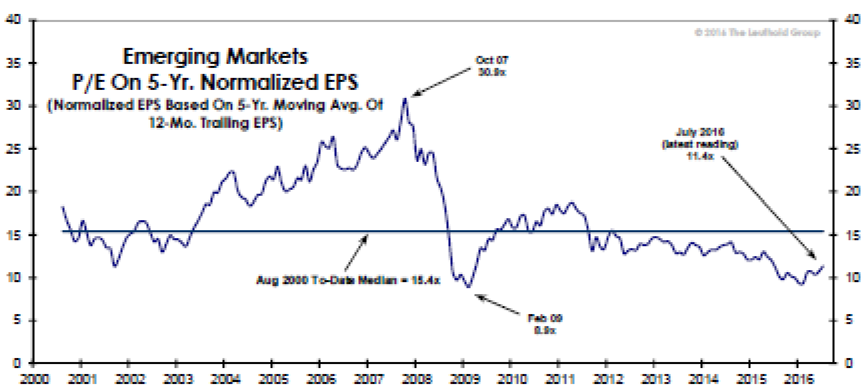


Chart 4- *The valuation of emerging market stocks are below their historical median:*

Please give us a call if you have any questions on this commentary or if you would like to discuss investment strategy. We appreciate and thank you for your business!

AWM Investments (8/16)