FA Financial Alternatives
integrated wealth management

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Review of 2016

It was an interesting year to put it mildly. The US stock market as measured by the S&P 500 overcame its worst start to a year since 1930 and returned 11.96% for 2016. International developed-market stocks returned 1.15% and Emerging Markets 11.19%. Real Estate Investment Trusts (REITs) were up 4.68% and Commodities gained 11.77%

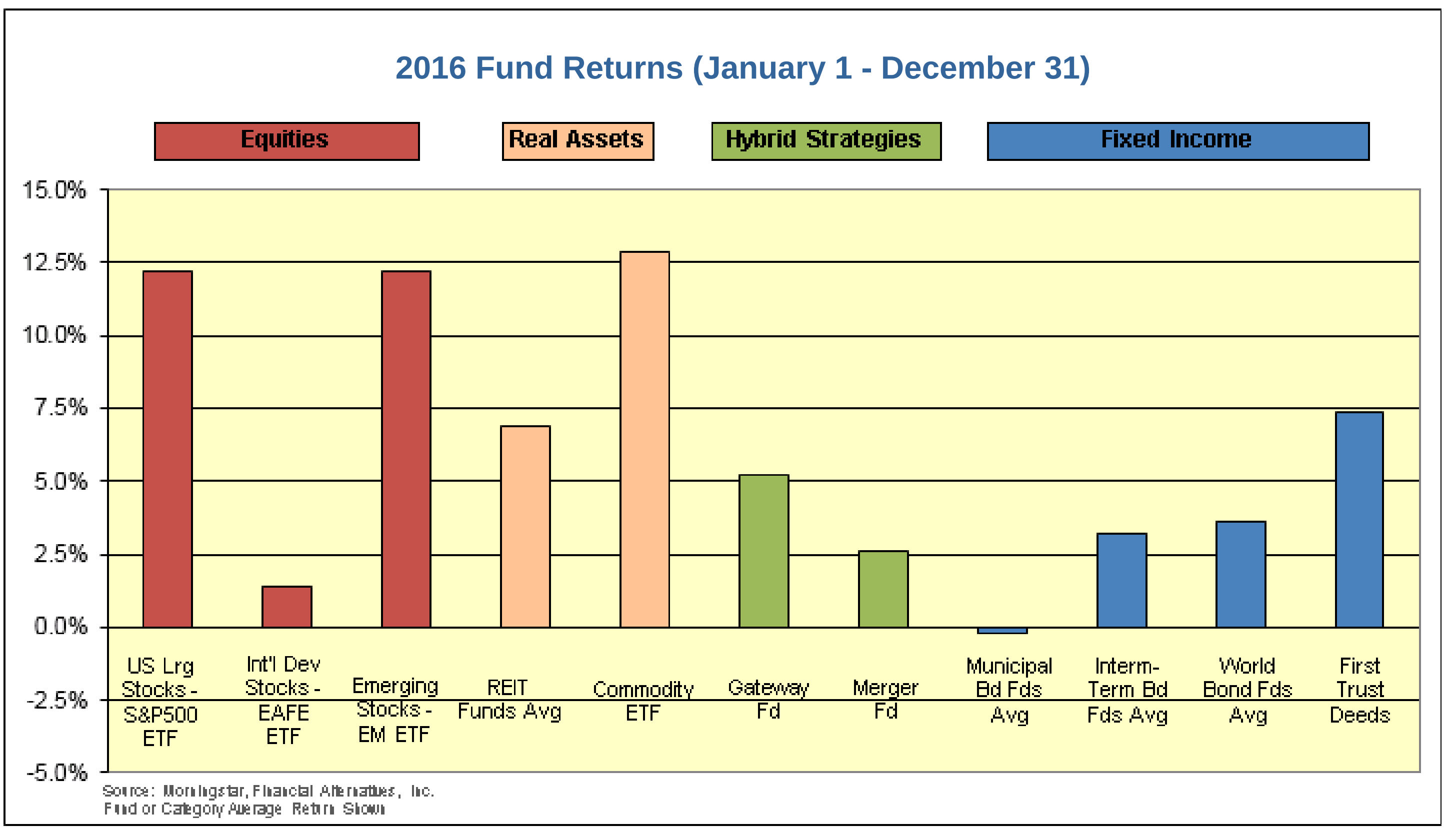
Bonds also experienced a roller coaster ride in 2016. The 10-year Treasury bond yield (which falls as bond prices rise) tumbled nearly a percentage point by the summer hitting a record low of 1.366% in July. This remarkable price rally was then followed by the biggest quarterly selloff in more than two decades. The 10-year Treasury yield climbed 0.841% between October and December, the largest quarterly yield gain since 1994.

After this significant rise and fall in the price of the 10-year Treasury, its total return ended up essentially flat for the year. Many believe we have hit a low point for interest rates in 2016 and that the trend will likely be up from here.

Corporate bonds outperformed Treasury bonds and Municipal bonds - like Treasuries - were flat. The First Trust Deed investment we use significantly outperformed high quality bonds by returning 7.34%. The top performing bond sectors in 2016 were lower rated corporate bonds and Emerging Market bonds returning 17.13% and 10.02%, respectively.

Executive Summary

- Stocks and bonds were volatile in 2016, but overall it was a decent year for patient investors.
- Intermediate-term bonds performed in line with shorter term bonds in three of four rising interest rate environments - so no changes are planned in these assets.
- First Trust Deeds continue to provide a high interest yield and should perform well in an increasing rate environment.
- New all-time highs in equity markets have historically not been useful predictors of future returns.
- It is impossible to time the market consistently and profitably.
- Ensure you are comfortable with the risk in your portfolio so you don't panic and sell your investments during a severe market downturn.



The year was full of unexpected twists and turns. On June 23rd the UK surprised the world and voted to exit the European Union - sending the US markets down over 5% in two days. Markets surprised investors again by reversing course and hitting new highs just three weeks later.

This year's presidential election - featuring two of the most unpopular candidates in recent history - was like no other to say the least. In the weeks prior to election day, markets seemed to rebound when the news favored Clinton and to fall when the election news favored Trump; which led many to believe that markets would react negatively to a Trump victory. On election night, as results began favoring Trump, futures markets plummeted and it looked like a rout was underway. Yet before the US markets opened the next morning, the drop had turned into a gain and rose to another high.

A year like this serves as a stark reminder that we cannot time the markets and that markets truly are unpredictable in the short-term. Yet for calm, patient, and diversified investors, 2016 was a decent year overall.

Will interest rates continue to rise and how will this affect fixed income investments? In addition, is the U.S. stock market overvalued after notching all-time highs in 2016? We'll address these questions in this quarter's newsletter.

Fixed Income in a Rising Rate Environment

There are two fundamental principles to be aware of with bonds in a rising interest rate environment: Bond prices fall as interest rates rise; and the longer the maturity of the bond, the larger the price drop. Given the interest rate risk of longer term bonds, they pay higher yields to compensate.

That stated, does it make sense to shorten the maturity of your bond investments in anticipation of higher interest rates? We use some recent research by Dimensional Fund Advisors (DFA) to help shed light on this question.

DFA researches found four recent periods of rising interest rates, and compared the performance of short-term bonds to intermediate-term bonds. See the "Periods of Rising Rates" table and graph below. In these four periods, rates increased at least 1.50% over 12 months or longer.

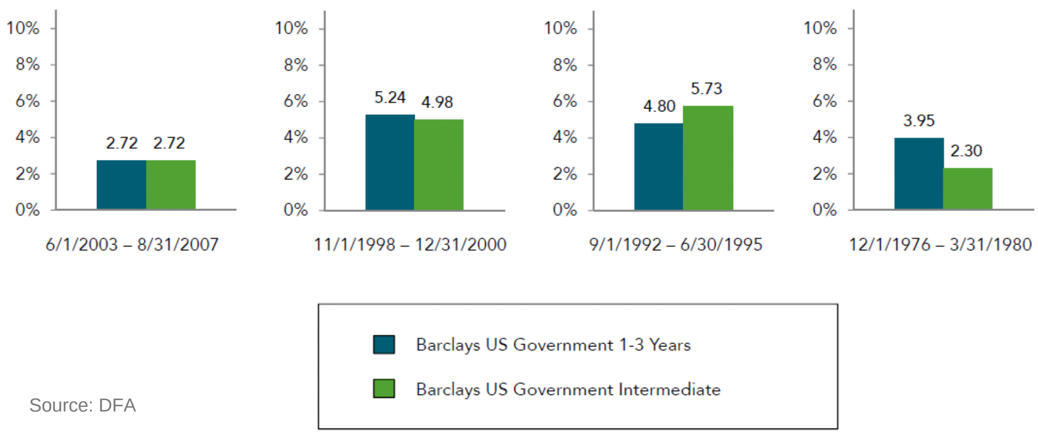
Periods of Rising Rates

As you can see from the graph on page 3, the performance of short-term bonds and intermediate-term bonds was not substantially different except during the period from

Periods of Rising Rates

PERIOD	Beginning of Period	End of Period	Change
June 2003 – August 2007	1.00	5.25	+4.25
November 1998 – December 2000	4.75	6.50	+1.75
September 1992 – June 1995	3.00	6.00	+3.00
December 1976 – March 1980	4.75	20.00	+15.25

Short vs Intermediate-Term Bond Returns During Periods of Rising Rates



Source: DFA

1976-1980 when there was a massive increase in interest rates. Yet even then the return difference between short-term bonds and intermediate-term bonds was only 1.65% annually. During this period both short and intermediate-term bonds posted positive nominal (before inflation) returns.

Interest rates changes are impossible to predict in both the short-term and long term. Because of this and also because of research we have done, we are maintaining clients' intermediate-term bond positions rather than moving to shorter term bonds even though interest rates could continue to rise over the next few years.

Why We Like First Trust Deeds as a Bond Substitute

For many clients, due to the low interest rate environment, we've used a first trust deed investment in place of high quality intermediate-term bonds for many years. This type of fund provides a relatively high interest yield, and a risk/return profile which makes it less sensitive to increasing interest rates and inflation.

Is the U.S. Stock Market Overvalued?

By themselves, new all-time highs in equity markets have historically not been useful predictors of future returns. See the graph to the right which shows that from 1926 through the end of 2016, the subsequent annual returns after hitting a new high are similar to other periods. Thus, the index level itself is not a useful predictor of performance.

The short answer to the question of whether the market is overvalued is that nobody knows. Only with time will we be able to look back and determine whether markets were overvalued, undervalued, or fairly valued.

It appears that the market is forecasting stronger economic growth under the Trump administration. If this increased growth materializes, the market is probably fairly valued but if it doesn't, the market is likely somewhat overvalued.

In our opinion, long-term investors are far better off not even asking this question on the relative valuation of the market. It's impossible to answer in the present with any reliable degree of accuracy, and it tempts investors to try to time the market which almost always hinders long-term performance. That stated, we believe it can be beneficial for investors to look at pessimistic forecasts when times are good and optimistic forecasts when times are bad. Looking at opposing views can help contain the natural human emotions of fear and greed.

For a current negative forecast we need look no further than the GMO 7-year forecasts which we have referenced in past newsletters. As you can see from the graph on page 4, GMO is forecasting negative real returns for most assets classes over the next 7 years. The returns forecasts are a little better for developed international and emerging markets but still not great.

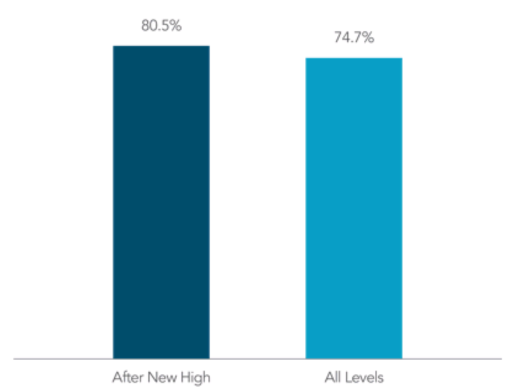
We like to view GMO's forecasts as a kind of worst case scenario but one that could happen nevertheless. They would be the first to admit that these forecasts assume interest rates will return to historical averages and if they don't, the forecasts will likely be too pessimistic.

Our view is that clients should maintain the equity allocation they currently have and not fret about increasing or decreasing their allocations based on the prevailing expectations of the markets or expert forecasters.

Stay Balanced, Patient & Calm

When investors accept that it is impossible to time the market consistently and profitably, it makes sense to maintain

S&P Total Return Index Highs: 1926–2016
Percent of Months With Positive Return Over Next 12-Month Period

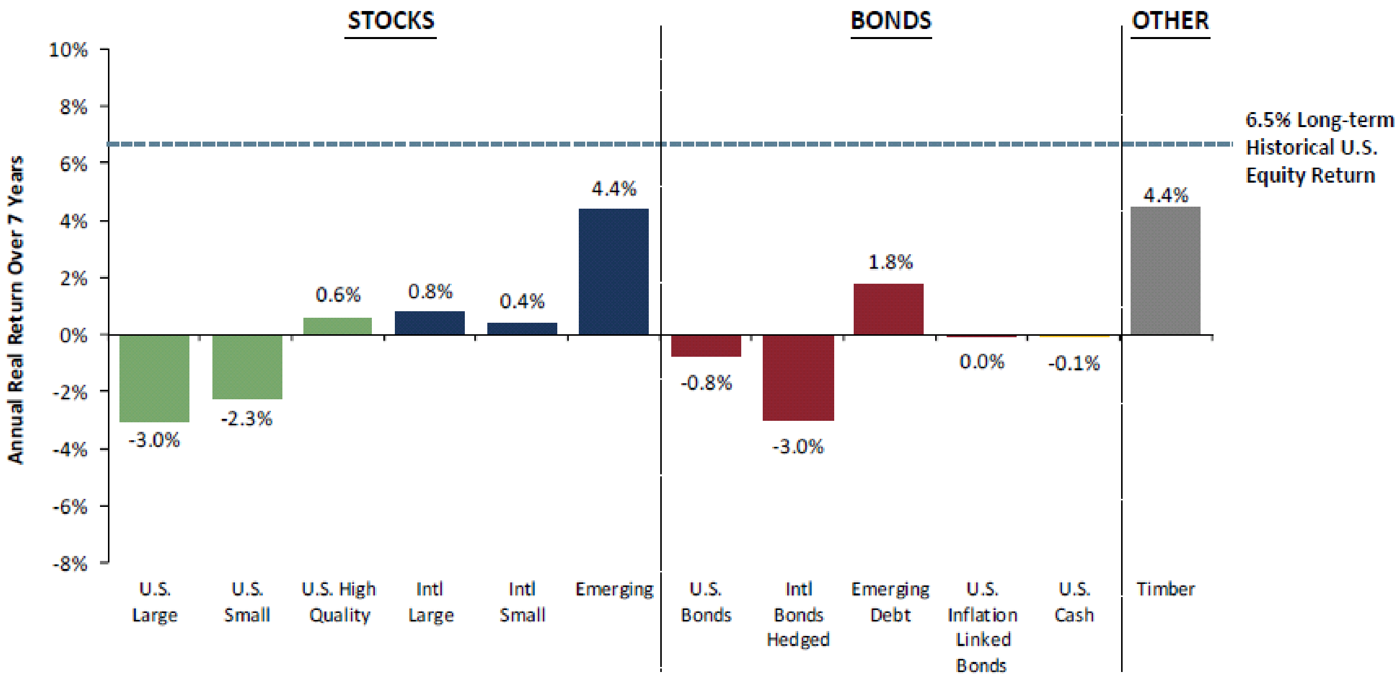


From January 1926–December 2016, 319 months, or approximately 29% of monthly observations, were new closing highs.

Note: 1,081 monthly observations.

The S&P data is provided by Standard & Poor's Index Services Group. For illustrative purposes only. Index is not available for direct investment. Past performance is no guarantee of future results.

GMO 7-Year Asset Class Real Return Forecasts
as of November 30, 2016



a balanced portfolio and a long-term mindset. Furthermore, remaining patient and calm as markets gyrate through periods of overvaluation and undervaluation in the short-term will serve you well.

A key to enduring market gyrations is to make sure you are comfortable with the downside risk in your portfolio - so that you don't panic and sell your investments during a severe market downturn. Keeping ample conservative investments in your portfolio and in cash reserves will help you remain calm during the inevitable periods of high volatility that have been a part of stock market investing and always will be.

Summary

2016 was a colorful year and a stark reminder that market timing is a difficult if not impossible task. New all-time highs in equity markets have historically not been useful predictors of future returns and it is impossible to be certain when the market is overvalued, undervalued, or fairly valued. A better course of action is to ignore the forecasts and stick with a reasonable equity allocation; then prepare yourself mentally to hold onto your investments through the inevitable market cycles to come. Keeping enough in conservative and cash assets helps investors remain patient and calm when things get volatile.

Bond markets were more volatile than usual but as the above research shows, the difference between short-term bond and intermediate-term bond performance in rising interest rate environments has not been substantial. Sticking with intermediate-term bonds is a rational choice even though we may be entering a rising interest rate environment.

Please call us if you'd like to discuss your investments or any other aspect of your financial life in greater detail. We want to wish you all a Happy New Year.

Past performance is no guarantee of future results. All content in this newsletter is intended as general information, not specific advice. Performance data listed is for illustrative purposes only. Portfolios are personalized and often consider many variables, including investment objectives, age, time horizon, risk tolerance, and tax variables. Information contained herein has been obtained from sources believed reliable, but not guaranteed.

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