| 2017 SECOND QUARTER COMMENTARY

SING TO ME, SIREN

John William Waterhouse: "Ulysses and the Sirens"

"Sing to me, siren, lay your head on my shoulder and rock me to sleep
For a consequent phrase, I will happily give to you all of my dreams
As my ship of secrets scatters the shores of your ominous seas
Just sing to me, siren, and your voice will carry me into the deep"

-Baker and the Knight, "Sing to Me, Siren" (2017)[1]

The mythological siren's song enchants the wary sea traveler, tempting him closer until his ship is cast upon the rocks of a nearby island. In Homer's Odyssey, Odysseus orders his men to tie him tightly to the mast of his ship, to plug their ears with beeswax, and not to untie him (no matter his pleas) until they pass through the treacherous strait and out of earshot from the sirens' calls. (Spoiler alert: They make it through.)

While the sirens promised the renowned Odysseus knowledge, the sirens of today's financial markets promise low-risk returns. Just as Odysseus commanded his men, the best way to navigate these waters is to plug one's ears. Many opportunities look enticing—tech stocks, yield plays, short volatility—each opportunity carrying its own song, and each with the potential to bring the reckless portfolio manager to shipwreck.

Of course, we must take risks if we want the opportunity to earn a real return. This quarterly commentary will take the pulse of the market environment today as well as address the opportunities and risks we see on the horizon.

REVIEW OF THE MARKETS: 2Q17

The second quarter saw the dollar fall relative to other major currencies while equities, rates and credit all rallied—a proverbial "risk-on" quarter. There was strength in health care, industrials and financials, while weakness in energy and telecom (smaller weights in the index) were both quite pronounced. Growth outperformed value and large-cap outperformed small-cap—both continuations of the first quarter.

Many markets this quarter continued to grind higher. In fact, if you had picked any random day in the first quarter, bought the MSCI World and held it for three months, you would have earned somewhere between 3% and 6%. That is an astonishing degree of consistency and the tightest range of 3-month returns for the MSCI World since the index's inception. As further confirmation, many measures of equity volatility are near their all-time lows.

Emerging markets continued to outperform on the year, particularly in Asia. Latin America took a breather as corruption weighed on Brazilian equities (although Mexico continues higher). The Japanese Yen consolidated after significant weakening in the fourth quarter of 2016 followed by a reversal in the first quarter. The weak Yen drove Japanese equities higher. South Korea's KOSPI index was a standout performer in the quarter and on the year (up 18% YTD), demonstrating the wide moat between news about ICBMs and investor risk appetite—or, perhaps, fact and fiction (I'll leave the reader to figure out which is which).

[1] Author's note: While the markets are my day (and night) job, *Baker and the Knight* is a musical collaboration between another musician and myself. With yesterday's release of "Sing to Me, Siren", I thought it would be especially appropriate given today's market environment. Click here to listen or find on Spotify, Apple Music, or anywhere else. I hope you enjoy!

INVESTOR RISK APPETITES

Investors are doing one of three things: 1) Overpricing risk; 2) Accurately pricing risk; or 3) Underpricing risk. Let's walk through each of these examples:

If investors are overpricing risk…

…then these historically low levels of volatility are still too high and an investor could profit by executing an option-selling strategy or by taking short positions in the VIX[2]. These strategies tend to do very well for a period of time and then have brief periods with extraordinarily steep losses—up the staircase, down the elevator shaft. If one times the strategy correctly, one can make a lot of money. Continuing with the siren analogy, it would be like trying to absorb the siren's wisdom and still plugging your ears with beeswax just before she convinces you to drive your boat into the rocks.

For those investors looking to wallow in an opportunity missed, the chart below plots the total returns of XIV (Daily Inverse VIX Short-term ETN – i.e. "short volatility") and SPY (an S&P 500 ETF) over the last 12 months. Yes, that is 234% in total return over the last year if you were bold enough to hold.

"Investing" in a short volatility ETF makes the S&P 500 look like a boring bond fund:

Source: Bloomberg, as of 6/30/2017

[2] Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility.

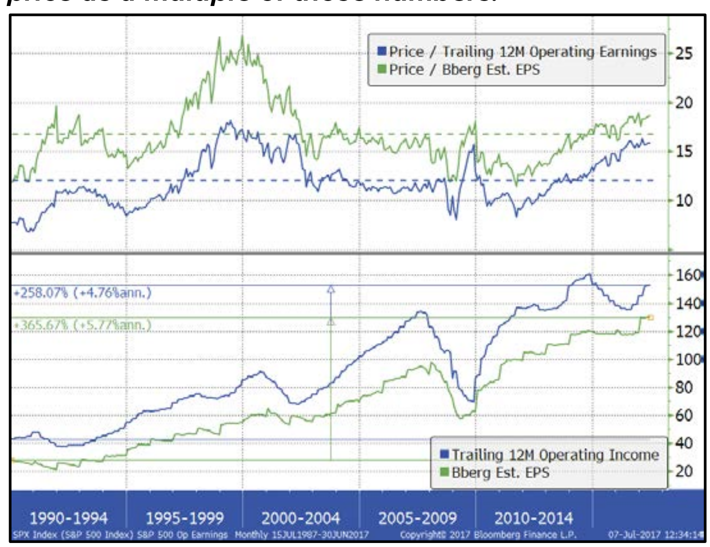
If investors are accurately pricing risk…

…then buying and holding equities is the best way to continue taking advantage of the environment. The assumptions I am making here are two-fold: First, if volatility is accurately priced at these low levels then interest rates in developed markets will continue to stay persistently low to reflect the low levels of inflation that would likely continue to justify the level of rates. Second, there is no such thing as an "orderly" sell-off in equities. These things usually happen quickly, catch people off guard, and the ride down tends to be quite bumpy.

If investors are underpricing risk…

…then equity market valuations should fall. We could take the next few pages going over historical earnings estimates, the equity risk premium, the discount rate applied to future earnings, but instead the best use of your time is to look at the following charts:

Operating income and earnings of the S&P 500, and price as a multiple of those numbers:



Source: Bloomberg, as of 6/30/2017

The top half of this chart shows price multiples over the last 25+ years, which is a proxy for investor's assumptions for growth and risk. After all, if I'm willing to pay almost $20 for $1 of earnings that says something different than if I am only willing to pay $13.

The bottom half of the chart shows the growth of operating income and earnings over the last 25+ years. Notice these numbers have grown between 4.8%-5.8%, annualized.

<u>If that growth continues</u>, these models show the S&P 500 as overvalued by somewhere between 11% and 28% today, meaning it would take between 2-5 years of 4.8%-5.8% earnings growth to bring markets back in line with fair value. Not a glowing recommendation for equities.

Equity performance during different interest rate regimes:

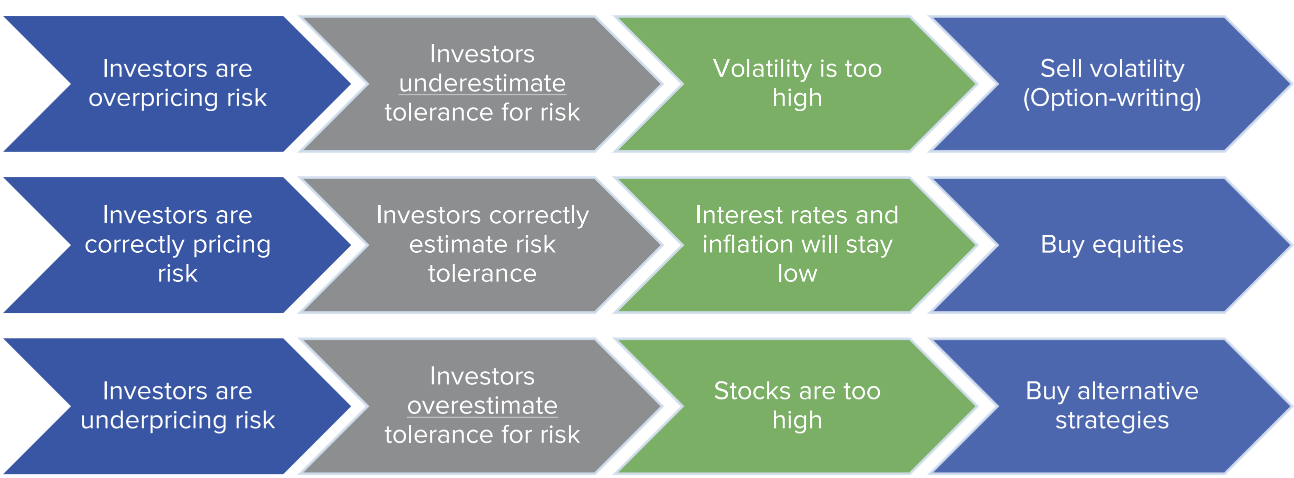
Source: Bloomberg, as of 6/30/2017

	Rising Rates 3/30/1962 - 9/30/1981	*Falling Rates* 9/30/1981 - 6/30/2017
S&P Total Return, Annualized	**6.7%**	**11.7%**
Avg Yield on 10yr U.S. Treasury	**6.8%**	**4.3%**
Spread	**-0.2%**	**7.4%**

Equities perform differently relative to fixed income, depending on the interest rate regime, and there have been only two regimes over the last 50+ years. The last interest rate bear market—the late sixties to the early eighties—was quite a challenging environment for the stock market… in fact, equities made less than the average yield on the 10-year Treasury! Given long-term interest rates help to define the discount rate for equities, a move up in interest rates does not bode well for stocks theoretically. History also supports theory and equity bulls should beware.

None of this research is ground-breaking; all of it carries with it decades of data. While the race to acquire new technology has investment firms creating new factor indices, new machine learning algorithms to trade tick data and new risk management software to more accurately view risks, <u>there exists no technology to cure the human psyche (yet)</u>. As fascinating as the growth of machine learning is, let us remember that technology is created by humans and it is implemented by humans. No system is immune to our imperfections.

How are investors pricing risk, and how can an investor respond:



PRUDENT INVESTOR'S PARADOX #2

Acknowledging our biases, it makes sense to revisit an old quarterly letter: Last year's third quarter commentary, "The Prudent Investor's Paradox". This commentary touched on the idea that although markets may have a good chance of continuing to grind higher, even a small probability of a fall from elevated valuations tips the scales too far for equities to be the largest allocation for a long-term investor. It is the major reason we hold a significant allocation to alternative strategies in our total portfolios—an allocation I expect will flip sometime over the next five years.

For now, we must continue to allow markets to grind higher and participate only marginally, given our current underweight to equities. "Sitting on the sidelines" during a slow march upward is incredibly painful for the psyche. In classic Monday-morning-quarterback fashion, our minds trick us: "There was no risk in buying equities… look at how smoothly they went up!" "I can't afford to miss out on these returns!" There is no device (yet) to counteract these feelings. So we must continue to push back on our emotions and look to logic to guide our investment philosophy.

Let me present two statements about the S&P 500:

1) Historically, when the first five months are each positive, the average year ended +28.77%. This has happened 12 times since 1926 and all 12 years ended with positive, double-digit gains.

2) Going back to 1881, a CAPE ratio[3] higher than 30 (30.06 on June 30, 2017) has generated future 7-year annualized returns of about 2% (meaning returns after inflation have been negative).

One statement is incredibly bullish for the rest of the year; the other does not bode well for equities over a seven-year time horizon. Also, while one statement has a bit of tea-leaf to it, the other is rooted in mathematical certainty (e.g. the more you pay for a dollar of earnings, the smaller your percentage return on investment).

What axioms guide your investment philosophy? What is your time horizon?

Conclusion

We do believe that for most investors with longer time horizons it is always important to hold equities *at some percentage of a portfolio*. Our question to our readers: What is your current allocation, and why?

Because we believe both fixed income and equities are poised to deliver very low real returns over the next seven years, our allocation to alternative strategies is quite high at this point. While our total models have generated positive returns this year, quarters like 1Q17 and 2Q17 can be more challenging because many of the same clients who were scared in 2008 are the ones anxious about potentially missing out on tech stocks or who want to reach for yield in overpriced markets. Our job as advisors is to try and help our clients to weed through the "bullish this year" balderdash and to maintain a prudent allocation to stocks, bonds and alternatives based on time horizon and risk tolerance. Everything else is a siren's song.

All the best,

Jonathan Belanger, CFA
Director of Research
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[3] Cyclically-adjusted price-to-earnings, also known as the Shiller PE Ratio, or PE 10.

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