Investing Utopia

By Kevin O'Keefe, CIMA®, AIF®

Diversified portfolios across the risk-return spectrum again ratcheted higher in the third quarter as global financial assets rose in unison. Not only did investors receive strong returns, they also achieved them with little volatility.

Stock Funds Continued to Gain

Corporations are generating bigger profits again. A parade of better-than-expected earnings reports, as well as the prospect of tax cuts, helped to lift all kinds of equity portfolios. Mutual funds and folios focused on the smallest stocks were notably strong, after lagging other equity categories earlier in the year.

International stocks did even better, outperforming U.S. stocks for the quarter and YTD. Emerging markets stocks have gained even more, for the same periods. The main reason: with U.S. stocks at all-time highs, overseas markets have been trading at more attractive prices. International equity markets have been lagging their U.S. counterparts for years and only in the past year have started to catch up.

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Also In This Issue

Quarterly Performance Benchmarks

Passive Benchmarks*	Q3 2017	YTD	1 Year	3 Year**	5 Year**
S&P 500 Index	4.48	14.24	18.61	10.81	14.22
MSCI KLD 400 Social Index	4.47	14.05	17.04	9.72	13.82
DJIA (reinvested dividends)	5.58	15.45	25.45	12.35	13.57
S&P MidCap 400	3.22	9.40	17.52	11.18	14.43
Russell 2000 (Small Cap)	5.67	10.94	20.74	12.18	13.79
MSCI EAFE (Europe, Australasia, Far East)	5.40	19.96	19.10	5.04	8.38
MSCI Emerging Markets	7.89	27.78	22.46	4.90	3.99
Bloomberg Barclays Aggregate Bond	0.85	3.14	0.07	2.71	2.06
Morningstar Mutual Fund Benchmarks					
U.S. Large Cap Growth	5.30	19.85	19.75	10.37	13.68
U.S. Large Cap Value	3.81	9.41	16.18	7.97	12.18
U.S. Mid Cap Growth	4.54	16.74	18.13	9.13	12.61
U.S. Mid Cap Value	3.11	7.56	14.88	8.01	12.68
U.S. Small Cap Blend	5.08	8.42	18.88	10.01	12.84
Foreign Large Blend	5.30	20.29	17.98	5.11	7.78
U.S. Real Estate	0.72	3.99	1.55	8.73	8.73
Intermediate-term Bond	0.87	3.40	0.84	2.52	2.14

* Sources: Morningstar
**3-Year and 5-Year returns are average annual returns for that benchmark.

Performance data presented reflects past performance. Past performance is no guarantee of future results. Investing involves risk, including loss of principal. Passive benchmarks are unmanaged groups of stocks and are not directly available for investment. Information has been obtained from a source considered to be reliable; however, neither First Affirmative nor its agents can guarantee the accuracy of the numbers reported.

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A Nobel Prize to Cheer

This month the Nobel Prize in economics was awarded to Richard Thaler. It's an award that non-economists can celebrate. Thaler has spent decades "nudging" the field to take a more realistic view of human behavior by acknowledging that people act irrationally much more often than economists once believed.

Thaler's ideas were once considered avant-garde, as were those of Daniel Kahneman and Amos Tversky, but his ideas are now mainstream. His work is remarkably accessible: Read his memoir, *Misbehaving*, or *Nudge*, which he co-wrote with Cass Sunstein. The essence of *Nudge* is that small incentives can prod people into making better decisions to their benefit. The principles have helped increase participation in 401(k) plans.

"A nudge…is any aspect of the choice architecture that alters people's behavior in a predictable way without forbidding any options or significantly changing their economic incentives."

"The combination of loss aversion with mindless choosing implies that if an option is designated as the "default," it will attract a large market share. Default options thus act as powerful nudges."

"Unrealistic optimism is a pervasive feature of human life; it characterizes most people in most social categories. When they overestimate their personal immunity from harm, people may fail to take sensible preventive steps. If people are running risks because of unrealistic optimism, they might be able to benefit from a nudge. In fact, we have already mentioned one possibility: if people are reminded of a bad event, they may not continue to be so optimistic."

— Richard H. Thaler, Nudge: Improving Decisions About Health, Wealth, and Happiness

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Value stocks outperformed growth stocks in non-U.S. developed markets but not among U.S. or emerging market stocks.

Bonds Were Resilient

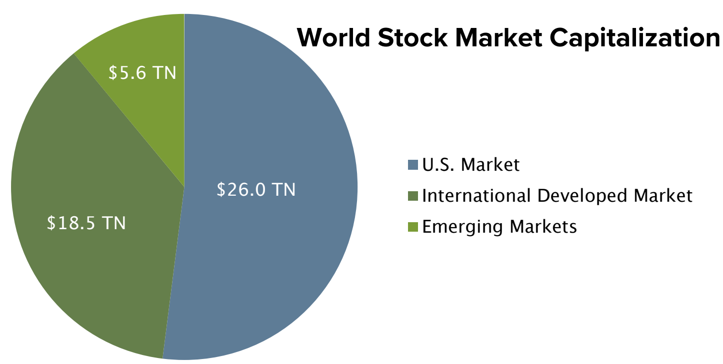
Bonds turned in positive returns, even with weakness in September, as investors anticipated another interest rate increase by the Federal Reserve. Mutual funds focused on intermediate-maturity, investment-grade debt (the most prevalent type of fixed income fund) fell 0.4% in September, but gained 0.9% for the quarter. The average intermediate bond fund was up 3.4% YTD. Funds invested in riskier bonds did even better during the quarter.

Heading into 2017, many investors were bracing for losses from bond funds even though bonds are supposed to be safe. The reason: expectations that interest rates would keep climbing. Rates leapt after the 2016 election on speculation that faster economic growth (and therefore inflation) was on the way. The 10-year Treasury yield went from 1.85% to 2.60% in little more than a month. (Rising rates mean newly issued bonds pay more interest. This in turn causes older, lower-yielding bonds to be less attractive unless the market price is adjusted to compensate—which is of course what happens: bond prices move in the opposite direction of interest rates.)

But expectations did not meet reality and interest rates have not marched higher. The yield on the 10-year Treasury hit its low point for 2017 during the third quarter, at just above 2%. The drop in yield corresponds with increases in bond prices so far this year.

Volatility: How Low Can It Go?

To achieve gains in stocks, investors must accept the risk of big (temporary) declines along the way. That said, the third quarter was unusually quiet. The Russell 3000 Index (an index comprised of the 3,000 largest U.S. stocks) only



Source: Dimensional Quarterly Market Review

lost more than 1% for the session twice (in Q3 2015 investors had to endure twelve daily declines of 1% or more).

About 95% of mutual funds had positive returns in the third quarter — even mutual fund categories that struggled earlier in the year. Steady upward momentum made it easy for most investors to maintain their course. The question is: Have investors become too complacent? If so, is this a problem, and what is the remedy?

One way of measuring complacency is to examine the relationship between the valuation and the volatility of stocks. As this graphic shows, the P/E to VIX Ratio recently reached its highest level since 1990 — and is on the verge of

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surpassing it — indicating a complacent market. Extensive investor complacency can be a problem because

Calm waters… for now

of the harm associated with misperception of risk. The remedy is simply to maintain investment discipline: Review your Investment Policy Statement, especially if it has been a while since you have done so. If it is out of date, or if your circumstances have changed, update it and follow it. This might mean trimming some stock positions, which in turn means realizing capital gains. While no one likes to pay taxes, it is preferable to having a portfolio positioned too aggressively. A subset of maintaining investment discipline is cultivating the practice of dismissing market forecasts. History is replete with forecasts[1] that have enticed investors to throw their well-conceived investment strategy out the window.

A Challenging Time for Income Investors

With stocks at record highs and the income stream from bonds near record lows, there is growing evidence that income-oriented investors are becoming anxious.

"Chasing yield" — seeking higher investment income — is a common way of self-inflicting harm. According to FactSet, $1.6 billion in new money was invested into exchange-traded funds comprised of high-yield corporate bonds (junk bonds) last month. In and of itself, this is not worrisome as some exposure to low-credit quality bonds can help with portfolio diversification. What is worrisome is that lower credit-quality bonds now offer almost no additional yield over high-quality debt. As of September 30, a standard measure of the income available on such bonds, based on an index from Bank of America Merrill Lynch, had shrunk by 3.42% since the end of 2015. Over the same period, the equivalent yield on 10-year U.S. Treasurys has declined by only 0.06%. In other words, the additional yield that investors should receive to compensate them for the elevated credit risk has disappeared.

1. http://awealthofcommonsense.com/2017/10/financial-news-doesnt-rhyme-but-it-does-repeat-itself/

A related problem: The longer markets continue to generate decent performance with little observable risk, the more investors consider high returns as a kind of entitlement. A 2016 survey of 750 individual investors by Natixis Global Asset Management found that, on average, they "need" returns of 8.9%, after inflation, to reach their financial goals. In the same survey, respondents, on average, said they needed returns of 8.5%.

These expectations are utterly unrealistic. Since 1926, the beginning of research-quality stock market data, returns on U.S. stocks after inflation averaged about 7% annually. Balanced portfolios have averaged about 5.3% annually. Against this backdrop, how in the world can investors expect to achieve the investment results they say they "need?"

A Recipe For Disaster?

Stretching for improbable returns can lead investors to ignore or downplay risk, and almost every get-rich-quick scheme looks tempting. The latest example: companies in various industries are associating themselves with cryptocurrencies such as bitcoin.

This month, a little-known Colorado company named Bioptix, which had been licensing fertility hormones for livestock and horses, announced its entry as "…a first mover on the NASDAQ as a pure play focused on blockchain technology," with a name change to Riot Blockchain — in other words, digital currencies. The stock more than doubled in the past month.

This may stir memories of the late 90s, when many companies changed their names to include ".com." Per a 2001 study, these stocks significantly outperformed peers in the period when the name changes were announced. But when the dot-com bubble burst in 2000-02, many of the name-changing companies were among those stocks that lost the most.

Back in the "good old days," savers could park money in savings accounts and expect to get 4-5% interest. Those with greater savings could buy CDs and lock in FDIC-insured interest rates well in excess of that. Prudent investors could combine insured deposits with stocks and bonds for a balance of current and future income, along with growth potential.

Those days are gone. Relatively few alternatives exist for safe, reliable portfolio income and principal preservation — chasing yield is a temptation investors should resist. For near-term investment objectives, investors should swallow hard and keep cash on hand, even if this means using low-or-no-interest bank accounts. Zero percent interest is better than losing money. For long-term goals, it's a different story. With time on your side, you should diversify and be patient. Even with the advantage of time, don't expect returns that are greater than the markets can realistically provide.

Fixed Income Commentary

By SNW Asset Management

Staying in the Sweet Spot

We all know the sweet spot when we see it. It's that point on a bat, racket or club that delivers the ball effortlessly exactly where it should go.

And while it may not be obvious to most people, there is a sweet spot in fixed income investing happening now. Rates and spreads are stable to tightening and there is not a lot to worry about. While today's fixed income markets may not give the same rush as swinging a two iron and landing on the green from 220 yards, it is still satisfying.

This last quarter and year-to-date treasury rates have fallen, muni ratios have contracted and corporate spreads have tightened. Sweet results, if not spectacular. This has all occurred while the Fed is normalizing monetary policy by raising interest rates and planning to shrink its balance sheet.

Total Return %	3Q17	YTD
Municipal Index	0.71	3.31
Corporate Index A-AAA	0.91	3.19
Treasury/Agency Index	0.33	1.47

Hitting the sweet spot can be fleeting, and since tennis serves and markets can be unpredictable, we have our eye on a few things: Federal Reserve tapering, signs of inflation, and the direction and pace of the economy and corporate earnings.

This quarter the FOMC announced the Federal Reserve would start shrinking its $4.5 trillion balance sheet starting in October 2017. The technical term is tapering, and the Fed will start slowly by shedding $10 billion monthly, gradually increasing to $50 billion monthly. The Fed has not disclosed how far it wants to run down its balance sheet, but most expect a reduction to the range of $2.5 to $3.0 trillion. Of course, tapering means more bonds will be in the market, and we expect this increase in supply will depress prices and slowly increase yields. Some analysts anticipate a 20 bps increase in treasury and agency yields due to tapering over the next year. The Fed will also continue normalization of the fed funds rate, but again this appears to be a very gradual process, with the Fed projecting to increase the rate from 1.25% today to 2.75% in 2019, and 3.0% in 2020.

Raising the fed funds rate will be dependent on the outlook for inflation. The inflation rate, as measured by PCE (Personal Consumption Expenditures), has been below the Fed's target of 2.0% for the last five years, so it is obvious a little bit of patience is in order when talking about inflation. However, we do believe a very low and still falling unemployment rate will eventually lead to higher wage pressures and inflation, and we do not think it will take another five years.

Inflation is currently resting, and the economy continues its slow and steady expansion. Outside of unanticipated inflation, geopolitical shock, or central bank policy mistake, we don't expect any derailment of this recovery.

Corporate earnings are growing faster than the economy, supported by synchronized worldwide growth, accommodating central banks and a weaker dollar. A reduction in the corporate tax rate would boost already strong corporate earnings and a repatriation of cash would likely increase stock buybacks. Introducing tax breaks with the economy at full employment may risk quickening inflation and pull forward fed tightening, moving us closer to recession.

The impact of tax reform on municipals is unknown, ultimately depending on the details of a final plan, yet absent a few well-known weaker credits, municipal finances and credit quality are quite strong. A favorable supply and demand environment should continue to support municipal bond prices.

Sources: The Federal Reserve, Bloomberg, The Wall Street Journal, Financial Times

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SNW Asset Management *is an independent investment advisor and certified B Corp focusing exclusively on managing low-cost, tax-efficient fixed income portfolios based in Seattle, Washington. SNW is a fixed income separate accountmanager for certain clients of First Affirmative Financial Network.*

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