# MONTHLY MARKET REVIEW

MAY 2016

## In This Edition

- *It pays to be patient and optimistic*
- *Waiting for Mr. Market to make a mistake*
- *Investing globally just makes sense*

CLS INVESTMENTS

## Market Performance

| Stock Market | LAST MONTH | YTD '16 | 12-MONTH |
|---|---|---|---|
| Total U.S. Market[1] | +1.79% | +3.41% | +0.22% |
| Domestic Large-Cap Equity[2] | +1.80% | +3.57% | +1.72% |
| Domestic Small-Cap Equity[3] | +2.25% | +2.28% | -5.97% |
| International Equity[4] | -1.69% | +0.52% | -11.39% |
| Developed International Equity[5] | -0.91% | -1.10% | -9.68% |
| Emerging Market Equity[6] | -3.73% | +2.32% | -17.63% |
| **Fixed Income** | **LAST MONTH** | **YTD '16** | **12-MONTH** |
| U.S. Bonds[7] | +0.03% | +3.45% | +2.99% |
| Cash Equivalent[8] | +0.01% | +0.09% | +0.11% |

*[1]Russell 3000 [2]S&P 500 Index [3]Russell 2000 Index [4]MSCI ACWI ex-U.S. Index [5]MSCI EAFE Index [6]iShares MSCI Emerging Markets Index [7]Barclays Capital U.S. Aggregate Bond Index [8]Barclays Capital 1-3 Month U.S. Treasury Bill Index*

## May Market Review

May was another decent month for the U.S. stock market. The overall market (Russell 3000) gained nearly 2%, with both large-caps (S&P 500) and small-caps (Russell 2000) up by about 2%. International stocks, however, relinquished their year-to-date advantage over U.S. stocks with losses in May. Developed markets (MSCI EAFE Index), such as Europe and Japan, lost 1%. Emerging market stocks (MSCI Emerging Markets), which include China and Brazil, lost 3%. Meanwhile, the bond market was essentially unchanged with only a small gain for the month. As of the end of May, bonds have still been outperforming the stock market so far this year. The 10-year Treasury ended last month with a yield of 1.92%.

## It Pays to Be an Optimist

Despite plenty of bad news in recent months and years, it's important to note that the U.S. stock market is currently experiencing one of [its longest bull runs *ever*]!

Since the start of the bull market in March 2009, the overall U.S. stock market has not seen a 20% loss from a peak to low price. However, there have been plenty of reasons to worry about the market during that time, including: the European debt crisis, U.S. debt downgrade, crises in Greece, Italy, and Spain, U.S. fiscal cliff and sequestration, taper risk, Ebola, Zika, Grexit, Brexit, weak dollar, strong dollar, potential Chinese global domination, potential Chinese market crash, skyrocketing commodity prices, crashing commodity prices, fear of rising interest rates, fear of plummeting interest rates, "worst presidential candidates ever", massive debt, and the list goes on, and on, and on.

When the noise of chaos in the world gets too loud, it pays to remember that the financial markets are not coin flips. They typically generate positive gains, and they have more up days than down. They even have more up weeks than down, and as the duration stretches from months to quarters to years, the odds of gains improve. That makes sense because the economy grows over time, and the stock market participates in that economic growth. For a long-term investor to succeed, it pays to keep the historic perspective in mind, be patient, and not follow the news.


### Rusty Vanneman, CFA, CMT

*Chief Investment Officer*


*Rusty Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, Mr. Vanneman was Chief Investment Officer and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial. During this time, Mr. Vanneman was the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial.*

*Mr. Vanneman received a Bachelor of Science in Management from Babson College, where he graduated with high distinction. He holds the Chartered Financial Analyst (CFA) designation and is a member of the CFA Institute. He is also a Chartered Market Technician (CMT) and a member of the Market Technician's Association (MTA).*

# Even the Media Now Overrates Bad News

It's not uncommon for the media to focus on the negative, let's review some of the negativity and how they're driving investor's fears.

***Brexit Fears***

There always seems to be something to worry about. Currently, many worry about a possible "Brexit" (an abbreviated term for a "British exit" from the European Union). The UK will hold an in-out referendum on its EU membership on June 23.

It's not likely to happen. The latest odds on a Brexit are approximately 20%.

***Election Fears***

OK then, let's worry about the U.S. presidential election. Actually, at least from an investing standpoint, let's not. The historic evidence shows that while the markets usually spin their wheels during the first half of election years, the back half of election years are usually quite good and lead to well-performing post-election years.

Here are the latest odds on who will win the U.S. Presidential election (Hillary Clinton currently holds a 20-point lead over Donald Trump — though the gap has closed).

***Federal Reserve Fears***

Another worry for investors is that the Federal Reserve (Fed) will raise rates. Well, this is already happening, and one should expect it to continue. Why?

1. The Fed has already started to raise rates
2. The unemployment rate is well below the long-term average
3. Inflation, notably wage growth, is increasing

Does that mean the markets have to stumble? No. Since the Fed raised short-term interest rates on December 16, 2015, the stock market has moved higher, long-term interest rates have *dropped*, and asset class segments that were supposed to suffer (like emerging market stocks) have gone up in price. Only the U.S. dollar has fallen since the Fed started raising rates.

Here are the latest odds on the Fed's next moves.

***Recession Fears***

Economic growth has been slower than many expected in recent years. But looking at historical precedents, nobody should really be surprised. Economic growth is usually slower after financial crises (and 2008 definitely qualified as a financial crisis). Economic growth is also usually slow when the global economic system holds a lot of debt, which is the case now.

The latest odds on a recession (which are a few months old) provided by the Federal Reserve Bank of St. Louis are approximately 3%. That is well below the long-term average of 12%.

## Why Pessimism Sounds So Smart

So if the market is usually moving higher, why does it seem that bad news is so prevalent, especially now? And why does it seem so actionable?

This article is written by one of the best financial journalists of our day, Morgan Housel. In short, here's why Housel says pessimism sounds smart:

1. Optimism appears oblivious to risks, so by default pessimism looks more intelligent.
2. Pessimism shows that not everything is moving in the right direction, which helps you rationalize the personal shortcomings we all have.
3. Pessimism requires action, whereas optimism means staying the course.
4. Optimism sounds like a sales pitch, while pessimism sounds like someone trying to help you.
5. Pessimists extrapolate present trends without accounting for how reliably markets adapt.

## Mr. Market

It is often expected that investors should forecast what will happen in a variety of elections, economies, or markets. It just seems right that one should be proactive and act on information. However, when it comes to the markets, the best course of action for an enterprising investor is to wait for the markets to get emotional and then react. In other words, wait for "Mr. Market" to create opportunity.

The allegory of Mr. Market was first created by the great investor, teacher, mentor, and author, Benjamin Graham. He introduced the concept in his book, The "Intelligent Investor," which Warren Buffett has called "by far the best book on investing ever written." This Wikipedia entry sums it up well:

*Graham asks the reader to imagine that he is one of the two owners of a business, along with a partner called Mr. Market. The partner frequently offers to sell his share of the business or to buy the reader's share. This partner is what today would be called manic-depressive, with his estimate of the business's value going from very pessimistic to wildly optimistic. The reader is always free to decline the partner's offer, since he will soon come back with an entirely different offer.*

*The example makes it clear that the sole reason for the change in price is Mr. Market's emotions. A rational person will sell if the price is high and buy if the price is low. He would not sell because the price has gone down or buy because the price has gone up.*

*Mr. Market is often identified as having human behavioral manic-depressive characteristics, it:*

1. *Is emotional, euphoric, moody.*
2. *Is often irrational.*
3. *Offers that transactions are strictly at your option*
4. *Is there to serve you, not to guide you.*
5. *Is in the short run a voting machine, in the long run a weighing machine.*
6. *Will offer you a chance to buy low, and sell high.*
7. *Is frequently efficient...but not always.*

*This behavior of Mr. Market allows the investor to wait until Mr. Market is in a 'pessimistic mood' and offers [a] low sale price. The investor has the option to buy at that low price. Therefore patience is such an important virtue when dealing with Mr. Market.*

## International Investing Still Makes Sense

International markets are now trailing the U.S. market in year-to-date returns and are significantly trailing over the last three- and five-year periods. Why hang on to non-U.S. investments?

From an active management (i.e., changing allocations to potentially enhance returns) standpoint, CLS is emphasizing international markets more than usual in portfolios because they are on sale. Global markets have underperformed in recent years, but they are still growing and their valuations (how much one has to pay for a dollar of earnings or cash flow) are underpriced. In fact, they are so undervalued that we think it's reasonable to expect international markets to potentially outperform the U.S. market by as much as *5% or more per year* over the next 10 years.

But even if valuations weren't so attractive, we would still believe in investing abroad for strategic (i.e., maintaining a long-term allocation target) reasons too. Vanguard, for instance, wrote an important white paper on international investing several years ago, which showed the typical U.S. investor only held about a quarter of his or her equity portfolio in non-U.S. stocks, while over half of the global stock market was invested in non-U.S. stocks (by the way, this "home bias" is not unique to U.S. investors). It's not just about having a larger opportunity set to potentially generate higher returns; it's also about managing risk. While Vanguard suggested investors hold at least 20% in international, the data also suggested optimal risk reduction is a 30% to 40% allocation. Global portfolios of up to 70% international still experienced less overall volatility than domestic-only portfolios.

There are even more reasons to like international. We have written several papers that explain our reasoning for global investing, including a recent piece titled *15 Reasons to Invest Internationally*. Please tune into our CLS Monthly Market Review video this month to hear more about these resources from their lead author Kostya Etus.

As long-term investors, we believe a global approach to balanced portfolios remains one of the best ways to achieve attractive, long-term, risk-adjusted performance, which in turn means better investor results over time.

Thanks for reading. Stay balanced.

The S&P 500® Index is an unmanaged composite of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks. The Russell 3000 Index is an unmanaged index considered representative of the U.S. stock market. The index is composed of the 3,000 largest U.S. stocks. The Russell 2000® is an index comprised of the 2,000 smallest companies on the Russell 3000 list and offers investors access to small-cap companies. It is a widely recognized indicator of small capitalization company performance. The MSCI EAFE International Index is a composite index which tracks performance of international equity securities in 21 developed countries in Europe, Australia, Asia, and the Far East. The MSCI All-Countries World Index, excluding U.S. (ACWI ex US) is an index considered representative of stock markets of developed and emerging markets, excluding those of the US. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Barclay's Capital 1-3 Month U.S. Treasury Bill® Index includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than 3 months and more than 1 month, are rated investment grade, and have $250 million or more of outstanding face value. The Equity Baseline Portfolio (EBP) is a blended index comprised of 60% domestic equity (represented by the Russell 3000 Index) and 40% international equity (represented by the MSCI ACWI ex US Index), rebalanced daily. An index is an unmanaged group of stocks considered to be representative of different segments of the stock market in general. You cannot invest directly in an index.

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