Portfolio Strategy

June 2, 2017

Ignoring the Noise

May felt a lot like April as stocks shook off more political noise to finish the month with modest gains. International markets continued to lead stocks higher despite some potential hiccups - most notably a re-emerging political crisis in Brazil. The Bovespa index fell over 8% in one day as the latest political corruption threatened to bring down Brazil's new president. With R$2.37 trillion, the Bovespa is the world's 13th largest stock exchange.

Index (% Total Return)	*May*	*YTD*	*Last 12 Mos.*
MSCI All-World Equity	2.2	11.0	17.5
75% U.S. Stocks/25% Foreign Stocks*	1.9	9.9	17.3
S&P 500 (U.S. Large-Cap Stocks)	1.4	8.7	17.5
Russell U.S. Mid-Cap Stocks	0.9	6.9	15.9
Russell 2000 U.S. Small-Cap	2.0	1.5	20.4
MSCI EAFE (Euro, Australasia, Far East)	3.8	14.4	17.0
MSCI Emerging Markets	3.0	17.3	27.4
Barclays Aggregate U.S. Bond	0.8	2.4	1.6
Barclays Long-Term Treasury Bonds	2.0	5.0	1.9
SPDR: DJ Global REIT ETF (Real Estate)	0.7	2.7	1.0
DJ-Bloomberg Commodity ETF	1.3	5.1	2.6

Sources: FactSet, Interactive Data Corporation. Red indicates negative return.

**75% MSCI USA Std Index (Large/Mid); 25% MSCI All-World ex U.S. Index (Large/Mid)*

Interest rates declined, driven by a fall in inflation expectations. Reported consumer prices came in below expectations last month, falling to 2.2% after touching 2.7% in February, reducing some fears inflation was slowly slipping out of the Fed's grasp. What's more, the oil market continues to convulse with big down days on supposedly oil-positive headlines. Energy prices are the largest drivers of inflation in the short-run, so large price drops typically ratchet down the bond market's inflation expectations.

Oil Battle Royale

At the forefront of the oil price declines is the face-off between OPEC-producing countries and domestic shale producers. It appears domestic producers may be winning, at least for now. Production in the US ramped up this year, while OPEC extended its production cuts for another nine months, attempting to reduce the current inventory glut. This worked in the past as they were the marginal producer. That may not be the case now with technological advances reducing the fixed costs of drilling in the US shale region.

It's hard to see who will ultimately prevail in this battle for market share, but the dynamics of the oil market can reverberate throughout the entire economy and financial markets. Regardless, the large overhang of oil stored above ground should reduce the chance of future oil price spikes. That means inflation shocks in the bond market are likely to be subdued and gas prices will likely stay low. Exactly how energy stocks will fare will depend on how this game plays out. Our investment focus is on large, vertically integrated oil companies, many of which are ramping up investments in alternative energy sources.

To the Frontier and Beyond?

A notable area of strength in the international equity markets is the so-called frontier markets. This basket of stocks from the likes of Argentina, Kuwait and Pakistan are an extension of the emerging markets, which have traditionally been the wild west of international investing – providing growth-driven return with significant volatility. Now, the frontier markets have taken over as the new, new thing.

But does it warrant investing? So far this year, frontier markets have performed handsomely, returning about 18% in 2017 and beating EM's 15% return. Of course, outperformance alone is not evidence frontier markets belong in your portfolio. Nor should its sole existence warrant holding either as a pure market indexer might suggest.

In our view, an asset class must offer some unique risk exposure that over time should generate appropriate compensation for accepting that risk. And, most importantly, we need a good reason why this risk should be rewarded over time. This is an important step to reduce that chance that we are being fooled by some spurious result in the data. If there is a coherent reason why the risk is rewarded, there is a better chance that behavior should continue into the future, even if other investors also spot the opportunity.

Based on our analysis, we do not believe frontier markets offer additional risk/reward benefits over the emerging markets for a diversified portfolio. Since 2002 when MSCI launched the original index, frontier markets have underperformed emerging markets by 1.1% annually. When we isolate the part of the frontier market return closely associated with emerging markets, we find the remaining frontier-market-specific component has not generated much return but has added a lot of extra risk – poor liquidity, unstable governments, weak rule of law. This is a feature we don't find attractive.

What's more, the implicit and explicit costs of investing in these market is higher than for emerging markets. Currently, an investor can buy an emerging market fund costing 0.14% annually. The cheapest broad frontier market fund costs 0.58%. That doesn't include the higher transaction costs incurred for trading in more obscure, less liquid markets. Fundamentally, equity investing is tied to global economic growth and developing markets have been an excellent vehicle for adding return and diversifying globally. But as we see it, there is little compelling reason to add frontier markets to the mix.

Bonds - What We Are Doing

We recently rebalanced fixed income portfolios. We lowered our exposure to corporate bonds and rotated a portion of the credit spread risk into mortgage-backed securities. Additionally, we have extended the duration of the bond portfolio slightly, adding the duration risk with high-quality government bonds.

The return outlook for bonds is weakening for the intermediate term as credit spreads (the reward for owning corporate bonds over government bonds) are low. We see little upside to taking a lot of risk in corporate credit currently. Mortgage pass-through securities are a way to add incremental return over Treasuries, but with lower credit risk. When upside is limited and the downside is potentially much larger, it is time to be cautious.

A key attribute of bonds is their tendency to zig when equities are zagging. Increasing the exposure to government securities enhances this property in a bond portfolio. With limited returns currently for many sectors of the bond market, we believe it is time to focus on the diversification and risk management aspect of bonds.

What It All Means

The whims of the oil market are difficult to predict but can have a significant impact on your portfolio. Fixed income investors may benefit as falling oil prices drive inflation expectations lower. Equity investors heavily invested in energy companies may feel pain as the same oil move reduces profits for energy firms. Other firms and their stock prices may benefit as lower oil prices puts more money into consumer pockets, boosting the outlook for the consumer sectors. Over the long-run, the impact of commodities on the economy should essentially be neutral. What matters is how corporations adapt and create value as input costs and consumer behavior changes.

We continue to evaluate the most efficient and cost-effective ways to earn the highest risk-adjusted returns for your portfolio. Sometimes that evaluation results in the addition of new investment vehicles. Often our analysis indicates that new investment products are superficially attractive, fundamentally flawed, riddled with hidden costs, or need time to prove themselves before committing your money.

As always, please contact us with individual questions or concerns.

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