"Be sure to put your feet in the right place, then stand firm." **—Abraham Lincoln—**

August 12, 2016

Have a plan and stick to it—advice we've given for years. We also recommend that plans be reviewed regularly to evaluate the situation and adjusted to make any prudent "mid-course corrections" to stay on-track. Record market highs and lots of headline events suggest it may be a good time for such a review. For quite some time, we have shared views held by Vanguard, Russell, and us about the expectation for continued slow global economic growth, low interest rates, more moderate future returns, and plenty of volatility. This is not the kind of news anyone wants to hear—but we just want to honestly report what we believe. We think this is a good time for a renewed conversation about risk and returns.

The US stock market continues to set record highs as interest rates, unemployment and oil prices are at historically low levels. But US stock valuations are arguably somewhat high in a bull market that is aging—both of which argue for lower future expected returns. Russell interestingly pointed out that returns for traditionally higher risk software/internet companies and traditionally lower risk utilities/consumer staples/REITs have outperformed the broad market by 37.5% and 12.5% respectively over the 12 months ending 5/31/16. Everything else was basically flat—so not all American companies may be currently quite so expensive. By contrast, there are signs that developed non-US stocks may be undervalued—and with some currency tailwinds and very accommodative central banks, global stocks look reasonably attractive for investors with a reasonably long time horizon. Vanguard notes that REITs look remarkably expensive—and Russell seems to agree based on the strong recent returns. Interest rates are at historical lows (especially for government bonds)—but there seems to be very little inflation and central banks seem unlikely to change their accommodative stance very soon—so we expect "lower for longer". And as usual, there is no shortage of "the sky is falling" commentaries from "experts".

Based on this backdrop, we continue to encourage clients to set reasonable expectations for returns and to think about how much risk they want/need to take in their investments. In my Q3 report, I noted comments by CALPERS (California Public Employees Retirement System) chief investment officer about their lower 6.4% average annual return expectation for the next decade. Using Russell's most recent return assumptions for our balanced model strategy, we come up with a 5.6% return assumption for 10 years and 6.2% for 20 years. Vanguard's assumptions are pretty similar. Of course, no one has a crystal ball that can accurately predict the future—but we think these are realistic and use them for planning purposes.

Now let's talk about risk. In addition to estimates for expected returns, we look at estimates for expected risk (volatility). In general, expected risk for stocks is much higher than for bonds—viewed as the price investors pay for higher expected stock returns. History supports this—as stocks tend to provide higher long term returns but with a much greater range of year-by-year results. Statisticians refer to this as "standard deviation". According to a study Russell updates each year (1), US large cap stocks (S&P 500) had an average annual return of 10.50% with a 15.13% standard deviation over the past 40 years. In English, this means annual returns ranged from -4.63% (10.50 minus 15.13) to +25.63% (10.50 + 15.13) two-thirds of the time (one standard deviation). By contrast, bonds (Barclays Aggregate Bond Index) averaged a lower 7.67% return with a much lower 5.42% standard deviation—creating an annual return range of +2.25% to +13.09% two-thirds of the time. Bottom line—stocks earned more over a long time period but annual returns were way more volatile—"risky".

The Russell study goes on to show how diversifying across the different asset classes not only reduced risk—but actually slightly improved returns. Consider the 100% stock strategy that combined large cap, small cap, real estate and international equity. It produced an 11.48% annualized return which beat all the individual choices—with a 14.41% standard deviation which was lower than any of the single equity markets. Many of our clients tend more toward a balanced strategy—and the study shows some interesting results. The 60/40 asset-allocated strategy captured 97% of the S&P 500's returns—with just 61% of the volatility. This seems like a good risk/reward trade-off for many investors—and we heartily agree. Strategies with more stocks lived with greater volatility to generate somewhat higher returns while more conservative bond-centric portfolios earned lower long-term returns but provided a smoother ride. We think it's sensible to think about how much return you hope for or need—and look at how much risk you likley have to live with ("tolerate"). As we've said many times over the years, if you can't take the volatility and bail out when markets are tough you may not be there for the rebounds that eventually come and are unlikely to enjoy the long-term returns hoped for.

Forward looking forecasts are somewhat different than results over the past four decades both in terms of risk and return. For our balanced model asset-allocation, the 10 year return forecast of 5.6% comes with a 12.8% annualized standard deviation—and 20 years returns of 6.2% with a 14.1% standard deviation. Lower expected returns with more risk than markets experienced over the long past. This is consistent with the "lower return/higher volatility" outlook we've been sharing for some time. Sorry folks, but we don't make the news—we just report it.

So, what (if anything) should you do with all of this news/information? Opinions vary even among resources we respect. The folks at Russell just published a well thought out "point of view" talking through many of these issues—and sharing their view that investors might want to employ a somewhat more defensive tact—and noting the importance of a "proportionate response". Responses should be different if you truly believe "the sky is falling" versus "sooner or later it will rain". In general, Russell made modest reductions to US equity with proportionate increases to fixed income across all of their model strategies. Russell commented that it might be smart to "trim the risk sails without bailing out of the regatta". By contrast, Vanguard has not changed allocations to their target-risk strategies—but rather suggested that investors set realistic expectations looking forward and that this might be a good time for conversations about risk. We think that "staying the course" may well be the best advice for clients with long-term goals and perspective—perhaps thinking about taking a little risk off the table if you're very nervous about markets and/or have a shorter-term time horizon. Note this discussion is not about trying to time markets—but more about making sure risk/reward trade-offs are sensible in trying to help you meet your financial goals. Much like Abraham Lincoln's quote, we think it is prudent to "make sure your feet are in the right place" (the right kind of strategy—consistent with your goals, time horizon, and risk-tolerance)—and then stand firm. We continue to believe that it's the "standing firm" that can add the most value and success.

Please let us know your thoughts/questions—and if you'd like to talk more about the plans we've put in place. As always, we're here for you.

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(1) Russell study Comparing Single-Asset to Multiple-Asset Portfolios dated 01/01/2016. A copy of this study can be found on our website at www.greenewealthmgmt.com or is available upon written request. .