

Investment Perspectives –1st Quarter 2017

“The two most powerful warriors are patience and time.” - Tolstoy

One of the keys to long-term investing success is developing a diversified portfolio that reflects one’s investment period, risk tolerance and financial objectives. Just as Tolstoy wrote about the power of patience and time in the Napoleonic era, we believe those two elements are integral to forming a sound investment approach in our own time.

It can be challenging to have the patience and discipline to stick with an investment strategy. It hasn’t been that long since the end of 2015, when investors faced uncertainty about the pace of economic growth. Many sold assets that had underperformed, such as value stocks, emerging markets and even bonds. Patient investors following a strategy that incorporated disciplined rebalancing were rewarded in 2016 and the first quarter of 2017. U.S. and international equities have rebounded, emerging markets and high yield corporate bonds have experienced significant gains, corporate profits have accelerated, and economic sentiment has improved.

You have our commitment that the principles of diversification and rebalancing will remain as cornerstones of our philosophy and that we will strive to avoid noise and the temptation to predict the unknown. In this commentary we offer our views on the quarter just concluded as well as our portfolio perspectives.

Performance Commentary

Data ending 3/31/2017 (Annualized for periods greater than 1 year)

Indices	1-Qtr	1 year	3 years	5 years	10 years
Equities					
MSCI ACWI (All Country World)	7.1%	15.7%	5.7%	9.0%	4.6%
S&P 500 (U.S. Large Cap)	6.1%	17.2%	10.4%	13.3%	7.5%
Russell 2000 (U.S. Small Cap)	2.5%	26.2%	7.2%	12.4%	7.1%
MSCI EAFE (International Developed)	7.4%	12.3%	1.0%	6.3%	1.5%
MSCI EM Emerging Markets (International Emerging)	11.5%	17.7%	1.6%	1.2%	3.1%
Fixed Income					
Citigroup World Government Bond (Global Bonds)	1.6%	-3.7%	-1.2%	-0.6%	3.0%
Barclays U.S. Aggregate (U.S. Investment Grade Bonds)	0.8%	0.4%	2.7%	2.3%	4.3%
Barclays Municipal Bond 5Y (4 - 6) (Municipal Bonds)	1.9%	0.4%	2.0%	2.1%	3.8%
Barclays U.S. Corporate High Yield (U.S. High Yield)	2.7%	16.4%	4.6%	6.8%	7.5%
Other Indices					
S&P Developed REIT (Global Real Estate)	1.6%	1.5%	8.0%	9.3%	2.9%
HFRI FOF: Conservative Index (Diversifiers)	1.4%	5.5%	1.8%	3.2%	1.1%

Most asset classes experienced gains through the first three months of the year, ranging from +0.8% for U.S. investment-grade bonds to +11.5% for emerging market equities. For the twelve-month period ending March 31, 2017, most equities and high yield bonds provided double-digit returns, while high quality bonds earned less on a total return basis than their underlying low single digit coupon rates.

U.S. equities continued to advance, supported by positive economic data and perhaps also by the new administration's fiscal stimulus proposals. These include tax cuts, increased infrastructure spending and a relaxed regulatory environment for businesses. In a reversal from 2016, U.S. large cap stocks have outperformed U.S. small caps so far this year, and foreign equities have outperformed their U.S. counterparts.

Modera's Perspectives

It would not surprise us to see volatility increase as the market environment remains unsettled. Inflated price-to-earnings ratios for stocks, shrinking spreads between high yield bonds and U.S. Treasuries, and a flattening yield curve lend some caution to our market view.

Stock market valuations appear to be slightly above long-term trends, but when accounting for expected earnings growth, valuations do not seem too stretched. With continued jobs and earnings growth, consumer spending may still grow and consumer confidence, at its highest level since 2000, could remain stable. We account for volatility when formulating the diverse composition of your portfolio. Diversification and asset allocation are essential risk management tools.

Rising Rates

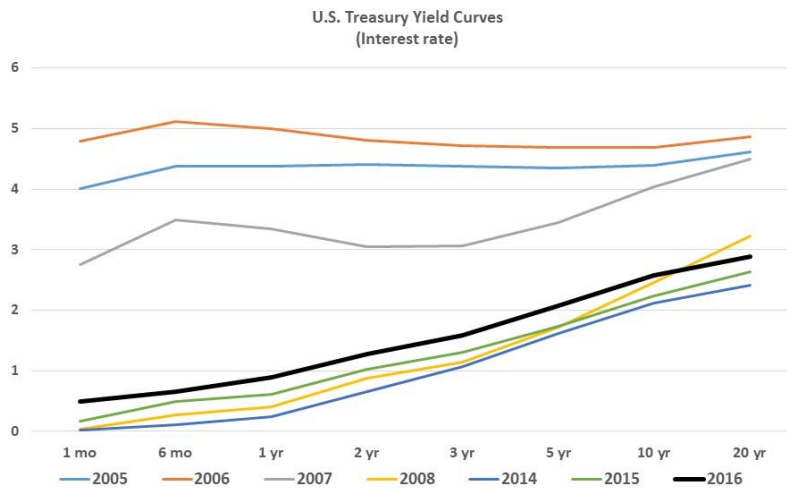
Even though the Federal Reserve raised short-term interest rates in March for the third time since December 2015, market interest rates were mostly unchanged during the quarter. The Federal Reserve has implied that it may raise rates two to three more times this year. As illustrated in the following chart, the 36-year trend of decreasing interest rates may be starting to reverse itself.



Source: <http://www.macrotrends.net/2016/10-year-treasury-bond-rate-yield-chart>

While the above shows the long-term trend of the 10-year treasury rate, a review of the yield curve over the past decade shows how rates have shifted for bonds of varying maturities. Prior to the recession, short-term interest rates were equal to or higher than long-term rates (phenomena known respectively as “flat” and “inverted” yield curves). Rates dropped in 2008 as monetary stimulus accelerated to stabilize the economy, and for the most part they have remained low for the past eight years.

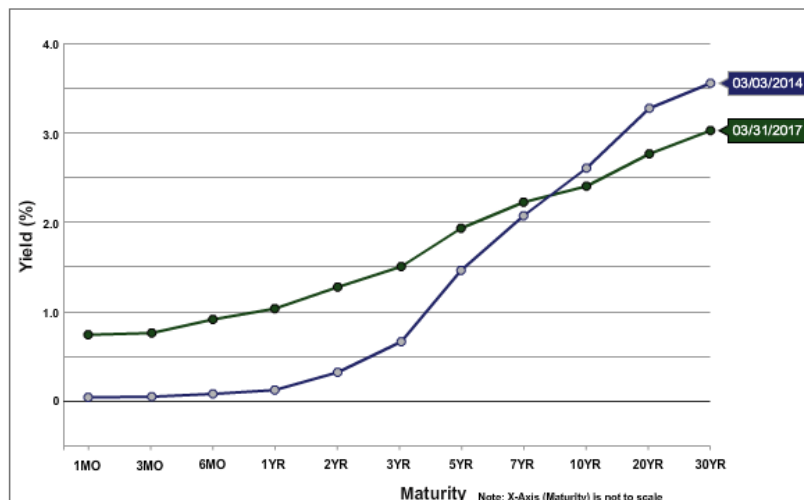
Historical U.S. Treasury Yield Curves (End of year)



Source: treasury.gov

The following chart shows that short-term rates in 2017 are higher today than they were in 2014 while long rates have dropped, causing the yield curve to appear flatter. Keep in mind that the Fed only influences shorter-term interest rates, while longer rates are driven by market forces of supply and demand. A flattened or inverted yield curve historically has preceded many economic slowdowns. We keep a close eye on interest rates across the entire spectrum of maturities and bond types. Rising rates are not necessarily a negative trend, as they may be a signal that the economy is strengthening and can actually absorb the higher rates. Nevertheless, there is a concern that the Fed could increase rates too quickly and cause a slowdown.

U.S. Treasury Yield Curve (End of year)



We are often asked how we are positioning portfolios in a rising rate environment. We are acting to keep average durations lower while maintaining high credit quality. Within our core fixed income allocation we recently added a short-term U.S. treasury inflation-protected securities or TIPs fund that has a very low duration. Should inflation unexpectedly rise, the real yield of the TIPs is expected to increase, supporting overall returns.

We have also added a global macro absolute return fund with the expectation it will reduce overall portfolio volatility and deliver consistent returns. With low duration, different risk characteristics, and limited sensitivity to traditional systematic risk, the correlation of this fund to treasuries is lower than many other bond-like assets, which could help if the Fed continues to raise rates this year.

Equity Valuations

As illustrated in the following chart, equity valuations are currently above average but not out of the one standard deviation historical range.



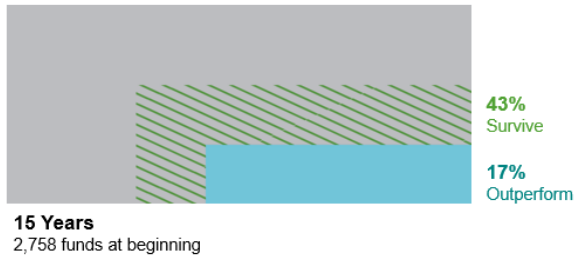
Source: FactSet, FRB, IBES, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.

We rebalanced most client portfolios in the first quarter to pare back on equities given the recent run-up since the election. This should allow for short-term positioning without sacrificing long-term strategy and maintain adherence to allocation targets in your Investment Policy Statement. We do not take a view on whether or not the rise in equities is sustainable.

Our Investment Approach

If patience is a virtue, chasing returns is a road to frustration. Very few funds stick around over long periods of time and even fewer actually perform well. As illustrated below, only 17% of the U.S. equity mutual funds sampled in the below study have survived and outperformed their benchmarks over the past 15 years.

US Equity Mutual Fund Performance



Disclosure: Beginning sample includes US equity mutual funds as of the beginning of the 15-year period ending December 31, 2015. Survivors are funds that were still in existence as of December 31, 2015. Non-survivors include funds that were either liquidated or merged. Outperformers are funds that survived and beat their respective benchmarks over the period. Past performance is no guarantee of future results. Data Source: Analysis conducted by Dimensional Fund Advisors using data on US-domiciled mutual funds obtained from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago. Sample excludes index funds. Benchmark data provided by MSCI, Russell, and S&P. MSCI data © MSCI 2016, all rights reserved. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. The S&P data is provided by Standard & Poor's Index Services Group. Benchmark indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Mutual fund investment values will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Diversification neither assures a profit nor guarantees against a loss in a declining market.

Our approach is guided by the belief that asset allocation is the primary determinant of portfolio variability. This risk-managed approach is intended to be well-diversified across major asset classes using low-expense, highly liquid, fully transparent mutual funds and ETFs. We should note, however, that diversification does not assure a profit and does not guarantee against a loss. We believe our firm's strengths and core competencies revolve around the key components of a long-term investment approach: total return, risk management, diversification and integrated strategies. We intend to continue to allocate for long-term trends and diversify while maintaining a disciplined, strategic approach and aligning clients' investment strategies with their planning goals. Time and patience.

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Thank you for your continued confidence and trust in our services. We welcome your questions and comments.

Modera Wealth Management, LLC

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