Financial Advisory Service, Inc.

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FAS Monthly Economic & Market Update

June 2017

As of May 31, 2017

Contents

Economic Conditions

Gross domestic product (GDP) increased at an annual rate of 1.2% in the first quarter of 2017, according to the second estimate from the US Department of Commerce last week. This was an increase form the advance estimate released at the end of April in which Q1 GDP was estimated to have increased at a rate of 0.7%. As S&P 500 companies continued to report first quarter earnings throughout the month of May, about 72% of companies had beaten their estimates for first quarter growth[1]. Within the S&P 500, multinational corporations were, for the most part, recording higher profits than pure domestic companies. As of mid-May, firms that generate more than 50% of their revenues from outside the US were expected to report a 21% increase in profits compared to their domestic counterparts, which were expected to report 9.9% growth[2]. Improving fundamentals and a weaker dollar are proving to be beneficial for foreign markets, both developed and emerging.

1. Source: S&P Capital IQ/CNBC
2. Source: Fact Set/WSJ

Market Conditions

All major market indexes trekked higher for another month, albeit not before taking a few blows mid-month with more turbulent headlines coming out of Washington. Doubt continued to loom over the Trump administration and their progress in passing through legislation any time soon. The leaked memos from former FBI director James Comey detailing a conversation regarding the investigation into former National Security Adviser Michael Flynn added to the volatility and we saw a significant drop in the markets. This drop however, like several others this year, was short lived as investors came to realize that it was just political noise and that politics do not drive stock returns; earnings growth does. And earnings have been on pace for their best quarter in several years. International markets continued their outperformance compared to the broad US market throughout the month of May, specifically in emerging markets. In the fixed income markets the low interest rate environment along with the aggressive Fed talk regarding interest rate hikes continues to be a bit of a drag on bond returns.

Index Returns	May '17	YTD
S&P 500	1.16%	7.73%
DJIA	0.33%	6.30%
NASDAQ	2.50%	15.15%
MSCI EAFE	3.07%	12.24%
Barclays Aggregate	0.77%	2.38%

Rebalancing Discipline

As we have discussed many times in the past, at FAS we believe that the starting point for developing an investment strategy should begin with adopting an appropriate asset allocation for a client's portfolio. Asset allocation is arguably the most crucial piece of the overall framework for a portfolio. A study from 1986 determined that over 90% of the variation in a portfolio's returns were explained by the portfolio's asset allocation[1]. This essentially means that over 90% of the returns realized in an investor's portfolio can be attributed to how that portfolio is allocated among asset classes. In order to determine an appropriate asset allocation for a client, we must first determine his or her overall risk tolerance, which can be assessed by looking at three major factors: time horizon, risk tolerance, and objectives.

After determining an investor's proper allocation we must then formulate a strategy for rebalancing their portfolio in order to maintain that allocation without compromising the portfolio's potential returns. There is a balance that we must be aware of when investing that takes into account maintaining a target allocation and risk/return profile while also being aware of transaction costs and rebalancing too often or not often enough which could diminish the potential for returns. This month we will explain our rebalancing discipline and why it makes sense for our clients.

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Rebalancing Discipline

In 2015 Vanguard released a study that tested several different rebalancing disciplines in order to determine an optimal strategy that answered the questions of how frequently a portfolio should be monitored, how far an asset class can deviate from its target allocation, and whether or not to implement a periodic rebalancing strategy – essentially "how often, how far, and how much." Let's take for example a 50% equity and 50% fixed income portfolio. If this is an investor's target allocation, it is important that, in order to achieve the results that the investor is looking for, it must remain within a range of that overall allocation over time. As asset classes are not perfectly correlated (i.e. stocks do not move in tandem with bonds) it is likely that during a stock rally the equity portion of the portfolio could increase by more than the bond portion and therefore drift from a 50/50 portfolio to say, 55/45. A 55/45 portfolio certainly has more risk associated with it than a 50/50. So it is important that we sell portions of the equity positions and buy portions of the bond positions (i.e. sell your winners and buy your losers) in order to reestablish the proper allocation. The question that remains here, because the markets are so unpredictable, is should we choose a specific timeframe in which to rebalance, choose a specific threshold that a portfolio's allocation must cross before rebalancing, or a combination of the two? Furthermore, should what should that timeframe be and what should those thresholds be?

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Rebalancing Discipline

The study tested a number of different rebalancing strategies that included time-only rebalances (monthly, quarterly, and annual), threshold-only rebalances (1%, 5%, and 10%), as well as time-and-threshold rebalances. Without diving too much into the individual details, the study found that while the average annual returns and standard deviation (risk) were fairly similar across all of the different strategies, with annual rebalance and a 5% threshold having the most optimal risk/return profile. However, the study did not take into account one major factor; transaction costs. More frequent monitoring and rebalancing, as well as lower thresholds can lead to high portfolio turnover and higher transaction costs which will ultimately diminish returns. Additionally, rebalancing more frequently than annually can cause gains in after-tax accounts to be recognized as short-term gains rather than long-term gains, which are typically taxed at more favorable tax rates, potentially reducing investors' total returns.

We have found that the optimal strategy for rebalancing, in general, is an annual rebalance with target thresholds that would also trigger a rebalancing event. Our thresholds will typically vary among different asset classes since not all volatility is the same. For example, more volatile asset classes may have slightly wider thresholds than less volatile asset classes and should be given more room to run

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Rebalancing Discipline

due to wider variation of returns. This also helps to lower transaction costs by reducing the frequency of needing to rebalance an asset class that is expected to have a wider corridor width due to greater volatility. The same may go for specific securities that have higher transaction costs than others.

While this strategy, like most others when it comes to investing, is not necessarily one-size-fits-all, it is certainly the starting point for our discipline. Different clients may have different needs, tax situations, objectives, etc. which can affect the ways in which we rebalance. However, regardless of an individual's situation, it is imperative that we identify an appropriate rebalancing strategy, communicate it to the client, implement it and monitor the strategy over time.

1. Brinson, Hood, Beebower (1986) "Determinants of Portfolio Performance"

Disclosures & Index Definitions

Under style performance boxes, indexes referenced in the equities section for large, mid and small reference the Russell 1000, Russell MidCap and Russell 2000 stock indices, respectively. The Barclays US Government, Barclays Credit and Barclays High Yield fixed income indices refer to Gov't, Corp, and HY, respectively. Short, Intermediate and Long refer to the time frame of the investments and their positions on the yield curve.

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Investments in bonds will be subject to credit risk, market risk and interest rate risk. Interest rates will have an inverse effect on prices of bonds. Bonds of lower credit ratings, also known as High Yield bonds which hold a rating of less than investment grade (BB+ and below), will have greater risks attached than will those of investment grade bonds and will experience greater volatility.

All dates are as of May 31, 2017 unless stated otherwise.

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Index Definitions

The **S&P 500 Index** is based on the market capitalizations of 500 large companies whose stocks are listed on the NYSE and NASDAQ. This is widely regarded as the single best gauge of large cap US Equities.

The **Dow Jones Industrial Average** is a price-weighted average of 30 actively traded blue-chip stocks, primarily industrials. It is used as a barometer of how shares if the largest US companies are performing.

The **NASDAQ** is a market capitalization weighted index of the more than 3000 common equities listed on the NASDAQ Stock Exchange. These securities include American Depository Receipts, common stocks, real estate investment trusts, and tracking stocks.

The **MSCI EAFE (Europe, Australasia, Far East) Net Index** is recognized as the pre-eminent benchmark in the US to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America, Europe, Australia, and the Far East.

The **MSCI Emerging Markets Index** captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 822 countries, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **Barclays US Aggregate Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS, ABS, and CMBS.

All index information has been gathered from public sources who are assumed to be reliable, although we cannot guarantee the accuracy or completeness of those public sources.