JANICZEK® WEALTH MANAGEMENT

Portfolio Matters

October 14, 2015

LONG TERM AND LEVEL-HEADED

Our Response To The Third Quarter's Global Market Selloff

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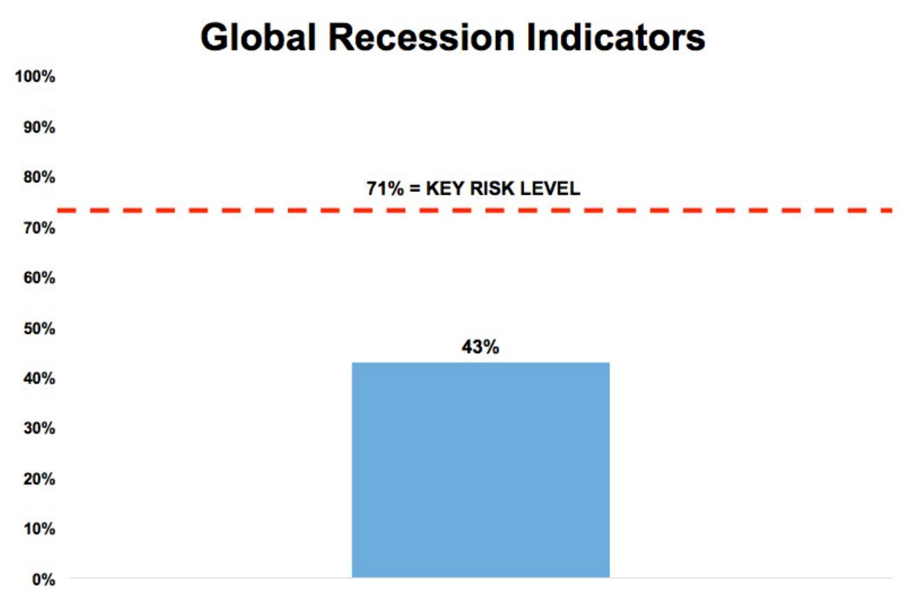
In reviewing the third quarter, we find it remarkable how short the typical investor's "long term" becomes in the short term.

For example, a recent study by Fidelity Investments looked at thousands of individual brokerage accounts and countless trades across all its clients. Fidelity wanted to know why some accounts consistently performed well while others didn't. Was it access to research or unique trading techniques? Or investor profile characteristics such as age and gender? Perhaps geography?

The study purportedly found that the best performance came from the accounts of the deceased. Yup, the accounts that should have been closed because the owner had passed away. Another group of top performers were owners who had simply forgotten they had an account at Fidelity. In both cases, obviously, the impact of investor fear and short-termism were absent.

We're not suggesting that a strict "buy-and-hold" approach is best. But we are emphasizing what researchers have known for decades: When left unchecked and unmanaged, human psychology plays a detrimental role in the returns generated by the average investor. And the data show that even small doses of fear and greed make the long term pretty darn short for most investors.

These are some of the more powerful conclusions we've baked into our evidence-based investment management process. We don't remove investor fear and greed from the equation. Instead, we quantify and track it as an input in our decision-making process. In doing so, we maintain our long term perspective while others fall prey to their own psychological biases.



Source: NDR Research, as of 9/30/15

BOTTOM LINE

- The difficult third quarter doesn't trump a decent economy and a long run bull in stocks
- Evidence of the end of the correction is growing but still inconclusive
- Negative momentum in midstream MLPs offers increasingly attractive opportunities
- Short term declines highlight the importance of a long term, disciplined investment process

In this edition of Portfolio Matters, we'll examine the volatile quarter seen across global markets and provide our views on what's in store going forward.

Economy

Concerns over China and the timing of interest rate hikes by the Federal Reserve dominated the third quarter. And beneath the headlines, the economic data we follow suggest a softening yet positive global economy.

China is showing signs of slowing, but we're stopping short of calling for a global recession. The Chinese economy is the second largest in the world and a big contributor to global GDP growth. But China's annual GDP growth rate has declined from 10.4% in 2010 to 7.4% in 2014. A closer look at recent underlying economic data suggests the Chinese economy isn't even running at its official 7.0% rate in 2015.

We believe that concerns about a Chinese-driven global recession aren't giving credit to the firepower available to the Chinese government. With $3.6

trillion in foreign currency reserves and plenty of room to lower rates, China has significant monetary tools with which to manage its slowdown. It will be interesting to see how they deploy their monetary policy, given their desire to continue the shift from an investment and infrastructure economy to a consumer and services driven country.

Further, we believe investors are not differentiating which nations are being affected positively and negatively by lower commodities prices. While China's growth engine will play a lesser role in global growth in the near term, the bulk of *developed* countries' economies benefit from lower commodities prices. Within emerging markets, there are also significant differences across countries regarding the impact of cheaper commodities. When it comes to China and the global economy, it's likely that the proverbial baby is being thrown out with the bath water.

The economic indicators we follow suggest heightened risks but no global recession. A look at "PMIs" (an indicator of manufacturing growth) around the world shows slowing but expanding activity. However, weaker global trade data plus subdued leading economic indices require diligent monitoring.

In the U.S., the economic news is better, and history provides several instances in which the global economy fell into recession without the U.S. economy participating. The recent data continue to support the notion that the U.S. has one of the strongest economies in the world, with some of the more cyclically important sectors performing well.

For example, the health of the U.S. consumer has several tailwinds. More consumers are employed as the unemployment rate fell to 5.1%, below its 50-year average of 6.2%. Interest rates remain low, resulting in historically low costs to service debt. Auto and home sales continue to head higher, and low commodities prices have led to a low inflationary environment, particularly at the gas pump.

With so many positives in the economy, why did the Federal Reserve delay raising interest rates yet again? Frankly, we're disappointed in the lack of movement by the Fed, as we believe the strength of the economy justifies short term rates above zero percent. Given the recent soft patch, a rate hike in October is unlikely. And based on prices in the Fed Funds futures market, a December hike would be more of a surprise than not.

In sum, we believe the economic backdrop is still a positive one for investors, but we acknowledge the slowdown in several economic factors during the quarter.

Asset Allocation

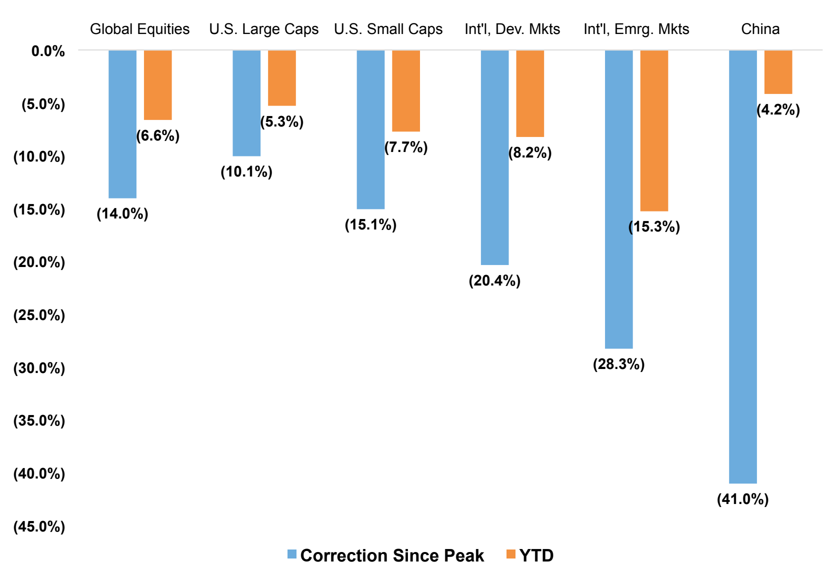
Stocks around the world shed 9.5% in unison during the quarter and are now slightly in negative territory for the year. As one would expect in such a "risk-off" environment, bonds globally rose during the quarter, pushing yields lower. (We review alternative asset classes later in this report.) Notably, the U.S. dollar tacked on another 2% appreciation, adding to its rise versus nearly all other currencies over the last 12 months.

The quarter was a relatively active one for our client portfolios, as we repositioned using our evidence-based approach to investment management. Our first move came in early August. Despite already being down 4% through July and 13% the previous 12 months, our research pointed towards a worsening environment for emerging markets stocks. So, we trimmed our emerging markets equities and rolled the proceeds into developed markets. This effectively underweighted exposure to emerging markets.

Also in early August, we made a similar move within U.S. stocks, underweighting small cap stocks and adding to large cap stocks. In the case of small caps, it wasn't only the current environment but also the historical one: small caps had enjoyed an unusually long cycle of outperformance versus large caps. So while we maintained an overweight to global equities overall, these two moves added a defensive posture to our portfolios.

Starting August 20th, stocks around the world declined over 10% in 4 trading days, an unusually fast correction historically as we discussed [in our blog](). We paired back our equities across the board during this period, but

The Global Stock Market Correction



Source: Bloomberg, as of 9/30/15

it's important to qualify our move. We entered August in a 10% overweight position, one that was supported by our research and investment process. However, given the speedy deterioration in stocks, we could no longer justify the overweight risk across our clients' portfolios. We trimmed stocks back to neutral, and we added to our bonds as well as our cash.

Interestingly, we didn't observe a stampede into bonds as the yield on the 10-year U.S. Treasury bond fell marginally from 2.12% to 1.90% during these 4 trading days. Although we have stated our concerns for bond investors over the long term, high quality bonds do serve an important role during short term selloffs in equities. Still, we anticipate our bond purchase is likely a short term one until the equity correction plays itself out.

We covered all of this in a 13-minute webinar to our clients back on August 27th. As of the date of this publication, we believe the correction isn't over yet, and many of the data points we review in the webinar are still instructive. So, we invite our readers to the webinar's slides and audio available here.

Looking forward, although we can't declare the correction dead just yet, we do see some positive signs. Historically, 10% corrections play out over a couple of months, which is right where we are today. So it's possible the downside is limited to the 10% we've already experienced.

But if a deeper correction ensues, there's a silver lining. We're in a long term bull market for stocks, and downturns in such secular bull markets are shorter and shallower than average. Cyclical downturns within long term bull markets can be 9 months long with declines as much as 20%. We're not predicting this outcome, as we see the current evidence as leaning slightly bullish.

We're seeing some positive developments, and these have led us to unwind our defensive underweight in emerging markets. After having fallen 15% year to date and 25% from its 2011 high, the MSCI Emerging Markets Index is now back at levels not seen since 2009. Valuations are cheap and sentiment is overly pessimistic, two important conditions that put the odds of investing success in our favor.

While we monitor markets for signs that warrant further portfolio moves, we remind our clients of the benefits of our diversified approach. Let's highlight a few portfolio characteristics. First, our portfolios have increased exposure to more stable investments. We're carrying more cash than usual, given the market uncertainty, and this complements our short term bond and absolute return bond positions. Combined, the typical client portfolio has about 11% in stable exposure.

Second, the current yield on the portfolio offers a buffer against further volatility. Our bond positions generally yield 2.3% while some of our alternative investments include yields of 5.4% and 6.7%. We'll take comfort knowing that part of our future returns are visible today.

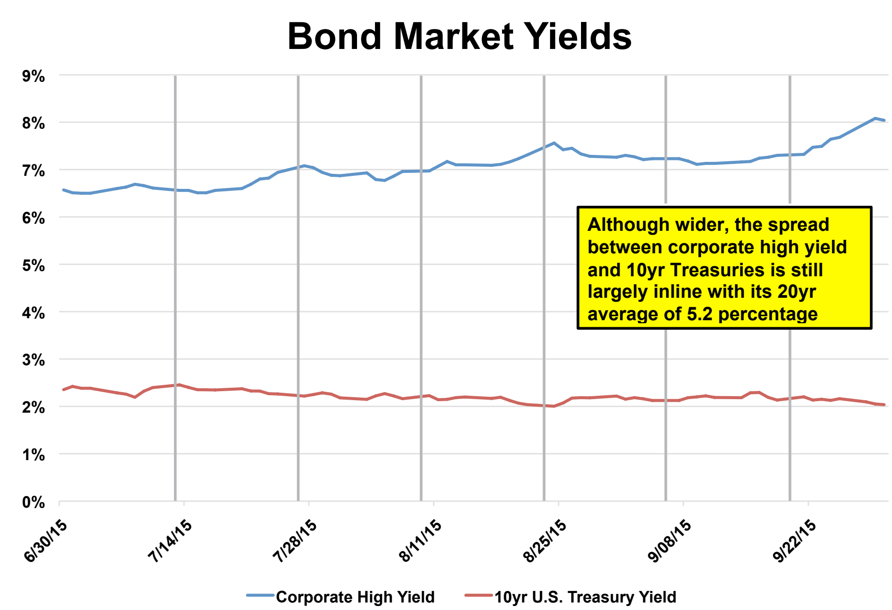
Finally, we remind investors of the importance of an efficient portfolio. Because we deliberately select passive investments for certain parts of the markets, the embedded cost of our typical portfolio is about 0.46%. A simple math exercise shows that a portfolio containing entirely actively managed mutual funds would have an embedded cost of about 0.78%. For a $2.5 million portfolio using all active managers will cost the investor nearly $100,000 over 5 years. Our research shows that an efficient portfolio is a critical component to a successful asset allocation process.

Fixed Income

Relative to other asset classes, Treasury bonds held up well in a world of volatility. The same cannot be said of the relatively riskier sectors of the bond market.

As equity markets sold off and investors sought safety, the 10-year Treasury yield fell to an August low of 1.90% before finishing the quarter at 2.03%. The return on the benchmark Barclays U.S. Aggregate Index was 1.2% during the quarter, while municipal bonds gained 1.7%.

Anything related to emerging markets was out of favor in the quarter, and its debt market was no exception. Bonds in emerging markets fell 2.4% but remain in positive territory for 2015. Non-U.S. bonds in developed markets returned 0.6% but remain in the red for the year thanks mainly to a stronger U.S. dollar.



Source: NDR Research, as of 9/30/15

We see fair value for the 10-year Treasury at about 2.20%, but we still expect an upward drift over time. We don't think the attention placed on whether the Fed will raise short term rates by 0.25% is nearly as important as people believe it to be. Instead, our long term expectation includes a growing economy, a world awash in cash, and greater inflationary forces.

Across the bond landscape, we're watching the recent decline in the high yield sector for two reasons. On the one hand, widening spreads between Treasury bonds (risk-free) and junk bonds (risky) are a bad signal for high yield debt. An increase in this spread historically has come prior to meaningful downturns such as those seen in 2000, 2008 and 2011.

On the other hand, high yield bond prices often mirror stock prices, and our views of the stock market make current junk yields tempting. While the media screams that higher spreads relative to Treasuries spell doom for high yield bonds, we'd point out that the current spread of about 6.0 percentage points is roughly in line with the 20-year average of 5.2 percentage points. Put another way, spreads during the recessions of 2001 and 2008 were 10.4 and 20.4 percentage points, respectively, a far cry from current levels.

With a global economy still on decent ground, we continue to see long term challenges for bond investors. Despite the continued low interest rate environment, we seek capital preservation and income from our fixed income investments. So as a growing economy and a U.S. central bank seeking to raise interest rates, we think investors must adjust their bond investing strategies accordingly.

Equities

There was no place to hide in the global equity markets in the third quarter. U.S. large caps held up relatively well with a 6.4% negative return while small cap stocks fell 11.9%. Non-U.S. stocks in developed markets fell 12.1%. Emerging markets equities declined 17.8% during the quarter.

Diving deeper into some of these indices, we find the correction a bit worse than headline data show. For example, the S&P 500 was down 6.5% during the quarter, but this index is weighted by size, giving more weight to larger companies. An equal weighted S&P 500 shows the third quarter's return to be down 8.0%. Further, one third of the stocks within the S&P 500 are down 20% or more from their highs, a decline generally signifying bear market territory. While we never enjoy such declines, our goal is to help readers keep things in perspective. Let's review what we already knew prior to the August downturn.

Stocks in the U.S. had an unusually long run without a decline of 10% or more. We also knew that equity valuations had gotten full in the U.S. (less so abroad). And as we wrote back in January: *"… such a correction would allow for greater gains over a longer time period going forward."* Notably, we were referring to a possible 20% correction in the U.S., not the mere 12% drawdown we saw during the third quarter.

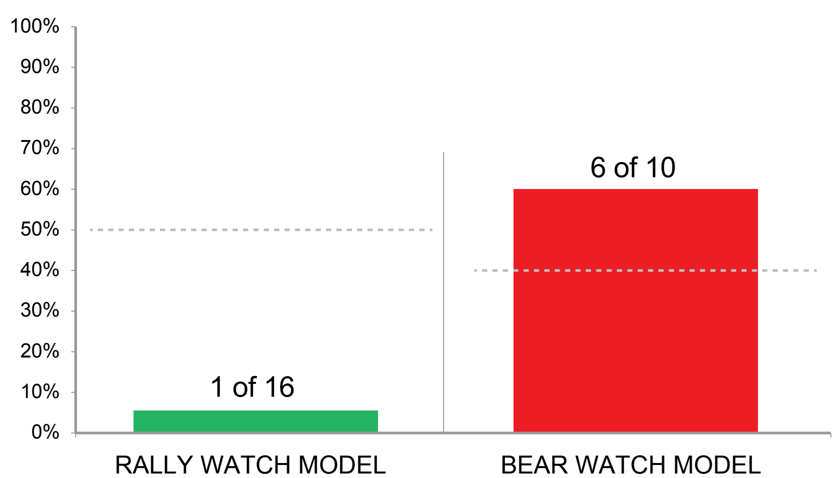
Looking forward, we find evidence that the long term prospects for equities are still positive. The third quarter decline doesn't offer any evidence that the secular bull market in stocks is over. Perversely, the deeper the correction, the better this long term bull market will be, and recent history offers some perspective.

Just 12 months ago we experienced a similar correction. Last fall, the S&P 500 declined 9.8% in a month, just shy of a double-digit correction. By year-end, the S&P 500 Index was up 11.0% from the low and 13.7% for the year. But while everyone felt better, we acknowledged the fact that the shallow correction relieved only some of the excesses, and that another selloff was likely as stock valuations got bloated.

We already discussed some of our portfolio positioning, so let's focus on the equity indicators we're watching. Past cycles tell us much about how corrections such as these play out, and this one is no different. After setting a low in stocks such as the one we set on August 24th, we usually observe a re-test of that low over the next couple of months. Such a re-test occurred on September 29th, and equity indices have

The Global Stock Market Correction

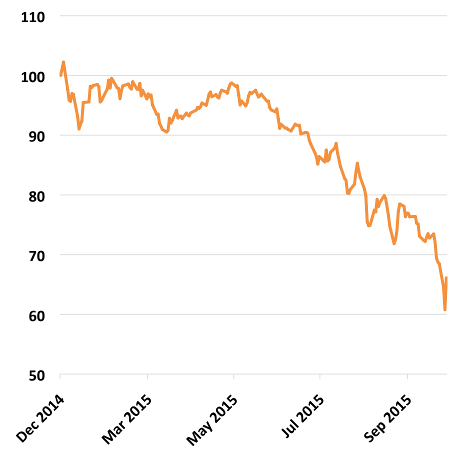
Our equity models aren't confirming the end of the correction



Source: NDR Research, as of 9/30/15

The Opportunity in Midstream MLPs

Alerian MLP Index



Select Data from MLPs' Q2 financial results:

- EBITDA: 2.4% higher than consensus expectations and 9.0% higher than Q1
- Distribution Growth: 3.0% increase from Q1 and 12.2% increase YoY
  - 42 MLPs announced increases
  - No MLPs announced reductions
  - Remainder were unchanged
- Distribution Yield: 8.5% average
- Share Prices: down 34% YTD and 43% over the last 12 months ending 9/30

Source: Oppenheimer, Bloomberg

moved higher since. However, the retest occurred without some of the typical characteristics of a market bottom, so we're not convinced that we're out of the woods just yet.

Let's review some indicators we're watching for signs that the correction has run its course. First, volume. Historically, the typical correction is over when there is a heavy skew of volume in advancing stocks. Second is breadth, or the number of stocks participating in short term upward moves. We've seen neither flash a green light yet, but other indicators suggest an improving environment.

Two models we follow also fall short of concluding that the correction is over. In our quarterly reports to clients, we begin with a snapshot of these models, both from one of our research partners, NDR Research. One model follows 10 indicators that look for a near term bear market, the other follows 16 indicators looking for a near term bull market. Combined, these models tell us that risks remain elevated and evidence of a near term rally is absent.

One positive factor has been sentiment, which as you may guess has been extremely negative. Recent readings on sentiment have reached the lows seen in 2011 (when stocks sold off about 20%) and 2008. But considering our growing economy and our long term secular bull in stocks, we've viewed overly pessimistic sentiment as a good reason why we'll avoid a longer and deeper correction.

Once we see evidence that the correction is over, we anticipate that we'd re-establish an overweight stance on stocks, given the secular bull market. But we'll stay true to our process and let the evidence inform our decisions at that time. Until then, we'll watch the research while keeping our long term perspective.

Alternatives

The spectrum of alternative investments we follow didn't escape the global selloff in the third quarter. Absolute return strategies fell 1.3% while real estate investments trusts (REITs) generated a 0.5% return in the quarter. Commodities (which we exited in early 2014) continued their long term bear market with a 14.5% negative return, including gold which sank 4.9%.

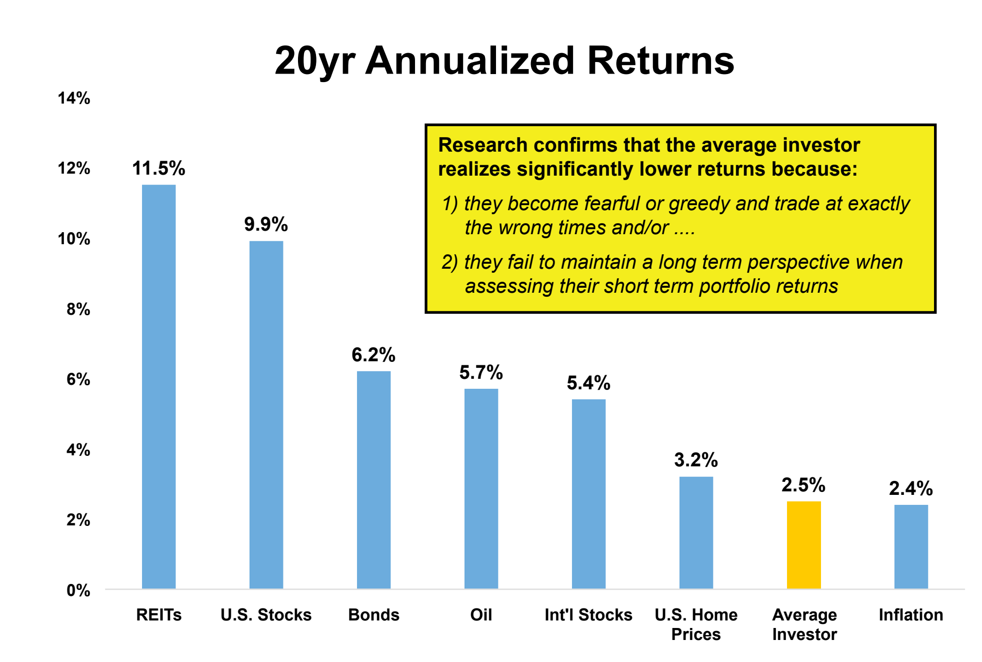
The most dramatic decline came in master limited partnerships (MLPs), where the main benchmark returned a negative 22.1% during the quarter and is now down 30.7% for 2015. In fact, the third quarter marked the worst one on record for MLPs, even topping 2008's decline. MLPs have now declined 4 consecutive quarters, and the only other time this occurred, MLPs doubled over the subsequent 5 years.

(Interestingly, one of our MLP managers generated the highest alpha … or return above the respective index … among all our active managers during the quarter. The manager did this while returning a negative 15.5% for the quarter, nearly 7 percentage points ahead of the benchmark. This underscores a point we make when speaking with investors who are overly concerned with beating the market: Beating a benchmark is only a small part of assessing progress on your overall financial plan. So while performance comparisons to market indices are valuable, make sure your highest priority is always performance relative to your plan.)

Our MLP focus remains on the midstream part of the energy chain, the pipelines that carry raw energy commodities from their point of extraction to the refineries and transport terminals. (For a primer on MLPs, please see our *2/1/2012 Portfolio Matters*.) As we'll explain, the fear-driven selling witnessed in these midstream MLPs presents more opportunity than risk.

First, a quick recap of the year to date in MLPs. The beginning of 2015 saw continued selling from the previous year across all energy-related names, including MLPs. When interest rates rose midyear, all yield-oriented investments (including MLPs) sold off. And when the global equity correction took hold in August, MLPs continued their freefall.

The recent trough in MLPs was driven by one extremely negative research report that went viral. During the final week of the quarter, one blog post from an independent research firm called for the end of the MLP structure as a business model. The market swiftly reacted by cratering 11% in the final 2 days of the quarter, despite quick rebuttals from company executives and MLP portfolio managers alike.



Source: JP Morgan Asset Management, through 12/31/2014

We've reviewed our investment thesis for MLPs plus the aforementioned report, and we remain convinced in our bull case outlook. Over the long term, the infrastructure buildout required to take our country's newly tapped energy resources from the ground to market means hundreds of billions of dollars in energy infrastructure over time. Ironically, the bears view the investment required for such opportunities (and the resulting negative cash flows in the near term) as a death knell for MLPs. We couldn't disagree more.

With positive fundamentals, we see two ways the bull case for midstream MLPs plays out. The first is a top-down reversal of the negative momentum seen not only in the energy sector but equities in general. When we see evidence of the end of the correction and a resumption of the long term bull in stocks we expect the most punished names to lead the market higher.

The second bullish scenario doesn't require any material recovery in oil and natural gas prices. If commodities stagnate, MLPs will be investing in the growth of domestic oil and gas production. And as those production volumes grow (2% historically, but more so prospectively), MLPs will see revenue, earnings, and distributions grow. Regardless of which scenario plays out, investors are being paid about 8% tax-advantaged (or a taxable equivalent yield as high as 14%) to wait.

Although the momentum has been the enemy of MLPs for over a year now, perhaps the best summary of the recent market action comes from one of our MLP managers:

"…history tells us momentum trading patterns eventually peter out and that fundamentals eventually come back into focus. Unfortunately, the timing of these turns only seems obvious in retrospect. We are sure the blogosphere will then be filled with commentaries declaring how clearly they saw the turn was coming but just forgot to tell us."

MLPs present a great example of the importance of staying focused on the long term and avoiding the fear and short termism that lead to poor decision-making. As Baron Rothschild is famously reported to have said over 200 years ago, "Buy when there's blood in the streets … even if it's your own."

Conclusion

The correction in global stocks isn't over yet, but our evidenced-based process will provide the data to conclude when it is. We then expect the long term bull market in stocks to continue. Although recent volatility and declines are never fun, they are part of the territory in equity investing. Keeping a sound mind during market corrections is critical to one's success.

Stepping back and observing investor behavior, we find it remarkable how the most important truths in investing seem to disappear at the exact worst times. *"Do your homework and know what you're buying." "Invest for the long run, avoid getting caught up in short term movements." "Don't let your emotions get the better of you."*

Frankly, investing can be very trying at times, and readers should know that we experience the same emotions that all investors do. Declining portfolio values can cause angst, doubt, and fear. And we're no different in experiencing these emotions … but our reaction to these psychological biases is what differentiates us from the typical investor.

We believe investors must take a balanced and objective approach to decision-making. Yes, the market is experiencing a double-digit correction. But a balanced and objective assessment reminds us that such a correction actually occurs fairly regularly. As we've shown before, the average intra-year drop in the S&P 500 since 1980 has been 14%. So the 12% we saw in the quarter is perfectly normal. One more point: Despite these intra-year drops, the market posts a positive calendar year return 82% of the time.

Second, and perhaps more importantly, we believe in investing for the long run. In this day and age, trades occur in fractions of a second, and individuals trying to compete at this level are fighting a losing game. But note that the speed at which a company's shares trade doesn't affect the speed at which the company generates its profits. Confusing the two violates the long term investment mantra.

Let's illustrate what the long run means to an individual investor. When constructing a comprehensive financial plan for our clients, we stress test their portfolios using returns from all the 40-year market cycles dating back to 1900. (That's 114 unique 40-year cycles, for those keeping count.)

Note that baked into this stress test are historical periods in which stocks fell for 36 months or churned sideways for 10 years. This reminder alone makes the recent correction seem pretty tame, no? Further note that one quarter accounts for a mere 0.6% of time periods within this test. A little perspective during trying times can be a powerful thing.

Finally, we believe investors should get out of their own way. As the study we discussed in the beginning shows, our own psychological bias can turn investment opportunities into losses. This has been well documented, and those interested in reading more are welcome to our investment white paper.

The conclusions from this research are tough to swallow, as the data show that investors' timing of purchases and sales, in general, cut their potential returns by 50% or more across all asset classes. In other words, it's the psychological factors, not the investment conditions, which play the bigger role in squashing the chances for profitable returns.
The good news is that there are several solutions investors can pursue. Automating one's finances, from 401(k) deductions and auto-debits to automated portfolio rebalancing, yields a better chance of doing the right things at the right times while avoiding the big mistakes that are often driven by our own psyche.

More importantly, by having a comprehensive financial plan focusing on the long term, investors can better benchmark their portfolio's performance. Remove yourself from the game of trying to beat the market and re-focus on generating a portfolio return that meets your plan. In doing so, you'll avoid the short term fear and greed that drives so many people to make such poor decisions.

Let's end with an illustrative story that compares the typical investor with a well-prepared investor. The latter has a comprehensive financial plan in which the portfolio serves a specific purpose and interacts with all other components of her wealth.

The typical investor, on the other hand, can recite all the investment rules of thumb, can state the closing prices of his positions and his gains year to date, and thinks of his wealth solely through the lens of his stocks and bonds, independent of his overall finances.

Then the markets decline. Although some of his mutual funds are beating their benchmarks, they're still down and he really doesn't know what how much of a decline his portfolio can withstand. The typical investor suddenly loses his confidence. And without knowing what his smaller portfolio means to his overall finances, he takes defensive action and seeks safety, selling stocks at the worst time.

The well prepared investor already knows that the decline is nothing compared to the stress test her portfolio passed, and since she's integrated her portfolio with her cash flows and overall balance sheet, she knows that she has her "rainy day" cash reserve established.

So, although seeing the value of her investments decline doesn't bring her joy, she knows she'll review her portfolio with her advisor soon. More importantly, her thorough and complete approach to managing her wealth allows her to overcome the fear and uncertainty that's blasted out from the typical investor and hundreds of media outlets.

In closing, we've discussed how reactive moves that are driven by emotion are detrimental to one's wealth. At Janiczek Wealth Management, we've created a patented and comprehensive process that puts the odds of success in our clients' favor.

For those who lack such a process, we hope we've shown that, if nothing else, keeping a long term perspective allows for informed decision-making and prevents knee-jerk reactions that destroy one's wealth.