John Cogswell CFA
Chief Market Strategist
Portfolio Manager
Baystate Wealth Management
200 Clarendon St, 25th Floor
Boston, MA 02116
jcogswell@baystatefinancial.com

Looking Backwards and Forwards

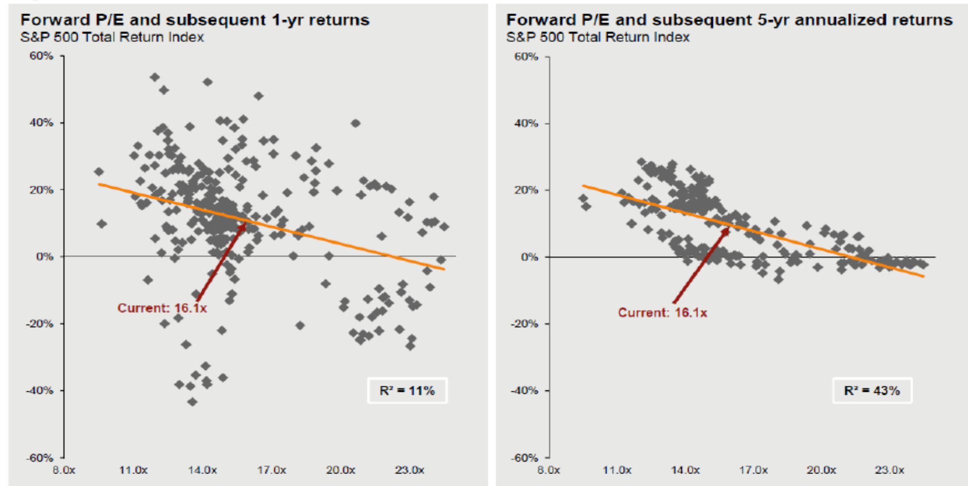
It's that time of the year again where we recap the prior year relative to our expectations and then look toward the future. While there are plenty of topics to disagree about over the last year, one thing we can probably all agree on is that it's been remarkably fascinating. That said, let's look back at 2016.

Stocks – Looking Back

Valuations are at the core of our decision-making process. We believe that when equities are expensive relative to their history, future returns are likely to be lower than average. On the other hand, when stocks are trading at lower than average P/E ratios (P/E ratios are a classic valuation metric) we believe future returns will be above average. The reason we believe this to be true is that, in addition to the common sense aspect of "buy low/sell high," there is significant historical evidence supporting this theory.

A graph we commonly use to help investors understand this valuation/future return relationship comes from JP Morgan in their monthly *Guide to The Markets* (see Graph 1 below that we used last year).

Graph 1



Source: FactSet, Reuters, Standard & Poor's, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning December 31, 1990. R^2 represents the percent of total variation in total returns that can be explained by forward P/E ratios.
Guide to the Markets – U.S. Data are as of December 31, 2015.

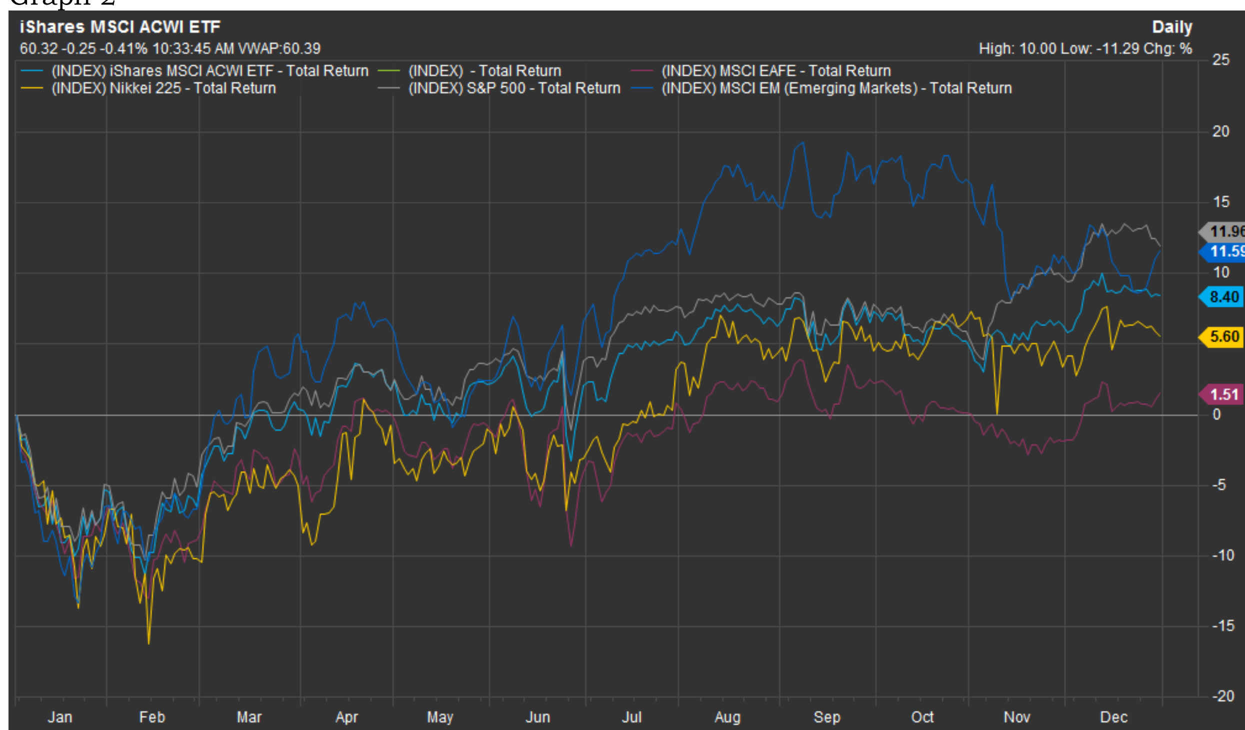
J.P.Morgan
Asset Management

BAYSTATE
WEALTH MANAGEMENT

This graph shows 1-year returns on the left side and 5 year returns on the right side. The vertical axis displays returns and the horizontal shows valuations. As the graph illustrates, valuations are a good, but not perfect, indicator of future returns. As the length of time increases (1 – 5 years), the strength of the relationship increases significantly.

Last year we stated that: *"Over time when valuations are fair, there have been many instances in which stock investors have received mid to high single digit returns."* A year ago, we found many areas of the stock market to be fairly valued. As of December 31, 2016 stocks across the globe, on average, increased 8.4% as measured by the iShares MSCI ACWI ETF. At the head of the pack were large U.S. companies (S&P 500) and emerging markets equites (MSCI EM) at almost 12% gains each. Japanese stocks (Nikkei 225) returned 5.6% while developed international (MSCI EAFE) gained 1.51%.

Graph 2



Source: Factset, Baystate Wealth Management

Interesting, if you look at the returns at the end of the year only, on average, as measured by MSCI ACWI, stocks were up about 8.5%. Yet, this doesn't reflect the fact that stocks fell significantly in the first quarter. Quite frankly, this is one of the reasons why Financial Advisors encourage their clients not to look at their investments on a short term basis.

The bottom line is that, on average, 2016 is yet another data point that will support our philosophy which is centered on the strong relationship between valuations and future returns.

<u>Stocks – Looking Forward</u>

Our outlook for stocks is, for the most part, similar to last year. At this point, most areas of the equity market are technically modestly above their average values, in our opinion broad stock valuations are largely full but not as full as they have been in the past. While it is true that the probability of higher than average returns is greater when valuations are below average, modestly high values can still lead to mid-single digit returns or even more.

To be specific about valuations, most stocks are trading within 1 standard deviation of their long-term valuations. A simple, but imperfect, way of thinking about standard deviation is that plus or minus 1 standard deviation is where a data series (like valuations or returns) falls in many time frames. At the same time, in most circumstances data falls within 2 standard deviations of the average. As an example, if the longer term historic P/E ratio for an index is 15x and 1 standard deviation is 1.5x, a lot of the time the ratio will fall between 13.5x and 16.5x. Yet, most of the time (2 standard deviations) the P/E would fall between 12x and 18x.

The reason this matters and the reason for explaining it is that often times stocks trade at valuations above their average and within 1 standard deviation. It is not something that should bring investors undue concern. By definition it is both normal and common. Standard deviation helps us evaluate the extent of over/under valuation. On the other hand, as valuations approach or exceed two standard deviations over the average it should not be taken lightly. When valuations are *below* the average by a magnitude of 2 standard deviations, it has historically represented an attractive point to make an initial investment or add to an existing position. Conversely, when valuations are *above* 2 standard deviations from their respective averages, it could lead to a "correction" via low or negative returns.

As a final, and encouraging, thought on expectations for just U.S. equities, we should address fiscal policy. If the widely discussed fiscal reform (lower corporate tax rates) is enacted it could be a very positive tailwind for U.S. equities and quite possibly stocks across the globe. If taxes are reduced at the corporate level, that reduction has the impact of raising net income and therefore lowering valuations, which increases the likelihood of higher future returns. In addition to our traditional systems and news sources, we will be monitoring our Twitter feeds to see how this progresses.

Bonds – Looking Back

Our forecast as of this time last year was very straight forward. To once again quote last year's report: *"In short, given that we believe rates are likely to be anywhere from stable to modestly higher, by definition we believe many types of bonds will return low single digit returns in the near term."*

As the year progressed and eventually ended, it did turn out to be the case that rates were somewhere between stable and modestly higher. Though, the path of rates was anything less than linear. Rates actually fell the first half of the year, as bond prices went up. Then, in the second half of the year, bond prices fell, driving yields higher than where they were at the start of the year.

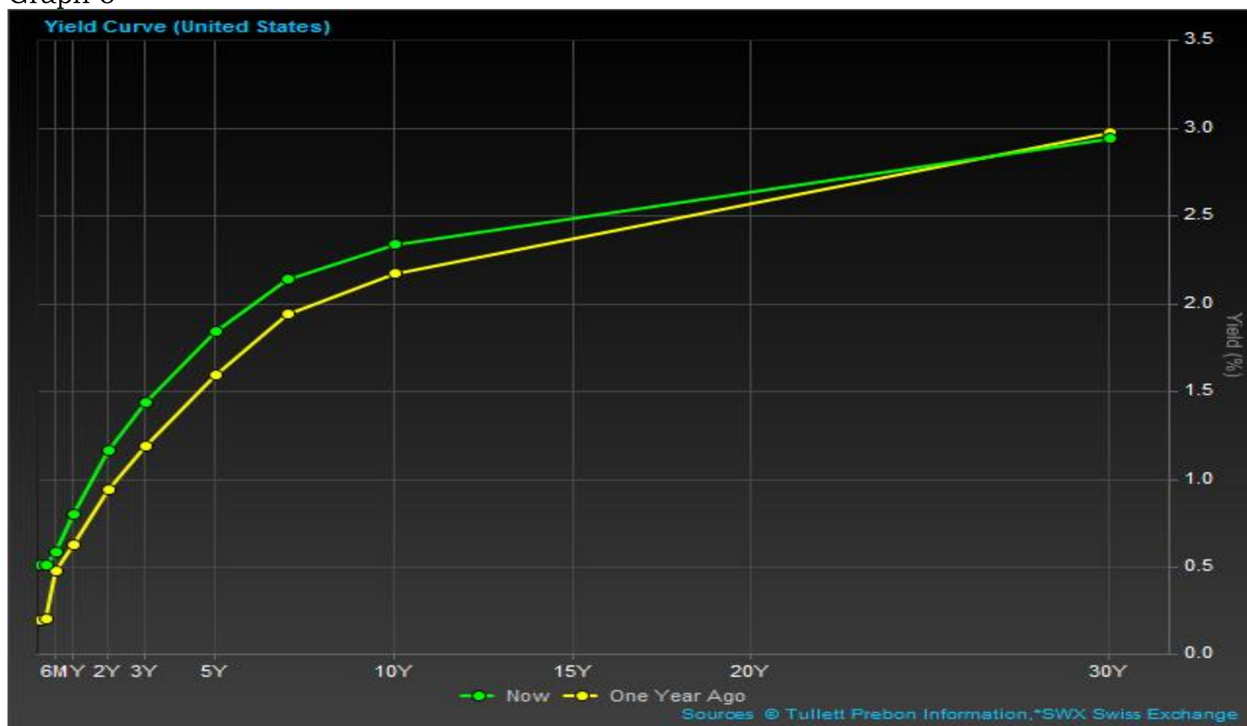
The Graph below (Graph 4) shows the yield on the 10 – year U.S. treasury, which is generally considered to be a common benchmark for bonds. During the summer, rates were a little lower than 1.4% before rebounding to almost 2.5%.

Graph 4

Source: Factset, Baystate Wealth Management

When the year ended, rates, and therefore bond prices, moved modestly as we had suggested. For a before and after picture, see Graph 5 below for the U.S. 10 – year yield curve over the last year.

Graph 5

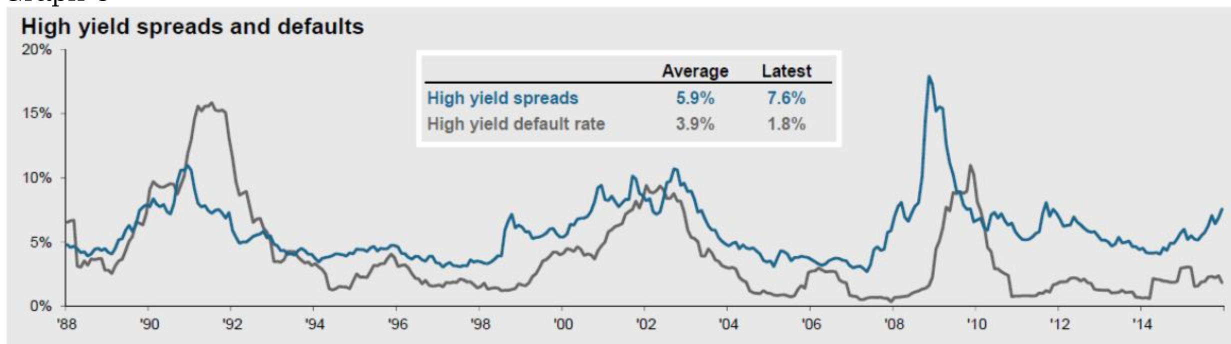


Source: Factset, Baystate Wealth Management

The yield curve in yellow is from one year ago while green depicts the current rate structure. It is certainly the case that when you look at 2 data points, in this case the beginning and end of year, it paints a different picture than the day-to-day experience of a bond investor.

In addition to last year's view that more traditional types of bonds would have modest price/yield movements, we did see one area of the fixed income market that was attractively priced. Once again to quote from last year's PM report: *"We do see one bright area in the fixed income area. High yield bonds, which are highly sensitive to changes in the perception of credit conditions have recently sold off and thereby have increased spreads relative to history, increasing the current yield. Taking into consideration a higher yield and a higher spread relative to history our return expectation increases according."* At the same time, we provided a graph showing the current spread, which is a classic valuation metric for bonds. Specifically, as can be seen in Graph 6 below, the spread on high yield bonds was almost 2%.

Graph 6



Source: JP Morgan Asset Management

As the year ended, high yield bonds, as measured by the Barclays High Yield Bond Index, increased 17.1%. Yet again, another data point suggesting valuations matter.

Bonds – Looking Forward

If potential fiscal stimulus and a re-pricing of equities is the good news, returns for many areas of the bond market is likely to be the bad news. Our outlook going forward is not significantly different than last year's in that many types of bonds should be stable to modestly higher. What has changed is that some types of bonds, particularly those that are more sensitive to interest rate movements, now have a higher probability of posting negative returns. Indeed, it is not an unreasonable expectation that some more traditional fixed income indices could lose value in the near future.

We believe high yield bonds (which should be thought of differently than other types of bonds because of their risk characteristics) have the potential to generate solid returns not significantly different than their current yields. The caveat with this expectation is that it is contingent on the fact that stress and concern with the general level and quality of credit does not change materially. At this point, high yield spreads are effectively at their long term average compared to above their long term average last year. To be clear, a wider spread represents attractive value, while a tighter or negative spread indicates over valuation.

In summary, many areas of the bond market could struggle to generate low single digit returns while we continue slowly on the path to normalized interest rates. For clients of Baystate Wealth reading this report, please be comforted in the fact that we are confident our fixed income allocation is positioned according to our expectations. From our vantage point, the

long-term benefits of normalizing interest rates far out weights any short term challenges with returns.

Alternatives – Looking Back

As a reminder, alternatives are investments that are neither a traditional long stock or a long bond position. Some examples of these securities are REITs (Real Estate Investment Trust), commodities, MLPs (Master Limited Partnership) and absolute return funds.

Valuing and forecasting returns for some alternatives is relatively straightforward. For example, REITs and MLPs have the classic data points (sales, expenses, yield spread to the 10-year, earnings and dividends) that are helpful to an investor attempting to calculate a fair value. On the other hand, some alternatives like commodities and absolute return strategies do not possess those classic attributes, thereby making them much more difficult to forecast.

As we stated last year, there are three reasons to allocate a portion of the portfolio to alternatives:

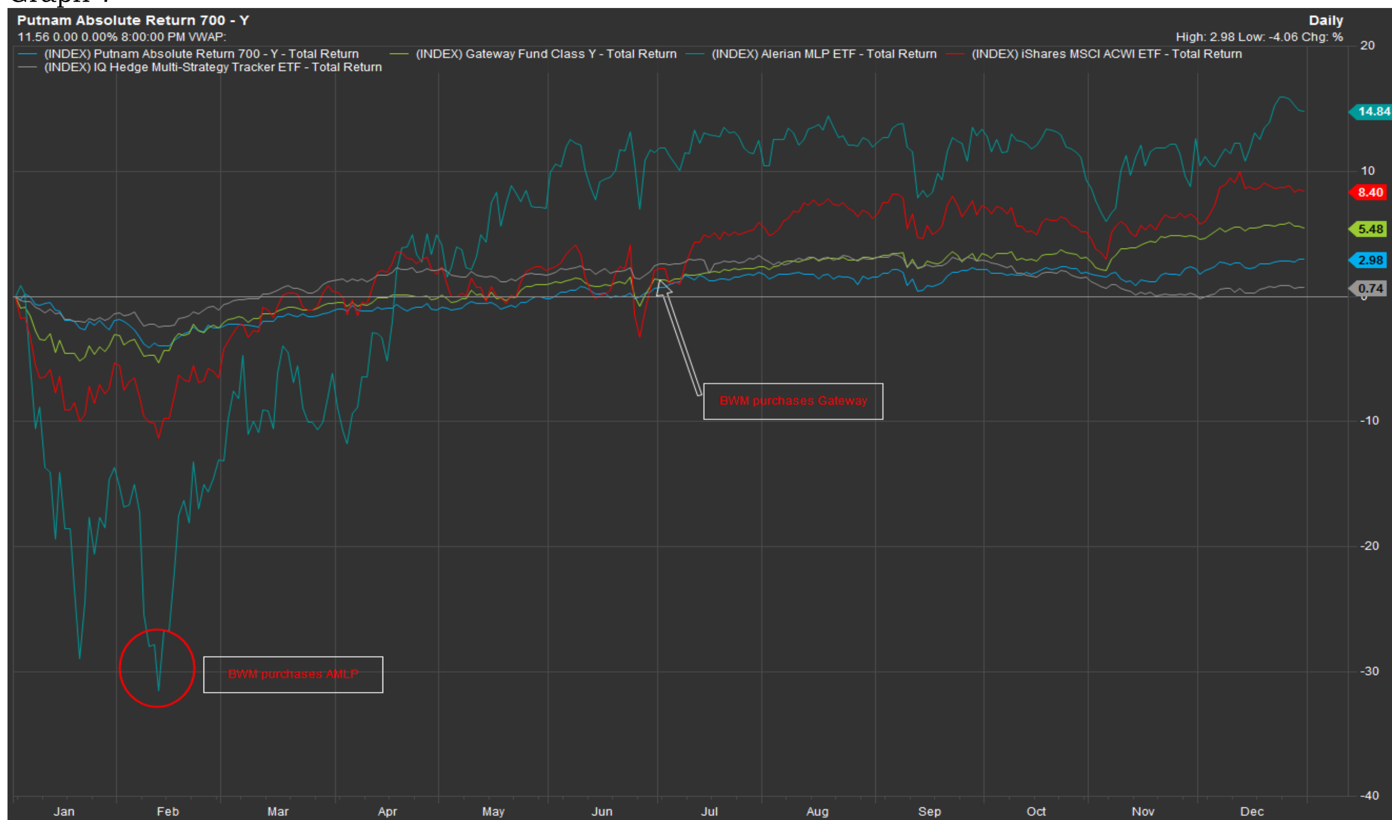
1. Reduce risk
2. Enhance returns
3. Some combination of #1 and #2.

In the beginning of the year our focus, and forecast, was on absolute return (AR) strategies given that this asset class occupied 100% of our alternative exposure. AR, in our opinion, is definitely one of the areas of the alternative market place that is challenging to forecast given the nature and flexibility of their mandate, as well as the lack of classic data points mentioned earlier. The reason we invest in these strategies to reduce risk via the correlation benefits and ideally generate returns that fall somewhere between stocks and bonds.

At the end of the year, they did their job. Specifically, as proxies for AR funds, the two AR funds we invested in for our clients resulted in positive returns over the year. Over the same time, as can be seen in Graph 7 (blue and gray lines) they fell significantly less when markets pulled back in the first two months of the year as well as the end of June (Brexit).

Over the year two additional alternative investments were incorporated into client portfolios. AMLP, the first alternative we purchased, is an index that tracks a specific sector of the energy industry (mid-stream MLPs). The reason we forecasted attractive future returns was because, as should be expected, valuations. At the time, the two commonly used valuation metrics for this asset class were significantly undervalued. It should be noted that unlike AR funds that typically exhibit both lower volatility and correlations to equity markets, MLPs are very much a risk asset as can clearly be seen in Graph 7. Although this investment may at some point technically reduce volatility because of its erratic correlations to other investments, it is an asset class that should be invested in for the yield and potential capital gains – not for the diversification benefit. Interestingly, regardless of the extent to which this alternative has increased in value, it is still arguably one of the most undervalued asset classes available to investors.

Graph 7



Source: Factset, Baystate Wealth Management

In the summer we added yet one more type of alternative investment into the portfolios. Gateway is a fund that falls under the category of a “buy-write” strategy. In short, the fund invests in US Large Cap Stocks while employing an options strategy to both generate income and to some extent protect the portfolio from pullbacks in the equity markets (a.k.a “drawdowns”). This particular strategy has more sensitivity (beta) to equity markets than many other types of alternative investments. In fact, when trading into the position we referred to it as taking a “half step” into the market. The return expectations should be lower than the overall market in a robust environment while outperforming when equities in general are negative or are producing low single digit returns.

<u>Alternatives – Looking Forward</u>

Regarding some of the more straightforward alternatives, we still find MLPs to be attractively priced with compelling yields. REITS, on the other hand, seem expensive, and are therefore off our shopping list for the time being. In terms of expectations, given the elevated unpredictability and volatility of these asset classes it makes setting short-term expectations even more difficult than it is with other areas of the market. While we have less specific return assumptions with alternatives, our expectation is they will enhance returns, reduce risk, or better yet some combination of the two.

Finally, we will address the absolute return (AR) category within alternatives. Absolute return investments are strategies that are designed to generate returns that are independent of the behavior in stocks, bonds, real estate, and other asset classes. In our view, over the last few years these types of strategies have typically been at the back of the pack in terms of performance. Our goal, over time, is for these strategies to have returns that fall somewhere between stocks and bonds with mild correlation, or sensitivity to traditional investments like stocks and bonds. In our experience, and based on our research, most asset allocators have

found this area of the portfolio to have generated barely positive returns while underperforming more traditional types of bonds. Our view currently is that they are more likely to add value moving forward relative to their performance over the past few years. Our conviction in this belief is in large part a function of the challenges we see in many areas of the bond market.

It may be the case that AR strategies with low volatility and a low degree of correlation may be a welcomed addition to a portfolio that uses a traditional bond exposure to dampen the risk and volatility inherent with stocks.

As always, time will tell.

John P. Cogswell, CFA
Chief Market Strategist, Portfolio Manager
200 Clarendon Street, 25th Floor
Boston, MA 01226
(T)781-876-4112
jcogswell@baystatefinancial.com

This report contains the opinions and views of John Cogswell, Josh Pierce and Stuart Long. While John Cogswell, Josh Pierce, and Stuart Long are employees of Baystate Wealth Management, the views and opinions expressed herein are their own, and do not necessarily represent the views and opinions of any other employee or representative of Baystate Wealth Management. This report is not intended to provide investment advice and no one should rely on the views and opinions expressed herein in making investment decisions. All recipients and readers of this Report must consult with and rely on their own investment professionals in making investment decisions or when buying or selling securities of any type.

*Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Baystate Wealth Management), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Baystate Wealth Management. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Baystate Wealth Management is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. If you are a Baystate Wealth Management client, please remember to contact Baystate Wealth Management, **in writing**, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services. A copy of the Baystate Wealth Management's current written disclosure statement discussing our advisory services and fees is available upon request.*
Baystate Wealth Management is a Registered Investment Adviser located at 200 Clarendon St, 25th Floor, Boston, MA-02116
Submission# 1209365