The Lam Group
Investment Management

Obviously the outcome in the US Presidential election trumped Brexit for the global event that upset expectations in 2016.

From an investment performance standpoint, 2016 was a great year, but not without its surprises. Unexpected events and the uncertainty they inspire are why we diversify. In many ways, 2016 was a tale of two periods: pre-election (Column C) and post-election (Column B).

Pre-election, emerging markets stocks and bonds (up +16.30% and +13.34%) led 2016 asset class returns through Halloween. In comparison, US large and small stocks, were up +5.87% and +6.16%, for this period. Most equity markets rebounded to varying degrees from a difficult 2015.

Also in the pre-election period, commodities were in the nascent stages of a recovery (+8.34%), and the bond markets were stable, if not strong. Non-US dollar denominated bonds were up +8.97% reflecting a slowing of the appreciation of the US dollar (which began in mid-2014) despite continued aggressive monetary policy by foreign central banks.

Post-election however, everything changed and uncertainty reigned. In what remained of 2016, US stocks surged (small caps were up +14.27%) and the US dollar gained almost +4%. As investors struggled to come to grips with a new political reality, inflation expectations surged giving the fixed income markets a long-awaited punch in the eye, and emerging markets (both equity, down -4.39% and debt, down -2.82%) suffering amidst protectionist rhetoric.

Table 1: Periodic Asset Class Returns as of 12/31/16	A	B	C	D	E	F	G
EQUITY ASSET CLASSES	**4Q 2016**	**Nov/Dec 16**	**Jan/Oct 16**	**2016**	**5 Years***	**10 Years***	**15 Years***
S&P 500 Index - *Domestic Large Cap Stocks*	+ 3.82%	+ 5.75%	+ 5.87%	+11.96%	+14.66%	+ 6.95%	+ 6.69%
Russell 2000 Index - *Domestic Small Cap Stocks*	+ 8.83%	+14.27%	+ 6.16%	+21.31%	+14.46%	+ 7.07%	+ 8.49%
MSCI EAFE Index - *International Large Cap Stocks*	- 0.71%	+ 1.36%	- 0.35%	+ 1.00%	+ 6.53%	+ 0.75%	+ 5.28%
MSCI EAFE SC Index - *International Small Cap Stocks*	- 2.86%	- 0.02%	+ 2.21%	+ 2.18%	+10.56%	+ 2.95%	+ 9.53%
MSCI EM Index - *Emerging Markets Stocks*	- 4.16%	- 4.39%	+16.30%	+11.19%	+ 1.28%	+ 1.84%	+ 9.50%
DJ US Select REIT Index - *Domestic Real Estate*	- 2.53%	+ 3.28%	+ 3.29%	+ 6.68%	+11.77%	+ 4.63%	+10.67%
S&P Global (ex-US) REIT Index - *International Real Estate*	- 8.36%	- 1.96%	+ 5.19%	+ 3.12%	+ 8.30%	+ 0.00%	+ 9.27%
FIXED INCOME ASSET CLASSES	**4Q 2016**	**Nov/Dec 16**	**Jan/Oct 16**	**2016**	**5 Years***	**10 Years***	**15 Years***
BarCap Aggregate Bond Index - *US High-Grade Bonds*	- 2.98%	- 2.23%	+ 4.99%	+ 2.65%	+ 2.23%	+ 4.34%	+ 4.58%
BarCap High-Yield Bond Index - *US High-Yield Bonds*	+ 1.75%	+ 1.36%	+15.56%	+17.13%	+ 7.36%	+ 7.45%	+ 8.35%
BarCap TIPS Index - *US TIPS*	- 2.41%	- 2.02%	+ 6.84%	+ 4.68%	+ 0.89%	+ 4.36%	+ 5.30%
Bloomberg Commodities Index - *Commodities*	+ 2.66%	+ 3.16%	+ 8.34%	+11.77%	- 8.95%	- 5.58%	+ 1.16%
Citigroup Non-$ World Govt Bond Index - *Non-$ Bonds*	-10.84%	- 6.57%	+ 8.97%	+ 1.81%	- 1.94%	+ 2.54%	+ 4.81%
JPM EMBI Global Diversified Bond Index - *Emerging Markets Debt*	- 4.02%	- 2.82%	+13.34%	+10.15%	+ 5.91%	+ 6.88%	+ 9.02%

Sources: Morningstar, JP Morgan & Dimensional. *annualized

It is worth noting that the post-election difficulties in the bond markets were not caused by the Fed or any change in monetary policy, but rather a shift in inflation expectations brought on by the likely changes in US economic policy. This recent rise in longer-term US interest rates and the corresponding increase in the value of the US dollar, while damaging in the short-run, will be interesting to watch (the punch in the eye was not blinding). Future policy increases in US interest rates may be limited as a US dollar that is too strong may have negative implications on domestic corporations that are dependent on exports.

With the US stock market at record highs, the valuation of domestic stocks have also increased (especially when compared with the rest of the world). Historically, valuations brought on by optimistic investor sentiment and rising consumer confidence have often been contrary indicators with regard to market direction. While the domestic stock and bond markets seem to have fully priced in the features of a pro-business/growth regulatory and legislative environment, it remains to be seen how much is actually accomplished and the long-term effects on the global markets.

The New Year brings many predictions from the pundits, both new and old. We are reminded of former presidential candidate and publisher Steve Forbes' proclamation:

“You make more money selling advice than following it. It’s one of the things we count on in the magazine business-along with the short memory of our readers.”

A lamentable but honest quote and an indictment of financial “journalism”. With that in mind, during a period of unexpected political transition, uncertainty and the potential for the unknown are often at their highest levels. In the face of such uncertainty, adherence to the disciplines of portfolio diversification and balance are essential.

Accurately predicting macro-economic events, or the forces influencing them, is hard enough. Successfully translating these forecasts into how the markets will incorporate these events is even more difficult. As we have recently experienced, widely-held predictions can fail after all, with very few correctly predicting the US election results and even fewer forecasting the resulting market reaction.

With a diversified portfolio strategy and a long-term perspective, you don't need to know who is going to win to make money.

Despite the overall volatility, 2016 was a great year, with all asset classes posting positive results (Column D). 2017 is off to a strong start and we expect to rebalance the portfolio towards our long-term asset allocation targets in the midst of all the uncertainty.