

Investment Update



January 2016

A Flight Plan for 2016: Themes and Investment Strategies

Earlier in my career, before I was such a seasoned traveler, I took a trip to China. At the end of my visit I found myself in Shanghai, looking forward to returning to my hometown in the Bay Area. As I studied my ticket closely, I realized I had a connection through Hong Kong. Due to scheduling, I was going to fly three hours backwards, have a two-hour layover, and then fly direct to San Francisco. You can imagine my frustration when, eight hours later, I looked down from 30,000 feet to see the city of Shanghai. In that span of time I could have been nearly home, but was instead only back to where I had started.

While seeming inefficiencies can be frustrating, patience is needed in order to reach our destination, whether in travel or investing. Most global markets in 2015 reminded me of that trip taken so long ago, as markets moved in a sometimes violent back-and-forth manner, ending the year very close to where they started. With 2015 behind us, it's time to look ahead to 2016's major market themes and our strategic positioning.

Modest but Favorable Gains in Equities

Equities will continue their 2015 trend of modest gains in 2016, as earnings growth is expected to range

between 3% and 5% next year. Adding a 2% dividend yield, we predict equity returns of 6% to 8%, as we expect P/E multiples will remain around current levels. In light of these more modest return projections, we have diversified domestic equity exposure within capitalization and style. To enhance our equity diversification we have also included modest exposure to international developed large and small cap stocks. Emerging markets is the only significant equity underweight in the portfolio, as we see some countries in this asset class facing many near-term challenges. While we like the asset class longer term, we wish to see some more tangible evidence of positive catalysts before increasing our exposure. Our preference for stocks over bonds has been a consistent, long-term theme and one that we believe will endure in 2016, even in the face of continued modest equity gains.

Rising Rates a Challenge, but Don't Forsake Bonds

In December, the Federal Reserve (Fed) called for its first rate increase in nearly a decade. Following this long-awaited rate hike, we believe the Fed will raise rates another two or three times in 2016, in gradual increments, likely 25 basis points at a time. A moderate, data-driven pace and magnitude of rate increases will allow markets to adjust along the way. Nonetheless, rising rate environments can be tricky. Although bonds deliver income, investors may suffer from a slight loss on principal making diversification across maturity and yield structures extremely important. Holding short-term bonds that mature during the year allows investors to reinvest that principal at higher interest rates, while holding longer-term bonds gives investors greater yield. We also recommend exposure to bonds that are less susceptible to interest-rate risk, such as floating-rate debt. Diversification such as this protects bond portfolios in rising rate environments, allowing bond allocations to fulfill an important role of providing total portfolio diversification and a stable source of income.

A Strong Dollar Persists as Policies Diverge

While the Fed has begun to raise rates, other central banks such as the European Central Bank, the Bank of Japan, and the People's Bank of China remain poised to continue easing. In light of this global policy divergence,

the dollar should remain strong, though without a rapid rise in strength like we witnessed over the past year and a half. While the strong dollar may limit the earnings power of large multinational companies that count on exports for a portion of their sales, it should help to constrain U.S. inflation by making imports less expensive.

Oil Prices Stabilize

Commodities as well as unhedged international investments may also remain under pressure as policies diverge and dollar strength persists. One commodity in particular, oil, has experienced tremendous pricing pressure over the past couple of years; however, we expect oil prices will likely begin to stabilize in 2016. Although near-term excess supply may continue to keep prices below marginal cost of production, consumers may finally accept these price reductions as the norm and begin to spend their gas savings dividends. Many energy companies will continue to struggle given the long duration of low energy prices and ongoing stress in meeting debt payments. As such, we would not be surprised to see more downward pressure on their bonds and more volatility in the high yield bond market. Likewise, the equity energy sector will continue to face challenges, especially companies involved in exploration and production. These challenges may eventually produce opportunities to buy beaten-down assets such as Master Limited Partnerships, high yield bonds, and energy stocks that reach attractive valuation levels from a risk/return/yield perspective.

Fasten Up

Volatility, unfortunately, should persist as markets adjust to continued Fed interest rate hikes, assess the strength of global growth and digest worldwide geopolitical issues. We enter 2016 in a mid-to-late cycle bull market with more fairly valued markets—two conditions that typically encourage volatility. While volatile markets by nature are never comfortable, they do create opportunities for disciplined investors to capitalize on short-term mispricing and to rebalance equity positions by pulling money from assets that have done relatively well and deploying those proceeds into undervalued assets.

When combining this expected volatility with our modest outlook for U.S. stocks and a more challenging fixed income environment, alternative asset classes such as absolute return and managed futures might deserve a fresh look. As the saying goes, “you own bonds and alternatives so that you can own equities.” This phrase may prove especially true in 2016.

Stay the Course

At times in life, it is necessary to go back and forth in order to eventually move forward. The markets in 2016, just like my flight so many years ago, may be one of those times where patience and discipline are necessary to endure subpar returns and capitalize on value opportunities. Sustained global growth is likely to continue in 2016 as we enter the seventh year of our projected eight-year expansion. Given this backdrop, expect modest equity returns with developed economies outpacing emerging markets, modestly higher interest rates across the maturity curve and persistent volatility. And let's not forget that 2016 is also a presidential election year, bringing unique challenges as markets react to the latest polls, tweets and stump speeches from the candidates. In the end, sticking to your flight plan, or in this case your long-term investment plan, will help you reach your intended destination.



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