Market Perspective

Q42016

All data and information as of September 30, 2016
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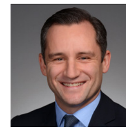

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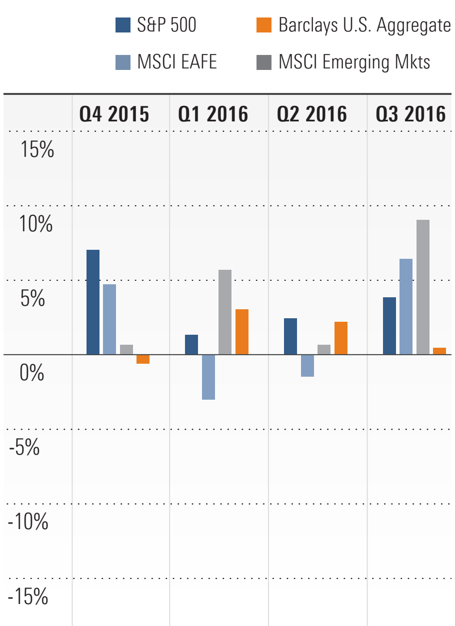
Quarterly Index Returns



Returns %	Q4 '15	Q1 '16	Q2 '16	Q3 '16
U.S. Stocks				
S&P 500	7.04	1.35	2.46	3.85
Int'l Stocks				
MSCI EAFE	4.71	−3.01	−1.46	6.43
Emerging Markets				
MSCI Emerging Mkts	0.66	5.71	0.66	9.03
Bonds				
Barclays U.S. Agg.	−0.57	3.03	2.21	0.46

Global stock markets rallied in 2016's third quarter, as fears related to Britain's vote to leave the European Union were eased by additional support from policy makers and a growing belief that any economic damage would take time to surface and likely be more modest than commonly forecasted. Emerging-markets equities led the rally with a 9.03% quarterly gain.

Can you feel the pot warming?
Our colleague John Owens wrote this quarter to investors in the Morningstar® Managed Porfolios℠ Select Stock Basket series he oversees about the parable of the boiled frog. At the risk of sounding unoriginal, we'll repeat it for your benefit: A frog will immediately leap from a pot of boiling water, but if you put a frog in a pot of cold water and gradually warm it, you'll eventually have a boiled frog.

John Owens, CFA, who is a senior portfolio manager and head of equity strategies at Morningstar Investment Management LLC, isn't a mean-spirted person, nor does he have anything against frogs. He shared this tale to illustrate a behavioral mistake investors can make—namely, ignoring slow-building risks (like a warming pot). Some investors may look at the relative calm in the stock markets, see that stocks are comfortably ahead for the year so far, and conclude that it's a good time to maintain full exposure to U.S. stocks.

However, we keep our eyes on the fundamentals, and for the past five quarters, earnings have been weak and valuation levels have grown more expensive. When stock prices are high relative to their long-term earnings power, we become concerned, regardless of any positive momentum the market may have.

So the U.S. stock pot is warming, but it's not the only pot out there for multi-asset investors. Unfortunately, the U.S. bond pot also appears to be quite warm. Investors have bid up prices of long-term bonds so much that returns on bonds over the next decade or so almost

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assuredly will be low. We recognize these potential risks, and we're doing what we can to avoid becoming cooked frogs.

Two Options

Investors facing warming pots have two ways out, as we see it: cool off the pot, or jump out.

We have made "cooling off" moves within our portfolios. For example, we are underweight equities overall and especially U.S. stocks because prices on stocks outside the U.S. are much more attractive than those for domestic stocks. We've also lowered interest-rate risk in U.S. bonds because we don't think the risk of higher rates is worth slightly higher yields that can be earned in longer-term bonds.

To be clear, we're not calling the top or timing the market; we are adjusting our portfolios away from richly priced assets and moving into more attractive ones. Our investment approach focuses on buying underpriced but fundamentally strong assets, which may benefit our portfolios in two ways. First, buying low protects somewhat against price declines, as the difference between an asset's price and intrinsic value usually can get stretched only so far before the market spots a bargain and prices bounce back. Second, paying less (or getting more than you paid for) has historically improved chances for better returns in the long run. Of course, buying assets at attractive prices doesn't immunize us from market declines; but as long-term investors we believe it can help position us for the long-run.

Another way to possibly cool the pot is to review your portfolio with your advisor to ensure you're taking an appropriate amount of risk. This isn't an invitation to try to time markets; instead, it's a reminder to check in with your advisor and re-examine your risk tolerance profile. It may be that you're five years older than when you last checked in, five years closer to retirement, and you may be ready for a portfolio adjustment. U.S. stocks have climbed about 275% through August since March 2009, and, as we mentioned, they're a lot more expensive now. If you're going to rebalance out of stocks, doing so when valuations are rich typically makes more sense than doing so when they're cheap.

Jumping Out

What doesn't make sense in our opinion is selling out of stocks entirely. This might seem like a way for an investor to jump out of the pot and avoid being cooked. But there's a risk to that, too. Global growth could strengthen and drive earnings and stock prices even higher, which would tempt many to get back in after missing substantial gains. And even if the move out of stocks proves well-timed, investors will profit only if they also pick the right time to get back in. That's why we think it's so hard to make market timing work. Instead, we believe investors should stick with the investment plan you've worked out with your advisor. We'll try to keep the frog cool.

Thank you for your consideration.

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Index Information

Individual index performance is provided as a reference only. Each index is unmanaged and is not available for direct investment. Since indexes and/or composition levels may change over time, actual return and risk characteristics may be higher or lower than those presented. Although index performance data is gathered from reliable sources, we cannot guarantee its accuracy, completeness or reliability. Index data sources are as follows.

S&P 500 Index—An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. The S&P 500 is a market value weighted index.

MSCI EAFE Index (Europe, Australasia, Far East)—A free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. & Canada.

Barclays U.S. Aggregate Index—A market value weighted performance benchmark for investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities, with maturities of at least one year.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

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