Trumbower Financial Advisors, LLC
3rd Quarter 2016
Investment Market Commentary

"Curb Your Enthusiasm"

"Happy Days" are here again for Small Cap US and Foreign equities. Leadership shifted in our "Homeland" away from Large & Mid Caps during Q3 (up +3.85% & +4.14%) to Small Caps (up +9.05%). YTD investors are still "Bewitched" by Mid Caps (+12.4%) but the spread over Small Caps narrowed to ~ 1%.

Foreign equities, once "The Walking Dead," came back to life as Developed Markets rose +5.8%. Emerging Markets continued their ascent from "Six Feet Under" to finish the quarter and YTD up +9.03% & +16.02%. Improving fundamentals and stabilizing commodity prices are just two factors that garnered favor for the volatile asset class.

Short-Term US Treasuries, measured by the Barclays 1-5 Year Index, dipped slightly during Q3. Prices remain higher YTD despite yields worthy of a trip to the "ER". As low as they are, rates offered by US bonds are far superior to overseas issues. Nearly $12 trillion of foreign paper boasts negative yields – but that hasn't stopped "Mad Men" from chasing after them.

"Desperate Housewives" rummaging for positive returns continue to plow capital into the stock market. More than 7 years into a bull cycle the S&P 500 has surpassed its previous "Twin Peaks" (3/2000 & 10/2007). Nervous Nelly's caution investors to "Get Smart" pointing out that the trailing average price-to-earnings "PE" ratio of the Index constituents hovers around 24 compared to an 80-year average of ~16. "True Detectives" may observe evidence that low interest rates can support higher PEs. This relationship was pretty clear during several periods in the 1970's and 1980's - less so since the turn of the century. Using

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3rd Quarter Equity Market Results

	3rd Qtr. % Chg.	12-mth. % Chg.
S&P 500	3.85	15.43
S&P 400	4.14	15.33
Nasdaq	10.02	16.42
Russ 2000	9.05	15.47
MSCI EAFE	5.80	3.48
MSCI Emg	9.03	16.78

The Index Olympics

Last quarter we sank our teeth into the variety of methodologies adopted by major equity index providers. We observed enough potential divergence in performance to extend this research into an examination of Blend, Growth and Value style subsets within domestic asset classes defined by market cap, as well as Developed Foreign equities.

The contingent of stock index providers included S&P, Dow Jones, Russell, MSCI, Morningstar and CRSP. Data spanning 20 years or more is available for all but CRSP which offers back tested statistics beginning in 2001.

We compared rolling returns over 1, 3, 5 and 10 years from February 1995 through July 2016. Using the popular Russell series as a control in the US equity stadium, we observed the frequency with which the others performed better.

S&P and Russell Share the Large Cap Podium

In the Large Cap Growth subset, S&P topped Russell ~60% of the time over all periods and performed progressively better over longer terms. CRSP showed promise over its shorter history beating Russell in 69% of 10 year periods. Its largest advantage, however, was only 0.89%. S&P was 4 times more likely to beat Russell by 1% than to trail by 1% over 5 years and never lagged by 1% or more in any 10 year stretch.

A different story emerged in the Large Cap Value space. Russell experienced more favorable outcomes at least 61% of the time compared to S&P, Morningstar and MSCI over all periods and was unbeatable in all 10 year cycles. S&P, Morningstar and MSCI trailed by 1% or more in 47%, 83% and 45% of those trials. CRSP compared slightly better than the rest of the competition but Russell held on to the Large Cap Value gold medal.

The test group of Large Cap Blend indexes trailed the Russell 1000 most of the time. Over longer periods Russell dominated MSCI, Dow Jones and Morningstar offerings. None of them beat Russell over 10 years and trailed by more than 1% in 47% to 73% of the trials. The S&P 500 came out on top in only 17% of 5 year rolling periods and failed to beat Russell over 10 year durations.

Remember Russell divides the universe of equities into larger overlapping subsets, and the Russell 1000 Large Cap proxy includes the smallest stocks that also make up its Mid Cap index. We believe the presence of higher flying Mid Caps explains Russell's superior long-term returns, but it also means that using the 1000 for exposure to Large Cap US equities will unavoidably overweight Mid Cap allocations. The more tightly constructed S&P 500 trailed Russell by ~0.30% on average over 5 and 10 years but never by more than 1%. Since Russell's advantage over the S&P 500 Large Cap has been minimal and the choice to use Russell as a Large Cap Value proxy was clear, we decided to stick with S&P as our core passive Large Cap Blend position.

S&P Dominates Mid Cap US Arena

When the goal is a focused US Mid Cap equity allocation, S&P took gold on the Growth podium. It topped its Russell counterpart in 59% of 1 year trials progressively improving to 96% over 10 years. The advantage was 1.98% on average and it overtook Russell by more than 3% in 39% of 10 year rounds while never trailing by more than 1%.

The competition was more intense in the Mid Cap Value match. The also-rans, Morningstar, CRSP and MSCI rarely excelled over longer periods and the latter ended up trailing by more than 1% in 73% of 10 year trials. Russell came out ahead in a slim majority of 1 and 3 year intervals, but S&P's Value basket came out ahead 60% of the time over 5 year passes. The likelihood of winning by more than 1% was narrowly in S&P's favor for short/intermediate time frames but its experience over 10 year innings tipped the scale.

Mid Cap Blend heats turned into a one index show. S&P won in 53% of 1 year periods ratcheting up to 88% of 10 year runs. The advantage was skewed heavily in S&P's favor as it overtook the Russell by more than 1% in 47% of 5 and 10 year tenures while trailing by more than 1% in only 11% of 5 year and none of the 10 year stints.

Small Cap Contenders Battle it Out

Russell 2000 Growth set a low hurdle on the Small Cap Growth field. S&P and MSCI both topped Russell substantially and repeatedly in 3, 5 and 10 year tenures. MSCI blew past the Russell by 1% in 84% of 5 year periods and 100% of 10 year terms. S&P came in

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second topping Russell by 1% or more in two-thirds of 5 and 10 year trials. Morningstar stumbled in all periods and never beat Russell in more than 50% of our tests. CRSP could have been a strong contender, but actual data was limited and we are unable to confirm the validity of back tests. Although MSCI theoretically won the competition, it is not currently replicated by any ETFs. We are, therefore, sticking to the silver medal winner, S&P 600 Growth.

Competition was fierce among the Small Cap Value challengers. If the hypothetical data is reliable, the CRSP took top prize trouncing the Russell by an average of 2.7% in 100% of the ten year test periods. We have disqualified it, however, until more actual historical statistics are earned. Morningstar and MSCI won over Russell in more than 80% of 5 year cycles and 94% of 10 year periods.

S&P was less consistent but still appealing having overtaken Russell in 63% and 56% of those respective shifts. S&P exhibited the widest spread over 10 year rounds outdistancing Russell by more than 1% 35% of the time and never trailing by more than 1%. On average S&P delivered almost 50 basis points more than Russell over longer spans. In any event, MSCI does not currently have an ETF sponsor since Vanguard opted to change its underlying Small Cap Value index to CRSP in 2013. Morningstar has ETF representation but its average daily trading volume is just 4% of iShares S&P Small Cap 600 Value – too small to seriously consider at this time.

Further research confirmed the Russell 2000 woes that we highlighted last quarter. The other Small Cap Blend indexes overwhelmed the Russell more than 64% of the time in 1, 3 and 5 year periods. Over 10 years, every competitor defeated Russell in every run. The S&P advantage was more than 1% in 87% of the trials and it outperformed Russell by an average of 1.84% in rolling 10 year courses.

MSCI Dethroned by S&P Internationally

In the game for over 40 years, MSCI's EAFE was widely deemed the preeminent indicator of Developed Foreign equity markets. It represents 21 countries in Europe, Australiasia and the Far East and excludes the US and Canada. Its 925 constituents have an average market cap of over $31 billion. We have used the EAFE ETF clone to provide passive Developed Foreign participation for many years but it was time to see if preferable alternatives exist.

Using the EAFE as a control we tested MSCI EAFE IMI - an "All Cap" version of the classic with over 2,500 positions and an average market cap of $21 billion; S&P Developed exUS BMI – a 1,260 member index with average market cap of $23 billion; FTSE Developed exUS, FTSE Developed exUS All Cap and Russell Developed exUS. The FTSE indexes have shorter histories but the others go back to at least 2001.

Country allocations for the EAFE and EAFE IMI are nearly identical. They differ principally in that IMI includes smaller companies – valuable when it doesn't make sense to add concentrated market cap specific positions to an International portfolio allocation. The S&P BMI also welcomes smaller companies and it includes both Canada and South Korea. This is an important distinction because our Emerging Market ETF has bumped South Korea up to Developed status so it is left out of portfolios that rely on EAFE for core Foreign equity exposure.

The EAFE proved to be an easy mark. Russell, IMI and S&P outpaced it in 91%, 81% and 86% of 5 year trials. IMI beat in 85% of 10 year periods but never by more than 1%. Meanwhile, S&P and Russell held top billing 100% of the time at a premium of more than 1% in 35% of 10 year rounds. The FTSE trailed consistently over longer periods and the FTSE All Cap has very limited history.

There are no ETF clones for the Russell at this time but the SPDR World exUS ETF has been around since 2007. The SPDR is pricey at 0.34% compared to the IMI ETF at 0.08%, but its underlying index returned an average of ~0.50% more over 5 and 10 years and lead by 1%+ more 10% of the time while rarely trailing. A greater degree of country diversification translated into lower volatility for the SPDR over the last 5 years also justifying the cost.

Our work has identified historical winners and there are plausible reasons why some indexes should remain more competitive than others. The past never guarantees the future so we have carefully considered fees and income tax consequences before recommending replacements. At the risk of a little fund proliferation, we suggest using preferred versions going forward. We also know that fashioning and maintaining investable market index securities is a work in process and we will continue to monitor their evolution.

Enthusiasm

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lower discount rates in fundamental valuation models will boost price expectations, but there are other actors on the set. Quantitative easing and voracious demand for Treasuries has artificially stifled interest rates and may distract historical tendencies to revert toward a mean.

Using an index average PE to assess overall market saturation masks the impact of plummeting oil prices on aggregate corporate profits. In 4 of the past 5 quarters S&P 500 earnings growth, excluding energy, would have been positive. Bulls think a more stable dollar and baby steps toward oil price recovery should send "Cheers" to equity investors. There is also a huge stockpile of cash sitting on the sidelines – some in out of favor hedge funds – that could prove to be a powerful force if and when it hits the Street.

No doubt, dividend greed is responsible for heating up utilities, staples and REITs. The last Fed Funds uptick had virtually no impact on longer-term rates, so even if it pops up another quarter point the rally in these sectors and widespread yield-driven appetite for stocks could persist. Prices have also been supported by corporations using cheap debt to buy back stock - instead of investing in growth opportunities.

To sum it up, EITHER stocks are not as overpriced as they might appear and investor enthusiasm is justified by positive fundamentals lurking beneath superficial averages, OR equity values are nothing but a "House of Cards" built on a foundation of genetically engineered rock bottom interest rates and an absence of desirable alternatives.

The FOMC "Arrested Development" in September and held rates steady. They acknowledged brisker economic activity but voiced concern about frozen personal incomes and the fact that plentiful household spending has been financed by devilishly low cost debt. They decided to wait for stronger signs of sustainable progress. Many believe a November hike is out of the question due to the impending transition in "The West Wing" but expect a December move.

Engrossed in mudslinging, our Presidential candidates seem to have ignored an elephant in the room. US National Debt stands at 75% of GDP – a 100% increase since "The Wonder Years" of 1999 – and is projected to continue along this trajectory. Aging demographics (higher entitlements and health care expenses) and ultimately an increase in the cost of debt service will pile on the load. Resources devoted to this kind of spending do little to stimulate growth. If Congress remains deadlocked it may be impossible to inject enough fiscal jet fuel into the system to offset the "Facts of Life" on a debt treadmill. This will become a crisis someday, but for the time being it has taken a backseat to back stabbing.

So far, the overseas "Entourage" appears to be muddling through. Many experts believe Chinese leadership is getting the hang of it – avoiding sharp dips and spikes – just in time for a regime change when over half of the Politburo retires next year. The reigns on the tethered yuan have been loosened and it floated down closer to fair value without sparking a global hullabaloo. The Chinese economy is far from home free but there are hopes that a new cast will implement structural reforms necessary to continue decelerating, graciously.

So why does the Deutsche Bank debacle feel "Too Close to Home?" Facing a $14 billion penalty by the US Dept. of Justice for "Breaking Bad" with Mortgage Backed Securities leading into the 2008 financial crisis, DB's stock and bond prices cratered. Their $60 trillion book of derivatives will keep Justice from forcing the bank into insolvency as the impact on global credit markets would be cataclysmic. However, the incident has focused attention on the shoddy state of European bank capital. Regulations were proposed that could curtail lending further diluting the effectiveness of the EU's monetary stimulants. US home owners may feel the punch more immediately as the fall out nudged the London Interbank Offer Rate up. Three-month LIBOR, the base rate for many US mortgages, is .5% higher over the past year. If the trend continues it could upset the US housing market and constrict consumer spending.

Rumor has it that October is a scary month for investors. Statistics dating back to 1950 show average October index declines in election years range from -.7% to -2.6%. But the truth is that September has heralded more "Black" days. We aren't superstitious and highly skeptical of averages. Without condoning full out market timing, however, those with enviable equity returns and limited time horizons might want to curb their enthusiasm and keep some profits "All in the Family".

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