

SIGNATUREFD

WINTER 2016

MARKET SENSE: 2015 Year-End Review



With final results in place for 2015, it is clear that the defining emotions for the year were indecision and confusion. The world is going through several important changes, and investors, who by definition have to discount likely future outcomes, are conflicted on how to process these changes. We identify the following key factors that investors are considering to make our point:

- First, after several years of *abnormally* calm market conditions fostered by central bank activity, volatility returned in 2015. The first eight months of 2015 were a continuation of the steadily rising equity prices that started in 2012. With a gradually improving economy in the U.S. and a continual drip of Federal Reserve liquidity, markets were historically smooth. This abruptly changed in August with currency shifts in China and the realization that Federal Reserve rate normalization was imminent. From August forward, volatility moved higher and has, on average, been about 50% above levels that existed during the prior three years.
- Second, not only did volatility increase, but the volatility exhibited wild swings into and out of positive territory over the course of the year. In fact, the S&P 500 market crossed the flat line (i.e., the January 1 starting point) 30 times in 2015, a new record dating back to 1926. This underscores the indecision by investors.
- Third, no major asset classes helped a diversified portfolio offset this increase in volatility. Global equities, commodities, real estate and long maturity bonds all produced negligible results (low single-digit gains or losses). A report by Societe General pointed out that it was the first time in 78 years that none of these asset classes produced double-digit returns.
- Finally, the only assets that did perform well could present a dangerous trap for investors who chose to chase them. A select group of stocks—FANG (Facebook, Amazon, Netflix and Google)—produced outsized returns as investors chased momentum. On average these stocks returned more than 60% last year. Most of the returns for these stocks were driven not by fundamental corporate performance, but rather multiple expansion. Essentially the stocks were getting more expensive relative to their financial metrics. Since 2012 the price/earnings multiple of these stocks has nearly tripled, rising from 20 to nearly 60.



MOST INVESTORS RECOGNIZE THAT EMOTIONALLY DRIVEN DECISIONS AT THE EXTREMES OF FEAR AND EUPHORIA CAN BE CATASTROPHIC TO A LONG-TERM INVESTMENT PROGRAM.

We understand the urge for change at a time when markets are churning and giving investors little hope for near-term improvement. In some ways a flat market is the most difficult for investors to understand and can cause one to ask: “Should I disband a diversified approach in hopes of generating any type of positive return now?” We will touch on this question next. Before doing so, it may be helpful to review the table of major market returns in the chart below for context of the year just finished.

| | 4th Quarter | 52 Weeks |
|--|-------------|----------|
| S&P 500 | 7.04 | 1.38 |
| Dow Jones Industrials | 7.70 | 0.21 |
| MSCI EAFE (International) | 4.71 | -0.81 |
| MSCI EM (Emerging Markets) | 0.66 | -14.92 |
| Bloomberg Commodity | -10.52 | -24.66 |
| Barclays Global Bond (Global Bonds) | -0.92 | -3.15 |
| Barclays U.S. Aggregate (Taxable Bond) | -0.57 | 0.55 |
| Barclays 5-Year Muni (Tax-Free Bonds) | 0.66 | 2.43 |
| HFRI Fund of Funds Composite Index | 0.62 | -0.39 |

KEY INVESTOR ATTRIBUTES FOR A VOLATILE MARKET

Most investors recognize that emotionally driven decisions at the extremes of fear and euphoria can be catastrophic to a long-term investment program. However, we would also suggest that similar decisions made at a time of flat market results and economic confusion could also be similarly damaging to long-term results. We would suggest that the following three critical components to an investment plan represent the only time-tested way to achieve long-term financial objectives:

1. Designing a portfolio that minimizes the potential for permanent loss of capital
2. Understanding and having confidence in the source of long-term results from investments
3. Having a robust process for allocating capital in order to avoid emotional decisions

The word *risk* is a confusing one for investors. The core of investment academia uses a statistic called volatility to define risk. The foundation of most analytical work in investing is driven by a structure

called mean-variance optimization. Reaching back to your days of studying statistics, this is the old “bell curve” math. It is about placing values for the average or mean from data (the middle of the bell curve) and the standard deviation (uncertainty of outcomes) around that number. On a short-term basis we also think investors react emotionally to this same volatility figure.

By simply gauging investor sentiment and behavior at times when markets are moving violently, one assumes investors become less risk-taking. The reality is that investors react to short-term events but have investment time horizons of years or decades. Over this longer period of time, the biggest risk is really permanent loss of capital. There are fundamentally two ways that an investor can incur permanent loss of capital: improper diversification and changing portfolio strategy at market extremes. The concept of diversification makes complete sense, but it is harder to practice than most are willing to admit. Our imperfect brains make us fall prey to behaviors that are contrary to diversification: following the herd, hindsight bias, overconfidence, confirmatory bias and lack of patience. The phrase “buy low, sell high” is one of the most widely said but least followed keys to market success. Our brains are wired to do the opposite, favoring fight-or-flight responses rather than pursuing a disciplined plan. We feel safety in doing what everyone else is doing, and we search out information that confirms bias that is predetermined in our mind. We also recall actions we wanted to take that would have led to success, but forget the actions that would have failed. Finally, the \$1.5 billion Powerball of this month showed the human tendency toward “get rich quick” thinking even though the likelihood of being struck by lightning was 264 times the odds of winning. Even the world’s best investors are human and subject to these behavioral weaknesses.

But a sound investment philosophy and a constant questioning of decisions can help minimize many of these mistakes. First, an investor must practice discipline. Maintaining portfolio diversification across key asset classes, continuously trying to uncover areas of opportunity and maintaining a process of continual portfolio monitoring for rebalancing are methods we use to maintain discipline. Basing a portfolio design on the key long-term cash flow needs for an investor and regularly confirming this plan rather than focusing on the short-term implications of the inherently volatile portfolio should drive any structural portfolio change.

The second key to long-term success could be viewed as a faith-based question. Does an investor truly believe and have conviction that markets will deliver results similar to what they have done historically? At the end of this letter, we provide a chart that has become known as the *Periodic Table of Returns*. In this case we provide the results of eight core asset classes going back to the year 2000 as well as the return and volatility data for this 16-year period. This period covers two full economic and market cycles (expansion/recovery and bull/bear markets) and thus should be representative of the long term. In addition, even though much is made today of being in a low-return world, one could also point to the elevated valuations at the beginning of this period, which coincided with the peak of the Internet stock bubble. The end result is that all eight asset classes had positive results (returns ranging from 4% to 15%), and a simple portfolio with equal weights in all eight returned 7.1% over this time. The final observation is that the risk-adjusted return (the column titled “Sharpe”) of the simple diversified portfolio exceeded that of six of eight individual asset classes. It seems like an overly basic statement when asked about the future given all the apparent complexity and confusion in today’s world. But our answer is always the same: “We don’t know when or how the results will occur, but we fully believe that the next 16 years will provide results similar to those of the last 16.” Investors have to believe this at their core in order to overcome the behavioral risks we highlighted above.



TO IMPLEMENT A PLAN THAT MAINTAINS DISCIPLINE ABOUT DIVERSIFICATION, MANAGING EMOTION AND ACHIEVING HISTORIC RESULTS, AN INVESTOR HAS TO HAVE A ROBUST AND COMMITTED PROCESS.

This leads us to the final point. To implement a plan that maintains discipline about diversification, managing emotion and achieving historic results, an investor has to have a robust and committed process. At SignatureFD our investment team spends a significant amount of time studying and refining this process. We spend thousands of hours per year studying the analysis of a variety of investors and analysts. We look for outlier opinions that can shift our views. We take time in making tactical portfolio shifts in order to reduce the risks that we become subject to our own emotion. We follow preset processes in our manager due diligence work as we make decisions about how to allocate capital to underlying strategies. As a client you can have confidence that we recognize the three key attributes discussed above and are committed to adhering to them and constantly improving as new information is received.

BASE-CASE VIEW OF 2016

In our *News or Noise* piece on December 21, we quoted Dwight Eisenhower: “In preparing for battle, I have always found that plans are useless, but planning is indispensable.” This sums up our views on investment strategy over quarterly and annual time periods. Investors are bombarded with TV talking heads who often gravitate to both positive and negative hyperbolic forecasts. It appears rational to react to these dire warnings or overly optimistic predictions, but one must remember that these forecasts are often outlier possibilities. The reality is that the world most often conforms to a more middle-of-the-road path. Our approach is to develop our baseline expectation but outline alternative scenarios that are less likely but potentially high impact. We identify trigger points to watch for the potential signs that these alternative outcomes are materializing.

When looking at the world today, we continue to try to differentiate the underlying fundamentals from the financial market reactions to typical noise. In a world with higher but, again, historically normal volatility, discerning between these two is arguably even more important. When looking at current fundamentals, one would conclude that things remain relatively solid. The U.S. economy remains a bright spot in a confusing world. Key indicators such as employment conditions, consumer confidence, auto sales and the service sector of the domestic economy remain upbeat. Areas such as manufacturing and exports have been negatively impacted by a strong dollar, but on balance, a base case should anticipate historically modest yet generally stable growth for 2016. Providing some potential upside is federal and local government spending, which has been a drag on activity for four years but, as forecast by the team at Strategas Research Partners, could provide 0.7% to gross domestic product (GDP) activity in 2016. A recent piece by Goldman Sachs chief strategist Abbey Joseph Cohen concluded that “the underlying performance of the U.S. economy is actually quite good ... [Recent volatility] is really very much an emotional response.”

Outside the U.S., risks remain elevated, but many indicators show improvement rather than deterioration. Ned Davis Research recently provided an outlook that during the fourth quarter, “the [global] leading indicator edged up modestly” after “declining for almost two years.” Moreover, the “country breadth also improved, indicating that the global expansion is broadening.” The takeaway from this data is that the global economy is likely to see sluggish below-trend growth but could come in better than current investor expectations. The center of the storm in recent years has been the changing dynamics of Chinese growth and the impact on several emerging economies, especially those dependent on exporting commodities to China. On this front, we remain more constructive than those with more negative outlooks, as objective data shows a growth slowdown in China that is likely in the advanced stages and numerous levers that can still be utilized by policymakers in that country to manage this transition.

Thus the basis for a positive investment climate in 2016 hinges on a couple of key assumptions. First, if fundamentals do turn out to be improving, then stabilization in currency and commodity markets is likely to form. We believe that if this comes about over the coming quarter, then investors will likely start dipping their toe back into emerging market equities. With stability in these areas, a more constructive view of the stability for growth in key developed markets such as the U.S., Europe and Japan is likely to be reinforced. After several months of selling global equities and other risk-based assets, investors are likely to shift gears and begin putting money to work. In short, if investors have been preparing for a worst-case outcome—Chinese-induced global recession—and this does not come about, then a return to positive market returns is likely to develop, potentially abruptly.

SOME FINAL THOUGHTS

If the above is a base case, then we still have to recognize the obvious risks and be prepared to adapt if trends veer in a more ominous direction. To be intellectually honest, investors have to be open to the possibility that new information will develop that necessitates a change of plans. Similar to the above quote by President Eisenhower, Winston Churchill said before D-Day: “Flexibility of mind will be one of the decisive factors.” And the great economist John Maynard Keynes famously said: “When the facts change, I change my mind.”

So what would cause us to change our views on this base-case scenario? Several key risks inherent in today’s investment puzzle come to mind:

Policy error: We are in a world where errors by policymakers are likely higher than normal. With global growth modest but below the historical trend, a major policy mistake could be enough to tip things in a negative direction. Two errors that could occur would be currency devaluation in China and an overly aggressive Federal Reserve in the U.S. Our base case is dependent on generally stable currency markets. The two recent bouts of financial panic have occurred over poorly executed changes in the management of the Chinese yuan. Each instance has resulted in devaluations of the yuan to the dollar by about 2–3%. Several well-respected investors have a thesis that a more significant devaluation is likely and have proposed a yuan devaluation of 10–30%. If the Chinese do undertake a major action like this, then ramifications to the global economy and markets would be significant. We continue to believe this is unlikely during a U.S. presidential election year and in the lead-up to the yuan inclusion in the International Monetary Fund special drawing rights basket, but the risk does remain. In the U.S., the market continues to have a more sanguine view of rate increases—expectations of two rate hikes vs. the stated four hikes by the Fed. We do believe that if the Fed acts more aggressively, then it could derail a fragile improvement in global growth.

Dollar liquidity: Somewhat tied to the risks of Fed rate increases, a strong dollar has been central to economic risks over the past two years. Global trade occurs mostly in dollars, and as a consequence of the current environment, trade has declined at a pace recently seen only in 1982 and 2009, two recessionary periods. If the dollar strengthens significantly, the tight monetary conditions in many parts of the world could spill over into financial markets, forcing deterioration in credit conditions in many countries.

Energy prices: Our base-case view is also dependent on the stabilization of commodity prices. Energy markets have been tightly linked to the strength in the dollar. It is likely a prerequisite for crude markets to begin drifting higher to see investor fears subside. Here we also have a more optimistic view than the consensus. The 60% decline in prices over the past two years has occurred due to a supply-demand mismatch of approximately 2 million barrels per day (on a base use of almost 100 million barrels per day). Given the changing dynamics in the industry, global supply growth is likely to be very low in 2016, and even modest global growth should see close to 2 million barrels per day of demand improvement. As such, the mismatch should close this year, which would support stabilization. If industry fundamentals or geopolitics cause further declines in price, then market downside could continue. This negative scenario is also linked to potentially destabilizing events—financial or political—in Saudi Arabia.

Credit and financial market health: In recent months, yields on lower-quality fixed income instruments have moved higher and the health of banks and financial institutions has deteriorated. At the moment, these are both showing elevated risks but stop short of predicting recessionary conditions. However, a further deterioration of conditions could be an indicator of a more negative outlook. Similar to stabilization in currency and commodity markets, these indicators need to start improving to confirm a more optimistic view.

Geopolitical risk: Finally, geopolitical risks are ever-present. Worries over the Middle East have existed forever and are impossible to quantify. However, two outlier geopolitical possibilities could be more detrimental to global economic improvement. First, a major escalation of engagement between Turkey and Russia could pull a broader set of countries into the deteriorating conditions in Syria and the wider Middle East. Second, an outright confrontation between the U.S. and China in the Pacific Basin would certainly be impactful. Finally, presidential elections in the U.S. and the U.K. referendum on the European Union are set for the fall, and early 2017 will see national elections in France and Germany. The advance of extreme candidates or a vote for “Brexit” remain risks.

CONCLUSION

This letter is longer than normal, and we appreciate those who take the time to read it fully. We recognize that investor concerns are elevated, and we wanted to address many of the issues on your mind. Our investment team objective remains to stay true to our discipline and stick to our systematic and proven approach to investing client capital. We remain open to all questions and comments, and thank you sincerely for your confidence and business.

SignatureFD Periodic Table of Returns

Calendar Year Returns

| 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| Bloomberg Commodity | DJ US Select REIT | Bloomberg Commodity | MSCI EM | DJ US Select REIT | MSCI EM | DJ US Select REIT | MSCI EM | Barclays US Agg Bond |
| 31.8% | 12.4% | 25.9% | 55.8% | 33.2% | 34.0% | 36.0% | 39.4% | 5.2% |
| DJ US Select REIT | Barclays US Agg Bond | Barclays US Agg Bond | Russell 2000 | MSCI EM | Bloomberg Commodity | MSCI EM | Bloomberg Commodity | HFRI (Hedge Fund) FOF |
| 31.0% | 8.4% | 10.3% | 47.2% | 25.6% | 21.4% | 32.1% | 16.2% | -21.4% |
| Barclays US Agg Bond | HFRI (Hedge Fund) FOF | DJ US Select REIT | MSCI EAFE | MSCI EAFE | DJ US Select REIT | MSCI EAFE | HFRI (Hedge Fund) FOF | Diversified Portfolio |
| 11.6% | 2.8% | 3.6% | 38.6% | 20.3% | 13.8% | 26.3% | 10.3% | -32.3% |
| HFRI (Hedge Fund) FOF | Russell 2000 | HFRI (Hedge Fund) FOF | DJ US Select REIT | Russell 2000 | MSCI EAFE | Russell 2000 | MSCI EAFE | Russell 2000 |
| 4.1% | 2.5% | 1.0% | 36.2% | 18.3% | 13.5% | 18.4% | 11.2% | -33.8% |
| Diversified Portfolio | MSCI EM | Diversified Portfolio | Diversified Portfolio | Diversified Portfolio | Diversified Portfolio | Diversified Portfolio | Diversified Portfolio | Bloomberg Commodity |
| 2.7% | -2.6% | -3.0% | 30.8% | 16.1% | 12.8% | 18.2% | 8.8% | -35.6% |
| Russell 2000 | Diversified Portfolio | MSCI EM | S&P 500 | S&P 500 | HFRI (Hedge Fund) FOF | S&P 500 | Barclays US Agg Bond | S&P 500 |
| -3.0% | -3.7% | -6.2% | 28.7% | 10.9% | 7.5% | 15.8% | 7.0% | -37.0% |
| S&P 500 | S&P 500 | MSCI EAFE | Bloomberg Commodity | Bloomberg Commodity | S&P 500 | HFRI (Hedge Fund) FOF | S&P 500 | DJ US Select REIT |
| -9.1% | -11.9% | -16.0% | 23.9% | 9.2% | 4.9% | 10.4% | 5.5% | -39.2% |
| MSCI EAFE | Bloomberg Commodity | Russell 2000 | HFRI (Hedge Fund) FOF | HFRI (Hedge Fund) FOF | Russell 2000 | Barclays US Agg Bond | Russell 2000 | MSCI EAFE |
| -14.2% | -19.5% | -20.5% | 11.6% | 6.9% | 4.6% | 4.3% | -1.6% | -43.4% |
| MSCI EM | MSCI EAFE | S&P 500 | Barclays US Agg Bond | Barclays US Agg Bond | Barclays US Agg Bond | Bloomberg Commodity | DJ US Select REIT | MSCI EM |
| -30.8% | -21.4% | -22.1% | 4.1% | 4.3% | 2.4% | 2.1% | -17.6% | -53.3% |

SignatureFD Periodic Table of Returns (Continued)

| Calendar Year Returns | | | | | | | 16-Year Average | | |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Return | Risk | Sharpe |
| MSCI EM | DJ US Select REIT | DJ US Select REIT | MSCI EM | Russell 2000 | DJ US Select REIT | DJ US Select REIT | DJ US Select REIT | MSCI EM | Barclays US Agg Bond |
| 78.5% | 28.1% | 9.4% | 18.2% | 38.8% | 32.0% | 4.5% | 12.2% | 22.7% | 1.01 |
| MSCI EAFE | Russell 2000 | Barclays US Agg Bond | MSCI EAFE | S&P 500 | S&P 500 | S&P 500 | Diversified Portfolio | DJ US Select REIT | DJ US Select REIT |
| 31.8% | 26.9% | 7.8% | 17.3% | 32.4% | 13.7% | 1.4% | 7.1% | 22.7% | 0.55 |
| Diversified Portfolio | MSCI EM | S&P 500 | DJ US Select REIT | MSCI EAFE | Barclays US Agg Bond | Barclays US Agg Bond | Russell 2000 | Russell 2000 | Diversified Portfolio |
| 28.6% | 18.9% | 2.1% | 17.1% | 22.8% | 6.0% | 0.6% | 6.6% | 20.1% | 0.47 |
| DJ US Select REIT | Bloomberg Commodity | Russell 2000 | Russell 2000 | Diversified Portfolio | Russell 2000 | HFRI (Hedge Fund) FOF | MSCI EM | MSCI EAFE | HFRI (Hedge Fund) FOF |
| 28.5% | 16.8% | -4.2% | 16.3% | 11.3% | 4.9% | -0.4% | 5.5% | 17.3% | 0.35 |
| Russell 2000 | Diversified Portfolio | Diversified Portfolio | S&P 500 | HFRI (Hedge Fund) FOF | Diversified Portfolio | MSCI EAFE | Barclays US Agg Bond | Bloomberg Commodity | Russell 2000 |
| 27.2% | 15.7% | -4.3% | 16.0% | 9.0% | 4.5% | -0.8% | 5.4% | 16.9% | 0.33 |
| S&P 500 | S&P 500 | HFRI (Hedge Fund) FOF | Diversified Portfolio | DJ US Select REIT | HFRI (Hedge Fund) FOF | Russell 2000 | S&P 500 | Diversified Portfolio | MSCI EM |
| 26.5% | 15.1% | -5.7% | 11.6% | 1.2% | 3.2% | -4.4% | 4.1% | 15.2% | 0.27 |
| Bloomberg Commodity | MSCI EAFE | MSCI EAFE | HFRI (Hedge Fund) FOF | Barclays US Agg Bond | MSCI EM | Diversified Portfolio | HFRI (Hedge Fund) FOF | S&P 500 | S&P 500 |
| 18.9% | 7.8% | -12.1% | 4.8% | -2.0% | -2.2% | -4.9% | 3.5% | 15.1% | 0.22 |
| HFRI (Hedge Fund) FOF | Barclays US Agg Bond | Bloomberg Commodity | Barclays US Agg Bond | MSCI EM | MSCI EAFE | MSCI EM | MSCI EAFE | HFRI (Hedge Fund) FOF | MSCI EAFE |
| 11.5% | 6.5% | -13.3% | 4.2% | -2.6% | -4.9% | -14.9% | 2.3% | 5.1% | 0.12 |
| Barclays US Agg Bond | HFRI (Hedge Fund) FOF | MSCI EM | Bloomberg Commodity | Bloomberg Commodity | Bloomberg Commodity | Bloomberg Commodity | Bloomberg Commodity | Barclays US Agg Bond | Bloomberg Commodity |
| 5.9% | 5.7% | -18.4% | -1.1% | -9.5% | -17.0% | -24.7% | 0.8% | 3.5% | 0.02 |

The diversified portfolio is a simple equal weighted performance of the underlying index constituents. It should be considered for education purposes and should not be considered a representation of actual portfolio performance.

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The hypothetical diversified portfolio is a simple equal weighted annually rebalanced performance of the underlying index constituents. It should be considered for education purposes and should not be considered a representation of actual portfolio performance. The results reflect hypothetical, back-tested results, that were achieved by means of the retroactive application of an equal weighted asset class portfolio and, as such, the corresponding results have inherent limitations, including: (1) the portfolio results do not reflect the results of actual trading using client assets, but were achieved by means of the retroactive application of each of the referenced portfolios, certain aspects of which may have been designed with the benefit of hindsight; (2) backtested performance may not reflect the impact that any material market or economic factors might have had on the adviser's use of the hypothetical portfolio if the portfolio had been used during the period to actually manage client assets; and, (3) for various reasons (including the reasons indicated above), Signature's clients may have experienced investment results during the corresponding time periods that were materially different from those portrayed in the diversified portfolio.