# Stegent Equity Advisors Investment Letter

Stegent Equity Advisors, Inc. July 2016

## Second Quarter 2016 Key *Takeaways*

**U.S. markets were initially range-bound for most of the quarter until June, when the relative calm in global stock markets came to an abrupt end.** Upending most forecasts and taking world financial markets by surprise, the United Kingdom voted to leave the European Union on June 23. In the wake of the vote, British pound sterling fell 11% overnight against the U.S. dollar, its lowest level since 1985. The euro fell 2.4% to 1.10 versus the dollar. Global equities plummeted.

**Then in the week following Britain's historic vote, global equities rallied, despite still significant uncertainty regarding the economic, political, and financial market implications of Brexit.** When the dust had settled, developed international and European stocks remained in the red, while U.S. stocks edged into positive territory. The big winners in the quarter were emerging-markets stocks, which gained 2.6% and are now up 8.6% year to date.

**Before the Brexit vote, the big story in financial markets had been bonds, specifically negative yields on government bonds across the globe.** By month's end, the amount of government debt sporting negative yields had soared by nearly $1 trillion. Falling yields have been driven by economic growth concerns, central banks' interest rate policies and intervention in bond markets and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact.

**June Benchmark Returns (Preliminary)**

| Large Cap Benchmarks | Jun | 2Q | YTD |
|---|---|---|---|
| Vanguard 500 Index | 0.2% | 2.4% | 3.8% |
| iShares Russell 1000 | 0.3% | 2.5% | 3.7% |
| iShares Russell 1000 Growth | -0.4% | 0.6% | 1.3% |
| iShares Russell 1000 Value | 0.8% | 4.5% | 6.1% |
| **Mid-Cap Benchmarks** | | | |
| iShares Russell Mid-Cap | 0.5% | 3.2% | 5.5% |
| iShares Russell Mid-Cap Growth | 0.0% | 1.5% | 2.1% |
| iShares Russell Mid-Cap Value | 0.9% | 4.7% | 8.8% |
| **Small-Cap Benchmarks** | | | |
| iShares Russell 2000 | 0.0% | 3.9% | 2.4% |
| iShares Russell 2000 Growth | -0.4% | 3.4% | -1.3% |
| iShares Russell 2000 Value | 0.4% | 4.4% | 6.3% |
| **Other Benchmarks** | | | |
| Vanguard FTSE Developed Markets ETF | -2.0% | -0.1% | -1.9% |
| MSCI World ex USA Index | -3.0% | -0.8% | -2.6% |
| Vanguard FTSE Europe ETF | -4.0% | -1.9% | -4.0% |
| Vanguard FTSE Emerging Markets ETF | 4.9% | 2.6% | 8.6% |
| Vanguard REIT Index | 6.9% | 6.8% | 13.4% |
| Vanguard Total Bond Mkt Index | 1.9% | 2.3% | 5.5% |
| BofA Merrill Lynch U.S. High Yield Cash Pay | 1.1% | 5.9% | 9.3% |
| Vanguard Intermediate-Term Tax-Exempt | 1.4% | 2.1% | 3.8% |
| S&P/LSTA Leveraged Loan Index | 0.0% | 2.9% | 4.5% |
| Citigroup World Govt. Bond Index | 3.7% | 3.4% | 10.7% |

**While we do not expect a sharp rise in interest rates any time soon, at such low starting yields, expected returns for core bonds are extremely low.** Investors are earning very little (or actually *paying* via negative yields) for the safety of holding government bonds.

**Given current yields, valuations, and earnings fundamentals, we continue to view the return prospects of a "traditional" portfolio split 60/40 between stocks and bonds as poor. We believe the diversified portfolios we've assembled for our clients are well positioned to outperform ones that only feature traditional assets.** We saw strong performance for our flexible fixed-income strategies during the volatile quarter, with most of them beating the core bond index. Our alternative strategies positions also performed in-line with our expectations, fulfilling their role as important ballasts to our diversified portfolios when stock and bond markets overshoot.

**The quarter's market upheaval was yet another reminder that successful investing requires patience and the understanding that investing is part of a process, not a one-off decision, toward achieving your long-term financial goals.** There will be inevitable and unpredictable shorter-term market ups and downs along the way, and through these periods, it is our job to remain focused on the long-term objectives of our clients, maintaining a consistent investment discipline to guide our decisions over time.

## Second Quarter 2016 Investment Commentary

As the second quarter ended, investors could be forgiven for feeling both bruised and battered. In the aftermath of the Brexit vote, global financial markets initially hit the panic button. In the Brexit fallout riskier assets, especially equities, have been the most impacted by the vote. Overnight, stocks fell, bond yields dove and both the British pound and the euro swooned. We also saw the flight to safety typical at times like this, with U.S. Treasury notes, the U.S. dollar, Japanese yen, Swiss franc and gold all rising sharply.

The broad international developed market index ended the quarter down a slight 0.1%, and down 1.9% year to date, while the Europe-specific index fell 1.9% and 4% for the quarter and year to date periods, respectively. While equities started to rally less than a week after the Brexit vote, we haven't viewed that as an opportunity to take a breather. We continue to assess the short- and long-term impact, including the likelihood that central banks will intervene to support financial markets. We also expect potentially greater downside risk as investors, politicians, central bankers, and a host of others, digest recent events. However, we have conviction in our current target allocations with respect to Europe and do not believe this vote will materially affect companies' long-term cash-flow generation.

We have stayed in close contact with our fund managers, actively monitoring their market views and portfolio positioning. Like us, they are gauging the impact of recent events on short- and long-term valuations. Some have been using the market declines as an opportunity to add to positions. Many point to the unprecedented nature of the vote as a reason that making kneejerk predictions, and trading based on them, are really so much stumbling in the dark; a point with which we certainly agree. We've also taken comfort from the fact that though sharp, the declines we've seen in markets have so far been orderly (e.g., there have been no trading or market disruptions similar to those that took place at the onset of the financial crisis).

Addressing one of the most common questions our clients are asking, whether the current market volatility presents a buying opportunity, our quick answer is that it might. For now, equities have not

fallen to the point where we see a compelling benefit from adding to our position. Should further declines occur on the same order of magnitude as the ones in the first few days after Brexit, we may consider adding to our exposure.

And what about emerging markets? They held up well during the markets' post-Brexit panic, benefiting from expectations that the Federal Reserve will delay raising U.S. interest rates. Emerging-markets stocks finished the quarter up 4.9% and have gained nearly 9% year to date. Importantly, we continue to view our emerging-markets positions as having attractive long-term return potential given earnings growth trends and current valuation multiples, despite higher potential short-term downside risk.

We've talked about our expectation of a low return investment environment for some time now. The recent market weakness has not changed our view that U.S. stocks are unattractive from a valuation and expected return perspective. As this flight to safety continues (further driving down bond yields), and as central bankers gear up to add even more liquidity to reassure global equity markets, that also does not bode well for core bond returns.

There are several reasons why we believe the diversified portfolios we've assembled for our clients are well-positioned to outperform ones that only feature traditional assets. For one, we expect our tactical allocations to actively managed, flexible and unconstrained fixed-income funds as well as floating-rate loan funds and long dated US Treasuries to generate returns in excess of the core bond index. On the equity side, we believe our allocations to natural resource based stocks and emerging-market stocks could deliver upwards of double-digit returns over the next five years. We've also seen that our positions in alternatives like REITs and precious metals have performed well, and importantly are fulfilling their function as portfolio diversifiers. Lastly, as always, we will be proactive in taking advantage of compelling investment opportunities where we see temporary market mispricing and/or overreaction.

The bottom line is that we will continue to safeguard the assets clients place with us by sticking to our investment discipline of riding out short-term swings and only adding tactical exposure when our view of valuations and expected returns is warranted. In the short term, this kind of market volatility can certainly make for sleepless nights. However, we believe that overreacting to these market shocks is absolutely the wrong response for investors with a long-term investment focus. Running with the herd may sometimes seem like a safe option for some, but for us "this way madness lies."

If you would like to discuss recent market events or have questions specific to your portfolio, please don't hesitate to let us know.

And as always, we are grateful for the opportunity to continue to serve as your trusted advisor.

Loyd J. Stegent, President
Stegent Equity Advisors, Inc.