TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

October 2016

Quarterly Insights

EXECUTIVE SUMMARY

Stocks Rise In All Major Regions In Q3; Bonds Also Rise

In the Third Quarter, the domestic S&P 500 Index was up 3.85% and is up 7.84% through three quarters. In contrast to Q2, there was minimal market volatility. European and Japanese stocks recovered to the point of being slightly positive for the year. Emerging Markets led global markets in Q3 (+9.03%) and are leading through three quarters (+16.02%). The Barclay's bond index rose 0.79% and is up 6.16% year-to-date.

Remember The Baseline!

In the last 100 years, the US stock market has had an average annual return of 9.95% (the "baseline rate"). These returns have been remarkably consistent as measured over rolling 10-year periods of annual returns.

We observe many investors with long-term investment time horizons who bet against the baseline by going to cash - and by doing so, inevitably get hurt. We investigate why this happens, and what you can do to avoid repeating their mistakes.

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Third Quarter 2016

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Remember The Baseline!

Don't Bet Against The Baseline

The narrative on the current state of the stock market can be perplexing as TV personalities and friends tell us seemingly logical sounding stories that paint a picture of a market on the verge of collapse. "It's the longest bull market in history and it can't go on longer! Valuations are too high! There is no growth in the economy! Things will fall apart if Donald or Hillary win the election!" They all imply that the market is dangerous and action is needed to protect gains. The real danger of this type of commentary is that it obscures the single most compelling concept in forecasting market returns: the baseline rate.

In the last 100 years, the US stock market has had an annual return of 9.95% (the "baseline rate"). The century has endured two world wars, countless regional scuffles, assassinations of global leaders, nuclear detonations, recessions and depressions, impeachments, numerous scandals, asset bubbles, terrorism, and other external shocks. And yet the beat goes on: the baseline rate persists in a remarkably consistent fashion amidst countless times where it appears the world is falling apart. Let's look at rolling 10-year periods of annual returns for the S&P 500 Index. Virtually all decades have positive returns. Only 4 out of the last 90 rolling 10-year periods have had negative returns.

The Last 100 Years: Rolling 10-Year Annual Returns For The S&P 500 Index

Rolling 10-Year Period	Annualized Return	Total Return
2006-2015	7.31%	102.49%
1996-2005	9.04%	137.61%
1986-1995	14.84%	298.96%
1976-1985	14.33%	281.59%
1966-1975	3.27%	37.96%
1956-1965	11.09%	186.25%
1946-1955	16.69%	368.10%
Average Decade (The Baseline)	**9.95%**	**158.2%**
1999-2008	(1.4%)	(13.15%)
2000-2009	(0.96%)	(9.20%)
1929-1938	(0.87%)	(8.37%)
1930-1939	(0.04%)	(0.40%)

Betting against the baseline (going to cash) is a bad bet to take, and an increasingly bad bet the longer your investment time horizon. Why? You can't time the market. It is a virtual certainty you will miss periods of great returns while sitting in cash and dramatically reduce your long-term investment results. The frequency of great returns is shocking. Over the last 100 years, 3 out of 4 years have been positive and 37 years have seen 20%+ returns. The "prospective disaster" years that drive fearful investors to cash have been infrequent.

The Frequency Of Great Returns Over The Last 100 Years: Much Better Than You Think!

Annual Return	Frequency	Comments
<-40%	1	1931 Was The Worst Year: -43.3%
-20% to –40%	6	
0% to –20%	19	
0% to 20%	37	
20% to 40%	**33**	
>40%	**4**	1954 Was The Best Year: +52.6%

The Longer Your Investment Time Horizon, The Worse The Bet Against The Baseline

Investment time horizon drives optimal portfolio strategy. Life expectancy is the biggest factor in determining time horizon and it is likely longer than you think. Medical advances are increasing the number of years investors will be retired. According to Social Security Administration calculations, as age increases, the median age at death also increases. In other words, the probability of survival is conditional, not constant. Legacy considerations can also extend investment time horizon. For example, imagine an 80 year old investor who has more-than-adequate money for herself and wants to ensure her children inherit assets. In this scenario, the investment time horizon is greater than that of the individual.

Conditional Life Expectancy		
Age	**Male Life Expectancy**	**Female Life Expectancy**
50	27.3 years	30.7 years
60	19.8 years	22.5 years
70	13.5 years	15.4 years
80	8.3 years	9.3 years
90	4.1 years	4.2 years

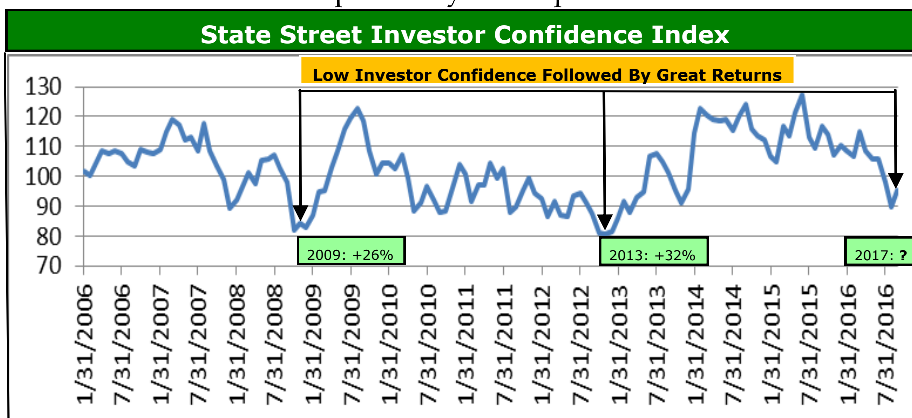
Most investors want to cash out when they feel the market is going to fall or in the midst a market fall. In doing so, they severely under-estimate their investment time horizon and disregard the baseline rate.

CASE STUDY 1 - 2008

Numerous investors fled the market during 2008, one of the worst years ever (the S&P 500 Index was down 37.00%). Many never came back. Cash may have felt good short-term: the rolling 10-year annualized S&P 500 return was –1.4% from 1999-2008 and –0.96% from 2000-2009 (see page 2). However, being in cash for a good part of the rolling 10-year period from 2006-2015 (a 102.49% total return) ruined many retirements.

CASE STUDY 2 - 2009 AND 2013

The State Street Investor Confidence Index captures the sentiment of institutional investors by analyzing their buying and selling patterns: the greater the percentage allocation to stocks, the higher the confidence level. The Index hit low points leading into 2009 and 2013. Investors feeling low confidence at these times stayed clear of the market. They paid dearly. The S&P 500 Index was +26.46% in 2009 and +32.39% in 2013. Right now, the Index is approaching another low point as evidenced by year-to-date mutual fund and ETF flows from stocks to bonds. Perhaps history will repeat itself and we will see a strong stock market in 2017.



Investment Company Institute Mutual Fund & ETF Flows ($ millions)		
	Stocks	**Bonds**
2014	$214,785	$94,472
2015	$95,908	$29,438
2016 YTD	($83,256)	$179,796

The best advice we give investors with long-term investment time horizons who say they are feeling nervous at the moment is to “stop feeling” and stick to the game plan with the highest probability of success - a disciplined approach to asset allocation that remembers the baseline.

The following section is reprinted from our Quarterly Insights April 2010 issue. At that time, 2008 was fresh in the minds of investors despite a +26.46% S&P 500 Index recovery in 2009 (see CASE STUDY 1 on page 3). Many investors disregarded the baseline, went to cash, and were irreparably damaged. This is happening again. Why? Behavioral Finance insight is just as relevant today as it was back then.

Behavioral Finance Offers Insight Into Why Individual Investors Are Avoiding Stocks

Much of financial theory is based on the notion that individuals act rationally and consider all available information in the decision-making process. However, there is a surprisingly large amount of evidence that this is frequently not the case. A field known as "behavioral finance" attempts to better understand and explain how emotions and cognitive errors influence investors and the decision-making process.

Over the last year, investors have over-weighted the probability of a bad event (ie. a significant market decline) and avoided stocks. Four factors explain investor fear in the midst of a rising market.

1. Representativeness

Investors typically give too much weight to recent experience and extrapolate recent trends. By doing so, they ignore or under-weight the "baseline".

2. Recency Effect

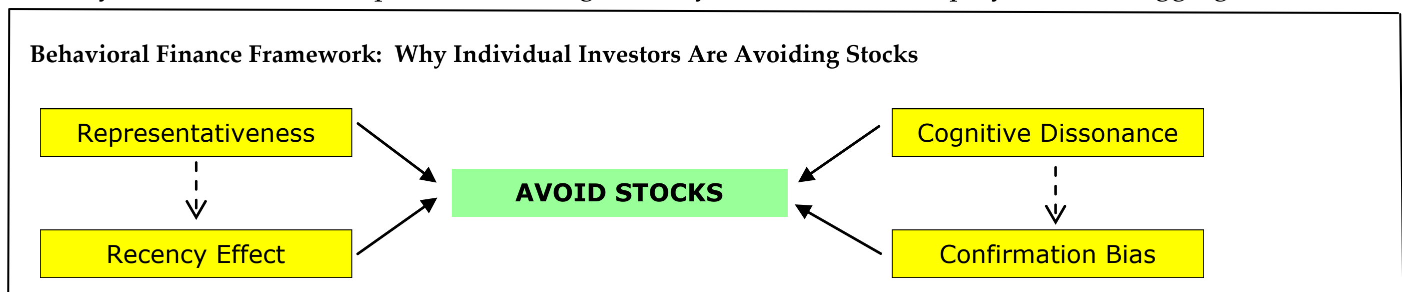
The Recency Effect is an example of Representativeness. Since investors got hurt in 2001, 2002, and 2008, the "recency" of the traumatic events causes them to over-weight the probability that it will happen again.

3. Cognitive Dissonance

Cognitive Dissonance is an uncomfortable feeling caused by holding two contradictory ideas simultaneously. For many investors, "good news" is inconsistent with their belief that the economy or the market is bad. They have consequently "tuned out" good news (such as positive economic indicators) to reduce their dissonance.

4. Confirmation Bias

Confirmation Bias is the effect of Cognitive Dissonance. Investors have "tuned in" any data that confirms their belief that conditions are bad. For example, the unemployment rate confirms to many investors that the economy and the market are poor, even though history tells us that unemployment is a lagging indicator.



CONCLUSION

If you are uneasy about the market, you are not alone. Perhaps this feeling has more to do with perception than reality. As a portfolio manager, we approach investing with as little emotion as possible. It is not always easy!

Stock Market Spotlight

Stocks Positive In All Major Regions In Q3

In the Third Quarter, the domestic S&P 500 Index was up 3.85% and is up 7.84% through three quarters. In contrast to Q2, there was minimal market volatility. European and Japanese stocks recovered to the point of being slightly positive for the year. The S&P 500 Index remains the leading developed market year-to-date. Oil prices fell 5% ($49.85 to $47.72 per barrel). Emerging Markets led global markets in Q3 (+9.03%), pushed by China (+13.92%) and Brazil (+11.31%) rather than Russia (+8.43%) and India (+5.92%). Year-to-date, Brazil (+62.9%) and Russia (+30.58%) have significantly driven Emerging Markets performance (+16.02%) .

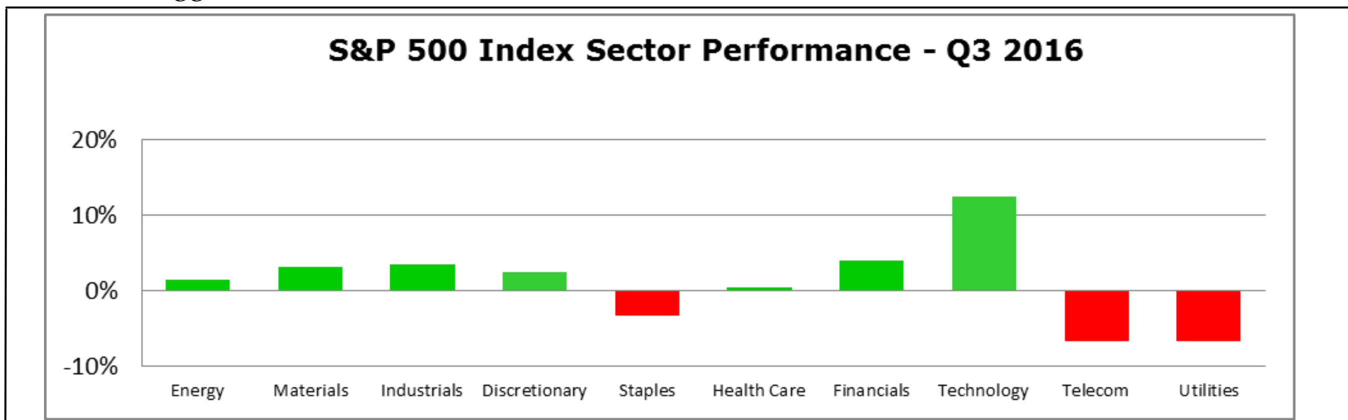
Equity Index Performance

Index	Q3 2016
S&P 500 (Domestic)	**3.85%**
MSCI EAFE (Foreign) *	**6.43%**
MSCI Emerging Markets	**9.03%**
MSCI EMU (European Monetary Union)	**7.78%**
MSCI Japan	**8.60%**

* Europe, Australia and the Far East

Technology Drives Sector Performance In Q3

Technology (+12.44%) dramatically led Q3 sector performance. Telecom (-6.60%) and Utilities (-6.72%) were considerable laggards.



2016 Interest Rate Sensitivity In Stocks: A Reversal In Q3

Interest rate sensitivity has been an abnormally large performance driver in 2016. Falling interest rates in Q1 and Q2 propelled the Telecom and Utilities sectors to leading heights (investors flocked to these sectors for high dividend yield) and hurt the Financials sector (due to a flattening yield curve). We saw a reversal in Q3.

We were surprised the Fed did not raise rates as it had signaled last December (see Quarterly Insights July 2016, Bond Market Spotlight). While Telecom and Utilities rose in Q1 and Q2, we did not like the attributes of companies in the Telecom and Utilities sectors entering the year and we still don't like them. Our focus has been, and will continue to be, on "good companies" with solid fundamentals. We were encouraged in Q3 to see the market recognize good companies such as those in Technology and Financials.

Bond Market Spotlight

Bonds Rise In Q3

The Barclay's Capital US Aggregate Bond Index, a broad-based representation of bond performance, rose 0.79% in the Third Quarter and is up 6.16% year-to-date. The yield curve hardly shifted in Q3 in contrast to slightly flattening in Q2. Having said this, there were several "head fakes" within the quarter regarding the direction of interest rates.

Key US Interest Rates	June 30, 2016	Sept. 30, 2016	Change
Federal Reserve Board Funds Target Rate	0.25%	0.25%	0 basis points
5-Year Treasury (Constant Maturity)	1.01%	1.12%	+ 11 basis points
10-Year Treasury (Constant Maturity)	1.49%	1.56%	+ 7 basis points
30-Year Treasury (Constant Maturity)	2.30%	2.28%	- 2 basis points

Note: 100 basis points (bp) = 1.00% Source: Telemet

The Fed Fiddles As Inflationary Pressures Build

The Fed's actions since the 2008 crisis have been unprecedented - they dropped interest rates to 0% and grew their balance sheet (Quantitative Easing) from $870 million (pre-crisis) to nearly $4.5 billion today. Many pundits such as Rick Santarelli and economists Peter Schiff and John Williams warned that "printing money" would lead to severe inflation. Now we see that virtually no inflation occurred.

We believe the most common inflation is due to rapid wage growth, which leads to too many dollars chasing limited goods and services. Right now, markets are not expecting significant inflation. Bonds imply an annual inflation rate of 1.45% over the next 5 years. The Fed forecasts 2.0% long term inflation.

Calculation For Expected Annual Inflation As Implied By The Bond Market

Expected Inflation = 5 Year Treasury Yield - 5 Year Inflation Indexed Bond Yield = **1.45%**

Federal Open Market Committee (FOMC) Forecasts As Of September 22, 2016

	2016	2017	2018	2019	Long Run
Unemployment	4.8%	4.6%	4.5%	4.6%	4.8%
Inflation	1.3%	1.9%	2.0%	2.0%	2.0%

We think inflation expectations are under-stated. The monetary benefits of out-sourcing labor to other global regions is declining as emerging market wages have risen six-fold in the last 15 years. If companies remain in the US versus relocating, labor demand will increase at a greater rate than labor supply, and wages should rise. The combination of rising wages and stronger consumer personal balance sheets should propel pent-up spending demand in areas such as housing.

Current Bond Strategy

We believe we will ultimately see more inflation than either the bond market or the Fed expects. Therefore, we think it is important to have a component of inflation protection in the bond portfolio.

Your Portfolio

We made several portfolio adjustments in Q3. The rationale for these moves included a desire to reduce European exposure and introduce Emerging Markets exposure. Additionally, we are increasingly sensitive to government/insurance company actions toward cost containment in Health Care.

We bought General Dynamics Corp. (symbol: GD), a leader in the defense industry. We believe GD is in a prime position to benefit from increased defense spending. For the first time in two and a half years, we added Emerging Markets exposure through buying iShares Edge MSCI Minimum Volatility Emerging Markets (symbol: EEMV), which is comprised of 250 holdings selected from the MSCI Emerging Markets Index. Reasons included attractive valuation, portfolio diversification, a growing global middle class, and a desire to replace previously-reduced European exposure with other foreign exposure. Finally, we bought PulteGroup Inc. (symbol: PHM), one of the largest US home builders. Rising rents, a demographic trend supporting household formation, a stronger labor market and rising wages should increase housing demand.

We sold Adecco Group AG (symbol: AHEXF), a leading European human resource company, and Myriad Genetics (symbol: MYGN), a medical diagnostics company. We pared back Fiserv (symbol: FISV), a financial services technology company, and Novo Nordisk (symbol: NVO), a European global leader in diabetes care.

As we approach year-end, you may see transactions in your portfolio geared towards tax loss selling (taxable accounts) and required minimum distributions (tax-deferred accounts).

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

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Disclaimer

The information presented herein is intended for informational purposes only. All views are subject to change based on updated indicators. The recommendations made in this publication are made without regard to individual suitability. Investors should consider their own needs and objectives before making any investment decision.

Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.

Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.