

The ACM Journal

LET'S ROLL

One recent weekend I was in particularly foul spirits. We were unpacking boxes and moving things around the house. I wanted to be doing something, anything, else. It isn't the work I object to, it is more the collaborative process. I like to see quick progress, but my bride likes to work on the small details, which I think is unproductive and time consuming.

I was also questioning why we packed up, moved, and stored so much junk that we were now throwing away. It would have been easier to just throw it out before we went to so much effort. Now we were doing twice the work, which slowed our progress even more.

While all this was going on, I was increasingly falling behind in mowing, weed whacking, general yard work, getting the garden set up, and all my livestock projects. It didn't help that there were kids' baseball games, dance lessons, music recitals, and soccer matches interspersed throughout the weekend to further consume my time.

Making matters worse, any time I was gaining on a stack of boxes, Nipa would pull me away with a request to help her organize the CD cabinet, or move a dresser in our daughter's room to see if it would look good in a different corner.

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PORTFOLIO REVIEW

The rally in investment assets continued in the second quarter of 2017. All major asset classes earned positive returns for the quarter, and most have posted very strong returns year-to-date.

Growth Stocks Dominate

Domestic stocks continued their rally, led by large-cap growth issues. Smaller stocks and "value" stocks provided positive, but more anemic returns. Today's market environment is starting to feel like the late 1990s when technology stocks were far and away the market's top performers. We don't have the same speculative excess today that existed in the 1990s, but there are some signs that it could be coming.

For example, Amazon agreed to purchase Whole Foods during the second quarter for roughly \$13 billion. The day the deal was announced, Amazon stock rose significantly, adding roughly \$13 billion to Amazon's market capitalization, and effectively making the purchase cost-free.

Also, consider the fact that Tesla is valued more highly by the stock market than Ford Motor Co. This is despite the fact that Tesla produces relatively few cars and has a fraction of the infrastructure that Ford has built over many decades.

There are many other examples that growth potential is being prized above all else these days. Valuation is a secondary concern. This could continue for some time, but eventually the relative bargains offered by other market sectors will again be sought by investors, and the sentiment will turn. This occurred at the turn of the century in an ugly manner, as tech stocks crashed down. It is unlikely that we are approaching a similar occurrence, but the longer the divergence between growth and value continues, the messier an eventual correction would be.

International Stocks Rebound

Another market disparity, between domestic and international stocks, is finally beginning to close. For too many years now, international stocks have lagged behind their U.S. peers. The valuations offered by much cheaper international stocks may have finally become too great to ignore, as international stocks have performed quite well this year. Signs that economic and political reforms are finally taking hold also help boost investor confidence in overseas stocks.

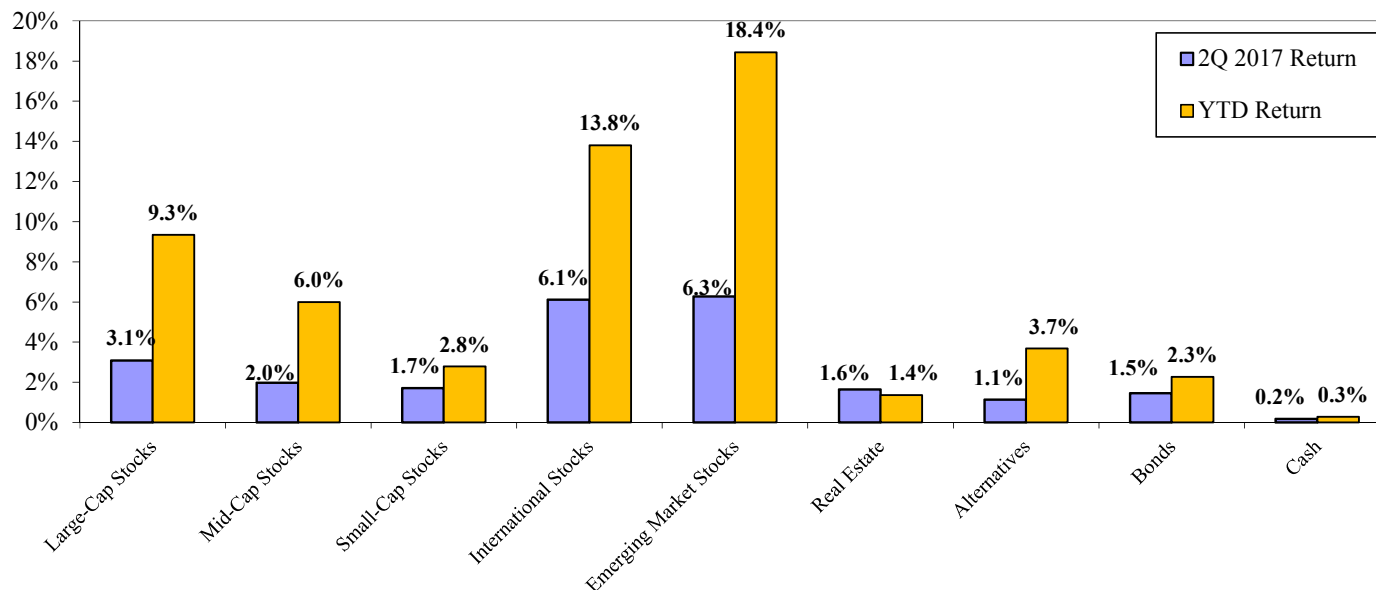
REITs Disappoint

Public real estate investments have languished of late. This is not too surprising since REITs generated very strong returns the past several years. With the Fed raising interest rates, higher-yielding investments are likely to come under pressure.

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SECOND QUARTER 2017 ASSET CLASS RETURNS



Large-cap, mid-cap, and small-cap stocks are represented by the S&P 500, 400, and 600 indices. International and emerging market stocks are represented by MSCI indices. Real estate is the Dow Jones Real Estate index. Bonds are the Barclays Aggregate Bond Index. Cash is the yield on the 30-day T-Bill.

PORTFOLIO REVIEW

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REITs remain a strong diversifier, but if interest rates rise in earnest, they could underperform for some time.

Bonds and Alternatives Plod Along

Speaking of underperforming, bonds produced low, single-digit returns. It is likely that this will continue for the next 6 to 10 years. Recent studies we have read indicate that the starting yield on bonds is a strong predictor of their annualized returns in the coming 6 to 10 years. Since the 10-year Treasury yields only 2.4% currently, it is likely bond market returns will be roughly the same as inflation for the foreseeable future. Bonds are still an important risk control in an investment portfolio, but expectations for future returns should be muted.

Alternative investment returns were also somewhat muted in the second quarter. These investments often move the opposite way of the stock

market, so it is not too surprising to see modest returns when the stock market has been strong.

Overall, this has been a good year for investors so far. Many are nervous that the stock market has come too far, and that a crash is imminent. We don't believe that to be the case. A recent study showed that big runups in the stock market are often not followed by market declines. Indeed, it is well known that valuation is not a good predictor of future market moves. Accordingly, we're sticking to our discipline, and investing in stocks is a big part of that.

We certainly want to buy stocks with lower valuations, and our rebalancing helps ensure that we continue to get exposure to more reasonably priced small-cap, value, and international stocks. We're at the half way point for 2017, but hopefully the back half of the year looks like the first half.

FIRM NEWS

We recently added a new team member. Craig Julien joined us in early June to help us with our systems, operations, and IT. Craig has a couple decades of experience in the IT industry, most recently with the accounting firm EFPR Group. Accordingly, Craig knows firsthand about data security and the importance of confidentiality in the financial industry. He's already done a great job of tweaking our systems so they are more efficient and user friendly, and we're looking forward to some enhancements that will make electronic account access easier for our clients as well.

In fact, we've been working on a portal to do just that. This would be a secure website where you could log in to view dynamic reports at any point in time. Account balances, performance, asset allocation, holdings, and tax reporting would be much easier to view, without having to wait for statements to come.

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ALTERNATIVES IN FOCUS

We've been getting a lot of questions about our alternative investments recently, so we thought we would introduce a new, at least quasi-regular, column in our newsletter focusing on this asset class. We'll talk this time about why we use alternative investments, but in the future, we'll do a deeper review of some of the funds.

Historically, a mix of stocks and bonds was sufficient to meet most investors' return needs. Stocks provided long-term growth, and bonds moderated risk. Though, in the past, even bonds were able to deliver decent returns. From the 1920s forward, bonds have provided average annual returns of 5.5%. A diversified mix of stocks has delivered annualized returns of almost 11% over the same period.

The basic rule of thumb in financial planning literature is that you can draw 4% per year from your portfolio for your living expenses. This would keep your purchasing power in tact over the long run, so your portfolio would always be there to provide for your needs. Using this concept, and if we do a little math, we can back into a required investment return. If you are drawing 4% from the portfolio, and paying roughly 1% in total fees (industry wide, most investors pay far more than this), and factor in 3% for inflation, then you need an annualized return of 8% over time. That's a pretty high hurdle, but traditional balanced stock and bond portfolios have been able to approximate that return over time.

Today, the scenario is different. Safer bonds are yielding 2.0 to 2.5%. Stock valuations are fairly high compared with historic norms, so it is unlikely

they will deliver the same sorts of returns we have enjoyed in the past. Accordingly, many studies conclude that investors will need to settle for lower returns, which means they should draw less from their portfolios and spend less on living expenses. That can result in some uncomfortable life choices, particularly for retirees.

We believe there is another way, and that includes the addition of alternative investments. These are not for everyone, but they do have the potential to add incremental, long-term returns without adding undue risk.

The term "alternative investments" typically means hedge funds or private equity. These types of investments are often illiquid, expensive, unregulated, and offer little transparency with respect to their investment approaches. Alternatives don't have to be hedge funds though. We have found asset classes and strategies that offer unique return characteristics, but with better terms than those offered by most hedge funds.

The alternative investments we use include catastrophe bonds; private lending; market insurance; private real estate; and strategies that involve options, futures, and other more esoteric investments.

Like hedge funds, the alternative investments that we employ are also more expensive than stock market index funds. They also are often not tax efficient, and sometimes they aren't as liquid as regular mutual funds. However, if costs are managed, and the net returns are high enough, we still think alternative investments can make sense.

Incorporating investments beyond stocks and bonds is a strategy that has been used in the institutional investment world for many years. In the past, these types of investments have required very large dollar amounts, and were not generally accessible to individual investors. Over the last decade or so, innovation in the financial industry has brought new mutual funds and exchange-traded funds to market in a more democratized fashion. Individual investors can now participate in asset classes that only a few years ago were unthinkable.

There will certainly be ups and downs with alternative investments. Some funds will thrive and others will falter at various times. However, that is the nature of a diversified portfolio. If returns are truly independent and uncorrelated among the assets in a portfolio, there will be winners and losers at any point in time. That doesn't mean we sell the losers. This is a long-term strategy, similar to the way we manage stock and bond portfolios.

These funds certainly are not perfect, but we believe the inclusion of these types of investments gives investors a fighting chance of meeting their return objectives over time.

This column will continue to focus on alternative investment themes, but please feel free to reach out to us anytime if you would like to discuss these investments, and how they may work for your portfolio, in greater depth.

LET'S ROLL

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Just as I was on the brink of creating a domestic disturbance, I went outside with another load of garbage and found a way to blow off a little steam. You see, our contractor had a very large asphalt roller brought in to compact the stones in our gravel driveway. He showed me how to use it and suggested I do some rolling in my spare time to further compress the stones.

I had other ideas.

I fired up the engine, pulled away from the house, and then set about finding all the items that had been a source of frustration in my recent past. I started with a toaster oven that had a nasty habit of burning me every time I tried to open the door to retrieve my toast. I put it in front of the giant machine and rolled many tons of vibrating steel over the top of it. It came apart in a very satisfying manner, leaving parts and toaster entrails embedded in the drive.

Next was a small toy lawnmower that my friend Tim gave to my son as a birthday present several years ago. It made an annoying racket that I had endured as the mower made its way, via hand-me-down, through my various children. While it challenged my patience over the years, it was no match for the roller. Plastic shattered and shot out in all directions.

Then, one of the children appeared, and notified me that “mom needs your

help”. I had to stop my rampage and attend to some trifling matter, which just brought my prior frustration back to the fore.

When I was finally free to resume my own worthy endeavors, I found a dehumidifier that I bought from Sears a few years back. I remember spending quite a bit on it, but it stopped working in fairly short order, and thenceforth served to clutter up the basement. It would soon meet its proper demise at the front of my roller.

After this went on for some time, I started to run out of things to flatten. My mind was racing trying to find any annoyance at all that would be worthy of a proper rolling. Perhaps this is what the late economist Joseph Schumpeter had in mind when he coined the term “creative destruction”.

Then, just as I was running out of annoyances, my wife beckoned to me from the garage: “Honey, would you come help me?” “Sure,” I replied, “just come out to the driveway for a minute...”



FIRM NEWS

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Electronic account access is already available through your custodian (e.g., TD Ameritrade or Charles Schwab), but our portal will give you the ability to run different kinds of reports, including performance, which is generally not available from the custodians.

We would also likely start to upload reports to this portal rather than sending hard copies. Of course, we realize not everyone is comfortable with electronic communications, so hard copies will always be available as well. When the time comes, you can let us know which you prefer.

Speaking of preferences, it has been three years since we last did a client satisfaction survey. We're currently working on the next one. We always like to hear your feedback on what we're doing and how we could improve. The survey will likely be sent both electronically and via hard copy, so keep an eye out for it, and please let us know what you think. You can expect it late summer or early fall.

Finally, we're considering moving away from semiannual billing to monthly billing. The rates for our service would stay the same. We would just bill smaller amounts each month, rather than larger amounts twice per year. The new approach would still bill in arrears, after we have provided service, but it would occur more often. This helps smooth our cashflow, which can be quite lumpy. It also should help provide greater transparency to our clients, as you will be able to look at any monthly account statement to see what your fees have been. This is still a work in process, and subject to change, so again, let us know what you think.



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