Investment Strategy Update

ASCENTIAL WEALTH ADVISORS
AN INDEPENDENT PRACTICE

Market Report — Quarter 3 • 2017

Economy & Earnings Extend Rally

The driver of market returns appears to have shifted from election euphoria to economic and business fundamentals. Whereas expectations for meaningful reform in Washington have fallen flat due to political gridlock, corporate earnings, a healthier economy, and low yields on safer assets have supported higher equity prices and kept stocks from losing their post-election gains. After three strong quarters, US equities are not cheap, and may require additional catalysts to move higher from here.

The first half of 2017 was positive for equity markets around the globe, with non-US equities leading the way, posting double digit returns. Emerging markets finished at the top with the MSCI Emerging Markets index up 19.3%. In the US, the NASDAQ was the big index winner with a 14.1% return, and technology, healthcare and consumer discretionary were the top performing equity sectors. The energy sector struggled again, as supply remained high and pushed oil prices lower from $52 per barrel at the beginning of the year to $46 at the end of June.

The Federal Reserve raised rates in March and again in June, moving their target rate from 0.75% to 1.25%, however the 10 year US Treasury yield fell from 2.4% in January to 2.3% at the end of June. With global interest rates remaining low, US rates are attractive and demand for US debt continues to be strong. As a result, the Fed's increases have had little impact on longer term rates although short term rates have risen. As of June 30, the 2 year US treasury was yielding 1.4%, the 10 year 2.3%, and the 30 year 2.8%.

Index	*2017 (through 6/30)*
S&P 500	+9.3
DJIA	+9.4
EAFE (Int'l)	+13.8
BC Ttl Bond	+2.3

Dow Jones Relative Risk Benchmarks	
Conservative	+3.2
Moderate	+7.4
Aggressive	+10.5

2017 Outlook

FIXED INCOME/BONDS — The Fed's attempts to boost rates have had a muted impact on long term bond yields due to strong global demand for US debt — which is perceived as safe and offers relatively higher yields compared to global alternatives. When the Federal Reserve embarked on its unprecedented bond buying program in 2008, it was unclear how they would unwind it and what impact it would have on interest rates. Now the Fed is looking to reduce its portfolio by not buying new bonds when they come due. This will reduce demand in the treasury market, and could finally allow yields to move higher. We believe that given competing factors including low global rates, the rise in rates should be gradual. We look to maintain a bond portfolio that is less sensitive to rising rates along with some intermediate maturity and corporate bonds to enhance yield.

Our View — *Remain positioned for slowly rising rates, with a preference for intermediate maturities.*

US EQUITIES — After the rally in US Equities since last fall, stocks appear fairly valued to slightly expensive. Based on forward earnings, the S&P 500 is currently valued around 17.5 times earnings, compared to a historical average of 16. While this is somewhat expensive, when considered relative to bonds which are carrying yields well below historical averages, equities remain attractive. S&P 500 earnings are rising, and corporate balance sheets are healthy. While we feel that there are reasons to remain positive about US stocks, we also feel that it is prudent to rebalance portfolios to take some profits from this run-up and keep relative risk levels intact.

Our View — *Take some profits from strong performance in US Equities .*

INTERNATIONAL EQUITIES — Non-US stocks are getting their turn in the spotlight after several years of underperformance. With valuations cheaper than US stocks, we have been patiently waiting for foreign stocks to catch up. It appears to have taken some signs of stability to give investors confidence in foreign markets. There have been indications of increasing stabilization in the Eurozone as many nations voted against populist candidates, dispelling fears of a Brexit contagion. We feel there is more room to run in this rally, with the MSCI All Country World ex-US index remaining below its 20 year average price to earnings valuation, and recommend a slight increase to developed international stocks.

Our View — *Increase developed international weightings slightly .*

Missing out?

- 91% of the companies that have >$1 billion in market capitalization are outside the United States — 46% developed world, 45% emerging markets (*Morningstar, MSCI*)
- 14% is the average portfolio percentage that US investors age 35-50 have invested overseas (*Time, May 2017*)

ASCENTIAL WEALTH ADVISORS

GET THERE FROM HERE

11 East Superior Street, Suite 508
Duluth, MN 55802
218.336.2500 • 888.840.8299

ascentialwealth.com

The Power of Rebalancing

Over time, especially when the stock market experiences a period of strong performance, portfolios get out of balance. Higher performing assets grow to more than their intended share of a portfolio, creating a divergence in the asset allocation when compared to its risk managed target. Given that asset allocation is a major determinant of risk and return, rebalancing ensures that the risk level of the portfolio stays consistent with the investors goals and objectives. The concept of rebalancing seems counterintuitive, selling assets that have done well and purchasing assets that have lagged. Rebalancing is the natural process of buying low and selling high.

Rebalancing too often can also be unproductive if trends in markets are not given time to play out, and consideration should be given to taxes. So how frequently should rebalancing occur? A study by Vanguard from 2010 demonstrated that "annual or semiannual monitoring … is likely to produce a reasonable balance between risk control and cost minimization for most investors." This study also showed a meaningful reduction in risk as a result of rebalancing, with a modest reduction in return. As the figures below show, rebalancing can add value over time, and we believe it is a critical part of portfolio management and key to meeting long term expectations.

50% Stock, 50% Bond Portfolio 1926-2014

	Annually Rebalanced	Never Rebalanced
Average Stock Weighting	**51.0%**	**81.0%**
Final Stock Weighting	**49.0%**	**97.0%**
Average Annualized Return	**8.1%**	**8.9%**
Annualized Volatility	**9.9%**	**13.2%**

Portfolio Volatility 1926-2014

	50/50% Stocks/Bonds	100% Stock
Best Calendar Year Return	**32.4%**	**54.4%**
Worst Calendar Year Return	**-22.7%**	**-43.5%**

Source: Vanguard, Best Practices of Portfolio Rebalancing, Nov 2015. Stocks are represented by: Standard & Poor's 90 (1926-1957), S&P 500 (1957-1969), MSCI World (1970-1987), MSCI AC World (1988-1994) & MSCI AC World IMI (1994-2014). Bonds are represented by: S&P High Grade Corp (1926-1968), Citigroup High Grade (1969-1972), Lehman Long-Term AA Corp (1973-1975), Barclays US Agg (1976-1989), Barclays Glbl Agg (1990-2014).