ON OUR MINDS

The Long, Strange Trip Ahead

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Picture a man at a desk in the White House, with tangerine hair and ruby-red ties.
Somebody calls him, he answers quite brusquely; the woman named Hillary sighs.
Equity markets quiver and soar, towering over your dread.
Look for the stock with the high dividend and it's gone.
Follow the Fed with fiercest attention; on Wall Street the traders are slapping their thighs.
Everyone smiles as you glance at bond prices – they've grown so incredibly high.
Newspaper stories of Brexit and crude waiting on every front page.
Climb on the bus with your head in the clouds and you're gone.[1]

For many people, 2016 seemed surreal; whether it was a good LSD trip or a bad LSD trip depended on political perspectives, but it was surely unprecedented. For investors, too, the past year took several unexpected turns before reaching a mostly satisfying conclusion. It is in this context that we undertake our annual review of our tactical asset allocation. Each year in mid-January, we look back at the prior year to evaluate how well we responded to different types of risks and whether our investment strategies were successful. We can then take a snapshot of the U.S. economy as it stands today, and construct our investment strategy for the coming year.[2]

2016 Markets Review

Domestic equities. A year ago, markets began the year with a thud: Stocks were down over 10% by mid-February, while bond yields hit historic lows as investors feared that falling oil prices and a strong dollar were driving the U.S. economy into a recession after seven years of improvement. Certainly, corporate America remained mired in a "profits recession," as earnings fell for five consecutive quarters through June. Low oil prices, a strong dollar, and weak capital spending were to blame.

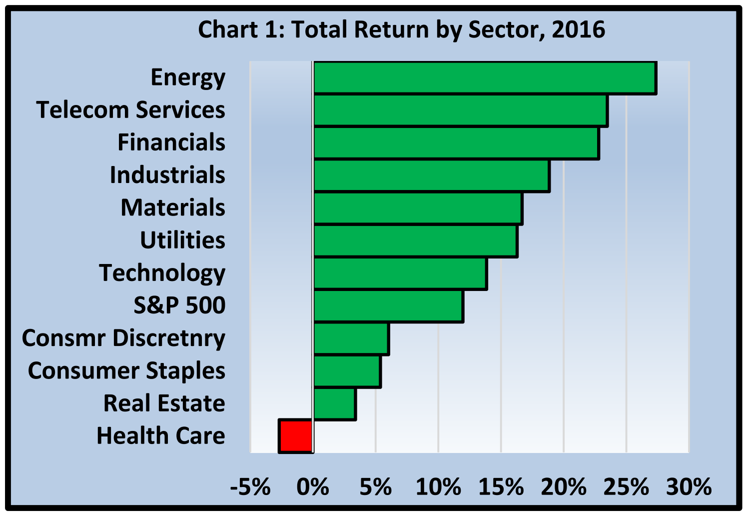
Yet consumer demand remained strong, and oil prices rebounded from their mid-February lows – eventually doubling to about $50. The dollar correspondingly softened and equity prices quickly reversed their losses. By late June, markets were back to their year-end levels.

[1] It was (nearly) fifty years ago today: The Beatles released *Sgt. Pepper's Lonely Hearts Club Band* on June 1, 1967.

[2] We do this in the middle of January rather than at the beginning, to give us a chance to digest important year-end economic data that is published in January and to get an early sense of December-quarter earnings reports.

Global investors gravitated to the U.S. markets, recognizing the strength in the U.S. economy and comparatively high payouts available from American securities. These global investors preferred the ease of using passive exchange-traded index funds, which took in record levels of fresh cash – and boosted the values of their underlying holdings. As a result, the biggest stocks were also the best-performing stocks through the first half of 2016.

The late June Brexit vote and then Donald Trump's election victory were both shocking to many people, but perhaps even more surprising was the response by financial markets: Rather than falling sharply into bear markets, stocks jumped on both occasions, while bond prices fell as interest rates crept upward. These moves were directionally in place before the two landmark votes, but they accelerated sharply in November as investors gained confidence that the federal government would likely become more market-friendly under a GOP Congress and President.



Source: FactSet

By year-end, the S&P 500 had posted a total return of 12%, well above what most market strategists had expected. The energy sector soared, primarily because higher oil prices ensured healthier cash flows. High-dividend sectors such as telecom and utilities posted strong advances through the first nine months; financials and industrials regained momentum in the final quarter as investors accepted the Fed's commitment to raise interest rates and as they saw the initial stirrings of revived business capital spending after the election. The worst-performing sector was health care, battered from all sides throughout the year by attacks on its pricing practices.

Global equities. Domestic stocks once again proved superior to other markets in 2016. Among major industrial nations, only Canada and New Zealand outperformed the S&P 500, mainly because of their reliance on commodity price increases; other markets across Asia and Europe badly lagged U.S. equities. The best performing major European market, for example, was France, with a 6.1% total return. China was up by 1.1%. Measured in U.S. dollars, many markets lost money during the year – among them the U.K., Spain, India, and Mexico. The American winning streak is now at eight consecutive years against international markets, and the margin of outperformance expanded in 2016.

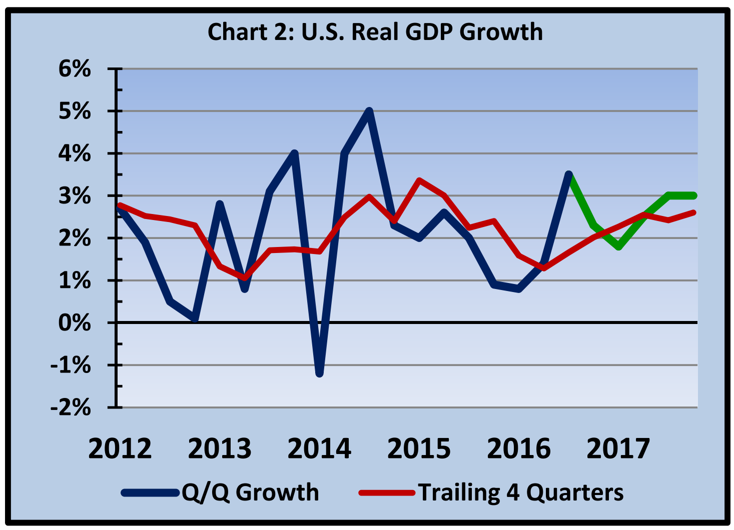
Fixed income. In a repeat of 2015, the Federal Reserve raised its benchmark Fed Funds rate only once last year, despite many warnings of more aggressive action. But the market dynamics around the Fed's actions were very different. Throughout 2015 and into early 2016, investors feared the economy might slip back into recession; Treasury bonds outperformed corporate debt during this period, as investors preferred safety over yield. Last year, investors' confidence in the strength in the U.S. economy steadily grew, and those yield spreads collapsed; high-yield corporate debt was the best-performing corner of the U.S. bond market.

In bonds as in stocks, the year pivoted sharply around Election Day. In the days following the election, investors came to the conclusion that the Republican sweep would lead inexorably to lower tax rates, more infrastructure spending, and less regulation of American business. In that environment, the U.S. Treasury balance sheet would see less income and more expenditure, leading to wider deficits and deteriorating credit quality; meanwhile, corporations would be paying less in tax and would have more money-making opportunities, leading to stronger balance sheets. Not surprisingly, bond prices sank across the board, although corporate bonds fared slightly less badly. November was the worst single month for the U.S. Treasury bond market in 14 years. In the end, for the fifth consecutive year, stocks posted better total returns than bonds.

Domestic Economy

Financial markets are telling us that the U.S. economy is poised on the verge of acceleration in 2017.[3] The post-election stock market surge suggests that investors anticipate that the GOP Congress and President Trump will enact large fiscal stimulus legislation, in the form of a trillion-dollar infrastructure spending bill and deep tax cuts. Perhaps these actions will come to pass as contemplated, or perhaps they might be considerably diluted.[4] Regardless, the economic data has been pointing to acceleration for quite some time.

Chart 2 shows the steady decline in GDP growth from mid-2014 through early 2016, as inventory depletion, the rising dollar, and falling energy prices all affected output. But even as early as February, these factors had begun to reverse, resulting in the acceleration in economic growth evident later in the year. As-yet unreported December figures may soften due to additional inventory depletion, but the data still indicates solid growth regardless of who is in charge in Washington.

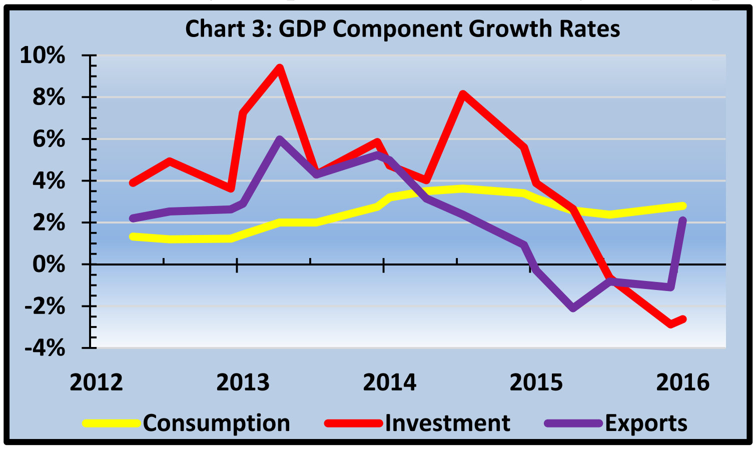


Source: Commerce Dept., Bureau of Economic Analysis

[3] To be fair, some indicators suggest that investors might be more cautious. Two bond market examples come to mind: First, the "real" interest rates on Treasury bonds today (i.e., quoted nominal rates minus the inflation rate) are lower than they were just before the election; second, the yield curve (the difference between long-maturity and short-maturity interest rates) has flattened considerably in the past few weeks. Both of these indicators suggest that bond investors are expecting higher inflation but not stronger growth, an outcome that would not bode well for stocks, either. It isn't the first time that stocks and bonds are sending mixed messages, and neither asset class consistently proves to be better anticipating economic outcomes. Further, the overall drop in bond prices is usually associating with stronger economic growth.

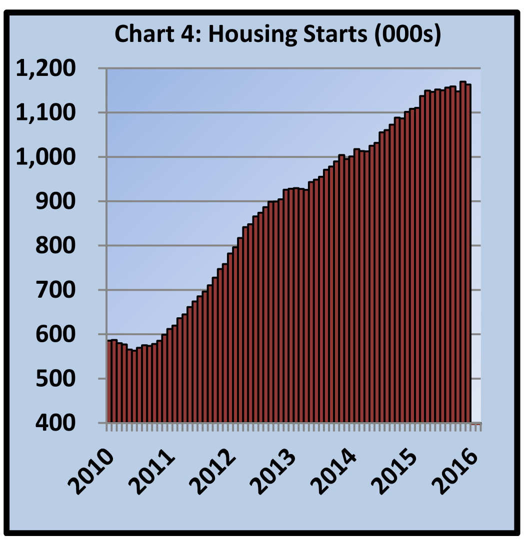
[4] Please refer to "For What It's Worth," December 27, 2016, for a more complete discussion of the possible ways that President Trump's campaign agenda might be altered on its way to becoming law.

Further, the complexion of the data is cause for economic optimism. Chart 3 shows the growth rates of three key components of the economy, namely personal and business consumption, business investment, and exports. As the dollar rode its ascent beginning in mid-2014 (rising nearly 30% against the Euro and yen), exports and investment both tumbled; American products had become less competitive both at home and abroad. But as oil prices firmed last year, the dollar softened and exports recovered well. Even business investment showed its first glimmer of recovery in the most recent reported quarter.

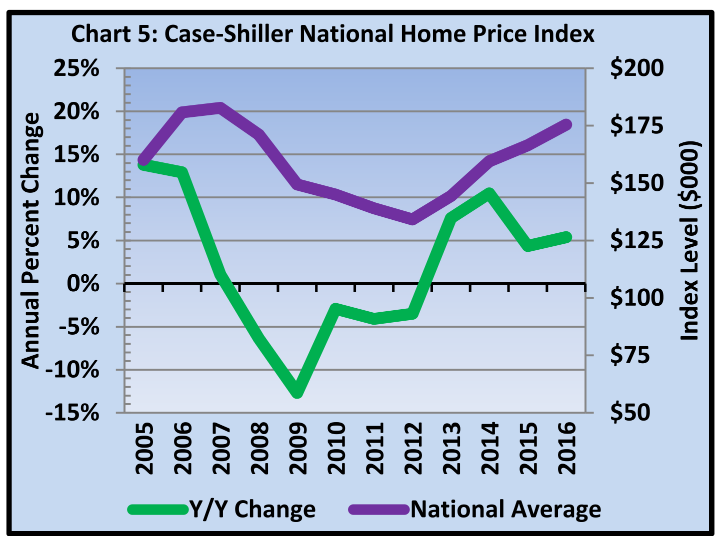


Source: Commerce Department, Bureau of Economic Analysis

While business investment and exports finally showed some life in the latter part of the year, the housing market – which was a major contributor to the economy's expansion in the past several years – finally showed some signs of cooling. Charts 4 and 5 show that the pace of new construction moderated while underlying demand remained strong, resulting in prices climbing an average of 5% during the year. Although housing prices haven't surpassed their 2007 peak nationally, the Boston market set new records last year.



Source: Census Bureau



Source: Standard & Poors

The jobs market developed very similarly to the housing market last year: slowing unit growth and rising prices. The average monthly jobs gain fell for the second straight year, from 207,000 to 182,000, while average hourly wages ticked up 2.3%. The slowdown in employment growth isn't surprising after six years of solid gains (see Chart 6); last year, the U.S. population and labor force both grew 1.1%, while the number of jobs ticked up 1.5%; the difference drove the unemployment rate down to 4.7%. Interestingly, the labor force participation rate remained stubbornly low (Chart 7), indicating that people are not being drawn back into the workforce despite increasing opportunities; hence the rise in the average hourly wage.

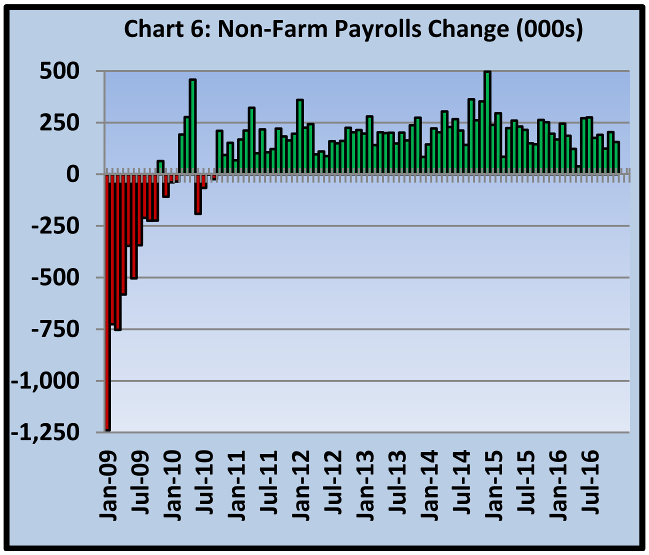


Chart 6: Non-Farm Payrolls Change (000s)

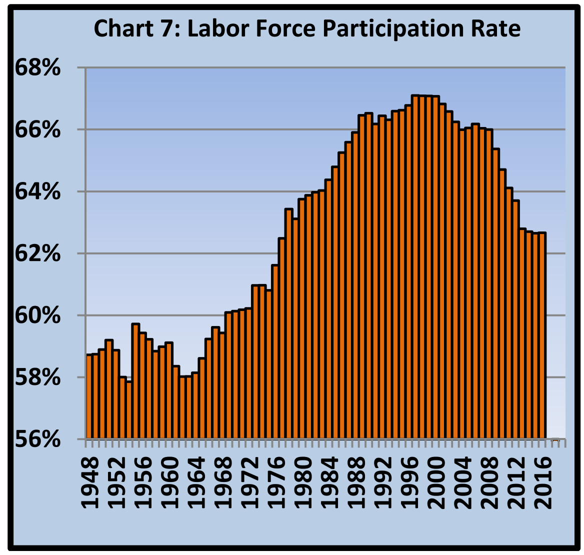


Chart 7: Labor Force Participation Rate

Source (both charts): Labor Department, Bureau of Labor Statistics

International Economies

Although China and Mexico dominated the international economic debate during the presidential election campaign, the more historically important debates were taking place within central banks in Europe and Japan. Faced with intractably low GDP growth, these banks experimented with novel policies to stimulate demand – most notably, with negative interest rates. The experiments failed: GDP growth hasn't picked up noticeably, stock market performance has been dismal, and the pressure of ultra-low rates has threatened the solvency of some major European commercial banks.[5]

The central banks are now considering whether to abandon some of their ultra-loose monetary policies, especially if their respective governments adopt more aggressive fiscal policies. Europe may well succeed, but Japan has the additional problem of a shrinking and aging population. Unless Japan can change its cultural resistance to immigration, it will be difficult to generate new domestic demand; it's not possible to sustain economic growth without population growth.

China has a different set of problems as it tries simultaneously to create a consumer-driven domestic economy and to gain more respect in international markets. During the U.S. election campaign, Donald Trump (and others) repeatedly asserted that China is manipulating its currency in order to price its goods more competitively on global markets; yet the exact opposite was the case: China intervened in foreign exchange markets mainly to prop *up* the yuan, which hurt its global competitiveness but made it easier for Chinese consumers to buy imported goods.

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[5] Please refer to "The Brave New World of Negative Interest Rates," March 21, 2016, for more analysis of this policy experiment. Bear in mind also that the commercial banks are more central to Europe's economy than their counterparts are to the U.S. economy. The financial system here has evolved to include many additional sources of capital, including hedge funds, private equity, venture capital, high-yield bonds, and many others; in Europe, entrepreneurs don't have nearly as many choices about how to finance their businesses. In consequence, Europe's banking problems pose a greater threat to the Continent's overall financial system than comparable problems at American banks here might cause here.

2016 Economic Outlook

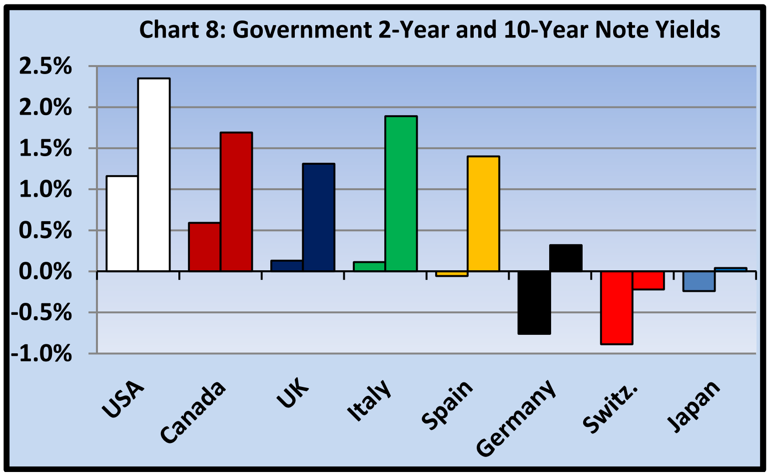
U.S. GDP Growth. Most investment strategists anticipate robust economic growth this year, driven partly by trends that have been in place for months and partly by the Republican sweep in November. We agree that the current trajectory of most macroeconomic data is constructive, and we recognize that President Trump's stated legislative agenda would likewise lead to higher GDP growth. On the other hand, we think that markets may be unhappily surprised by some stumbles along the way. Congress has its own agendas, and it's clear that Speaker Paul Ryan and President Trump differ on key issues. Republican infighting can derail progress. We also recognize that curtailing immigration and expanding deportation practices are both significantly contractionary in nature; fewer residents equals lower overall spending. Population and labor force remain the biggest determinants of overall economic activity in the U.S.

Politics aside, the data are solid: Personal consumption remains strong. Job growth is steady if a bit slower than it was a year ago. The housing market is still robust, with price increases and steady construction of new homes. Exports are holding steady even as the dollar continues to creep higher. Business capital spending is finally beginning to revive. With so many sectors of the economy doing relatively well, and with little fear that the Fed will inadvertently kill the expansion by raising interest rates too quickly, we think GDP growth can improve from about 2.0% last year to about 2.6% this year. (See Chart 2, where the green extension of the quarterly GDP growth line represents our estimates for the year ahead.)

Inflation. Ever since the current recovery and expansion began in 2009, inflation has been notably subdued, kept down by excess slack in the system – in wages (due to high unemployment), in production capacity (due to slow sales growth), and in energy prices (due to rapidly increasing U.S. oil and gas production). Last year we saw this dynamic begin to change. As oil prices recovered, inflation rose to 2.1% by year-end, in line with the Fed's target. Even "core" consumer prices (excluding volatile food and energy) rose by 2.2% last year. Rising home prices, health care costs, and wages will become more evident in the coming year, while the offsetting benefits of cheaper imports have already diminished. We think inflation could rise another 25 to 35 basis points, to perhaps 2.5%. This would not be a bad outcome; additional pricing power could help corporate profits, higher wages would boost consumer incomes and expenditures, and the Fed would have little reason to act too harshly.

Corporate Profits. The outlook for corporate profits – not the same thing as GDP, but a better measure of the stock market's earnings power – is improving sharply after a poor showing over the past two years. The adverse effects of the strong dollar have dissipated, after knocking several percentage points off of S&P 500 earnings growth rates; meanwhile, higher oil prices have cause energy to become a net contributor to earnings growth rather than a net detractor. Rising interest rates are welcome news to banks and other financial companies. Fiscal stimulus in the U.S. and Europe can benefit technology and industrial companies. But profit margins are already at very high levels, and are vulnerable to rising wages. All told, we think profit growth for S&P 500 companies may grow by 7% to 10% this year – a considerable improvement over the five straight quarters of negative comparisons that ended last June, and even over the 1% gain of the September 2016 quarter.

Interest Rates. When the Fed finally lifted short-term interest rates above zero 13 months ago, the Fed's own forecast suggested that four more quarter-point hikes were in the cards for 2016, while bond market futures prices suggested that only two hikes were likely. In fact, the Fed raised the Fed Funds rate only once last year. The Fed currently forecasts three hikes this year, while the bond market's implied forecast is for only two. We think the Fed will still raise rates again in June and again in December, as inflation becomes more evident.



Source: FactSet

American government debt is in the enviable position of carrying higher interest rates and yet having better credit quality than every other major economy; in other words, Treasury bonds are both better and cheaper than their global alternatives. For as long as foreign central banks persist in their current experiment with negative interest rates, this anomaly will support the dollar against other currencies and will attract investment capital. For global investors, U.S. Treasury debt is both the highest quality and the cheapest sovereign debt available, as shown in Chart 8. Global demand for U.S. debt will likely keep longer-term interest rates low here, even as short-term rates drift upward. The result is likely to be a flatter yield curve, as we have begun to see. If foreign central banks begin to embrace higher rates, the relative attractiveness of U.S. debt could diminish rapidly.

International Economies. Consumer-driven markets such as Europe and Japan have begun to demonstrate improving economic growth, and their governments are beginning to loosen the purse strings slightly; yet they still have a long way to go. Global exporters domiciled in those regions will continue to benefit from weaker currencies and strong demand in the United States. Commodities-driven emerging markets fared surprisingly well last year, helped immensely by the recovery in oil prices and by associated gains in industrial metals and other goods as well. As China's economy regains some momentum, we think commodities prices can stabilize, but we don't expect meaningful additional gains from here.

Asset Allocation

Bonds. With short-term interest rates likely to rise slightly and long-term interest rates pinned by aggressive monetary policy abroad, we think bond investors are headed for another challenging year in 2016. The Treasury market, in particular, is likely to be pressured by expectations of higher inflation and wider fiscal deficits. We have begun to use Treasury Inflation Protected Securities (TIPS) to provide some insulation from higher interest rates caused by higher inflation. We also have invested in an exchange-traded fund that focuses on short-term floating-rate debt, providing further protection against higher interest rates.

We are still comfortable owning credit risk, but we are not alone in that sentiment. The interest rate differential between top-quality and low-quality debt compressed significantly in 2016. The spread between Treasury bonds and comparable-maturity high-yield corporate debt has been cut in half, to about four percentage points. Such a tight spread is symptomatic of a bond market top, but the combination of ultra-low global interest rates and increasingly healthy U.S. corporate balance sheets leaves us more sanguine about credit risk.

Conversely, we are reducing our exposure to duration risk. Even if the yield curve flattens somewhat (i.e., if longer-term interest rates rise less than shorter-term rates), the damage to value is still greater for long-term bonds than for short-term bonds. We are using ETFs to manage our duration risk, keeping client portfolios a bit shorter than respective benchmarks; for example, we have shifted our high-yield corporate debt position from an ETF with a duration of seven years to the Shenkman Short Duration High Yield Fund, whose duration is just under two years.

Equities. Stock prices in the U.S. are verging on expensive, as investors have grown more optimistic that corporate profit growth is likely to accelerate in 2017. Valuations are still within one standard deviation of their historical average, so we are not concerned that prices have gotten at all out of hand. We think that stock prices will find support from domestic economic strength, from improving corporate earnings (especially if companies begin updating their outlooks to reflect lower taxes or improving capital spending trends), and from continued equity inflows from bonds and from international investors.

Yet profit margins are vulnerable to rising labor costs. Merger and acquisition activity is again setting records (although the incoming Justice Department may look more favorably upon big transactions than the Obama team did). The IPO market has been terrible. None of these developments are good for stocks.[6] With this in mind, we think that stocks may have to endure a correction sometime this year (possibly quite early in the year) before they resume their upward trajectory. Even so, robust earnings acceleration and acceptable valuation levels suggest that we can ultimately see nearly double-digit returns from year-end 2016 levels. We don't pretend to be market timers, so we have opted to remain fully invested in equities with the intention of riding through any potential correction.

Most of our U.S. equity participation is in large-cap companies, either directly or through exchange-traded funds. We have also increased our participation in smaller companies by initiating investments in the Russell Mid-Cap Growth ETF and the Russell Small-Cap Value ETF. The Mid-Cap Growth fund comprises a large number of industrial and technology companies that should benefit from global economic expansion. In addition, mid-cap companies derive a greater share of their revenues from the United States and are burdened by higher income tax rates than is true for the large-cap S&P 500 firms, which suggests that they can benefit disproportionately from the incoming Trump Administration's agenda. The Small-Cap Value fund is disproportionately invested in banks and other financial companies that should benefit when interest rates rise.

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[6] Neither is the so-called presidential market cycle, which holds that stocks do best in the final year of a Presidency and worst in the first year of a new administration. The statistics bear out this trend, although no conclusive theory explains the phenomenon. The first half of the hypothesis was certainly upheld last year.

We have redirected some of our international equity participation. As it became evident that negative interest rates in developed markets were not having their desired effects – and indeed were threatening the solvency of local banks – we pulled back our participation modestly. We still see improving corporate profits thanks to cheaper currencies; it is also possible that Europe's central bankers may back away from their ultra-loose policy, which we think can also help stock prices. Even so, the risks of bank failures have grown substantially, and we are remaining more cautious than we were a year ago – especially because the Brexit vote and migrant crisis have considerably increased the risks of investing in major European markets. We think Europe and Japan are cheap but potentially value traps, so we are holding somewhat smaller positions than we did at this time a year ago.

While we have reduced our overall international weighting in global equity portfolios, we have increased our investments in selected areas. Most notably, we have increased our emerging markets exposure, which now encompasses holdings of Vanguard's conservatively managed global emerging markets ETF and an iShares ETF focused on Russia. (The DFA International Small-Cap fund also has a few emerging markets stocks among its holdings.)

To summarize, in our Multi-Asset portfolios, we are positioning our client portfolios as shown in Chart 9:

Chart 9: Asset Allocation	**New**	**Jan. 2016**	**Change**
Tactical Equity Weighting	**+3.0%**	**+6.5%**	+3.5%;
Equities:			
U.S. Large-Cap Stocks	73.0%	76.0%	-3.0%; more ETFs
U.S. Mid-Cap Growth	3.0%	0.0%	+3.0%; stronger economy
U.S. Small-Cap Value	3.0%	0.0%	+3.0%; rising interest rates
SPDR S&P 500 Trust	2.0%	0.0%	+2.0%; tactical opportunity
Consumer Discretionary ETF	0.0%	2.0%	-2.0%; replaced by mid-cap
Financial ETF	2.0%	0.0%	+2.0%; rising interest rates
Health Care ETF	2.0%	0.0%	+2.0%; battered sector
Industrial ETF	2.0%	0.0%	+2.0%; accelerating demand
Technology ETF	2.0%	2.0%	0.0%; productivity gains
Total U.S.	**89.0%**	**80.0%**	+9.0%
Benchmark	**~82.0%**	**~80.0%**	
Developed Europe ETFs	4.0%	13.0%	-9.0%; hedged currency
Asia / Japan ETFs	0.0%	4.5%	-4.5%; wait out turbulence
Emerging Markets ETFs	3.0%	0.0%	+3.0%; stable commodities
Global Small-Cap ETF	2.0%	2.5%	-0.5%; global GDP growth
MSCI ACWI ex-U.S. ETF	2.0%	0.0%	+2.0%; global GDP growth
Total International	**11.0%**	**20.0%**	-9.0%
Benchmark	**~18.0%**	**~20.0%**	

Chart 9: Asset Allocation (Cont.)	New	Jan. 2016	Change
Fixed Income:			
U.S. Investment Grade	76.2%	76.0%	+0.2%; six-year ladder
Inflation-Protected ETF	6.0%	0.0%	+6.0%; rising CPI expected
Floating-Rate Notes ETF	4.6%	5.0%	-0.4%; offset by cash
Intermed. Credit ETF	5.5%	5.5%	0.0%; swap CIU for LQD
Intermed. Gov't ETF	2.7%	5.0%	-2.3%; duration risk mgmt.
Intermed. High-Yield ETF	0.0%	8.5%	-8.5%; duration risk mgmt.
Short Dur. High-Yield ETF	5.0%	0.0%	+5.0%; credit risk mgmt.

Chart 9 shows targeted allocations for our flagship Multi-Asset model using actively selected individual stocks and corporate bonds. We have developed comparable models for client portfolios that use mutual funds and ETFs instead of individual securities (our "Funds-Based" or "Wealth Accumulation" portfolios), and for variants of the Multi-Asset style including Core (which excludes international assets) and three Sustainable and Responsible Investment styles. All of our model portfolios are derived from the same economic analysis and market interpretation, and therefore have analogous asset allocation targets. Individual client portfolios often differ from these models because of factors unique to each client, so these targeted allocations should be read as guidelines rather than as reflections of actual accounts.

2016 Report Card

Finally, we think it is appropriate to evaluate our investment decisions in the year just ended. This evaluation necessarily must cover only our hypothetical guideline models; since each client's portfolio is unique, it would be impossible to judge any individual client accounts here.

- U.S. economy. In a year as surreally unpredictable as 2016, we were gratified that most of our macroeconomic view played out according to script. In the U.S., we correctly anticipated that steady jobs gains and healthy consumer appetites would pull the economy back into better growth rates after a first-quarter swoon, and we likewise were wise to fear moribund business capital spending for most of the year. It now appears that the annual growth of the U.S. economy and the core consumer price index will both nudge the low end of our year-ago forecasts, at about 2.0% and 2.2% respectively. We were a bit too pessimistic about oil, which rebounded more quickly to the $50-$55 range than we had anticipated in our "lower for longer" view.

- International economy. We should have wiped the rose tints off of our eyeglasses. We had anticipated improvements across developed markets, aided by monetary and fiscal stimulus and by cheaper currencies. We got the currency call right, but the monetary policy failed and the fiscal stimulus hasn't yet happened. We certainly didn't anticipate Brexit, although the vote did give a boost to our portfolios. The immigration and banking crises in Europe short-circuited much of the Continent's economic recovery. In emerging markets, meanwhile, the rebound in oil prices was accompanied by gains across most industrial commodities, as China averted a "hard landing" and stabilized its economy.

- Asset allocation – by asset classes. For the fifth consecutive year, our asset allocation decisions added value to client portfolios – although we could have done even better. Last January, we trimmed our equity overweight from +6.0% to +3.0%. This proved to be an excellent decision in the first quarter, as stocks suffered a 10% correction while bonds gained ground; these moves were reversed by mid-June. For the first half-year, then, our modest positioning helped smooth our volatility without harming performance. Beginning with the Brexit vote in late June, equities began to outperform; after the U.S. presidential election, equities ran away from bonds at full gallop. Our overweight helped, but in retrospect we should have doubled-down immediately after the Brexit vote.

- Asset allocation – by geography. Our substantial investments (only in global Multi-Asset portfolios) in Europe and Japan early last year didn't succeed; we cut our losses quickly, and carried much smaller positions through the balance of the year. While we had expected significant capital flows toward the U.S. in fixed income markets, the sheer volume of foreign money being parked in U.S. equities was surprising; neither our initial neutral geographic weighting nor our subsequent slight tilt toward the U.S. took full advantage of the relative strength in the S&P 500 versus international markets.

- Equity stock selection. Our client portfolios lagged their benchmark indexes but were closely in line with our competitive peer group, across all of our equity styles. This performance record is more a function of unusual market conditions than of skill. Ordinarily, market capitalization is unrelated to performance; but from early 2014 through mid-2016, size was almost all that mattered. In that two-year stretch, the largest American companies – the S&P 500 outdistanced mid-caps, and mid-caps did better than small-caps. This sudden correlation began just as the U.S. dollar began its ascent against the euro, pound, and other currencies; foreign investors began pouring money into U.S. equities, and their preferred method was through S&P 500 index funds.

  In that same period, equal-weighted active managers (like us) couldn't possibly compete with capitalization-weighted indexes, and the S&P 500 index beat over 87% of active managers. When sentiment suddenly shifted in November, smaller stocks came roaring back, and active managers began to look better. We were no different: Our 9-month performance against the benchmark was quite weak, but we erased about half of the shortfall in just the last two months.[7] Throughout the year, our performance was much closer to our competitive peer group (the 4,000+ active large-cap managers tracked by Morningstar) than it was to the benchmark S&P 500 index. Indeed, we were in the middle quintile (closest to the median) throughout the year.

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[7] Please refer to the *On Our Minds* commentary "Active Strategies vs. Passive Index Funds," August 31, 2016, for a more detailed examination of how active and passive funds compare. A more recent study published by Hartford Funds, "The Cyclical Nature of Active and Passive Investing," December 2016, notes that active managers have outperformed passive indexes in 15 years of the past 31 years – essentially a long-term stalemate. Further, the study notes that the prevailing style tends to build long winning streaks: On only two occasions in the 31-year study did one strategy outperform for a single year; most times, active beat passive for three or four years in a row, or vice versa. The Hartford study also noted that active managers tend to shine best in bear markets and when the dispersion of stock returns (i.e., the variation in performance among the 500 largest stocks) is higher than normal. In those conditions, active managers' "torpedo avoidance" becomes a critical attribute of successful investment performance.

- Fixed income. In client fixed income portfolios, we aim to produce stable and predictable cash flows with limited reinvestment risk; most accounts use a multi-year individual bond ladder. This results in portfolios with shorter duration than most bond benchmarks. Since our objective (cash flow and capital preservation) differs from that of the benchmark (total return), performance assessment is of only limited utility. We do use ETFs and some mutual funds to sculpt overall credit and duration risk, so it is still a mostly fair comparison. Early last year, we lengthened our portfolio duration in order to capture some additional yield; we adjudged relatively little duration risk. This was a smart decision, and it helped offset the short duration of the core bond ladder. We also held a large position in high-yield bonds throughout the year, which was tremendously successful. Although performance relative to the Barclays benchmarks was soft, this was entirely due to the use of a bond ladder; our investment decisions around that core were quite successful.

Although it wasn't a superb year – and parts of it were quite disappointing – we are gratified that we successfully guided our clients through a volatile and challenging 2016, protecting and enhancing their investments despite all the turmoil in the markets and the wider world. We approach 2017 with some optimism but also with a keen awareness of what can go wrong. This will not be an easy year, even though the stars are favorably aligned for continued economic growth. Things have changed and will continue to change. The long, strange trip continues. We thank all of our clients for placing their trust in our stewardship of their financial assets, and we hope to see you all in the new year.