TOWNELEY Capital Management Inc

Thoughts from Towneley – Third Quarter, 2017

Equities Grab the Spotlight

Few market commentators predicted it, but we're entering the fourth quarter of 2017 on the heels of a positive market performance across all asset classes. While gains posted across the board, the equities market has proven to be the real attention-getter.

Domestic stocks are up 4.6% in the third quarter and 13.9% year to date (YTD), as represented by the Russell 3000 Index. International equities have done better still, gaining 6.2% in the third quarter and 21.1% YTD, as represented by the MSCI ACWI ex US Index. It's all a welcome payoff for the strategic rebalance we performed last year, increasing the ratio of international to domestic equities in client portfolios. Further, thanks to low inflation and interest rates, advancing global economic growth, stronger corporate earnings, and the anticipation of US tax cuts soon, the third quarter equity returns surpassed historical averages. Fixed income and commodities have also performed well this year, posting positive returns for both the quarter and YTD.

The Price of Fame

With all this positive news comes the inevitable reality that domestic equities are becoming more expensive. The Shiller Cyclically Adjusted Price/Earnings (CAPE) ratio, a valuation of the Standard and Poor's 500 Index that reflects the average inflation-adjusted earnings of the previous 10 years, has reached a level not seen since the eve of the dot.com bust in 2000. Such high ratios fuel worries of a market correction. However, it's helpful to remember that price decreases are not the only way to shrink the CAPE ratio; higher earnings will also reduce the ratio. In addition, historically-low interest rates provide little incentive to switch from equities to bonds. An increase in short-term interest rates would, at some point, reduce the attractiveness of equities. With these conditions in mind, Towneley has positioned client portfolios to profit from the possibility of a further rise in international stock values and the potential decline in US stock values. We've captured gains and rebalanced client portfolios back to equity targets from earlier this year. We continue to monitor the global equity markets and will consider another rebalance as client portfolios' asset allocations drift from their targets.

A Look Ahead

As 2017 winds down we are reviewing the ratio of index to managed funds in the domestic equity segment of client portfolios. Currently, 78% of the domestic equity portion of client portfolios is invested in index funds and 22% in actively-managed funds. In 2009, we performed a tactical replacement of certain actively-managed domestic equity funds with index funds that provide comparable exposure, as most managed funds struggled to outperform. Over the past eight years, client portfolios have benefited from this calculated emphasis on index domestic equity fund exposure. Today, given the increasingly expensive level of the equity market, we believe it's appropriate to re-examine the index exposure relative to the managed fund exposure.