THE

Envestnet Edge

INSIGHTS FROM ENVESTNET | PMC

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Markets are quiet for now. What next?

After a rousing start to the year, equity markets have been in a calmer state and bond yields have leveled off, leading investors to question whether global geopolitical and election concerns (and our own domestic legislative challenges) may be signaling that trouble lies ahead. A rapid market correction is always a possibility, and a surge in equity prices can occur just as quickly. This month, we suggest using this period of calm to construct a prudent investing strategy, including diversifying, rebalancing, and repositioning, and mixing active and passive approaches.

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After a dramatic start to the year, with equities rallying worldwide and bond yields rising in anticipation of stronger economic growth, markets have entered one of those eerie calm periods whose very placidity tends to spook investors. It's springtime, and while the weather becomes progressively milder, investors seem less certain than ever. The "Trump rally"—which we have suggested may be less attributable to Trump than commonly assumed—stalled around the beginning of March. Since then until the week of April 24, everything was one big zero (Figures 1 and 2). Our take? It's the perfect time to rebalance, reposition, and put one's financial house in good order. Take advantage of the calm: gather ye rosebuds while ye may.

The calm before...what?

The market's calm is in almost inverse proportion to the investors' agitation. Although fear gauges, such as the VIX indicator of volatility, have been staying stubbornly low, most investors appear to be anticipating trouble—even with the strong global equity rally after the results of the first round of the French presidential elections. Not a day passes without someone warning of an impending correction, overvalued equities, and rumblings in bond markets, not to mention a seemingly endless series of geopolitical crises and potential domestic imbroglios over government spending, government shutdowns, healthcare, and tax reform. And yet, markets have so far failed to do much but shrug and meander in place.

As we have said before, it should be taken as a given that a five to ten percent correction is *always* possible, at least for equities, for one reason or another. It's best, in fact, to assume that such corrections will occur from time to time, and that for higher beta stocks, the number will be greater than 10%. In a time when the Federal Reserve has begun to raise short-term rates modestly, after years at the zero bound, bond investors also could expect a resetting of yields and prices, and accept that years of price gains on bonds might not be in the offing. If either of those assumptions proves wrong, then no harm, no foul; but if both prove correct, having factored in their possibility will make investors less likely to panic.

On the flip side, it also should be taken as a given that equities can *surge* 5%-10% quickly, perhaps because of a few good earnings reports, a global crisis that subsides, or any number of other reasons. And, of course, interest rates can go up or down 50bps or more in a matter of days, after long weeks or months of moving hardly at all.

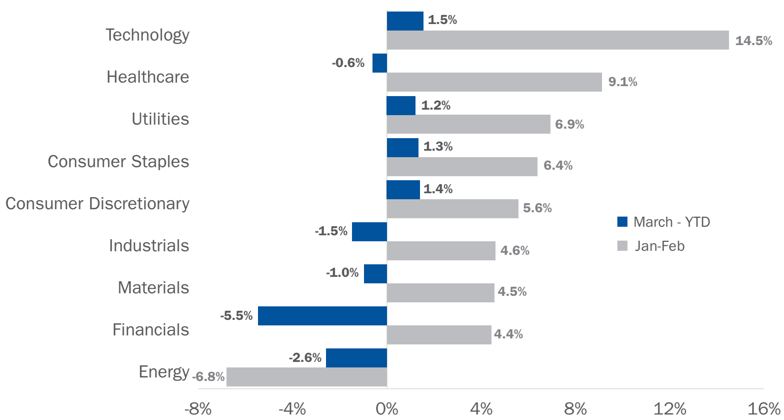
Such moves can happen in a blink of an eye—far too quickly, in fact, for most investors to react either meaningfully or constructively. Read too much into the downward moves, and the result will be premature, precipitous selling that may be regretted in retrospect. Rush in when assets are jumping, and the result could be a brief momentum trade that ends as quickly as it started.

That is why being well positioned *before* markets go for a spin is crucial. Trying to reset a portfolio during bouts of up or down movements, in the midst of heightened volatility, is a fool's errand. Not only will prices be skewed during those periods (either on the upside or downside), but investors' emotions add yet another risk. Even the most calm and rational investor is hard pressed in such times to maintain a calm detachment.

The best course, then, is to use calm times to construct a portfolio that is diversified with an eye toward long-term needs and desires. It doesn't matter what the goals are—income, retirement, appreciation, yadda yadda—the time to position is when there is a decent chance of paying a fair price and having the luxury of being deliberate about where to invest and with whom.

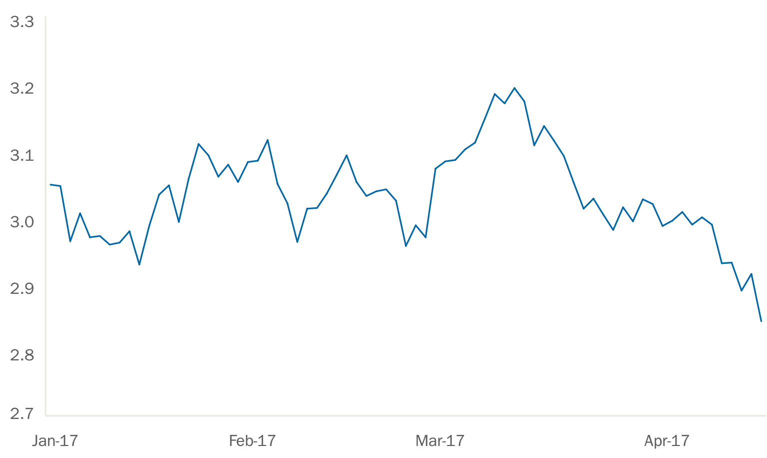
These days of calm are also perfect for not joining the herd. We know, for instance, that assets have been pouring into passive funds and fleeing active ones. Given how those strategies faired in 2016, that makes sense, as a significant

Figure 1:
"Trump rally" losing steam?
Signs of weakening in many equity sectors between March and mid-April



Source: Financial Times.
Jan-Feb and March-YTD data reflects change in close prices between 1/3/17 and 2/28/17, and 2/28/17 and 4/18/17, respectively. Indices above are S&P 500 Sector TR (Financial, Industrials, Materials, Energy, Consumer Staples, Utilities), and S&P 500 Sector IG (Technology, Healthcare).

Figure 2:
"Trump rally" losing steam?
Bond returns falling or flat between end of March and mid-April



Source: Yahoo Finance. 30 Year U.S. Treasury represented by TYX.
Chart reflects adjusted close prices for TYX from 1/3/2017 to 4/19/2017.

majority of active equity managers fell short of their benchmark. But year-to-date in 2017, a slight majority (52%) of active managers have beaten their indices (Figure 3). Active bond managers also have been performing well, and this outperformance is true for both domestic and global markets. That would seem to augur for money flow reversing and moving back into active strategies, but that has not happened—not at all.

As many active managers discourage frequent, rapid trading, either in times of volatility and fear, or when momentum is up, it is easier for most investors to use ETFs, rather than active managers. Although passive strategies are frequently preferable, a mix of passive and active is often optimal when the strategy desired does not have a great passive index, or when skilled active managers can make a difference (such as emerging markets, bonds, small-cap stocks, concentrated strategies, or unconstrained bond funds). Periods of placidity are precisely when such decisions are best made.

Finally, these are perfect periods to tweak, hone, assess, and revisit diversification. Diversified portfolios had a very troubled few years after 2010, but 2016 was quite healthy, with an average diversified stock and bond portfolio returning in excess of 7%. In a year of low inflation (around 2%) and global interest rates in the 2%-3% range at most, that diversified return was more than decent. Such portfolios also tend to be more stable and steady over the long-term, and compared to expensive, esoteric hedge funds (which in aggregate had yet another extremely mediocre year in 2016), straightforward diversified portfolios continue to have much to recommend them.

The key to good diversification, however, is being rigorous about what funds to use and disciplined about keeping allocations in line, neither of which is best accomplished in periods of volatility. That is yet another reason to gather ye rosebuds while ye may, and use the opportunity of calm weeks to position portfolios for the longer term.

Of course, by the time you read this, the market's sentiment and action could have changed significantly. If so, then the same principles apply, but it may be more complicated to implement them. *C'est la vie.*

A notable quality of our present time is the inverse relationship between our collective and

Figure 3:
Active Manager Performance vs. Benchmarks

			Q1 2017 Relative Performance	
Benchmark	**# of Funds**	**Assets Under Mgmt ($billion)**	**% of active managers MISSING benchmark**	**% of active managers BEATING benchmark**
Large Cap Total	974	$4,428	54%	46%
Small & Mid Cap Total	700	$1,079	54%	46%
MSCI/Other	589	$946	31%	69%
All Fundamental Funds	2,263	$6,453	48%	52%
All Quant Funds	122	$139	68%	32%
ALL FUNDS	2,385	$6,593	49%	51%

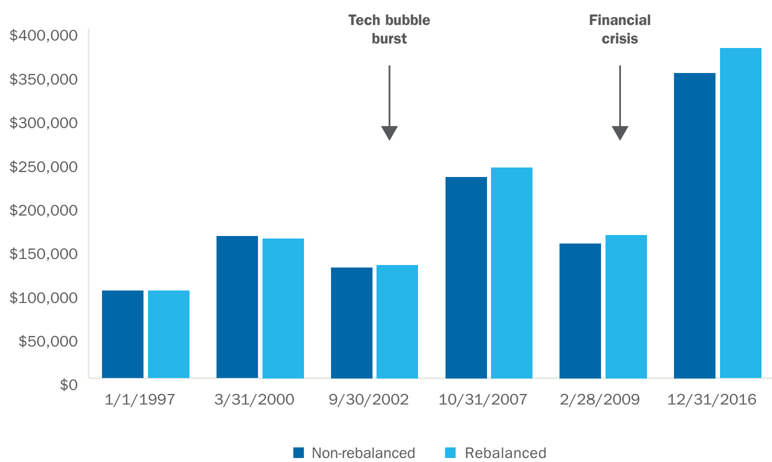
Source: CNBC.com via J.P Morgan and Bloomberg. Large Cap Total consists of Russell 1000, Russell 1000 Growth, Russell 1000 Value. Small & Mid Cap Total consists of Russell Midcap Growth, Russell 2000, Russell 2000 Growth, Russell Midcap Value, Russell 2000 Value, Russell 3000.

Figure 4:
Diversification: rocky in recent years, but much improved in 2016

		Returns (%)	
Index	**Category**	**Q1 2017**	**2016**
S&P 500 TR USD	Large Cap	6.07	11.96
Russell 2000 TR USD	Small Cap	2.47	21.31
MSCI EAFE NR USD	International Equity	7.25	1.00
MSCI EM NR USD TR USD	Emerging Mkts Equity	11.45	11.19
Bloomberg Commodity TR USD	Commodities	-2.33	11.77
Barclays US Agg Bond TR USD	Gov't/Corp Bond	0.82	2.65
Barclays US Corp High Yield TR USD	High Yield Bond	2.70	17.13

Source: Morningstar

Figure 5:
Rebalancing can potentially improve long-term portfolio performance
...and consider rebalancing during calmer markets



Source: T. Rowe Price. Charts show returns for hypothetical portfolios both beginning with $100,000. One is rebalanced annually to the original 60% stocks/40% bonds allocation over the next 20 years, while the other is not rebalanced at all. For illustrative purposes only.

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heightened sensitivity to risks known and unknown and markets that have been placid for the past few years. It is possible that those risks will explode at any moment: a bullet is dodged with the French election, but another looms with the British election in June; or tensions mount on the Korean peninsula; or another major terrorist attack occurs; or we experience a US federal government shutdown—or, or, or. It is also possible that markets will continue their benign action, with occasional bouts of buying and selling, as we saw at the beginning of 2016, when stocks swooned in January and February and then recovered, or in November 2016, when stocks soared and interest rates spiked. And so the tried-if-not-sexy answer remains the same: diversify, rebalance, and position your portfolio according to your needs and goals, and do so deliberately when you can, rather than reactively when you must. ■

April Takeaway:

Soaring equity markets and rising bond yields fueled investor euphoria at the beginning of the year. Since then, a period of clam has ensued, causing investors to query whether it may be masking storm clouds on the horizon. Yet, there is always something in the offing, either known or unknown, that can heighten volatility, and investors would be well served to factor in that possibility. And rather than wait for a market correction to occur before making needed adjustments, when prices may be skewed and emotions run rampant, investors be deliberate in tweaking and honing their portfolios now to correspond to long-term needs and desires. A well-diversified portfolio will be steady and stable over the long term.