2017 Market Review

At the beginning of 2017, a common view among money managers and analysts was that the financial markets would not repeat their strong returns from 2016. Many cited the uncertain global economy, political turmoil in the US, implementation of Brexit, conflicts in the Middle East, North Korea's weapons buildup, and other factors. The global equity markets defied their predictions, with major equity indices in the US, developed ex-US, and emerging markets posting strong returns for the year.

The broad global advance underscores the importance of following an investment approach based on diversification and discipline rather than prediction and timing. Attempting to predict markets requires investors to not only accurately forecast future events, but also predict how markets will react to those events. The 2017 markets were a good reminder that there is little evidence suggesting either of these objectives can be accomplished on a consistent basis.

Instead of attempting to make predictions about future events, investors should appreciate that today's price reflects the expectations of market participants and information about future expected returns. The following quote by the late Merton Miller, Nobel Laureate, describes this view:

"Everybody has some information. The function of the markets is to aggregate that information, evaluate it, and get it incorporated into prices." —Merton Miller

World Stock Market Performance

MSCI All Country World Index (IMI) with selected headlines from 2017

Source: MSCI.

Past performance is not a guarantee of future results. In US dollars, net dividends. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

The chart above highlights some of the year's prominent headlines in the context of global stock market performance as measured by the MSCI All Country World Index-Investable Market Index (MSCI ACWI IMI). These headlines are not offered to explain market returns. Instead, they serve as a reminder that investors should view daily events from a long-term perspective and avoid making investment decisions based solely on the news.

2017 MARKET PERSPECTIVE

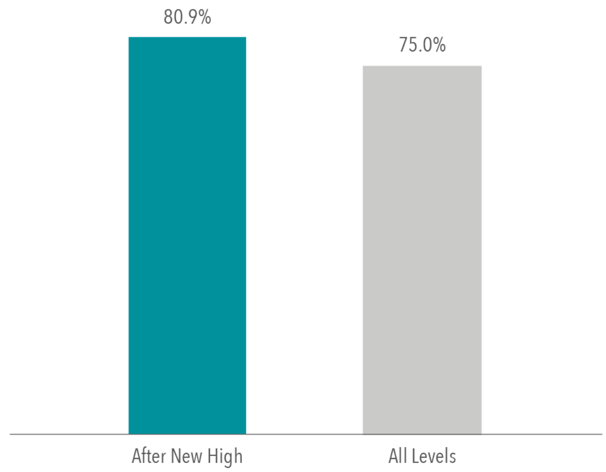
Equity Market Highlights
Global equity markets posted another positive year of returns in 2017. The S&P 500 Index recorded a 21.83% total return and small cap stocks, as measured by the Russell 2000 Index, returned 14.65%, both above their long-term average return of 11.96% and 11.73%, respectively, since 1979.

Returns among non-US equity markets were even higher. The MSCI World ex USA Index, which reflects non-US developed markets, logged a 24.21% return and the MSCI Emerging Markets Index a 37.28% return[1], making this the fifth highest return in the index history.

As the S&P 500 and other indices reached all-time highs during the year, a common media question was whether markets were poised for a downturn. History tells us that a market index being at an all-time high generally does not provide actionable information for investors.

S&P 500 Total Return Index Highs: 1926–2017

Percent of Months with Positive Return over Next 12-Month Period



For Jan 1926–Dec 2017, 331 months or approximately 30% of monthly observations were new closing highs.

Note: 1,103 monthly observations.

The S&P data is provided by Standard & Poor's Index Services Group. For illustrative purposes only. Index is not available for direct investment. Past performance is no guarantee of future results.

For evidence, we can look at the S&P 500 Index for the better part of the last century. From 1926 through 2017, the frequency of positive 12-month returns following a new index high was similar to what is observed following months of any level. In fact, over this time period, almost a third of the monthly observations were new closing highs for the index. The data shows that new index highs have historically not been useful predictors of future returns.[2]

Global Diversification Impact
Developed ex US markets and emerging markets generally outperformed US equities. As a result, a market cap-weighted global equity portfolio would have outperformed a US equity portfolio.

The S&P 500 Index's 21.83% return marked its best calendar year since 2013 and placed 2017 in the top third of best performing calendar years in the index's history. Despite these returns, the US ranked in the bottom half of countries for the year, placing 35th out of the 47 countries in the MSCI All Country World Index (IMI).

[1] All non-US returns are in USD, net dividends.

[2] Dimensional Fund Advisors, "New Market Highs and Positive Expected Returns," Issue Brief, 5 Jan. 2017.

Fixed Income

Both US and non-US fixed income markets posted positive returns in 2017. The Bloomberg Barclays US Aggregate Bond Index gained 3.54%. The Bloomberg Barclays Global Aggregate Bond Index (hedged to USD) gained 3.04%.

Yield curves were upwardly sloped in many developed markets for the year, indicating positive expected term premiums. Realized term premiums were indeed positive both globally and in the US as long-term maturities outperformed their shorter-term counterparts.

Conclusion

The year of 2017 included numerous examples of the difficulty of predicting the performance of markets, the importance of diversification, and the need to maintain discipline if investors want to effectively pursue the long-term returns the capital markets offer. The following quote by David Booth provides useful perspective as investors head into 2018:

"The key is to have the correct view of markets and how they work. Once you accept this view of markets, the benefits go way beyond just investing money." –David Booth

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Sources:
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Investing risks include loss of principal and fluctuating value. Small cap securities are subject to greater volatility than those in other asset categories. International investing involves special risks such as currency fluctuation and political instability. Investing in emerging markets may accentuate these risks. Sector-specific investments can also increase these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, liquidity, prepayments, and other factors. REIT risks include changes in real estate values and property taxes, interest rates, cash flow of underlying real estate assets, supply and demand, and the management skill and creditworthiness of the issuer.

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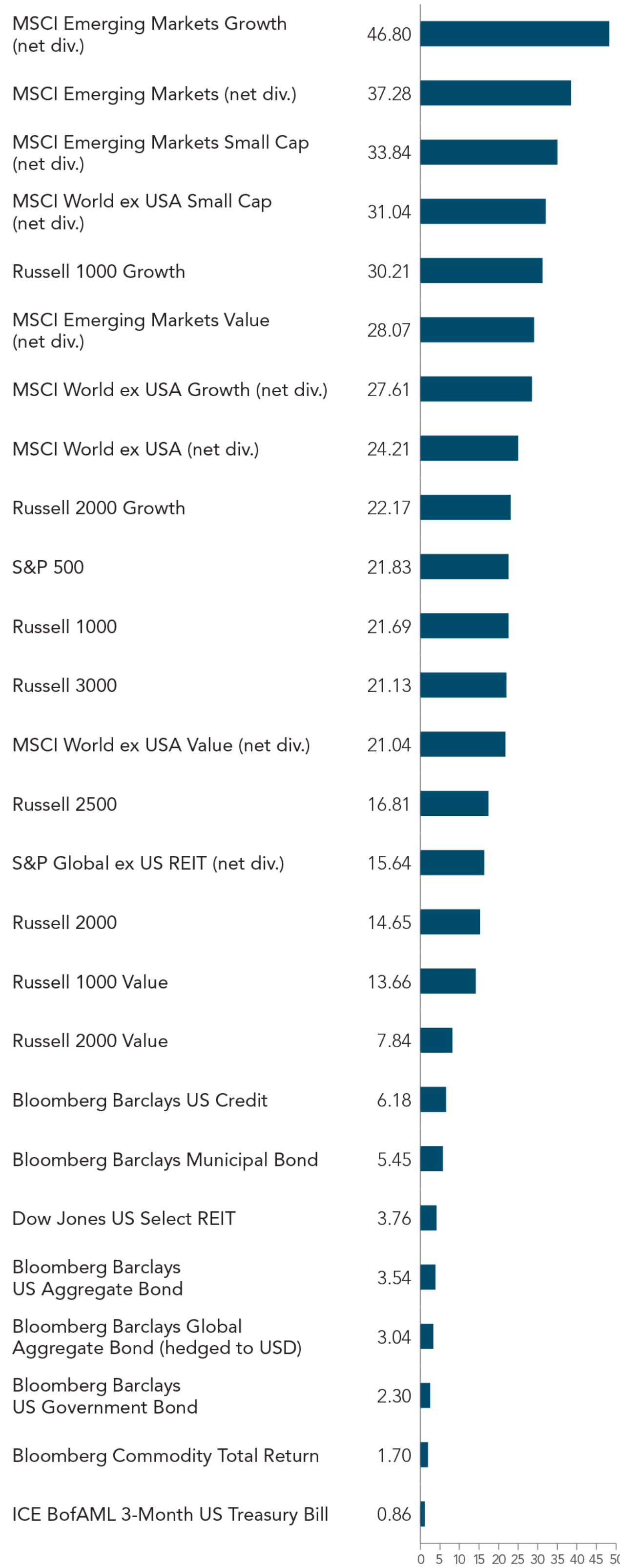
Major World Indices Ranked by One-Year Performance (%)

As of December 31, 2017



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