STATERA
ASSET MANAGEMENT

Commentary: February 2017

ONE STRATEGY FOR ALL

With changes in weather, we change our clothes. The more wide-ranging and unpredictable the patterns, the bigger our closets. So it goes with our investments. Markets never fail to press for change of fashion and function, as shifts from balmy rally to stormy correction can come swiftly. And our natural response to an abruptly changing environment, depending on the direction, is to duck and run for cover or to drop the coat and umbrella for shorts and sunglasses. But, what if we build our investments with an all-weather attitude in mind? That basic mindset defines our investment approach.

Human After All

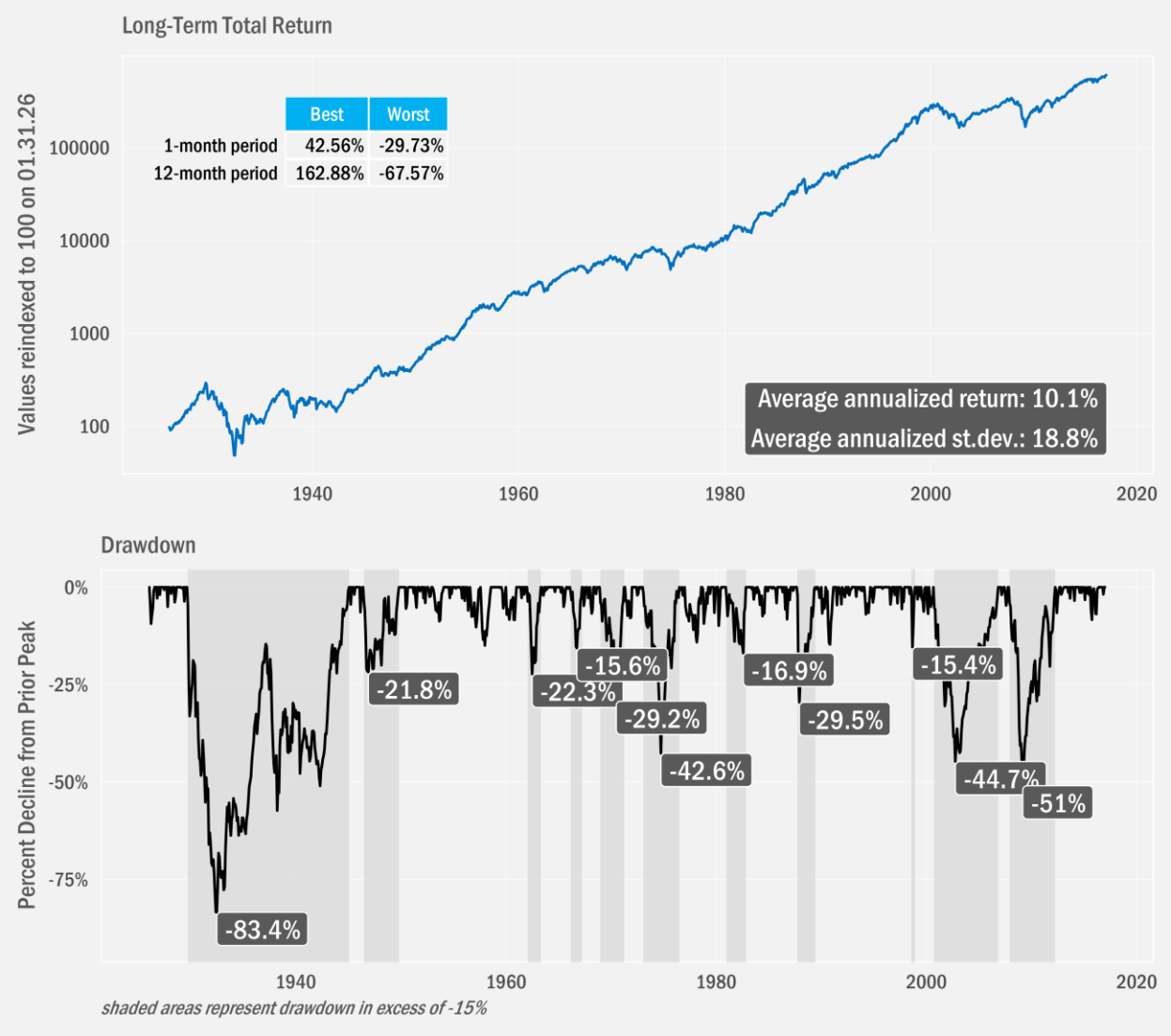
The first element of that approach is to determine, to the best of our ability, our individual tolerance for market risk. In gauging that tolerance, we really mean to determine our stomach for losses along two dimensions: depth and time. How much can we stand to lose over what time frame?

Seeking to answer that question, a review of market history is pertinent. For this discussion, we generally prefer to combine a view of long-term returns with a view of the range of drawdowns experienced along the way. We touched on the concept of drawdowns in last month's commentary as we discussed the relative riskiness of equity, versus fixed income. Readers may recall that we defined a drawdown as the maximum loss subsequent to a peak in the index. A drawdown also can be expressed as the length of time after an initial loss for an index to recover to a prior peak.

This month, we'll look at equity only to provide context for looking at return and risk over time. In Figure 1 we show for the S&P 500 Index the long-term total return since the beginning of 1926 along with a chart of the drawdowns over that same time frame. We use a special axis to show the index series so that downturns and upswings visually equate to the same percentage changes, even though the index begins at 100 on 01.31.26 and ends at more than 614000 on 01.31.17. As for the drawdowns, the chart displays the drawdown periods we detailed in last month's commentary.

The point of the display is to reinforce the idea that, while very long-term returns certainly can be described as robust, those returns came with substantial volatility. And investors might have experienced long periods of time underwater on their investments. We tend to focus on the risk side of that balance, because myriad studies have shown that the mental regret humans derived from loss can be more powerful than the mental benefit derived from gain. Better then to ask ourselves what level of losses in the interim makes the eventual return irrelevant.

Figure 1: S&P 500 Index Historical Total Return and Drawdown

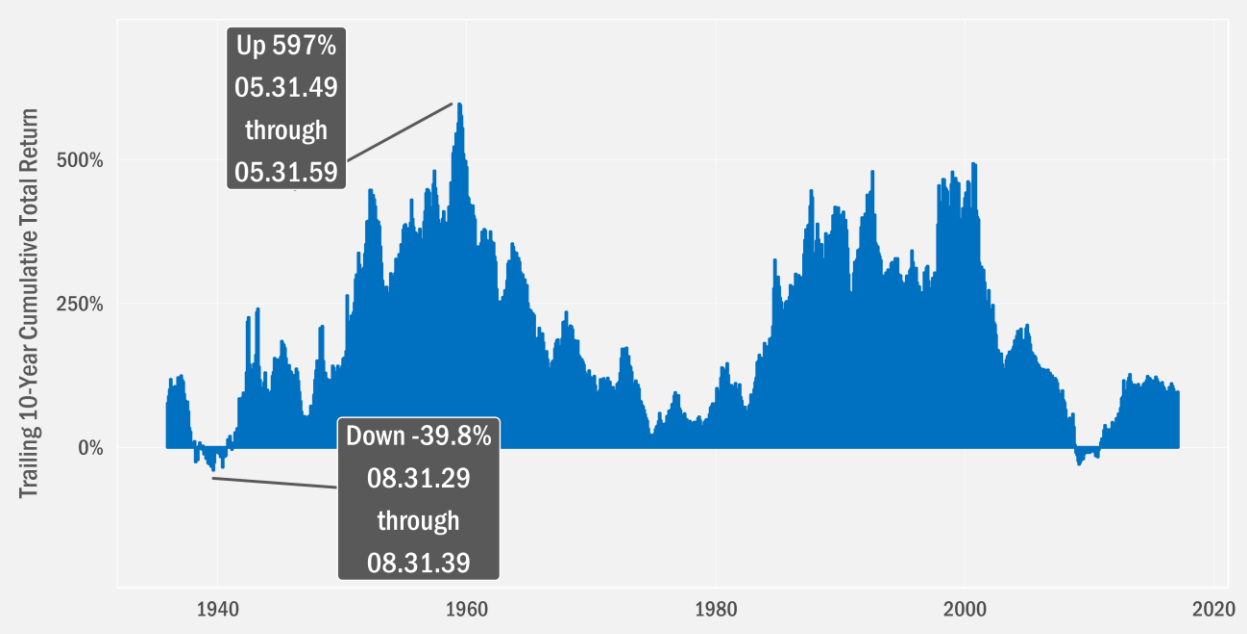


From 01.31.26 to 01.31.17. Logarithmic scale reindexed to 100 on 01.31.26. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. Standard deviation is a statistical metric that describes the variation of a set of data about its average. A higher number reflects more variation (or volatility). Abbreviated to st.dev. above. Drawdown may be measured as the maximum loss from a prior peak value and/or the length of time the portfolio requires to return to breakeven after a prior peak. SOURCE: SRCM using data from Dimensional Fund Advisors

As we discussed last month, we focus primarily on the split between equity and fixed income to express a relative level of overall expected risk and returns for our portfolios. Again, we are seeking to answer what level of risk (volatility, losses and/or drawdown) might leave an investor too weary and wary to remain invested. The challenge, in particular after two substantial drawdowns in the domestic equity market within the past two decades, is to offer a fair representation of potential return. Importantly, we want to be careful not to needlessly scare investors from equity.

Still, we strive to provide an honest historical perspective to support the investment process. An additional perspective we often provide is one that shows, for a given investment time horizon, what past returns might have been achieved by investors in a particular allocation. To show what such a review might look like, we have charted a review of the rolling[1] 10-year return of the S&P 500 since January 1926 through January 2017 in Figure 1. The 974 10-year rolling periods in the data form a somewhat wave-like series. This makes sense, as the data underlying each point on the chart is different from the one before it and the one after it by just 2 months-worth of data.

Figure 2: S&P 500 Trailing 10-Year Cumulative Total Return



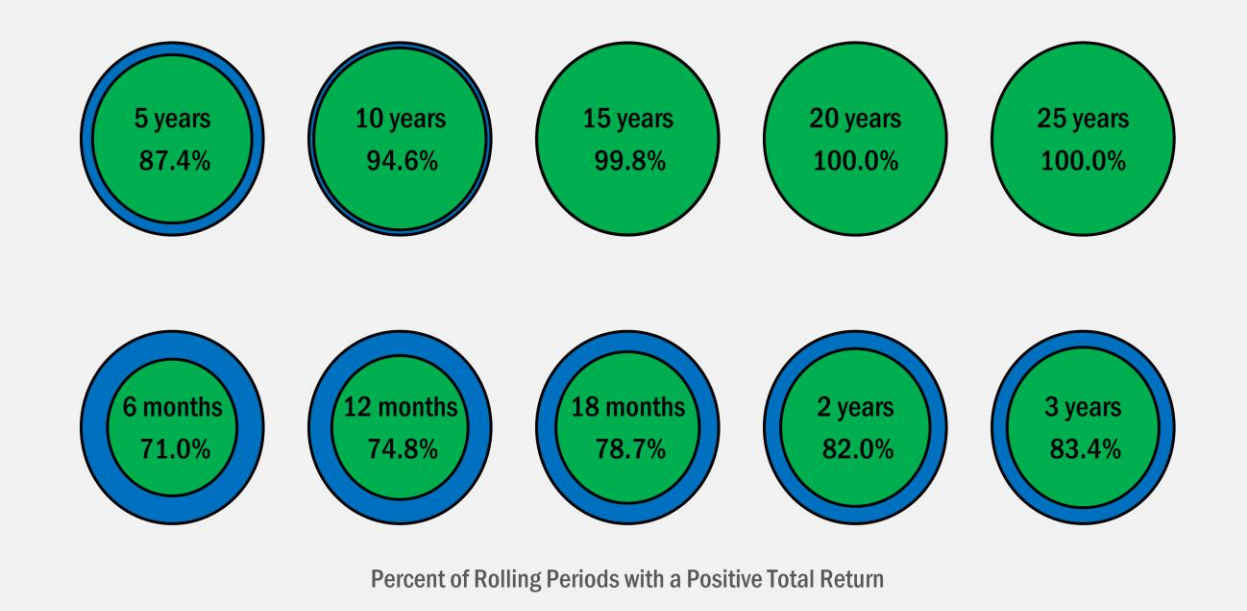
From 01.31.26 to 01.31.17. Underlying data are monthly total returns for the S&P 500 Index. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Standard & Poor's Index Services Group via Dimensional Fund Advisors

What should jump out in the chart above is that, while the returns the index achieved ranged wide, they have a clear positive bias. And that sets us up for the reason we started talking about rolling returns in the first place: though equity investing[2] involves risk, patience generally has been rewarded in the fullness of time. Still no guarantee, of course, but the odds tilt further in an investor's favor the longer one remains invested.

[1] A *rolling period* is a window of time of a specific length with an underlying periodicity. An example would be 10 years using monthly periods (meaning there are 120 months in each rolling 10-year period). Importantly, rolling periods overlap. For a 10-year monthly series, we start with the first 120 months to take a measurement. We then drop the first month (month 1) and include the month after the last month in the prior series (month 121) along with each month in between. This process goes on until we arrive at the final 120 months in the series. Since we are looking at the data from the end of each rolling 10-year period, we refer to the data as a *trailing* series. Were we looking at each rolling period from the first month of the window, the resulting data comprise a *forward* view.

[2] Near all investing requires the assumption of risk. We at the moment simply are focusing on equity investing.

Figure 3: Length of Holding Period and Risk of Loss



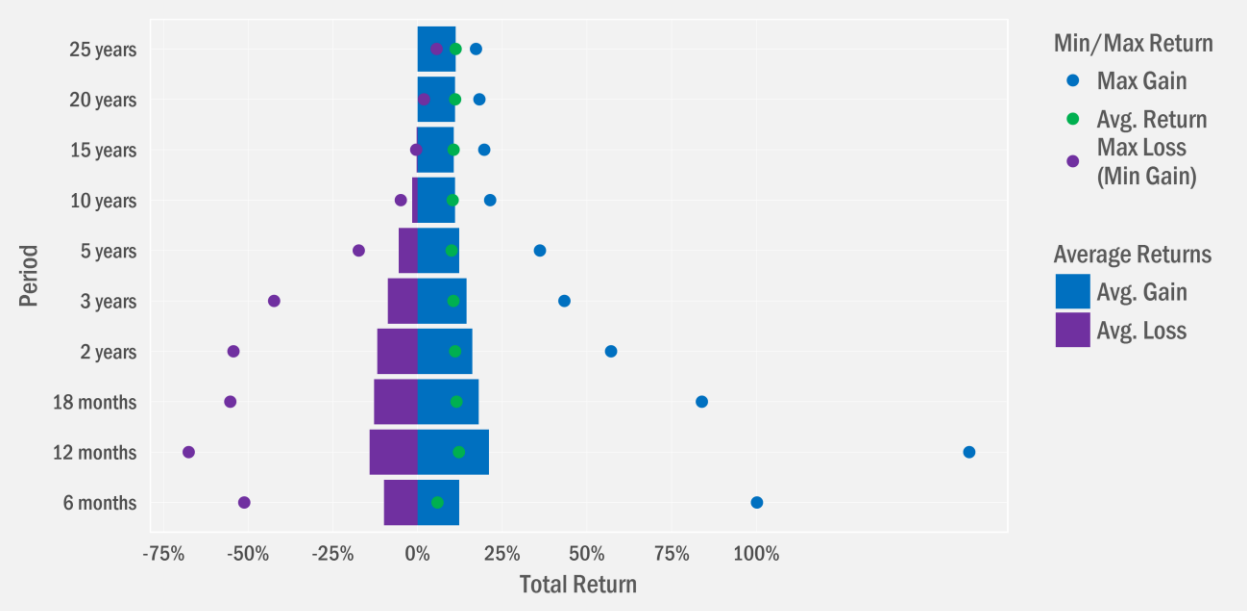
From 01.31.26 to 01.31.17. Underlying data are monthly total returns for the S&P 500 Index. Rolling calculations based on given trailing periods for each month end. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Standard & Poor's Index Services Group via Dimensional Fund Advisors

To support that statement, in Figure 3 we show the percentage of time the S&P 500 has turned in losses over various lengths of time. For this chart, we used historical monthly returns for the S&P 500. The data show that, the longer the time horizon, the less likely the index was to have suffered losses, with no losses having ever been recorded over the 854 20-year periods since the beginning of 1926.

There were two 15-year periods, however, over which investors in the S&P 500 might have lost money: the 15-year periods ended August 1944 and September 1944 as World War II raged on. Of course, fifteen years is a long time to invest only to fail to turn a profit. Even though it only occurred twice in the 914 rolling 15-year periods over the past 91 years, it's no less probable over the next 15. Losses are possible even over the next 20 and 25.

But, we can look at those same data another way: what's the range of returns over those time frames? That view, which we share in Figure 4, shows that the level of losses fall while the level of cumulative gains have increased over increasing lengths of time. Put differently, a review of the historical data suggests that not just the *likelihood*, but also the *level* of cumulative losses generally has fallen with increases in the investing time horizon, while the likelihood and level of cumulative gains have grown.

Figure 4: S&P 500 Trailing Periodic Returns Comparison



From 01.31.26 to 01.31.17. Underlying data are monthly total returns for the S&P 500 Index. Reutns for periods greater than 1 year are annualized. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all of the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Standard & Poor's Index Services Group via Dimensional Fund Advisors

Gauging Endurance

Key then is to understand how we may react to varied circumstances as time moves forward. Generally speaking, our response may be to reduce the overall risk in our portfolios. That generally means reducing the level of equity exposure in our portfolios in favor of adding fixed income. As we demonstrated in last month's commentary, equity markets generally are more volatile than fixed income markets, meaning that equity-related losses generally have proved larger, longer-lived and more frequent than they have for broader fixed income markets. In working with our clients, we therefore like to revisit the performance of various mixes of equity and fixed income over time, first to show how return and risk are related and second to assess client comfort with that tradeoff.

The purpose of the reviews most certainly is not to scare folks from investing. Rather, we hope in any scenario to provide support *to be invested*. Indeed, the goal of these conversations we have with clients is to resolve a suitable approach that acknowledges each unique mix of life goals, interim challenges and range of aversions to market uncertainty. Almost invariably, the suitable answer in our view involves some manner of exposure to the capital markets.

Regular Checkup Required

Whether equity or fixed income, investing can prove a constant source of mental anguish. Spirits may lift with each new high or sink on increased fear of potential declines. Knees will shake amidst heightened market volatility, or flex at the chance to invest at market lows. Those contradictions suggest there's some wisdom in, "only if we let it." To that end, we strive to remain a source of solace and guidance as we partner with our clients in the pursuit of their life's goals.

Important Information

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

The S&P 500 Index represents 500 U.S. companies and captures approximately 80% coverage of available market capitalization.

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