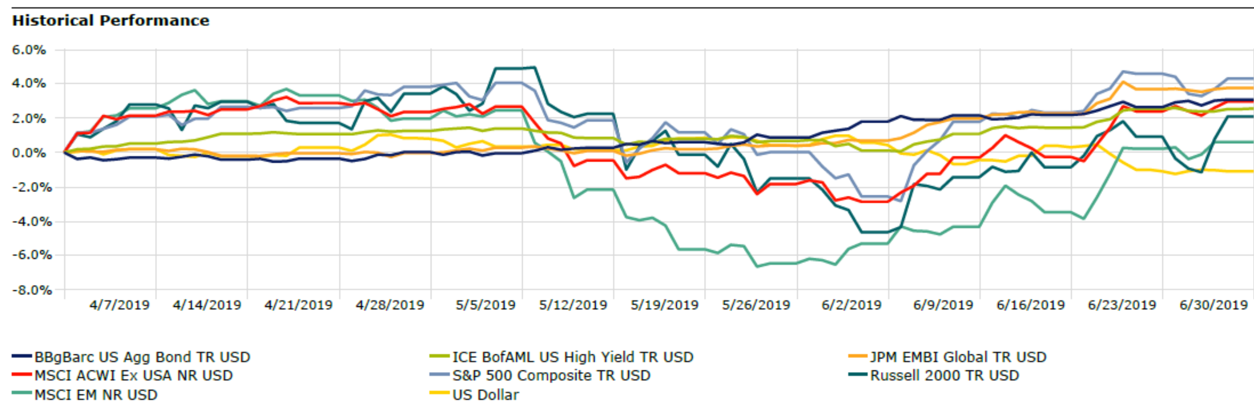
mABC LLC
Investment Advisors

After a big bounce to start the year, the second quarter saw a continued rally, albeit smaller and more volatile. Trade disputes continue to dominate headlines and GDP growth around the world has slowed, but under the surface the global economy continues to show signs of strength.

Global Markets Performance

The US stock market, as represented by the S&P 500, finished up 4.30% on the quarter, adding to a positive return in the first quarter and an 18.54% return so far this year. Smaller US stocks[1] also rose, though less than their larger peers, up 2.1% for the quarter and 16.98% year to date. International stock markets[2] and emerging markets[3] rose as well though not as strongly as domestic equity markets, with returns of 2.98%% and 0.61%. On the credit side, core bonds[5] rose strongly at 3.08% and high yield bonds[6] rose as well, up 2.57% for the quarter, impacted by lower rates that more than offset modest widening spreads[a]. Emerging market (EM) bonds[7] fell in line as well with a positive performance of 3.76% on the quarter.



Calendar Year Returns

	YTD	2018	2017	2016	2015	2014
BBgBarc US Agg Bond TR USD	6.11	0.01	3.54	2.65	0.55	5.97
ICE BofAML US High Yield TR USD	10.16	-2.26	7.48	17.49	-4.64	2.50
JPM EMBI Global TR USD	10.60	-4.61	9.32	10.19	1.23	5.53
MSCI ACWI Ex USA NR USD	13.60	-14.20	27.19	4.50	-5.66	-3.87
S&P 500 Composite TR USD	18.54	-4.38	21.83	11.96	1.38	13.69
Russell 2000 TR USD	16.98	-11.01	14.65	21.31	-4.41	4.89
MSCI EM NR USD	10.58	-14.57	37.28	11.19	-14.92	-2.19
US Dollar	-0.04	4.40	-9.87	3.63	9.26	12.79

© Morningstar 2019. All data as of 6/30/2019. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied, adapted or distributed; and (3) is not warranted to be accurate, complete or timely. Not all index performance mentioned is displayed above. See references for more detail.

mABC LLC Investment Advisors

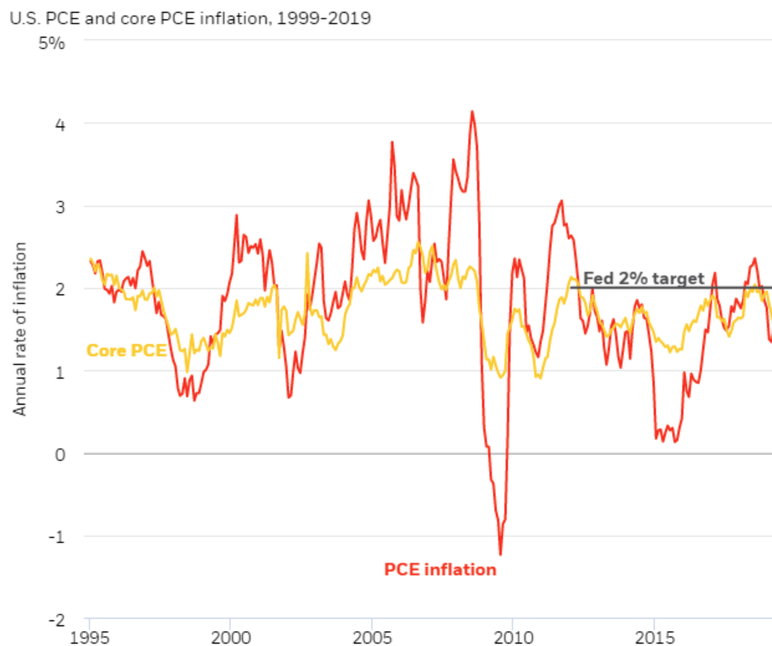
All Fed Up

If you've tuned into financial news in the last few months you've no doubt heard mention of the Federal Reserve, or Fed, and its influence on the stock market. The Fed has for many been a source of obsession for the past few years, as they've attempted to decipher every public statement from the institution in the hope of gaining an advantage in the market.

So what exactly is the Fed and how does it affect the markets? At the broadest level, the Federal Reserve is a bank for banks. It takes in bank deposits and allows banks to lend to one another with those deposits once they've met a certain minimum at a rate called the federal funds rate,[b] which is set by the Fed. Control over this interest rate allows the Fed to largely, though indirectly, control all shorter-term interest rates in the US.

Its other primary tool is known as quantitative easing (or quantitative tightening), which refers to the ability to purchase (sell) securities directly in the market to affect the supply and demand. The vast majority of these items are US government bonds, though it can include other federally-guaranteed fixed income such as agency mortgage bonds[c]. Economics 101 teaches us that more demand for an item tends to push the price up, and when the Fed purchases securities in the market it thus increases the prices on them.

A direct effect from these price increases is to lower the yields, which makes it cheaper to borrow. Thus, the Fed can (to a degree) control the cost of lending in the US, either by setting the federal funds rate or by purchasing/selling securities in the open market. The major difference between the two is the targeted term of lending. Since 2009, the Fed has both kept the federal funds rate relatively low and purchased large quantities of securities directly in the market, which has kept rates low along the spectrum.



Source: BlackRock Investment Institute, May 2019[8].

So why would the Fed want to lower the cost of borrowing? Its congressional mandate gives responsibility for two key objectives – to maintain maximum employment and stable prices. In the aftermath of the 2008-2009 financial crisis, the Fed looked to stimulate growth and boost employment by lowering interest rates and thus corporate financing costs.

The Fed has had a harder time managing stable prices, or inflation, as it continues to hover at or below the target of 2% growth per year. Classical economic models

explain that low interest rates should lead to higher inflation, but as the Fed has learned that doesn't always work out. However, many investors believe that the actions of the Federal Reserve will directly affect future movements in the markets, and will thus continue to keep their ears to the ground.

Baby Got Buyback

Corporate stock buybacks in the US reached an all time record in 2018, rising more than 50% from the prior year to over $800 billion[9]. The magnitude of that number can be partially understood by the 2018 tax holiday afforded to US corporations for cash held overseas, which allowed them to return cash to the US at relatively de minimis tax rates. And given that rapid influx of cash, many firms chose to allocate at least a portion to stock buybacks.

Source: Goldman Sachs Global Investment Research, Compustat[9].

What exactly are buybacks? They're a form of financial alchemy wherein a company buys back its own stock in the market, which reduces the total number of shares available to investors and increases the earnings available to each unit of stock. In other words, while the total earnings of the company haven't changed, each unit of stock has a relatively higher value of earnings because there are less shares that can be purchased. This can cause a stock to appreciate in value despite the fact that no aggregate value has been created; it's simply been redistributed.

The record cash spent on buybacks in 2018 escalated the discussion to the political arena earlier this year, with many on the Democratic side arguing that companies were wasting money buying back their own shares when they should be investing in their employees and not their shareholders[10]. From an ethical standpoint that view may hold merit. But from an economic standpoint those comments don't hold much weight – in capitalism, that corporate cash should be directed to the activity that generates the highest expected return.

Restricting the ability to allocate cash could in turn negatively impact companies, which would be a poor result for both shareholders and employees. NYU professor and investment luminary Aswath Damodaran has stated publicly that limiting a firm's ability to distribute cash would likely cause companies to make bad investments[11]. In today's economy with near-daily uncertainty, buybacks are a much more efficient means of providing income to shareholders than dividends because of their flexibility, he argues.

The bottom line is that buybacks are neither inherently good or evil but are instead employed in both positive and negative ways by those in charge. Were Congress to ban buybacks, that could prove a large negative for those companies who have come to depend on them. On the other hand, there are some

that would likely benefit from lower cash spent on buybacks and more on the current and future operations of the company.

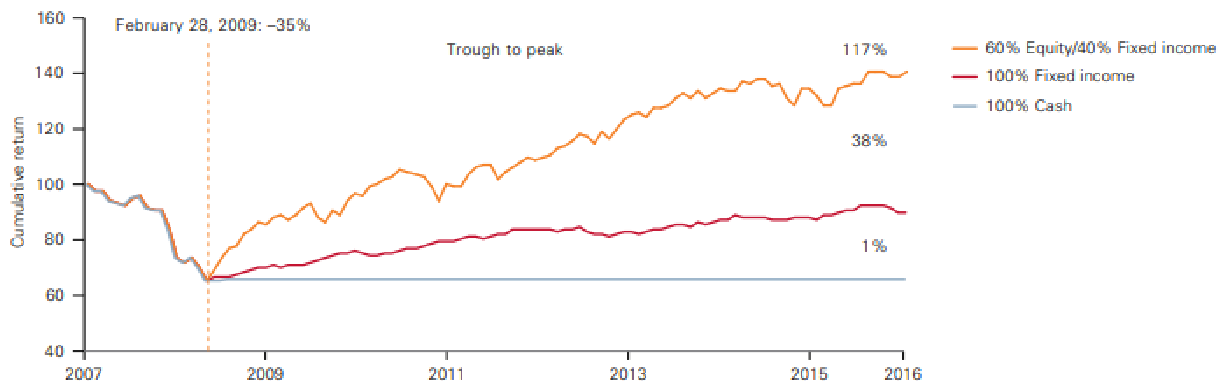
(Re)Balance of Power

For today's average investor, the most common sense approach to long-term investing involves allocating certain percentages of their wealth to various asset classes, such as fixed income, equities, and alternatives. In industry parlance, this is known as diversification and its benefits are widely touted. Less spoken of, however, are the benefits that long-term investors can reap from disciplined rebalancing.

Rebalancing is, in essence, the practice of selling your winners and using that cash to invest in the underperformers, all within the framework of your larger long-term strategic asset allocation[d]. Much academic research has shown that rebalancing helps keep investors on track for their long-term planning goals, but there remains debate on when and how often to do so. Some rebalance quarterly or annually, others only after certain quantitative triggers have been tripped, and still others on specific calendar dates. None have yet to be found empirically superior, but all confer certain benefits.

In today's volatile market environment marked by trade wars, global growth concerns, and ever-faster trading capabilities, rebalancing also offers a major, yet subtle, advantage: it reduces volatility. By nature of rebalancing, assets are reallocated from those asset classes that have been the most volatile to those that have not. In the long run, this will generally see assets reallocated from equities and into fixed income, which will further mute volatility within the portfolio[e].

As noted by Morgan Stanley, "rebalancing takes advantage of the long-term effects of mean reversion" and "does not require any insight over which asset class will outperform in any given period."[12] Thus, with the exception of transactions costs and potential tax consequences, rebalancing is an effectively cheap method of bolstering long-term performance and an important consideration in the face of market drawdowns.



Source: Vanguard, Thomson Reuters Datastream[13].

Looking Forward

The following quarter is bound to see a continuation of trade disputes, developments in US elections, and ongoing political polarization. But perhaps the most important date to keep in mind this quarter is July 31st, when the Federal Reserve will next meet to consider adjusting the federal funds rate. Markets will be broadly anticipating the outcome of this meeting the entire month of July, and if the Fed surprises in any manner it's likely volatility will find its way into the markets in August.

Yet no matter how these actions translate into the financial markets, it's important to remember that these are short-term events that are unlikely to impact our long-term investment portfolios. With short-term dislocations we should look to ensure our portfolios are properly diversified, and evaluate whether or not rebalancing makes sense to stay within those strategic guideposts.

Markets will fluctuate, pundits will prognosticate, and the media will continuously fete the newest issue du jour. But the disciplined investor will ignore the distractions and look to the endgame. In the words of Ben Graham, "the best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go."[14] We couldn't agree more.

Ryan Walsh, CFA® is an investment advisor representative of NWAM, LLC dba Northwest Asset Management and RIA Innovations, an SEC registered investment adviser. This publication is in no way a solicitation or offer to sell securities or investment advisory services. Statistical information, quotes, charts, references to articles or any other quoted statement or statements regarding market or other financial information is obtained from sources which we believe reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. All domestic and international rights are reserved. No part of this newsletter including text, graphics, et al, may be reproduced or copied in any format, electronic, print, et al, without written consent from Ryan Walsh, CFA® and RIA Innovations. Neither Ryan Walsh CFA®, nor RIA Innovations provide legal or tax advice. Please be advised to consult your investment advisor, attorney or tax professional before making any investment decisions.

References:

Smaller US stocks[1] – as represented by the Russell 2000 TR Index

International stock markets[2] – as represented by the MSCI All Country World ex-USA Index

Emerging markets[3] – as represented by the MSCI Emerging Markets TR Index

US Dollar Index[4] – as represented by the US Dollar Currency Index (DXY)

Core intermediate bonds[5] – as represented by the Bloomberg Barclays US Aggregate Bond Index

High yield bonds[6] – as represented by the ICE BofAML US High Yield Index

Emerging market bonds[7] – as represented by JPM Emerging Market Bond (EMB) Global Index.

US PCE and Core PCE inflation chart[8] – sourced from "Why the Fed is reviewing its monetary policy strategy," June 2019.

Stock buybacks[9] – sourced from Goldman Sachs Top of Mind: Buyback Realities, April 2019.

Politics & buybacks[10] – sourced from Eaton Vance blog, "Stock buybacks are going out of vogue," March 2019.

Aswath Damodaran[11] – sourced from Goldman Sachs Top Of Mind: Buyback Realities, April 2019.

Morgan Stanley rebalancing[12] – sourced from "The Rebalancing Effect," Morgan Stanley, September 2015.

Vanguard rebalance discipline chart[13] – sourced from "Vanguard's Principles for Investing Success," Vanguard, 2017.

Ben Graham quote[14] – sourced from Davis ETFs, "Wisdom of Great Investors."

Glossary:

Spreads[a] – the difference in bond yields of the same maturity but differing qualities, e.g. corporate bonds vs. US government bonds.

Federal funds rate[b] – the interest rate that banks charge other banks for lending them money from their reserve balances (held at the Federal Reserve) on an overnight basis.

Agency mortgage bonds[c] – mortgage securities that are issued by government-sponsored entities (GSEs) like Fannie Mae or Freddie Mac, or guaranteed by a government agency like Ginnie Mae.

Strategic asset allocation[d] – the long-term asset class goals for an investor which specify on average, how much of your money should be invested into stocks, bonds, etc.

Muting volatility[e] – equities have empirically outperformed fixed income over the long-term, and are similarly more volatile. By trimming outperformers volatility can be mitigated due to the longer-term reversion to the mean of performance.

mABC Investment Advisors, LLC is a state registered investment advisor in the State of Texas and certain other states. This content is provided by a third party and may not necessarily reflect the expertise of this Advisor. This publication is not intended to provide investment advice and is intended for your information only. This publication is reprinted with the permission of NWAM, LLC dba Northwest Asset Management and RIA Innovations, an SEC registered investment adviser. NWAM, LLC is unrelated to mABC Investment Advisors, LLC.