PERSONAL FINANCIAL MANAGEMENT

PERSPECTIVES

The Year in Review

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

-Mark Twain

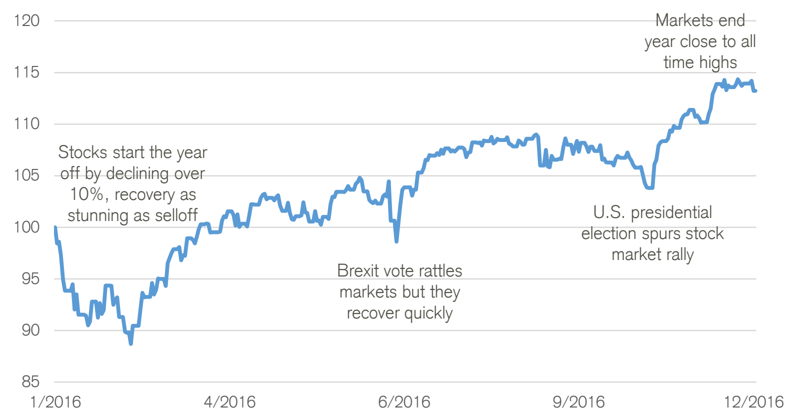
Surprise /sə(r)ˈprīz/ – An unexpected or astonishing event, fact, or thing. 2016 was a year of surprises from start to finish. It will likely be remembered for providing the worst start to a year in the history of global stock markets, for the passage of a U.K. referendum to leave the European Union (i.e. Brexit), and for the election of Donald Trump as President of the United States. A theme that stood out perhaps this year more than most was how completely wrong expert predictions can be. Statistically, expert analysts tend to be right 47% of the time when they make 1-year predictions. (They have an even lower 7% accuracy rate for predictions that look out 2 years.) However, in 2016 it seemed that economic and political experts were wrong all of the time. Studying the reaction in financial markets to the surprises that resulted from these failed predictions provides interesting insight into human emotion. Likewise, it affirms a strategic investment approach that looks beyond short-term predictions.

Jumping to Economic Conclusions

At the beginning of 2016, it became very clear that China's rate of growth had slowed down from its meteoric level of 9% to something more like 6%. While 6% growth is amazingly high compared to developed markets, some forecasters suggested that slower growth in China could still derail the fragile economic recovery across the rest of the world and lead to a global recession. Pressure was felt across the globe, and global stock markets dropped 11% in just 39 days, literally providing the worst start of any calendar year in history. However, this attention-grabbing headline proves to be a bit dramatic when placed in context. Corrections of 10% or more are actually quite common, but simply have not often occurred at the start of a year.

At any given time, it is fairly easy to find someone forecasting the "next 2008" or a "major market crash." (This is a great way to generate website clicks or newsletter subscribers.) In anxious environments, negative views such as these gain incredible media attention. Last January was no exception. After the market's fall, we recall one widely publicized article from an analyst at a prominent investment firm that recommended selling everything except for high quality bonds in anticipation of further stock market declines. The recommendation was made in mid January, just a few weeks before February's bottom. (We had more than a few concerned individuals call us to discuss this recommendation.) Anxious investors who took this advice did so to their own detriment. In early February the prevailing negative sentiment evaporated as suddenly as it had transpired in the first place. Global stock markets proceeded to recover lost ground and much more. Moreover, a global slowdown did not materialize.

2016 U.S. Stocks

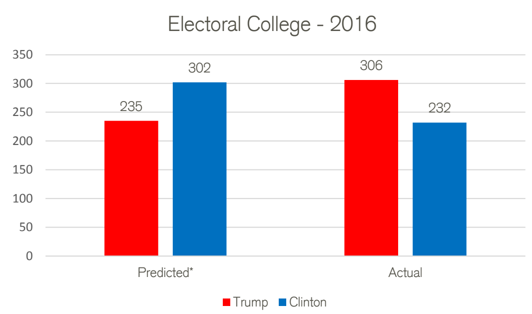


Poll Fail #1: Brexit

In the lead-up to the U.K.'s referendum on European Union membership, polls widely indicated that the U.K. would vote to remain in the E.U. With confidence in these predictions, markets largely ignored the looming vote. As results came in, however, it became apparent that the polls were wrong. Following the U.K.'s unexpected vote to leave the E.U., stocks around the world sold off sharply, with the British pound and smaller U.K. stocks faring the worst. Many large banks warned that these events would lead to an imminent recession in the U.K and suggested that this recession might even spread globally.

Markets quickly settled down as it became clear that departure from the E.U. would be slow and methodical and that other countries would simply strike new trade agreements so that they could continue doing business with the U.K. It has not been well publicized, but many of the large banks that issued recession warnings have since walked them back (though due to the dynamic nature of the situation, it may be premature to draw any conclusions). Stock markets outside of the U.K. began their recovery within a few days and have gone on to reach record highs. Similar to the China -driven sell-off earlier in the year, the emotional overreaction of sellers provided a buying opportunity for those willing to remain focused on the longer term.

Poll Fail #2: Trump



*Predicted numbers do not sum to 538 due to additional candidates, Source: fivethrityeight.com

The lead-up to U.S. elections was similar to that of the U.K. referendum. Polls and pundits led the public to believe that a Clinton victory was virtually assured. Several publications and speeches made leading up to the election went so far as to state that Trump had quite literally zero chance of winning. (Perhaps the results across the Atlantic just five months prior should have given pause to those drawing such conclusions.) Although the polling errors made in Brexit and the U.S. election similarly missed actual populist sentiment, the U.S. stock market response following the election's surprise was quite different. Most experts believed that U.S. financial markets would respond negatively if Trump were to win due to uncertainties around how he might govern. In reality though, forecasters proved to be wrong yet again. U.S. stock markets reacted very positively to Trump's victory on hopes that an outsider might shake things up in Washington and return the United States to a more prosperous path.

The 2016 election's outcome demonstrates the incredible difficulty of positioning a portfolio in anticipation of future events. *It is hard to correctly predict an event; and it is entirely impossible to correctly predict the markets' reaction to that event.*

It is important to note that many markets did respond negatively to the election, including U.S. bond markets and non-U.S. stock markets. Here we focus on the outcome in U.S. stock markets simply because the results were so contrary to what forecasters expected.

2016 Year in Review – What Worked, What Didn't

Even with surprises along the way, 2016 ended up being a positive year in global stock markets due to improving

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economic expectations, although the level of return varied widely amongst categories, especially after the U.S. election. U.S. stocks ended the year reaching new highs, whereas the rest of the world pulled back, which muted stronger returns from earlier in the year.

Asset Category	2016
U.S. Large Stocks	12.1%
U.S. Midsized Stocks	13.8%
U.S. Small Stocks	21.3%
Foreign Developed Large Stocks	1.0%
Foreign Small Stocks	2.2%
Foreign Emerging Large Stocks	11.2%
Global Real Estate	4.8%

Source: Morningstar

A notable aspect was strong performance from the majority of the growth-oriented categories that Paracle emphasizes for the return benefits they tend to provide over time. This was a nice turn of events, since higher growth categories have not provided a great deal of return benefit over the last several years, given global investors' favor of safe haven U.S. large companies.

Small stocks and foreign emerging stocks outpaced their larger and developed market peers. It is encouraging to see these results materialize, as these categories have struggled over the past few years to provide returns close to their historical averages. Foreign small stocks did not post as strong performance as other growth categories, but nonetheless beat their larger counterparts. Headwinds such as a strengthening dollar and poor performance from smaller U.K. companies following the Brexit vote contributed to this result.

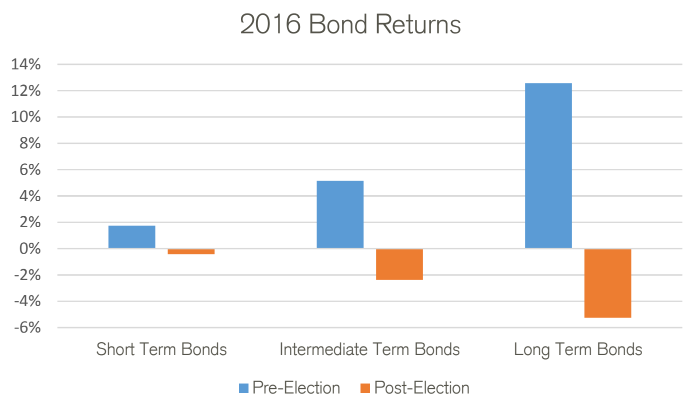
With much uncertainty in Europe, foreign large companies barely squeaked out a positive return. However, this had little impact on performance since Paracle has a relatively low strategic allocation to foreign large companies in our portfolios. This is the fourth consecutive year that U.S. stocks have outperformed foreign developed stocks. When this dynamic turns, it will present a headwind to performance relative to the global benchmark. However, it is important to note that our portfolios are designed for a good long-term outcome for the families that we serve, not for what happens from one year to the next.

Asset Category	2016
Intermediate Term Tax-Exempt Bonds	-0.4%
Short Term Taxable Bonds	1.3%
Intermediate Term Taxable Bonds	2.7%

Source: Morningstar

Investors have become accustomed to very little bond market volatility over the last decade. Bonds do indeed turn down at times, however, and the level of the bond market's decline after the election was well within longer term historical norms. Nonetheless, even small bond movements feel disturbing since bonds are intended to serve as safe ballast in portfolios. In a recent call, one global market strategist quipped that a bear market in stocks is a akin to a grizzly, while a bear market in bonds is more like a koala. *It is important to observe that even an unsettled bond market is usually safer than an average stock market environment.*

Although bonds provided lower returns in 2016 than in years past, our strategic positioning in intermediate bonds worked out well. Shorter term bonds held up better in the aftermath of the election, but the greater yields that intermediate bonds delivered throughout the year caused them to end the year with a higher overall return. On the other side of the



maturity spectrum, long term bonds demonstrated their tendency toward volatility by losing more than twice the value of intermediate bonds following the election.

We continue to believe that intermediate term bonds offer the best tradeoff between yield and downside risk. As part of our normal investment category review cycle, Paracle's investment team is reviewing our bond portfolio in the first quarter of 2017 to confirm our positioning and the strategies we are utilizing. We will of course be in touch if we determine that any strategic changes are desirable. Additionally, we always welcome questions from anyone with specific concerns.

Asset Category	2016
Hedge Funds	2.3%
Bank Loans	10.2%
High Yield Bonds	17.1%
Emerging Market Bonds	9.9%
Commodities	11.8%

Source: Morningstar

Non-traditional investments are intended to provide diversification from U.S. stock and bond exposure. However, since unsettled global investors have largely considered U.S. stocks and bonds a safe haven over the last many years, non-traditional categories have performed less well and have proven to be a trying asset class to own. In a welcome turn, 2016 provided a change of direction. The budding global economic recovery has provided a rebound in oil prices that aided commodities as well as strategic fixed income categories such as high yield bonds and emerging market bonds.

Looking Toward 2017

As in any environment, each day brings new developments. Looking overseas, much remains to be seen with regard to the effects of China's slowdown, the details of the U.K.s exit from the E.U., as well as whether other E.U. member countries will attempt to follow suit. Here at home, it is likely that the Federal Reserve will continue raising interest rates, and the Trump Administration's policies will unfold over the coming months. Any surprises have the potential to unsettle investors at times, and financial markets may exhibit volatility as these issues are digested.

Although some things may seem clearer than others, the lesson of 2016 teaches that trying to gain from predictions is difficult if not impossible. In light of this, we will continue to pursue a long-term strategic focus, while also taking advantage of market driven near-term opportunities to harvest tax losses and rebalance portfolios. Markets can cycle around predictively and emotionally in the short run, but they eventually come back to rationality.

Indices:

Global Stocks: U.S. Stocks—Russell 3000, U.S. Large Stocks—Russell 1000, U.S. Midsized Stocks—Russell Mid Cap, U.S. Small Stocks—Russell 2000, Foreign Developed Large Stocks—MSCI EAFE, Foreign Developed Small Stocks—MSCI EAFE Small Cap, Emerging Market Stocks—MSCI Emerging Markets; Non-Traditional: Emerging Market Bonds—JPM Emerging Market Bond Index, High Yield Bonds—Barclays U.S. Corporate High Yield, Bank Loans—S&P/LSTA Leveraged Loan, Commodities—Bloomberg Commodity Index; Bonds: Intermediate Term Tax-Exempt Bonds—Bloomberg Barclays Municipal 5 Yr, Intermediate Term Taxable Bonds—Bloomberg Barclays U.S. Aggregate, Short Term Bonds—Bloomberg Barclays U.S. Aggregate 1-3 Yr, Long Term Bonds—Bloomberg Barclays US Long Govt/ Credit

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