

FIRST QUARTER MARKET OVERVIEW

First Quarter 2017 saw stocks around the world pick up where they left off at the end of 2016.

The Dow Jones Industrial Average, S&P 500 index, and Russell 2000 (small stock) index all reached record highs in February and achieved double-digit gains for the one-year period ending March 31. Specifically, the Dow finished the quarter up 5.19% and the prior twelve months up 19.91%. The S&P 500 index gained 6.07% for the quarter and 17.17% for the one-year period. Meanwhile, the Russell 2000 index gained 2.47% for the quarter and was up 26.22% for the one-year period.

International stocks outperformed their domestic counterparts in the first quarter of 2017, with the MSCI EAFE index of large developed-country stocks gaining 7.25%, and the MSCI Emerging Markets index posting a strong 11.45% gain. Bonds posted modest gains for the quarter. The Barclays U.S. Aggregate bond index gained 0.82%.

The strong gains that stocks have enjoyed over the past year caught many investors off guard. The fact that equities enjoyed their strongest gains in years is a testament to the inherent unpredictability of the stock market and a dramatic illustration of the need for long-term investors to stay the course.

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First Quarter 2017

The Uncertainty Paradox:

Doubt is not a pleasant condition, but certainty is an absurd one. —Voltaire

“The market hates uncertainty” has been a common enough saying in recent years, but how logical is it? There are many different aspects to uncertainty, some that can be measured and some that cannot. Uncertainty is an unchangeable condition of existence. As individuals, we can feel more or less uncertain, but that is a distinctly human phenomenon. Rather than ebbing and flowing with investor sentiment, uncertainty is an inherent and ever-present part of investing in markets. Any investment that has an expected return above the prevailing “risk-free rate” (think T-Bills for US investors) involves trading off certainty for a potentially increased return.

Consider this concept through the lens of stock vs. bond investments. Stocks have higher expected returns than bonds largely because there is more uncertainty about the future state of the world for equity investors than bond investors. Bonds, for the most part, have fixed coupon payments and a maturity date at which principal is expected to be repaid. Stocks have neither. Bonds also sit higher in a company’s capital structure. In the event a firm goes bust, bondholders get paid before stockholders. So, do investors avoid stocks in favor of bonds because of this increased uncertainty? Quite the contrary, many investors end up allocating capital to stocks due to their higher expected return. In the end, many investors are often willing to make the tradeoff of bearing some increased uncertainty for potentially higher returns.

EQUITY INDICES

	Mar. '17	1 st Qtr.	YTD
S&P 500 Total Return (Large-Cap Stocks)	0.12%	6.07%	6.07%
Russell 2000 Total Return (Small-Cap Stocks)	0.13%	2.47%	2.47%
MSCI EAFE (Developed International Stocks)	2.75%	7.25%	7.25%
MSCI Emerging Markets (International Emerging Stocks)	2.52%	11.44%	11.44%

FIXED INCOME INDICES

	Mar. '17	1 st Qtr.	YTD
Barclays U.S. Aggregate (Broad Domestic Bonds)	-0.05%	0.82%	0.82%
Barclays 1-5 Yr. Credit (Short-Term Domestic Bonds)	0.09%	0.89%	0.89%
Barclays 5-10 Yr. Credit (Intermediate-Term Domestic Bonds)	-0.03%	1.49%	1.49%
Barclays U.S. TIPS (Treasury Inflation Protected Securities)	-0.05%	1.26%	1.26%
Citi World Gov't 1-5 Yr. Hedged (Short-Term Global Bonds)	0.02%	0.29%	0.29%

Managing Emotions: While the statement “the market hates uncertainty” may not be totally logical, it doesn’t mean it lacks educational value. Thinking about what the statement is expressing allows us to gain insight into the mindset of individuals. The statement attempts to personify the market by ascribing the very real nervousness and fear felt by some investors when volatility increases. It is recognition of the fact that when markets go up and down, many investors struggle to separate their emotions from their investments. It ultimately tells us that for many an investor, regardless of whether markets are reaching new highs or declining, changes in market prices can be a source of anxiety. During these periods, it may not feel like a good time to invest. Only with the benefit of hindsight do we feel as if we know whether any time period was a good one to be invested. Unfortunately, while the past may be prologue, the future will forever remain uncertain.

Staying in Your Seat: In a recent interview, David Booth, the founder of Dimensional Fund Advisors, was asked about what it means to be a long-term investor:

“People often ask the question, ‘How long do I have to wait for an investment strategy to pay off? How long do I have to wait so I’m confident that stocks will have a higher return than money market funds, or have a positive return?’ And my answer is it’s at least one year longer than you’re willing to give. There is no magic number. Risk is always there.”

Part of being able to stay unemotional during periods when it feels like uncertainty has increased is having an appropriate asset allocation that is in line with an investor’s willingness and ability to bear risk. It also helps to remember that, during what feels like good times and bad, one wouldn’t expect to earn a higher return without taking on some form of risk. While a decline in markets may not feel good, having a portfolio you are comfortable with, understanding that uncertainty is part of investing, and sticking to a plan that is agreed upon in advance and reviewed on a regular basis can help keep investors from reacting emotionally. This may ultimately lead to a better investment experience.

Investment Shock Absorbers:

Ever ridden in a car with worn-out shock absorbers? Every bump is jarring, every corner stomach-churning, and every red light an excuse

to assume the brace position. Owning an undiversified portfolio can trigger similar reactions.¹

Throw in the risk of a breakdown or running off the road altogether, and there’s a real chance you may not reach your destination. In the world of investment, a similarly bumpy and unpredictable ride can await those with concentrated and undiversified portfolios or those who constantly tinker with their allocation.

Of course, everyone feels in control when the surface is straight and smooth, but it’s harder to stay on the road during sudden turns and ups and downs in the market.

For that reason, the smart thing to do is to diversify, spreading your portfolio across different securities, sectors, and countries. That also means identifying the right mix of investments (e.g., stocks, bonds, real estate) that aligns with your risk tolerance.

Using this approach, your returns from year to year may not match the top performing portfolio, but neither are they likely to match the worst. More importantly, this is a ride you are likelier to stick with.

Here’s an example. Among developed markets, Denmark was number one in US dollar terms in 2015 with a return of more than 23%. But a big bet on that country the following year would have backfired, as Denmark slid to bottom of the table with a loss of nearly 16%.²

It’s true that the US stock market (by far the world’s biggest) has been a strong performer in recent years. But a decade before, in 2004 and 2006, it was the second worst-performing developed market in the world.¹

Predicting which part of a market will do best over a given period is tough. US small cap stocks were among the top performers in 2016 with a return of more than 21%. A year before, their results looked relatively disappointing with a loss of more than 4%. International small cap stocks had their turn in the sun in 2015, topping the performance tables with a return of just below 6%. But the year before that, they were the second worst with a loss of 5%.³

¹ Adapted from “Investment Shock Absorbers,” Outside the Flags, February 2017.

² In US dollars. MSCI developed markets country indices (net dividends).

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Highest Return	Switz. 44.25	Finland 121.64	Finland 152.60	Switz. 5.85	NZ 8.42	NZ 24.24	Sweden 64.53	Austria 71.52	Canada 28.31	Spain 49.36	Finland 48.65	Japan -20.21	Norway 87.07	Sweden 33.75	Ireland 13.71	Belgium 39.55	Finland 46.04	US 12.69	Denmark 23.43	Canada 24.56
	Italy 35.48	Belgium 67.75	Singapore 99.40	Canada 5.34	Australia 1.68	Austria 16.55	Germany 63.80	Norway 53.27	Germany 25.52	Ireland 46.81	HK 4.120	Switz. -30.49	Australia 76.43	Denmark 30.73	NZ 5.54	Denmark 31.27	Ireland 41.15	Denmark 7.34	Ireland 16.49	NZ 18.37
	Denmark 34.62	Italy 52.52	Sweden 79.74	Denmark 3.44	Ireland -2.80	Australia -1.34	Spain 58.46	Belgium 43.53	Austria 24.64	Singapore 46.71	Germany 35.21	US -37.57	Singapore 73.96	HK 23.23	US 13.6	Singapore 30.96	US 317.9	Denmark 6.18	Belgium 12.10	Norway 19.31
	US 33.38	Spain 49.90	Japan 61.53	Norway -0.89	Austria -5.65	Norway -7.26	Austria 56.96	Ireland 43.07	Denmark 24.50	Norway 45.12	Norway 31.43	Spain -40.60	Sweden 64.16	Singapore 22.14	UK -2.56	Germany 30.90	Germany 31.37	HK 5.07	Japan 9.57	Australia 11.45
	Spain 254.1	France 41.54	HK 59.52	Italy -1.33	Belgium -10.89	Italy -7.33	NZ 55.43	Sweden 36.28	Norway 24.26	Sweden 43.39	Canada 29.57	France -43.27	HK 60.15	Canada 20.45	-6.77	NZ 29.26	Spain 3132	Belgium 4.12	Austria 3.46	Austria 1126
	Germany 24.57	Ireland 35.33	Canada 53.74	Nether -4.09	Spain -11.36	Japan -10.28	Canada 54.60	NZ 35.17	Finland 16.69	Denmark 38.77	Singapore 28.35	Canada -45.51	Belgium 57.49	Japan 15.44	Norway -10.01	HK 28.27	Nether 31.30	Singapore 3.03	Italy 2.30	US 10.89
	Nether 23.77	US 30.14	Norway 31.70	France -4.31	Norway -12.22	Switz. -10.31	Australia 49.46	Italy 32.49	Switz. 16.33	Belgium 36.66	Australia 28.34	Germany -45.87	Canada 56.18	US 14.77	Belgium -10.62	Austria 25.90	Belgium 27.61	Ireland 2.29	Finland 2.02	France 4.88
	UK 22.62	Germany 29.43	France 29.27	Australia -9.95	US -12.39	Singapore -11.05	Denmark 49.25	Denmark 30.82	Austria 16.02	Singapore 36.54	Denmark 25.59	Singapore -47.35	NZ 50.40	Australia 14.52	Australia -10.95	Australia 22.07	Japan 27.16	Canada 1.50	Nether 1.34	Nether 4.82
	Finland 17.28	Switz. 23.53	US 21.92	UK -1153	UK -14.05	Canada -13.19	Norway 48.11	Australia 30.34	Singapore 14.37	Germany 35.99	Spain 23.95	Denmark -47.56	Spain 43.48	Switz. 11.79	Nether -12.12	Sweden 2197	Switz. 26.61	Switz. -0.09	US 0.69	Germany 2.75
	Ireland 15.84	Nether 23.23	Germany 20.04	Austria -11.96	Denmark -14.81	Belgium -14.97	Ireland 43.83	Spain 28.93	Nether 13.85	France 34.48	Nether 20.59	Nether -48.22	UK 43.30	Norway 10.95	Spain -12.28	France 21.29	France 26.33	Finland -0.71	Switz. 0.44	Japan 2.38
	Belgium 13.55	UK 17.80	Australia 17.62	Ireland -12.73	HK -18.61	UK -15.23	France 40.22	HK 24.98	Sweden 10.31	Italy 32.49	France 13.24	UK -48.34	Austria 43.20	Finland 10.28	Canada -12.71	Nether 20.59	Denmark 25.25	Australia -3.41	France -0.11	HK 2.27
	Sweden 12.92	Sweden 13.96	NZ 12.90	US -12.84	Canada -20.43	Spain -15.29	HK 38.10	Singapore 22.27	Germany 9.92	Nether 31.38	NZ 6.90	Sweden -49.86	Nether 42.25	Austria 9.88	Japan -14.33	Switz. 20.35	Sweden 24.50	Nether -3.46	HK -0.54	Singapore 14.2
	Canada 12.80	Denmark 8.99	UK 12.45	Finland -14.21	Switz. -21.38	Denmark -16.03	Italy 37.83	Canada 22.20	France 9.88	Australia 30.88	UK 8.36	Italy -49.96	Denmark 38.57	UK 8.76	Sweden -5.98	Norway 18.65	UK 20.67	Japan -4.02	Germany -1.89	Sweden 0.82
	France 11.94	Australia 6.07	Denmark 12.06	HK -14.74	Nether -22.10	HK -17.79	Singapore 37.60	UK 19.57	Germany 9.05	Belgium 30.81	UK 6.06	Australia -50.67	France 31.83	Germany 8.44	-16.02	US 15.33	Italy 20.43	-4.65	Sweden -5.02	UK -0.10
	Norway 6.24	Japan 5.05	Nether 6.88	Germany -15.59	France -22.36	Nether -20.83	France 35.91	France 18.48	HK 8.40	US 30.35	HK 5.44	HK -51.21	Italy 26.57	NZ 8.32	-16.02	US 15.25	UK 13.42	Austria -5.39	UK -6.26	Spain -10.2
	Austria 1.57	Austria 0.35	Spain 4.83	Spain -15.86	Germany -22.39	France -21.18	Belgium 35.33	Germany 16.17	UK 7.35	Finland 29.94	Switz. 5.29	NZ -53.79	US 26.25	Nether 1.74	France -16.87	Finland 14.57	NZ 11.27	Sweden -7.55	UK -7.56	Finland -4.70
	Australia -10.44	HK -2.92	Italy -0.26	Belgium -16.85	Singapore -23.42	US -23.09	Switz. 34.08	Japan 15.88	US 5.14	Switz. 27.40	Austria 2.17	Finland -55.17	Switz. 253.1	Belgium -0.42	Singapore -17.92	Italy 12.48	HK 110.9	Italy -9.53	Australia -9.95	Switz. -4.87
	NZ -14.15	Canada -6.14	Switz. -7.02	Sweden -21.29	Italy -26.59	Ireland -26.34	UK 32.06	Switz. 14.96	Spain 4.41	Canada 17.80	Sweden 0.62	Norway -64.24	Germany 25.15	France -4.11	Germany -19.08	Canada 9.09	Norway 9.40	France -9.92	Norway -14.99	Ireland -7.07
	HK -23.29	Singapore -12.88	Austria -8.11	Singapore -27.72	Sweden -27.18	Finland -30.31	US 28.41	Nether 12.24	Italy 1.90	NZ 16.56	Belgium -2.73	Belgium -66.48	Ireland 12.28	Italy -15.01	Italy -23.18	Japan 8.18	Canada 5.63	Germany -10.36	Spain -5.64	Belgium -7.57
	Japan -23.67	NZ -22.62	Ireland -12.63	Japan -28.16	Japan -29.40	Sweden -30.49	Nether 28.09	US 10.14	NZ 1.74	US 14.67	Japan -4.23	Japan -68.41	Finland 11.14	Ireland -18.12	Finland -31.90	Ireland 5.74	Australia 4.16	Austria -22.04	Austria -17.71	Italy -10.45
Lowest Return	Singapore -30.05	Norway -30.06	Belgium -14.26	NZ -33.55	Finland -38.18	Germany -33.18	Finland 19.40	Finland 6.14	Ireland -2.29	Japan 6.24	Ireland -20.09	Ireland -71.92	Japan 6.25	Spain -2195	Austria -36.43	Spain 3.00	Singapore 170	Austria -29.77	Canada -24.16	Denmark -15.77

If you've ever taken a long road trip, you'll know that conditions along the way can change quickly and unpredictably, which is why you need a vehicle that's ready for the worst roads as well as the best. While diversification can never completely eliminate the impact of bumps along your particular investment road, it does help reduce the potential outsized impact that any individual investment can have on your journey.

High Valuations Conundrum:

Much research has been done on stock valuations, and historically buying into the market at lower valuations has seen higher returns than when buying in at higher valuations. However, the data is noisy.

On the following chart, the green area represents the 10-year trailing price-to-earnings (P/E) ratio of the S&P 500, commonly referred to as the CAPE ratio. You can think of this as a gauge to see if the overall price of the stock market is expensive or cheap. As you can see, we're currently at a fairly-elevated level, around 29 dollars of price for every dollar of earnings, though far below the peaks seen in 2000.⁴

³ In US dollars. US Small Cap is the Russell 2000 Index. International Small Cap is the MSCI World ex USA Small Cap Index (gross dividends).

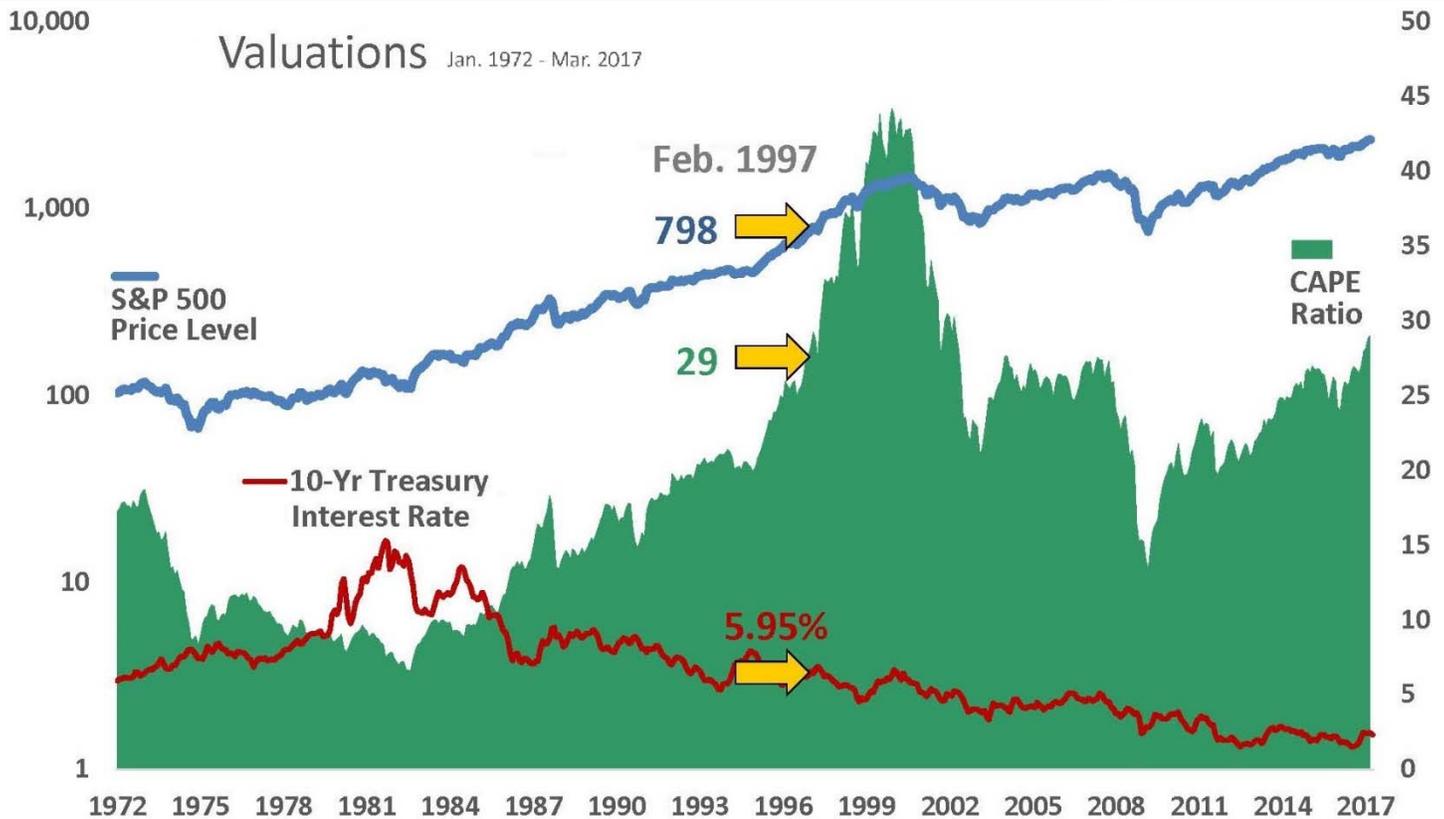
⁴ Source: Robert Shiller Online Data library via Yale. CAPE tracks current S&P 500 price versus average of inflation-adjusted earnings over previous 10 years.

It can be enticing to think it's possible to time the market based on valuation ratios like these, but even the creator of this ratio, Professor Robert Shiller, cautions against using the ratio to make trades. And keep in mind you have to guess right not once, but twice — knowing when to get back into the market.

Take, for example, the last time the 10-year trailing P/E ratio of the S&P 500 broke through the current level was in February 1997. If you had sold out fearing high valuations at that time, you would have missed out on another three years of up markets, cumulating an additional 86% gain before seeing any meaningful decline.

At that point in February 1997, the S&P 500 was trading at 798; if you sold out waiting to buy back in once the market was lower, you would have had to wait twelve years, until March 2009. And if you missed this brief opportunity, you might still be waiting some 20 years later. Meanwhile, the S&P 500 is above 2,300.

Furthermore, it is important to note the level of interest rates over the last 20 years, as they are a major force on stock prices. A stock is generally valued by how much cash can be obtained from the company between now and judgement day, discounted by a benchmark rate. Many stock investors



use the yield on the 10-year US Treasury bond as their benchmark rate, because it is assumed to be risk free and generally matches their investment time horizon.

In February 1997, the yield on the 10-year Treasury was 5.95%, and it has steadily declined since then, now standing at 2.38%, as of March 31, 2017. This might seem like a small change of only 3.57% ($5.95\% - 2.38\% = 3.57\%$), but in percentage terms, it is a large 60% decrease ($3.57\% / 5.95\% = 60\%$).

In the stock price equation, when the discount rate goes down, stock prices go up, and, at these levels, small changes in the discount rate can have a significant effect on an investor's final valuation of a stock—this is just mathematics.

The difficulty arises in trying to predict the future scenario for interest rates. If an investor assumes

these low levels of interest rates will continue for a long time, then stock prices look cheap, and they should buy, buy, buy. However, if an investor assumes interest rates will rise, then stocks start to look fully valued to expensive.

And both interest rate scenarios are a reality—for the low interest rate outcome just look to Japan over the last 30 years or the US in the 1940s, and for the high interest rate outcome look to the US in the 1980s.

Therefore, at TAGStone Capital, we recommend a balanced approach between stocks and bonds, with an appropriate rebalancing strategy, in case either scenario plays out. Instead of trying to predict what interest rates will be in three to ten years, we think a better strategy is to target dimensions of higher returns (size, value, and profitability) and stay the course when the market gets bumpy.

Past performance does not guarantee future results. All investments include risk and have the potential for loss as well as gain.

Data sources for returns and standard statistical data are provided by the sources referenced and are based on data obtained from recognized statistical services or other sources we believe to be reliable. However, some or all information has not been verified prior to the analysis, and we do not make any representations as to its accuracy or completeness. Any analysis nonfactual in nature constitutes only current opinions, which are subject to change. Benchmarks or indices are included for information purposes only to reflect the current market environment; no index is a directly tradable investment. There may be instances when consultant opinions regarding any fundamental or quantitative analysis do not agree.

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