Market Commentary - October 2016 View this email in your browser

CLEARVIEW WEALTH SOLUTIONS

Corporate earnings for the third quarter will begin to be announced next week, and are expected to decline (by 2.3%) for the sixth straight quarter. A lot of that has to do with stocks in the energy sector whose earnings have been decimated since 2014 because of the drop in oil prices. However, earnings are expected to be higher in the fourth quarter as well as 2017. We remain skeptical of analysts' 2017 expected rise in earnings of 13%.

After the third quarter's increase of 3.3% for the S&P 500 stock index, we think further progress in the fourth quarter could be difficult. Reasons include our above-mentioned earnings skepticism, uncertainty over when the Fed will raise interest rates, concerns about Deutsche Bank's capital cushion, and further fallout from the shocking scandal at Wells Fargo. In addition, the election could cause volatility as investors gauge the agenda of the new president.

Why We Recommend Large Cap Stocks for Retirement Portfolios

Let's start by reviewing the more important portfolio specific and overall strategy characteristics we believe are essential when working with retired individuals or those preparing for this new chapter in life. This more conservative portfolio strategy may also be attractive to younger, more risk-averse investors. We are convinced that the most important deliverable is the development of

- Preservation of principal and less volatile portfolio values are preferred.
- More consistent, steady returns, although this is largely dependent upon overall market returns.
- Less chance of a catastrophic year which negatively affects the sequencing of returns–especially dangerous for the newly retired. Of course, there are no guarantees for investors. For example, even the S&P 500 lost 37% in 2008. Since 2008, however, the market has appreciated over 150%.
- A focus on long-term holdings with little need for trading–buy good quality stocks and hold them for a period of years, not months.
- Finally, a focus on after-tax returns in taxable portfolios. What you keep is as important as the pre-tax return. Tax-loss harvesting is an often overlooked strategy that we employ across all taxable portfolios as it can significantly improve after-tax returns.

Now let's look at large company stocks (those that have market capitalizations over $10 billion) and see whether they qualify and make the grade for use in retirement portfolios. Below is a short list of the potential benefits associated with investing in large caps stocks:

- First, large cap companies tend to have more stable financial results and experienced management teams.
- Those companies in cyclical industries have weathered the storm of multiple recessions. They are survivors. Smart stock picking here greatly reduces the risk of owning companies that will not survive the next recession.
- Many large cap stocks have more consistent earnings and sales growth than their mid cap ($2-10 billion market cap) and small cap (less than $2 billion market cap) brethren.
- Large companies typically pay dividends which can cushion the price drop associated with a bad market. Dividend stocks have been especially strong over the last few years as a result of investors' search for income given record setting low bond yields.
- Large caps often have less volatile price moves than mid or small caps. One caveat here: because valuations are currently very high, we question whether large caps will afford investors the same protection on the downside they have historically.
- As shown below in the table, the largest capitalized stocks provide better risk-adjusted returns than small stocks.

1926-2013

	GEOMETRIC ANNUAL RETURN	STANDARD DEVIATION (VOLATILITY)	SHARPE RATIO
Large Company Stocks	10.1%	20.2%	.33
Small Company Stocks	12.3%	32.3%	.27

Source: Ibbotson SBBI, 2014 Class Yearbook

As you can see in the table, small caps have provided a higher annual return for this 87-year period but with **much higher volatility** (standard deviation is often thought of as risk)–about 60% higher! The Sharpe ratio is a measure that takes both risk and return into account and shows that large caps have a much higher Sharpe ratio which indicates they offer a better risk-adjusted return.

We are not suggesting small caps do not have a place in retirement portfolios but they should be considered a satellite investment (non-core) and limited to a small part of the funds allocated to equities (10-15% max). Those investing in small caps should brace themselves for more volatility in share prices, especially in weak markets, and be prepared to stay the course when the markets go through inevitable cycles.

Large cap stocks are not a magic bullet–they will also fall in price when the market corrects or enters a bear market. However, there is a certain comfort in knowing these companies should consider them the best choice for retirement portfolios, including those portfolios now being funded.

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