

CCR WEALTH MANAGEMENT OUTLOOK

July, 2015

"In order to properly understand the big picture, everyone should fear becoming mentally clouded and obsessed with one small section of truth"

-Xun Zi, ancient Chinese philosopher

The structure of this Outlook intends to follow the pattern of discussing "one small section of the truth", then broadening the topic base into areas we feel are actually of more significant importance for investors, culminating with a recommendation that all investors review what impact expected returns may have on their financial plans in light of their specific asset allocation.

Small Truths...

In recent weeks we have witnessed some moderate market volatility due to drama initially borne out of the (latest) Greek-EU confrontation, which was quickly reinforced by a plunge of ~30% in the mainland Chinese markets. We say "moderate volatility" because the S&P Volatility Index (known as the VIX) popped all the way up to 20 from a three-year average of about 15. In contrast, when the contemporary Greek economic debacle first reared its ugly head in 2010, the VIX Index rose to 48.20 that turbulent May. Early in 2012 we wrote:

We expect the bizarre ritual of faux-summits & grand announcements to continue for some time. Ultimately, Greece will default (it's a mathematical certainty). By the time it does, maybe this year, it likely won't be termed a "default" anymore. Something more diplomatically palatable will replace that word—but the end result will be the same.

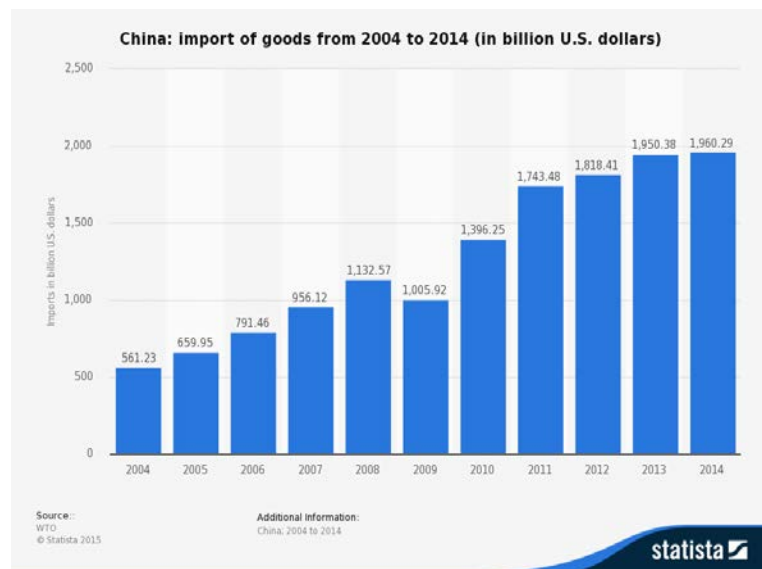
Greece supposedly finally defaulted on their obligation to creditors at the end of June, though as a matter of semantics, they're simply in arrears (a true default would occur 30 days past the due-date). If Greece were a corporation, they'd have been in technical default long ago (borrowing from one credit card at 15% to pay another, call it what you will). Prior to receiving their third bailout, we were treated to the spectacle of an entire nation essentially voting themselves out of the developed world, and into a lower-echelon emerging market status by a popular margin of nearly 20%. While this was astounding in our view, *Greece's economic importance to the overall health of Europe has always been miniscule*. Greece's stock market capitalization is about the size of Bed Bath & Beyond. Since the eruption of this drama

in 2010, the vast majority of their debt obligations are *held by governments and the IMF*, not financial institutions and banks. So from a systemic financial risk standpoint—this was a non-story (but don't tell that to the media). **This was a political drama.**

The outcome of the latest negotiations was always going to be more important in terms of what *political signals* it would send to other parties in other teetering countries seeking to thumb their noses at creditors (once they run out of other people's money), rather than what immediate economic ramifications it would have on Europe as a whole. All European officials knew this to be true, and Greece was either going to capitulate to demands—or leave the Euro, no matter the results of the referendum vote. Further, we do not discount the possibility of a future “Grexit” regardless of what recent deal has been struck. **Importantly, then as now, we want our clients to discern between political volatility and more hazardous financial instability, which was exhibited five years ago and we believe is absent in Europe today.** We do not believe the Greek drama is over, despite the most recently agreed-upon bailout.

Right around the time that the Greek economy was foundering and their banks closing, the Chinese stock market went off a cliff. Beginning in mainland China, where most shareholders *are not institutional* investors, but individuals trading with high margin balances—this mini-contagion eventually leaked to the Hang Seng Index based in Hong Kong, to which many investors across the globe (institutional and individual) do have exposure.

Many have believed for some time that the Chinese stock market has been in the midst of a massive bubble. This bursting exposes interesting, if hazardous risks, as it lays bare the implications of a globally interconnected financial system yet again.



First, the Chinese economy is about *40 times* that of Greece's and it is the second largest single economy in the world. On a global economic basis, *it matters*. China's trade extends throughout the globe (while Greece's does not). So while China's growth has been slowing over the last five years, the implication for a major *economic stumble* could have a significant impact on their trading partners

and the burgeoning global economy as a whole. Stock markets often “correct”—especially when stock prices are historically rich—as they are in China. But the concern expressed by global volatility in recent weeks could be translated as a fear that China’s market correction might be more of a forward-looking signal about the underlying economy. For now, given their recently released second quarter economic growth rate of 7% (beating expectations), we are inclined to chalk the recent market tumble up as a correction—fueled by irrational individuals in the mainland market trading stocks with highly leveraged portfolios, and *not a signaling* of imminent economic or financial peril.

This brings us to the **second** hazard the market must digest, and as in Europe, this has a political component. The Chinese government reported a growth rate in the second quarter of 7%, besting consensus economic estimates of 6.9%. This release came shortly after the apex of market volatility both in Hong Kong and in the mainland markets. Is this reported outperformance a coincidence? The timing might seem suspicious to some. The reality is that there has always been a great deal of skepticism among market participants surrounding official Chinese economic releases. The Middle Kingdom after all has never been known for its transparency. Transparency and free markets are the hallmarks of *developed economies*—and here, China remains woefully short of the mark, despite their massive economic growth in recent decades. Many of the companies on Chinese exchanges are state-owned. China’s reaction to falling stock prices in recent weeks included issuing directives to certain share-holders forbidding them to sell their shares and purchasing stocks to support prices. Prior to all this, the government flooded the markets with cheap money most of the year to encourage margin trading and keep the stock

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	16.2	16.4	18.8
	14.2	16.2	21.1
Mid	17.2	19.3	21.5
	14.4	16.7	22.1
Small	16.9	19.1	21.6
	14.6	17.4	21.6

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	110.2%	101.0%	88.6%
Mid	120.2%	113.6%	94.4%
Small	118.0%	108.6%	96.7%

Source: FactSet, Russell Investment Group, Standard & Poor’s, J.P. Morgan Asset Management. All calculations are cumulative total return, including dividends reinvested for the stated period. Since Market Peak represents period 10/9/07 – 6/30/15, illustrating market returns since the S&P 500 Index high on 10/9/07. Since Market Low represents period 3/9/09 – 6/30/15, illustrating market returns since the S&P 500 Index low on 3/9/09. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell-style indexes with the exception of the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. P/E ratios reflect latest available data. Earnings estimates are as of May for Russell Indexes and as of June for Standard & Poor’s. Guide to the Markets – U.S. Data are as of June 30, 2015.

market rally (bubble?) going. These interventions harm markets because they prevent true price discovery and foster investor skepticism (even among the Chinese) when they don't work—as they didn't in early July.

CCR Wealth Management's model portfolio with direct exposure to China is *de minimis* (less than 1%), but given China's economic integration in the global market place, we are all exposed to China *indirectly*.

Bigger Picture...

Not losing sight of the forest for the trees is our message this summer. The “bigger picture”, we confess, does not break new ground. Rather, we hope to reinforce where our conviction lies looking out two to three years. While we believe the “Grexit” to be a distraction, and Chinese market issues to be a speed bump, we remain steadfast that comparatively more attractive equity opportunities exist outside our borders over this time frame.

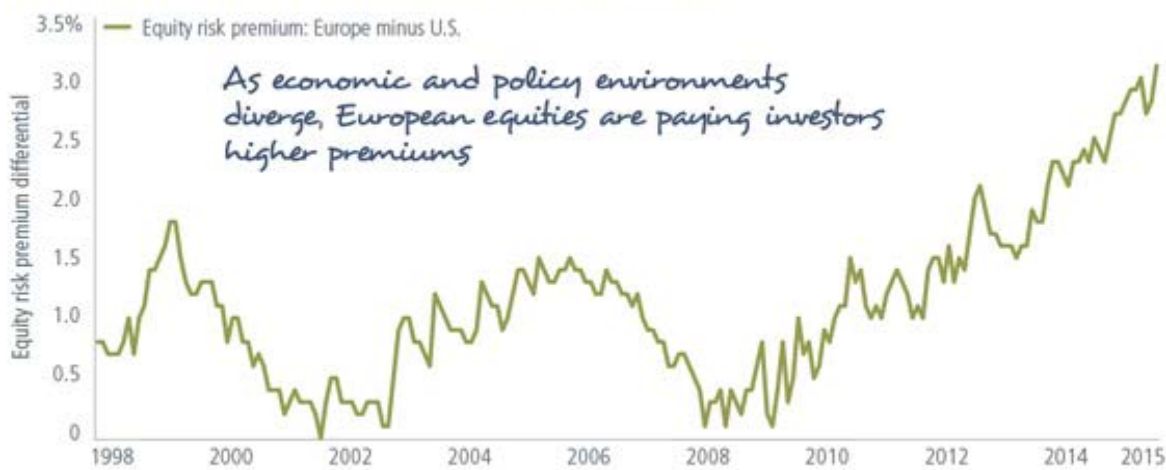
Regular readers will recognize the updated chart to the right from previous Outlooks. Stock valuations in the US continue to advance. While we reiterate that stocks are not abnormally expensive—it's difficult to make the case that on a broad-index basis that there are any “bargains” out there (we also reiterate our skepticism of the “growth” column's seemingly undervalued status in this chart—as historical P/E comparisons include the bubble years of the tech boom in the late '90's in the denominator. To wit; the NASDAQ Composite finally pierced its May, 2000 high this spring, and at this writing stands at its all-time high of 5,210.).

As P/E's have risen among all market caps and styles, the US market becomes ever more “efficient”. Outperformance of a major equity index generally requires identifying and *exploiting inefficiencies*—mispriced stocks. Such instances become increasingly rare in an increasingly efficient market. In this environment, exposure to smaller-cap funds and certain sector funds may improve the odds of shorter-term outperformance of broad-based benchmarks.

Longer term—market participants know that US interest rates will rise this year, perhaps even this quarter. While there is ample empirical evidence to suggest this is not necessarily an impediment to higher stock prices ahead—we feel rates will rise more out of the Fed's desire to “get off the bottom” than because of an inflationary fears or over-heating signals in the economic data.

Our portfolio shifts early this year to a higher non-US, developed market equity allocation acknowledged the reality and the totality of the ECB's commitment to greasing the European economic recovery.

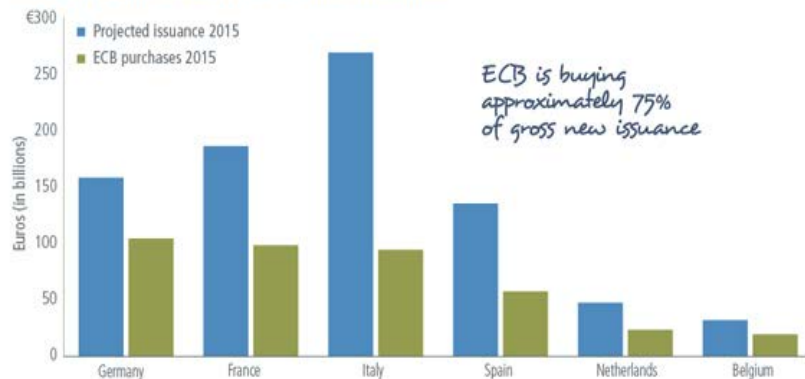
Equity investors are being rewarded for taking on risk



Source: Morgan Stanley. Data through 10 March 2015.

Importantly, the fact that markets have stalled a bit since the Greek distraction resurfaced does not in any way alter our thesis regarding the larger impact of the trillion-dollar stimulus the ECB began just in March—and its eventual reflection in asset prices. An equally ambitious stimulus remains underway in Japan, where Japanese government pensions have been directed to increase their allocation to higher risk assets, *even to equities*.

ECB's QE program is having a significant impact

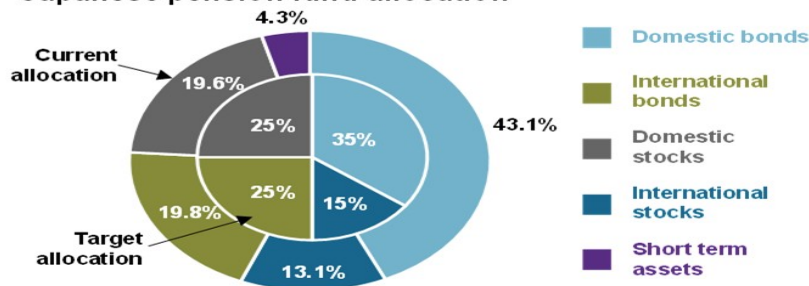


Source: Cornerstone, PIMCO. Data as of 26 January 2015.

Year to date we've seen encouraging signals like increasing credit demand and upward earnings revisions in the Eurozone, and wage growth in Japan. These are much more vital data-points for forming expectations for the foreseeable future than the daily (or hourly) drama emanating from Greece.

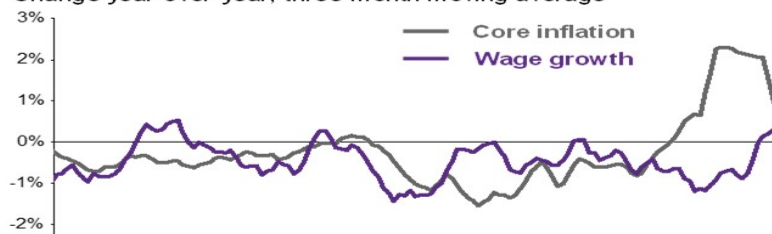
These central bank actions and their likely impact on capitals markets represent the “forest” we would have our clients focus on, while Greece and China are the “trees” that shouldn't

Japanese pension fund allocation



Japanese wage growth

Change year-over-year, three-month moving average



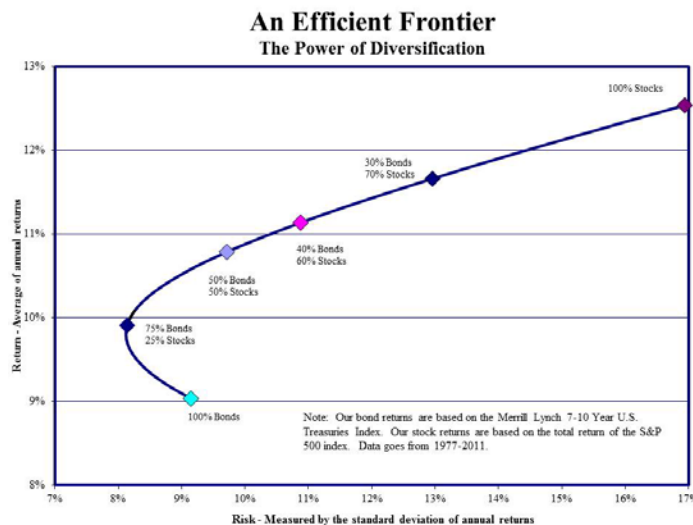
Source: FactSet, Government Pension Investment Fund, Japanese Cabinet Office, Japan Investment Trust Association, Japan Ministry of Health Pension Fund Association, J.P. Morgan Asset Management, Guide to the Markets – U.S. Data are as of June 30, 2015.

impede strategy. We acknowledge that history never repeats—but we think it a reasonable assumption to expect it to rhyme. US economic and capital market recoveries were aided in no small part by the Fed's quantitative easing over the last six years—to the extent that QE was ended nine months ago, and we today stand on the verge of our first rate-hike in nine years. We continue to expect positive investment results from both the ECB and the Bank of Japan's actions over the next 3-5 years.

The Long View...

Having **expectations** is essential to planning for the future. Expectations are assumptions on which we base the numerous decisions we need to make in financial planning. When

expectations change—the decisions we make in the nearer term change, affecting expected future outcomes. But forming expectations can be tricky. For the purpose of financial planning, it's important to understand that expectations *are not* in themselves *predictions* that apply to all periods (a 5.50% expected average nominal return on assets for the next 25 years *is not a prediction* that any one year will garner a 5.50% return). Rather, they are operating assumptions which we must be willing to occasionally alter given reasonable cause to do so.



The **asset allocation** decision is the most essential strategic investment decision an investor makes with regard to their portfolio. Asset allocation determines the amount and nature of risk and return exposure a portfolio has and therefore gives us a basis on which to assume return expectations. It is important to understand that there is actually a very quantitative process to determining an appropriate asset allocation. Portfolios are selected from an “efficient frontier”, as depicted nearby. Theoretically, each point on the line which makes up the efficient frontier has a discrete mix of assets (an asset allocation), yet each point on the line—each portfolio-- represents the highest possible return for each level of risk taken for that particular allocation. Efficient frontiers are generated by an “optimization” process (software these days). The primary inputs to this process happen to be expected returns, and expected risk (standard deviation).

In reality—most investors as well as financial professionals, have for the last 30 years or so approached asset allocation using an *experienced-based* methodology. This has often lead to a general 60/40 (or similar) asset allocation, from which an individual may adjust equities up or down slightly to account for personal risk appetite or return goals. In any event—whether experienced-based, or using the quantitative “mean-variance” analytical process, the most important input to generating an appropriate allocation has been expected returns—which more often than not has been an **average of historical returns**.

Here’s the problem today: Both equity and fixed income returns in the next five to ten years will likely be below the long term historical averages typically assumed in the asset allocation process. Our canvassing of asset managers’ macro-market expectations has



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returns in 2014 were not closer to the double digit return of the S&P 500 (the only major equity index to post such returns last year). In short, ***asset returns on average*** have been bearing out the thesis of lower returns, which have been concurrent with lower average volatility the last few years. As valuations in the US are slightly higher than long term averages, interest rates are poised to rise, and global GDP growth is likely to remain anemic, this trend is likely to persist.

We reiterate to our clients that faced with this reality of lowered forecasted asset returns, *some may be required to adjust their own portfolio expectations, and therefore strategy, in pursuit of the return required of their financial plan.* Strategy adjustments may include 1) adjustments to the asset allocation (i.e. moving to the right on the efficient frontier), 2) pursuit of more tactical opportunities, 3) the inclusion of alternative asset classes in the portfolio, or all three. Of course, investors may choose to maintain their current strategies—in which case the simple adjustment that needs to be made is to their own expectations. Historical averages will likely be less applicable to future returns.

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