Virginia Capital Strategies

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Second Quarter 2017 Investment Commentary

Market Recap

The second quarter proved to be another very strong period for global stocks. Large-cap U.S. stocks gained 3.1%, developed international stocks rose 6.4%, and emerging-market stocks rose by 3.4%. First half 2017 stock performance was even stronger. Large-cap U.S. stocks surged 9.3%, while international and emerging markets stocks were each up in the mid-teens.

A significant trend reversal took place late in the quarter. U.S. financial stocks rallied in June on strong results from the Federal Reserve's "stress tests" plus more positive sentiment given rising interest rates, while technology shares (which had been on fire for the first five months of the year) declined.

June Benchmark Returns (Preliminary)			
	June	Q2	YTD
Larger-Cap Benchmarks			
Vanguard 500 Index	0.6%	3.1%	9.3%
iShares Russell 1000 ETF	0.7%	3.1%	9.2%
iShares Russell 1000 Growth ETF	-0.3%	4.6%	13.8%
iShares Russell 1000 Value ETF	1.7%	1.3%	4.5%
Smaller-Cap Benchmarks			
iShares Russell 2000 ETF	3.4%	2.5%	4.8%
iShares Russell 2000 Growth ETF	3.3%	4.4%	9.9%
iShares Russell 2000 Value ETF	3.4%	0.6%	0.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	0.6%	6.4%	14.8%
Vanguard FTSE Europe ETF	-0.5%	8.4%	17.3%
Vanguard FTSE Emerging Markets ETF	0.8%	3.4%	15.0%
Vanguard REIT Index	2.1%	1.6%	2.5%
Vanguard Total Bond Market Index	0.0%	1.5%	2.3%
Vanguard Intermediate-Term Tax-Exempt	-0.3%	1.8%	3.2%
BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.1%	2.1%	4.9%
S&P/LSTA Leveraged Loan Index	0.0%	0.8%	1.9%

Commodities prices and energy stocks remain a weak spot amid a global rally in risky assets. Oil prices fell 14% during the quarter and nearly 20% for the first half of 2017 on fears that production will continue to outstrip demand.

Core bonds delivered solid returns, rising 1.5% for the quarter. The yield curve "flattened" considerably, with the difference between the 10-year and 2-year Treasury yields ending the quarter at close to a post-2008 low.

The calm investment environment, as manifested in low measures of volatility across global markets, was briefly interrupted during the last few days of June. Global stock and bond investors were rattled by comments from the heads of the European Central Bank and the Bank of England suggesting they may be considering the potential end to bond buying policies designed to stimulate markets and a move to raise interest rates, respectively. They were further jolted by Fed Chair Janet Yellen's statement that "by standard metrics, some asset valuations look high." In response, bond yields quickly spiked higher, while currency markets saw large swings. Nevertheless, at quarter-end, the S&P 500 was only about 1% below its all-time high.

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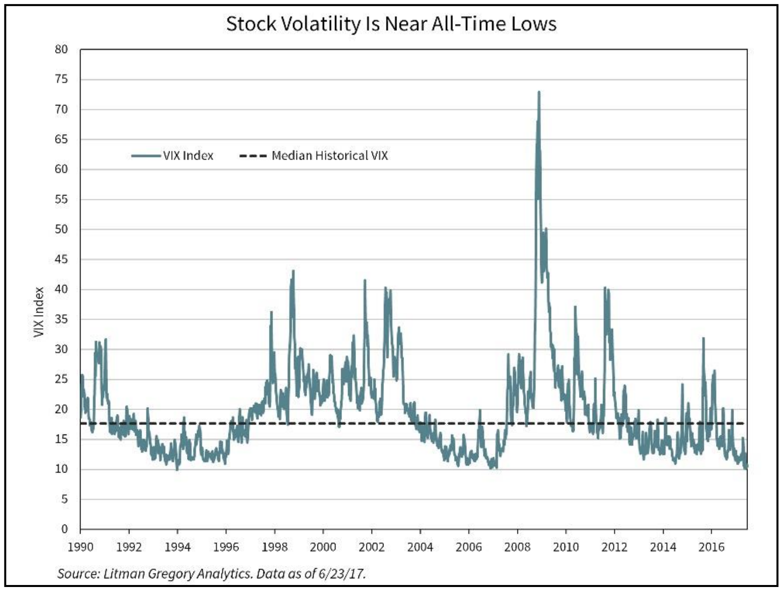
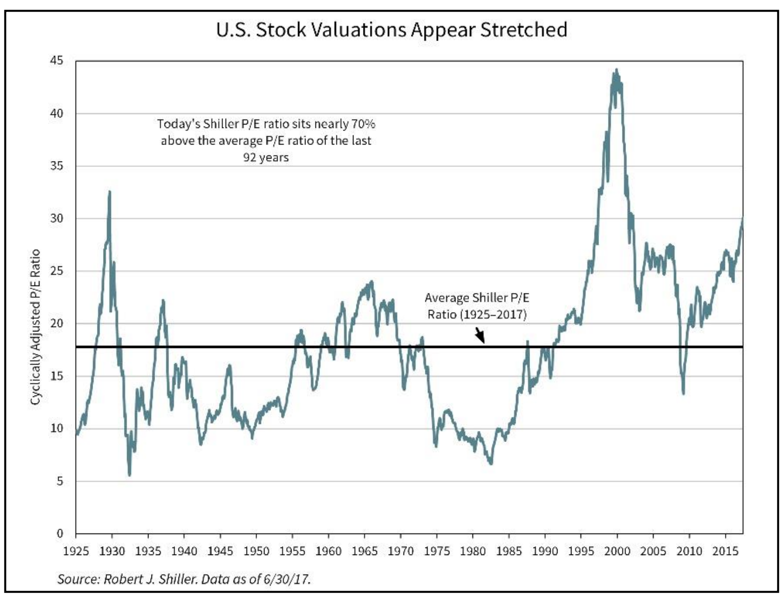
Overall, economic and corporate fundamentals largely still look solid, and investors expect the second quarter earnings season to demonstrate a continuation of the strong growth trends exhibited so far in 2017. We continue to view exogenous risks—from central banks and geopolitics—as posing the most likely near-term threats to markets. U.S. stock markets, although expensive, could become more expensive. However, we don't plan to add to this category – for now, we'll continue with the level of exposure we have. We continue to like foreign and emerging markets stocks very much, and plan to add further to these investments. We're lukewarm on bonds, although we do like some specialized parts of the bond market. In a moment, we'll give our full outlook on the financial markets.

Investment Environment

The widely followed VIX index—an indicator of the S&P 500's expected 30-day volatility, fell to a 23-year low in early May. It remained at its lowest ever recorded percentile as the second quarter ended, while the S&P 500 Index continued to hit all-time highs this year.



The U.S. stock market's calm ascendance seems to fly in the face of ongoing political uncertainty and geopolitical tumult, including tensions with North Korea, the ongoing crisis in Syria, terrorist attacks in Europe, cyberattacks in the United States, and widening investigations of President Trump as well as members of his administration and election campaign staff. Each day seems to bring a new headline concerning something else to worry about.



Why are the financial markets so calm and why do stocks continue to go up? Do markets reflect a dangerous complacency in the face of so many risks and unknowns? Yes, U.S. stock investors probably are too complacent now. We see this reflected not just in the extremely low market volatility, but also in high stock market valuations (e.g., price-to-earnings multiples), which implicitly discount a very rosy economic scenario. Based on our analysis of valuations and longer-term earnings fundamentals—even putting aside any near-term political/geopolitical risks—U.S. stocks present unattractive expected returns over our five-year tactical investment horizon, evaluated across the macroeconomic scenarios we think are most likely to play out. In that sense, we think the high level of complacency leaves stocks particularly vulnerable to a negative surprise. Valuation risk is high and offers no margin of safety in the event the optimistic scenario currently baked into valuations doesn't play out.

Maintaining a degree of equanimity is a valuable attribute of successful long-term investors. Global risks *always* exist and unexpected events inevitably happen, causing markets to fall no matter their valuation. The world and financial markets have faced numerous negative shocks over the decades, but the broad economic impacts have ultimately proved transitory. Over the long term, financial assets are priced and valued based on their underlying economic fundamentals—yields, earnings, growth—not on transitory macro events or who occupies the White House. Therefore, we believe it is beneficial for investors not to react to every domestic political development or geopolitical event with the urge to sell their stocks nor get overly excited and jump into the market on some piece of news they view positively. We don't think refraining from such short-term trades is complacency—*if* the choice is supported by a sound decision-making framework. Having a disciplined investment process and a focus on the long term are essential to best achieve your financial objectives.

Don't Fixate on Donald Trump and Washington, D.C.

At a high level, most of the market reversals we've seen this year are consistent with, if not driven by, an unwinding of the so-called Trump trade. This is shorthand for the markets' almost knee-jerk reaction (which soon became consensus) that Trump's election and the Republican sweep of Congress would herald a period of inflationary, pro-growth fiscal, tax, and regulatory policies, unleashing the U.S. economy's animal spirits. Instead, as the Trump administration has gotten bogged down in a myriad of other issues, with little progress on the economic front, confidence in that scenario has diminished.

Interestingly, the stocks currently going up the most are of companies benefiting from global growth; companies such as Google, Apple, Facebook and Netflix. There is now a widespread belief in synchronized global growth. Foreign stocks and U.S. companies with large exposure to foreign markets have clearly been the biggest winners in 2017. Europe, the U.K. and Japan have surprised economists with the strength of their recoveries this year. On the other hand, "Trump Bump" opportunities, such as small companies, infrastructure stocks and non-tech cyclicals, have given back almost all their post-election gains. While Virginia Capital Strategies has been focused on opportunities abroad, and has taken advantage of global growth through purchases of investments benefitting from this theme, other investors have focused too-heavily on Trump, and have missed 15%+ gains which have taken place so far in 2017, and have been whipsawed by major reversals in trends which have taken place.

In general, we agree with Warren Buffett who recently said, "If you mix your politics with your investment decisions, you're making a big mistake." We made no changes to our portfolio positioning when Trump was elected, and we highlighted the significant uncertainty around potential Trump policies. That's not to mention the highly uncertain *timing, implementation,* and *magnitude* of their *ultimate economic and financial market impacts*.

If the Trump agenda does ultimately get enacted, this may prove to be icing on the cake for investors, and could propel other parts of the market higher too, which would clearly boost returns even further.

Portfolio Performance and Positioning

We think it is prudent to construct portfolios that are prepared for, and have resilience to, a range of potential outcomes. Thus, in our balanced portfolios, we maintain some exposure to core bonds (approximately 15%, using Dodge & Cox Income), despite very low current yields, because of their risk-mitigating properties in the event of a recession or other shock. But given core bonds' paltry yields and unattractive longer-term (five-year) return prospects, we maintain meaningful exposure to other more flexible and opportunistic fixed-income funds as well as to select alternative strategies. These investments should also provide some protection against rising interest rates and inflation. As you're aware, Osterweis Strategic Income, Templeton Global Bond, Weitz Short-Intermediate Bond, the Merger Fund and the Arbitrage Fund are our preferred flexible fixed income and alternative strategies.

On the equity side of the portfolio, we see unattractive valuations and low expected returns for the U.S. market over the next five years. However, we don't see any near-term trigger for a sharp market decline. Our favorite domestic stock funds are Jensen Quality Growth, Blackrock Equity Dividend and Vanguard Strategic Equity. Outside of the United States, we see strong potential for both improving earnings growth *and* higher valuations—leading to relatively attractive longer-term expected returns. We have and will continue to purchase foreign developed and emerging-market stocks. We favor Dodge & Cox International, American Funds EuroPacific Growth and the American Funds New World Fund in these categories.

Conclusion

From a big picture perspective, we think the odds favor a continuation of the ongoing mild global economic recovery we've witnessed so far this year. That should be broadly supportive of riskier assets, such as stocks and corporate bond funds such as Dodge & Cox Income. We believe there is still more room to run regarding the outperformance of foreign stocks given their superior valuations and earnings growth potential versus the U.S market. Even with their strong performance so far this year, our longer-term return expectations still materially favor developed foreign and emerging markets compared to the United States.

We don't expect a recession in the near term, but we remain alert to and positioned to meet the high level of uncertainty that characterizes both global financial markets and the current geopolitical environment. We maintain exposure to assets—core bonds and select alternative strategies in particular —that should generate positive returns in the event of a recession and a bear market in stocks. Over the longer term, they also provide attractive risk-adjusted return potential and valuable diversification to the overall portfolio. While there has seemed to be little need for such strategies over the past eight years of a raging U.S. equity bull market, history teaches that this cycle will turn too and the portfolio benefits of these alternatives will then be apparent.