Third Quarter 2016 Review Letter

Dear Clients:

Glancing at the numbers, it has been a strong year so far. For the first three quarters of 2016, US stocks are up 7.4%, world stocks are up 6.3%, and US bonds are up 5.8%, as represented by the S&P 500 Index, the All Country World Index, and the Barclays Aggregate Bond Index. Please refer to the following statements for your assets' performance and quarter-end balances. Our portfolios continue to outperform their benchmarks this year, thanks to returns from small stocks, high quality stocks, emerging markets, intermediate term bonds, and higher yielding bonds that exceed the benchmark indexes mentioned above. The clarity of hindsight is such a pleasure.

Will this continue? Deutsche Bank gave us a scare recently by looking a great deal like Lehman Brothers just before Lehman collapsed almost exactly eight years ago. You may recall that Lehman's bankruptcy plunged us into the financial crisis. With the US presidential election about a month away, we know from recent volatility that the markets view Hillary as the safer choice and the Donald as a wild card bringing greater uncertainty. But Deutsche Bank's stock price recovered when it appeared that the Justice Department would extract a less onerous penalty for the bank's fraudulent sale of mortgage securities, and we expect that any decline in market prices as a result of the election will be short-lived. What continues to hold our attention is the unprecedented and unnatural suppression of interest rates, and our desire to hold onto the handsome returns that we have received over a period when global economic growth has been comparatively lackluster.

How does this play out and how do we position the portfolios for maximum return from minimum risk? Chief Allocation Strategist Steve Bobo and I maintained our biweekly strategy meetings throughout the summer, and we continue to ponder a guiding question from our Investment Framework:

Who will benefit or get hurt from rising rates?

Since the bottom of the financial crisis nearly 8 years ago, annual global growth has averaged a tepid 3.3% for a cumulative growth rate of about 29%. During this time, the All Country World Index returned about 127%, and the S&P 500 was up nearly 200%! Even from the height of the pre-crisis period in October 2007, the markets grew over 50%. This has been an outstanding time to own a low-cost passive strategy, and Ridley Cove clients have benefited from many dirt-cheap passive investments. But when interest rates eventually rise, passive funds owning highly levered balance sheets will likely suffer. We think it might be wise to shift additional passive assets to more active management. We have started a screening process, and we expect to recommend some changes in the near future.

Please contact us if you have any thoughts or concerns about our investment strategy. Our money continues to be invested right alongside yours.

Sincerely,

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