



Artemis
FINANCIAL ADVISORS LLC

Market Outlook & Strategy

Third Quarter of 2017

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Executive Summary

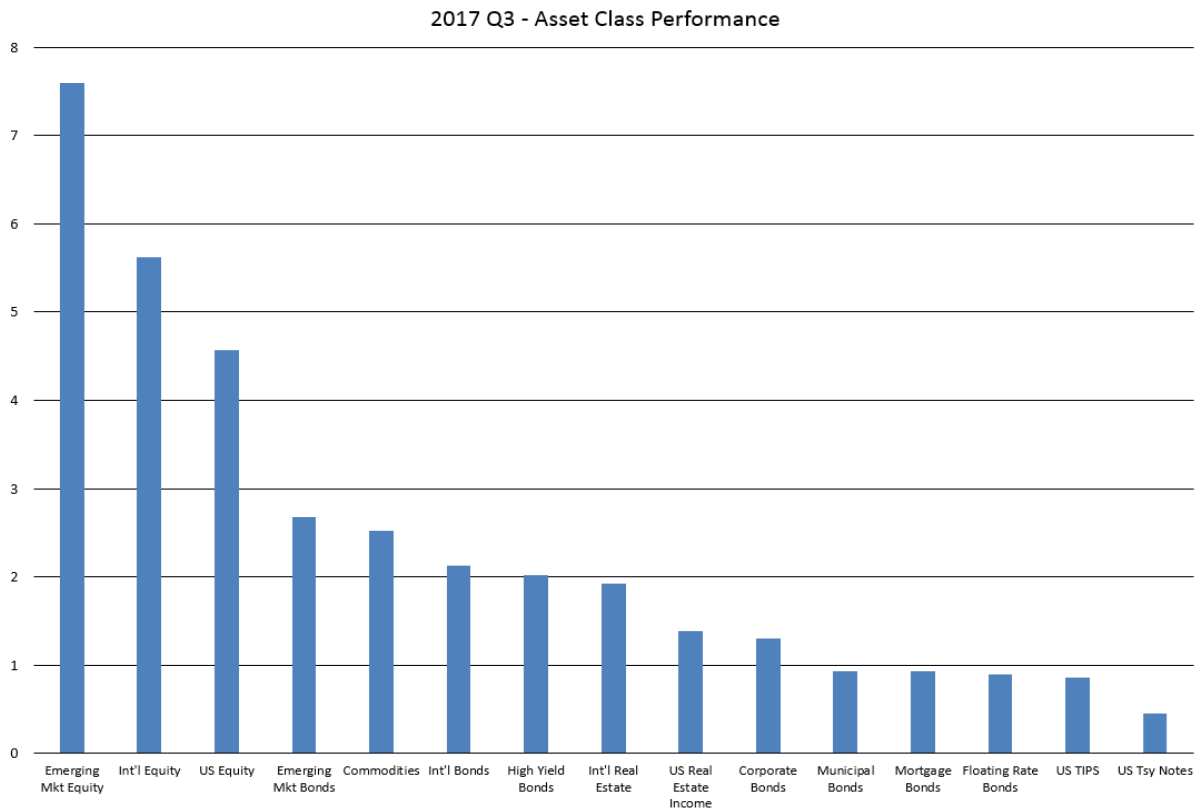
- It was another great quarter for global equity markets in Q3, with the all-country global equity index returning a remarkable +5.3%. Global equities were supported by positive economic data across all regions, including decent growth, solid corporate earnings and modest inflation.
- In the U.S., the overall market returned +4.6% during the quarter. The U.S. market was helped by news that the economy grew 3.1% in Q2 and by robust corporate earnings reports. International returns outpaced domestic returns again this quarter with developed international markets increasing by 5.6% and emerging markets increasing by 7.6%.
- Fixed-income returns were more muted but positive in all segments, with the benchmark Barclay's Aggregate Bond Index increasing 0.8%.
- In this issue, we examine a recent report on the so-called "endowment model". The endowment model is a style of investing that involves diversifying investments across strategies, asset classes and investment horizons. It also involves allocating a significant portion of assets to non-traditional asset classes such as distressed debt, venture capital, commodities and real estate. Artemis subscribes to the endowment model but does not utilize alternative asset classes, given their cost and complexity. A comparative look at investment returns suggests that Artemis clients are not missing out.
- We also explain how most institutional investors adhere to a comprehensive set of standardized, industrywide ethical principles that provide investment management firms with guidance on how to calculate and report their investment results. We follow these same principles at Artemis.
- In terms of Artemis' strategy, we continue to modestly add to our international and emerging market allocations to better capture the hoped-for (but not guaranteed) premium from investing in less expensive markets. We are also maintaining our focus on taking credit risk rather than interest rate risk in our fixed income allocations.



3rd Quarter in Review

Up, up, up! It was another great quarter for global equity markets in Q3, with the all-country global equity index returning a remarkable +5.3%. Global equities were supported by positive economic data across all regions, including decent growth, solid corporate earnings and modest inflation. On a year-to-date (YTD) basis, the global index is up 17.2%. Nice.

Figure 1: Market Performance by Asset Class in Q3 2017 (percentage points)



See Disclosure page for details on indices.

In the U.S., the overall market returned +4.6% during the quarter (and has returned 13.5% YTD.) See Figure 1. The U.S. market was helped by news that the economy grew 3.1% in Q2 and by robust corporate earnings reports. The market also got a boost late in the quarter as investors started to pin their hopes on Congress passing a tax reform package along the



lines proposed by President Trump. This optimism propelled the returns of smaller company stocks as it is widely believed that smaller companies stand to gain more from a tax overhaul.

Outside of the U.S., both international developed market equity returns and emerging market equity returns outpaced U.S. equity returns again this quarter, increasing by 5.6% and 7.6%, respectively. In the Eurozone, economic data remained robust, with unemployment stabilizing and economic sentiment indicators rising to their highest level since 2007. Asian markets also performed well as economic data improved. In particular, Japan saw a jump in headline inflation, which has eluded the country for many years. Emerging market returns were underpinned by rising commodity prices and continued momentum in the Chinese economy.

In contrast, bond yields oscillated over the quarter, and were ultimately little changed. Yields moved lower in August, but reversed course in September as risk appetite returned. Most segments of the market ended modestly higher by the end of the quarter. See Figure 1.

The Endowment Model – Are We Missing Out?

As many of you know, there are several different ways to invest, and most investment managers deploy one or more “investing styles” in their approach. An investing style is an overarching strategy or theory used to set an asset allocation and choose funds and/or individual securities for investment. For example, some investors are “value investors”. Value investors look for those stocks that are out-of-favor or undervalued. Value investors expect that these securities will rise and seek to buy them before they do. Warren Buffett is one of the more well-known proponents of this style of investing. Another style is “growth investing”. Growth investors seek stocks of companies whose earnings are growing faster than most other stocks and are expected to continue to grow. These stocks have a high price-to-earnings ratio, and a value investor will likely consider them to be overvalued.

One style that has received a lot of attention in recent decades is the so-called “endowment model”. The endowment model is an investing style that involves diversifying investments across strategies, asset classes and investment horizons. It also typically involves allocating a significant portion of assets to non-traditional asset classes such as distressed debt, venture capital, commodities and real estate. This style of investing was popularized by Yale University’s Chief Investment Officer David Swenson, and the strategy is deployed by most university endowment managers today, hence the name.



Artemis is a proponent of the endowment model as we absolutely seek to diversify our clients’ investments across different strategies, asset classes and time horizons when setting our strategic and dynamic asset allocations. But we are not a proponent of utilizing non-traditional asset classes to achieve the desired level of diversification.

Are we missing out? It’s a fair question to ask, as according to a recently published study of endowments by the National Association of College and University Business Officers (NACUBO), the average endowment has about a 53% allocation to alternative strategies. (See Figure 2.) It’s also no longer an academic question because many of these non-traditional strategies are now available to small investors through mutual funds or ETFs. (Such products are known as “liquid alternatives”.) These products have become quite popular in the last decade following the financial crisis as investors have been seeking new ways to diversify.

Figure 2. Endowment Asset Allocation – All Institutions in Study

Asset Class	% of Total Portfolio
U.S Equities	16%
Fixed Income	8%
Non-U.S. Equities	19%
Cash	4%
Alternative Strategies	53%
<i>Private Equity (leveraged buyouts, mezzanine, mergers-and-acquisitions funds and non-U.S. private equity)</i>	11%
<i>Marketable Alternative Strategies (hedge funds, absolute return, market neutral, long/short, 130/30, event-driven and derivatives)</i>	20%
<i>Venture Capital</i>	6%
<i>Private Equity Real Estate</i>	6%
<i>Energy and Natural Resources</i>	6%
<i>Commodities and Managed Futures</i>	1%
<i>Distressed Debt</i>	1%
<i>Other</i>	2%
<i>Alternatives Sub-total</i>	53%

**Dollar-weighted*

Source: 2016 NACUBO Commonfund Study of Endowments

The NACUBO study reviewed asset allocations and performance for 805 U.S. endowments that manage \$515 billion of assets and, as one of my clients likes to tease me, employs the “smartest people around”. So how are they doing? Figure 3 below summarizes the average annual returns of all 805 endowments in the study for periods ending June 30, 2016 (which is the end of the fiscal year for virtually all universities) and compares those returns to what Artemis investors have received over the same time periods. Both the endowment and Artemis returns are net all advisory fees.

Figure 3. Endowment Versus Artemis Returns

Institutions	1-year	3-year	5-year	10-year
Average Endowment	-1.9%	5.2%	5.4%	5.0%
Top 25% of Performers	-0.7%	6.1%	6.2%	5.6%
Bottom 25% of Performers	-3.3%	4.2%	4.5%	4.2%
Artemis Aggressive Composite	-1.1%	5.8%	5.2%	no data
Artemis Moderate/Conservative Composite	-0.5%	4.4%	4.4%	no data

*Dollar-weighted; periods ending June 30, 2016
Source NACUBO and Artemis Financial Advisors

A note about the Artemis figures. Artemis maintains a database of all of its clients quarterly returns and divides those clients into two segments (composites) based on percentage of risk assets in the portfolio. The “aggressive” composite is comprised of the weighted-average returns of clients who have generally held 65% or more risk assets in their portfolios. The “moderate/conservative” composite is those portfolios that contain less than 65% equity, ranging from 35%-65%. The only exclusions are portfolios managed to very short-term objectives (e.g., for a near-term home purchase or tax liability), hence we also have a short-term composite that is not included in the data above.

The results suggest that we are not missing out by excluding these newer, non-traditional asset classes in our lineup. The results also help to validate our choice to use a 5.0%



investment rate of return assumption in many of our financial planning projections. (We will use a 6% return for younger clients who demonstrate high tolerance for risk.)

The GIPS Standard

At this point, some of you might be wondering whether the above institutions, including Artemis, are measuring and reporting performance in a consistent manner. Historically, performance reporting was ripe with abuse, with firms cherry-picking which portfolios to measure, reporting model results versus actual client results, and so forth. To minimize this problem, almost 20 years ago, the Certified Financial Analyst (CFA) Institute developed a comprehensive set of standardized, industrywide ethical principles to provide investment management firms with guidance on how to calculate and report their investment results. These so-called GIPS Standards (Global Investment Performance Standards) are voluntary but have been around long enough that most institutional investment firms claim compliance and have been verified as doing so by an independent verifier.

The GIPS standards are very specific, and in order to claim compliance, firms must meet all requirements of the GIPS standards. A key component of the GIPS standards is the concept of a “composite”. A composite is an aggregate of one or more portfolios managed according to a similar investment mandate. The composite is then used to represent how the investment strategy performed historically. The GIPS standards require all fee-paying discretionary portfolios managed by the firm to be included in at least one composite. The standards also have detailed requirements that address disclosure and statistical information that must be provided to clients.¹

We spent the last year at Artemis refining our performance database to be GIPS compliant for all years since the founding of Artemis. As a result, we now place each of our portfolios in one of the three aforementioned composites. While we have not yet taken the last (expensive) step of being independently verified (which is not required to claim GIPS compliance), we are confident in our methods.

¹ Hence, the reason why all current investment clients at Artemis are receiving our GIPS-compliant presentation this quarter as part of their quarterly package. We are happy to make our presentation available to others on request.

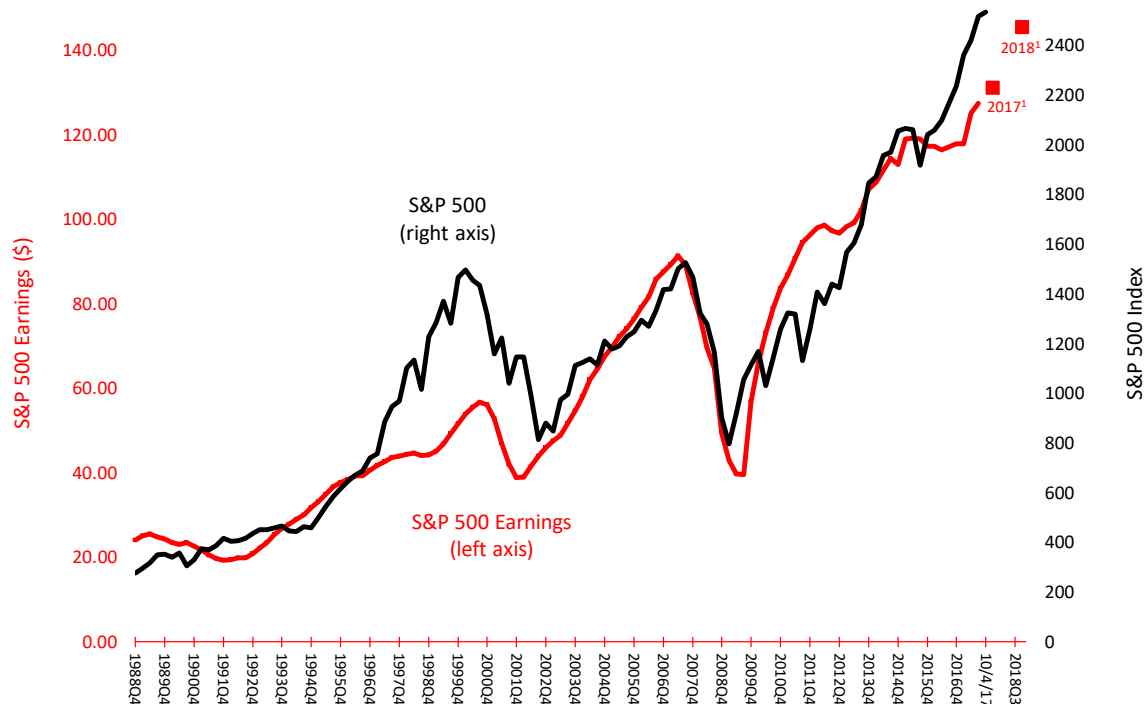


Artemis Investment Strategy

In our report last quarter, we focused on the variety of reasons why we thought the stock market would continue its positive trajectory over the next months and, as such, why we were sticking to our equity overweights. Well, so far, so good, given that global equity markets increased by over 5% in the aggregate in the last three months. Indeed, economic indicators have only been getting better, especially internationally, and so we have been rotating a bit more out of U.S. equity into international equity of late.

Should we be rotating more? Figure 4 is one of my favorite charts because it really shows how stock markets work. The black line (stock prices) closely matches the red line (corporate earnings) over time because earnings drive the stock market. The graph also shows the latest consensus 2017 and 2018 earnings forecasts (left axis) plotted against the S&P 500 (right axis). The chart demonstrates that while the U.S. market is not cheap, it's not out way ahead of earnings – if earnings come in as predicted.

Figure 4. S&P 500 vs. Actual and Estimated Earnings



¹ 2017 (estimated) and 2018 (estimated) bottom-up S&P 500 operating earnings per share as of October 2, 2017: for 2017(e), \$131.12; for 2018(e), \$145.45. S&P 500 index price data through October 4, 2017. Sources: Yardeni Research, Inc. and Thomson Reuters I/B/E/S for actual and estimated operating earnings from 2015. Standard and Poor's for index prices and actual operating earnings data through 2014.



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On the fixed-income side, we still favor the more credit-sensitive sectors such as high yield and emerging market debt. This has added almost a full percentage point of return to the fixed income allocation to most portfolios since the beginning of this year relative to the benchmark. The only real detractor on an absolute basis has been our allocation to inflation-protected U.S. Treasuries, primarily because inflation readings have declined since the start of the year, a development that Janet Yellen of the Federal Reserve is watching quite closely. Indeed, muted inflation is keeping the Fed from putting on the brakes, which is helping the stock market.



Market Index Descriptions (for Figure 1)

Equities:

The **Dow Jones U.S. Total Stock Market** is a market cap-weighted index providing broad-based coverage of the U.S. stock market. Considered a total market index, it represents the top 95% of the U.S. stock market.

The **MSCI EAFE + Canada (net)** is a market cap-weighted equity index that is designed to measure the equity market performance of developed markets, excluding the U.S.

The **FTSE Emerging Markets All Capitalization China A Inclusion (net)** is a market cap-weighted index representing the performance of large-, mid- and small-capitalization stocks in emerging markets.

Fixed Income:

The **Bank of America Merrill Lynch U.S. Treasuries 7-10 Year** measures the performance of U.S. Treasury securities that have a remaining maturity of at least seven years and less than 10 years.

The **Bank of America Merrill Lynch U.S. GNMA Mortgage Backed Securities Index** is a market cap-weighted index, including generic-coupon Ginnie Mae mortgages, with at least of \$150 million principal amounts outstanding.

The **Barclays Capital 1-15 Year Municipal Bond** measures the performance of tax-exempt investment grade debt of U.S. municipalities having at least one year and less than 15 years remaining term to maturity.

The **Bank of America Merrill Lynch U.S. Corporate 5-7 Year** measures the performance of U.S. dollar denominated investment grade rated corporate debt having at least five years and less than seven years remaining term to maturity.

The **Bank of America Merrill Lynch Global Government Bond II Ex-U.S.** tracks the performance of public debt of investment-grade sovereign issuers, excluding the U.S.



The **J.P. Morgan Emerging Market Bond Global Core** is a broad, diverse U.S. dollar-denominated emerging markets debt benchmark that tracks the total return of actively traded debt instruments in emerging market countries.

The **Bloomberg Barclays U.S. Treasury U.S. TIPS** measures all publicly issued, U.S. Treasury inflation-protected securities that have at least one year remaining to maturity.

The **Bloomberg Commodity Index** is a broadly diversified commodity price index that tracks the prices of futures contracts on physical commodities on the commodity markets.

The **Fidelity Real Estate Income Composite** is a benchmark that combines the total returns of the Merrill Lynch Real Estate Corporate Bond Index (40%), Morgan Stanley REIT Preferred Index (40%), and the FTSE NAREIT All REIT Index (20%).

The **Dow Jones Ex-U.S. Select Real Estate Securities** measures the performance of equity REITs and real estate operating companies (REOCs) traded globally, excluding the U.S.

The **Bank of America Merrill Lynch U.S. High Yield Master II** tracks the performance of U.S. dollar denominated below investment grade-rated corporate debt publicly issued in the U.S. domestic market with a maturity of at least one year remaining.

The **S&P/LSTA U.S. Leveraged Loan 100** reflects the performance of the largest facilities in the leveraged loan market.