KEATSCONNELLY

ENRICHING YOUR CROSS-BORDER LIFESTYLE

March 31, 2016

REVIEW OF THE FIRST QUARTER

The first quarter saw a pick-up in performance in US accounts. By now the January drop of almost 10% in US and Canadian stocks is old news although it serves as a recent reminder of how quickly stock markets can turn down.

By the end of the first quarter, the US stock market (as measured by the S&P 500) had gained back January's loss and was back to where it started the year. Canadian stocks (as measured by the S&P/TSX 60) dropped almost as much but were up almost 4% YTD on March 31, 2016.

Performance in US accounts at KeatsConnelly did well during the quarter. They did not drop as much as the market during the January downturn due to the diversification into bonds and other asset classes. By the end of quarter most US accounts were back into positive territory.

Performance in KeatsConnelly accounts does not track the US stock market. The stock market averages that are commonly quoted in the news (the Dow Jones Industrial Average, S&P 500, and the Nasdaq) are made up of US large company stocks. For diversification purposes, most KeatsConnelly managed portfolios have less than a third allocated to US large company stocks.

What has caused the recent increase in performance is that some of the themes in accounts that have been working against us in the past two years have corrected in early 2016.

The US dollar is one example. The US dollar started rising strongly against other world currencies in 2014 and continued throughout 2015. Many of you watch the USD:CAD relationship and have seen the CAD rise since the beginning of the year. The US dollar has also weakened against other major world currencies. We have exposure to investment markets in other currencies for better diversification. The strong rise of the US dollar over the past couple of years has hurt foreign stock returns when measured in USD. The recent pullback in the USD has helped our foreign stock positions to appreciate in USD terms since the beginning of the year. This is not true for all parts of the world but it is true for enough that it shows up as a slight gain relative to US stocks when foreign stocks are translated to US dollars.

Another area of the market that is making a comeback is the price of oil. Oil dropped below $30 dollars per barrel and has now strengthened to around 40 (depending on which measure you watch). This has boded well for the energy sector, of which we have exposure through stocks, commodities, energy and materials funds.

Also, our emphasis on undervalued stocks has been out of favor for the past couple of years, and it is showing its strength again. If you read our commentary with the 4Q15 investment report, you are aware that there have been long periods of time where value has been out of favor but it has always come back to reveal stronger long-term performance over almost all 10-year periods since this data has been collected. There is a theoretical basis why the value effect should manifest itself over time. Emphasizing undervalued stocks is a "bet" away from market neutral stance. By definition, if you have more value stocks then the market, you have less growth stocks. Since growth stocks are by definition stocks where the earnings, cash flows, and assets are not large enough to support their current valuations, then growth stocks are "over-priced". People pay too much for growth stocks. Market prices fluctuate, and these fluctuations cause stock prices to revert to mean valuations.

No growth stock goes up forever, it has to come back to reasonable valuations sometime. If the market is valuing a growth stock as a larger allocation of the index than its index "should" support, then it is over-priced. So it will eventually drop in price.

The opposite is true of value stocks. By definition they are "underweighted" in the stock market relative to their earnings or book value. Therefore, by systematically allocated more to value stocks you should get outperformance as the market self corrects through its "reversion to the mean" process.

Benchmarks

On your quarterly report this quarter we have included an updated benchmark. We told many of you of this change during our investment review meetings and said there would be further communication at the time the benchmark change is made.

We have recast our benchmarks to be more in line with the actual investments in accounts. In the past we had a benchmark comprised of stocks, bonds, and cash. In accounts we also had other asset classes, like real estate, gold, and commodities. In addition, the stock exposure in most accounts has "tilts" to value, small company stocks, and emerging market stocks. None of these tilts were reflected in the benchmark. Now they are.

A benchmark should be as simple as possible but also reflective of how the portfolio is invested. Over the past couple of years, there has been significant deviation away from the benchmark for portfolios. The benchmark change will be more reflective of the actual portfolio investments. This is not a change to the actual investment strategy, but only a change to the benchmark that the strategy is measured against. What you should expect to see in the future is a tighter distribution between the account performance and the benchmark performance.

The following changes were made to US benchmarks:

The bond index has been changed from the JP Morgan Global Government Bond Index to the Barclays US Aggregate Index. The Barclays US Aggregate Index is the index used by a couple of our largest bond holdings and is more commonly accepted as an appropriate bond index. The JP Morgan Global Government Bond Index has been used as our bond index for over a decade but has become outdated and even difficult to get information on it. (There was very little published information and when we asked JP Morgan for more information they even had a difficult time locating additional information about their index!)

On the stock side, our benchmarks are now going to break out the small and value tilts in roughly the proportion we hold them in accounts.

We are adding the following additional pieces in benchmarks because they are held in portfolios:

Commodities
Gold
Real Estate
Natural Resources

In all cases we have chosen an index that we believe is most representative of the asset class. The index we selected in each case is often the same index that the fund held in the account is benchmarked to at the fund company. By way of example, for commodities, our benchmark is the Bloomberg Commodities Index. This is the same index that our primary holding, Dimensional Fund Advisors Commodities Fund, is benchmarked to. We will add commodities to the benchmark at approximately the same time we added it to portfolios (in 2012) and if we ever exit this asset class we will also remove it from the benchmark at approximately the same time.

We can provide more details on your specific account benchmark upon request. This change has us going from three indexes up to ten for some accounts, but it will provide a better representation of what accounts are invested in.

Investment Committee Update

Our investment committee reviewed domestic fixed income during the first quarter 2016. We added a separate account manager for tax-free US municipal bonds to our approved list. Separately managed accounts (SMA) are a way to access direct exposure to asset classes, instead of doing so through a pooled product like an exchange traded fund or a mutual fund.

Tax-free bonds are a great asset class to access directly instead of through a pooled fund for a couple of reasons, most notably because these bonds have state specific attributes that often are not available through pooled products.

The SMA provider we added is Templeton Financial Services. We have already spoken to some clients about this and will be talking to everyone where it is appropriate in the future. It is only appropriate if you have a critical mass in tax free bonds and expect to be a high tax bracket in future years.

Our investment committee also started to look at how much value and small cap tilt to have in portfolios. As mentioned above, value and small cap were two tilts that lagged the overall stock market in the last few years. This wasn’t a poor timing decision because these tilts have been in place for many years and helped performance in previous periods. Our investment committee is starting to discuss methods for adjusting these tilts based on economic or market conditions.

Another area that our investment committee is looking at is the area of market hedges and inflation hedges. In most portfolios we have allocations to asset classes other than stocks, bonds, and cash. We are revisiting our mix of alternative assets to see if any changes are warranted.

As always, we endeavor to provide a great investment experience to you. Please let us know if you have any questions, comments or feedback on your investment portfolio.

Sincerely yours,

KEATSCONNELLY

Robert F. Keats, CFP® (US and Canada), MSFP, RFP® (Canada)
President

John E Rice

John Rice, CFA, CFP®
Chief Investment Officer