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INVESTMENT MANAGEMENT

PORTFOLIO INSIGHTS

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In this Issue:

2 | Stock Market Summary
3 | Bond Market Review
4 | TIPs Behaving Badly
6 | Where Will Stocks Finish in 2017?
7 | Dow 20,000 is Upon Us
8 | The Big Picture & Fast Facts

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Acropolis was born from a simple idea:

In an industry where high quality, objective advice is hard to come by, we make a difference by putting the client's interests above our own.

Subtle Shifts Turn Dramatic

Three months ago, the headline for this publication was 'A Quiet Quarter of Subtle Shifts,' that chronicled some of the market adjustments that had occurred, even though the overall market was quiet.

"This chart should clear up any confusion you may have with the new investment strategy."

For example, we noted that the Russell 2000 index of small-cap stocks had dramatically underperformed large-cap stocks through the end of the second quarter but were neck and neck by the end of the third quarter.

After the election in November, that trend exploded and the Russell 2000 ended up gaining 21.3 percent for the year, while the S&P 500 'only' went up 11.9 percent.

Indeed, the election was a major turning point for every kind of asset, from stocks and bonds to commodities and currencies. The biggest headlines belonged to the run-up of the Dow Jones Industrial Average (DJIA), which rocketed 8.2 percent higher after the election to all time highs near 20,000 - a nice, big round number. Although other US equity asset classes like mid- and micro-cap stocks fared largely as well as small-cap stocks, overseas stocks didn't fare as well for US investors, partly because of the strong US dollar.

Bonds are a fascinating tale, in my opinion, because prices and yields ended the year about where they started and returns looked exactly like what you might expect. During the course of the year, though, yields plunged (and prices surged) and were negative around the world until the election, when yields spiked (and prices tumbled).

Despite the big moves, 2016 was about average in terms of volatility. The standard deviation of one-day price changes dating back to 1926, puts last year in the 47th percentile - almost exactly in the middle. After all of the activity in the fourth quarter, it's easy to forget that we had a 43-day streak where prices didn't move by more than one percent - something that's only happened about 35 times since World War II.

The post-election period was an exciting and profitable time for investors. Now we have to wait and see how the proposed agenda will actually turn into law and whether the prices set on current expectations were too high or too low. As always, we think it's prudent to maintain a balanced outlook and portfolio as the process works itself out.

Stock Market Summary

By Tim Side

To be an investor, you must believe in a better tomorrow.

- Benjamin Graham, Famed Investor

US stocks finished the year with a bang as the Dow Jones Industrial Average finished the year just shy of the 20,000 point mark.

Small-cap stocks were the winner, rising 9.8 percent in the final quarter followed closely behind by mid-cap and micro-cap stocks which rose 8.3 and 10.9 percent respectively.

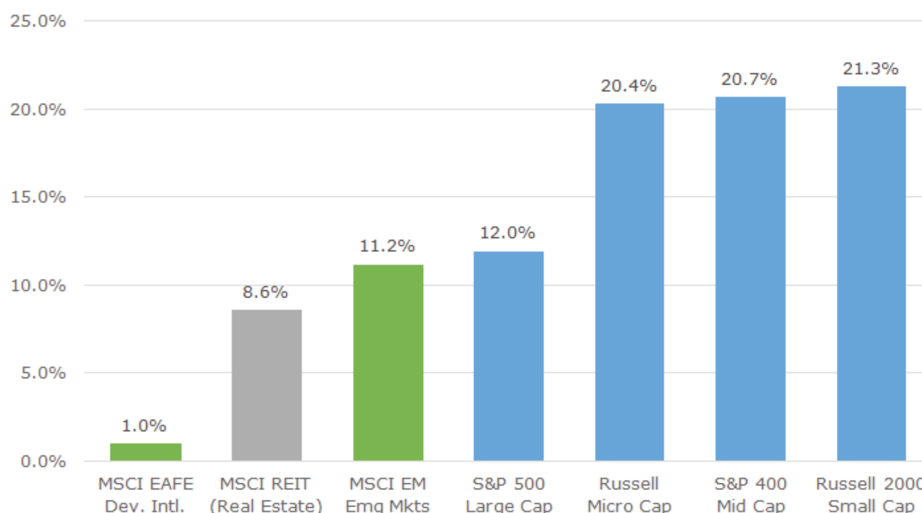
The primary driver to the gains was the "reflation trade" after the election as investors sold off bonds and "safer" stocks for riskier bets.

The last quarter was eventful as it saw the US election, The Organization of the Petroleum Exporting Countries (OPEC) agreement, and the only US rate hike in 2016.

Markets were surprised when Republican Nominee Donald Trump was elected president on November 8th. Contrary to projections that the markets would fall if Trump was elected, equities rose on expectations that he, along with a Republican majority in the House and Senate, would introduce more policies that would be friendly to small American businesses and introduce even more stimulus spending.

On November 30th, OPEC agreed to cut production by 1.2 million barrels of oil per day in an effort to lower the supply and raise prices. In December, Russia, who is not a member of OPEC, also agreed to cut production by 300,000 barrels for the first half of the year. If all parties follow through with their agreement, then global supply will be reduced by two percent. Oil finished the year at $53.72 per barrel; up 46.14 percent for the year.

The Federal Reserve raised rates by 25 basis points (0.25 percent) on December 14th. This was the first and only rate hike for 2016. The Federal Open Market Committee (FOMC) unanimously agreed to raise rates in the December meeting and increased the projected number of hikes in 2017 from two to three. The FOMC cited an increasingly favorable economy and increasing inflation. Markets reacted calmly to the news as the rate hike was fully anticipated.



Data Source: Bloomberg

Bond Market Review

By Ryan Craft, CFA

Interest rates spiked following the election, resulting in one of the worst months in history for bonds. The US Aggregate Bond Index posted a loss of -2.37 percent in November alone. Across the globe, bonds performed even worse.

Since 1990 there have only been a few worse months for bonds. Over this 26 year period, the monthly standard deviation, or normal volatility of returns, has been 1.05 percent, which makes November a nearly 2.5 standard deviation event, which roughly means that volatility like this only happens about two out of 100 months.

While historically bad, the reality is that it was just a rapid unwind of the fear-driven trade from earlier in the year. Even with that terrible performance in November, the Aggregate still ended 2016 positive 2.65 percent. The first half of the year saw yields fall to near historic lows as the market feared a crash from Brexit. Since early July, bonds had moved very little, with investors waiting out the US election.

The primary driver of return on bonds is income. Over a long time horizon, investors' return should roughly be equal to the yield on their portfolio. Even though there has been a lot of price/yield volatility this year, the yield on the Aggregate is nearly right where it started the year (2.59 percent in 2015 vs. 2.61 percent to end 2016).

Many claim to know where yields are going from here, but the bond market can act more irrationally than stocks over short periods. The reality is that we don't know what will happen, what the data will look like, or what the administration will do. Much of the movement in November is simple speculation. Markets were taken by surprise by the Trump win; now investors are placing new bets on the ramifications. Until policies get enacted, it's all just speculation.

Structural headwinds remain against a huge rise in rates. Rates are up 100 bps from the summer lows. This alone will have a slowing effect on our highly-leveraged economy. Investors should welcome higher rates. Getting there will hurt in the short term, but will provide an opportunity for much higher returns in the future.

Data Source: Bloomberg

It seems to be a law of nature, inflexible and inexorable, that those who will not risk cannot win.

- John Paul Jones, American Naval Commander

There are no secrets to success. It is the result of preparation, hard work, and learning from failure.
- Colin Powell, Statesman

TIPs Behaving Badly

By David Ott

Just before the 2008 financial crisis, we began adding Treasury Inflation-Protected Securities (TIPs) to our portfolios.

TIPs are a unique creature because, unlike most bonds, they are specifically tied to inflation, as measured by the Consumer Price Index (CPI). The bond principal increases with inflation and decreases with deflation, and when a TIP matures, you earn the inflation-adjusted principal or the original principal, whichever is greater.

The interest payments are tied to inflation because the interest rate is tied to the principal, which is rising with inflation and falling with deflation (when aggregate prices fall).

In the immediate aftermath of the financial crisis, a lot of investors, including us, were worried about the spectre of higher inflation because of the ultra-low interest rates and the bond buying program that the Federal Reserve put in place.

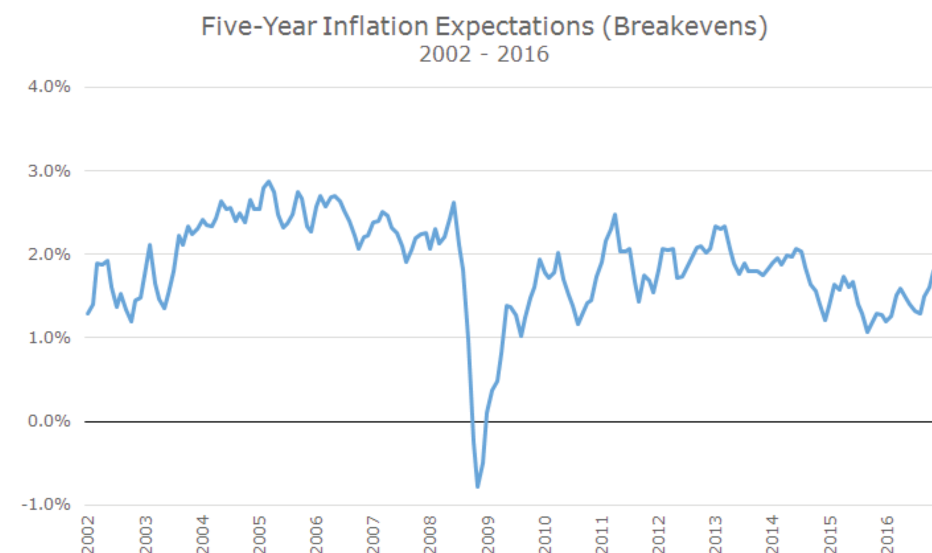
As it turned out, the inflation that some people feared, did not pan out, and for a while, the prospect of deflation became a material concern.

Even though some investors like us were concerned about inflation, the overall bond market was not.

The chart below shows the 'breakeven' rate between nominal (non-inflation-adjusted) bonds and TIPs, which indicates the market expectations for inflation. For example, if the 'real' yield on the five-year TIP is 0.25 percent and the yield on a nominal bond is 2.25 percent, the difference of two percent reflects the market view that inflation will be two percent.

The chart below shows that the breakeven rate for five-year bonds before the 2008 financial crisis ranged between two and three percent. During the crisis, the market expected deflation, as depicted by the plunge below zero during that time. Since the crisis, the market has expected inflation to land somewhere between one and two percent.

One of the nice features about owning TIPs is that you don't have to worry about what inflation will be, unlike a nominal bond.



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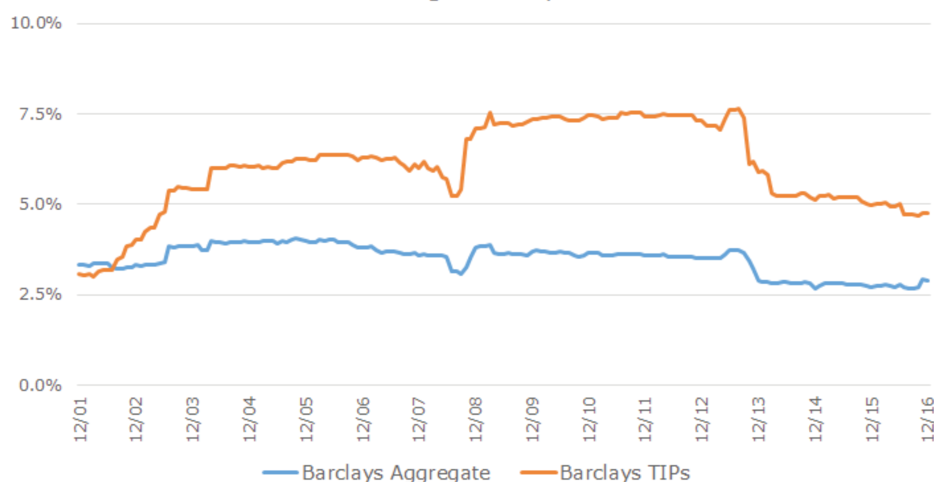


For example, if you think that inflation will be two percent over the next five years and a five-year bond is paying 2.5 percent, then your 'real,' or inflation-adjusted return will be 0.50 percent. If inflation turns out to be three percent, the real return on your nominal bond is now -0.50 percent. With a TIP, you don't have to worry about higher inflation because the bond will adjust automatically.

In theory, since the inflation risk is removed from TIPs, they should be less risky than nominal bonds since inflation is one of the primary risks for bonds. To be sure, there are other risk factors, but inflation is the big one.

Since a nominal bond is riskier, investors in nominal bonds should earn a slightly higher return as compensation for the risk that they are taking.

The problem that we have with TIPs is that they have been a lot riskier than nominal bonds. The chart above plots the five-year rolling volatility of TIPs versus the Barclays Aggregate, which represents all investment grade, nominal bonds.

TIPs have been consistently more volatile than nominal bonds, which is at odds with the idea that TIPs should be less risky than nominal bonds.

We also believe that TIPs have become more sensitive to changes in interest rates than they have been historically. If interest rates rise, TIPs could underperform nominal bonds, which might be a nasty surprise for those trying to hedge inflation risk.

For these reasons, we have been exiting our TIPs allocation because the risk/reward balance doesn't make sense: TIPs have lower expected returns than nominal bonds and have experienced higher volatility.

Overall, most bond prices fell after the election, but TIPs fared better than nominal bonds. In this case, inflation expectations shot up too, which helped offset some of the impact of rising rates.

Still, investing is all about risk and return and we just felt like the balance wasn't right for TIPs. We are now in the process of removing them from client portfolios unless there are unique circumstances.

You can be young without money, but you can't be old without it.
- Tennessee Williams, Playwright

> **I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups who behave in the market like children.**
>
> - Warren Buffet, Famed Investor

Where Will Stocks Finish in 2017?

By David Ott

It's forecast time on Wall Street, and despite the folly of it, individuals and professionals alike pay attention anyway.

On average, and according to Bespoke Investment Group, the 15 most prestigious analysts and strategists are calling for a measly five percent gain for the S&P 500, which would put the index at 2,356 in one year, compared to 2,234 at the end of 2016.

Collectively, that's the lowest average forecast since 2005, when the strategists said that the S&P 500 would only gain 2.8 percent. As it happened, they were on target that year, and the price change for the index was 3.0 percent (they never forecast the dividends, just the price targets).

While the analysts got it right that year, they have had as many misses as they have hits. Since the year 2000, as a group, the analysts thought that the S&P 500 would gain 9.6 percent annually, but the average actual change was just 4.2 percent.

You might look at that and think that they are overly optimistic, but a lot of it has to do with chronically missing the bear markets. Back in 2008, for example, they said that the market would rise 11.1 percent, and went on to miss the biggest calendar decline since the Great Depression, falling -38.5 percent.

In 2000, 2001 and 2002, when the S&P 500 lost -10.1, -13.0 and -23.4 percent respectively, the strategists had said that the market would gain 3.8, 20.7 and 12.4 percent. Wow – that's a cumulative loss of -40.1 percent compared to forecasted cumulative gains of 40.4 percent.

Despite the cockeyed optimism during those bear markets, the group has been dour since the 2008 global financial crisis. With the exception of 2009, when they did correctly call a strong market, they've said each year that the market would gain by mid to high single digits.

As it happens, not a single one of those years has been between five and 10 percent. In five of those years, the price gains were more than 10 percent (and as high as 29.6 percent), and in two of those years, the market was dead even or modestly down.

Most of the time, I think that the forecasts simply reflect the overall mood of the market at year-end. That theory doesn't work well this year given the election-related excitement, but I still think that analysts anchor on the long-term market average of 10 percent and make adjustments from there.

Year	Average Price Target	Actual Year End	Forecast Return	Actual Return
2000	1,525	1,320	3.8%	-10.1%
2001	1,593	1,148	20.7%	-13.0%
2002	1,291	880	12.5%	-23.3%
2003	1,004	1,112	14.1%	26.4%
2004	1,169	1,212	5.1%	9.0%
2005	1,246	1,248	2.8%	3.0%
2006	1,348	1,418	8.0%	13.6%
2007	1,550	1,468	9.3%	3.5%
2008	1,632	903	11.2%	-38.5%
2009	1,078	1,115	19.4%	23.5%
2010	1,225	1,258	9.9%	12.8%
2011	1,371	1,258	9.0%	0.0%
2012	1,344	1,426	6.8%	13.4%
2013	1,534	1,848	7.6%	29.6%
2014	1,955	2,059	5.8%	11.4%
2015	2,233	2,044	8.5%	-0.7%
2016	2,216	2,238	8.4%	9.5%
2017	2,356	???	5.3%	???

Source: Bespoke Investment Group

Dow 20,000 is Upon Us

By David Ott

When I graduated from college in 1995 and started in this industry, I was told that the current saying for the Dow Jones Industrial Average (DJIA) was '10,000 by 2000,' referring to the turn of the century.

It seemed impossible to me because, at that point, the DJIA was trading below 4,500. Just a few months before, one of my finance professors said the market was overvalued.

Less than six months on the job, the DJIA crossed 5,000, which turned out to be just the beginning. The DJIA crossed 6,000 in 1996, 7,000 and 8,000 in 1997, 9,000 in 1998 and 10,000 in 1999, almost a full year ahead of 'schedule.'

Newspapers featured photos of happy traders wearing Dow 10,000 hats and the mood was euphoric. By the time Y2K rolled around, the DJIA was trading around 11,500 and the market seemed unstoppable.

Of course, we know now that we were in the middle of a giant stock market bubble that spent the next three years falling back to earth. At the bottom in 2002, the DJIA traded around 7,300. On the way back down, there were plenty of dark jokes about getting out the Dow 10,000 hats for a second time.

The tech wreck was brutal; but by 2006, the DJIA was back to new all-time highs. After a few years of new all-time highs, we endured the global financial crisis and the whole process started again.

Now the DJIA stands on the verge of crossing 20,000, and beyond ordering new hats, it's natural to wonder what this milestone means.

Sadly, I don't think that milestones like this mean much at all. I know that's an unsatisfying answer, but the only reason that we like 20,000 is that it's a round number.

Part of the reason that the DJIA is closing in on 20,000 is technical in nature. The index only has 30 constituents and is price-weighted, which means that strange things can happen.

I've softened my view on the DJIA (it's odd, but not useless), but part of the reason that it's doing so well this year (16.4 percent, vs. 12.9 percent for the S&P 500) is that it is heavy in industrial and financial stocks, and underweight in technology stocks – a near perfect combination for the Trump bump.

The bigger point, though, is that the stock market tends to go up over time; not because there is something special about indexes or round numbers, but because stocks represent ownership in businesses.

As long as companies can create and grow profits, values should increase. The fellows that wrote 'Dow 36,000' in 1999 were definately early, but they may not be wrong (I covered this last year when the DJIA crossed 18,000).

I'm not making a prediction, but if the DJIA grows by 7.7 percent over the next ten years (which is how much it grew over the last 10 years), we'll be looking at Dow 43,000.

It's hard to imagine, but it's a realistic possibility. There is an enormous range of options, and we always have to prepare for bad outcomes, but if history is any guide, we'll continue to hit higher numbers - we just can't say when.

Both of these articles appeared in Daily Insights, a email newsletter that delivers our insights into your inbox each day. If you'd like to sign up, contact me at do@acrinv.com.

Success is not final; failure is not fatal: it is the courage to continue that counts.
- Winston Churchill, Former British Prime Minister

Data Center	2016
Dow Jones	16.50%
S&P 500	11.96%
S&P Midcap	20.74%
Russell 2000	21.31%
MSCI EAFE (Intl)	1.00%
MSCI Emerging Mkt	11.19%

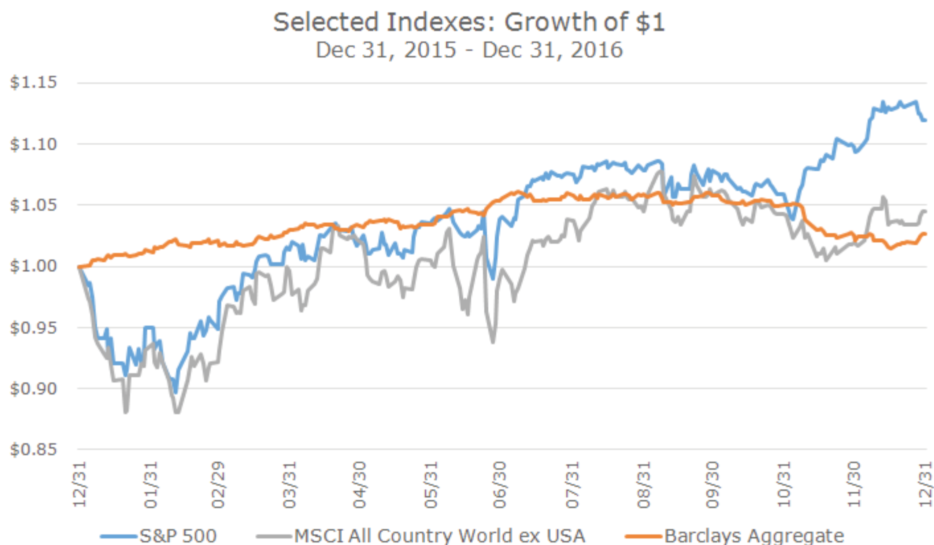
S&P Sectors	2016
Basic Materials	16.69%
Consumer Discretion.	6.03%
Consumer Staples	5.38%
Energy	27.36%
Financials	22.75%
Healthcare	-2.69%
Industrials	18.85%
REITs	0.01%
Technology	13.85%
Telecom	23.49%
Utilities	16.29%

Interest Rates	2016
Fed Funds	0.75%
Prime Rate	3.75%
3-mo. Treasuries	0.%
2-yr. Treasuries	1.19%
5-yr. Treasuries	1.93%
10-yr. Treasuries	2.44%

Currencies	2016
Euro	1.0517
Japanese Yen	116.96
British Pound	1.2340

All Data as of 12/31/2016

The Big Picture



Fast Facts: Dow 20,000 Edition (We're close enough)

62.76 - The first closing price for the Dow Jones Industrial Average (DJIA) on February 16, 1896. Charles Dow, the editor of the Wall Street Journal, created the index with Edward Jones, a statistician (unrelated to the investment firm).

239.45 - The December 31 closing price of Goldman Sachs, the highest price of the DJIA components. Because the DJIA is price-weighted, Goldman has ten times more influence than Cisco, whose price was 29.96 at year-end. It's odd because Cisco is about 50 percent larger than Goldman based on market capitalization: ~$150 billion compared to ~$100 billion.

12 - The original number of DJIA stocks. General Electric is the only original still in the index; some exist as parts of other companies like American Cotton Oil (now part of Unilever). Others are gone like US Leather, and one remains as is, albeit out of the DJIA: St. Louis' own Laclede Gas.

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