# INVESTMENT REPORT

LYNCH FINANCIAL GROUP LLC
Retirement Wealth Management

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## Investment Review and Outlook

**2015 was a poor year for financial markets across the globe and across asset classes (stocks, bonds, commodities, etc.)**

**Outside the United States, regaining more normal economic growth and inflation has remained more challenging.**

**As in 2014, the strength of the dollar exacerbated foreign markets' underperformance for dollar-based investors.**

**The worst-performing areas of the markets were commodity-related asset classes.**

### Benchmark and Mutual Fund Performance

The box below contains benchmark (capital market and investment style) performance results. The performance results of our recommended mutual funds and their benchmarks are shown on page 4. Client portfolios, except for the highest risk portfolios, underperformed their benchmarks for the year due to lower allocations to U.S. stock funds.

### Fourth Quarter 2015 Key Takeaways

2015 was a poor year for financial markets across the globe and across asset classes (stocks, bonds, commodities, etc.). Among the major global stock markets, the United States was the best performer, but that's faint praise given the S&P 500's 1.3% return. What's more, it was a market in which a handful of large tech/Internet companies (e.g., Facebook, Amazon.com, Netflix, and Google) generated huge gains and helped propel the index into positive territory, while the equal-weighted S&P 500 index actually *fell* 2.2% for the year.

One striking feature of last year's investment environment was the difference in the direction of the U.S. economy and U.S. monetary policy versus other major global economies. In December, the U.S. Federal Reserve was sufficiently comfortable with the outlook for economic growth and the potential for inflation to eventually normalize that it made its first increase in rates in nearly a decade.

Outside the United States, regaining more normal economic growth and inflation has remained more challenging. Sharply lower commodity prices (most notably oil), Middle East tensions, and China's slower economic growth all weighed on foreign stock market returns. Developed international stocks ended the year down 0.3% while emerging markets fared worse, falling 15.5%.

**Benchmark Returns (Periods Ended 12/31/15)**

| | Quarter | 12 Months |
|---|---|---|
| **Large-Cap Benchmarks** | | |
| Vanguard 500 Index | 7.0% | 1.3% |
| Russell 1000 Growth iShares | 7.3% | 5.5% |
| Russell 1000 Value iShares | 5.6% | -4.0% |
| **Mid-Cap Benchmarks** | | |
| Russell Midcap iShares | 3.6% | -2.6% |
| Russell Midcap Growth iShares | 4.1% | -0.4% |
| Russell Midcap Value iShares | 3.1% | -4.9% |
| **Small-Cap Benchmarks** | | |
| Russell 2000 iShares | 3.7% | -4.3% |
| Russell 2000 Growth iShares | 4.4% | -1.2% |
| Russell 2000 Value iShares | 2.9% | -7.5% |
| **Other Benchmarks** | | |
| Vanguard Developed Mkts Idx | 3.9% | -0.3% |
| Vanguard Emerging Markets | -0.4% | -15.5% |
| Vanguard REIT Index | 7.0% | 2.2% |
| Vanguard Total Bond Mkt Index | -0.6% | 0.3% |
| Credit Suisse High Yield Index | -2.6% | -4.9% |

***We welcome questions or comments regarding this newsletter at jlynch@lynchfinancialgroup.com. Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.***

As in 2014, the strength of the dollar exacerbated foreign markets' underperformance for dollar-based investors, detracting 9% from emerging-markets stocks and 6% from developed international stocks compared to their local-currency returns

The worst-performing areas of the markets were commodity-related asset classes. Commodity indexes were crushed, down on the order of 25%–30% as oil prices hit an 11-year low in December and fell 30% for the year, after plunging 50% in 2014.

Fixed-income offered little respite, with the core bond index gaining just 0.3%. High-yield bonds fared worse, down close to 5%, while floating-rate loans lost 0.7%. Investment-grade municipal bonds were a *relative* bright spot, with the national muni bond index up nearly 3% on the year.

### 2015 Investment Commentary

Overall, 2015 was a challenging year for the financial markets in general, and for our portfolios more specifically. In this quarter's commentary, we thought it would be instructive to break the portfolio down into four categories of investments that highlight their different roles: longer-term return generators; shorter-term risk reducers; hybrid investments, which have elements of both return generators and risk reducers; and diversifying alternative strategies. Understanding how we employ the various types of investments we own in our client portfolios should help in setting reasonable expectations of how they will perform.

***Longer-Term Return Generators:*** These are investments or asset classes that we own because of their ability to generate longer-term growth of capital, well in excess of inflation. U.S., developed international, and emerging-markets stocks are our portfolios' primary long-term return generators. However, we expect them to have higher shorter-term volatility and significant downside risk.

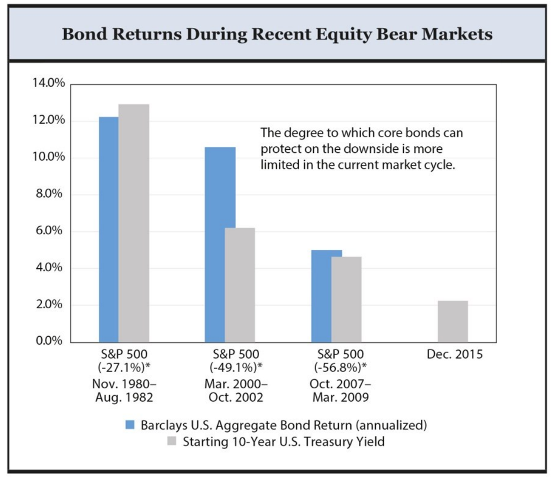
With prospective returns in the low double digits in our base case five-year scenario for developed international stocks, and comparable or higher return estimates for emerging-markets stocks, we believe we are being well compensated for their risk and that exposure to these markets will pay off over time.

Our investment thesis for developed international and emerging-markets stocks has not changed materially. In a nutshell, our analysis suggests both markets are undervalued relative to their normalized earnings potential looking out five or so years. Therefore, we expect to benefit from both stronger-than-expected earnings growth and some valuation (P/E multiple) expansion, generating the double-digit type of expected returns noted above. We are confident we will get paid (with outsized returns) for our current allocations to developed international and emerging-markets stocks.

Conversely, when it comes to U.S. stocks, our tactical outlook over the coming five years is much less positive compared to emerging-markets stocks and developed international stocks. Unlike in those markets, our analysis suggests U.S. valuations are high. And with U.S. corporate profit margins also well above normal, we see potential for disappointing earnings growth and valuation multiple contraction. Our base case scenario results in low single digit expected returns for the S&P 500. While that return may exceed that of low-risk core bonds, it is well below the upper-single-digit-type returns we are looking for, at a minimum, from our long-term return generators. Therefore, we are tactically underallocated to U.S. stocks in our portfolios.

***Shorter-Term Risk Reducers:*** To mitigate the shorter-term uncertainty, volatility, and downside risk that comes from owning stocks, our balanced portfolios also have dedicated exposure to core investment-grade bonds.

If there is a recession or economic shock that leads to increased risk aversion among investors, core bonds have historically performed well in absolute terms (generating solid gains) and very well relative to riskier assets like stocks that may be down 20%–30% or more. We'd expect a similar performance pattern this time around if and when stocks fall into a bear market. So core bonds have a very important risk-management role, particularly in our more conservative portfolios.




*Source: Morningstar Direct. Data as of 12/31/2015. *Cumulative price return during the period.*

However, given the very low current yield and our expectation for returns in the 0% to 2% range over the next five years, the degree to which core bonds can limit the downside during the current market cycle has been significantly reduced. This past year was a good example of this, with core bonds barely positive while global stocks were negative. That is a high price to pay (in terms of low longer-term returns) for the risk-reduction benefits of core bonds.

So we are in a situation where our two primary asset classes, U.S. stocks and U.S. core bonds, look unattractive relative to their respective return-generation and risk-reduction roles in our portfolios. This has been the case for the past several years and led us to research and invest in other asset classes and strategies that we think are more compelling on a risk/return basis.

***Hybrid Investments: Part Risk Reduction, Part Return Generation:*** As the primary examples of what we consider hybrid investments, we have allocated a meaningful portion of our portfolios to a diversified group of fixed-income funds representing a variety of investment categories: multisector and absolute-return-oriented funds. We believe these investments have the potential to generate returns over the next five years that are several percentage points above the core bond index and in line with or better than our base case return expectations for U.S. stocks. Importantly, these funds should have much less volatility and downside risk than stocks. However, in most scenarios, these funds will have higher volatility and short-term downside risk than core bonds, due to their below-investment-grade and/or non-dollar currency exposure.

***Alternative Strategies/Portfolio Diversifiers:*** The final piece of our portfolio is allocated to alternative strategies. These investments also play a dual role of return generator and portfolio risk diversifier. Within our alternative strategies allocation we own Pimco All Asset, Pimco All Asset Authority and Westwood Income Opportunity funds. Broadly speaking we believe these investments will both add valuable diversification benefits and will also be additive to our balanced portfolio returns over the next five years.

## Concluding Comments

We were disappointed in our portfolios' overall performance in 2015. However, we'd reiterate that it is in the nature of our long-term, fundamental, valuation-driven investment approach to go through periods of subpar performance. It is exactly during these challenging periods that it is *most* critical, but also most difficult, for an investor to stick with their approach and remain disciplined in order to ultimately harvest the long-term rewards.

We believe our portfolios are well positioned to generate solid returns over our five-year horizon, but we think it is prudent to be prepared for potentially increased market volatility and downside risk (as well as positive returns) over the shorter-term. We may even get the opportunity to add to our undervalued positions or establish some others before this market cycle turns. In other words, we believe the key to successful investing ahead is to maintain the healthy patience, perspective, and discipline necessary for long-term investment and financial success.

*This article utilizes research from Litman/Gregory Analytics, LLC.*

# LFG Recommended Mutual Funds
## Performance Results for Funds and Benchmarks

| Fund Name[1] | Benchmark (BM)[2] | % Returns For The Periods Ended December 31, 2015 | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | 3 Months | | 12 Months | | 3 Yrs Annlzd | | 5 Yrs Annlzd | |
| | | Fund | BM | Fund | BM | Fund | BM | Fund | BM |
| Baron Emerging Markets[3] | Vanguard Emerging Markets Index | +3.4 | -0.4 | -11.0 | -15.5 | +2.0 | -7.0 | +1.7 | -5.0 |
| Parametric Emerging Markets[3] | Vanguard Emerging Markets Index | -1.4 | -0.4 | -16.4 | -15.5 | -6.7 | -7.0 | -4.7 | -5.0 |
| Tweedy Browne Global Value | Vanguard Developed Markets Index | +2.6 | +3.9 | -1.5 | -0.3 | +6.2 | +4.6 | +6.3 | +3.5 |
| Artisan International | Vanguard Developed Markets Index | +6.8 | +3.9 | -3.9 | -0.3 | +6.0 | +4.6 | +6.8 | +3.5 |
| Litman Gregory Masters Select International | Vanguard Developed Markets Index | +0.7 | +3.9 | -5.5 | -0.3 | +3.7 | +4.6 | +2.3 | +3.5 |
| Rainier Small/Mid Cap Equity | Russell Midcap iShares | +2.6 | +3.6 | +1.1 | -2.6 | +12.1 | +14.0 | +9.4 | +11.3 |
| Harbor Capital Appreciation | Russell 1000 Growth iShares | +8.1 | +7.3 | +11.0 | +5.5 | +18.9 | +16.6 | +14.4 | +13.3 |
| Jensen[3] | Russell 1000 Growth iShares | +7.7 | +7.3 | +1.8 | +5.5 | +14.8 | +16.6 | +11.3 | +13.3 |
| BBH Core Select[3] | Vanguard 500 Index | +4.2 | +7.0 | -2.7 | +1.3 | +10.1 | +15.0 | +10.9 | +12.4 |
| Selected American Shares | Vanguard 500 Index | +6.8 | +7.0 | +3.6 | +1.3 | +13.4 | +15.0 | +9.5 | +12.4 |
| Dodge & Cox Stock | Russell 1000 Value iShares | +4.5 | +5.6 | -4.5 | -4.0 | +14.0 | +12.9 | +11.6 | +11.1 |
| Vanguard Windsor II | Russell 1000 Value iShares | +4.5 | +5.6 | -3.2 | -4.0 | +12.0 | +12.9 | +11.0 | +11.1 |
| FPA Crescent[3] | 60% Russell 2500 Index; 40% Vang Tot Bd | +2.8 | +1.7 | -2.1 | -1.6 | +8.4 | +8.0 | +7.7 | +7.4 |
| PIMCO All Asset | Barclays TIPS Bond iShares | -0.0 | -0.7 | -8.7 | -1.6 | -2.5 | -2.4 | +1.9 | +2.4 |
| PIMCO All Asset All Authority[3] | 50% S&P 500/50% Barclays TIPS Bond iShares | -1.4 | +3.2 | -11.7 | -0.2 | -6.6 | +6.3 | -0.3 | +7.4 |
| Westwood Income Opportunity[3] | 25% S&P 500, 25% NAREIT All Equity, 25% Citigroup Treasury Bill 3 mo., 25% Citigroup Treasury 10 Yr | +3.2 | +3.3 | -2.6 | +1.6 | +6.8 | +6.8 | +7.1 | +7.5 |
| Osterweis Strategic Income[3] | Vanguard Total Bond Index | -1.7 | -0.6 | -0.9 | +0.3 | +2.3 | +1.2 | +3.9 | +3.0 |
| Doubleline Total Return[3] | Vanguard Total Bond Index | -0.5 | -0.6 | +2.3 | +0.3 | +3.0 | +1.2 | +5.5 | +3.0 |
| PIMCO Total Return | Vanguard Total Bond Index | +0.5 | -0.6 | +0.7 | +0.3 | +1.1 | +1.2 | +3.5 | +3.0 |
| Vanguard Intermed Tax-Exempt | Vanguard Total Bond Index | +1.4 | -0.6 | +2.9 | +0.3 | +2.8 | +1.2 | +4.7 | +3.0 |
| Loomis Sayles Bond | 1/3 CSFB HY, 2/3 Vang Tot Bond | -0.8 | -1.3 | -6.9 | -1.4 | +1.1 | +1.3 | +4.3 | +3.6 |

[1]Funds were selected using the LFG Proprietary Mutual Fund Rating System℠. This system is based on extensive research using both quantitative and qualitative factors. The system seeks to identify top funds in each asset class and investment style. LFG typically combines 8 to 10 funds in client investment portfolios.

[2]iShares exchange traded funds were used where available and respective Russell indices were used for the other periods.

[3]Funds which were not recommended for entire 5 year period.

The above table reflects past performance and should not be considered indicative of future results. The results contained in this schedule were obtained from sources we believe to be reliable. We cannot, however, guarantee the accuracy of this information.