DIVERSIFIED TRUST

COMPREHENSIVE WEALTH MANAGEMENT

white|paper

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Don't Worry, Be Happy!

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I have been humbled by the markets enough times over the years that I would never suggest that investors have "got it wrong." But, I do think it is worthwhile to occasionally point out what seem to be anomalies in the capital markets and then try to determine what I (or they) may be missing. Currently, we have what I consider an odd state of affairs in that all of the quantitative measures that we can evaluate suggest investors believe there is very little risk in the world. Perhaps that is correct, and there are certainly many recent developments that point toward a stronger economy and better news regarding corporate earnings. But, it seems to me there are at least the usual number of things to worry about, and one can argue that the world is likely to be more rather than less volatile. Let's begin by taking a look at what the markets are saying.

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Is the World Risky?

How does one gauge investor sentiment? In other words, how do you know whether investors are feeling optimistic or risk averse? Of course, you can ask, but their investments frequently are not consistent with the views they express-they talk the talk without walking the walk. Luckily, we have a number of objective, quantitative measures that are based on investors' actual decisions.

First, we will look at recent returns on various types of securities:

12 Month Returns Ending February 2017

Barclays Aggregate Bond Index	**1.4%**
Barclays High Yield Bond Index	**21.8%**

MSCI World Stock Index	**21.3%**
Russell 2000 Index (Small Cap Stocks)	**36.1%**
Russell Microcap Stocks	**35.7%**
MSCI Emerging Markets	**29.5%**

In the case of both stocks and bonds, you will note significant outperformance on the part of the riskiest segments of the respective markets. That certainly is a sign of investor willingness to take risk because relative performance is largely determined by investor flows.

Important Notes And Disclosures

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A great quantitative measure of risk aversion is the high yield bond spread. In order to induce investors to step down in quality from US Treasury to high yield or "junk" bonds, they rationally demand extra return in the form of yield. This extra return or "spread" tends to increase or widen when investors are nervous and vice-versa. The most extreme example of widening occurred when the spread went from 3% in 2007 to 17.5% at the height of the global financial crisis. The following chart depicts the spread since 1997:

As you will note, we are currently trading at levels similar to those that prevailed immediately prior to the financial crisis. Simply stated, investors are very comfortable stepping down in quality in return for a moderate increase in yield. It is also worth noting that spreads can stay low or "tight" for extended periods so the fact that they are currently low does not provide much if any information on timing.

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The primary determinant of the price of an option is the expected level of volatility of the underlying investment over the option's life. By taking the actual market price of an option and using some fancy math, one can solve for the expected level of volatility. There is an index called the VIX which looks at the expected volatility of the one hundred largest stocks in the S&P 500. When the number is high, it suggests investors are anxious and expect considerable volatility, and the converse is true. The following chart depicts the VIX Index since 1990. As was the case with high yield spreads, note that we are at levels similar to those that prevailed in 2007. Again, you should realize that volatility can stay low for extended periods of time.

A related measure is the put/call index which measures the ratio of the volume in put options versus call options. When the ratio is high, it suggests that investors are worried about the stock market and therefore purchasing lots of put options in order to protect their portfolios, and a below-average reading suggests comfort or even complacency. Today, the ratio is .88 versus the long term average of .95 which suggests that anxiety is relatively low.

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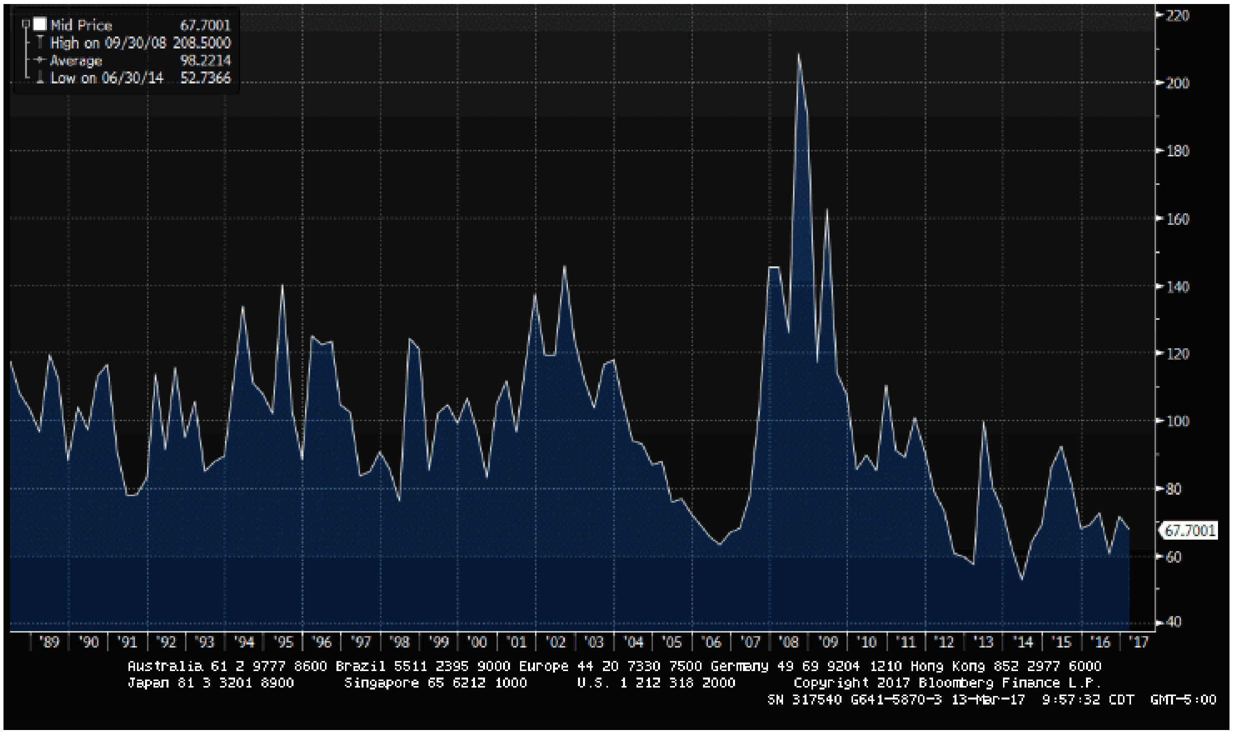
Finally, there is an indicator called the Move Index which measures the expected volatility in interest rates in the same way that the VIX measures expected volatility in stocks. The following chart depicts the Move Index since 1988. Once again, you will note that it is very near historical lows which suggests that investors do not expect a major change in interest rates.



Hopefully, you see the consistent message from the markets that risk is low, and stability and optimism are the order of the day. Once again, these are objective measures and not the pronouncements of financial pundits.

The Good News

So, is there justification for the perception that all is calm? First off, the economy is relatively stable as characterized by real GDP growth of 1.9% and 2%, respectively, over the past one and five years. Similarly, inflation is very moderate at 1.4% annually over the past five years. In the fourth quarter, corporate earnings were up about 5% which represents the first back-to-back quarterly increase since late 2014. And, investors are optimistic regarding President Trump's promises to cut both individual and corporate taxes, increase infrastructure spending, and significantly reduce regulation.

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Not So Fast!

Alas, there are also plenty of things to worry about. You can probably come up with your own list but here are some of mine:

RISKS THE STOCK MARKET SEEMS TO BE IGNORING

Tax cuts and infrastructure spending may have negative implications for the deficit and ultimately, interest rates. 1

Uncertainty regarding elections in France and Germany. 2

Tariffs and the potential for trade wars have major implications for political stability, inflation, economic growth, corporate profits, and so on. 3

Various **Trump investigations** 4

China has **serious capital outflow** issues as well as questions regarding the size and quality of debt, the possibility of a real estate bubble, and so on. 5

The FED has already increased **short term rates** several times and more are expected. 6

Uncertainty stemming from Brexit implementation and other independence movements. 7

Concern regarding **Italian bank difficulties**. 8

Risk of **additional terrorist events** such as those that occurred in 2016. 9

Potential turmoil due to **repeal of ACA**. 10

Are all of the **effects of deregulation** good? 11

Aggressive behavior of **Russia and North Korea**. 12

Lack of **corporate capital spending-questions** regarding future competitiveness. 13

High valuation of **stocks**. 14

Longer term **demographic and productivity issues.** 15

Budget hawks may make it difficult to pass tax cuts and infrastructure programs. 16

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So?

The goal of this paper was not to make a stock market prognostication nor do we make any attempt to weigh the pros versus the cons. But, we do think it is important to recognize that the markets are quite optimistic, and seemingly unconcerned about risk. Warren Buffett said, "Be fearful when others are greedy. Be greedy when others are fearful." Our message is not to be fearful, but it is also not to get carried away. Our current portfolio positioning calls for a full allocation to equities, below average weighting in fixed income, and an overweight to diversifiers. We believe this structure should give us significant participation in any upside but also provide protection should risk reappear. ■

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