ASPIRIANT

Market Perspective

April 2017

EUROPEAN EQUITIES
Accounting for political uncertainty

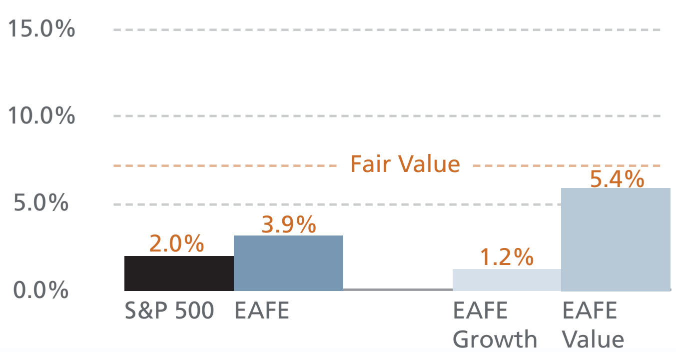
Overview

First, let us be very clear: We believe that *every* financial asset class around the planet is expensive today. There is no low-hanging fruit. However, investors can absolutely succeed in markets characterized by lower future returns.[1] To do so, one must have a disciplined framework for understanding the *relative* attractiveness of asset classes. History 101, Economics 101 and Investing 101 suggest that the most sensible approach for the long-term investor is to estimate the expected cash flow from an investment relative to the price paid for it. Our Capital Market Expectations (CMEs) represent forward-looking return and risk assumptions we expect to be realized by the market over a full market cycle. The CMEs serve as the primary inputs into our portfolio construction process, which tends to tilt our portfolios toward asset classes we expect to generate the highest rate of return relative to the overall level of expected risk.

European equities: More opportunity, different risks

International equities, and European equities in particular, provide a useful example of how we use valuation and our CMEs to construct portfolios. The bar chart below compares our CMEs for two pairs of asset classes: U.S. equities and European equities[2] as well as European growth and European value. A few observations can be made. First, our annualized return for each of the four asset classes is well below our assumption of a long-term fair value return of approximately 7%. From our perspective, the price levels (i.e. valuations) are all elevated relative to the cash flow likely to be earned by investing in each of the asset classes. Second, European equities appear to be less expensive than U.S. equities. Third, European value stocks appear to be cheaper than European growth stocks.

Capital Market Expectations - Select Equities
February 2017

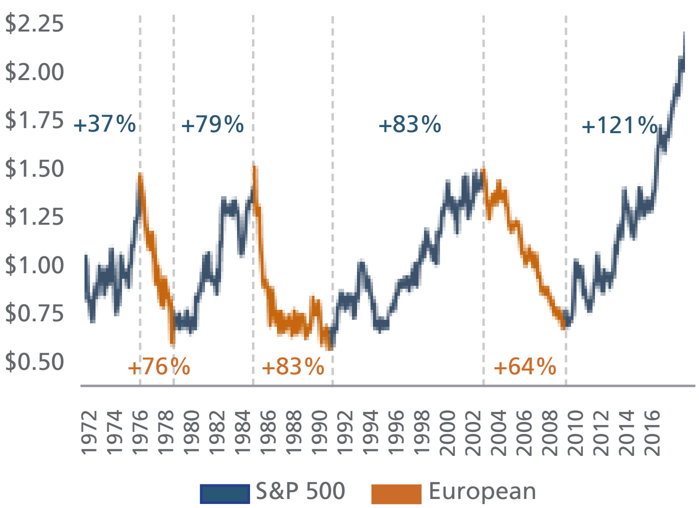


Given these expectations, we have tilted our portfolios toward European equities, favoring European value over European growth. Our CME framework results in portfolio allocations that are intuitive, analytical, unbiased and dispassionate. For example, it neither favors nor disfavors one asset class versus another due to personal views, including those related to political outcomes. At the same time, it is sufficiently flexible to incorporate difficult-to-quantify risks, including shifting political patterns. For example, we routinely assess the stability of established political parties, which have dominated government policy across nations. In that vein, we have been closely monitoring the recent trend in populism across Europe, which represents new risks, but also creates new opportunities. Although populism has created a wedge in European politics, we do not believe it is sufficiently deep to completely fracture the European Union (EU). Therefore, we expect our CMEs to prove out over the next seven years and believe the relative opportunities will outweigh the risks.

There's no divine right when it comes to investing

Another key aspect of our investment philosophy is that markets are generally efficient and that individual asset class performance tends to revert to its long-term average. The following line chart shows the performance of U.S. equities versus European equities.[3] Clearly, there have been prolonged periods of time when one asset class outperformed the other. However, no asset class is ordained to win in all environments. Since the global financial crisis (GFC), U.S equities have set an all-time relative record, outpacing European equities by +121%. We believe three primary factors driving this result were a) the substantially greater impact of monetary stimulus deployed by the Federal Reserve in the United States, b) the European Central Bank's decision to enact austerity measures following the GFC and c) the strengthening of the U.S. dollar. Going forward, we believe the trend will reverse, with European equities outperforming U.S. equities over the next seven years.

S&P 500 vs European Equities
Cumulative Relative Wealth



Reaffirming our tilt to european equities

Assessing any risk, including the impact of political uncertainty is difficult. Nevertheless, we have a responsibility to evaluate these risks, including the potential for a splintering of the Economic Union. The shaded discussion is a summary from our concurrently published Market Perspective, "You're Up," detailing the facts and circumstances of political events and pending elections across Europe. In short, after careful consideration, *we have concluded that the EU will likely remain intact for the foreseeable future.*

Given both our CMEs and continuing research, we have concluded that maintaining our modest overweight to

State of the European Union[4]

For a broader discussion please see our accompanying Market Perspective, "You're Up."

The merits of economic integration (the movement of goods, services, capital and labor) across Europe have been challenged in recent years. Up until the GFC, Europeans broadly embraced ties with other member nations. Recently, the bond between countries has frayed, causing many to reevaluate the tradeoff between lost sovereignty and unproven prosperity. Great Britain's decision to leave the EU is a clear sign that support has been growing to disband the EU, which would alter the investment landscape. New opportunities would be created, while other risks would develop. Throughout the year, all eyes will be on upcoming elections in two of the largest economies, Germany and France.

German elections: October[6]

As the largest, wealthiest, and, arguably, the most financially sound economy in the EU, Germany steadies the economic bloc. Most Germans view the country's participation in the European Union as a resounding success. The larger economic zone combined with a less expensive common currency has stimulated exports, increased employment and improved growth across Germany. Much of that success has come under the leadership of Chancellor Angela Merkel, who was voted Germany's first female Chancellor is 2005 and demonstrably won subsequent elections in 2009 and 2013. Moreover, in May 2016, Merkel was named the most powerful woman in the world for a record *10th* time by Forbes. If re-elected in October, we believe she would continue to contribute to the stability of the EU, lending support to economic conditions as well as equity valuations.

However, Merkel's re-election is no foregone conclusion. In fact, her political party, the Christian Democratic Union, recently suffered its worst election results. Among other factors, the results were largely attributed to voter unease relating to Germany's immigration policies. As another sign of dissatisfaction over immigration policies and Eurozone participation, the Alternative for Germany political party recently picked up its first seats in the Berlin state parliament since the 1990 reunification. Notwithstanding the party's rising popularity, it significantly trails the three established political parties, each of which supports Germany's open border policies and participation in the EU. *As a result, we expect Germany's commitment to the EU to remain steadfast, but acknowledge growing murmurs for Euroscepticism and potential secession.*

French elections: April (and May)

With persistently high unemployment, sluggish economic growth and rising nationalism, France represents more fertile ground for a populist movement/election surprise. The country will soon hold its presidential election(s), which may consist of either one or two rounds of voting. The first round will occur on April 23.

If no candidate wins a majority, then a run-off election will take place between the top two vote-getters two weeks later, on May 7. The incumbent, President François Hollande, suffering from historically low approval ratings, recently declined to run for re-election.

France is characterized as a multi-party political system, primarily consisting of two stable coalitions: the Socialist Party (center-left) and the Republican (center-right). A candidate supported by each of the coalitions along with an independent appear to be leading contenders. However, an "anti-establishment" contender Marine (Marion) Le Pen is also considered a leading candidate (at least in the first round of voting). Her party, the National Front, is considered far-right, espousing protectionism, opposing immigration and criticizing integration. Le Pen has made strides to soften her party's image, leading to favorable polling and increasing her odds of making it to the second, decisive round of voting. However, to win, she would have to vastly broaden her appeal beyond its enthusiastic core to overcome seemingly insurmountable historical voting patterns. Even if Le Pen were to win the presidency, her ability to dramatically pivot on any number of issues, including France's relationship with the EU, would be hindered by the lack of support from deputies in the National Assembly. Given these circumstances, we expect France to remain in the EU, at least for the foreseeable future.

European equities, especially value-oriented companies, will serve clients well over the long-term. To mitigate any near-term risks, political and economic, we have established significant allocations to defensive equities and defensive strategies, each of which should buttress portfolio stability. Going forward, we expect volatility (variation in portfolio values) to rise as the market attempts to assess and quantify the ramifications of any unexpected election results. Accepting these types of risk is precisely why investors are rewarded with long-term investment returns.

We will continue to actively monitor political events and will communicate any changes in our outlook and portfolio positioning as they occur. In the meantime, please feel free to reach out to your client service team to discuss this further.

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1 Likewise, investors can also fail in inexpensive markets.
2 The EAFE Index stands for Europe Australasia Far East, which includes exposure to non-European countries, including Japan. The inclusion or exclusion of Japan would not materially alter our perspective.
3 The chart displays the relative cumulative performance of the S&P 500 versus the MSCI EAFE ex-Japan Index.
4 For a broader discussion, see our Market Perspective "You're Up, Investors look warily toward key votes in the EU in 2017," published in March 2016.
5 For a broader discussion, see our Market Perspective "The Vote is In, Britain is Out," published in June 2016.
6 German federal elections are scheduled to be held no later than October 2017.