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First Quarter 2016

"The trouble with the world is not that people know too little; it's that they know so many things that just aren't so". -Mark Twain

Just last quarter we highlighted the nearly 10% performance differential between the Russell 1000 Growth stock index (+5.7%) and Russell 1000 Value stock index (-3.8%) during 2015, and noted that trends like that do not last forever. In a reversal of fortune, Value stocks (Russell 1000 Value index) outperformed Growth stocks (Russell 1000 Growth Index) by almost 1% during the first three months of 2016. This is partially attributable to the stock market correction that accelerated in January and bottomed by mid-February. Most investors who stayed the course during the correction did fine as the S&P 500 ended the quarter up +1.3%. This serves several important reminders for long-term investors that we believe are key investment principles:

First, gyrations in the stock market (both up and down) are normal and should be expected from time to time, but not reacted to in a way that dislocates long term investment planning. This chart from Goldman Sachs shows that since 1990 the S&P 500 was down on a year-to-date basis at some point during most years (blue dots), but that did not necessary translate into a bad year for stock investors (gray bars). In fact, the S&P 500 was down in just 5 of these 26 years, or less than 20% of the periods shown.

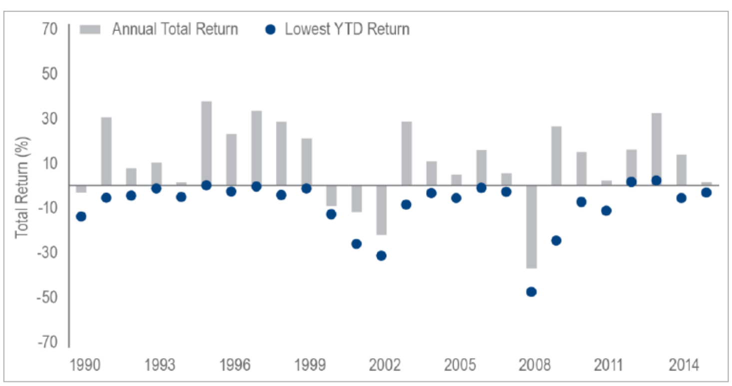
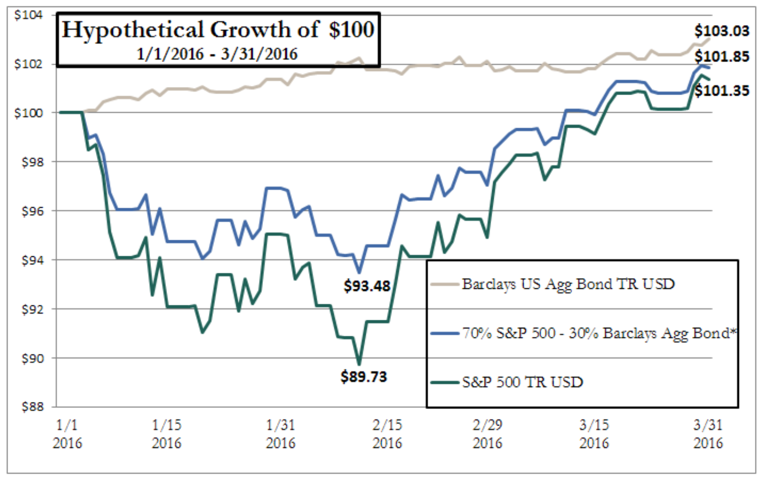


Chart Source: Bloomberg and GSAM. Analysis is based on total return data for the S&P 500 Total Return Index from 1989 to 2015. The lowest year-to-date (YTD) Return represents the minimum YTD return on a year-over-year basis. Past performance does not guarantee future results, which may vary.

Second, investment portfolios should be constructed in a way that helps investors to withstand market gyrations and <u>stay the course</u>. As shown in the next table, the S&P 500 was down -10% at its lowest point of this year (February 11, 2016). Bonds, however, were quite resilient and ended the quarter up +3%. A simple hypothetical portfolio of 70% Stocks (S&P 500 Index) and 30% Bonds (Barclays Agg. Bond Index) was down only -6.5% at its worst point this year, and recovered in value more quickly than the S&P 500. This is just one simple example of why we believe asset allocation should serve as a primary mechanism to manage risk in investment portfolios, and that bonds can still serve as an important portfolio component to manage stock market volatility.

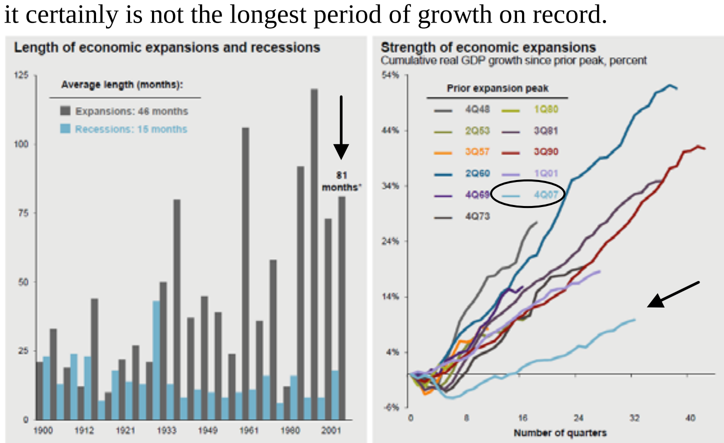


*Hypothetical portfolio consists of 70% S&P 500 Total Return Index and 30% Barclays U.S. Agg. Bond Total Return Index and assumes income reinvestment but does not include any expenses or fees of investing, and does not represent any actual portfolios held by PCM clients. You cannot invest directly in an index. Past performance does not indicate future results, which may vary. Data provided by Morningstar Direct as of 3/31/16.

If the recent stock market volatility continues, asset allocation could be particularly important for long-term investors. For this reason, we have a detailed historical analysis on asset allocation, so please call us if you want to discuss your portfolio in more detail.

Economic Expansion, Earnings and Valuations

There has been a healthy amount of discussion regarding the length and strength of the current economic expansion. As the J.P. Morgan graph below shows, this has undoubtedly been one of the weakest economic expansions on record. But, what this expansion has lacked in strength, it is has made up for in length at 81 months and counting. While this expansion has exceeded the 46 month average, it certainly is not the longest period of growth on record.



Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through March 2016, lasting 81 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through March 2016. Guide to the Markets – U.S. Data are as of March 31, 2016.

First Quarter 2016

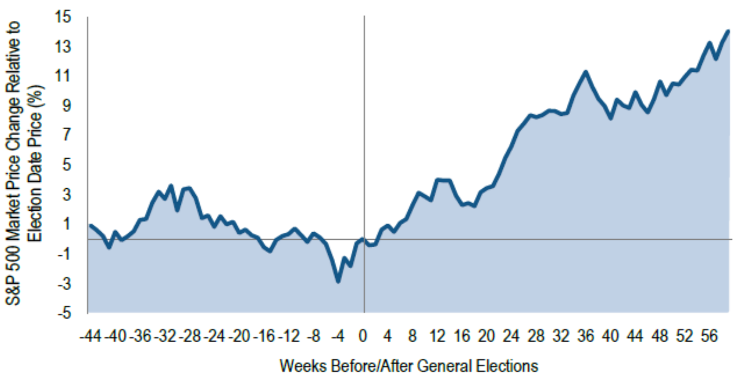
As a result of the current economic expansion, the unemployment rate has fallen to 5% (from 10% in Oct. 2009). In addition, corporate earnings have largely recovered and, in some cases, surpassed 2007 levels. More recently the energy sector has been a drag on earnings, which should subside over time as the earnings from energy related companies stop declining, flatten, and then start growing again. We still believe that the S&P 500 remains reasonably valued by most major valuation measures as summarized in the table below.

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	16.6x	15.8x	0.2
CAPE	Shiller's P/E	25.6	25.7	0.0
Div. Yield	Dividend yield	2.3%	2.0%	-0.5
P/B	Price to book	2.6	2.9	-0.4
P/CF	Price to cash flow	11.6	11.4	0.1
EY Spread	EY minus Baa yield	0.7%	-0.5%	-0.6

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management. Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure. *P/CF is a 20-year average due to cash flow data availability. Guide to the Markets – U.S. Data are as of March 31, 2016.

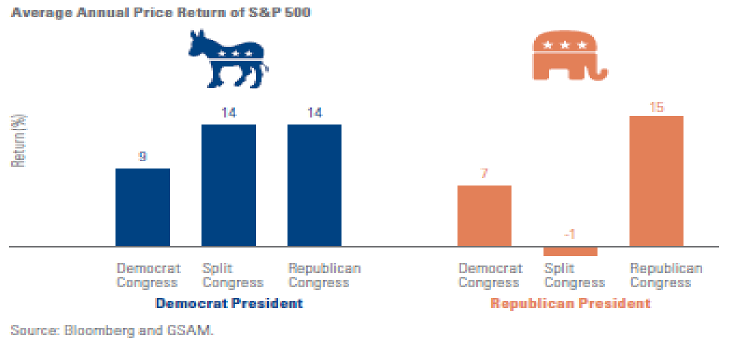
Presidential Elections and the Stock Market

With the U.S. presidential elections dominating global news headlines this year, we thought it would be timely and interesting to share some information about the stock market around election years, and under various political regimes. The graph below shows that on average since 1928 the S&P 500 has been volatile in the year leading up to the election, but has enjoyed an average 11% gain in the 52 weeks following the election, which exceeds the overall average annualized equity return of about 7%.[1]



Source: Goldman Sachs. Chart data is from January 1928 to June 2015. General elections refer to presidential and congressional elections. The election week is taken as the week during which a president or congressman is elected into office, during November of the election year. The chart shows average cumulative S&P 500 price changes relative to the start of the election. Past performance does not guarantee future results, which may vary.

Another common question is whether a Democrat or Republican President is better for the stock market. According to the next infographic from Goldman Sachs, the simple answer is that it depends on Congress. If the President is a Democrat, equity investors seem to do better with a split or Republican controlled Congress. However, Republican Presidents appear to do well under a Republican majority in Congress. It is widely believed that a split congress is best for investors, but that doesn't seem to be the case with a Republican President. While this return information regarding Presidents and Congress is interesting, it is important to note that there is a small sample size of equity returns around U.S. elections so the explanatory power of this analysis is fragile. As such, we encourage investors not to extrapolate this information into important investment decisions. Additionally, there are many external factors that affect the markets during any President's term.



Analysis from December 31, 1946 to December 31, 2015. The S&P 500 returns show average annual price returns for each Presidential party and corresponding Congressional party majority. Republican Congress refers to when both the House of Representatives and Senate have a Republican majority in both chambers; Democrat Congress refers to when both the House of Representatives and Senate have a Democrat majority in both chambers; Split Congress is when House of Representatives and Senate are not controlled by the same party. Past performance does not guarantee future results, which may vary.

Important Reminder about Social Security

There are changes coming to Social Security this month. The deadline to take advantage of the popular File and Suspend strategy for married couples ends April 29th. Also, the Restricted Application strategy is going to be phased out over the next four years. If you have questions about Social Security planning, we can help. Call us!

Thank you

We would like to express our sincerest gratitude to our clients and colleagues for continuing to inspire us to do our best work, and for allowing us to be a partner in helping them achieve their dreams for success and prosperity. – *The PCM Team*

By the numbers…

Index	Close	1st Quarter	Year-to-Date
S&P 500	2059	+1.3%	+1.3%
Dow Jones Industrial Average	17,685	+2.2%	+2.2%
Russell 2000	2768	-1.5%	-1.5%
MSCI EAFE	1652	-3.0%	-3.0%
MSCI Emerging Markets	836	+5.7%	+5.7%
Barclay's US Aggregate Bond	-	+3.0%	+3.0%
Bloomberg Commodity	78	+0.4%	+0.4%

Data provided by Morningstar as of 3/31/2016

1 Goldman Sachs. "WHICH PARTY TRUMPS THE MARKET?" Market Pulse September 2015 (Sept. 2015): 2. Email.