Rinehart
WEALTH & INVESTMENT
ADVISORY

April 2017

INSIGHTS

INVESTMENT OVERVIEW

REVISITING REAL ASSETS AMID RISING INFLATION

With interest rates rising alongside expectations for economic growth, concerns over inflation are reemerging after years of deflationary pressures: for more information, please refer to our February 2017 edition of INSIGHTS (February 2017 INSIGHTS). When the conversation turns to inflation, a discussion about the role of real assets as hedges against inflation often follows.

As a distinct asset class, real assets differ from traditional financial assets in that their inherent value is determined by the fundamental economic attributes of the underlying physical assets. In other words, real assets have an innate value that is separate and distinct from its function as a financial security or investment, which is attributed to the sensitivity of the asset's value as an economic resource at various stages in the business cycle. Included within real assets are physical commodity goods (e.g., energy, industrial, and agricultural commodities) and real estate.

Unfortunately, the theoretical discussion of investing in real assets is relatively easier than the practical implementation of incorporating real asset exposure into investment portfolios. Securities regulations preclude open-end investment vehicles from investing exclusively in real assets due to delayed mark-to-market pricing (i.e., value determination based on recent transaction prices), making the construction of an effective liquid investment instrument virtually impossible.

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WEALTH ADVISORY OVERVIEW

LOWER RETURNS REQUIRE GREATER SAVINGS

Many financial planning assumptions are based on historical returns; however, at Rinehart, we believe that these historical returns may not be relevant in the future. Last year, the Investment Team wrote the article "Target Returns Amid Reduced Expectations" (February 2016 INSIGHTS) and we began updating all financial plans to reflect these revised return assumptions. Academic studies have shown that the total market capitalization of U.S. stocks grew from 50% of gross domestic product ("GDP") in 1980 to 120% by October 2016. This means that stocks in 2016 were nearly three times as expensive as they were in 1980 for each dollar of profit. Therefore, investment prices are currently much higher than in the recent past, suggesting a greater likelihood that portfolio returns will fall below the assumptions commonly used today by the financial planning community.

CHANGES IN LONGEVITY

While retirement is significantly more expensive in a low-return environment, it is even more expensive if a person lives longer. Life expectancies for older Americans have increased considerably over the last 100 years, and they are projected to continue to increase. Individuals today who expect to retire at the same age as retirees in previous generations will face an even greater cost of funding

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SPECIAL POINTS OF INTEREST

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Investment Overview

Revisiting Real Assets amid Rising Inflation

As a result, the Investment Team is extremely cautious when reviewing real asset strategies and prefers to limit our utilization in order to avoid imperfect representation and unintended risk exposures.

Defining Real Assets

As previously indicated, real assets can be broadly defined as tangible assets whose underlying value is derived from their fundamental properties, such as commodities (including precious metals) and real estate. As such, real assets provide diversification benefits relative to conventional equities and fixed income securities defined by their cash flow streams.

Given the clear difference and diversification benefits, exposure to real assets is intriguing; however, accessing this asset class is complicated for individual investors. There are two ways to gain exposure to real assets: *direct ownership* of real assets is the physical possession of the underlying real asset, while *indirect ownership* relates to the investment in an intermediary financial instrument or vehicle whose financial returns or operating results are primarily related to the underlying real asset. Direct ownership of real assets is often prohibitive to individual investors because considerable capital is required to fund a targeted allocation to real assets and the committed capital can be excessive relative to investors' liquidity needs. Below, Table I defines direct vs. indirect ownership for real assets (e.g., commodities, precious metals, and real estate), while, on the next page, Table II compares several of the potential advantages and disadvantages of direct and indirect ownership.

As indicated in Table II, the influence of broader financial market performance over a given time horizon represents a relative disadvantage of indirect ownership of real assets, as publicly-traded investments in real estate or commodities are often more influenced by public market dynamics than the change in the value of the hard asset, causing security prices to deviate

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Table I: Overview of Direct vs. Indirect Ownership

Real Assets	Direct Ownership	Indirect Ownership
Commodities	Cash market purchase of physical commodities; Exposure to changes in spot market values via derivatives (e.g., futures)	Equity investments in companies owning or producing commodity products; Investments in publicly-traded investment vehicles (e.g., mutual funds and/or ETFs)
Real Estate	Investments in residential, business, or commercial real estate, as well as investments in agricultural land	Equity investments in companies owning, developing, or managing real estate assets, such as real estate investment trusts ("REITs"); Investments in mutual funds and/or ETFs

Source: CFA Institute 2017

Monthly Index Review (USD Total Return)

Data as of March 31st 2017	March 2017	2017 YTD	2016	2015
S&P 500	+0.12%	+6.07%	+11.96%	+1.38%
Dow Jones Industrial Average	**-0.60%**	+5.19%	+16.50%	+0.21%
NASDAQ Composite	+1.57%	+10.13%	+8.87%	**+6.96%**
Russell 2000	+0.13%	+2.47%	**+21.31%**	-4.41%
MSCI Emerging Markets	+2.55%	**+11.49%**	+11.60%	**-14.60%**
MSCI EAFE	**+2.87%**	+7.39%	+1.51%	-0.39%
Barclays US Aggregate	-0.05%	+0.82%	+2.65%	+0.55%

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Table II: Advantages & Disadvantages of Direct vs. Indirect Ownership

	Direct Ownership		Indirect Ownership	
Real Assets	**Advantages**	**Disadvantages**	**Advantages**	**Disadvantages**
Commodities	Improved exposure to risk-return benefits; Futures market is liquid	Carry/storage costs; Concentration risks	Lower costs/ expenses; Ability to diversify via basket of commodities	Financial market risk; Ineffective/imperfect exposure;
Real Estate	Potential tax benefits; Direct control of property; Lower volatility of returns	Higher costs/ expenses; Relatively illiquid; Idiosyncratic/ location-specific risks	Lower costs/ expenses; Increased liquidity; Potential diversification	Financial market risk; Ineffective/imperfect exposure to risk-return benefits

Source: CFA Institute 2017

from the underlying assets' intrinsic value. Open-end indirect investment vehicles, such as mutual funds and exchange-traded funds ("ETFs"), give investors the ability to trade in and out of positions on a daily basis, while at the same time they may be exposing them to the short-term whims of market sentiment. For example, over the past 10 years, the Dow Jones U.S. Select REIT Price Index has exhibited a **+0.87** correlation to the Russell 2000 Price Index (*Source: FactSet Research Systems*). As such, investors looking to diversify away from their equity investments are unlikely to have realized the intended diversification benefits by investing in REITs, which have exhibited risk-return characteristics more similar to small cap U.S. equities than owning actual property.

On the other hand, investors with direct ownership of real assets may not experience the same short-term volatility, as their underlying holdings may not be subject to daily mark-to-market valuation. Price discovery for directly-owned real assets may prove difficult if there is no active market for the asset or if pricing data are not readily available because of a scarcity of comparable transactions (i.e., the asset is illiquid). Essentially, an investor will not see day-to-day price volatility until the asset is brought to market to be sold.

That being said, long-term returns generated by either direct or indirect ownership of real assets should be primarily driven by the impact of broader economic conditions on the underlying assets' intrinsic value, such as supply-demand dynamics and inflation. For investors with long time horizons, direct and indirect ownership of real assets can provide meaningful diversification benefits to traditional investment portfolios during periods of rising inflation given their positive correlation.

Real Assets & Inflation

Financial markets and economic forecasts typically incorporate *expected inflation* into expectations and asset pricing models to distinguish between *real* (i.e., inflation-adjusted) and *nominal* (i.e., not adjusted for inflation) growth rates or rates of return. If the rate of inflation rises above or falls below expected inflation, this differential is appropriately termed *unexpected inflation* because it had not been accounted for in capital market expectations or economic forecasts. Both expected and unexpected inflation are factored into realized inflation rates.

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About Rinehart

Rinehart Wealth & Investment Advisory is an experienced, boutique Registered Investment Advisor dedicated to independent, comprehensive wealth management. Founded in 1985 by Mary Rinehart, the firm, from its inception, has had a singular focus: to provide highly customized investment management and financial planning solutions to clients.

Boutique Firm:

Being a boutique wealth management firm allows us the flexibility to provide more personalized service and offer unique investment solutions to clients in a Fee-Only environment.

Team Approach:

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Proprietary Investment Research:

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Revisiting Real Assets amid Rising Inflation

Historically, traditional investment portfolios have benefitted from exposure to real assets during periods of rising inflation. In particular, commodities have exhibited a positive correlation with rising inflation, which may improve the risk-adjusted returns of traditional investment portfolios during periods of unexpected inflation. Over the past 20 years, the S&P GSCI® Commodity Index has exhibited positive correlation of **+0.16** with unexpected inflation, as measured by the Citi Inflation Surprise Index which measures deviations in price inflation relative to market expectations, while both the S&P 500® Price Index and the Bloomberg Barclays U.S. Aggregate Bond Index have exhibited negative correlations of **-0.21** and **-0.46**, respectively. It is extremely difficult to find positively-correlated exposure to unexpected inflation, which is why real assets, such as commodities, are often attractive to a variety of investors concerned with hedging their portfolios against unexpected inflation.

This positive correlation with unexpected inflation can be attributed to two fundamental components of commodity investment returns. First, the *spot return*, or price return, is calculated as the change in spot price of the underlying commodity, which is primarily driven by supply-demand dynamics and is reflective of economic activity. Commodity production is restricted in its ability to quickly scale in response to short-term trends, therefore any unexpected increases in the demand for, or corresponding declines in the supply of, a particular commodity can be generally expected to result in a positive spot return, as the spot price rises to reflect the increased economic value of the physical commodity.

Second, the *roll yield*, or roll return, is significantly more complicated, as it is determined by the shape and term structure of futures prices relative to spot prices. A futures contract represents a financial claim to purchase a commodity at the contracted price (i.e., the futures price) at a specified date in the future (i.e., the maturity date). Therefore, an investor can earn a positive roll return if the spot price of the commodity is *higher* than the original price of the futures contract at the maturity date because the futures price will converge towards the commodity's spot price. This reflects and helps to partially explain why commodities' returns are positively correlated with, and provide incremental protection against, unexpected inflation. If inflation surprises to the upside, the ability to buy the underlying commodity at the lower price stipulated by the futures contract is increasingly valuable to end users of the commodity.

While expected and unexpected inflation are identifiable factors that directly impact the returns of commodity investments, both are influenced by and reflective of trends in economic activity. These trends, however, have not historically coincided with or corresponded to the economic drivers of financial markets, including equity and fixed income markets.

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Stock & Strategy Spotlight

Name	Ticker	2017 YTD
Henderson European Focus Fund Class A	HFEAX	**+4.01%**

Description & Investment Thesis

The Investment Team recently had the opportunity to speak with Stephen Peak, Direct of International Equities at Henderson Global Investors and Portfolio Manager of the Henderson European Focus Fund ("the Fund"), about the current investment landscape and his outlook for European financial markets. As part of this conversation, we focused on the Fund's recent underperformance relative to broader European equity markets over the past 12 months. Due to the Fund's concentrated positioning, stock-specific underperformance tends to have an outsized negative impact on portfolio-level performance, as has been the case for two of the Fund's largest holdings: Teva Pharmaceutical Industries Ltd. Spons. ADR ("TEVA") and Nokia Oyj Spons. ADR ("NOK"). While Mr. Peak has been working through trimming his exposure to both TEVA and NOK, he remains hesitant to chase performance in other areas of the market, which appear overvalued and susceptible to downside risks, such as Financials and Materials. He remains focused on adding undervalued names to the portfolio, which should provide relative downside protection should volatility reemerge amidst ongoing geopolitical and socioeconomic risks in Europe.

INVESTMENT OVERVIEW

REVISITING REAL ASSETS AMID RISING INFLATION

COMMODITY CYCLE

Commodity prices and returns tend to exhibit a high degree of sensitivity to the business cycle, which may not align perfectly with the market cycles influencing equity and fixed income market performance. As previously indicated, commodity production levels tend to be relatively inelastic over the short term due to the capital requirements and high fixed costs associated with expanding and/or opening additional production facilities (e.g., mines, oil rigs, refineries, processing stations, etc.). Therefore, whenever near-term demand outpaces supply, commodity prices are likely to rise, which is in turn reflected in the rate of inflation, even when economic conditions may be deteriorating.

As can be seen below in Chart II, the S&P GSCI® Commodity Index hit a its cyclical peak on July 3rd 2008: approximately *seven months* into the worst global financial crisis since The Great Depression and almost *nine months* after the S&P 500® Index hit its cyclical peak on October 11th 2007. During that time, the S&P 500® Index generated a total return of **-17.51%**, while the S&P GSCI® Commodity Index returned **+62.42%**. Eventually, this favorable supply-demand dynamic reverses, as commodity producers "overproduce" at a time when economic activity is decelerating and demand is declining, leading to a build-up in inventories, which exerts downward pressure on commodity prices and results in diminished returns on commodity investments. The bottoming of the commodity cycle tends to occur when surplus capacity is sufficiently reduced and incremental demand begins to coincide with a sustained increase in economic activity, at which point it may be worth reviewing how best to incorporate commodity strategies into a long-term investment portfolio.

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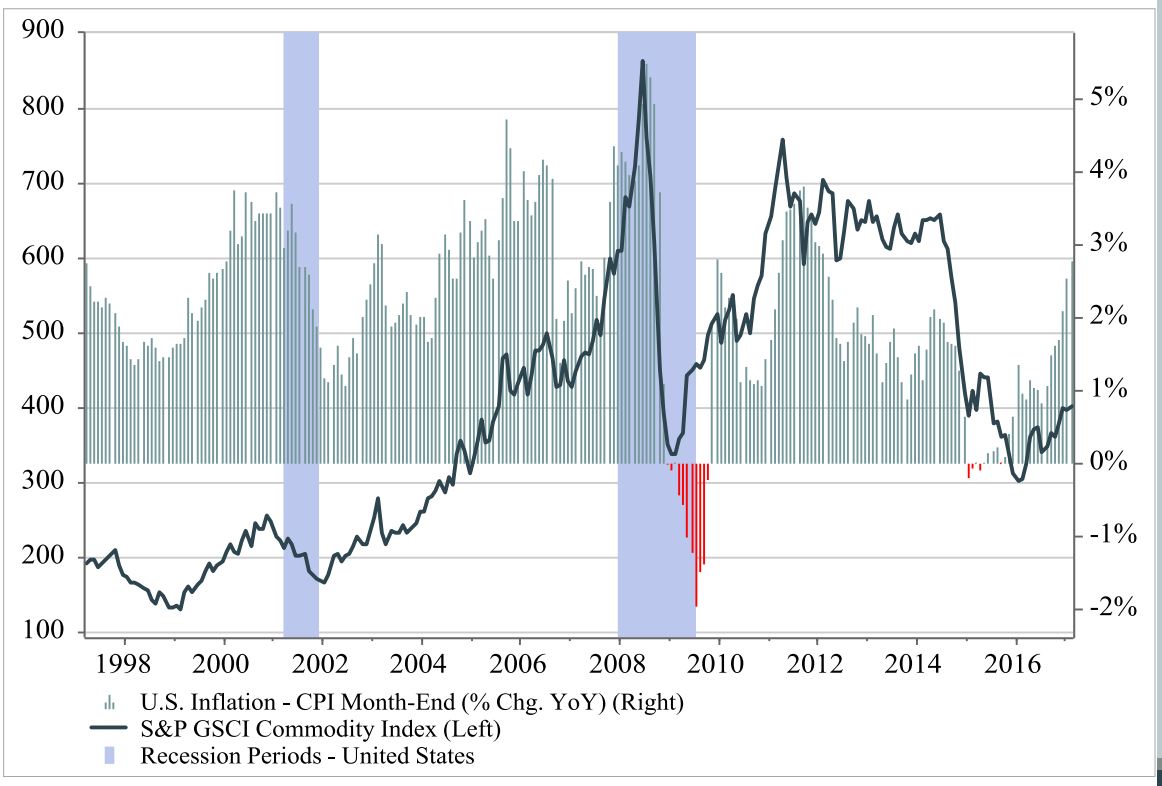
CHART II: COMMODITIES VS. INFLATION



Source: FactSet Research Systems, Inc.

ABOUT RINEHART

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Boutique Firm:

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Team Approach:

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Cautious on Commodity Strategies

Commodity mutual funds and ETFs have continued to gain in popularity as easy ways to incorporate commodity exposure into any investment portfolio. These strategies, however, do not always properly communicate the inherent complexities of trying to replicate the risk-return benefits of commodities in a publicly-trade liquid investment vehicle.

The majority of strategies available via mutual funds and ETFs do not invest in physical commodities due to regulations and liquidity requirements. Instead, mutual funds and ETFs invest the majority of their assets in commodity futures and invest a portion in risk-free securities (i.e., collateral), which involves a significant amount of discretion as to relative positioning along the futures curve and weightings in the underlying commodities. This can lead to flawed replication and imperfect exposures for mutual funds and ETFs, further complicating the inherent biases exhibited in the construction of commodity benchmarks and indexes.

In particular, commodity benchmarks and investable indexes utilize various weighting methodologies, which may result in unintended exposure to a single commodity. For example, the S&P GSCI® Index is constructed using a world production-weighted basis, resulting in a **±63%** weighting to energy-related commodities. Investment strategies may also seek to create proprietary or factor-based commodity indexes, which may result in imperfect representation of the risk-return dynamics and diversification benefits that investors are looking to incorporate into their portfolios.

For these reasons, we recommend conducting extensive due diligence prior to investing in any commodity-related mutual fund or ETF strategy and have yet to find a suitable option for client portfolios.

"Sooner or later, everyone sits down to a banquet of consequences."

- Robert Louis Stevenson

Wealth Advisory Overview

Lower Returns Require Greater Savings

retirement due to increases in longevity after the age of 65. Therefore, funding these additional years of retirement further contributes to the argument that a greater retirement savings rate will be needed to fund future retirement income needs.

Increased Risk Exposure

Perhaps the most fundamental rule of finance is the steadfast relationship between risk and return. Higher expected returns rarely come without taking on greater risk. However, when faced with the option to boost returns, individuals may assume more risk in their portfolios because they fail to understand the risks they are taking, or they fail to properly assess their ability to withstand the eventual downside of riskier investments. Individuals purchase riskier assets with higher yields or higher expected returns because they need a certain portfolio return to make their retirement plan work. For investors near retirement or already in retirement, this decision can have disastrous consequences on their long-term retirement plan.

Go to Cash

This option involves selling investments and sitting on the sidelines in cash until there is a feeling that times are right to reinvest. Temporarily holding cash implies that investments will fall in price, bringing them back to more reasonable valuations. The reason that market timing has been a failure for nearly all who have been lured by its appeal, is that this approach requires getting the timing right on both the exit and the reentry. For individuals who get one side right, they often fail to get the other side right generally making this option painful and detrimental to their overall financial plan.

Invest in a Diversified Portfolio

A better option in light of the lower return environment is to invest in a diversified portfolio and plan more diligently. This requires incorporating lower return expectations into financial planning assumptions and making necessary adjustments to spending, saving, retirement date, or other variables that are controllable. No one preparing for retirement wants an environment of lower investment returns. However, research indicates that investment returns over the next decade or so are likely to be lower than they have been in the past. This is not a good reason to avoid investing, but it highlights how important the planning component is when preparing for retirement.

Individuals facing inflated asset prices, and the lower expected future returns they imply, must accept the reality that they will need to save more to maintain their lifestyle in retirement. The steady increase in life expectancy has also led to a need for a larger nest egg at retirement. Advisors using historical asset return data or outdated mortality assumptions may be providing their clients with an unrealistically optimistic estimate of either the age at which they can comfortably retire, or the amount of savings needed to maintain their current lifestyle. We spend a significant amount of time building out realistic return expectations and then incorporate those expectations into your retirement plan. If changes to your plan are necessary to achieve a successful result, we do not add risk to the portfolio, or advocate market timing. We identify the variables that are within your control and then have a substantive conversation about which options are most practical and palatable to change.

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Around Rinehart

Congratulations Brittany & Hayden!

Brittany Danahey tied the knot with Hayden Priester during a beautiful ceremony on March 18th! Members of the Rinehart Team were in attendance and later joined friends and family of the newlyweds' in celebrating the happy couple that evening at the Charlotte Country Club!

Please join us in wishing them a lifetime of love and happiness together, and be on the lookout for Brittany's new email address (bpriester@rinehartwia.com) over the coming weeks!

Maybry McShane Family Offices Sponsors YWCA We Believe Lunch

Daniele Donahoe and Leah Maybry hosted a great group of clients and friends to hear an inspirational discussion by Dr. Garmon-Brown.

Thank you to those who joined us in supporting this important organization addressing critical issues in Charlotte!

Rinehart Sponsors Women's Impact Fund

Rinehart proudly sponsored the Women's Impact Fund ("WIF")!

Women Executives 40th Anniversary Party

Daniele, Leah, and other members celebrated the 40th anniversary of the Women Executives ("WE")!

Fidelity's Executive Forum

Sandy Carlson will be attending the 2017 Executive Forum presented by Fidelity Investments in Orlando, FL on May 1st and 2nd, which brings together thought leaders in the industry on an array of topics allowing select financial firms the opportunity to be on the cutting edge of demographic, regulatory, and technological trends within the industry.

Presentation at Blowing Rock Country Club

Daniele Donahoe and Sandy Carlson will be speaking at the Blowing Rock Country Club on June 22nd at 6:00 PM, with cocktails starting at 5:30 PM. The presentation will include an update on the markets and the importance of tax efficient investing.

If you are interested in attending the event, please contact Sandy Carlson (scarlson@rinehartwia.com).

Rinehart Wealth & Investment Advisory

Wealth management is our only business; therefore, our attention is undivided and our intentions are transparent.

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