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Market Commentary

Fall 2015

Q3 Key Takeaways

- Increasing concern about China's economy, accompanied by a surprise albeit modest devaluation of the yuan currency, helped trigger a sharp drop in global equity markets in late August, with the S&P 500 falling 12% from its high. The S&P 500 then bounced briefly from its August 25 low, but dropped an additional 2.5% in September, ending the quarter down 6.5%. This marks the first negative quarterly return for the index since 2012.
- Developed international stocks, as measured by the Vanguard FTSE Developed Markets ETF, also dropped 12% intra-quarter, from high to low. For the quarter as a whole, they were down 9.7%. European stocks did a bit better, losing 8.5% in dollar terms and 7% in local-currency terms.
- Emerging-markets stocks fared the worst, dropping 21% from their intra-quarter high in early July to their low on August 24. For the quarter, the emerging-markets stock index was down 18%. That return includes several percentage points of losses to dollar-based investors from the continued depreciation of emerging-markets currencies against the U.S. dollar.
- Given the broad negative environment for global stocks, let alone that much of the angst was driven by disappointing developments in China, it's not surprising emerging-markets stocks had the worst downside performance. While we have viewed (and continue to view) emerging-markets stocks as attractive over our five-year and longer investment horizons, we have also assumed they are riskier than developed market equities and will suffer larger short-term losses in a negative macro scenario for various reasons (e.g., due to concerns about slowing global growth).
- Moving on to the fixed-income markets, the core bond index gained about 1% during the U.S. stock market's 7% drop.
- We believe that part of successful investing involves riding out these nervous markets, where prices are driven by short-term news and investor cycles of emotion, and staying focused on long-term fundamentals.

Q3 Investment Commentary

On the night of August 23, 2015, one would have thought, after watching TV, that global economies were collapsing and the U.S. stock market was in a severe bear market. After all, that night, CNBC ran a special "Markets in Turmoil." This special was presumably triggered by a 3.2% sell off in the S&P 500 along with a 531 point drop in the Dow on Friday, August 21. However, as of that close, the S&P was down just 3.0% year-to-date! More shockingly, prior to that 3.2% drop on Friday, the S&P 500 was actually up 0.2% for the year! Finally, since the start of the year through the 2nd quarter, June 30, the S&P was up 1.23%, so the market had fallen a little over 4% since the quarter began. What kind of turmoil is that? In addition, we read several articles referring to a "market meltdown." The drop on August 21, influenced by events in China, didn't even officially put the market in "correction" mode. Corrections are defined by a decline of 10% and as of Friday, the market was down just 7.5% from its May highs. However, the coverage, we believe, helped drive the market into one the next day. The close on Monday, August 24th was 11.2% lower than the high set on May 21st. (In fact, the market hit a low the next day on August 25th that was 12.4% lower than the May high.) The CNBC special that night contributed to an official correction in the market by creating fear in investors that led to a mini-flash crash of 1,000 Dow points at the open on Monday. We have to admit, we wanted to thank CNBC for getting this long overdue correction over with, so investors could focus on 2016.

Given the market's historical pattern of corrections, we've mentioned the potential for a market correction in our prior quarterly investment commentaries. So, we weren't surprised by the volatility witnessed in the third quarter as the market had gone four times the average duration without one. But that's not to say we were predicting it would happen or what the triggers or catalyst might be. Short-term market predictions are a fool's errand, and history doesn't exactly repeat. But, knowledge of market history and cycles is useful for putting the present moment into context and thinking through different potential scenarios, risks, and investment opportunities. Having a historical perspective on the market also gives one the intuition of what is going on and, in this case, not to panic sell into the decline.

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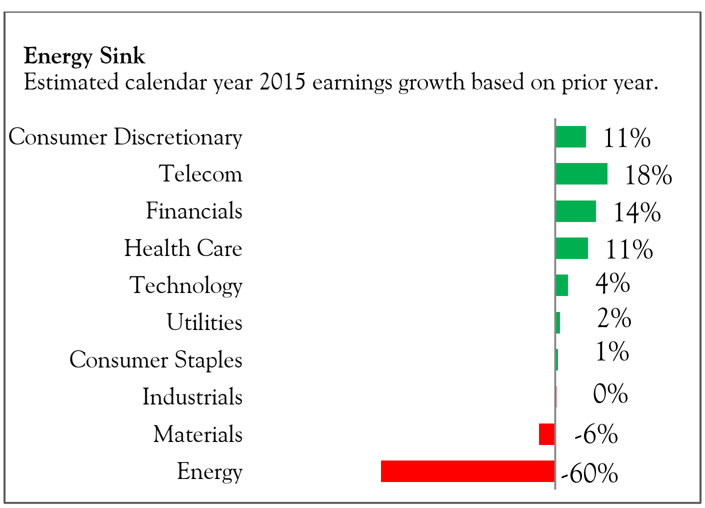
On the morning of August 24th, we put out an email blast to our clients sharing our thoughts on what was happening and that this was not a time to panic. We stated the market was overreacting to the fears of a global slowdown, particularly in China, as less than 1% of U.S. GDP is exported to it. We have stayed fully invested and as of Friday, October 23rd, the market is up over 11% since that low on August 25th. In fact, October, which has averaged a positive return since 1950, is on pace (up over 8%) to be the best performing month since October 2011 when it was up 10.9%. We are not holding our breath, but perhaps next time the market has some big move to the downside, CNBC will run a special "Great opportunity in the markets for long-term investors!"

Market Outlook

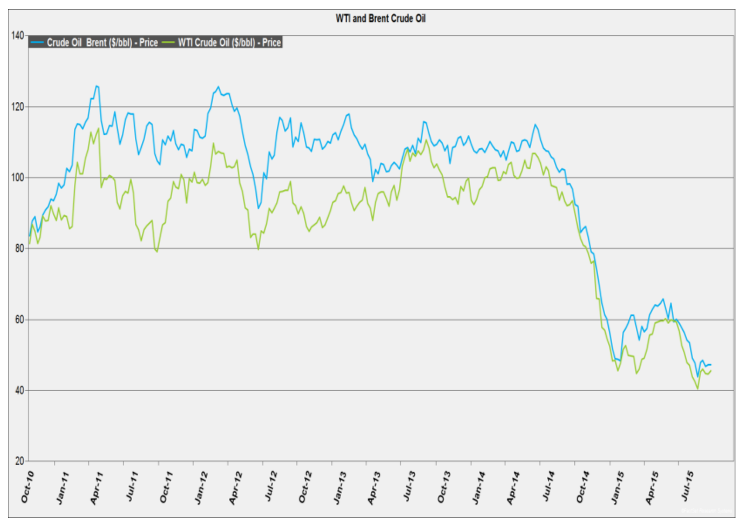
We believe the markets paused in 2015, but a bull market remains intact. Why? The market is driven by earnings growth and because of a strong dollar impacting multi-national earnings and a 60% drop in profits for the energy sector, earnings for the S&P are less than robust in 2015. Energy accounted for around 10% of the S&P at the start of the year. With earnings falling 60% in that sector, the impact was a -6% hit to the overall growth of the market which virtually wiped out any earnings growth for the year in the S&P 500. So, the market has followed that lead. However, 2016 looks much brighter with



Source: FactSet Research Systems, Inc.

consensus earnings at 9% above 2015. It is unlikely that the dollar will increase another 20% against global currencies and energy earnings will unlikely repeat in 2016 (at least with respect to the relative movement). When you add the yield of 2%, it is not unreasonable to expect an 8-10% return for the market in 2016. With a correction out of the way, thanks to CNBC, the markets have started to find strength once again.

In addition, continued global fiscal and monetary stimulus and lower energy costs should provide some support to growth. Mario Draghi, President of the European Central Bank, just last week hinted at more stimuli for the Eurozone which led the markets higher. We also believe that lower oil prices can only help the U.S. economy by acting as a quasi-tax cut to the American people and enhance consumer spending (70% of GDP). However, the rapid decline of oil, and other commodities, since May of 2014 has trumped that hope as investors decide how much of the decline is due to rapid production increases versus slowing global demand.



Source: FactSet

The drop in oil prices over the past 18 months from $110/barrel to a trough of about $37/barrel in the 2nd quarter represents a decline of nearly two-thirds. Oil has now stabilized in the $45-$55 range. Since the drop in prices, significant steps have been forced on the industry to curb production. Fracking operations, in many cases, are no longer profitable and are being shut down. The offshore drill rig count is also down significantly from peak levels. The stabilization of oil and, probably a resumption of higher prices, and bottoming commodity prices, should help assuage the fears of a global slowdown.

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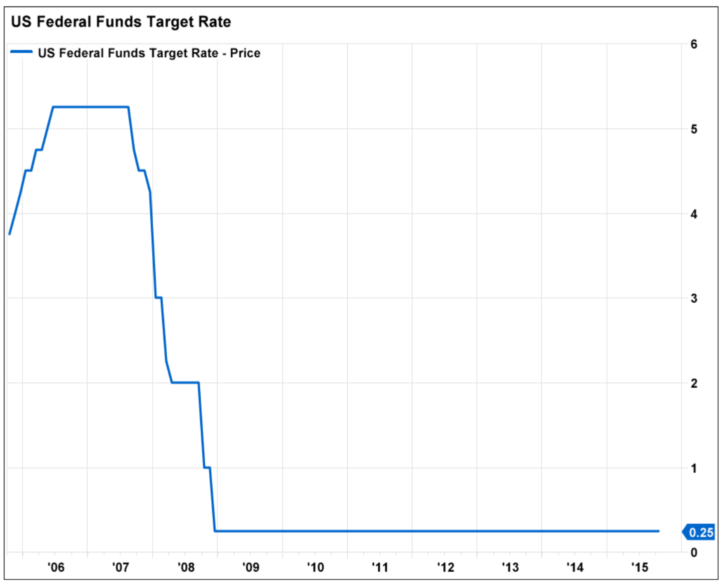
The Fed

Another issue looming for the markets during the quarter was whether the Federal Reserve was going to raise interest rates for the first time in more than six years. Ultimately, the Fed decided to hold off on a rate hike, citing that "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." Fed Chair Janet Yellen pointed specifically to the recent developments in China and emerging

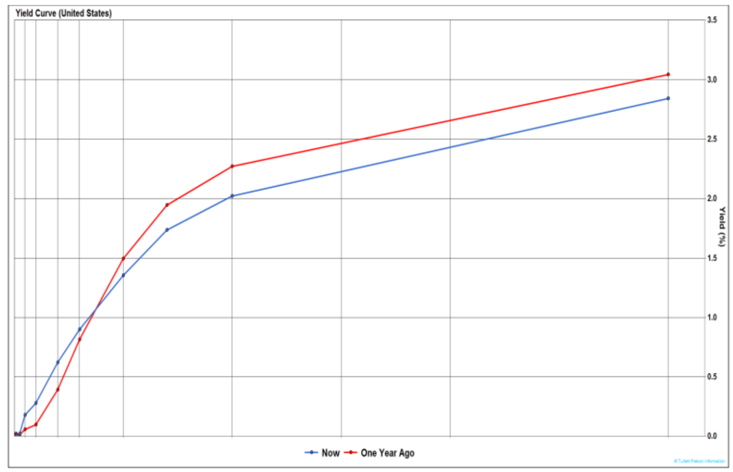


Source: FactSet

markets as factors that gave them pause. She also noted the "tightening of financial conditions" due to stock market declines, a stronger dollar, and wider credit spreads since the FOMC's last meeting. Thirteen out of the 17 Fed policymakers indicated they expect to raise rates at least once this year, with six of the 13 expressing a preference for two rate hikes. The decision to delay a rate hike caused some temporary weakness in the market. Most of Wall Street was expecting a rate hike and it was the perfect time for the Fed to do it as it was "priced in." However, when the Fed failed to do so, the markets sold off wondering "What does the Fed know that we don't?" Then, just days after the Fed made its decision, a Fed governor stated the Fed would raise rates by year end and that helped the market find its footing. It's amazing to us that the Fed's models are so precise as to not raise rates in September, but see a need just a few months later. In essence, we believe the Fed has lost some of its credibility.

Bonds/Interest Rates

We believe, as we stated earlier, the action by the Fed to raise rates has already been priced into the market so the action will have little impact on overall interest rates. We do believe, however, as the economy continues to improve, rates will gradually move higher, but not by much to have any material impact on bond prices, especially on the shorter maturities that we invest in. Despite the absolute level of interest rates, bonds remain an important component of most portfolios providing income and stability to our clients.



Source: FactSet

Concluding Comments

The reality of owning stocks is that occasionally, inevitably, we will experience losses. This underscores the importance of our risk management, in which we seek to reduce our balanced portfolios' vulnerability to stock market downturns through strategies that include owning "insurance" assets such as bonds. Another key ingredient in managing through down markets is helping our clients accurately assess their risk tolerances and investment objectives. If you are in an appropriately structured portfolio, there is no benefit to selling in a market downturn. In fact, by doing so, you risk selling nearer to the bottom and then missing the subsequent recovery (i.e. October). We would argue any material decline may possibly warrant a tactical allocation to equities in your portfolio, if appropriate.

Again and again, we find that most successful investors are the ones who ignore the noise of the markets and their emotions and instead focus on the long-term. This may sound cliché, but it is so very true.