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Market Commentary

Fall 2016

Q3 Key Takeaways

- **Despite numerous uncertainties, including a U.S. presidential campaign that continues to unfold as the most unconventional in recent memory, the S&P 500 rose by nearly 4% in the third quarter.** Stock market volatility remained at extremely low levels through July and August.

- **September seemed to usher in a change in tone.** During the month, stock investors registered high anxiety, with markets rising and falling sharply in response to any oil-related headlines and any suggestion of interest rate hikes by central banks.

- **European stocks outperformed the S&P 500 after the Brexit low and for the third quarter. They still trail U.S. stocks for the year (both in dollar-hedged and unhedged currency terms).**

- **Yields on U.S. 10-year Treasury bonds rose to as high as 1.75% during the quarter on worries over central bank policies, but the Federal Reserve's decision not to raise interest rates in September soothed markets.** Yields ended the quarter at 1.56%, still up from 1.44% on July 1. A December rate rise is potentially still on the table, and financial markets remain keenly attuned to this possibility. Subsequent to quarter end, yields hit 1.80%.

Q3 Investment Commentary

The S&P 500 Index rose by nearly 4% during a quarter that witnessed populism gain ground in Europe, the installation of a new government in the United Kingdom after the Brexit vote, an unsuccessful coup attempt in Turkey, and a U.S. presidential campaign that continued to unfold as the most unconventional in recent memory. Markets handled these uncertainties with aplomb. The U.S. stock market continues to trade near record highs, consumer confidence is robust, personal debt levels and unemployment are at historic lows and oil prices are currently at some of the lowest levels we've seen in the past decade. On economic growth, a reacceleration appears likely. Consumer spending appears to be growing at a 3%+ pace in the third quarter and recent data on investment spending looks more hopeful. The economy could grow between 2% and 3% over the next year.

Yields on U.S. 10-year Treasury bonds ended the quarter at 1.56%, up from 1.44% as of July 1, as investors braced for an interest rate hike by the Federal Reserve that didn't come (bond prices fall as rates rise). However, those looking only at starting and ending levels would have missed the big mid-September move. Yields briefly backed up to 1.75% on worries over central bank policies. The Fed's decision not to raise interest rates in September soothed markets. But a December rise is potentially still on the table. Financial markets remain keenly attuned to this possibility. For now, flows into core bonds are strong, the buyer base is broad, and central banks across the developed world remain hesitant to either spook the markets or hinder a still fragile economic recovery by doing more than just paying lip service to a move away from their easy monetary policies.

Performance and Portfolio Positioning

U.S. Stocks

The S&P 500's rise occurred in the context of a market that saw sharp intraday drops followed by swift reversals, as well as strong rotation into and out of sectors perceived to be "safe," such as utilities, telecoms, and consumer staples. Financials continue to be pressured by low interest rates, a challenging regulatory environment, and negative investor sentiment—headlines surrounding Deutsche Bank and

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Wells Fargo have not helped. However, rising interest rates during the quarter lifted financials to a strong finish. Banks' earnings have a lot of upside leverage to higher interest rates. In Q4, S&P 500 earnings are finally expected to rise versus the prior year. This would end a six quarter streak of earnings decline. The rise in the equity market despite falling EPS growth has put the markets at a slight premium valuation compared to its history. Ultimately, EPS will have to grow faster than the market appreciation or the market will stay at a premium valuation. Of course, the market could decline and put the valuation back to median levels. Either way, we think that any adjustment would be short-lived as a pickup in earnings in Q4 and the fact that the market is only slightly overvalued should mitigate any downside.

Developed International Stocks

European stocks outperformed the S&P 500 after the Brexit low and for the third quarter. But they still trail U.S. stocks for the year (both in dollar-hedged and unhedged currency terms). There is any number of known and unknown catalysts that could result in an earnings recovery for the developed markets. Earnings may recover due to the European Central Bank's continued efforts to keep borrowing costs down as a way to stimulate lending and investment spending. The ECB recently started buying investment-grade corporate bonds as part of its quantitative easing program. According to research firm GaveKal, since the program was announced in March, the average yield on eligible bonds has fallen from 1.45% to almost 0.5%. That significant decline may spur investment and lead to better economic growth. Or, it may spur financial engineering, with companies using the proceeds from issuing debt to buy back their stock and boost earnings per share, as we have seen in the United States. Either outcome would bode well for future profits and stock prices.

Brexit, along with the rise of many right-wing political parties, may serve as a wake-up call to European authorities that they need to generate better growth in the economic bloc soon. As a result, they may become more open to loosening the fiscal purse strings to assist the ECB's reflation efforts.

The exact timing is highly uncertain. It's possible nothing much gets done on the fiscal stimulus (i.e. tax cuts) front until major elections are completed over the next year, meaning the ECB continues to do what it can and Europe continues to muddle along.

Fixed-Income

Despite unattractive yields, the bond market has performed fairly well in 2016 as falling yields have resulted in higher bond prices. In other words, rising bond prices have contributed more to the total return than the yield. However, an increase in yields over the past few months have lowered the year-to-date returns in bonds since they peaked during the summer. A major reason yields have increased is due to the widely held belief that the Fed will increase rates before the end of the year. While this is the first time we actually believe the Fed may increase rates in a while, we think the media is much too focused on one rate hike. Could it lead to more hikes down the road? Perhaps, but we do not believe the current level of economic growth warrants significant rises in interest rates.

Perception versus Reality: Managing Risk

While we spend time analyzing each of our individual positions and holdings, when it comes to portfolio management, the whole is very much more than simply the sum of its parts (Harry Markowitz won a Nobel Prize in 1990 for this insight). By definition, a well-diversified portfolio of assets (i.e., a portfolio of investments that do not all move together in the same direction) will contain some laggards during any given measurement period, particularly over shorter-term periods. But it's at least as important to focus on the overall portfolio and how the pieces fit together and complement one another—how they are performing relative to each other and whether that performance is consistent with the original rationale for owning them.

Successfully managing portfolios also requires the discipline to resist trading based on emotion (fear and greed), rather than on long-term return drivers such as valuations and earnings growth. Even in an advanced economy like the United States, the stock market has had at least a 10% decline every 16 months on average since 1950. Bear

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markets (20% or greater declines) in the United States have happened about every seven years, on average. The catch is that in most cases you can't predict what the exact cause of the volatility will be or exactly when it will hit. Even if you did successfully call the bear market, you'd need to also successfully time your re-entry so as not to miss out on the subsequent gains. And you'd need to do this consistently and repeatedly over an investment lifetime. That is simply not realistic, which is why our investment approach is based on a range of potential outcomes and a longer-term time frame. As the examples we discuss below illustrate, in our view, making investment decisions based on short-term market forecasts (guesses) is a losing game. We have no confidence that this approach can be executed successfully over time.

The Brexit Vote

In the run-up to the vote, polls suggested the outcome could be close but would most likely result in the United Kingdom remaining in the European Union. Financial markets were clearly surprised by the opposite result. Global stocks sold off in the two days following the vote. The S&P 500 dropped 5.3%, emerging-market stocks fell 6.7%, and European stocks plunged 13.6%. In contrast, investment grade bonds gained more than 1%.

We believed the vote increased the nearer-term risk of recession in the United Kingdom and Europe, and potentially globally. But in our assessment, Brexit did not materially impact our longer-term five-year outlook and assumptions for European and U.S. corporate earnings growth and valuations. Therefore, we held our positions at a time when many investors were fleeing to traditional safe-haven assets. That decision proved beneficial for our portfolios' performance in the third quarter, as stocks rebounded from their Brexit lows.

The U.S. Presidential Election

Each time a U.S. presidential election approaches, we get questions from clients about our view and the impact on our investment outlook and portfolio positioning. Given the atypical background and behavior of the nominees, we are being asked about the election even more than usual this year. Here is a quick review of how we think about elections in general within the context of our overall investment approach. While the specific circumstances of any given election are always unique, our approach remains the same. First, to the extent a particular result is widely expected, current asset prices will reflect the market consensus. In order for us to believe there is a tactical investment opportunity stemming from a particular election outcome, we'd need to believe (1) we have an edge in assessing the outcome better than the market does and (2) our view would have to be materially different from the consensus.

There is too much uncertainty and too many "non-election" variables that impact investment outcomes for us to likely see any value in positioning our portfolio for a particular result. Even if we had a higher degree of certainty as to both the outcome *and* the policies that would be implemented, the ultimate economic effects and outcomes would still be highly uncertain. Macroeconomics is far from a hard science, and there are a multitude of other factors and variables that impact economic and financial market outcomes beyond U.S. fiscal and monetary policy.

Central Banks and Market Distortions

Lastly, global central banks have been a driver of significant market distortion in recent years. Along with the U.S. presidential election, their policies, particularly the Fed's, remain a key near-term wildcard for financial markets. At its last meeting on September 21, the Fed remained on hold but signaled it is on course to raise the federal funds rather later this year, likely at the December meeting. (We've heard this story before.) The Fed also lowered its longer-term forecast of interest rate hikes yet again. It now forecasts just two rate hikes in 2017, down from the three hikes forecasted at the June meeting and the four hikes forecasted at the March meeting. Bond and stock markets responded positively.

The distortionary effects of these extraordinary central bank policies can be seen as investors are effectively being forced out of low-risk, but extremely low-yielding, core bonds into riskier assets that offer higher current yields. For instance,

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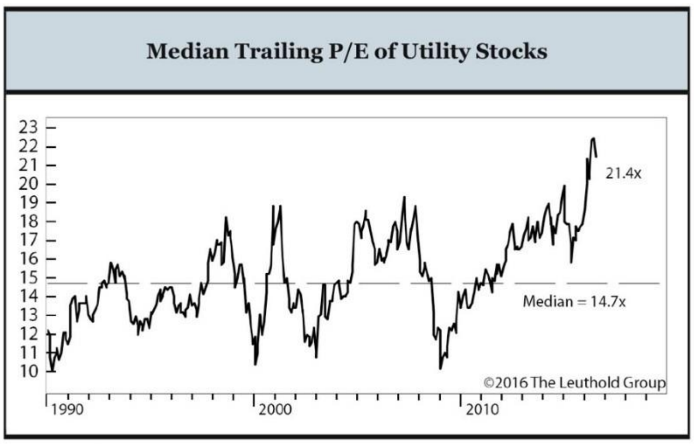
the traditionally "defensive" yield-oriented sectors of the stock market, such as utilities, is an area where many investors appear to be "reaching for yield" as well as perceived safety, but where we actually see significant risk. As bond yields have been depressed, money has flooded into this sector. As a result, their valuations have soared. Strong short-term performance has attracted more money, perpetuating the cycle. Ironically, the perception that these are low-risk investments and appropriate "bond-like" substitutes for true fixed-income exposure has made them much riskier due to their high valuations and what looks a lot like speculative short-term money flows rushing into these stocks.



Source: The Leuthold Group. S&P 500 Utilities, data as of 8/31/16.

But these trades can unwind quickly and the momentum can work in reverse. Market history is replete with examples of investors getting burned by ignoring valuation, reaching for yield, and chasing recent performance. Because investors view these sectors as bond substitutes and a play on continue depressed bond yields, one clear catalyst for a reversal would be a rise in rates.

Putting It All Together

Our decision-making is anchored in our long-term fundamental and valuation-driven approach. Given our approach, we and our clients need to be psychologically and financially prepared for periods of market stress and able to ride them out on the path to achieving our long-term investment and financial goals. Investors who can't stomach a given level of volatility or downside risk should reallocate into a portfolio with a lower targeted risk level. And the time to do that is before a period of volatility strikes, not during or right after it when they would be selling their riskier assets at lower prices and buying more defensive or safer assets at higher prices.

We structure our balanced portfolios across a well-diversified mix of investments, each with a distinct role to play within the overall portfolio. We expect our portfolios to be resilient and to perform at least reasonably well across a wide range of outcomes, balancing our objective of long-term capital appreciation with shorter-term downside risk management appropriate for each client's risk tolerance.

Closing Comments

While July and August were unusually calm months for the markets, volatility picked up in early September. We're prepared for more of it heading into (and potentially coming out of) the November election, as well as market swings related to the increased likelihood of a Fed rate hike in December.

In addition to our tactical positioning and portfolio tilts, we remain diversified across multiple asset classes/sectors and strategies with diverse risk exposures and return drivers. This diversification should smooth out the overall portfolio ride over time. Finally, we remain alert to new investment opportunities as well as new risks we will need to manage against.