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Market Commentary

Summer 2014

Q2 Key Takeaways

- **Asset classes across the board rose in the second quarter despite lackluster global economic growth, an uncertain outlook for global monetary policy, and geopolitical tensions in Ukraine and Iraq.** This reinforces that markets and the economy are not one and the same. Larger-cap stocks were up 5.2% for the quarter and 7.0% year to date. Smaller-cap stocks lagged their larger-cap counterparts in the quarter, as they have so far this year.

- **In economic news, U.S. GDP growth was revised further downward for the first quarter,** marking the largest drop since the first quarter of 2009. Expectations are for growth to rebound in the second quarter; however, the fact remains that the economic recovery continues to be subpar. Other indicators were more positive, including continued improvements in the labor market.

- **Developed international gained 4.4% in the quarter as the European Central Bank took further easing** steps as it combats concerns about long-term deflation risk while Japan's Prime Minister Shinzo Abe continued his multi-pronged effort to generate healthy inflation and boost Japan's economy.

- **After a poor first quarter, emerging-markets stocks rallied strongly in the second quarter,** bringing their year-to-date gain to 6.1%. Among larger emerging markets, China's growth outlook remains a source of investor uncertainty while India's newly elected prime minister was viewed favorably among investors and the country's stock market staged a huge second quarter rally.

- **Core investment-grade bonds shared in the gains, earning nearly 2% as Treasury prices rose** and bond yields continued to fall, a surprise to many investors.

- **Overall, our macro view and assessment of the risks and returns across the major asset classes has not changed meaningfully since last quarter.** We continue to see the U.S. and global economies on a slow path of recovery from the 2008 financial crisis.

- **Despite our more positive fundamental outlook, we also continue to view the markets as too dependent on central bank largesse,** too short-term focused, and too complacent about the risks and imbalances that remain in the global economy in the aftermath of the financial crisis.

Q2 Investment Commentary

Update on our Macroeconomic Outlook

Overall, our macro view and assessment of the risks and returns across the major asset classes has not changed meaningfully since last quarter. We continue to see the U.S. economy—and the global economy more broadly—on a slow path of recovery from the 2008 financial crisis. Private sector balance sheets continue to strengthen (reflecting the U.S. household and financial system deleveraging that has occurred since 2009). This lessens the odds of another financial crisis and is a key support for the recent increase in our estimate of fair value for the stock market as we discounted a less stressed macro environment. Despite being in the fifth year of an economic recovery, which is the average duration of an economic cycle, we believe the U.S. economy remains somewhere in the middle of its current expansion. We see no signs of an overheated economy due to sluggish growth, low inflation and reasonable inventory levels.

GDP is expected to accelerate in the second half of the year, not only in the US, but globally as well. In the U.S., the first quarter was marred by unfavorable weather resulting in a surprisingly downward adjustment of GDP to -2.9%, down from an original estimate of 0.1% and from the 4th quarter of last year where growth was 2.6%. Stock markets still performed well as the downward revision was expected and investors have considered this a temporary decline, supported by improvements in other economic data such as home and auto sales and residential construction. Globally, additional central bank stimulus should help improve the Chinese and European economies.

Employment in the U.S. continues to improve, but at a slow pace. Employment has returned to 2007 levels, averaging nearly 200,000 jobs per month over the past year, while unemployment approaches 6.0%. Labor improvements (and increases in disposable income) can only improve the outlook for consumer spending going forward which accounts for two-thirds of GDP.

Finally, corporate America is strong. Earnings are expected to increase 7% in 2014 and balance sheets are flush with cash. Many companies, especially those in our Select Dividend Growth strategy, are announcing major stock buybacks and substantial dividend increases.

Risks

Risks remain, however. More recently, we are becoming more sensitive to inflation risk, given the uptick we have seen in the United States over the past quarter and the strengthening (although still not strong) labor market, which at some point should start pressuring wages higher. Improved wage growth should be beneficial for consumer spending and the overall economy (and Federal Reserve Chair Janet Yellen has explicitly said she wants to see higher wage inflation), but it would also likely put pressure on corporate profit margins and therefore earnings.

Based on Fed statements and behavior, we continue to see the risk of the Fed overshooting in terms of accommodative monetary policy, keeping rates "lower for longer," and allowing inflation to move above their 2% long-term target. This strikes us as a bigger risk than

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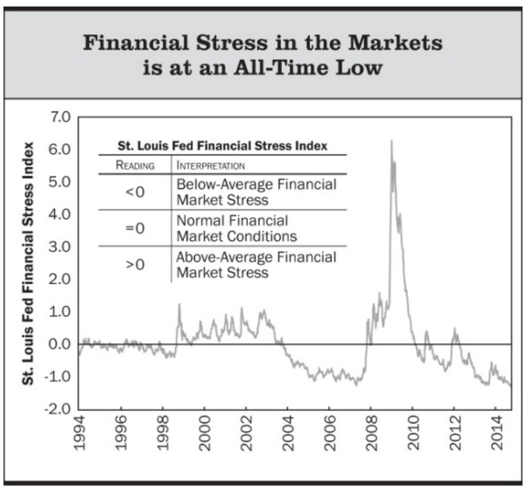
the Fed tightening too soon and snuffing out the tepid economic recovery. But it isn't clear how or when the markets will react if the Fed remains accommodative in the face of a sustained rise in inflation above 2%. And the markets' reaction will almost certainly influence the Fed's behavior as well. Fed credibility has been critical to market stability, and markets have reacted positively (or at least neutrally) to the most recent Fed statements and actions. But that credibility may be increasingly called into question if the market perceives the Fed is remaining inactive in the face of inflation or other potentially worrisome economic indicators.

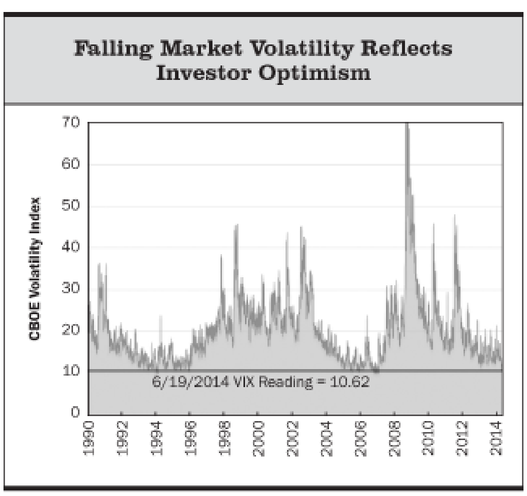
The Lack of Concern Could be Cause for Concern

One thing that stands out about the past quarter amidst the record-setting highs of the S&P 500 is the very low stock market volatility. By late June (6/19/14), the VIX, a volatility index that measures expected 30-day volatility of the S&P 500, had dropped to 10.6, a level last seen in February 2007.



Data as of 6/13/14. Source: Federal Reserve Bank of St. Louis.

Another indicator of the market's' state of calm is the recent all-time-low level of the St. Louis Fed Financial Stress Index, which measures the degree of financial stress in the markets based on a compilation of 18 weekly financial market data points.



Data as of 6/19/14. Source: CBOE.

While low volatility and high stock prices reflect the market's apparent lack of concern about risk—likely buttressed by a belief that the Federal Reserve will continue to support financial markets with accommodative monetary policy—this seeming complacency is causing us some near-term concern because it suggests a market more vulnerable to negative surprises.

But what might disrupt the market's calm? Unfortunately, geopolitical shocks are always a risk and one that we don't try to anticipate. But even with this year's events in Ukraine and the sectarian violence in Iraq (to name just two), markets in general have remained relatively calm (except for some short-term, temporary stock-market declines).

Inflation vs. Deflation

Away from the geopolitical realm, a deflationary or inflationary surprise could be disruptive. In Europe, core inflation fell to a low year-over-year rate of 0.7% in May (headline inflation, which includes food and energy, was only 0.5%). Several smaller European countries are in outright deflation. However, the markets have been worried about European deflation for a while now, and the latest CPI number was in line with consensus expectations. Meanwhile in June, the European Central Bank initiated new monetary policies in an attempt to help reflate the economy, and also signaled that it would act more aggressively, if necessary, to prevent a deflationary shock in Europe from happening. (This echoed its actions in late July 2012, when ECB President Mario Draghi assured the markets it would "do whatever it takes" to prevent a breakup of the European monetary union, triggering a huge rally in European stock and bond markets).

In the U.S. economy, deflationary and inflationary risks are more balanced. While inflation, and importantly, inflation expectations remain under control, it has recently been ticking higher. Core CPI hit 2% on a year-over-year basis in May. The inflation measure the Fed focuses on, the core personal consumption expenditures price index, rose to 1.5% in May, which is still below the Fed's long-term inflation target of 2%. In her most recent policy statement, Yellen expressed little concern about the recent uptick, referring to the short-term inflation data as "noisy." But several economists have pointed to the acceleration in the inflation rate over the past year as a potential harbinger of higher inflation to come. For example, core CPI has increased at a 2.8% annualized rate in the past three months, compared to the 2% trailing 12-month rate.

Inflation obviously bears watching, and no one is watching it more closely than the central banks. But that doesn't mean the financial markets will necessarily agree with central bankers' assessment of the inflation risks or that the central banks' assessment will be correct. Central bank policies have been a huge driver of financial market returns in recent years, e.g., driving down bond yields and pushing up stock market valuations. Monetary policy remains a key uncertainty, and its impact—both intended and unintended—on the markets and the economy must be taken into account in managing investment portfolios.

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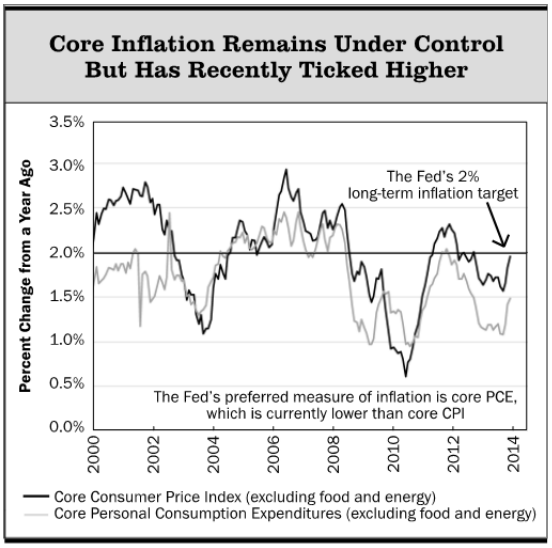

Data as of 5/31/14. Source: U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics.

Our Portfolio Positioning

In the meantime though, the music is playing, the punch bowl is out, and the equity markets are dancing to the central banks' tune. This party may continue for several more months or quarters. But we don't think relying on central bank generosity is a sound investment strategy over the five-year horizon on which we base our tactical portfolio decisions. We are also less tolerant of earnings misses from companies and, therefore, you may see us liquidate positions in companies that disappoint. There are too many other companies doing well and we feel we can always come back to a name if the stock valuation warrants it. On the bond side of the portfolio, we have positioned our portfolios for the likelihood of rising interest rates, consistent with some increase in inflation.

Closing Thoughts

As we consider the range of potential outcomes, we are comfortable with our positioning and the risk and return trade-offs we are making. **While the market is at record highs, that is not necessarily a bad thing. After hitting new highs in the early 1980s (140 in January 1981 on the S&P 500), the market went on to a nearly two decade advance, to reach all-time highs in March 2000 of 1527 on the S&P 500. In addition, just because the markets are at record levels, doesn't mean we have to buy stocks at record highs.** Over the past year we have added names significantly off their 52 week highs such as Target and Wynn Casinos. In addition, increases have justified the move in the market as well as the current valuation. As long as earnings stay strong and interest rates low, we remain bullish.