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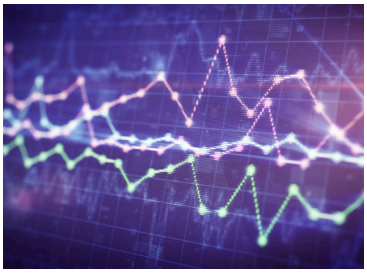
FALL 2015

MARKET SENSE: China, the Fed and Volatility

Global markets suffered a bout of volatility in the third quarter. This eventually pushed equity markets to their worst performance in four years. The volatility derived from multiple factors, but in our opinion the two most important ones were the change in currency policy announced by China and the hesitation of the U.S. Federal Reserve. We will discuss both of these in some detail in this letter. We will conclude the letter with a few forward-looking thoughts on the portfolio and where we are focusing our research efforts. In addition, for context we have provided a summary of major global indexes in the table below.

	3rd Quarter	52 Weeks
S&P 500	-6.44	-0.61
Dow Jones Industrials	-6.98	-2.11
MSCI EAFE (International)	-10.23	-8.66
MSCI EM (Emerging Markets)	-17.90	-19.28
Bloomberg Commodity	-14.47	-25.99
Barclays Global Bond (Global Bonds)	0.85	-3.26
Barclays U.S. Aggregate (Taxable Bond)	1.23	2.94
Barclays 5-Year Muni (Tax-Free Bonds)	1.16	1.85
HFRI Fund of Funds Composite Index	-3.28	0.27

Before getting into the micro, we will first provide a few high-level thoughts on our current base case view. We remain marginally optimistic on the economies of the developed markets—U.S., Europe and Japan. These core economies continue to grow, albeit at a below-average trend rate. In the case of the U.S., pent-up consumer demand continues to be reflected in auto sales, consumer confidence and housing. Europe is showing strength in corporate earnings and better consumer trends. Finally, Japan continues to benefit from solid corporate earnings growth and broadening reforms, especially as they



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relate to views toward stock shareholders. This is manifesting itself in the form of growing dividends and stock buybacks.

Optimism has to be tempered with the fact that we are now six years out from the Global Financial Crisis (GFC), and the economic recovery is aging. The current cycle won't be sustained forever, and a multi-quarter decline in company earnings will occur at some point. Moreover, U.S. equity valuations remain on the high side, though one could argue it is for good reason as the domestic economy is the most insulated from the global risks. Valuations in Europe and Japan are relatively more attractive, but these economies are more exposed if emerging market weakness persists. On balance, our portfolios have remained tilted toward these developed economies with only modest allocations to core emerging markets. Bonds have not fulfilled their historically defensive characteristics this year, with generally flat performance. Our portfolios continue to be underweight this asset class. We have utilized alternative strategies to try to manage the risk in portfolios while holding the lower bond allocations.

CREDIBILITY OF CENTRAL BANKING IS IN QUESTION

The Federal Reserve has a difficult job. First, it is charged with balancing two official mandates—maximum employment and stable inflation, which at present are giving strikingly different signals. Second, post-GFC the Fed was given increased oversight over systemic market risks, specifically in the banking sector. In addition, for good or bad, it has been trying to impact longer-term risks such as income inequality in the absence of government policy action as a result of the dysfunctional political process in Washington, D.C. Finally, while the Fed is not explicitly responsible for global economic conditions, it is forced to navigate U.S. policy through an increasingly connected world where struggles abroad have an impact on domestic conditions. This complex set of objectives resulted in a confusing message last quarter that caused investors to question the path forward for interest rates—both the timing of the first rate hike and the pace of future hikes. The lack of clarity affected a market already jolted by China's currency volatility.

In a world that is in many ways still reeling from the volatility of 2007–2009, central banking credibility is a key stabilizing force. When the market begins to question this credibility, it is no wonder that risks start to rise. The hesitation—or at least the lack of a clear explanation—by the Fed in September was in hindsight a mistake. Theodore Roosevelt once said, "In any moment of decision, the best thing you can do is the right thing, the next best thing is the wrong thing, and the worst thing you can do is nothing." In a more succinct way, Yogi Berra offered up great wisdom: "If you come to a fork in the road, take it." The market's interpretation that the Fed is now unsure of what to do has created a new environment with infinite possibilities.

Part of the problem is that a feedback loop has formed whereby investors are basing investment decisions on a set of anticipated Fed policy moves. At the same time, the Fed is watching the markets both for signals of market risks and as a gauge of likely future economic activity via the so-called wealth effect. Professional central bank observers have told us that the Yellen Fed watches the market more closely than any they have seen. This focus of Fed policy on raising asset prices to drive consumer spending can't be ignored. The challenge, of course, is that both the market and the Fed can't watch each other and gain any new information if they are both trying to anticipate the other's next move.

As we head into earnings season, we are hopeful that the market will turn its focus more toward fundamentals and less toward monetary policy. However, we acknowledge that the Fed will likely be front-page news until more policy clarity is achieved. But with global growth weakening and risks from China continuing, is there any belief that this will happen soon? After the poor September employment report, the market has assigned only a 1-in-3 possibility that the Fed will raise rates in 2015, even though Fed Chair Janet Yellen recently said this remains the most likely scenario. Moreover, there continues to be an uncomfortably large gap between market expectations and Fed board member projections for rates at the end of 2016. The Fed believes rates a year from now will be at 1.3%, while the market anticipates less than half of this—0.6%.

All hope is not lost. Yellen and the Fed will work hard to recover from the recent communication challenges and regain market confidence. But the healing process always takes longer to fix than a communication blunder. Central banks in the U.K. and European Union continue on message. The Bank of Japan has seen some market anxiety as the economy there continues to waver. The expectations for rising inflation expectations are currently lagging, and that remains a risk. But hopefully, after a few more months of economic data and increased communication by the Fed, the markets and central banks will move back into sync.

EMERGING MARKETS: FROM HERO TO GOAT

After the GFC, the world rallied around the growth potential of emerging markets, led by China and the many countries that supplied critical raw materials to the nation. Global investors concluded that the emerging world had fully decoupled and that the developed economies of the U.S., Europe and Japan were going to spiral into irrelevance from debt overhang, poor demographics and anemic growth opportunities. Fast-forward five years and the sentiment toward emerging markets has rarely been worse. We have been traveling extensively in recent weeks, and the most widely held view has been that prospects for emerging markets are dire with no change likely for at least the next few years—a structural bearish story with no end in sight.

We have been cautious on both emerging markets and natural resources over the past few years and have been generally underweight and more defensive in our posturing within those allocations in our portfolios. So in light of the current declines, are we ready to increase our conviction in emerging markets or resources? Long-term opportunity is beginning to look attractive, but we are likely to hold off a while longer. One of the factors that led to our caution in recent years was our belief that investors were underestimating the slowdown potential of China. Given the extremely negative sentiment and poor expectations toward China presently, it does appear that the market is now discounting a lot of bad news. For this reason, we are increasing our research and do believe an increased allocation will be recommended in the next few quarters.

MOST EMERGING MARKETS HAVE MORE FLEXIBLE CURRENCY FRAMEWORKS THAN DURING PREVIOUS CYCLES, WHICH TEMPERS THE NEGATIVE MOVE BUT EXTENDS THE TIME FRAME.

Yet we still have concern that parts of the market may get worse before they get better. China is a big part of this equation. Although, on balance, our research shows that a healthy transition toward a consumer-led economy is underway in China, the fallout from this is not yet fully visible. The transition will have winners and losers. The biggest winners will be domestic Chinese companies that are focused on consumers, health care, technology and finance. The losers will be companies outside China that have provided it with industrial goods, commodities and luxury brands. The transition has been underway for some time, but judging the ultimate trough in this move won't be evident with foresight.

Most emerging markets have more flexible currency frameworks than during previous cycles, which tempers the negative move but extends the time frame. It is akin to letting the air out of a balloon slowly rather than popping it. This helpful change is offset, though, by a large buildup in debt that acts as a wet blanket on these economies' growth potential. As global liquidity is slowing down and commodities prices remain weak, the ability for many companies in the emerging markets to meet debt payments is likely to be at risk.

But even more than these issues, the biggest challenge confronting the emerging economies may be their pace of reforms. Unfortunately, during the boom years, corporate managements and government policymakers weren't active enough in using the windfall to create more sustainable futures. This lack of reform means that many companies are not as competitive globally as they need to be, and political involvement in markets means that capital has been misallocated for years.

As we have said numerous times, we need to see something break to signal we are getting close to the end of the cycle. That is now starting to occur. The *Financial Times* recently reported that 16 emerging market bond issues have failed so far in 2015, which is more than last year's total. Once things start to break, we often see the necessary reforms occur. Here again, China may be key to watch. The potential for reform in China's huge state-owned enterprises (SOEs) is very large. The government has already provided reform objectives in this space, but seeing action and not words would force the market to take a fresh look. We will close with the conclusions from a recent market conference held by one of our key research providers, BCA Research:

> "Emerging markets need structural reform to reinvigorate return on capital. This requires cost-cutting, which is painful and causes economic contraction. There is little evidence that this process is underway, which means there is more downside for EM economic growth and thus, profits. A first step indicating a willingness to retrench would be the allowance of bankruptcies, rather than continued injection of capital into failing enterprises."

INVESTMENT CONCLUSIONS

Broadly, our target portfolio allocations are currently underweight fixed income and modestly overweight growth, with most of the fixed income differential invested in alternative strategies. We believe this balances the offsetting objectives of risk and reward. Within equities, our bias is toward developed economies, with a tilt toward Europe and Japan due to better valuations and stronger earnings potential. Our emerging market exposure is generally limited to a modest allocation to Asia and our long-term focus on frontier markets. Within real assets, we have held little energy or natural resources in recent quarters, and at present we are principally invested in global REIT and infrastructure investments.

Though the market has moved lower, this move happened over the course of five trading days in August—a period of time that is virtually impossible for most investors to capture. Since the low on August 24, the broad markets have stayed within a fairly tight range. Our decision to hold portfolios steady after the initial pullback has been rewarded. We continue to monitor all indicators with a goal of determining if a more actionable trend change is setting up—either up or down. At present, we do think the odds are more favorable for improvement heading into year end, and we would likely look to increase equity exposure slightly. But this is not yet certain, and we are watching closely.

What opportunities have opened up, and where would we be likely to increase capital if they do occur? Our investment team was mostly focused on three areas during the past quarter—emerging markets, energy and U.S. growth equities. As mentioned above, we will continue our work on emerging markets, but we are unlikely to add capital to this area during the quarter. However, the energy markets have presented some specific ideas that we are likely to act on this quarter. First, master limited partnerships (MLPs), specifically pipeline companies, are an area in which we have invested in the past. This asset class has been sold off with broad energy moves but now trade at very attractive valuation levels. Secondarily, distressed energy is a space that is becoming interesting. We have investments in both the liquid and the private side that we are reviewing. Finally, with the pullback in U.S. stocks, some opportunities have opened up in the growth sectors of technology and health care. We would be comfortable adding capital to managers that focus on this space.

As always, we remind our clients and friends that investing is a marathon and not a sprint. Long-term winners in this race are characterized by the attributes of persistence, flexibility and thoughtfulness. We believe our team and process get better every day, and we are committed to always maintaining that attitude. Thank you for your ongoing support and confidence.