Investment Commentary

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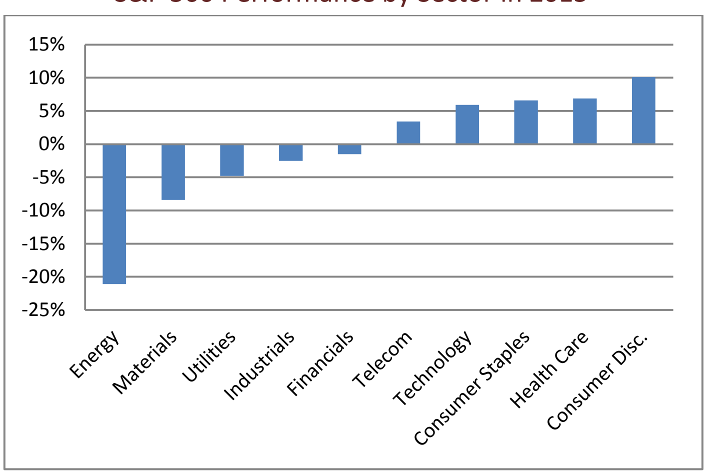
January has proven to be a challenging start for the year. With this commentary, we explore some of the risks that have been building up recently and may contribute to choppiness in 2016. However, we remain favorable on the U.S. economy and market valuations. As a result, we believe this year will test the resolve of many, but patient investors will be positioned to do well.

Investors were challenged in 2015 with many market segments turning in negative returns. Specifically, income-focused strategies and anything in the commodity (i.e. materials and energy) space suffered.

Market Forces Drove a Wedge Between Old-World & New-World Sectors

Consumer-related and service sectors did well as the economy continued to grow amid strengthening household balance sheets and employment gains. Other sectors suffered as the grinding halt in infrastructure development in China drove down the prices of commodities. Domestically, companies exposed to the energy and materials sectors suffered.

S&P 500 Performance by Sector in 2015



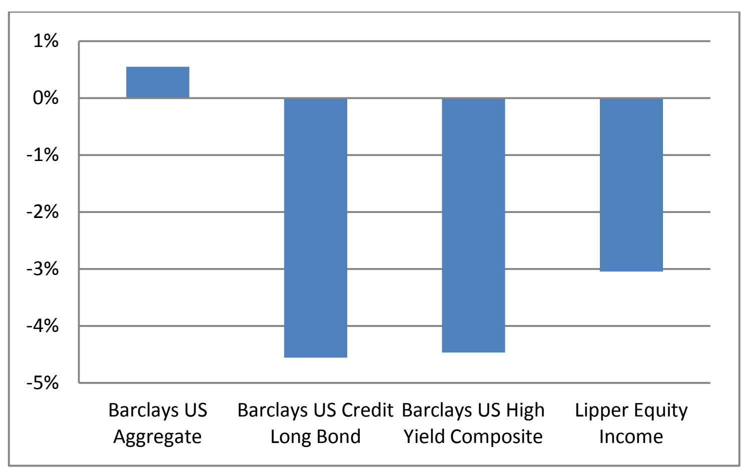
Source: JP Morgan

Refinancing costs rose for many businesses, and income-related strategies suffered

As oil prices fell, concerns related to energy company bonds spread to the broader corporate borrowing world. High yield bond rates climbed 2%.

Investments tied to Corporate Bonds and Equity Income strategies suffered in 2015.

Total Returns for 2015



Source: Barclays, Lipper

Storm Clouds

As witnessed in the start of 2016, storms can appear quickly in the market and with little warning. Despite this, businesses tend to grow over time, and ownership in business tends to be profitable for investors who weather the storm.

Many of the challenges described in 2015 remain. These have potentially negative but transitory impacts on company profits and the market. We are paying close attention to these risks:

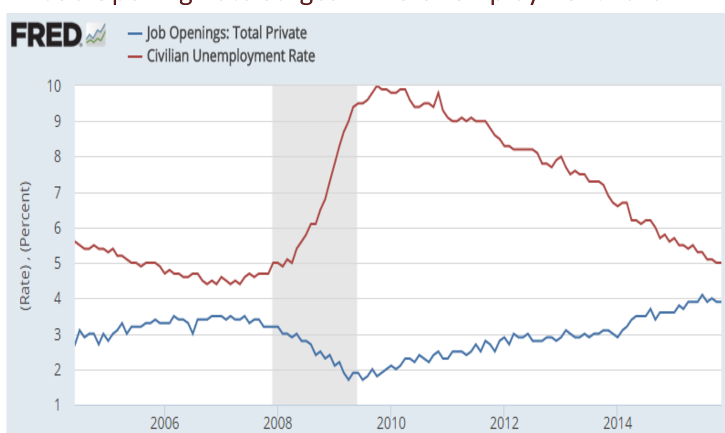
- **Increased global economic risks.** Specifically, the slowdown in China seems like it will continue into 2016. As a result, we do not expect a powerful rebound in commodity prices. We have also seen a lot of money leave China over the past few months – contributing greatly to the U.S. Dollar's strength. Weakness in China has negatively impacted countries and companies that do business with China. As a result emerging market countries, for example, have suffered as exports to China have shrunk. Mining and basic material company margins have been squeezed, and their ability to access capital has too. As a growing swath of businesses and economies suffer as a result of China's woes, global economic activity has as well.

- **Continued disruption in the energy markets.** Eventually, the balance between the production of oil and the demand for it will be found. In the meantime, many companies in the energy space are earning less money. Since many companies in the energy sector have relied increasingly on external financing over the past few years, falling profits have made it difficult to capitalize current and future projects.

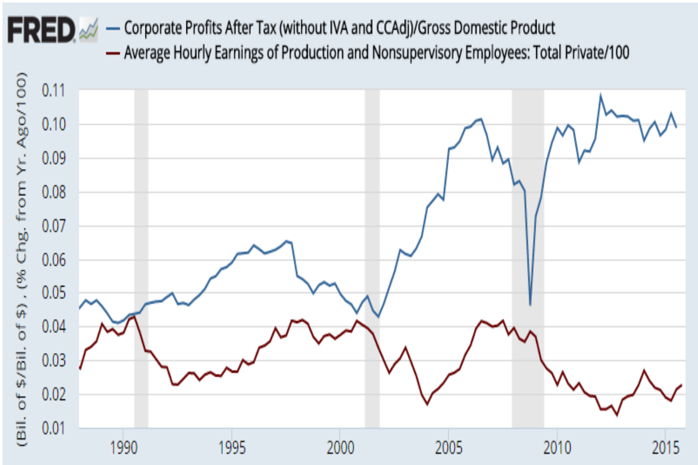
- **Yields have climbed for high-yield corporate bonds.** This is the result of investors feeling less comfortable with credit risk. What investors have known for some time is many energy companies would likely be more challenged to pay off debt as oil prices have fallen. Investors have also realized energy companies have represented a growing share of corporate debt issuance – especially for junk bonds. It has become clear, however, that concerns regarding debt of energy companies have spread to a broader part of the corporate bond market. This is a risk for two reasons: 1) problems in the corporate bond market tend to correspond with stock market declines, and 2) as it becomes more difficult for companies to borrow money, many would be forced to abandon capital expenditures, dividends, and share buy-backs. The good news for patient investors is there will be plenty of bargains once yields reach their zenith.

- **Wage growth may sap profit margins in the short-run.** Wages appear to be positioned to rise given the decline in unemployed workers and increase in available jobs. We have already witnessed wage increases for many large businesses like McDonalds and Wal-Mart. While an increase in wages is associated with a healthy economy, profit margins may suffer in the short-term given the added expense.

Job Opening Rate Surges while Unemployment Falls

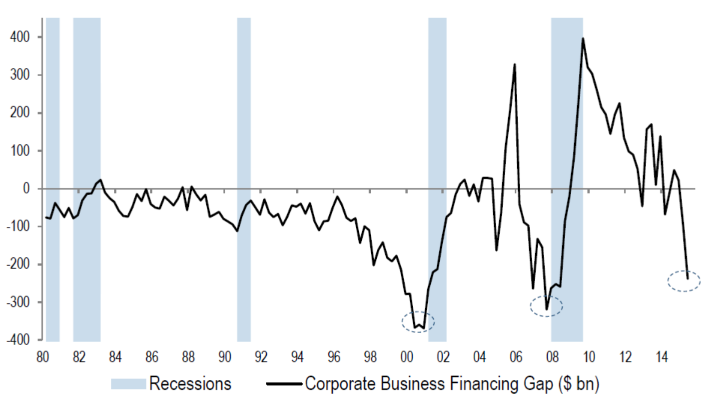


Wage Growth and Profit Margins



U.S. Corporate Financing Gap

The net result of these risks is earnings may come under pressure for many businesses at a time when acquiring funding from capital markets is difficult. For the past several years companies have been fortunate with solid earnings growth and easy access to capital (ability to raise money by issuing stocks, bonds, and loans). Beyond typical operating expenses, this has led to a pattern of increasing share buy-backs, dividend payments, and capital expenditures (i.e. equipment, buildings, and other property). Now, with a tighter debt market and possibly softer earnings, there are higher risks that a broad group of companies would have to decide where to cut back. *This interplay between cash earnings and non-operating expenditures is known as the Financing Gap. With the rise in non-operating expenditures, it has been in decline for a few years.*



Source: JP Morgan

Weathering the Storm

While the risks described above have been building up, the sharp decline in stock prices at the start of this year may be the market's way of efficiently pricing them in. Positioning portfolios for continued volatility seems to makes sense. In our view, companies with ample cash and limited debt are best positioned to hold up.

- Strong balance sheet and cash flows – Companies with low debt levels and reasonably strong cash flows have little need for external financing. In a challenging environment, these businesses will not have to sacrifice shareholder value to continue business as usual. Further, these businesses would be positioned to gain market share if competitors are cash-strapped.

- Some businesses will benefit from a weaker China and lower commodity prices. While the dust has not settled in China or in the energy space, some companies will benefit from lower input costs given the strong U.S. Dollar and the nature of their expenses.

- In terms of asset allocation, investors with high-quality bonds would be largely insulated from most of the described risks. There seems to be little chance of a sharp rise in inflation expectations over the next few quarters. Consequently, interest-rate risks seem muted for 2016.

- As prices adjust to risk-factors, sometimes they overshoot their mark. As a result, an additional allocation to cash may be warranted for some opportunistic investors who seek to buy at market lows.

2016: Early Morning Thunderstorms Followed by Mostly Sunny Skies

Despite rough weather in the early part of 2016, our base-case for the full year remains that overall stock market returns will be positive given our view of the following three factors:

- **Earnings are poised to grow.** In the previous section, we considered several economic and market risks that may negatively impact earnings growth in the first part of 2016. Despite these risks, earnings are positioned for growth in our view. While earnings for the S&P 500 declined somewhat in 2015, consensus is earnings will grow in 2016. We support this view since the U.S. consumer drives the majority of economic activity and is positioned well to support overall economic growth.

- **Companies are fairly valued.** For example, the forward price-to-earnings ratio for the S&P 500, a broad U.S. stock market index, stands at 16 times; in line with its 25 year average. Other measures such as the price-to-book, dividend yield, and price-to-cash flow paint a similar picture.

- **Dividend payouts will remain healthy**. In this low interest rate environment, companies that have paid dividends have attracted investors. We believe companies overall will continue to give a large portion of earnings back to shareholders.

Conclusion

Despite a pick-up in identifiable risks, we expect the economy to continue to grow in 2016 since consumers are well-positioned to support growth. Further, unlike prior periods, the financial and banking system is solid and can facilitate the needs of the economy. Consequently, the challenges for 2016 relate to certain companies, particularly highly indebted ones, and certain economic sectors. The risk appetite of investors tends to swing pendulously and has been headed towards safety. Despite this, patient investors will be rewarded as quality businesses grow and become more valuable over time.