2016 Outlook
Market Commentary

January 11, 2016

This is a "Reader's Digest" version of our overall Market Commentary. If you like the big picture, you can stop at this page. If you want the detail, please enjoy! This commentary is longer than most because there is a lot to discuss.

2015 Review

- On a price basis, the S&P 500 was negative. If you include dividends it was up 1.38%.
- Strength – Under the hood: the market was weak with over 30% of S&P 500 companies experiencing a 20% drop from peak to year end.
- US Dollar – The US Dollar strengthened against most foreign currencies. A rising dollar decreases the earnings of those companies that receive income from outside the United States. This was the major reason earnings decreased in 2015.

Moving Forward

- We are in the 7th year of a strong market. Risks have increased, which is why it's important to stay with a disciplined strategy
- Although the short term oulook is cloudy, we are optimistic long term

Growth vs Value

- FANG – Facebook, Amazon, Netflix & Google were up over 60% providing most of the return for the whole market

Credit & The Strong Dollar

- High Yield Bonds make up 50% of global debt. 20% of high yield bonds are issued to energy companies. This is a very large area of global risk

- US Dollar – The US Dollar strengthened against most foreign currencies. A rising dollar decreases the earnings of those companies that receive income from outside the United States and drove of lower earnings in 2015

China & Oil

- China's growth has decreased from 11% in 2005 to 7% in 2015. However, 39% of all Global growth came from China in 2015
- China is transitioning from a manufacturing to a consumer economy, which takes time.
- It's all about supply and demand. The world simply has far more supply than is currently needed
- Oil moves in cycles and will recover at some point as the world must have oil long term

Moving Forward

- Return forecasts have declined moving forward. Focus on the things you can control:
  - Fees & Tax Efficiency
  - Diversification
  - Tactical Management
  - Discipline

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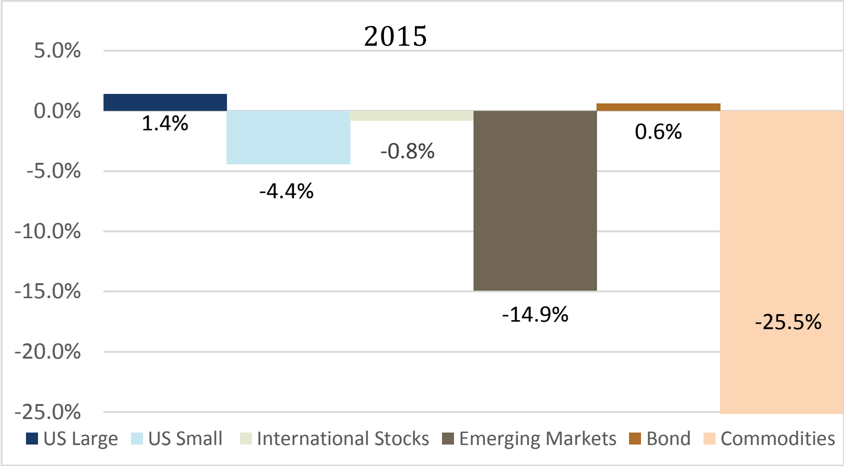
Cautiously Optimistic

"If you're not confused [on the economy], you don't understand things very well."
–Charlie Munger

2015 Look Back

Happy New Year! As we look back at 2015, the stock market (S&P 500) is essentially flat. However, the flat index doesn't tell the whole story. Bonds were also about flat, small companies were negative and many foreign companies were in the red by double digits. The market was largely carried by 4 stocks, which the media has named FANG (Facebook, Amazon, Netflix & Google). Those four stocks were up nearly 70%, while the remainder of the market was actually negative. In fact, over 30% of S&P 500 companes were down over 20% from their peak at year end, which most define as bear market territory.



Two of the biggest factors to overall performance were the value of the US Dollar and the price of oil. As we will discuss in further detail a strong dollar (up 9.4% in '15) has a negative effect on companies that sell their goods outside the US. Crude Oil was down 27.6%, which is a positive to nearly all consumers. However, the market doesn't like uncertainty and there is now a lot of fear in the energy sector, which accounts for about 20% of all outstanding global high yield debt. Low oil is a major negative for both oil exporters and energy companies. Over time, we believe the price of oil will normalize and we will be presented with many opportunities in the energy sector.

Although 2015 wasn't the most exciting year from an investment return standpoint, there are some positives. A sideways market certainly beats a big down year (consolidation vs correction). The Federal Reserve started raising interest rates, which shows the economy is actually doing okay based on employment and inflation data. In our investment committee meetings, we constantly compare the data points in the market tops in 2000 and 2007 versus today's. The current data shows us that markets are not excessively valued, earnings are solid, and debt levels are reasonable. Most importantly, we don't see a recession on the horizon. Most broad market sell-offs of 20% conincide with recessions. We continue to have confidence that the bull market is intact.

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Moving Forward

As we enter 2016, we remain mindful that we are in the 7th year of a strong bull market, and as the length of its run grows longer, emotions rather than sound advice and fundamentals tend to drive prices. Volatile price swings in both directions become commonplace and markets move counter to common sense. While difficult during times like this, it's important to stay disciplined in your strategy and continue to focus on long term investment objectives.

Unfortunately, many of the issues that markets faced in 2015, remain at the forefront as we start the New Year: commodity prices continue to affect Emerging Nations and the High Yield bond market, a slowdown in China is renewing global growth worries, and a strengthening dollar is setting up potential headwinds for domestic growth and oil prices. With a similar backdrop to 2015, a year where very little produced positive returns, investors are rightly worried about where their returns will come from. The natural tendency for those disappointed with returns is to try to shake things up, trade, take on more risk, fire a manager, chase hot stocks, etc., but now more than ever is the time for investors to sit back and be patient. When the risk return payoff is poor, it's best to wait until the right opportunities present themselves.

There's no doubt that high valuations plus anemic growth forecasts signal low equity returns for the foreseeable future, but there is also nothing to compel us to run for the hills. There has been a lot of good news since 2008: balance sheets are strong, cash is still sitting on the sidelines, economies are improving, and just about everyone remains cautious. While the trajectory of returns since the March 2009 bottom is unsustainable, we believe that markets can and will continue upward. This doesn't mean that there won't be volatility, but people tend to forget that before we hit highs in 2013, the market, on a price basis, had been flat for 13 years. It's only been 2 ½ years since that record high, and if history repeats itself, which it tends to do in the investment world, the bull still has room to run.

Below we address some the major themes from 2015 that have carried over into the New Year.

Growth vs Value

While the S&P 500 ended positive on the year, it's important to look under the hood to see what drove performance. Stylistically, 2015 ended up being another year in which Growth beat Value. The disparity in performance was particularly wide as risk-on trading and momentum investing were in favor. Fundamental value investors like Warren Buffett suffered greatly from this. Berkshire Hathaway was down almost 12% as were a number of other famous and successful hedge fund managers. Digging deeper, one discovers that while Growth beat Value, most of Growth's excess return came from just four stocks, and they are what drove much of the market's performance last year. These stocks have come to be known as the FANG Portfolio – Facebook, Amazon, Netflix & Google. So, while the S&P 500 may have ended the year up 1.38%, without those 4 stocks, as noted in the graph below, it would have finished the year down 1.30%, a difference of 2.68%.

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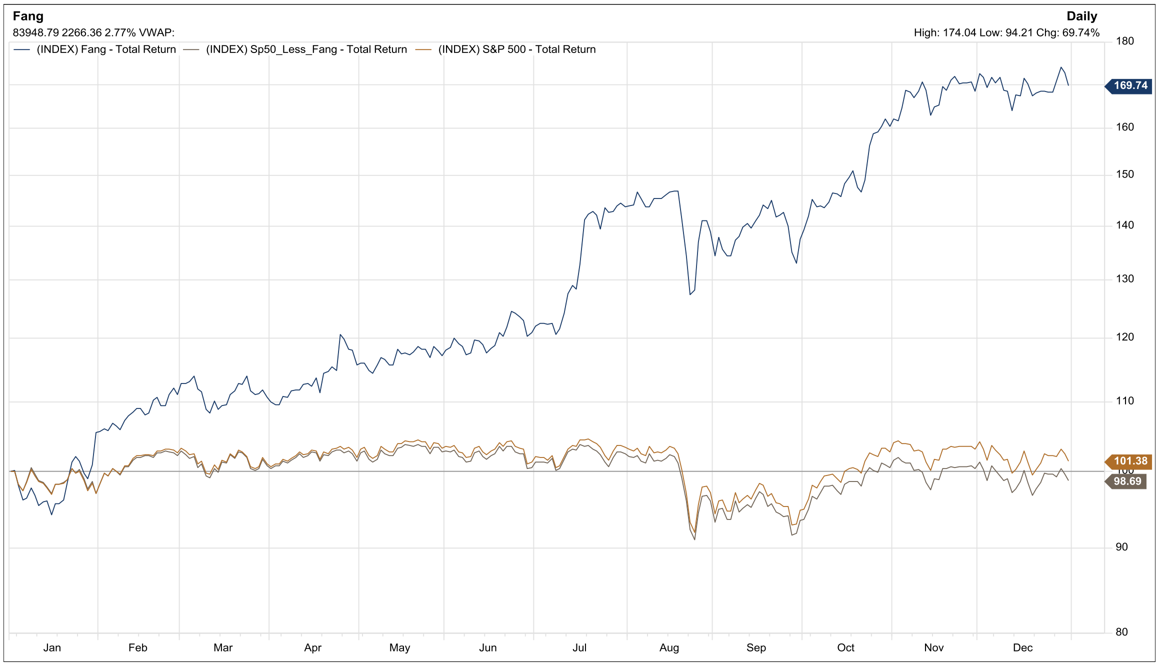

(Source: Factset, Canal Capital Management),

Over the past few years we have experienced a broad market recovery from which all have benefited, but momentum and growth investors have reaped the greatest rewards. We now appear to be entering an environment where correlations amongst stocks will begin to diminish and fundamentals will become that much more important. Companies with good balance sheets, healthy cash flows and growing dividends are trading at attractive prices, offering safety, value and income all at the same time. As we enter a period of uncertainty and turmoil, we believe that these types of stocks will drive market performance. Historically, over the long term, Value stocks have outperformed Growth. After 7 years of underperformance, a reversion to the mean is to be expected.

Credit Concerns Continue

The High Yield bond market now makes up approximately 50% of global debt, so investors need pay close attention to its effects on the rest of the market. Credit issues typically are early warning signs of something more systemic. The chart below shows that High Yield spreads tend to widen above long term averages just before a recession. Intuitively this makes sense as the buyer of the debt is pricing in a higher probability of default. This pattern repeated in 1990, 2001 & 2008. With close to 20% of the High Yield market made up of energy companies, fears of default will correlate closely with the price of oil. Therefore we expect volatility to continue in Credit markets. As predicted in our previous newsletter, liquidity issues are exacerbating volatility. Wharehouses which have been buyers of bonds during periods of market turmoil are no longer around. When investors get spooked by credit markets and large scale redemptions occur, there are few to no buyers for poorly performing bonds. Therefore, in order for bond fund managers to meet redemptions,

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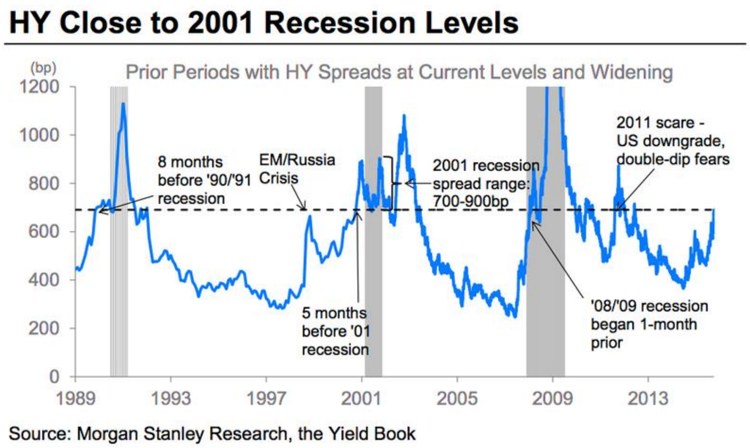
they must either sell their higher-rated, more liquid bonds or stop redemptions from happening all together. During this past year, most funds did a combination of both. This problem wasn't experienced by just a few small managers, some of the biggest and most well-known names fell prey as well. Carlisle, one of the largest Private Equity managers in the world, had to close its distressed debt fund, Claren Road, this past October as investors demanded more than $2 billion in redemptions. Third Avenue, one of the largest credit managers, shocked the investing world when it stopped withdrawals altogether from one of its large (nearly $800 million in assets) bond mutual funds.

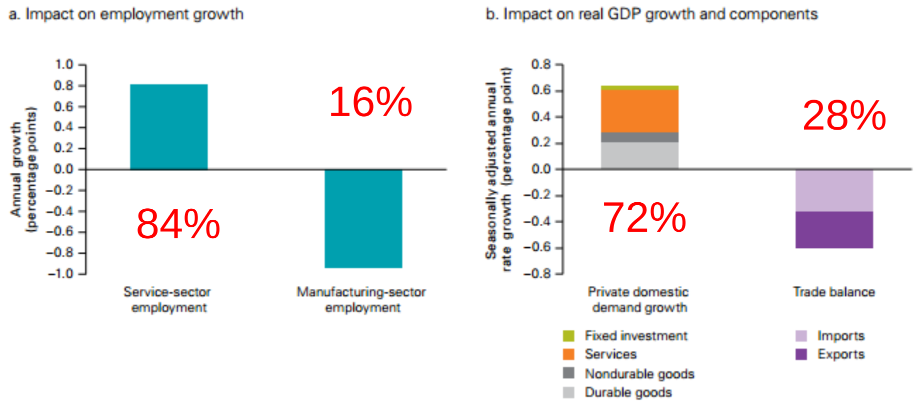


While a rise in spreads is of concern, there is a high probability they will remain reasonably narrow if contained within the energy sector. As a result, investors able to stomach some volatility have good buying opportunities as those forced to sell are doing so at discounts. This requires a high level of investing and legal skill as well as knowledge and understanding. Because of the idiosyncratic risk, we favor using managers with proven track records of successfully buying during periods of turmoil and dislocation – a la 2009. We are currently spending considerable time and research to identify some of these opportunities. In the meantime, all of this further affirms our continued move to own only highly liquid and high quality individual bonds and ETFs.

Strong Dollar

While the dollar is the currency in which the world trades, its value relative to other currencies weakened during the first part of this century. As the US emerged from the financial crisis of 2008 stronger than any other economy, the dollar began to gain strength once again. As the US wound down its quantitative easing program and began raising interest rates, the dollar's strength has gained even more momentum. What affect will that have on markets?

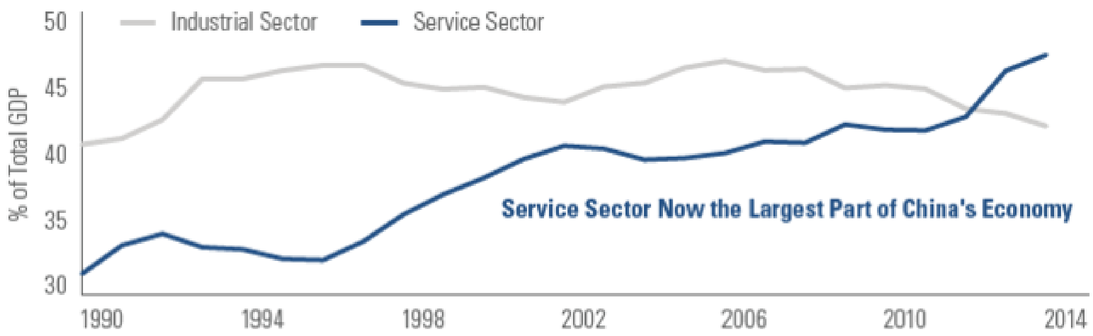
Domestically, a strong dollar has historically been negative for the United States. When the US was predominantly a manufacturing economy, a strong dollar meant that more goods were purchased overseas by weaker currencies. As we have shifted to a consumer and service driven economy, the effect of a rising dollar now has the potential to become a net positive. As illustrated in the charts below, exporting goods makes up just 13% of US GDP and the manufacturing sector as whole makes up just 16% of all jobs. With consumer services making up the largest part of our economy, lower import prices should be a net positive for consumers, and in turn, the economy as a whole.



(*Source: Vanguard*)

China Stumbling or Evolving

There is no doubt that China's growth is decelerating, yet despite the slowdown, they are still experiencing high growth compared to other economies worldwide. While growth has declined from 11% in 2005 to 7% in 2015, where else in the world does one see equivalent numbers? And when we look under the hood, part of China's economy is actually accelerating. As seen from the chart below, the slowdown is a result of the transition from an industrial to a service and consumer driven economy.



While productivity and manufacturing take hits, consumer wealth begins to increase which in turn leads to greater spending and investment. While the trajectory of growth may never resume to its former height, China's transitioning economy increases the chance for sustained long term growth. All that being said, it won't happen without some hurdles – expect volatility to continue. Not only is China transitioning its economy, it's changing the way in which it does business. An economic transition of this magnitude takes time and a lot of effort, but we think long term it will be good for China and the rest of the world. In 2015, 39% of Global Growth in came from China. A successful transition will be positive for everyone.

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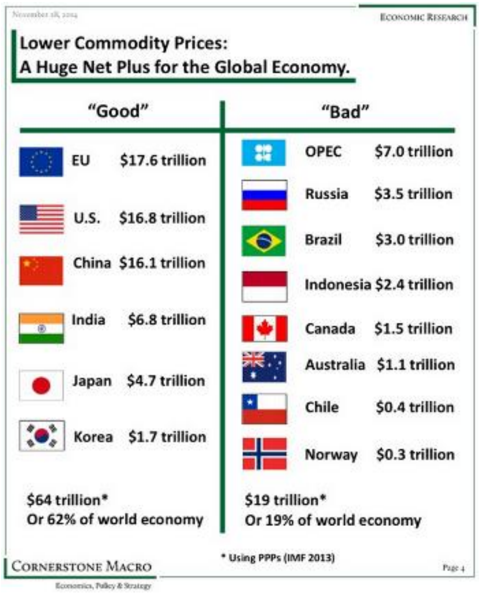
Oil

It’s a given that as geopolitical tensions in the Middle East rise, volatility in oil prices will occur. Prices may even experience a drastic rise again if tensions escalate between Saudia Arabia and Iran. Nevertheless, one thing that is certain is that the way the world produces and consumes oil has greatly changed. Technological advancements have made the process of extracting fossil fuels much cheaper and more efficient. In addition, due to governmental regulations, technology, and an increasing concern over climate change, demand for traditional fossil fuels has slowed down. As a result, supply has now greatly outstripped demand. While fear may have overly depressed prices, fundamental changes in the industry lead us to believe that when all is said and done, energy prices will be much lower than historical averages going forward. We believe that lower prices for the foreseeable future may cause short term problems in the market and result in some bankruptcies in the energy sector, but we believe that it will be a long term positive for consumer-based economies around the world. As you can see in the chart to the right, it’s a net positive for the United States, Europe and Asia (ex Russia).



Moving Forward

Return forecasts over the next several years are muted across just about every asset class. Couple that with investors’ irrational tendencies typical toward the tail end of a bull market, and one confronts a challenging landscape for money managers moving forward. Now, more than ever, it’s important for us as investment managers to stick to our discipline and process: avoid all the noise from the markets and stick to observing and factoring in meaningful signals when making investment decisions. Our focus as stewards of our clients’ assets continues to be driven by their long term objectives, focusing on risk management and capital preservation by minimizing drawdowns and striving to outperform over time. We believe that:

- A focus on fees and tax efficiency can greatly enhance total returns
- Diversification is vital and must extend beyond traditional US Stocks and Bonds to include alternatives and international stocks
- Tactical management is crucial to managing risk
- Discipline in execution and process helps manage emotions
- Innovation and creativity are crucial in helping to deliver consistent returns in an ever changing and volatile world

As we tailor portfolios to the difficult environment that lies ahead, we put a premium on asset class diversification. Goldman Sachs, in their most recent market insight, put it best when they said wrote “the most enduring answers to a complex market environment can be found in a commitment to strategic portfolio design.” As we enter 2016, we are shaping our clients’ portfolios to reflect an environment that may be similar in nature to 2015.

Within our Equity allocations we continue to favor US stocks as a strong dollar and lower commodity prices are supportive of growth. In particular, we remain committed to our Dividend Stock allocation composed of companies that offer safety and income at a reasonable price. Growing dividends will allow these companies to keep pace with interest rates. Their large cash positions give them the ability to either buyback their stock or organically stimulate growth, and they should benefit from a reversion to the mean that will favor Value over Growth, which has outpaced Value over the past 7 years.

While International Equities continue to face headwinds, we believe there are pockets of opportunity beginning to surface. Continued monetary easing and low commodity prices have the potential to provide a sustained tailwind for growth in a number of regions around the world.

Our Bond allocations will continue on a path toward simplicity, offering the diversification and safety it was designed to provide in portfolios. These allocations also give us the ability to create liquidity quickly when dislocations occur and buying opportunities present themselves.

As discussed in our previous newsletter, we continue to increase our allocations to alternatives that we feel will provide true diversification and opportunity for gains in a difficult market environment.

DISCLOSURE: Past performance is no guarantee of future results. Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than original value. These investments may not be suitable for all investors, and there is no guarantee that any investment objective will be obtained.

All indices are unmanaged and investors cannot invest directly in an index. Unlike investments, indices do not incur management fees, charges or expenses.

Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potential illiquidity. The purchase of bonds is subject to availability and market conditions. There is an inverse relationship between the price of bonds and the yield: when price goes up, yield goes down, and vice versa. Market risk is a consideration if sold or redeemed prior to maturity. Some bonds have call features that may affect income. Treasury bonds are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, they offer a fixed rate of return and fixed principal value. U.S. Treasury bonds do not eliminate market risk.

The precious metals, rare coin and rare currency markets are speculative, unregulated and volatile and prices for these items may rise or fall over time. The commodities industries can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.