Third Quarter 2015

Quarterly Letter to Clients

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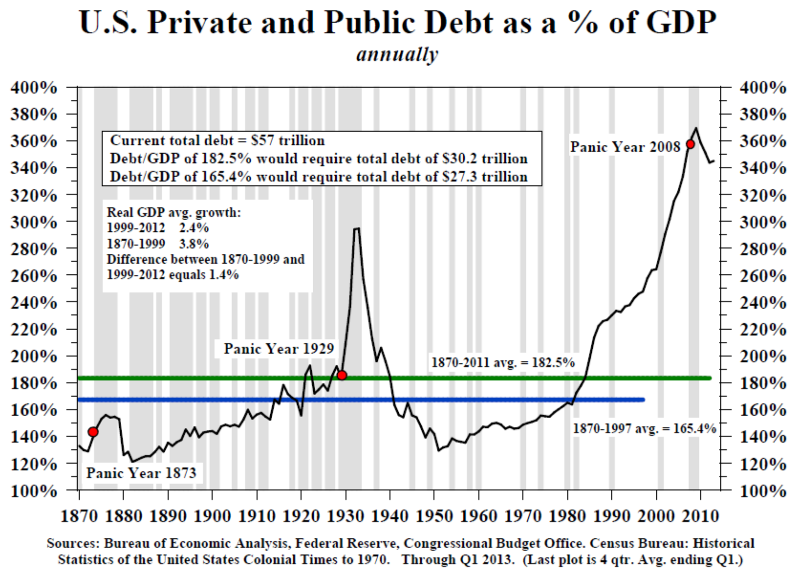
The weakening fundamentals of the current business environment continue to be masked by the actions (or inactions) of the Central Banks around the world. Here in the United States, our Federal Reserve is still center stage in most capital market participants' minds, influencing their investment decisions either directly or indirectly. The duration of the current easy money policy, combined with its unintended consequences, has masked the true nature of an economy that continues to suffer the lingering aftereffects of the Great Recession of 2008. Nearly seven years into the recovery from the brink of catastrophe, the U.S. Economy continues its sub-par growth trajectory, while remaining the leader in the Global Economy that is showing signs of slowing.

Central Bank actions have translated into capital market gains, with limited impact on the real economy. Most investors, weary of earning near zero on more credit worthy instruments, have thrown in the towel in favor of reaching for the "better than nothing" yields found in less credit-worthy investments that provide the higher return *on* their principle, but an even greater chance of not seeing the return *of* their principle investment. All the while, market participants continue to be anesthetized to the increasingly dire consequences of the tools being used to provide the appearance of financial improvement – namely the gargantuan pile of IOUs being offered to fund today's growth at the very real cost of tomorrow's prosperity. The chart below details U.S. Private and Public Debt combined and provides some historical perspective on how the most recent estimate compares in relation to the U.S. Economic capacity, measure by Gross Domestic Product (GDP).



Take a minute to review this graphic and ponder the impact of the difference between using a little debt responsibly, and the problems associated with extending the amount of debt over and above the ability to repay that obligation. This over-indebtedness, while providing short-term stimulus, has known and unknown long-term consequences. Japan and Greece both provide recent case studies. The former is still trying to reflate an economy that has bounced along between stagnation and deflation for over 20 years. The latter is a flagrant example of the over-use of debt, resulting in financial instability, high and growing unemployment, weak aggregate demand for goods, lack of liquidity, and finally, the withdrawal of normal credit functions as distrust builds and trade comes to a standstill. Our current circumstance is more akin to the Japanese experience, implying that policy makers will spend years trying to avoid the inevitable – and thus maintain the current “easy money” policy for the foreseeable future.

Markets do not like uncertainty. The anticipation of the Federal Reserve changing course, combined with the unfolding events in China and the Emerging Markets, appeared to cause enough uncertainty to spark the first stock market correction greater than 10% in the past 4 years. The stock market’s seemingly unstoppable upward trajectory was reversed, as market participants began to consider the increasingly hostile geopolitical environment in the wake of a global economy that already is feeling the impact of slower Chinese growth. This slower growth has had a domino effect impacting Emerging Markets, Less Developed, and Developed countries which are all reporting softer trade statistics. While it appears common knowledge that China has and is experiencing a significant slow-down in economic activity, how significant is still in question. Reported Gross Domestic Product (GDP) numbers place China’s growth around the “officially stated” 7 % level. However, anecdotal evidence from companies exporting goods into China provides a case for even slower than reported growth. Couched in terms of the multi-year transition that the Chinese government is undertaking to transform their economy into one more dependent on consumers instead of manufacturing, the downturn may be larger in magnitude than anything previously experienced by the Central Planners. In fact, a reduction in Real GDP to levels seen in the United States of 2 to 3 percent would be the equivalent of a "hard landing" for an economy used to much higher growth levels. The additional impacts of increasing deflation in China and their modest devaluation of the Renminbi both could point to further difficulties in reigniting Chinese growth.

Additionally, the decline in what just a couple of years ago was considered the most prolific arena for economic growth – the Emerging Markets – discovered that the laws of economic growth cannot be bent when the two edge sword of debt is used too liberally. Many Emerging Market companies and governments have fallen into the temptation of borrowing in dollars, to take advantage of low U.S. interest rates and to leverage their growth "potential". Fast forward to 2015, where a strengthening U.S. Dollar and the potential of rising interest rates only exacerbates the Emerging Market company (or government's) problem of not having the growth they expected to fund repayments in the future. To add insult to injury, they now have to pay the debt back with more local currency (due to dollar strength) and have the potential of having to refinance at a higher cost of capital IF the Federal Reserve begins its journey towards normalcy and lets interest rates return to something other than zero.

With markets unsettled across the globe, global growth waning, and no inflationary pressures indicated on the Central Bankers Dashboards, Chair Yellen and the FOMC took a pass on removing the punch bowl – for now. However, the question increasingly before the committee will be: "If economic conditions deteriorate and combine with the current disinflationary trends, what tools are left to provide the reflation stimulus necessary to rekindle growth?"

The **Fixed Income** markets are keenly aware of their future performance depending on the answer to the Fed toolbox question. To maybe oversimplify the problem: The Fed can either normalize (raise rates) or not normalize (continue current policy). Forcing rates upward would be bad for bonds – at least initially, as rising rates would cause bond prices to fall. However, by delaying and not refilling the proverbial quiver with arrows, the FED may not be able to reflate to offset softer future economic growth. However, a rate rise in a period of low growth and low inflation could also add to the current disinflationary pressures and could bring on a period of deflation – what most would call every economic policymaker's worst nightmare. This is only exacerbated by increased worries over the global trade slump that only magnifies the Catch-22 paradox the Fed now finds itself in.

Thus, if they raise rates and then the economy goes into recession, the Fed would be able to put some arrows back into the quiver, but it could be at an indeterminable cost, given the slowing world economy. Not great alternatives to choose from.

Despite the hand wringing surrounding the FED's policy decision, the bond market posted respectable performance for the quarter. This, after the decline in commodity prices and the plummeting Chinese Stock market increased the demand for safer U.S. Treasury bonds, which pushed the yield on long-term Treasuries back down to levels seen at the beginning of the year. However, risk aversion increased, causing Corporate spreads to widen and consequently provide a lower relative return versus U.S. Treasuries. As the bond performance chart below shows, intermediate corporate bonds provided only 0.68% return for the quarter, while intermediate government bonds posted a 1.91% quarterly return. A further examination of the bond performance chart confirms that longer maturity bonds performed better than shorter ones, while poor quality (riskier credits) underperformed the higher quality paper.

Morningstar Bond Indexes

Broad Market	**Quarter**	**1-Year**	**3-Year**	**5-Year**
Intermediate Core Bond	1.46	3.99	2.27	3.46
Long-Term Core Bond	2.35	3.89	2.27	5.34
Short-Term Core Bond	0.38	1.46	0.99	1.30
Corporate				
Intermediate Corp Bond	0.51	2.52	2.69	4.30
Long-Term Corp Bond	0.68	0.52	2.24	5.37
Short-Term Corp Bond	0.19	1.44	1.76	2.45
Government				
Intermediate US Govt Bond	1.91	4.42	1.31	2.57
Short-Term US Govt Bond	0.45	1.45	0.76	0.96
US Govt Bond	1.78	3.77	1.30	2.51

Source: Morningstar Index Review

Most market pundits expect a slow, gradual rise in interest rates as the Federal Reserve starts its journey towards normalizing rates. However, the high-yield sector provides some clues as to how market participants may react to anything other than a gradual increase in rates. During the 3rd Quarter, high-yield bond funds saw spreads widen, prices fall, and the result was significant outflows from these funds, as many investors reacted to the widespread economic uncertainty and the bump up in junk-bond default rates. Bond fund investors felt the impact of the changing economic landscape as bond yields climbed in the second quarter and many bond mutual funds lost 12 to 15% of their value. The paltry improvement in the 3rd quarter has shaved the year-to-date loss in many funds, while providing a small improvement in the 1-Year returns shown above.

The return and risk parameters of the bond market will continue to be hinged to Federal Reserve Policy decisions and favor a strategy of preserving capital over reaching for yield. Consequently, our fixed income strategy remains resolute on using the fixed income portion of your portfolio to match your overall risk tolerance. We continue to prefer a shorter-duration portfolio that is constructed with high-quality issues that compensate us for the increasing risks found in fixed income markets.

The **Stock Market** again provided mixed results in the Third Quarter of 2015, with the major indices all in negative territory, recording their first correction in the past 4 years. For the quarter, the Dow Jones Industrial Average declined -7.0%, and the S&P 500 was off -6.4%, while the tech-heavy NASDAQ posted a loss of -7.1%. As the Lipper Mutual Fund chart below shows, larger capitalization stocks outperformed their smaller brethren, while the divergence between types of stocks widened considerably. The average mutual fund, represented as General Equity in the chart below, saw a loss of -8.2% for the quarter. The quarter's downdraft pulled year-to-date returns and most categories of year-over-year returns into the loss column.

LIPPER MUTUAL FUND INVESTMENT PERFORMANCE AVERAGES

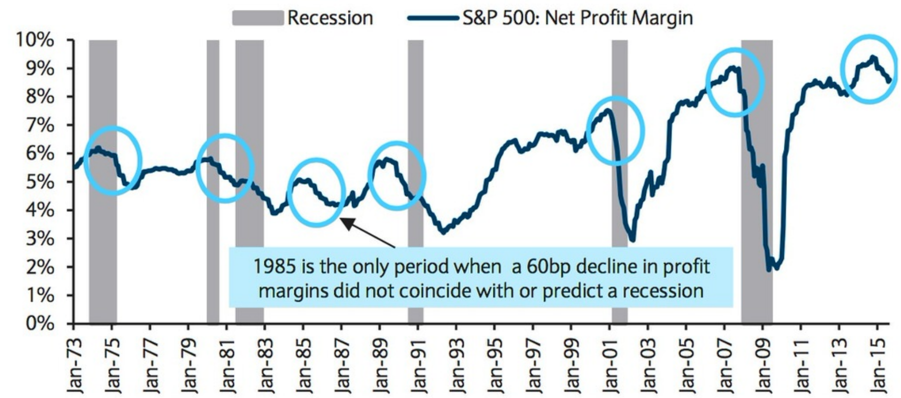
MONDAY, OCTOBER 5, 2015

	Qtr	1 year	5 year	10 year
S&P 500	(6.6)	(1.2)	12.7	6.3
S&P 500 Index P	(6.9)	(2.7)	11.0	4.6
Dow Jones Ind. Average P	(7.6)	(4.5)	8.6	4.4
Equity Income	(7.4)	(4.6)	10.1	5.8
General Equity	(8.2)	(1.5)	10.7	5.9
Large-Cap Core	(7.2)	(2.2)	11.8	6.0
Large-Cap Growth	(6.3)	2.1	13.0	7.1
Large-Cap Value	(9.0)	(5.4)	10.8	5.0
Mid-Cap Core	(9.2)	(1.7)	11.3	6.5
Mid-Cap Growth	(9.7)	1.0	12.0	7.2
Mid-Cap Value	(9.1)	(2.5)	11.8	6.4

P-Price only index. Calculated without reinvestment of dividends. Source: Lipper

The poor performance of stocks during the 3rd Quarter reflected the continued deterioration in profit trends, with analysts reducing their estimate of 3rd Quarter S&P 500 Earnings per share and expecting a -5.1% year-over-year decline. This would be the second negative quarterly earnings report since the 3rd quarter of 2012, and the first back-to-back quarterly declines since 2009. Most likely the U.S. has entered a profits recession. Thus, the focus will be on profit margins going forward, as investors try to determine whether the declining trends in profits seen in the Energy, Materials, Industrial, and Utility Sectors will migrate into a more broad based slowdown. As the graph below shows, the annual change in 12 month forward EPS expectations turned negative, providing ***higher odds of an economic recession, if margins deteriorate further***.

FIGURE 2
A large decline in profit margins usually leads to or coincides with a recession



Source: Thomson Reuters, Barclays Research

Chart from on Business Insider

According to FactSet, one of the major drivers of 2015 S&P 500 earnings per share growth was share buybacks. "Dollar-value share repurchases amounted to $134.4 billion over the second quarter, which represented a 6.9% decline from the first quarter and a 4.4% decline year-over-year."[1] This implies that both the quality of earnings and the momentum into the fourth quarter are deteriorating, which will place even more pressure on the final quarter of the year to make up the short fall and meet annual earnings expectations.

The correction during the quarter provided a short window of opportunity to buy some stocks at more reasonable prices. However, prior to the correction stocks were so richly valued that the correction only brought valuations down to around the long-term average of 16 times forward earnings -- not a "pound the table buy" type of moment. Consequently, while we were able to put some capital back to work over the last few weeks, our overall strategy for your account remains consistent with our long-term focus on purchasing stocks below our estimate of their fair value. As we penned repeatedly in our quarterly letters to you, finding value, without sacrificing quality in a high and rising valuation environment can be challenging and require an extra dose of patience. Nevertheless, we will continue to be methodical in our process, acquiring those stocks that can be bought at prices that meet our investment standards, while providing an acceptable margin-of-safety. Similarly, we will reduce or sell those stocks that exceed our estimate of fair value, irrespective of the gyrations of the markets.

[1] "The S&P 500 Bought $134 Billion Worth of Itself in Q2" by Sam Ro in Business Insider on September 22, 2015.