

## Market Commentary—3rd Quarter 2015

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Equity markets across the globe had a tough go of it in the third quarter. Investors sought refuge in the wake of unsettling international political and economic events, and even signs of weakness in the domestic economy. Though second quarter Gross Domestic Product (GDP) growth was revised up to 3.8%, it is apparent that third quarter growth was more modest – likely closer to 1.0%, due to weakness in the manufacturing, transportation and energy sectors. Investors turned to large-capitalization stocks over small caps, and “growth” over “value” (except for small caps, exemplified by the Russell 2000 Growth® Index which lost 13.06% compared to -10.73% for the Russell 2000 Value® Index). The S&P 500® Index lost 6.44% in the quarter, in contrast with -8.01% for the Russell Midcap® Index, -10.30% for the Russell 2500® and -11.92% for the Russell 2000® Index.

During the quarter, all sectors in these indices were in the red except for utilities, which generally gained 4-5.5% depending on the index, a consequence of their lower beta and risk

characteristics. Consumer staples and financial sectors also held up reasonably well, while energy was the worst—due to extended weak oil and gas prices, and in many cases, stretched financial resources. Health care was down by double digit percentages in these indices, as well—the result of political figures challenging the rationale of pharmaceutical pricing policies. Investors also seemed unnerved by the Federal Reserve’s decision in September to maintain interest rates—seen by many as an indication of a vulnerable economy, and likely pointing toward generally weak revenue and earnings growth prospects in coming quarters.

Challenges were broad and pervasive in the period, with primary triggers of weakness precipitated by emerging markets. Although a crisis in Greece was averted by new agreements between the Greek government and European lawmakers early in the quarter, cracks in the Chinese edifice became apparent, punctuated by a devaluation of the Yuan on August 11 followed by government controls on market

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activity to halt collapsing stock prices. As a consequence, the U.S. dollar surged against most emerging market currencies, causing their debt obligations—mostly denominated in United States Dollar (USD)—to bulge out, leading to impending economic and financial stress in those countries. Simply stated, China is sneezing and emerging market countries, with few exceptions, are catching a cold. Developed markets are feeling the effects too, though less so, due to less dependence on China—trade with China accounts for less than 1% of U.S. GDP. Russian roulette? The Russian dilemma best exemplifies the emerging market conundrum. Heavily dependent on oil exports to maintain growth and fund government programs, the Russian economy is in contraction, reinforcing Putin's inclination toward aggressive domestic and international policies and actions; thereby adding instability to spheres of influence, and upending peace initiatives as well as trade and political stability. Even Saudi Arabia, with its 10 million+ barrels of daily production, must currently borrow to meet burgeoning government budget needs.

Focused market vigilance is imperative. With international cross-currents referred to above, an often dysfunctional U.S. political process, and with more complexity in the capital markets, much caution, wariness and a keen analytical awareness is a requisite. Regarding the capital markets, investors have moved en masse into alternatives, synthetics, and derivative securities in recent years, many with leverage and most with yet undefined risks, partly due to their limited trading histories in the real world and their untested theoretical selling points which may be based on hypothetical back-tested calculations. To wit, over the past 12 years, the average endowment in the U.S. has reduced equity exposure from 50% to 36% and fixed income exposure from 23% to 9%. During this same time period, exposure to the "alternative" asset class has increased from 24% to an astonishing 51%. The prevalence of "alternatives" and ETFs has added a destabilizing influence to the market environment. These issues surfaced in the week of August 24, when many ETFs decoupled from their underlying securities, collapsing ETF values. In a front page headline the next day, the Wall Street Journal summarized:

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“Significant flaws in the new architecture of Wall Street were exposed in Monday’s mayhem, as many traders reported difficulty buying and selling ETFs.”

What’s an investor to do? The environment referred to above—one of weak commodities, debt-burdened countries, geo-political and economic uncertainty, and frequent stock market volatility—gives credence to focusing on companies with high visibility toward a path of potential revenue and profit growth, strong competitive positioning and fortress financials. These are some of the key tenets of our investment philosophy in any environment. The typical company in which we seek to invest has better than average earnings visibility and is not burdened with too much debt or other fixed payment obligations. Furthermore, we currently favor companies that operate in stable countries and operating environments. In our domestic portfolios, we lean toward companies with a heavy domestic representation. In our international portfolios, we emphasize developed countries and have relatively little emerging markets exposure.

We believe the current environment is one in which the strong often get stronger, and the weak are at risk of fading.

Companies with fortress financial strength—strong balance sheets and free cash flow generation—have the potential advantage of being able to fully take advantages of opportunities as they arise, such as acquisitions or investments in future growth, providing the opportunity to extend competitive advantage. It also allows them the possibility to pay out higher dividends or make fortuitous share repurchases should they choose to do so. In the current economic environment—one in which growth and profits are becoming harder to achieve—we see a clear advantage to investing in companies with these qualities, ones which will likely be able to differentiate themselves by their ability to achieve growth, all the while maintaining prudence in financial management.

Opinions expressed are subject to change, are not guaranteed and should not be considered investment advice.

**Past performance does not guarantee future results. Index performance is not illustrative of fund performance. Please call 1.800.280.6111 for fund performance.**

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***Must be preceded or accompanied by a prospectus.***

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