JANICZEK® WEALTH MANAGEMENT

Portfolio Matters

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A "GREECE-Y" FINISH TO ANOTHER VOLATILE QUARTER

We See Evidence That Still Leans Bullish ... Albeit Less Strong

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There were plenty of headlines driving volatile markets during the quarter. Higher interest rates pressured bond and other income-oriented investments, Chinese equities experienced a big correction that clipped emerging markets, and Greece became the first developed country to default on a loan payment to the International Monetary Fund.

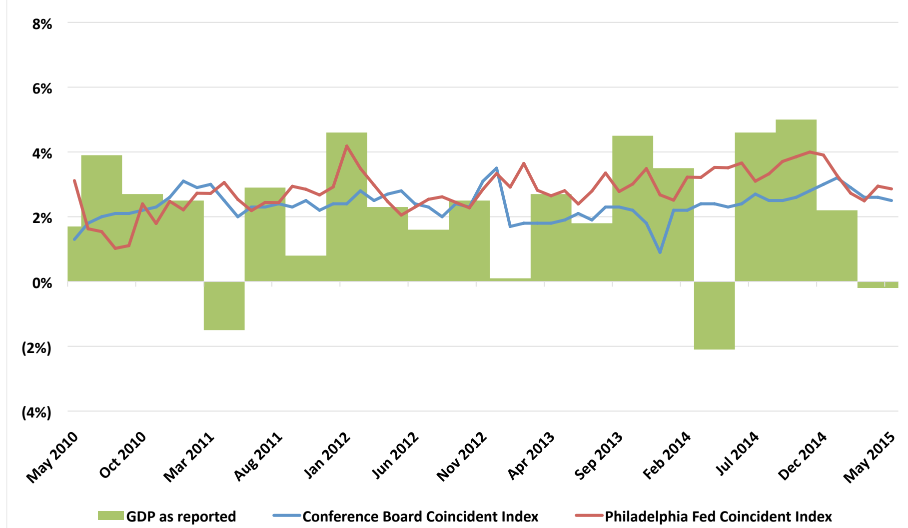
As always, we go beyond the headlines to assess the true strength (or weakness) of markets. We still find evidence that supports our bullish outlook, but we observe some signals that indicate increased risks across global markets.

This issue of ***Portfolio Matters*** won't provide any solutions to the Greek crisis or Chinese stock market plunge. Instead, we hope readers take away our insights on global markets during the quarter and our portfolio positioning for the remainder of 2015.

Economy

A slower economy in the first half of the year still looks good heading into the second half. We expect overall U.S. GDP growth of about 2.5% in 2015. This is lower than our original 2.8% - 3.0% range we stated in our 2015 Outlook, but indicative of about 3.0% over the next 6 months.

The U.S. economy contracted 0.2% in the first quarter, but growth may be better than reported. The Bureau of Economic Analysis (the government body tasked with reporting GDP data)



BOTTOM LINE

- The latest Greek debt crisis is taking place within a stronger global economy
- Increased volatility impacted global stock & bond markets in Q2
- The case for stocks over bonds remains intact, but admittedly not as strong
- We're monitoring our indicators for when to get defensive, but we see more room to run

acknowledged issues in how it adjusts first quarter GDP for seasonal effects. Seasonality needs to be accounted for, otherwise the impact of holiday spending would suggest too much growth in the fourth quarter and too little growth in the first quarter.

This issue of seasonality in GDP data has been raised before by Wall Street economists and even researchers at the San Francisco and Philadelphia Federal Reserve Banks. More important to us isn't the exact quarterly figure, but rather that the headline GDP number probably masks what was a healthier economy in the first quarter.

Other GDP indicators we follow give us confidence in the current economy. The accompanying chart shows two "coincident" indices, or collections of economic data that move in conjunction with GDP growth. As the chart illustrates, indirect measures of GDP growth suggest stronger and more consistent growth than the headline GDP number portrays.

Regardless of whether the Federal Reserve begins to raise short-term interest rates in September or later, the path of increases is likely to be flatter than in

past rate hike cycles. In the Fed's June press release, 15 of the 17 voting members expect at least 1 rate hike in 2015. Despite Greek, Chinese, and other global concerns, the latest jobs data showed unemployment down to 5.3% with continued nonfarm jobs growth.

When looking at the Fed's stated expectations further out, we see short-term rates rising to about 1.5% and 3.0% by the end of 2016 and 2017, respectively. This is a doveish Fed that consistently states their "data dependent" perspective, so we take these views with a grain of salt. But the lesser uncertainty around timing of rate hikes will serve as a positive for investors.

(Check out the Janiczek blog for additional commmentary such as expectations for short-term rate increases as well as the implications of long-term rate increases.)

Global GDP expectations for 2015 have also come down, as we wrote last quarter. But the key takeaway here is that the economic backdrop is still conducive for good investment returns within a disciplined portfolio management process.

Despite a low risk of a recession in the U.S., there is greater uncertainty in the economic issues globally. Of the 7 major economic models we follow, only 2 indicate the risk of a global recession. Regionally, Europe looks better than Asia, while the U.S. looks to be the strongest. Further supporting the economic indicators are the positive signals from global equity markets, with over 70% of the world's major markets trading above their long-term trends. Adding in accommodative monetary policy, we believe the global economic picture is a net positive.

Of course, we cannot conclude this section without a comment on Greece. Greece defaulted on a loan payment to the IMF and looks set to miss a larger payment to the European Central Bank (ECB) on July 20. Banks in Greece remain closed, and the country is relying on an emergency fund from the ECB to meet crucial cash requirements. Negotiations remain ongoing, and handicapping the outcome is anyone's guess. But assessing what we do know about this crisis provides some certainty about what risks we face.

The risks that the global economy faces from the Greek crisis are lesser today. Global GDP is growing faster today than in 2008 when Greece's economy first tanked. The global banking system has $54 billion of exposure to Greek banks, down from over $300 billion in 2008. And bond yields across Europe are 75% lower than 2008 levels, reflecting the reduced Greek exposure among other countries.

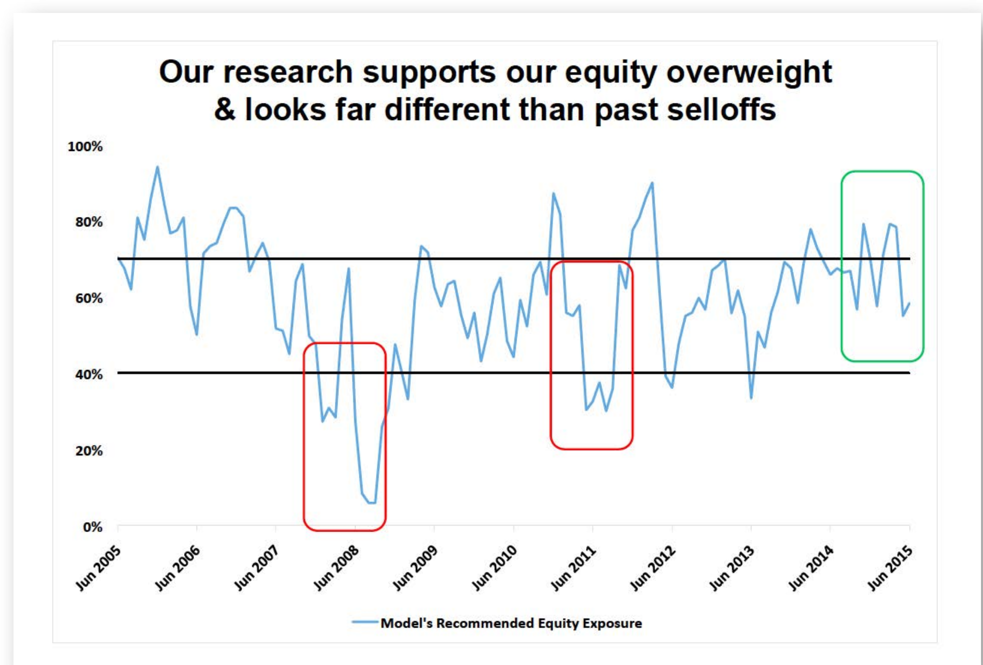
A Greek exit would be devastating for Greece, but the rest of the global economy can sustain such an event. The Greek economy would likely experience a deep recession as its banking system would fail. The pain of resetting the Greek economy would likely encourage other debt-laden countries to get more serious about austerity and debt reduction. The markets would have to price in a "Grexit", but the underlying strength of the global economy would mitigate these additional recessionary forces. For most investors, a portfolio analysis would show that exposure to Greece is likely very limited.

Since we don't own any Greek GDP futures contracts, we'll shift our focus to the portfolios we do manage.

Asset Allocation

Global equities eked out a 0.5% gain in the second quarter, bringing their 2015 return up to 3.0%. The global fixed income benchmark declined 1.2% thanks mainly to rising interest rates. However, the strong dollar continues to impact this benchmark. Alternative investments, as measured by the HFRX Absolute Return Index, returned 0.5% in the quarter and 2.2% for the calendar year.

We remain overweight equites and underweight fixed income, a tactical position we've held since the fall of 2013. Using these global benchmarks to assess this tactical move, equities have gained over 17% globally while fixed income around the world has returned just 7%. We've been asked about how much longer we'll hold this



position given the strong equity returns experienced. Our answer remains the same: We'll adjust our portfolios according to our evidenced-based investment process.

There are growing risks to our tactical position, but our conclusion still favors our current positioning. In our quarterly reports to clients, we show a chart that illustrates the risk of an imminent correction. The chart is based on a model we follow that tracks 10 data points on a daily basis, and its track record in signaling big corrections is good.

So rather than follow the news and the market volatility and guess if the next daily decline is the beginning of "the big one", we let the evidence inform our portfolio decisions. And when those market risks reach key levels, we have several moves lined up that will position our portfolios defensively and preserve capital until market conditions improve. The markets simply aren't at that point yet.

While our tactical positioning continues to add value, bottom line is also affected by security selection. Our equity exposure and our alternative investments both have a mix between active and passive strategies, while our fixed income is 100% active. When assesing active managers industrywide, studies show that about 75% fail to beat their benchmarks over time.

A long-term review of our active managers shows that 60% have exceeded their benchmarks since our initial purchase. Again, the industry studies show that 25% would be considered success, so in aggregate we are pleased with our manager selection.

A closer look reveals that two-thirds of our bond managers have exceeded their benchmarks. While only half of our active equity managers have outperformed, we have a heavy passive exposure that has delivered the benchmark return. Last but not least, 60% of our alternative managers have met or exceeded their respective benchmarks since our initial purchase.

Year-to-date, our active managers have been challenged by more volatile markets, and just under half have outpaced their benchmarks. More importantly, however, is that we remain long-term investors who are less concerned with short-term volatility. As we've written before, some of our active managers can lag over three, six, or even twelve months, and sometimes dramatically. But we believe that sticking with a complete investment process versus overreacting to noise will continue to deliver results for our clients' portfolios.

Fixed Income

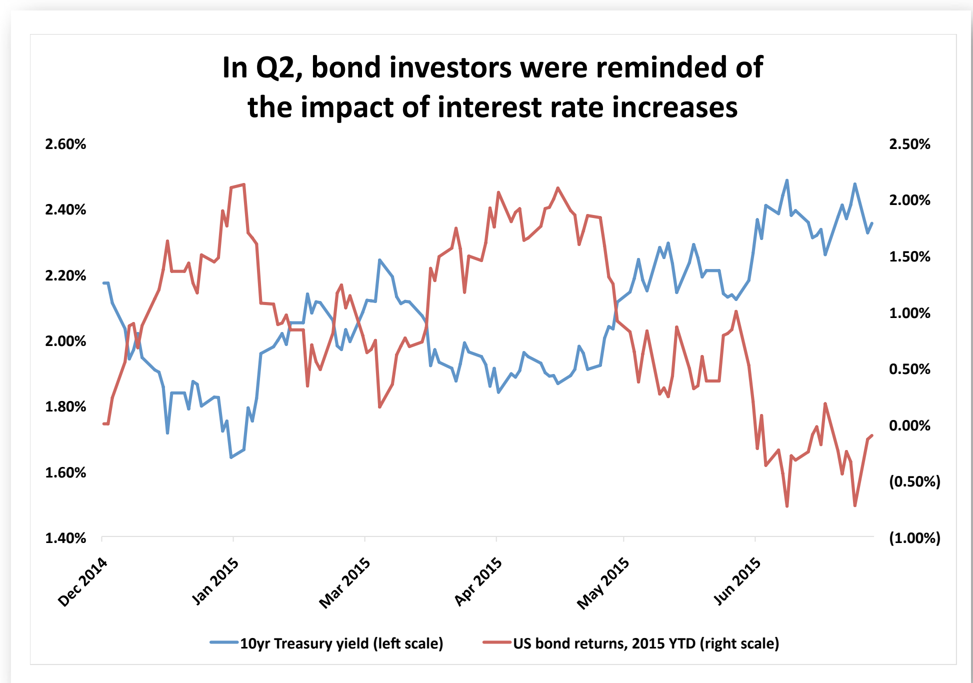
Higher interest rates took a toll on fixed income investments during the second quarter. While the Fed shed new light on the trajectory of short-term interest rate hikes, the 10-year Treasury yield rose from 1.9% to nearly 2.5% before ending the quarter at 2.4%.

As a result of higher rates during the quarter, bond returns faced meaningful headwinds. The Barclays U.S. Aggregate Index fell 1.7% during the quarter, erasing all of the year's gain. Municipal bonds ran a similar course, with their 0.9% loss bringing their 2015 return to just 0.1%.

Outside the U.S., developed market bonds had a 0.8% decline, while emerging market issues fared better returning 0.4% for the quarter. While the U.S. dollar chipped away at some of the non-U.S. bond performance, the real culprit was increased rates.

We would also note the increase in bond volatility during the quarter. This volatility wasn't entirely driven by interest rate movements, as one would expect. Instead, less liquidity in the bond market has caused some increased volatility. In the post-2008 environment, banks have come under heavy regulatory pressure. As such, they have reduced the inventory of bonds they hold on their trading desks. A smaller inventory means potentially wider spreads between what buyers and sellers want, hence more volatility.

We've preferred credit risk (i.e., lower quality bonds to get higher yields) over interest rate risk (longer maturity bonds to get higher yields) for several



years now, and the second quarter's performance highlights why. Three months ago, one could have purchased a longer-term, high quality Treasury or corporate bond yielding 1.9% or 2.5%, respectively. Or, one could have gone down in credit quality to earn 6.2% in a high yield corporate bond with a shorter maturity.

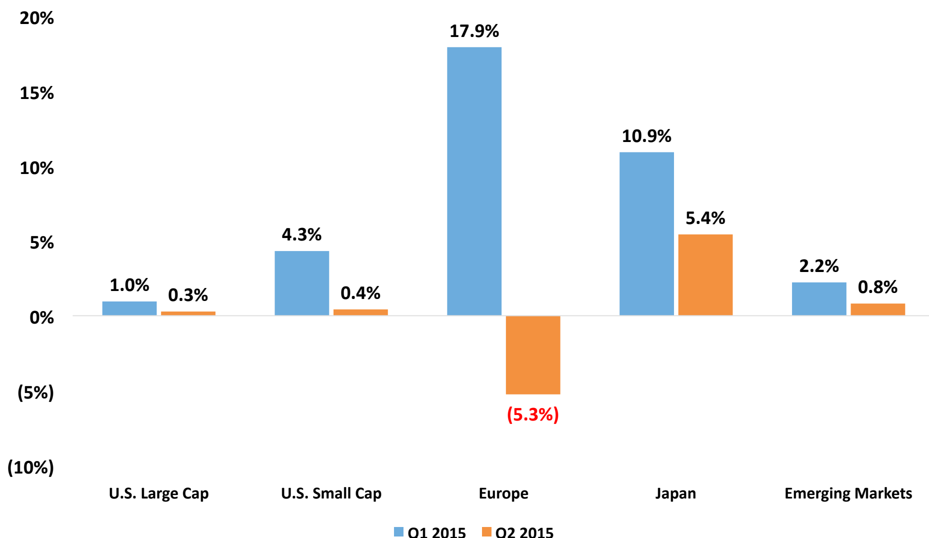
If the economy went into recession, a lower quality issuer would likely struggle, hence the credit risk one assumes. But, as our economy continued to grow and interest rates rose in the quarter, the supposedly safer Treasury and corporate bonds declined 4.4% and 5.0%, respectively, while the high yield corporate bond was flat. We continue to see a growing economy and a greater risk of higher (not lower) interest rates, and we've positioned our traditional bond exposure accordingly.

The speed of interest rate moves matters more than the level of interest rates, and this applies to both bonds & stocks. The market still doubts the Fed's short term interest rate assumptions, believing rates will stay lower longer. And we've already shown what happens to bonds when long term interest rates rise quickly. We'll close by adding an equity comment. While stocks can continue to gain while the 10yr Treasury yield climbs, the speed at which the yield climbs will be the bigger factor. And given the fact that it's starting from extremely low levels, this is a critical point.

History shows what happens to stocks when long term interest rates move up quickly. Our research dating back to 1969 shows the normal 6% equity returns when interest rate changes are within a normalized trend. But when rates move sharply higher, equities decline 3% annually. Our evidenced-based approach will provide signals when the interst rate environment deteriorates, and we'll adjust portfolios to protect capital accordingly.

Equities

After a strong start to the year, equity markets grinded their way higher in the second quarter. U.S. equities were led by large caps, which gained 1.2%, while small caps returned 0.9%. Non-U.S. equities, which were also affected by a stronger U.S. dollar, gained 1.7% in developed markets. Emerging market equities rose a mere 0.1% but are still up 2.2% for the year.



With all the drama in Europe over a possible Greek exit, it might surprise some readers to learn that European stocks are up nearly 12% in euros (5% in U.S. dollars) through June 30 and are one of the leading global markets. In fact, non-U.S. equities have outperformed U.S. stocks thus far in 2015.

In the U.S., equity returns have been robust the last 5 years, but we agree that an overdue correction is coming. Many experts liken the coming correction to what we experienced in the fall of 2011, when the S&P 500 fell 19.4% over 3 months. We would concur that a ~20% selloff is possible, but the macroeconomic backdrop is much stronger today. Let's examine more details between today's market and the 2011 market.

The technical indicators were flashing red lights 2 months before the 2011 peak. Fewer stocks were driving the major indices higher in 2011, and this breadth metric was consistent with negative stock market returns. Today, we have a much healthier market, with breadth readings indicative of normal stock market returns. Further, smaller stocks (more volatile) had already weakened before the 2011 selloff. Today, small cap stocks remain strong.

Investor sentiment has remained skeptical since 2011, resulting in stocks climbing the proverbial wall of worry. Should sentiment become too complacent towards risk, then the chance of a bigger correction would increase. However, sentiment today remains in a normal range, while some of our short-term sentiment readings have actually reached extreme pessimism (thank you, Greece).

Fundamentally, the picture is concerning when compared to 2011. Valuations are richer today than 4 years ago, while earnings growth is weaker. We believe fair value for the S&P 500 is almost 20%

lower than today's levels, which means the market has little room for error. As a reminder, the historical data show that valuations rarely trade at fair value and can extend above or below for many years at a time.

Without a reacceleration of earnings growth, though, the risk of a correction is fundamentally in place. First quarter earnings growth was a disappointing 5.6% drop from a year earlier. However, if we remove the impact of energy earnings, which plunged as oil fell, we find the rest of the Corporate America growing earnings at 8.5%. Energy is a meaningful part of the economy, but perhaps the health of earnings growth isn't as bad as commonly believed. If so, then a big correction would make equities even more attractive, in our view.

Alternatives

Bonds aren't the only investments affected by higher interest rates. Real estate investment trusts (REITs) and master limited partnerships (MLPs) fell 9.1% and 6.1%, respectively in the second quarter. Commodities, which we sold in 2014, gained 4.7% but are still in negative territory for the year and down 23.7% for the trailing 12 months.

When interest rates rise, all income-oriented investments are impacted in the short-term. Why? Because investors can get better yields from newly issued securities than existing ones … unless the existing securities can increase their income distributions. When it comes to bonds, investors usually count on a fixed coupon, hence, lower prices when rates rise.

But for income-oriented MLPs and REITs, rate-driven price declines can be short-term in nature. This is due to their underlying businesses (real estate properties, oil pipelines) that are growing revenue, profits, and ultimately the income distributed to investors. So, the short-term declines we've seen in both of these alternative investments are disappointing, but our research still points to better long-term results for both.

The interest rate move recently seen also highlights the bond alternatives we have in our client portfolios. While returns of traditional bonds fell nearly 2% during the quarter as rates rose, our alternative bond strategies as a group held their ground and preserved capital.

Conclusion

The investment environment in 2015 has gotten bumpy relative to recent years, but we believe investors will enjoy good returns in the years to come. It's a matter of when, not if, the market sells off, and it could be Greece, the 2016 election, shark attacks off the Eastern seaboard, or some other unforeseen catalyst. More important than why the market corrects is what we see thereafter. Our research shows no major risk of an economic recession on the horizon. Instead, we see the possibility of a short-term market correction (even as much as 20%) as the prelude to a longer term equity bull market. The greater the short-term pain, the greater the long-term gain.

We won't sit idly while the market heads lower, but we remind investors that doing nothing is doing something. As we've discussed the moves we can make to get defensive in a downturn, we also know that too many moves can be just as damaging to a portfolio's performance. Above all, any move we make will be a result of a thorough analysis, allowing the evidence to drive our conclusions. (For more on our evidence-based investment process, please see our white paper.)

We leave readers with two thoughts when assessing their recent performance. First, looking back at the last 114 years of investment market returns, we find that the median return for a balanced portfolio (60% stocks, 40% bonds) was 5.6% annually. There were obviously periods of stronger (i.e., 1990s) and weaker (i.e., 1970s) performance, but the data show that preventing short-term volatility from dominating one's investment decision-making will help avoid what's known as the Investor Behavior Penalty. Instead, sticking with a disciplined strategy to maximize the long-term performance puts the odds of success in your favor.

Second, and perhaps even more importantly, is that the ultimate assessment of one's investment performance isn't against a market index but rather one's own financial plan. Comparing active managers versus a benchmark is an important exercise, but it won't determine your financial success. The market doesn't care about you, so don't overly concern yourself with beating the market. Instead, integrate your investments into your plan and align your portfolio to deliver the required return without any excess risk.

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