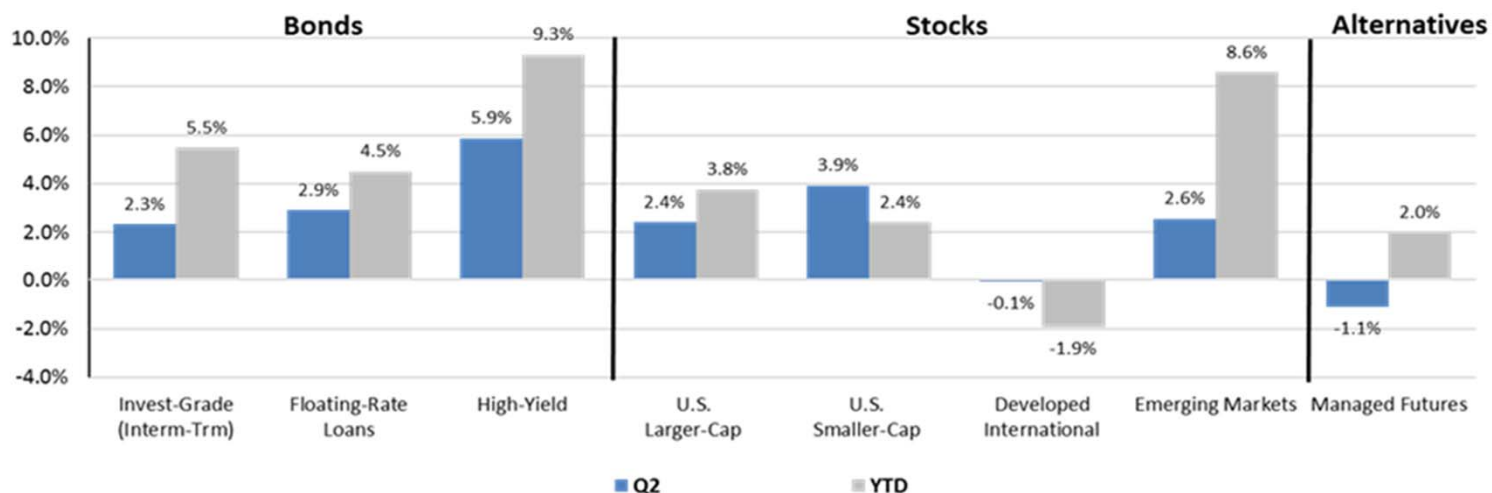


## Market Analysis / Second Quarter 2016



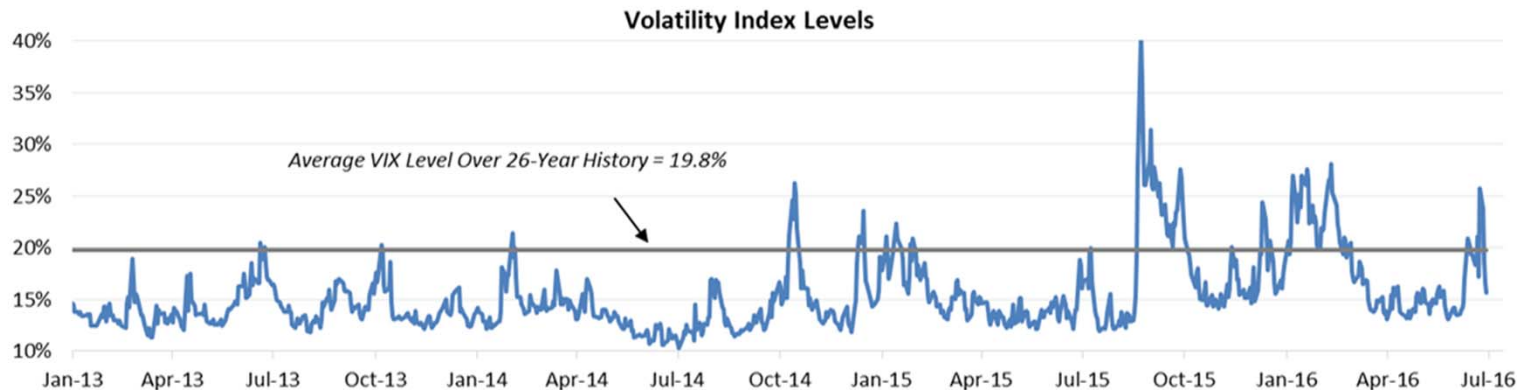
**INDEPENDENT WEALTH MANAGEMENT**

# Market Review



- Global stock markets were relatively calm for most of the quarter—until everything changed in June.
- Upending most forecasts and taking global financial markets by surprise, the United Kingdom voted to leave the European Union. In the wake of the vote, larger-cap U.S. stocks fell by almost 4% while developed international stocks declined roughly 8%. However, in the week following the Brexit vote, global markets rallied. When the quarter ended, developed international and European stocks remained in the red. U.S. stocks edged into positive territory, while emerging-markets stocks gained 2.6%.
- Another major trend during the quarter was the continued decline in yields on government bonds. By quarter-end, the amount of global government debt sporting negative yields had soared to an astonishing \$11 trillion. U.S. 10-year Treasuries ended the quarter with a yield of 1.48%, close to their historical lows, reached in July 2012.

# The Brexit Vote Marked the Latest Spike in An Increasingly More Volatile Global Equity Market



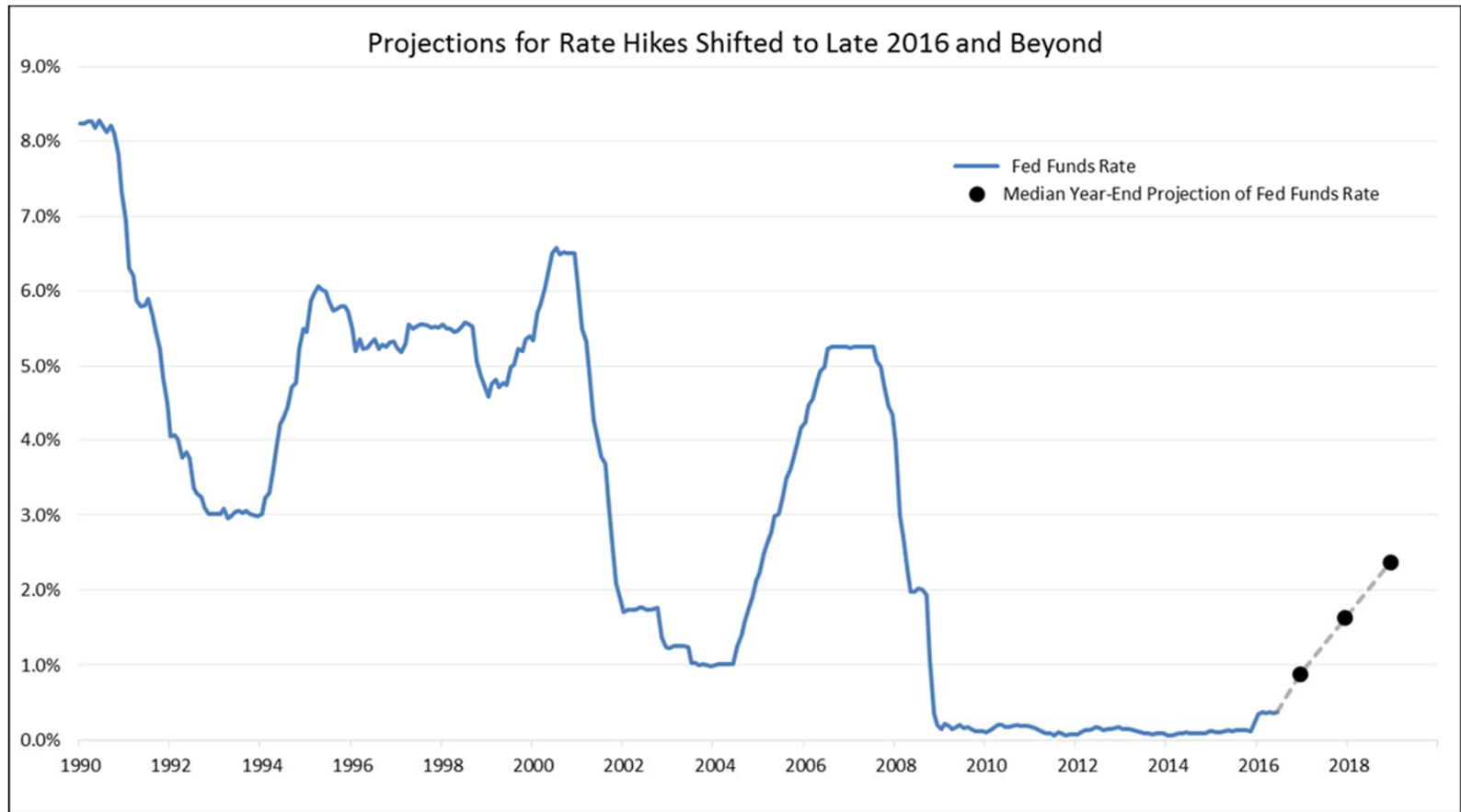
- The unexpected results of the Brexit vote resulted in a sharp spike in the VIX, a measure of stress in the equity markets, and triggered large selloffs in global equities.
- While the short and long-term implications of the vote are unknown, it is reasonable to expect an increase in overall stock market volatility as markets digest the impact on the eurozone economy and the financial markets in general.
- We don't believe this vote will materially impact companies' long-term cash flow generation, and we maintain high conviction in our Europe exposure. It is possible that increased volatility could provide us with an attractive buying opportunity.
- We have positioned our broadly diversified portfolios for resilience across a wide range of scenarios, including periods of increased volatility. While uncertainty and sharp reversals are inevitable but unpleasant aspects of investing, we emphasize that having the discipline to weather these storms and stay focused on the long-term drivers of investment performance—namely, valuations and long-term earnings expectations—is especially important at times like these.

# Asset Class Returns

Through – 6/30/2016 Past performance may not be indicative of future returns.

Asset Class	2nd Qtr. 2016	12 Months	5 Years (Ann.)
Russell 1000 Value iShare (Domestic Large-Cap Value)	4.47%	2.66%	11.12%
Russell 1000 Growth iShare (Domestic Larger-Cap Growth)	0.58%	2.82%	12.14%
Vanguard 500 Index (Domestic Larger-Cap Blend)	2.42%	3.84%	11.93%
Russell 2000 Value iShare (Domestic Smaller-Cap Value)	4.41%	-2.60%	8.04%
Russell 2000 Growth iShare (Domestic Smaller-Cap Growth)	3.45%	-10.49%	8.67%
Russell 2000 iShare (Domestic Smaller-Cap Blend)	3.93%	-6.56%	8.43%
Vanguard FTSE Developed Markets ETF (Foreign Stocks)	-0.07%	-8.22%	2.01%
Vanguard REIT Index (Real Estate Investment Trust)	6.77%	23.75%	12.29%
Merrill Lynch High Yield Master (High-Yield Bonds)	5.88%	1.71%	5.71%
Vanguard Total Bond Mrkt Index (Domestic Invest-Grade Bonds)	2.34%	6.02%	3.61%
Citigroup World Gov't Bond (Global Invest-Grade Bonds)	3.41%	11.26%	1.18%
Dow Jones-AIGCI (Commodity Futures)	12.78%	-13.32%	-10.62%
JP Morgan Emg Local Mrkt+ (Short-term Local Currency Emg Markets Bonds)	2.71%	1.99%	-2.23%

## Global Growth Worries Have Delayed the Fed's Plan to Raise Rates



# Investment Outlook

- **U.S. Equities: Risk**
    - Profit margins are near record highs and unsustainable
    - Stocks are pricey and historical outcomes from current valuation levels are not encouraging
  - **Rising interest rates: Risk**
    - Low returns expected for core bonds over the next five years
- 
- **International Equities: Opportunity**
    - Attractive stock valuations despite recent elevated uncertainty
    - Probability is high that market earnings growth will be higher than current depressed levels indicate
  - **Alternative strategies: Opportunity**
    - Risk-adjusted return potential in up and down equity and bond markets
    - Diversification and a source of return independent from traditional stock and bond markets

# Estimated Asset Class Returns

## Average Annual Returns Over Next Five Years

### Equity Asset Classes

	Bear Case	BASE CASE	Bull Case
US	-4.8%	4.0%	11.2%
Europe	-4.8%	14.5%	21.7%
Emerging Markets	0.6%	11.8%	18.7%
REITS	1.1%	2.9%	2.0%

### Fixed-Income Asset Classes

	Bear Case	BASE CASE	Bull Case
Investment Grade Bonds	1.6%	0.8%	-0.2%
High-Yield Bonds	1.7%	4.8%	3.9%
Floating-Rate Loans	6.7%	6.2%	6.5%
TIPS	0.6%	-0.4%	-2.4%

### Alternative Asset Classes

Alternative Strategies

Mid-single-digit returns in most scenarios

# S&P 500 5-Year Return Estimates Under Each Scenario

Potential Five-Year Avg. Annual Returns for S&P 500

	Bear	Base	Bull
GAAP Earnings	\$91	\$133	\$160
P/E	16x	17x	20x
Starting S&P 500 Level			
1400	4.1	13.8	21.6
1500	2.5	12.0	19.8
1600	1.0	10.4	18.1
1700	-0.3	8.9	16.5
1800	-1.6	7.6	15.0
1900	-2.7	6.3	13.7
2000	-3.8	5.1	12.4
2100	-4.9	4.0	11.2
2200	-5.8	2.9	10.1
2300	-6.7	1.9	9.0
2400	-7.6	1.0	8.0

**HOW THIS WORKS:**

If the S&P 500 were at 1900 today, and we factor in our estimate that earnings in our Base Case Scenario would reach \$133 over five years, and apply a 17x P/E multiple to those earnings, then add in dividends (which are not shown here), the annualized five-year return would be 6.3%.

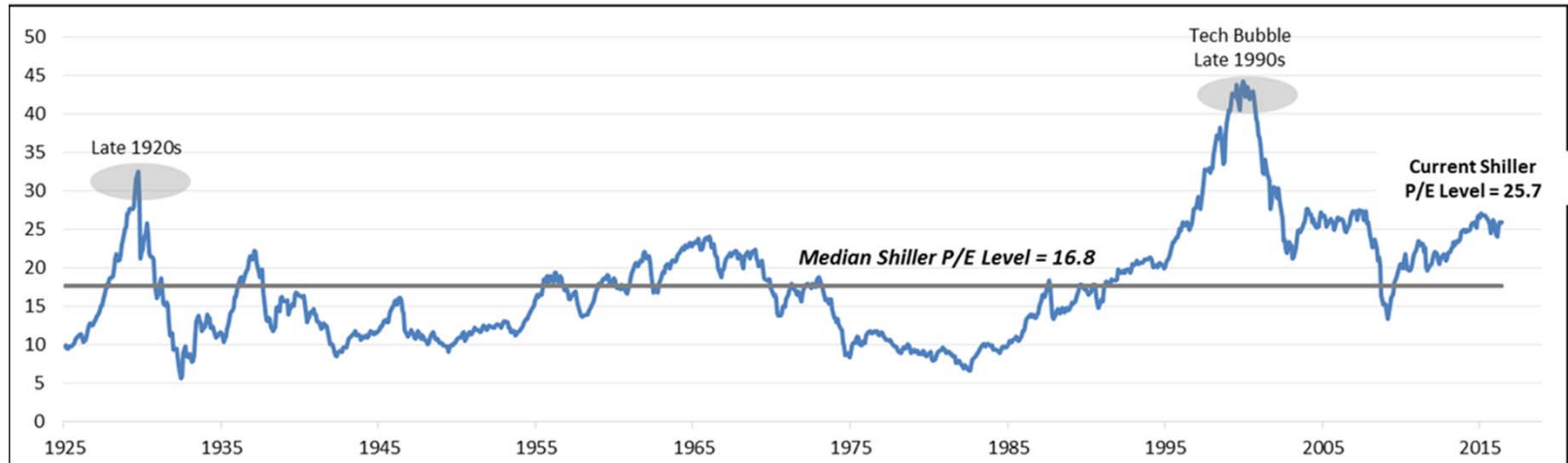


## Our Base Case Economic Scenario Continues to be a Moderate Economic Recovery

SCENARIO	DEFINITION
<i>Bull Case</i>	U.S. economic growth is above average and/or earnings end the period above the long-term trendline. Helped by stronger non-U.S. growth, releveraging of the U.S. consumer, and corporate investment spending, a self-reinforcing global growth cycle develops.
<i>Base Case</i>	Moderate economic recovery continues with no major crisis, but a normal recession is likely within the five-year time horizon. Assumes GDP growth rates and interest rates start to “normalize” toward the end of our five-year horizon.
<i>Bear Case</i>	The economy falls into recession for any of various reasons, such as deleveraging/deflation from Europe or China, unexpected systemic shock, Fed policy error, etc. This scenario does not assume another severe financial crisis, i.e., not a repeat of 2008-2009.

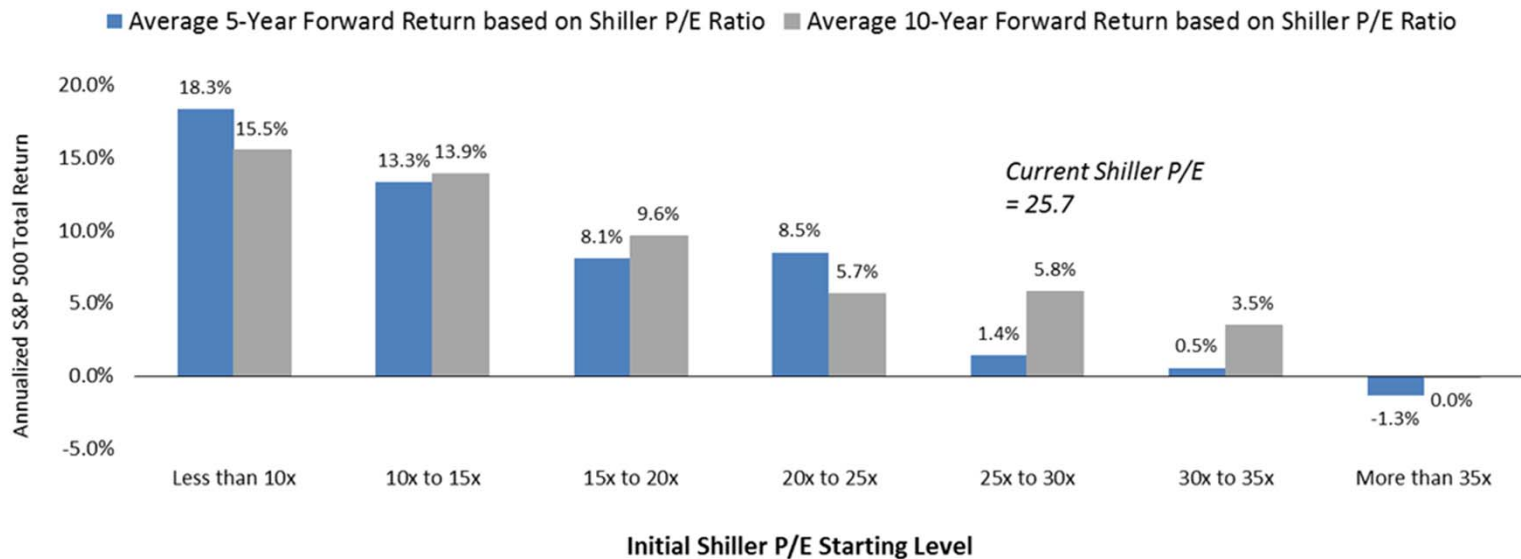
# Recent U.S. Stock Market Returns Have Been Driven Mostly by Valuation Multiple Expansion

Historical Valuation Multiple Expansion



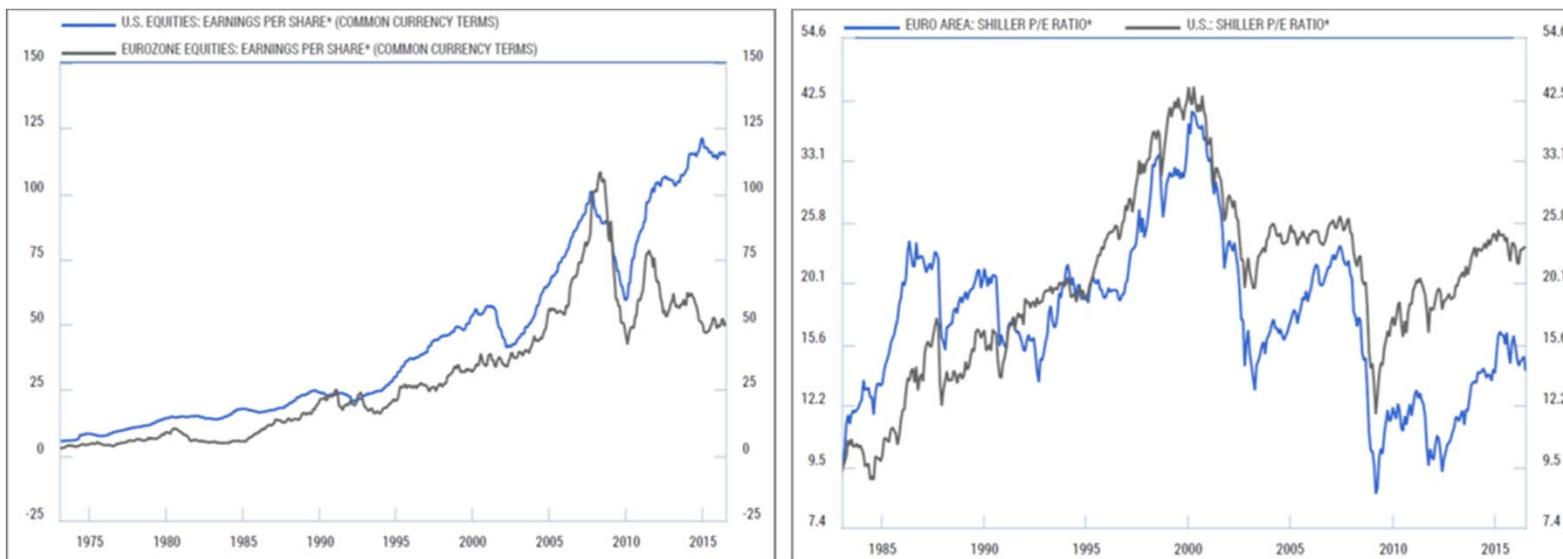
- In recent years, a significant majority of the S&P 500's return has come from P/E multiple expansion rather than actual earnings growth.
- For example, for the five years ending March 31, 2016, the S&P 500 gained 73%, but 46% points of that total return came from P/E expansion, while just 6% came from earnings growth and 11% from dividends.
- Expensive valuations for U.S. stocks imply lower future returns. While it is possible valuations could extend to significantly overvalued territory, we think the more likely outcome is for a reversal back toward their long-term averages.

# Expensive Valuations for U.S. Stocks Imply Lower Future Returns



- Starting stock market valuations (e.g., price-to-earnings multiples) have a historically strong inverse relationship to future market returns. That is, the higher the current valuation the lower the future return.
- When looking out over longer-term (five- to 10-year) periods and market cycles—a period over which we believe fundamentals ultimately are reflected in market prices—it becomes clear: valuation matters. Higher valuations mean lower yields, which lead to lower expected returns.
- Our current analysis suggests U.S. stocks are trading above their fair value range with expected returns in the low single digits (or worse), except in our most optimistic scenarios.

## Europe Remains Historically Attractive



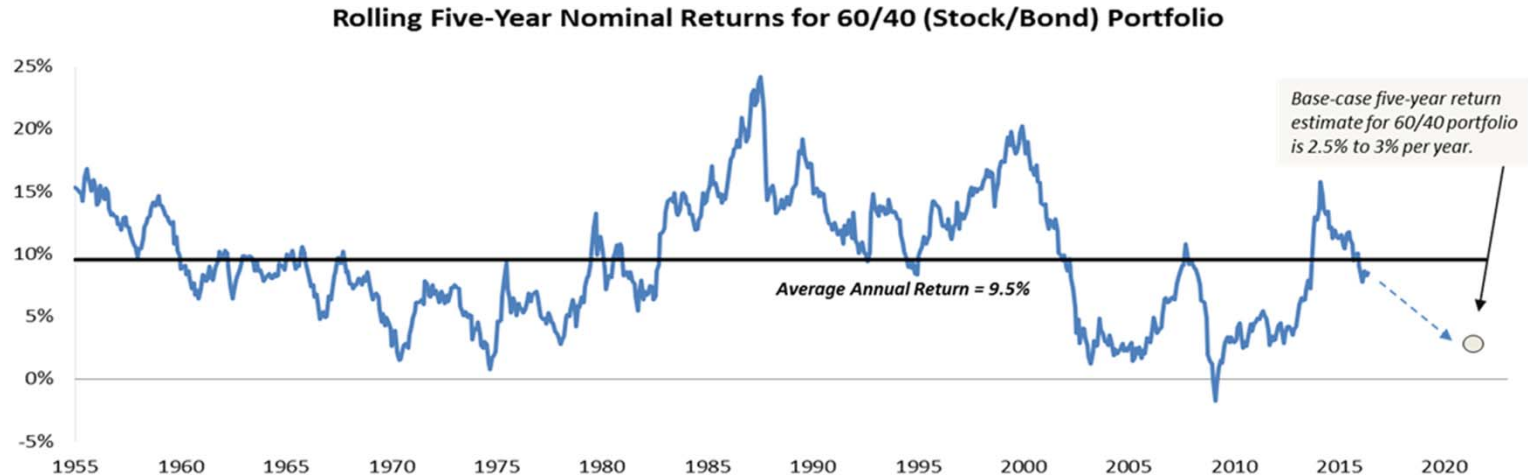
- Europe has gone through a crushing earnings recession, virtually unprecedented in the nearly 45-year history of the index.
- Market expectations for earnings growth over the next few years are depressed. However, our analysis suggests earnings growth will improve and be higher than what the market is expecting.
- While Brexit increases near-term uncertainty from a macro perspective, we believe it won't have a material impact on European companies' ability to do business and generate profits.
- For example, roughly 45% of Europe's revenue comes from outside the eurozone, where the International Monetary Fund expects economic growth next year to be much better (2.5% for the United States, 3.3% for other advanced economies, and 4.5% for emerging markets).

# Low or Negative Current Yields Imply Low Future Bond Returns

Government Bonds	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-1.13%	-1.10%	-1.07%	-1.05%	-0.98%	-0.91%	-0.84%	-0.70%	-0.61%	-0.55%	-0.31%	-0.18%	-0.04%
Japan	-0.33%	-0.30%	-0.29%	-0.30%	-0.30%	-0.31%	-0.31%	-0.30%	-0.28%	-0.22%	-0.11%	0.06%	0.08%
Germany	-0.62%	-0.66%	-0.66%	-0.63%	-0.56%	-0.53%	-0.44%	-0.37%	-0.25%	-0.11%	-0.05%	0.16%	0.43%
France	-0.54%	-0.52%	-0.45%	-0.40%	-0.31%	-0.25%	-0.15%	-0.04%	0.11%	0.24%	0.54%	0.79%	0.98%
Spain	-0.20%	-0.11%	-0.01%	0.13%	0.31%	0.38%	0.61%	0.98%	1.14%	1.31%	1.62%	2.02%	2.35%
Italy	-0.16%	-0.05%	0.05%	0.16%	0.38%	0.58%	0.77%	1.02%	1.22%	1.40%	1.67%	2.04%	2.40%
U.K.	0.24%	0.19%	0.25%	0.37%	0.45%	0.60%	0.74%	0.87%	0.86%	0.96%	1.51%	1.68%	1.80%
Canada	0.51%	0.50%	0.48%	0.54%	0.57%	0.69%	0.78%	0.87%	0.97%	1.08%		1.72%	1.73%
U.S.	0.44%	0.62%	0.72%		1.02%		1.28%			1.47%			2.28%

- The amount of global sovereign debt with negative yields has reached \$11 trillion, accounting for roughly 55% of total outstanding government debt in developed countries, while yields on U.S. Treasury's are near all-time lows. Low, let alone negative, current bond yields imply very low five-year expected returns for core bonds.
- While it is true core bonds can do well in risk-off market environments such as we've seen this year, eventually the "bond math" catches up to you. In other words, you can't escape the gravitational pull of the starting bond yield in determining your total return as an investor over longer-term periods.
- Across the range of economic scenarios we believe possible over the next five years, our range of expected returns for core bonds is limited to -0.2% to 1.6% annualized—largely a function of the very low current yield environment.

# Low Expected Returns for Traditional Asset Classes Increases Importance of Portfolio Diversifiers



- Since 1950, a traditional 60/40 portfolio (60% S&P 500 and 40% U.S. Core Bond Index) has generated an average annual return of 9.5% (over rolling five-year periods). However, we believe returns for U.S. stocks and bonds are likely to be lower going forward; therefore, the return potential of a traditional 60/40 portfolio is also lower. Our base case five-year return estimate for a 60/40 portfolio is 2.5% to 3% per year.
- **To compensate for lower expected returns for U.S. stocks and core bonds, we have invested in a diverse mix of asset classes that our analysis suggests has a more attractive return potential. These assets, along with exposure to U.S. stocks and core bonds, can be combined in a well-diversified, risk-managed portfolio with comparable risk to a traditional 60/40 portfolio, but with potential for a better five-year expected return.**



# Asset Class Descriptions

**Domestic Investment-Grade Bonds** (Barclays Capital U.S. Aggregate Bond Index): We are currently using the Vanguard Total Bond Market Index Fund to represent the Barclays Capital U.S. Aggregate Bond Index, an index of domestic investment grade bonds.

**Floating-Rate Loans** (S&P/LSTA Leveraged Loan Index): We are currently using the S&P/LSTA Leveraged Loan Index to represent an index of floating rate loans.

**High-Yield Bonds** (Merrill Lynch U.S. High Yield Master Cash Pay Index): We are currently using the Merrill Lynch U.S. High Yield Master Cash Pay Index to represent an index of domestic high yield bonds.

**Domestic Larger-Cap Stocks** (S&P 500 Index): We are currently using the Vanguard 500 Index Fund to represent the S&P 500, an index of primarily domestic larger-cap stocks.

**Domestic Smaller-Cap Stocks** (Russell 2000 Index): We are currently using the Russell 2000 Index iShares Exchange Traded Fund (ETF) to represent the Russell 2000, an index of primarily domestic smaller-cap stocks.

**International Developed-Market Stocks** (FTSE Developed ex North America Index): We are currently using the Vanguard FTSE Developed Markets Exchange Trade Fund (ETF) to represent an index of international developed-market stocks. Prior to May 2013, this Vanguard Exchange Traded Fund followed MSCI-EAFE. Prior to the July 2007 inception of Vanguard MSCI EAFE ETF, we use iShares MSCI EAFE Index from September 2001 to July 2007, and the MSCI EAFE Index adjusted for 0.35% expenses annually prior to September 2001.

**Emerging-Market Stocks** (FTSE Emerging Markets Index): We are currently using the Vanguard FTSE Emerging Markets Index Exchange Traded Fund (ETF) to represent an index of emerging market stocks. Prior to January 2013, this Vanguard Exchange Traded Fund followed the MSCI Emerging Markets Index. Prior to the March 2005 inception of Vanguard MSCI Emerging Markets ETF, we use iShares MSCI Emerging Markets Index from May 2003 to March 2005, and the MSCI Emerging Markets Index adjusted for 0.67% expenses annually prior to May 2003.

**Managed Futures:** We are currently using the Newedge Trend Index to represent an index of managed futures (trend following) strategies.

## Additional Disclosure

### **Disclosures:**

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