Chartwell Consulting

CHARTWELL REVIEW

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COMPLACENCY

"Summertime, and the investin' is easy! Stocks are jumpin', and the markets are high. Oh, the values are rich, and portfolios good-lookin'. So hush, little investor, don't you cry!" (apologies to George Gershwin and Dubose Heyward).

- Despite the unsettled political environment, stocks are having one of their quietest periods in history. The average daily swing in the S&P during the 2nd quarter was 0.3%, the lowest in more than 50 years;
- Since April 24th, the VIX index has closed above 12 only 3 days. It recently closed 5 days in a row below 10;
- Short rebates are slowly reappearing as the market's overall short interest has plummeted;
- The 1 year Sharpe Ratio (return per unit of risk) for the S&P 500 index is 2.50. The ten year average is 0.45;
- The S&P index has gone 1 year without a 5% correction – the previous longer period was in 1994-1996;
- S&P has gone the longest in 37 years without a down day over 3.5%;
- Over the past three years, the standard deviation of the annualized change in U.S. GDP – how it has tended to swing each quarter from its underlying trend – is 1.5%, which is as low as its ever been. The same trend is being matched elsewhere, with global GDP also exhibiting its lowest volatility in history.

The "sell in May and go away" contingent once again looked pretty smart through June, as May was filled with red ink in the domestic stock sectors and June was a weak month for bonds. But, if your mix favored international stocks, you're up over 4% since April, and rising.

Stock and bond markets have been in risk-on mode for most of 2017, and the 2nd quarter was no exception. And why not? The first quarter was the third straight blow out quarter for S&P 500 earnings growth, and the 2nd quarter is looking like a continuation of that trend. What could go wrong?

Figure 1: Index Benchmarks

Market Index	Trailing Returns *				
	2Q 17	1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	3.1	17.9	9.6	14.6	7.2
U.S. Top-cap Stocks	3.2	18.7	9.9	14.6	7.2
U.S. Mid-cap Stocks	2.7	16.5	7.7	14.7	7.7
U.S. Small-cap Stocks	2.5	24.6	7.4	13.7	6.9
Non-US Stocks (**EAFE**)	6.1	20.3	1.2	8.7	1.0
Non-US Stocks (**Emerg**)	6.3	23.8	1.1	4.0	1.9
3 mo. T-Bills	0.2	0.5	0.2	0.2	0.5
U.S. Aggregate Bonds	1.5	(0.3)	2.5	2.2	4.5
High Yield Bonds	2.1	12.8	4.5	6.9	7.5
Global Aggregate Bonds	2.6	(2.2)	(0.4)	0.8	3.7
Consumer Prices	*0.5*	*1.6*	*0.9*	*1.3*	*1.6*
Bloomberg Commodity	(3.0)	(6.5)	(14.8)	(9.3)	(6.5)
MSCI World REIT's	2.2	(2.5)	5.5	7.6	2.2

Figure 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	2Q 17	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	2.9	17.5	7.9	13.6	6.5
U.S. Mid-cap	1.9	18.0	6.2	13.4	6.7
U.S. Small-cap	1.5	21.4	6.4	13.4	6.5
International Lg. Cap	6.5	19.7	1.6	8.5	1.5
International Sm. Cap	7.9	20.5	4.3	11.9	3.7
Emerg. Mkt. Equity	5.8	19.8	0.8	4.3	1.8
Balanced/Hybrid	2.3	10.2	4.1	7.8	5.2
General Bond	1.5	0.8	2.3	2.5	4.8
High Yield Bond	1.8	10.7	3.3	5.8	6.4
Equity Hedge Funds	2.3	12.5	3.0	6.3	2.7

*Annualized trailing returns for periods ending 6/30/17.

Economies, Economics, Prices, and Policy

	6/2017	6/2016
CPI - headline, y-o-y	1.6%	1.0%
CPI - core, y-o-y	1.7%	2.2%
Real GDP Growth*	2.1%	1.6%
Employment (000's)	153,168	151,090
Employment / Population %	60.1%	59.6%

** 1Q17 vs. 1Q16, y-o-y*

The American economy continues to expand at a sluggish rate. Real GDP increased at an annual rate of 1.4% during the first quarter, compared to 2.1% during the 4th quarter and 1.6% for all of last year.

Personal spending contributed just over 50% of the quarter's growth (normally it's around 70%). Durable goods spending, especially on cars & trucks, declined. Business and residential fixed investment was robust, but was more than offset by very weak inventory growth. The latter shaved 1% off GDP, having added 1% last quarter.

Figure 3: Breaking Down Real U.S. GDP

	% Change from Preceding Period			
Factor	1Q '17*	4Q '16	3Q '16	2Q '16
Real GDP Growth	1.4	2.1	3.5	1.4
Nominal GDP Growth	3.4	4.2	5.0	3.7
Real Final Sales	2.6	1.1	3.0	2.6
Personal Spending	1.1	3.5	3.0	4.3
Private Investment	3.7	9.4	3.0	(7.9)
- Fixed, Businesses	10.4	0.9	1.4	1.0
- Fixed, Residential	*13.0*	*9.6*	*(4.1)*	*(7.7)*
*- Chg. In Inventories **($bn)***	*$3*	*$50*	*$7*	*($10)*
Export growth	7.0	(4.5)	10.0	1.8
Import growth	4.0	9.0	2.2	0.2
Government Spending	(0.9)	0.2	0.8	(1.7)

** BEA final estimate on 6.28.17*

Most economists expect GDP growth rose in the 2nd quarter compared to the first. The Blue Chip consensus forecast is for a 2.8% annualized growth rate, in a range of 2.3-3.2%. The Atlanta Fed has dropped its forecast sharply as the quarter passed, from 4.3% in early May to 2.5% by mid-July.

The pace of payroll jobs growth again weakened as we moved through the quarter. Ultimately 581k jobs were created, which compared quite favorably to 498k jobs in Q1. The household survey indicated a weak quarterly gain of just 168k jobs. Still, the unemployment rate fell to 4.4%, as some unemployed simply left the labor force.

The strong jobs market has inevitably led to a rise in wages, but not much. Average weekly earnings of private nonfarm employees increased just 2.8% during the past year through June, and +1.1% in real terms, despite payroll jobs growth over 2 million.

Price inflation continues to remain off the radar –

- ⇒ Before seasonal adjustments, **"headline" CPI** rose 0.5% during the 2nd quarter, and only 1.6% during the year ended June. This was increased from 1.0% the prior year.
- ⇒ **Core CPI** (*ex-food & energy*) rose just 0.3% during the second quarter, and +1.7% during the past year.
- ⇒ The headline **Producer Price Index** for final goods and services rose 0.7% during the latest quarter, and 2.0% the past year. The core PPI *ex-food & energy* advanced 2.0% the past year.
- ⇒ **Import** prices were flat in Q2 and rose only 1.5% during the twelve months, due to weak energy prices. **Export** prices declined slightly in the quarter, and have risen 1.5% during the past year.

Late in June, the ECB indicated it would be reviewing its active quantitative easing program in the fall, inferring that it may be approaching an end. Despite this guidance, actual base rates ex-US remain firmly fixed at extremely low levels (0.25% at BoE, 0.0% at the ECB, and -0.1% at the BoJ). In contrast, the Fed raised its Funds target again during the quarter, to a new range of 1.00-1.25%. The Fed also began floating the idea of beginning to very gradually shrink its balance sheet in the 4th quarter, by not re-investing maturing bond proceeds.

There was again little change on the fiscal policy front. Investor's hopes for implementation of a business friendly agenda in 2017 have clearly diminished, but many remain optimistic for a significant drop in business tax rates. With the average actual tax rate of the S&P 500 companies already at 26%, rate reductions will need to be robust in order to noticeably impact net profits. It's not clear how any reduction in business tax revenue would be made up.

The economy appeared to lose some momentum this quarter. Disappointing numbers were broad-based, as June/July reports on durable goods orders, employment, wage growth, commodity prices and retail sales all came in below prior estimates. Markets have also expressed skepticism regarding growth, as the U.S. Treasury curve has significantly flattened this year (see page 6). Normally an indicator of economic pessimism, the curve flattening has been driven by falling long-term bond yields as the Fed raises ("normalizes") its base rate.

As economic growth expectations have waned, so too has the Dollar's exchange value. The US Dollar index (DXY) fell by just over 2% in Q1. The weakness accelerated in Q2, with the Dollar down 5% versus major trading partners. It has declined another 2% in July. The Euro (57% of the index) has risen the most sharply, up almost 7% in Q2, and continuing to rise in July to $1.17, its highest level since August 2015. The Yen began 2017 at 117 to the USD, and traded as high as 108 in early Q2.

Gimme Some Credit

A perceived hawkish shift in tone from other major central banks spurred most developed market yields to rise modestly, even as longer-term rates actually fell in the U.S. Per Figure 4, it was a "better than the coupon" quarter for bond investors. Every primary bond sector posted positive total returns in excess of quarterly Y-T-M rates, as prices rose.

Short-term rates were most influenced by the Fed Fund's June rate hike, as the 3-month T-bill rose another 26bps. Two-year yields increased a modest 12bps for the same reason. The 3-month Treasury has risen by 75bps during the past year. The 2-year yield is up 80bps.

Notwithstanding a sharp selloff at the end of June, intermediate and long rates fell in the quarter, with the 10-Year ending the quarter slightly lower at 2.30%. The 30-year yield dropped 20bps. These rate declines led to a 4.0% return by the Treasury-Long index, which topped our performance charts.

Non-government sectors outperformed in the quarter, with the overall Aggregate Index ahead of Treasuries by 30 bps. Credit bonds led this advance, outperforming all other US sectors as credit spreads tightened –

- Investment grade credit outpaced similar maturity Treasuries by 100 bps, with corporates leading non-corporate credit. High yield corporates posted 146 bps of excess return versus Treasuries;
- Industrials outpaced financials, led by consumer non-cyclicals, communications, and transportation;
- Commodity price weakness and political tensions weighed on high yield bonds issued by metals and energy companies;
- Emerging credits were again strong performers. Dollar EM bonds returned a very solid 2.2% during Q2, while local currency EM bonds have taken advantage of the Dollar's weakness to post the top y-t-d return among bond sectors (+10.4%).

Structured products generally outpaced Treasuries on a duration-adjusted basis but trailed credit sectors. Non-agency MBS was one of the best performers in U.S. fixed income, supported by solid investor demand. Despite Treasury rate and spread volatility near all-time lows for most of Q2, agency MBS struggled versus Treasuries and ended up lagging on a duration-adjusted basis.

Global investment grade credit spreads tightened and yields declined in Q2. The sector returned +1.8%. Spreads were tighter overall given continued investor demand in a relatively stable global growth environment, low volatility and continued strength in equity markets.

Per Figures 5&6, during the past twelve months the developed country for which term interest rates have risen the most is the U.S. Looking back to late June '16, the flight to quality following the Brexit vote very likely resulted in a cycle low for domestic bond yields.

Figure 4: Primary Bond Sector Returns (%)

Index	2Q '17	1 Year	3 Years	5 Years
US Aggregate Bond index	1.5	(0.3)	2.5	2.3
US Gov't/Credit: (1-3yrs)	0.3	0.4	1.0	1.0
US Treasury: Long	**4.0**	(7.2)	5.6	2.8
US TIPS (1-10yrs)	(0.4)	(0.3)	0.4	0.3
Mortgage-Backed (MBS)	0.9	(0.1)	2.2	2.0
CMBS	1.4	0.0	2.7	3.3
Asset-Backed (ABS)	0.6	0.6	1.7	1.5
Inv. Grade US Credit	**2.4**	1.8	3.4	3.7
Leveraged Loans	0.9	6.2	3.9	4.9
US High Yield Credit	2.1	**12.8**	4.5	**6.9**
Municipal Bonds	2.0	(0.5)	3.3	3.3
Global Aggregate, ($ hdgd)	1.0	(0.4)	3.3	3.3
Global Credit, ($ hdgd)	1.8	3.9	3.9	4.8
Emerg. Mkts Bonds (US$)	2.2	6.0	**5.4**	5.7

Figure 5: Primary US$ Bond Yields

(YTW, % p.a.)	Jun-17	Mar-17	Dec-16	Jun-16	*1-Year Change*
US Treasuries					
3-month	1.02	0.76	0.50	0.26	*0.76*
2-year	1.38	1.26	1.20	0.59	*0.79*
5-year	1.88	1.93	1.92	0.71	*1.17*
10-year	2.30	2.39	2.43	1.49	*0.81*
30-year	2.84	3.02	3.05	2.31	*0.53*
BarCap Aggregate	2.55	2.61	2.61	1.91	*0.64*
BBB Credit	3.55	3.71	3.80	3.42	*0.13*
AA Credit	2.56	2.59	2.64	2.01	*0.55*
Agency MBS	2.87	2.91	2.85	2.07	*0.80*
Emerging Mkts ($)	5.37	5.46	5.79	5.37	*0.00*
US High Yield	5.68	5.85	6.17	7.27	*(1.59)*
UST30yr - UST2yr	1.46	1.76	1.85	1.72	*(0.26)*

Figure 6: Sovereign Bond Yields, selected countries

10-year yields (%)	Jun-17	Mar-17	Dec-16	Jun-16	*1-Year Change*
Switzerland	-0.07	-0.07	(0.15)	**(0.50)**	*0.43*
Japan	0.05	0.06	0.04	**(0.19)**	*0.24*
Germany	0.37	0.34	0.27	**(0.12)**	*0.49*
Britain	1.06	1.17	1.27	1.13	*(0.07)*
Spain	1.45	1.69	1.43	1.33	*0.12*
Italy	2.02	2.30	1.88	1.30	*0.72*
United States	2.30	2.40	2.43	1.49	*0.81*
Australia	2.46	2.73	2.79	1.99	*0.47*
Poland	3.29	3.54	3.71	2.93	*0.36*
China (5 year)	3.49	3.07	2.93	2.70	*0.79*
Greece (new bonds)	5.50	6.95	6.72	8.19	*(2.69)*
India	6.50	6.75	6.37	7.44	*(0.94)*
Russia	8.13	8.13	8.45	8.39	*(0.26)*
Brazil	10.01	9.85	11.31	12.15	*(2.14)*

And the Beat Goes On . . . . .

The broad equity trends that were in place at the close of the 1st quarter largely persisted through the 2nd quarter. Investors finally took the S&P 500 index past 2400 in mid-May, after more than a month of failed attempts. We then had to "endure" a one-day drop of 2%, followed by a virtually uninterrupted rise in the market value of the large cap sector through to mid-July. Returns weren't particularly high for the quarter, but they were consistent.

Very large-cap stocks (the Russell 200 index) posted a total return of 3.2% for the quarter, and are up 9.8% this year. But it really has been very large cap *growth* stocks that have attracted most of investor's money. That style index returned 4.8% in Q2, and has gained nearly 15% in 2017. By comparison, very large-cap value stocks returned just 1.3% and 4.4%, respectively.

Having underperformed by quite a wide margin already during the first quarter, small/mid-cap stock indices once again trailed in Q2. And, the weakness was most easily observable with value stocks. Small growth and midcap growth indices each returned over 4% in the second quarter, to nearly match large-growth. Small/mid value stocks returned less than 1.5%.

The one-year return numbers are not so heavily skewed toward growth, except with large-caps, but only because 2nd half returns last year favored value shares.

Figure 7: U.S. Equity Market - Size/Style Returns

		Trailing		
	2Q '17	1-yr	3-yrs	5-yrs
Growth				
Large Cap	4.8	21.6	12.4	15.8
Mid Cap	4.2	17.1	7.8	14.2
Small Cap	4.4	24.4	7.6	14.0
Value				
Large Cap	1.3	15.4	7.3	13.4
Mid Cap	1.4	15.9	7.5	15.1
Small Cap	0.7	24.9	7.0	13.4

In a real sense, this good year for the stock market would have been a lot less noteworthy if it hadn't been for the shares of Amazon, Apple, Alphabet (Google), Microsoft, and Facebook. Their combined market value has risen by over $500 billion since the start of the year. The entire S&P 500's gain is $1.7 trillion. Three stock sectors have posted double-digit gains this year: technology (Apple, Alphabet, Facebook, Microsoft), consumer discretionary (Amazon), and health care. Together these sectors account for 49% of the S&P's market cap, and for 68% of the S&P Growth market cap.

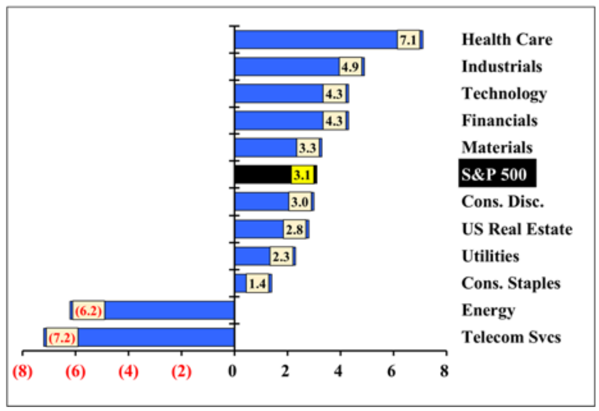
The performance differential across large-cap market sectors was just over 14%, as health care stocks returned 7% and telecom stocks lost 7%.

In small-cap space, the quarter's sector performance differential was a very large 29%. Small health care stocks rallied 9%, and small-cap energy stocks declined 20%. Small-cap energy stocks are largely exploration and production companies, the valuations of which rise and fall with the forward prices of oil and natural gas.

Of the total stock market's (Russell 3000) 3% return, the cap-weighted information technology and health care sectors accounted for 65% of it.

Performance contribution was starker in the value and growth indices. With the strong rally in June by the largest banks, financial services and health care stocks contributed 115% of the R3000 Value's 1.3% advance. In the growth space, info tech and health care stocks contributed 60% of the R3000 Growth's 4.7% return. Tech stocks now account for a very large 35% of the R3000 Growth's market cap.

Figure 8: US Sector Returns –2nd Quarter 2017



Per Figure 9, US stocks remain very pricey compared to recent history. At a 21.5x P/E, the S&P is trading at a nearly 50% premium to emerging markets equities, more than 40% above where it traded four years ago, and at its highest level since 2009. The P/E ratio for small growth stocks is 70% above where it was four years ago. Investors are absolutely paying up for the higher earnings we have finally seen the past three quarters.

Figure 9: One-year Trailing P/E Ratios – June 2017

	Value	Blend	Growth
US Large	18.5	21.5	24.7
US Mid	20.3	23.7	30.7
US Small	19.9	25.3	34.3
EAFE		18.1	
Emerg. Mkts		14.9	

International - Rebound, Recovery, or Routine?

The rally of global stocks continued into the second quarter as markets responded to a pick-up in global growth and solid corporate earnings. Globally, growth stocks continued to outpace their value counterparts. The US dollar weakened versus almost all developed market and non-commodity linked currencies, providing a tailwind for $-based investors. International equities outpaced US equities for the quarter and year to date.

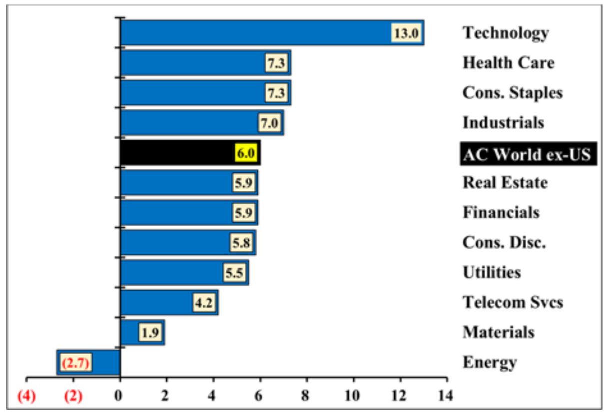
For the quarter, developed markets (MSCI EAFE) rose 6.1%. Emerging markets narrowly maintained their advantage with a 6.3% return. Canadian markets posted a strong month of June, as oil prices rose, but were still laggards for the quarter (+0.6%). The broad All-Country World ex-US index rose 5.8% in Q2. Strength was relatively broad-based, as all sectors participated in the advance, with the exception of the energy sector. Economically sensitive sectors (technology, industrials, health care) continued to be top performers.

Figure 10: International Equity Markets – Returns

	U.S. Dollar Returns (%)		Local Currency Returns (%)	
thru 6/30/17	2Q '17	1-Yr	2Q '17	1-Yr
World ex-USA	**5.6**	**19.5**	**2.3**	**21.2**
- MSCI Growth	*7.0*	*14.9*	*3.6*	*16.4*
- MSCI Value	*4.4*	*24.2*	*1.1*	*26.1*
- Europe ex-UK	8.4	24.4	2.2	21.6
- Pacific, ex-Japan	1.5	19.4	1.1	17.7
- Japan	5.2	19.2	6.1	30.5
- United Kingdom	4.7	13.4	0.8	16.7
Int'l Small Caps	**7.3**	**21.3**	**4.3**	**23.7**
Emerging Mkts	**6.3**	**23.8**	**6.6**	**21.8**
- EM Asia	*8.6*	*27.9*	*9.1*	*26.3*
- EM Europe	*2.4*	*18.6*	*1.7*	*15.5*
- EM Lat Amer	*(1.7)*	*15.0*	*(0.4)*	*16.7*
- EM BRIC	*4.7*	*25.4*	*5.7*	*24.4*

European stocks rose 7.4%, and are up 15.4% year to date. Investor sentiment was buoyed by the election of Emmanuel Macron in France; raising hopes of reforms in France and the assuaging concerns of the dissolution of the European Union. The euro staged a strong rally against the US dollar, rising 7%. Companies domiciled in the euro zone were among best performers, helped by evidence of economic improvement, easing inflation and lowered political risk. Smaller countries performed best in Q2, including Austria (21%), Denmark (15.3%), and Finland (13.4%). The French stock market jumped 9%, the Netherlands 7.8%, and Germany rose 6.4%. In the UK, a surprise general election resulted in no outright majority for any political party. The UK equity markets still advanced 4.7% during the quarter.

Figure 11: Ex-USA Sector Returns (2nd Qtr 2017)



In the Pacific region, Japanese equities posted a good quarter, rising 5.2%. The Japanese government upgraded its assessment of the economy for the first time this year, citing improved consumer spending and capital investment. Despite a downward revision in GDP (2.2% to 1%), it was the first time since 2006 that the economy expanded for five consecutive quarters. The yen weakened 1% versus the US dollar, providing support for exporters, particularly in the tech sector (Nintendo, Sony, Softbank, Tokyo Electron). In other parts of the region, Hong Kong posted the best quarter with an 8% return, as life insurance companies (AIA) and Macau-based casino operators traded higher. Australian equities were the only negative performers in the region, weighed down by large banks. YTD, the Australian dollar has strengthened by 6% versus the US dollar.

Emerging markets continued to rally, bolstered by a strengthening global economy, a weaker US dollar and solid growth from the technology sector. Asian emerging markets remained top performers, rising 8.6%, led by China (+10.6%), Korea (+10.2%) and Taiwan (+8.8%). Tech stocks led the way, as Samsung, Tencent, Alibaba and Taiwan Hon Hai Precision all rose 13%-31%.

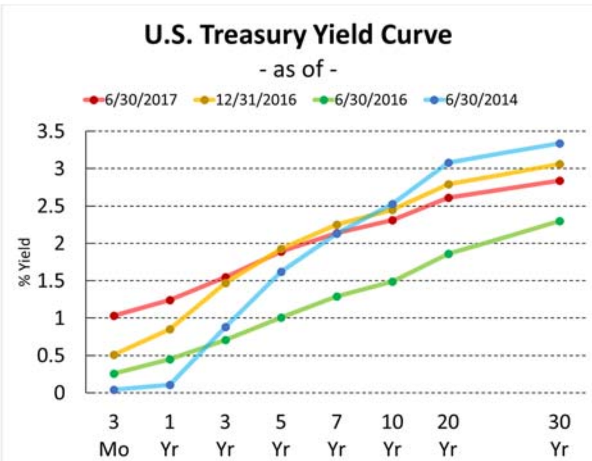
Latin America was the weakest emerging region, dropping -1.7%. Political turmoil once again rocked Brazilian markets (-6.7%), as President Michel Temer faces criminal indictment for encouraging political bribes. Companies in the financial and energy-related sectors fell most. Other countries in the region performed well – Mexico (+7.2%) extended gains for the year on hopes NAFTA is renegotiated amicably. The peso rose 4% versus the US Dollar and is up 14% this year.

Emerging Europe (2.4%) was held back by a weak Russia (-10%), which continues to be hampered by weak oil prices and the impact of economic sanctions. Smaller emerging European countries posted very strong quarterly results – Hungary (+19.4%), Poland (+13.6%) and Greece (+33.8%).

Back Page Perspectives – Asset Allocation

The U.S. yield curve has flattened this year as the Fed raised rates and unveiled a detailed plan to very gradually unwind its balance sheet. Declining inflation rates and economic growth expectations contributed to longer-term yields falling. Meanwhile, a perceived hawkish shift in tone from other major central banks spurred most developed market yields to rise even as rates (outside the front-end) actually fell in the U.S.

The 3mo/30yr yield curve is flatter by nearly 0.75% this year, as short rates rose and long rates declined. It has flattened by ***1.5%*** during the past three years.



Our View: We expect growth in the U.S. will continue to be lackluster in nominal and real terms. Despite the post-election optimism, it is increasingly difficult to envision a set of circumstances that could spur economic activity to meaningfully higher levels. The risk of recession has grown as even a modest disruption to the economy has the potential to push growth negative. 2% real and 4% nominal growth was considered dangerously close to "stall speed" as recently as two years ago. Now it is regarded as the "goldilocks" economy. Not buying it.

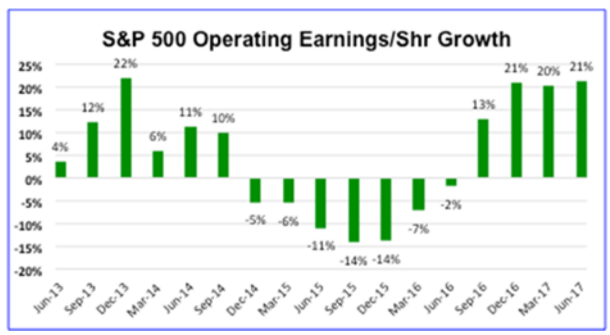
Our View: Asset valuations across markets are historically expensive, especially relative to growth prospects. As a result, investors aren't being adequately compensated for taking extra market risk at this late point in the cycle. The cycle will likely go longer still, but there are many potential catalysts that might trigger a painful deleveraging, including: higher interest rates, stress in the U.S. retail sector, challenges in European banks, a correction in Chinese currency or property markets, a stronger dollar, or a major geopolitical conflict.

Our View: We are increasingly concerned about the aging of the credit cycle and the potential for the record high leverage across both investment grade and high yield credit to unwind in a disorderly fashion. Credit spreads approach cyclically tight levels and the Fed is normalizing interest rates, which increases the risk of a painful deleveraging. A dovish Fed is critical at this stage.

We're recommending that investors keep short horizon assets, those which will be liquidated within three years, in safe houses, particularly when it comes to credit risk in both the investment grade and high yield sectors. Which is why Chartwell's base asset mix includes a 14% allocation to high credit quality and diversified domestic investment grade bonds. Clients with higher spending rates will want to raise that number.

Aggressive underwriting, an end-of-cycle phenomenon, was especially prevalent in the bank loan market this quarter. Compared to the cycle that ended in 2007, loan covenant protections were weaker across all categories according to Moody's. This concerns us, as bank loans have to-date been an excellent investment for those fearful of rate increases. A "watch this space" issue.

Our View: Like everyone, we think public market equity values, especially those of US stocks, are very high. Have they been higher? Yes, in 1999. We convinced ourselves then that growth was pre-ordained for a large group of stocks and bid them up accordingly. Value-biased portfolios, both large-cap and small-cap were de-selected, because their 10-year performance records were not good enough in relative terms. Sound familiar? This is the crux of why our base asset mix contains a 22% allocation to non-US equities, and a continuing allocation to value-biased portfolios. However with earnings growth once again evident, we also think it isn't likely that stock markets will decline very much, or for very long.



Our View: A large percentage of our recommended risk asset positions are in private market exposures. Private equity and direct real estate. To that we're adding private debt, which we see as increasing favorable as an alternative to public high yield bonds. Investments in these categories possess cumbersome structures and virtually no short or medium term liquidity. But for assets investors don't plan to touch for 10 years, we think they are a robust source of future growth.

Sell high, buy low. See you next quarter!

Natalka Bukalo
Richard Shaffer, CFA