CBIS

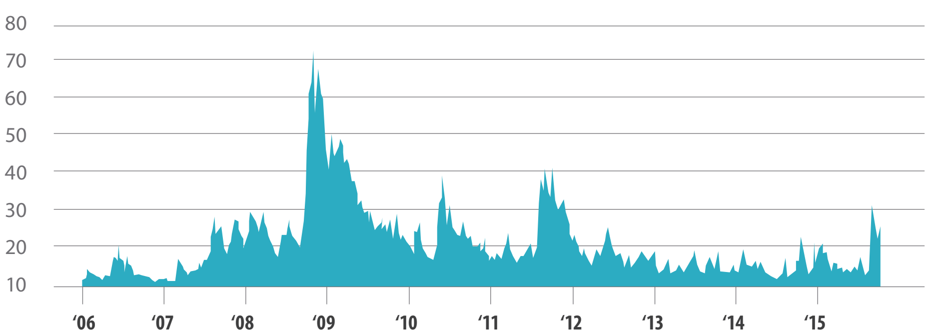
3Q 2015

Market Overview

EMBRACING VOLATILITY

Global markets posted their weakest quarterly performance in four years in the third quarter with spiking volatility. In hindsight, our second quarter letter was prophetic, with its Bracing for Volatility title and reference to evidence of market froth, although we will be the first to admit we did not expect the volatility to appear so soon. We've long said markets are due for a correction and one seemed, at the height of the August vacation season, to have finally arrived. In local currency terms, the MSCI All Country World ex-U.S. Index (ACWI ex-US), which contains developed and emerging market exposure, returned -9.5% for the quarter. The all-developed market MSCI EAFE Index returned -8.9%. Emerging market (EM) stocks were broadly weak on several concerns, including the impact of continued oil and commodity price weakness on export-dependent EM economies, and, worry over the impact of a stronger dollar on the countries' dollar-based debts, which have risen sharply in recent years. Brazil (facing recession and political scandal) was especially weak, off 33%, while the MSCI China Index was off about 22% (both in U.S. dollar terms).

CBOE VOLATILITY INDEX©



Source: Chicago Board Options Exchange

Market Summary

- Global markets posted their weakest quarterly performance in four years in Q3 with spiking volatility. The most widely cited trigger for the decline was China's August currency devaluation. A second was unease/confusion over the Fed's refusal to raise rates at its September FOMC meeting.
- Both events highlighted the more important and pervasive underlying concern — the persistence of weak global growth despite years of aggressive monetary stimulus from global central banks.
- Corporate earnings were flat to down in Q3, partly on energy sector weakness, but optimism still holds for 2016. Market gains going forward will likely demand evidence that global growth fears are overblown and earnings outlooks are stable.

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The US stock market was not immune to this volatility overseas, with the S&P 500 down -6.4% for the quarter bringing the last 12 months return to a modest -0.6% return. In the U.S. bond market, yields drifted down in Q3, partly in response to evidently slowing global growth and dormant inflation pressures. Credit spreads continued to widen, particularly for lower-rated debt. High-yield, in particular, underperformed for both Q3 and the trailing year, weighed down in part by the prominence of below-investment-grade energy company debt in high-yield indices.

CHINA AND THE FED

Probably the most widely cited trigger for the quarter's equity market weakness was China's August currency devaluation, which came on the heels of its internal equity market rout. (Its internal market, which is open only to domestic investors and is driven by heavily speculative flows, has fallen about 40% from a late 2014 high after surging over 100%.). A second trigger was unease/confusion over the Fed's refusal to raise rates at its September FOMC meeting, which was driven partly by concern over what the Fed termed "developments abroad." The International Monetary Fund in particular noted in its Global Financial Stability Report, released in early October, that Fed tightening poses a major risk to EM economies. Both events highlighted the more important and pervasive underlying concern — the persistence of weak global growth despite years of aggressive monetary stimulus from global central banks. The Fed's decision to maintain their zero interest rate policy would have likely been seen as bullish for stocks in recent years, as successive rounds of QE powered steady market gains. But, given the increasing worry over global growth, it was seen this time as a negative. The Fed confused matters further in a speech Fed Chair Janet Yellen gave a week after the Fed decided not to raise interest rates, when she laid out a rationale for why rates should increase: unemployment has fallen significantly and the benefit of falling energy prices and stronger dollar will subside in the inflation readings. However, in true Fed speak, she also stated she would like to see unemployment fall even further to jump start wage gains.

In terms of sectors, the quarter's worst performers within the ACWI ex-US Index were the economically sensitive materials (-21%) and energy (-20%). Oil slumped nearly 25% for the quarter in U.S. dollar terms, sinking to a new yearly low under $40 in late August before strengthening to the mid-$40s as the quarter closed. The industrials sector matched the broad index with a -12% return, supported in part by relative strength among scattered sub-industries, but the machinery industry within industrials was off more than 20%. Results were similar in the U.S. In the S&P 500, materials (-17%) and energy (-17%) were the weakest sectors. Industrials nearly matched the Index, returning -7%, but the sector was supported by airline industry strength. Airlines in the S&P 500 gained 7% on the fall in oil prices since fuel costs are a large component of airline operating costs. Within industrials, machinery (-18%) was weak; Caterpillar (-22% for the quarter) and Deere (-23%) were emblematic of global growth slump fears. Healthcare (-11%) also had a weak quarter. Pharmaceuticals and biotech shares saw pressure after Democratic presidential hopeful Hillary Clinton criticized the high price of U.S. drugs.

Global growth worries broadly encompassed global emerging markets, but China was the focus of analytical attention. China is the world's 2nd largest economy and weak economic reports there (e.g. industrial profits down -8.8% in August, -2.9% in July and -1.9% year-to-date through August, all versus year-ago levels), combined with its market rout, led to widespread questioning not only of whether it can effectively navigate the transition from an investment-driven to a more consumer-driven economy, but whether China's still buoyant broader economic data is believable.

The U.S. economy continued to outperform those of other developed markets. U.S. GDP in fact was revised upward to +3.9% in Q2 after a weaker +0.6% reading in Q1. Eurozone Q2 quarter-to-quarter growth slightly exceeded expectations, at +0.4%, despite widespread concerns that the Greek election drama early in the year and its attendant threat of a potential Greek exit from the Eurozone would kill the region's fragile economic progress. The region showed pockets of strength too; on an annualized basis, Ireland's Q2 GDP grew 7.3%, Spain's grew 3.1% and German's a more tepid 1.6%. However Italy and France saw continued sluggish performance, with annualized growth of 0.6% and 1.1%, respectively in Q2. The eurozone as a whole posted only 1.5% annualized growth in Q2. The U.K. grew a stronger 2.6% annualized for the quarter.

SLUGGISH EARNINGS PERSIST

As we highlighted last quarter, tepid global growth has translated into tepid earnings growth, although few economists (or the managers we speak with) see evidence that the U.S. is on the verge of a recession. According to Zacks Earnings Trends (October 8), Q2 S&P 500 earnings were down -2.1% year-to-year on -6.4% lower revenues. The energy sector was the primary reason. Excluding energy, total earnings for the S&P 500 index would have been up +5.1% in Q2 on +1.2% higher revenues. The trend isn't expected to improve much in Q3, with S&P 500 earnings expected down -5.7% from the same period last year on a comparable revenue decline. The headwinds from Q2 persisted into Q3 — a combination of energy sector weakness, dollar strength impinging on US exports and sluggish global growth. Excluding energy (where earnings are expected to be down -65.3% year-to-year), S&P 500 Q3 earnings would be up +1.4%, yet revenues would still be down -0.7%, with Zacks noting particular earnings weakness in basic materials companies, industrials and conglomerates – with all groups showing projected earnings declines of -15% to -20%. Q4 S&P 500 earnings are forecast to be down a similar -4.7% overall.

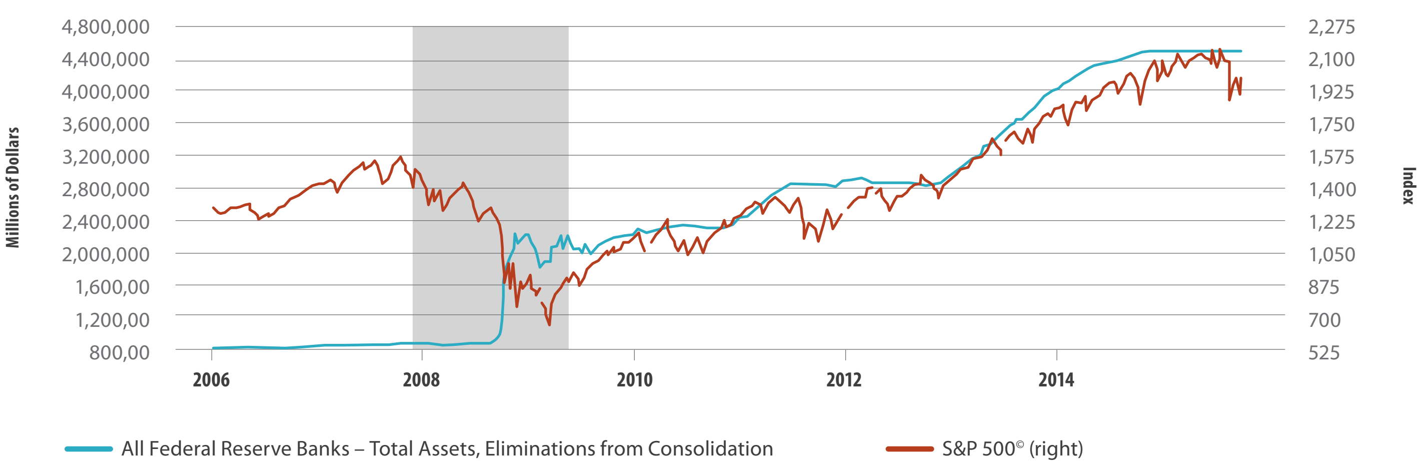
Stock analysts are an optimistic lot (as are Wall Street economists) and the earnings outlook for 2016 remains upbeat. Zacks pegs analysts' S&P 500 earnings outlook at +0.7% for Q1, +3.7% for Q2 and +11.9% for Q3 (as energy comparisons dramatically improve). Combined with dividend income, this sort of growth could certainly produce the high-single-digit broad equity market returns we've been suggesting is a reasonable scenario over the next year or so, and confirms the general views of the CBIS equity sub-advisers who closely track earnings outlooks. Moreover, equities could continue to benefit, as they have almost continually since the 2008/2009 financial crisis, from aggressive central bank support, particularly if the Fed continues to postpone any move to raise rates until well into 2016. But a persistence of weaker earnings growth and weak global growth could produce additional downside volatility.

FAITH IN CENTRAL BANKS

In fact, the impact of Federal Reserve QE on markets is hinted at in the accompanying charts.

The S&P 500 has pretty closely tracked expansion in the Fed's balance sheet since its aggressive market support began in 2009. It suggests a possible link between the end of QE, the flattening of Fed balance sheet growth and the flattening of market returns over the past year. And indeed, as Q4 commenced, market volatility turned to the upside when weak job numbers and commentary by Fed officials suggested

LIQUIDITY FUELED RALLY



Source: St. Louis Federal Reserve

any move to a tightening policy could be postponed well into next year. What was seen as cause for a market sell-off in mid-September became a spark for a rally in early October. Perhaps the dosage of prospective accommodation was the spark (market speculation included a prospective new round of QE) and dovish sentiment was notably increased. "Risk on" returned as Q4 began, despite the weak economic data. Investors were once again rewarded, as they have been so often in recent years, for buying the dip. While the ECB and the Bank of Japan are each embarked on aggressive balance sheet expansion, picking up slack from a dormant Fed, neither has the prominence of the Fed and Fed signaling (even more than economic or earnings data) continues to dominate both investor scrutiny and market moves.

THE VALUE/GROWTH DICHOTOMY

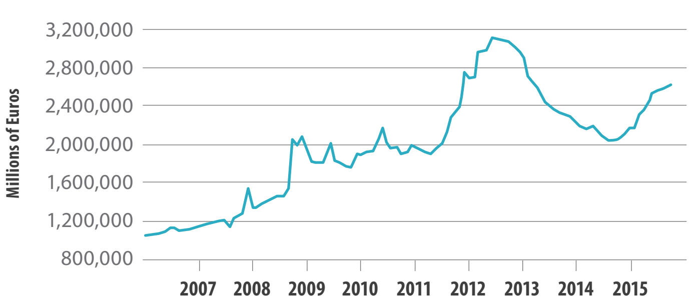
One of the equity markets' prominent trends over the past few years is the dominance of growth returns over those of value. Investors' search for earnings growth in a low-growth environment may be the equity market equivalent of investors' stretch for yield in a low global interest rate environment. In the trailing year at September 30, for example, the Russell 1000 Growth Index gained +3.2% versus the Russell 1000 Value Index's -4.4% return. Growth's outperformance persists, to a lesser degree, even to the trailing five-year period (at +14.4% versus +12.2%). Part of the explanation may be the industry/company compositions of the style indices. The very weak energy sector (down over 30% for the trailing year) is considerably overweighted in the Value index while the strong consumer discretionary sector (up +5% in Value and +13% in Growth) is far more dominant in the Growth index. The growth/value divergence is evident in the small-cap Russell 2000 as well. The small cap growth index outperformed value due to its relative energy underweight, strength among its consumer discretionary names, and strong performance by biotech, which gained 15% for the year even after the industry's Q3 slump.

But industry differences are not the whole story. Growth strength is evident across most sectors and industries. CBIS' quantitative sub-advisers have noted the strong performance of their growth-related factors, such as strong trailing and forecast earnings growth and price momentum, as another explanation for the strength of growth indices. They also note that reversals of investors' preference for growth can be swift and severe. CBIS encourages participants not to give up on value as an investing style. All market trends eventually come to an end. Value will once again have its day (as will international investing and emerging market exposure) and when it does it will affirm the worth of style diversification within a broadly diversified portfolio. Turning points in market trends are impossible predict in advance, but we can know with virtual certainty that they will occur and that a diversified, disciplined investor will benefit as a result.

EMBRACING VOLATILITY

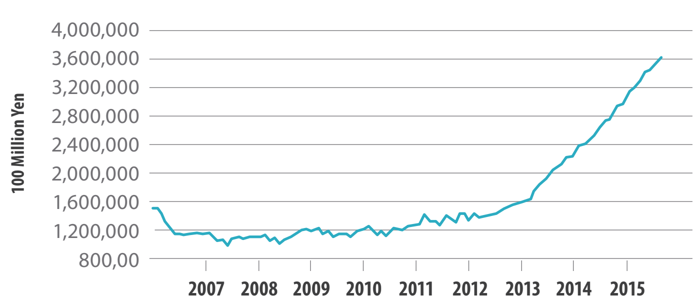
In both the Q1 and Q2 letters we remarked that market strength over the past few years has been driven in part by faith that central banks' zero short-term rates and easy money policies can stimulate economies enough to produce the earnings growth that supports further market gains. The market's rebound following the August/September weakness

CENTRAL BANK ASSETS FOR EURO AREA (11-19 COUNTRIES)©



Source: European Central Bank

BANK OF JAPAN: TOTAL ASSETS FOR JAPAN©



Source: Bank of Japan

only reinforces that thesis. The economic evidence did not change, but the perception that the Fed may be dovish for longer than was previously anticipated did change. And markets shot higher. But the tension between lack of tangible earnings growth and central bank support eventually has to be reconciled – and it will be in favor of hard evidence of earnings since earnings drive long-term stock returns. In the meantime, volatility is likely to persist as markets find their way to any eventual resolution. While we encouraged participants last quarter to brace for volatility, we would extend that advice this quarter to say they should embrace it. Downside volatility allows our sub-advisers to commit new capital at lower prices for better long-term returns. For the investor seeking long-term capital gains, particularly institutions with long-term investing goals, downside volatility can be a gift not a curse through disciplined rebalancing. Volatility is inevitable, although to be sure we've been though a stretch of quiet years on that front. As volatility returns to what we would argue are more normal levels, if investors can embrace it constructively, they can turn it into an advantage. We urge investors not to try and guess what will happen next, but rather prepare for whatever the markets may deliver and utilize disciplined rebalancing seek to turn volatility into a positive.

Market Summary continued

- Treasury bond yields drifted lower during Q3. U.S. inflation data remained subdued while renewed weakness in oil and global commodity prices and weak economic data from China (along with its August currency devaluation) were indicators of troubles in emerging market economies and signs of broadly slowing global growth.
- The Fed decided at its September FOMC meeting to postpone a rate increase, in part due to what it termed "developments abroad" and related risks to U.S. economic growth. Late in the quarter, disappointing employment data and comments by Fed officials suggested any rate increase could be postponed until well into 2016.