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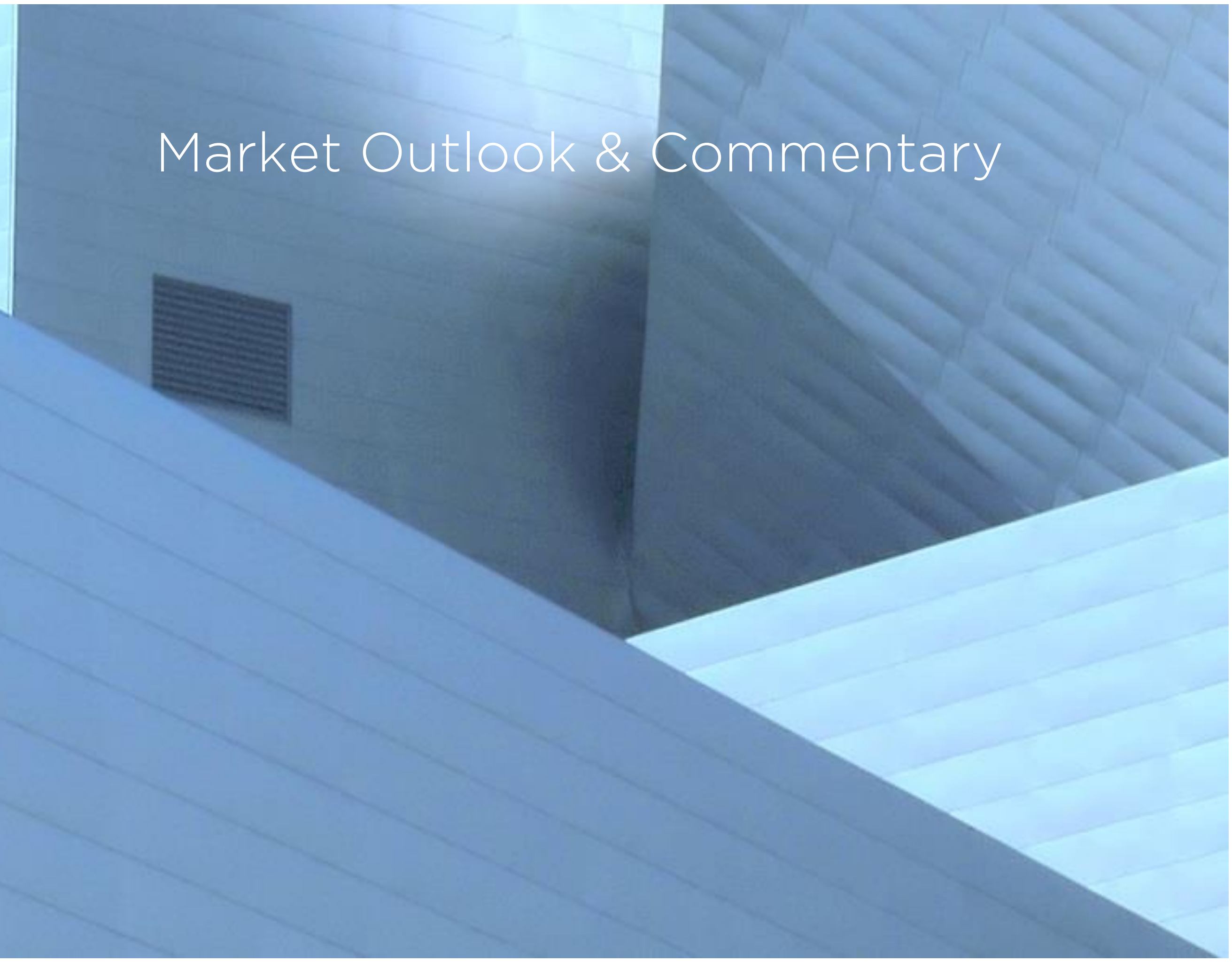
ASSET MANAGEMENT

Market Outlook & Commentary



3Q 2015

Equities Trends Stall as Macro Themes Dominate the Markets

One might be surprised by the narrow range of the S&P500 in the second quarter given the dramatic events in Greece, the market swoon in China, and the bond issues of Puerto Rico. Had the quarter finished just a week earlier, markets would have ended at the high mark, instead of at the very low. After the 2% drop on June 29th, the biggest one day decline for the year, the S&P500 returned just 0.3% for the quarter. In fact, there has never been another year in which the S&P has traded so close to the unchanged level this deep into the year. The gain for the entire year is the smallest first-half move in the history of the S&P.

Our view earlier in the year, that the U.S. economic slowdown in 1st Quarter of 2015 would not persist into the 2nd Quarter, proved correct. We maintain expectations for 3% GDP growth for the second half of 2015, and are still expecting the Fed to begin lift-off in September. Despite a tightening Fed, we are confident that macroeconomic and monetary conditions are still supportive of equity market gains. While U.S. equities will rely less on aggressive accommodative monetary policy to drive valuations higher, central banks in Japan and Europe should continue to push their stock markets higher.

Historically rich equity valuations, abnormally low interest rates, and volatile price moves in currency, energy, rates, and global equity markets make for difficult portfolio positioning. Market directions are subject to quick shifts without warning. Political decisions that are difficult to forecast can affect long-term risk allocations for multiple sectors. This market, more than ever, requires investors to be strategically allocated across the right regions and asset classes. As we review the second quarter and evaluate current market conditions, our key takeaways are:

- Despite historically high valuations and the situation in Greece, global equities, particularly Europe, offer superior return potential versus bonds.
- Equity returns in the U.S. will become more stock and sector specific as returns moderate.
- Bond market liquidity and the risk of higher rates are underestimated.

Investment Strategy Outlook

The first Fed rate hike should occur in September, and global interest rates should trend higher. Despite the crisis surrounding a bailout program for Greece, we expect European risk assets to outperform the U.S. sector.

During the second quarter, with little movement in equities, global bond markets and currency volatility took center stage, as 10-year German bond yields rose from just 0.05% to 1.06% between late April and mid-June. Similarly, U.S. interest rates, as measured by the 10-year Treasury bond, jumped more than 60 basis points over the same period to 2.4%. We were negative on bonds when rates were sub 2% on the 10-year, and despite the almost 50% increase in yields, expect the trend in higher rates to continue once markets stabilize.

After both the weather and West coast port related slowdown that occurred the first quarter, U.S. economic data continues to improve, although still at a slightly tepid pace. However, Data is strong, enough for the Fed to increase in rates in September, the first hike by the Fed in 11 years. If you remove the interruption of Fed tightening that occurred as a result of the Russian bond default in 1997 and 1998, there have only been two periods of initial Fed rate hikes over the past 20 years.

In equity markets, it has now been more than 43 months since the S&P500 suffered a decline of more than 10%. Many market forecasters are pointing to the performance of the stock market in 1994, when stocks fell more than 9% following the Fed tightening. In 2004, when the Fed raised rates, the S&P again fell, dropping more than 7%. With bonds, equities, and the U.S. dollar all at expensive levels, and the profit cycle far more advanced than in 1994 and 2004, should we be positioning for the long overdue equity market sell-off?

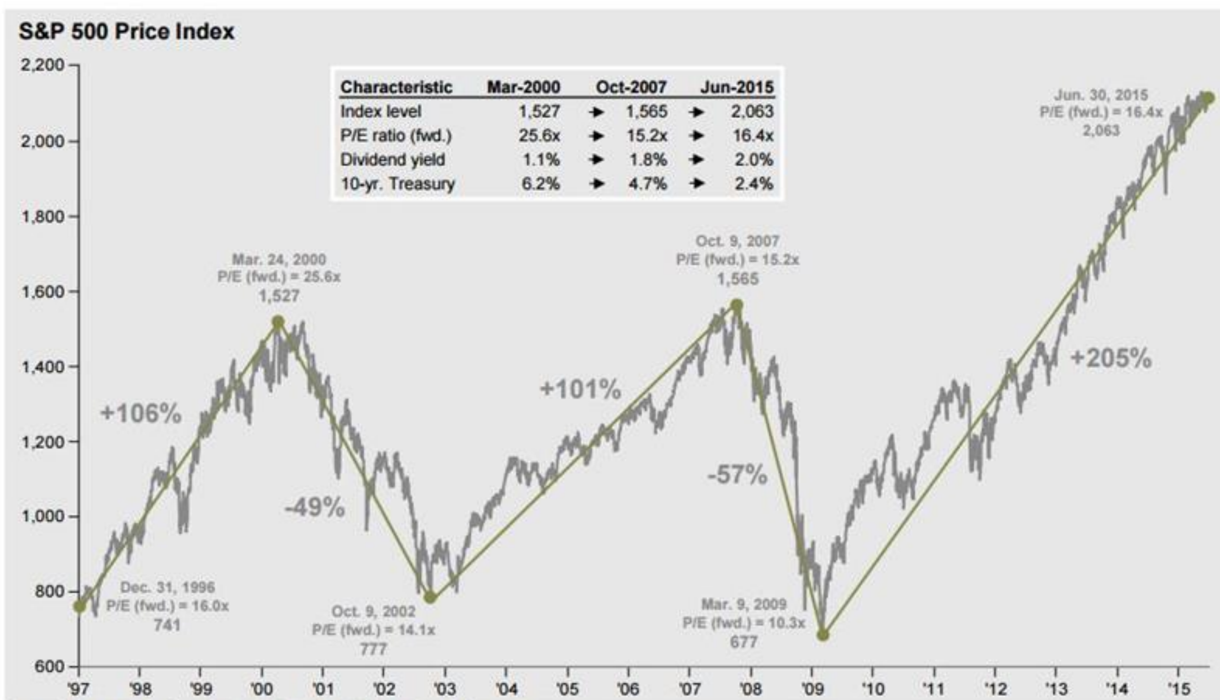
An argument could be made that unlike 1994 and 2004, this policy shift is highly anticipated; therefore, the impact on the U.S. equity market should be priced in. Our position is that any resulting market setback will likely be an inflection point, rather than a turning point. With the U.S. economy continuing to post moderate growth, Fed tightening is likely to cause volatility. But with the unlikelihood of a recession and excess capacity in labor markets and production, equity markets should remain buoyant.

Bond mutual funds, particularly credit sectors such as high yield corporates, have experienced significant inflows as the Fed drove rates to zero and investors extended their risk appetite for marginally higher yields. Our belief is these fund flows could unwind and provide further support to equity markets as investors seek to find sources of return.

Global Equities

When evaluating our exposure targets to equities, we look at two components: valuations and the business cycle.

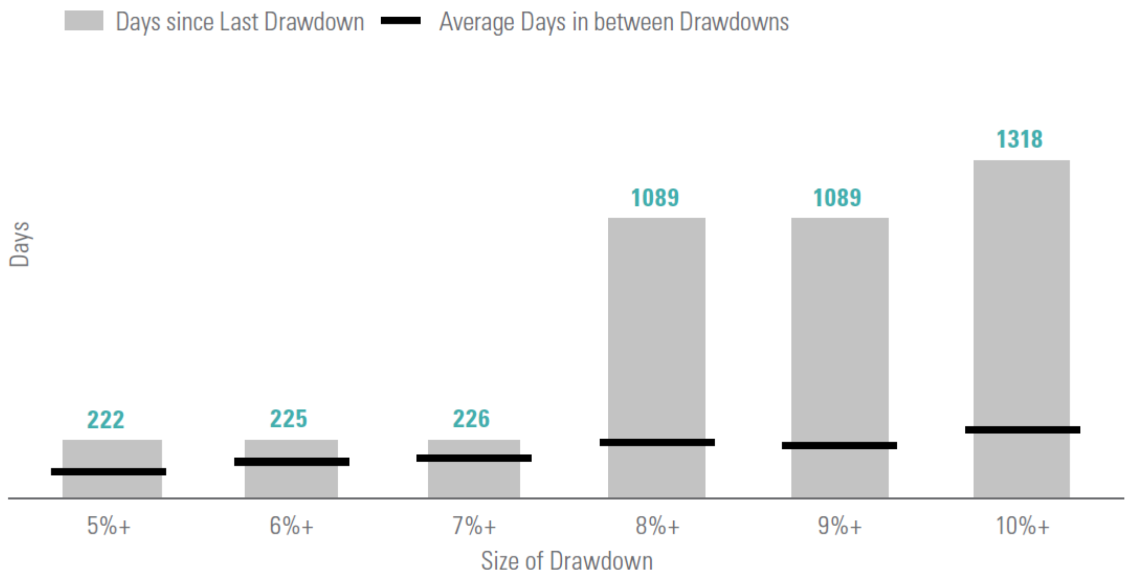
In terms of valuation, the U.S. market, as measured by the S&P500, is the most expensive market of the major global equity markets, trading at 16 times forward earnings. The energy sector is skewing the overall ratio with a 12-month forward ratio of currently 24.4 versus a 12.6 10-year average for that sector. Of the 10 industry sectors in the S&P500, 8 are trading at forward 12-month P/E ratios above their 10-year average. Only 2 sectors are below: Telecom (13.2 vs. 14.8) and despite the common refrain that we are in another tech bubble, Information Technology (15.6 vs. 15.7). In contrast, Germany is trading at approximately 13 times earnings, while riskier emerging market equities are at 12 times earnings. In comparing where the S&P500 previously reached inflection points in March of 2000, the P/E ratio hit 25.6; in October of 2007, the P/E ratio topped out at 15.2. Dividend yields are currently higher for the market, and bond rates are substantially lower for the current market.



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2015.

In terms of the business cycle, one needs to simply look at the continued growth in non-farm payrolls. Profits continue to grow at a moderate pace for U.S. corporations, with earnings beating forecasts. The housing market is showing positive momentum as millennials begin to establish new households, a significant source of a spending multiplier.

We continue to hear market pundits point to the chronologically overdue market sell-off and the length of the current bull market as a reason to be cautious. The lack of a major drawdown in the U.S. market is not without precedent (1991-1997 and 2003-2007), and we believe that a recovery from the financial crisis and distorted interest rate levels should result in an abnormally extended bull market.



Source: Bloomberg and GSAM.

In Japan, profits are also picking up, and given the likelihood of additional central bank stimulus, equity markets there should not experience significant headwinds. However, we are neutral on Japan long-term due to debt level concerns and long-term structural problems resulting from Japan's worsening demographic trends.

Despite the near term set back and confusion regarding resolving the Greek crisis, European markets look the most favorable. Economic data is showing improvement, and there are expectations for strong gains in earnings after a period of relatively slow growth. In emerging markets, falling commodity prices, a strong U.S. dollar and concern as to whether or not central planning can avert a China slowdown have led to lagging performance in that sector. While emerging markets look relatively expensive, we see the China market in bubble conditions and feel that the risk return profile is not favorable given continued dollar strength and the better visibility in the developed markets.

Equity market momentum remains slightly positive with market indices flirting with new highs. Even with the pull-back at the very end of Q2, markets appear to have an upward bias as they rally on the slightest signs of global stability. Until uncertainty surrounding the effects of a possible Greek exit from the Euro, and until the turmoil in the Chinese equity markets recedes, markets may remain short-term range bound.

We continue to position portfolios with a bias towards growth sectors of the S&P, specifically technology and healthcare, but we are still diversifying away from U.S. equities and the lower beta sectors of the market. We are using a mid-cap index for core U.S. market exposure as we expect a strong U.S. dollar to potentially dampen earnings in large cap stocks.

S&P500 Sector Performance, quarter and year to date

	Financials	Technology	Health Care	Industrials	Energy	Cons. Discr.	Cons. Staples	Telecom	Utilities	Materials	S&P 500 Index	
S&P Weight	16.6%	19.7%	14.2%	10.4%	8.4%	12.1%	9.8%	2.3%	3.2%	3.2%	100.0%	Weight
Russell Growth Weight	5.4%	27.0%	18.3%	11.1%	1.0%	21.0%	10.5%	1.8%	0.0%	3.9%	100.0%	
Russell Value Weight	29.6%	11.0%	11.8%	10.2%	14.2%	5.4%	6.7%	2.5%	5.7%	3.0%	100.0%	
QTD	1.7	0.2	2.8	-2.2	-1.9	1.9	-1.7	1.6	-5.8	-0.5	0.3	Return (%)
YTD	-0.4	0.8	9.6	-3.1	-4.7	6.8	-0.8	3.2	-10.7	0.5	1.2	
Since Market Peak (October 2007)	-19.9	80.0	139.6	47.7	11.4	130.5	110.6	26.3	37.5	34.1	55.9	
Since Market Low (March 2009)	337.1	277.1	286.3	306.0	104.1	433.5	195.4	141.3	140.7	219.5	248.5	
Beta to S&P 500	1.44	1.11	0.70	1.20	0.99	1.12	0.58	0.63	0.49	1.27	1.00	β
Correl. to Treas. Yields	0.42	0.30	-0.08	0.23	0.29	0.27	0.05	0.18	-0.53	0.31	0.27	ρ

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.
All calculations are cumulative total return, not annualized, including dividends for the stated period. Since Market Peak represents period 10/9/07 – 6/30/15. Since Market Low represents period 3/9/09 – 6/30/15. Correlation to Treasury yields are trailing 2-year monthly correlations between S&P 500 sector price returns and 10-year Treasury yield

Given our expectations for a Fed tightening cycle, we are also overweight financials which should benefit from the Fed eventually raising rates. We have also modeled an overweight exposure to energy given our expectations that the sector will rebound over the long term, but have so far remained mostly on the sidelines waiting for the demand and supply fundamentals to improve. Exposures to Russia and Norway ETFs are derivative energy plays; those positions have yet to be built out to their modeled exposures.

We are expressing our view that ECB quantitative easing will benefit risk assets by being long the German equity markets and broader European equity markets by investing in index ETFs, and that the effects of the turmoil in Greece will be temporary. We are taking a further step by also insulating our exposure to the Euro currency by using ETFs that hedge currency exposure. Currency hedged ETFs essentially express two bets. We expect positive returns from our view that the Euro is going to gravitate to parity, and that the ECB's aggressive monetary stimulus will lead to outsized returns in European equities.

Around our core positions in the U.S. and European markets, we are using satellite exposures in housing and cyber security. We have been bullish on new home construction and household formation due to housing being significantly under supplied. Furthermore, accelerating wage and job growth should be supportive to the sector.

Our exposure to the cyber security sector is a further increase in the technology sector for our portfolios. Corporations and governments continue to ramp up budgets to protect against cybercrime as companies focusing on software, hardware, and services attempt to prevent attacks on network infrastructure. We chose a diversified ETF composed of 31 companies to gain diversified exposure to a sector where market leaders are still emerging.

Conclusion: Given valuations in the U.S., we expect moderate single digit returns from the S&P500 once uncertainty regarding the situation in Greece is resolved, yet higher beta sectors such as technology, healthcare, and financials will outperform the broader market. While conditions should remain favorable for Japanese equity markets, we like the tailwind that ECB stimulus provides to European risk assets, particularly German equity markets.

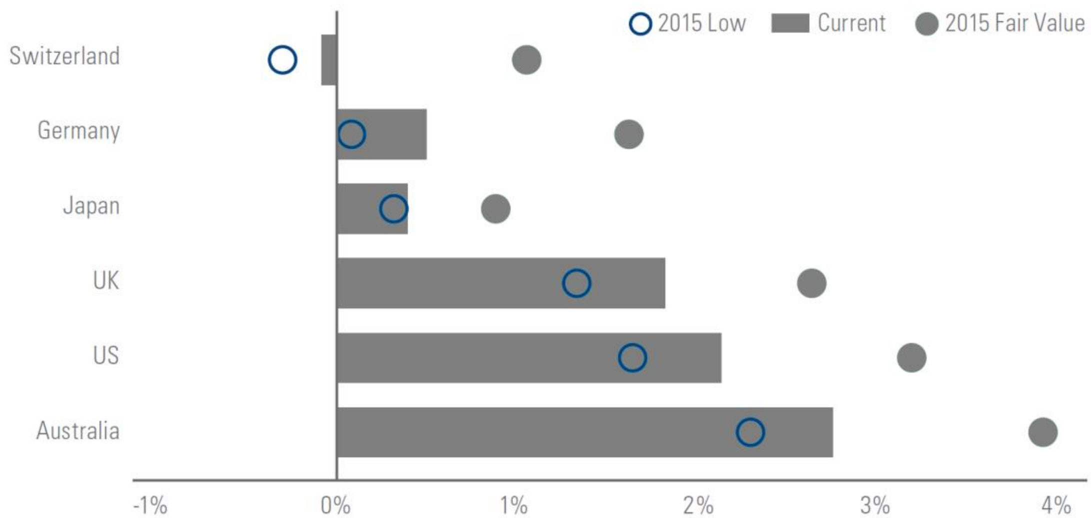
Short term, the uncertainty caused by the inability to reach resolution to a Greek bailout program is negatively affecting our exposures to these markets. Our belief, however, is that any effects will be transitory, and markets will aggressively move back to "risk-on", resulting in significant positive performance. Greece is too small to matter economically and Greek debt is now mainly in public hands. Contagion risk is limited, and the ECB is providing a strong quantitative easing safety net. We continue to search for satellite strategies and sectors to complement our broader market exposures and have positioned portfolios to benefit from the continued recovery in housing, and the focus on internet security infrastructure.

The market in China appears to be in the midst of a bubble, although at the end of the quarter, cracks began to appear in the best performing global equity market for 2015. Market valuations are high, especially in the U.S., and corporate earnings are stable and trending higher; however, with bond yields providing little up-side, there are few options for alternate sources of return.

Global Bonds

Global sovereign bond yields continue to remain below fair value, however improving US and European data is driving rates higher. Given the status of the current business cycle and inflation, bond yields are at levels that are at least 1% lower than what we would consider levels to be fair value. Janet Yellen has made it clear that the Fed would rather err with keeping rates too low for too long than to risk terminating a recovery from crisis levels. Despite evidence that rates at zero are actually impeding growth momentum, the dovish but data dependent Fed has implied that economic data should be more than sufficiently robust for "lift-off" from zero.

Fair Value, 2015 low levels and Current levels of Global Sovereign Debt

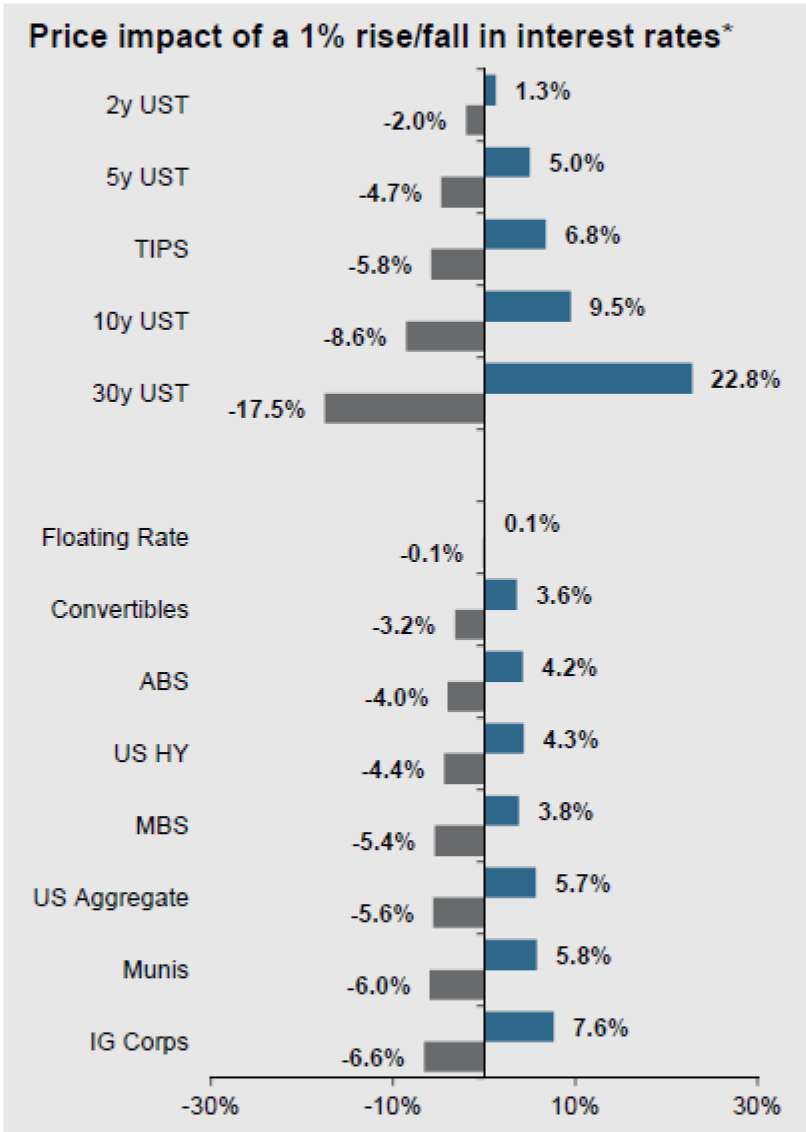


Source: Bloomberg, Goldman Sachs Global Investment Research, and GSAM.

Bond market volatility, which was declining through most of 2014, has suddenly seen resurgence (despite the lack of volatility in stocks). Market participants are pointing to Dodd-Frank regulations which have effectively neutered the liquidity providers on the trading desks of Wall Street. Comments from Bill Gross and Jeff Gundlach, two well-known bond managers, suggest that the German bond market looked like a "short of a lifetime" spiking yields significantly higher as a technical sell-off ensued, resulting in pull-backs in the broader financial markets. Quantitative easing from the ECB should benefit holders off European sovereign bonds, but we think that the better trade is being long European equities. Quantitative easing in the U.S. has provided a well-lit road map to the effects on equity risk assets; we believe that positioning portfolios with exposure to European equities has significantly more upside than being long European bonds.

From a valuation perspective, we consider bonds expensive and are limiting any exposure to short floating rate securities or fixed rate bonds with durations under three years. In terms of business cycle, while the fund flows from the ECB should support bond levels, economic data supports our view that economic growth will gain momentum and the Fed will eventually be seen as behind the curve.

We have been reminding our clients of the substantial impact that a rise of just 1% in interest rates could affect bond portfolio performance, illustrated in the table below. For example, for a 10 year municipal bond, the price could drop more than 6.0, effectively wiping out almost a third of the yield from the coupon over the life of the security.



Source: Barclays Capital, FactSet, U.S. Treasury, JP Morgan Asset Management. Sectors shown above are provided by Barclays Capital. For detailed information on the sectors shown, please contact Fortis Asset Management, Inc.

Conclusion: We are limiting exposure to short duration bonds, or cash. We believe that the bailout crisis in Greece will resolve itself for better or worse, or, at a minimum, just fade from the headlines due to investor fatigue. Global rates, especially U.S. rates should trend higher, with Eurozone bonds being the most attractive given the recent technical sell-off.

Strategy Commentary

Prior to joining Fortis Asset Management, my experience was on the institutional side of investment management. I worked with financial institutions managing fixed income portfolios, and with equity fund managers, performing sector research and managing portfolio trading and risk exposures. I also constructed multi-manager portfolios in hedge funds across various asset classes for institutional investors, and most recently for a family office managing a distressed credit portfolio as the sole portfolio manager and trader. Working with an endowment or a foundation is not too different from a family office or super high-net worth investor. Time horizons are extended, and volatility tolerances are somewhat wider, but the goal is always the same: produce the greatest return with the lowest volatility, and do it with favorable liquidity and low fees.

Over the past few months since joining Fortis and reviewing legacy client portfolios, I have discovered a difference between institutional and individual investors that seems to be a common theme. Individual investors not only diversify their investments, but their accounts and their advisors.

Sometimes the advisor diversification is inadvertent or unplanned. The investor had a 401k or an IRA that has been part of some other plan under some other advisory umbrella, and their taxable investments are held in another account at another advisor. Another reason might be that a client started an investment portfolio at one advisor, but then decided to use another advisor for new investments. While maybe it makes sense to bucket portfolios because an investor is taking a "needs and goals" bucket based approach, but I have yet to see that as the reason. Another possible reason is that an investor simply wants to see which manager is better, so it becomes a contest between the two. But unless a careful and rigorous performance attribution study is done and a time period is used that creates a sufficient sample size, it may be difficult to determine the "winner". Finally, an investor may have never made the conscious decision to consolidate their wealth in a way to make it easier to analyze and evaluate. More often than not, it is just because one account was opened somewhere, and then another account was opened somewhere else, and they were just left that way.

From an efficiency and risk perspective, it leads to unintended consequences. It is possible that an investor may end up with concentrated risk exposures. For example; you self-direct an IRA account and you buy a growth fund that has a high overweight to momentum tech stocks. For your taxable accounts, an advisor you work with decides to select an outside manager with the same view point. None of this is usually a problem, until of course it is, with the 2000's tech bubble providing a recent example. How many investors held too much WorldCom, Cisco, Enron, Global Crossing, or Intel? Investors were shocked to discover that their diversified mutual fund holdings not only had excessive concentrations in technology stocks, but the very same large-cap momentum technology stocks.

In contrast, what I am actually finding in investor portfolios are active investment management decisions that become passive because of over-diversification. For example, I recently reviewed an account that had over 25 different mutual funds.

Some were sector specific funds, and some were broad based strategy funds, such as large cap growth, or international or emerging markets. The portfolio essentially had one of everything. I did not have to perform the analysis to know that the tracking error to the "market" (or how closely a portfolio follows the index) was close to zero when you back out the fees. These portfolios could probably be reset to two or three simple line items, leading to a performance pick up of greater than 2% because of active management trading costs, and management fees. Maybe statement confusion is a strategy for some advisors, but I struggle with that excuse.

Why do portfolios that begin as actively managed become essentially a passive index portfolio with excessive fees? Some of it has to do with the open architecture approach to wealth management, where firms take a "best of breed" approach. They offer what they deem to be the best managers in each category in their recommended asset allocation. Just because this approach exists, does not mean that it can actually be implemented.

"Best of breed" selection is normally backward looking. When someone tells me that they have a "great" manager, they do not necessarily mean that they have a manager they *expect* to perform well, but a manager that has *already* performed well. In practice, the result is usually disappointing results. In a study performed in 2005 and published in the Journal of Investment Management, it was shown that US equity mutual funds with five-star Morningstar ratings beat their benchmarks by 4.3% in the three years before receiving the rating, but lagged their benchmarks by 5.3% in the subsequent five years.[1] Past performance not only can differ from future results, but is often a negative indicator.

In a study performed from 1994 to 2003 of the selection and termination of managers by approximately 3,400 institutional investors, the fired managers delivered on average a cumulative 5.2% better than their bench marks in the three years after they were terminated, while hired managers delivered only a 1.9% cumulative benchmark beating performance over the same period.[2]

[1] *Mooney, "The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating, Journal of Investment Management, 2005*
[2] *Amit and Wahal "The Selection and Termination of Investment Management Firms by Plan sponsors, "The Journal of Finance, 2008.*

Because advisors are always trying to illustrate their value add to the investor and investment process, an easy approach is to simply roll out the latest and greatest fund manager, showing how well the manager has recently done, as a reason to invest. The "fund of the day" approach works well in keeping the investor entertained, but little in terms of generating actual market beating performance. Mutual fund investors experience total returns that are significantly lower because their re-allocations reduce their wealth on average.

At Fortis, our approach is to build portfolios to express our views on the market rather than chase performance by selecting investment managers. Academic studies show that asset allocation explains greater than 95% of portfolio performance.[3] With luck, you have a 20% chance of picking a top quintile manager, but it becomes increasingly difficult to select a portfolio of top quintile managers, even with skill. If you select a manager that underperforms the index from just lack of investment picking skill, you actually lose by not only the underperformance, but by the fees and manager transaction costs which can easily approach greater than 2%.[4]

In meeting with clients, I spend a fair amount of time reviewing historical market performance and discussing market volatility, or risk. The highest returning assets have historically had the highest amount of volatility and drawdowns. While I enjoy history, the real purpose of the focus is to understand the market volatility on the front end, so that exposure to volatility is understood and reacted to in a reasonable fashion.

Many advisors simply try to dampen the volatility of their investor portfolios, regardless of their time horizons, by including an overweight in bond positions. We believe this approach, especially in an environment of distorted interest rates, is full of peril. A bond portfolio yielding 6% may make sense, but I find it difficult to believe that bond yields on long duration portfolios yielding under inflation is something I should be worried missing out on. If I have allocated 20% of a portfolio to 10-year treasuries yielding 2.2%, I have generated 0.44%. for the portfolio. Instead, I could save that simply by shopping around for the best product for exposure to equity growth stocks. Maybe I should be concerned that sitting on cash looks like we do not have an investment view, but it is actually quite the opposite, and in the end I am not concerned with the optics, just performance.

One final parting thought. With the explosion in ETFs, and sponsors now looking to create unique and specific strategies, it is becoming increasingly interesting to hear how people characterize these products. I often hear that ETFs "have great daily liquidity". Liquidity of a product is only as good as the liquidity of the underlying assets.

Recently Bill Gross penned a piece on underlying ETF liquidity, and Howard Marks of Oaktree Capital opined on the subject. Fixed Income ETFs provide an illusory comfort that, should market conditions change, it will be easy to liquidate this exposure due to bid / ask spreads appearing reasonable. Because the underlying liquidity of illiquid credit instruments can quickly deteriorate in a stressed market, this comfort is an

[3] *Brinson, Hood, Beebower, "Determinants of Portfolio Performance II: An Update", Financial Analysts Journal, May-June 1991*
[4] *Edelen, Evans, Kadlec, "Shedding Light on "Invisible" Costs: Trading Costs and Mutual Fund Performance, UC Davis*

illusion. I have seen the market for convertible bonds disappear overnight. Scores of hedge funds went away after they liquidated at fire sale prices (convert arb is not even considered a standalone strategy anymore). I was the risk manager for a biotech portfolio, and was unable to move blocks of 20,000 shares without causing significant market impact in 2002. With $330 billion in fixed income ETFs, an accident is bound to happen. When natural buyers disappear, and no sources of capital are able to provide a floor, expect the bid / ask on these products to suddenly gap wider. "Just when you need liquidity the most, it tends to not be there."[5]

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[5] *Howard Marks: Memo to Oaktree Clients 2015*