January 4, 2016

Overview

Uncharacteristically for the month of December, US equities concluded the year on a down note. The S&P's 500 Total Return Index dropped 1.58%. The Russell Mid Cap Index was down 2.68% and the Russell 2000 a much sharper 5.02%. International developed markets suffered too and were down about 1.13% (S&P EPAC BMI) while emerging markets continued their painful correction with a 5% drop on average.

In December, our four target portfolios were down from 1.3% to 2.1%. As a result, they finish the year slightly above or below the flat line on an after fee basis (from +.25% to -.70%). This compares to a .90% performance for a portfolio consisting of 50% SPY (S&P's 500 Total return) and 50% of SCHZ (US Bond Aggregate).

What worked for us and what did not

In all fairness, very little worked in 2015. The advance of the S&P's 500 was limited and narrow. Large Cap Growth performed well but very little else did. The rout in oil prices took emerging market equities with it. As for bonds, the US fixed income markets did not contribute meaningfully to performance. The much-anticipated Fed engineered interest rate increase finally materialized on December 16, and not a moment too soon, after creating much volatility throughout the year.

The table below provides a summary of performances by broad asset and sub-asset classes in 2015:

S&P's 500 Total Return	1.38%
Mid Cap Total Return	-3.30%
Small Cap Total Return	-4.41%
International Developed (EPAC BMI)	-1.71%
Emerging Markets (MSCI EM)	-15.70%
Commodities (DJCI)	-25.36%
US REITS	2.22%
European REITS	6.56%
US Long Bond	-1.59%
US Corporates	1.24%
US Municipal Bonds	1.30%
US High Yield	-3.30%

At the beginning of 2015 we felt that European equities provided better opportunities than US equities and allocated to the sector accordingly. We were right. Eurozone developed markets were up 8% in € on average (France, Germany, Italy). However, once converted into USD, they were down close to 2 %. In the end, we did not profit much from our correct call in spite of a partial currency hedge. We were better rewarded with our allocation to European Reits vs. US Reits. We gradually allocated more to European Reits during the year as the European Central Bank pushed interest rates down further. This proved to be a good call.

Within US equities our tilt towards US small caps was detrimental to performance. In the end, the narrowness of the US equity advance in 2015 penalized small caps. As for emerging market equities, they paid a hefty price as oil and other commodities collapsed.

Overall, I estimate that about half of our calls were rewarded/correct and half were not. What played in our favor were our allocations. Our exposures across asset classes were properly calibrated and allowed us to mitigate the heightened market volatility and the occasional sharp declines. Our portfolio returns went from a high of +4% at the end of June to a low of -2% at the end of September. This compares to highs and lows of +5% and -6% for the S&P's 50 at comparable times in the year.

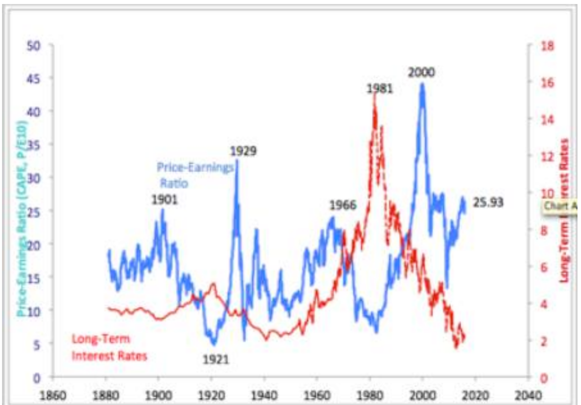
Roughly speaking, our portfolios experienced about 55% of the US equity market volatility and captured about 80% of its upside performance.

Looking ahead

The US economy is sending mixed signals. The industrial sector is weakening. Earnings have dropped close to 17% on average for S&P 500 companies in 2015. Other than for the perennially "gung-ho" Wall Street analysts, earnings growth is expected to be low or negative in 2016 and top-line growth inexistent for large swath of the economy. On the other hand, the unemployment rate is low, consumption is healthy, if not roaring, and Americans continue to manage their debt more wisely. Finally, US equity valuations are stretched; not to pre-crises levels but high enough to give us pause.

When putting it all together I see little upside for US equities in the next twelve months.

Giving us even more pause is the historical chart of the Schiller P/E ratio. The blue line is that of the P/E ratio, using 10 years worth of actual quarterly earnings, not earnings projections.



The Schiller P/E Ratio tells a story that the rational investor would be unwise to ignore.

The combined effects of a soft economy, earnings shortage and of the removal of monetary stimulus make for a challenging environment going forward. What this translates into for us as we start the New Year is as follows:

1) Reduce allocations to US equities by 10% across all our target portfolios.

2) Maintain European and Developed Asian markets (Japan in particular). On a relative basis, these markets offer better prospects.

3) Maintain emerging markets allocation at their current low level (5%) in spite of the more complicated picture. While Oil prices and the USD may continue on their current trends (down and up respectively), a reversal in 2016 is possible if not likely. Emerging equities will sharply rise when the turn around takes place. We want to be ready when it happens.

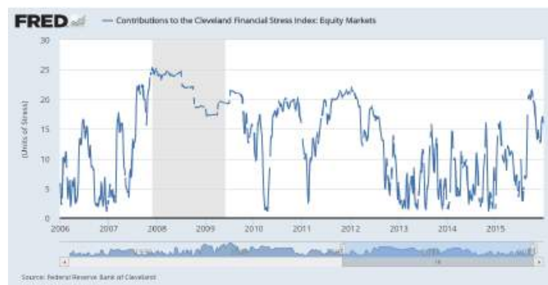
4) On a global basis, European Reits continue to offer better opportunities than their US counterparts and we will favor them.

5) The proceeds of our reduced US equities exposure will be reallocated to short term US treasury notes and to municipal bonds.

Conclusion

The US bull market is long in the tooth. The geopolitical environment is gradually worsening from Putin's increasingly shrill anti-western rhetoric to tensions between Saudi Arabia and Iran. All of this is developing over a backdrop of increasing terrorist activities and significant political events between now and the end of 2016. Among them the UK vote on whether to remain in the European Union, around the mid-year, and the US presidential election in November. There is enough here to want to hide for a while.

The study of financial markets teaches us that the wiser option is to stay engaged. Over the long run, more investors end up losing money (or not earning enough) from lack of equity exposure than they do from too much of it. In the current environment raising cash makes a lot of sense. Not going overboard with it makes also a lot of sense. While the Financial Equity Stress indicator of the Fed is relatively high, it is not near crisis levels.
We do not seem to be close to a meltdown but the



situation calls for our close attention.

In this tense environment diversification is imperative. Making sure that it fits with your risk appetite is key. Remembering that markets tend to mean-revert is also important. With that in mind, opportunities in the commodities and emerging markets and other battered sectors are likely to materialize, at some point in 2016.

We will do our best to capitalize on them when they appear.

I wish you all a great 2016.

Best regards.