SCS Financial
Strategic Capital Solutions

INVESTMENT PERSPECTIVES

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MAKING SENSE OF THE MARKETS

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Main Points

- Equity prices have experienced their worst January debut in history against a series of market headwinds but we do not see the makings of another 2008 crisis in current conditions.
- Many of the same forces we saw in 2015 are likely to remain in place in 2016, with the likelihood of continued volatility and muted returns.
- While conditions remain challenging, investors should stay focused on the principles of investing that have withstood the test of time.

Equity prices have experienced their worst January debut in history against a series of market headwinds led by uncertainty over China's growth and spiraling losses in the energy markets. The S&P 500, Dow and Nasdaq are down approximately 6-7% in the first five trading days of the year, and off 10% from their 2015 highs. International equities have slipped further. Oil prices have fallen more than 70% and are currently below $31 per barrel, prices not seen in more than a decade. High yield bonds were down 5% in 2015, and remain in a selloff triggered by energy declines and liquidity considerations. Against this backdrop, the Federal Reserve has actually begun to cautiously raise interest rates with a belief the economy is strong enough to weather modestly higher interest rates. Official GDP numbers, however, remain muted, while concerns are mounting about the potential for global recession in 2016.

We respect the gravity of today's investment environment. It is within the context of seven years of robust gains that lead many to believe we are at the turning point in the economic cycle. We expect many of the same forces we saw in 2015 to remain in place in 2016, with the likelihood of continued volatility, and possibly lower equity prices before they ultimately recover. However, we do not see the makings of another 2008 crisis in the current environment. We believe the US economy, led by the household sector, is fundamentally resilient. Japan and Europe also continue to make modest improvements in their economies. The big question is whether the emerging markets, and in particular China, will stabilize, or lead the global economy into recession. As a group, they now represent about 60% of global economic growth, up from less than 30% in 2000.

Below we explore today's landscape, why we believe conditions are healthier today than those leading up to the financial crisis, new risks to watch and how we are positioning portfolios to weather the volatility and capitalize on dislocations.

Where We Are - The Good News: Unlike the highly leveraged bubble conditions we saw with consumers, financial institutions and the housing market pre-2008, current debt levels are not rising, interest expense is at multi-decade lows, income growth has been strong, and capacity utilization is in a sweet spot. In addition, the banking and mortgage sectors are much healthier today than 2008, having strengthened their balance sheets while pursuing conservative lending practices. Although corporations have used the low rates to issue debt for share buybacks and other initiatives, current debt levels of corporations are within manageable parameters, from a very low base in 2009. As a result, the

US economy, 70% fueled by households, is on solid ground. Valuations from recent market pullbacks are now at historical averages in the US. Europe and Japan have cheaper valuations, modestly improving economies, and room for continued stimulative monetary policies. These positives are worth noting in this stressful environment, though of course other important challenges exist.

Today's Concerns: Uncertainty about China's growth prospects were a primary catalyst of volatility in 2015 and will be the main factor that could cause economic and market conditions to deteriorate further. The main reason is China alone accounts for 28% of global growth. China must have a "soft landing" to its economic slowdown, and while the country has a tremendous arsenal of fiscal and monetary policy tools at its disposal, the world remains very nervous, given many complexities faced by both the public and private sectors. A bad outcome for China will negatively affect the entire global markets.

Energy is another major concern. The global supply glut is a big reason why energy prices have collapsed, severely challenging the US fracking renaissance, and developed and emerging market energy producers. But we also know low energy prices are very beneficial for consumers and the majority of countries, who are energy importers. A distressed energy sector is very disruptive to the industry, and the countries who rely on its revenues, but on its own, unlikely to lead the world into recession.

A third consideration is the fact that Fed policymakers will need to be measured in their approach to normalizing rates. If they tighten too quickly it could jeopardize economic growth and stocks prices around the world. The famous example goes back to 1937, when the Fed raised rates after eight years of stimulative policies following the Great Depression, and the Dow lost more than half its value by 1938. Today's Fed has given every indication that it intends to proceed with great caution.

It seems clear we are past the midpoint of the economic cycle, which typically leads to lower than average asset class returns for both fixed income and equities, and increased volatility. There are few places to hide within traditional asset classes, with cash earning about zero, Treasury and municipal bond yields very low, high yield and emerging market debt in distress and equities struggling to hold onto the 200% gains they have registered since March 2009.

2016 - How SCS is Positioned: Simply stated, we do not believe we are at the end of the current economic cycle. We expect a relatively slow but steady global economy, and low but positive equity returns over the next several years. This will be supported mainly by the developed economies of the world, and Chinese authorities - with ample policy tools - hyper focused on a stable transition from an export- to consumer- led economy.

This is not to suggest markets cannot see lower levels from here. There are several examples of 20% and greater corrections in equities during an up-cycle, before markets rebounded to make new highs. Two notable examples include the 1998 Asian crisis, and the 2011 European credit crisis, both dropping close to 20% before making new highs within one year. We can't predict when this current downdraft will end, and continue to recommend a portfolio diversified across asset classes, sectors, and geographies, the mix depending on the appropriate risk profile of each client.

We have taken numerous steps in portfolios over the past year against today's complex and changing environment. Both of our active equity programs registered positive returns in 2015 against a decline in world equity indices, supported by overweights in Europe and Japan, quality growth companies, and a reduced weight in small caps in favor of mega caps. These moves have all added value to the program. Our hedge fund program currently has a low equity beta, and has added to various contrarian managers with defensive positioning, which helped deliver modest positive returns in 2015 against a negative global equity market. Within fixed income, we increased the credit quality of our exposures, favoring investment grade bonds, mortgage- and asset-backed securities with strong asset coverage, and floating rate loans that are senior in the capital structure. Finally, we continue to make allocations to private investments, believing they offer meaningfully better returns than public markets, with less price volatility and an ability to focus on creating long-term value and ignore short term noise.

It is just as important to know what to avoid as it is to know what to own. We have very little exposure to China and an underweight to the emerging markets. We sold our public energy and commodity investments in 2014, a move that was particularly helpful to returns in 2014 and 2015. In fixed income, we own very little high yield and emerging market bonds. Having said that, we are also evaluating hard-hit sectors that take advantage of these dislocations. Examples include non-performing loans trading at deep discounts in Europe; distressed energy in the US and Europe; consumer alternative lending for credit worthy US borrowers; MLPs of strong, well-positioned mid-stream companies yielding above 8%; and non-energy high yield borrowers with strong balance sheets, to name just a few. The goal is to find compelling new opportunities at rock bottom prices, similar to our efforts in 2008-2009, when we first allocated to the structured credit and distressed markets through several of our top hedge fund managers.

Conclusions - Time Tested Investment Principles: While conditions remain challenging, in such times it is important to remind ourselves of several principles of investing that have withstood the test of time. We include paraphrased insights culled from years of market analysis from professional investors, academics, respected writers and investment advisors.

Principle #1: Focus on Long Term Compounding of Wealth

- "Compounding is the eighth wonder of the world."
- "Interrupt your long term investments infrequently with transactional taxes and frictional costs."

Principle #2: Diversification Works

- "In euphoric markets, there are always people with stories about a highly concentrated investment that makes a lot of money. I don't hear these stories so much when markets get more challenging."
- "It is in down markets when the quiet wisdom of diversification shines most brightly."

Principle #3: Timing Markets is on Balance a Losers Game

- "Why do investors continue to chase markets up and down, when the empirical evidence overwhelmingly tells us that trying to time markets is a losing strategy."
- "Investors tend to buy what's been going up and sell what has been going down, and this approach has resulted in the equity returns of investors being significantly below a buy and hold strategy."

Principle #4: Keep Emotions in Check

- "The reason so many investors fail is because they make poor decisions when markets fall."
- "Resist the natural human bias to act; that impulse typically lacks wisdom."

Principle #5: Stay Disciplined

- "Investors who rebalance their portfolio regularly, and sell a portion of what's gone up and buy a portion of what's gone down, generally add several percent to their annual returns. Those who do the opposite generally subtract about the same amount from their annual return."
- "The natural impulse for investors is to only own things in one's portfolio that have worked most recently. Since when did driving using the rear view mirror help guide one to where the road leads to?"

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