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VOLUME 9

2015 Stocks Flat!

U.S. Large Cap Equity … Still the Lead

S&P 500 equity returns rallied in the 1st half (1H) but deteriorated in the 2nd half (2H) to end 2015 up 1.4%. Fixed income helped cushion the volatility but didn't return any better than equities.

Avoiding and limiting exposure to energy MLPs, global bonds, and international equity markets helped relative portfolio returns.

Tax efficiency was a benefit of the increased volatility in 2015. Market declines increased the use of tax swaps to lock in losses thus reducing tax liabilities.

<u>2015 Characteristic Summary*</u>

Market Cap: Bigger was better than smaller. 50 largest stocks up 1.5% while 50 smallest were down 11.9%

P/E: Growth was better than value as low P/Es declined 5% or more.

Dividends: Low yielding stocks were better as high yielders declined 14.6% vs. low yielders which were up 3.9%.

**Source: LAS Schwab Outlook 1/4/16*

Inside this issue:

2016 Market Themes

Return to Normal Volatility Curbs the Enthusiasm

1. U.S. Economic Growth - Better 2H 2016
   - job creation and light vehicle sales a plus
   - low gas prices help discretionary spending
   - industrial production and retail sales are sluggish
   - wage growth surfaces & inflation rises
   - recession risk for U.S. is a low probability
2. China Transition is Fast Paced
   - economic deceleration pressures global growth
   - financial transition from controlled to open market
   - economic transition to consumer driven economy
3. Oil Disorder - Economic Impact
   - hurts 1H 2016 earnings and improves 2H 2016
   - increased geopolitical tensions over oil supply
4. Global Macro Environment - Economic Decoupling
   - continued geopolitical tensions cause headline risk
   - global growth concerns persist
   - emerging markets continue to struggle
5. Sleeping Inflation - Economic Risk
   - energy price recovery from low base adds to inflation
   - U.S. unemployment rate at 5.0% & heading lower
   - economic slack runs out & turns into higher prices
6. The Dollar Bull Market
   - adds pressure to U.S. corporate earnings
   - unhedged foreign sales also pressured
7. Monetary Policy Normalizing
   - zero interest rate policy (ZIRP) ended Dec. 2015
   - rate hike cycle began, expect a few more in 2016
8. "Brexit" - British Exit from European Union
   - rising fears send uncertainty into global market
9. Domestic recoveries in Europe & Japan a plus
10. Rockier Road Ahead … Lower Lows, Higher Highs

S&P 500 ANNUAL RETURNS	
Year Ending	**Total Return Change**
12/31/2015	1.38%
12/31/2014	13.69%
12/31/2013	32.39%
12/31/2012	16.00%
12/31/2011	2.11%
12/31/2010	15.06%
12/31/2009	26.46%
12/31/2008	-37.00%
12/31/2007	5.49%
12/31/2006	15.79%
12/31/2005	4.91%
12/31/2004	10.88%
12/31/2003	28.68%
12/31/2002	-22.10%
12/31/2001	-11.89%
12/31/2000	-9.10%
12/31/1999	21.04%
12/31/1998	28.58%
12/31/1997	33.36%
12/31/1996	22.96%
12/31/1995	37.58%
12/31/1994	1.32%
12/31/1993	10.08%
12/31/1992	7.62%
12/31/1991	30.47%
Avg Last 25 Years	**11.43%**

Table Source: S&P Dow Jones Indices

2015 Benchmark Performance

Asset Class	2015	As Measured By
Fixed Income		
Investment Grade Short	0.7%	Barclays US Gov/Credit 1-3 Year
Investment Grade Muni	3.3%	Barclays Muni Bond 7 Year
Investment Grade Taxable	-0.6%	Barclays U.S. Aggregate Bond
High Yield Bond	-4.5%	Barclays U.S. Corp High Yield
Global Bond	-6.0%	Barclays Global Bond Index
Equity		
Large Capitalization	1.4%	S&P 500 Index
Small & Mid Cap	-2.9%	Russell 2500 Index
Small Capitalization	-4.4%	Russell 2000 Index
International Equity	-5.3%	MSCI All Cap World Ex US
International Developed	-0.4%	MSCI EAFE
International Emerging	-14.9%	MSCI Emerging Markets
Energy MLPs	-32.6%	Alerian Energy MLP Index
Gold	-10.5%	S&P GSCI Gold Spot Price

Data Source: Tamarac and providers to Tamarac

2015 Performance Commentary

Significant market divergence occurred in 2015. Domestic large cap equity and investment grade bond markets had nominally positive, albeit low performance, in 2015 as shown in the table above. High yield, global bonds, U.S. SMID, gold, and developed and emerging international equities were all negative.

Investment grade taxable bond returns eked out a positive return as equity market volatility supported the demand for quality fixed income. A strong U.S. dollar and flight to quality also provided a level of support.

At the beginning of the year, core high yield bonds yielded 5% but ended the year yielding 7%. This rising yield translates to falling prices. The negative 4.5% total return for the year is indicative of the energy decline which then spread to other high risk bonds.

Equity returns were negatively impacted by falling commodity prices, a weak energy sector, and a slow global economy led by faltering emerging markets. Equity revenues and earnings were hurt by the macro environment.

As the table to the left indicates, only 4 years have ended with negative returns out of the past 25 years. In addition, with all the volatility, the S&P 500 has exceeded 10% on average per year.

Tactical Outlook: Defensive Shift

Equities:

We have positioned portfolios more defensively in all 3 major asset classes - Equity, Fixed, and Cash. Equities are still positioned to favor growth style investments which were in favor the past few years.

Our equity portfolios have significant diversification that includes value, core, and growth styles. We changed this balance as we increased the direct value exposure in January 2016.

We increased value style exposure for two reasons. First, value has traditionally been a more defensive style. Second, as growth has become more fairly priced, the valuation spread between the two styles has narrowed.

We increased value by investing in a large cap value exchange traded fund (ETF) and by investing in a domestic real estate investment trust (REIT) ETF. The first is diversified across 50 securities with a yield of 2.5% and the second has over 150 holdings with a yield of 4%.

Fixed Income:

Our fixed income exposure is positioned defensively with a lower tactical allocation, lower average duration, and increased quality allocation verses our strategic targets.

We eliminated high yield (higher risk) exposure at the end of 2015 when it was already an underweight position. If yields on high yield continue to increase, the risk/reward tradeoff may become attractive again.

We've outlined our tactical asset allocation views which remain positive on equities and defensive on fixed income in the table below.

Your Strategy:

The right mix between cash, fixed income and equities is the first key decision to managing market risk and reaching your investment goals.

Our style choices, sub-asset class choices, diversification, quality, duration, security selection, etc. all build from the Investment Strategy decision.

Summary of Views

Asset Class	Current Tactical View
Cash	Increased. We increased cash positions as a defensive tactical move. Money market yields are nearly zero so this is more of a shorter term defensive position. This cash position was funded from underweighting fixed income.
Fixed Income **Investment Grade** **High Yield**	Reduced & Defensive. We are currently positioned defensively within fixed income in three ways. We have a lower overall fixed income allocation than the longer term strategic targets, we use lower duration targets to reduce sensitivity to changing interest rates, and we eliminated direct high yield (higher risk) exposure.
Equity **Large Cap** **Small & Mid Cap**	Neutral & Blended. We reduced equity exposure to a neutral position while at the same time introducing domestic REIT exposure to the portfolios. We increased large cap core value and reduced growth styles. We continue to favor U.S. stocks.

Tactical views are focused on the shorter term market cycle defined as the next 3 years. Strategic views are the underlying investment discipline focused on longer term market cycles up to 10 years.

5 Years: Then & Now

To add some perspective on how some very important things have changed …

Item	From : To	Change
Brent Oil $ per bbl	$95 to $38	down 60%
Gold per troy oz.	$1,421 to $1,063	down 25%
Global Smart Phone Penetration	18.6% to 74.6%	up 56 percentage points
Monthly Active Facebook Users	600M to 1.6 Billion	up 161%
Hours of Video uploaded to YouTube/min	24 to 400	16.7 x
Average wages in China (000's of CNY)	37.1 to 57.3	up 54%
Industrial Robots sold (000s)	121 to 229	up 89%
Oil Supply (million bbls per day)	87 to 97	up 11%
Number of dresses sold per min on eBay	6 to 90	15 x
Biggest Company by Market Cap	PetroChina	Apple
Speed of a 747 Jumbo Jet	988 to 988 km/hr	No Change
Temperature in Tokyo in Dec.	4.4 to 12 Celsius	up 173%
Fuel Efficiency of a Ford F150	17 to 22 mpg	up 29%
Cost of Sequencing a Genome	$46,774 to $1,363	down 97%
S&P 500 Total Return	baseline year	up 80.8%
MSCI All Country World Equity Index x U.S.	baseline year	up just 7.8%

Quite the mix of items. Jets aren't getting faster, who would have predicted that?

Summary

Some key 2016 market dynamics that we're paying close attention to:

1. Corporate earnings will still drive stock valuations.
2. Stocks aren't cheap nor are they expensive as the S&P 500 forward P/E multiple is fully valued at 16.1 as compared to a 25 year historical average of 15.8.
3. Interest rates gradually rise.
4. Strong dollar continues to put pressure on foreign earnings creating a headwind for U.S. stocks.
5. Foreign economic growth remains weak favoring U.S. revenues and earnings sources.
6. Broad diversification and security selection will be keys to investment performance.
7. S&P 500 dividend yield is 2.3% exceeding the 10 year treasury note at 2.2%. This may drive fixed income outflows and equity inflows.

In addition to the unknown shocks that arise every year, the pending Fed (FOMC) moves, U.S. election and Chinese economic growth challenges are known factors that will add to market volatility throughout the year. We plan on it. Both the recent FOMC interest rate hike and the equity market volatility over global growth concerns are a return to normalcy.

Check your risk tolerance and remember markets are "bumpy" in the short term. As Mark Twain said, "It ain't what you don't know that gets you into trouble. It's what you know for sure that ain't so."

Sincerely,

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Sources include: Liz Ann Sonders, *Schwab Outlook*, January 4, 2016. S&P Dow Jones Indices. 1Q 2016, JPMorgan Market Insights, *Guide to the Market*, December 31, 2015. Barron's, *A Currency Affair*, January 11, 2016. The BlackRock List, BlackRock, *Is Your Portfolio Built for 2016?*, December 28, 2015. Liz Ann Sonders, *Back to Zero*, January 4, 2016. S&P Capital IQ, *The Outlook*, December 21, 2015. S&P Capital IQ, *The Outlook*, January 11, 2016. Liz Ann Sonders, *Schwab Market Perspective*, January 8, 2016. Goldman Sachs, *Global Markets Analyst*, November 19, 2015. Goldman Sachs, *Newsletter—The Great Rotate*, January 6, 2016. Data source providers include Thomson Reuters, Tamarac and providers to.