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Market Note

We are sending this letter out prior to our statement this quarter. The contents are important but general in nature and do touch on some of the questions submitted by you. I do recommend that you spend some time with it. We will have some additional account specific commentary to provide to you when we send out our quarterly statement. Please note that we have created a new format for our statement with the goal of providing concise and useful information to you. Please give us some feedback if you are so inclined.

The Last Quarter

Markets were decisively negative during the third quarter of this year. In fact, the three months that ended September 30 was the worst quarter in the last 16. The market decline was not driven primarily by falling earnings, but rather a decline in the market's Price/Earnings multiple or P/E multiple. Over the last 15 months, the result of investing in stocks in this country was little gain. Corporate earnings went up, but this was offset by the P/E ratio coming down.

While this type of market behavior is not as enjoyable as steady gains, it does fall into the category of normal market behavior. If this is true, why bother with stocks at all? Short term volatility in the markets like this and the feelings that it creates is one of the negatives of investing in the market. Protecting your assets against the damaging effects of inflation over time is one of the big benefits, and this benefit outweighs the negative. Anyone with a balanced portfolio over the last three years has done much better than if they had invested in a 3-year Treasury bond or CD three years ago, or had invested in a series of 1 year Treasuries or CD's over the past three years.

What Happens Next

Okay Peter, let's say we understand this. So what are the implications for earnings and the P/E multiple going forward? Will changes in these measures cause the market to go up or down? Isn't today's market and economy different than it has been in the past? What are the implications of this? Should we manage money differently? Are we in store for larger losses or more market volatility?

Debt Makes Things Interesting

One negative feature of today's market and economy is the historic amount of debt across the globe. As debt increases, flexibility decreases and the odds of something going wrong goes up. It is no different than your own situation. If have too much debt, you will be very sensitive to your income/revenue going down. The debt remains in place regardless of how your ability to pay for it may change.

If there is more debt in the global financial system, then there is less flexibility, and less cushion against things going wrong. Many developing countries borrowed heavily in the last few years, and

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they did so not in their local currency but rather in dollars. The dollar strength during 4Q 2014 and 1Q of 2015 has caused this debt to grow in size in terms of their ability to pay for it. This has happened at the same time that their trade with China is weakening (their revenue to help pay for the debt).

Lenders extending credit to people can boost economic growth. When lenders cut back, it can retard economic growth. When they really cut back or just stop, you have a recession or depression. During 2007 and 2008, lenders pretty much stopped lending because many of them were insolvent, having made so many bad real estate related loans. Real estate prices fell, damaging personal balance sheets and people's ability to borrow. Job losses soared and economic activity shrunk for period of time.

Is a similar thing likely to happen today? In this country, I don't think so. In the U.S., individuals and financial institutions have cut back on their levels of debt. They are in much better shape than they were. Overall debt levels in this country have fallen, but not as much as these two categories. But since these two categories are the spenders and credit creators, if they are in god shape, I think it limits the severity of any economic decline.

Our government dramatically boosted its debt over the last six years. This dramatic increase is the reason that we did not experience a recession during this time, which would have been the expectation when you look at how much individuals and financial institutions reduced their debt. Remember that debt creation is expansionary and debt reduction is contractionary.

During 2003 to 2008, debt levels ballooned, and most of it was held by banks and individuals. This proved to be unstable. Even though debt levels are higher today than in 2005, more of the debt is owed by our Government. This makes the risk of a sudden shut off in credit across the board and the resulting recession less likely. Note that our Government pays for the debt by raising revenue through taxes and fees. But it can also just print money it needs to pay for an interest or principal payment. Therefore, it can last a lot longer than Lehman Brothers or Greece. Of course our Government printing money and possibly getting cut off by foreign lenders does have other ramifications. In summary, I believe that a credit collapse like we saw in 2008 is much less likely to happen, but if/when it does happen, the fallout could be much worse.

How Does This Reality Change the Way We Do Things? And One Important Comment About Today's Environment.

When investors had to reduce leverage quickly in 2008, they sold everything that they could at the same time. More debt in the system seems to be correlated with what we call correlation between assets classes going up. Diversification meant to spread money across different kinds of assets. The intent was to achieve some combination of lower volatility in prices and/or higher returns since these different assets did not move in synch. When everything gets sold at once, however, this benefit not only goes away, it works against you.

After 2008 and because of the increased level of debt, we decided to reduce the amount of risk we took in accounts across all investment objectives. This remains true through today. This is the first

"How we do things differently" item to mention. The second to mention is a decision to, at some point, reduce the amount invested in stocks on a tactical basis. We have mentioned before that recessions are marked by both earnings declines and P/E multiple contractions, two ways to experience declines in value, and material ones at that. It is worth attempt to avoid some of this decline. **As I write this, we are close to the point that we would consider this action**. In terms of what we would do, we would reduce the current exposure to equities by 8% to 15% depending on the current investment objective.

How Does Retirement Impact Investment Strategy?
My feeling is that many retirees that are doing things the same was as they were prior to 2008 probably should be changing the way that they do things. Our planning work puts portfolios and spending plans through a multi-scenario evaluation that includes 2008 like events. I might also note here that since 2008, our rate of return assumptions have declined. We feel that these steps have resulted in retirement income plans that have some basis for us to expect success.

Note that a retiree that has 40% invested in bond investments has multiple years of funding for their income requirements without having to sell a stock investment that happens to be down in price this month, this quarter or this year. Having a more conservative portfolio versus a pre-2008 portfolio allows for this.

Is There Any Good News Given Today's Market
A 'flat' market over a period of time like we have had over the last 15 months that is the result of greater earnings but a smaller P/E ratio can set the stage for a higher probability for positive gains going forward. The length of reset can depend on the starting P/E multiple. Since the current P/E multiple is close to the 15 year average, I would suggest that the length of reset will not last too long (over 6 more months). This assumes that nothing too terrible happens to decrease earnings. Then the reset might take longer.

To put things in perspective, losses this year remain a fraction of 2008 losses. As frustrating as this period may be, this market behavior is not abnormal, and is well within the established accepted level of risk tolerance.

Regards,

Peter B. Harre, CFA