STRATEGY

The U.S. economy continues to expand. Employment levels are rising; inflation is contained, the value of the dollar is rising; consumer confidence remains high, and the U.S. stock market hit new all-time highs during the quarter. Interest rates are historically low, with rates on two-year government notes below zero in multiple countries. We continue to believe that stocks, on balance, provide a higher expected risk-adjusted return than bonds, and that dollar-denominated assets remain attractive relative to other currencies. However, potential risks are increasing, leading us to emphasize, where possible, smaller and mid-sized companies, domestic sales, and low-leverage companies. We anticipate increasing day to day volatility in both stock prices and bond yields. Stock price volatility will be driven by increased uncertainly about earnings, as companies try to adjust to rapidly changing exchange rates. Bond yield volatility will be driven by uncertainty about the timing and implementation of Federal Reserve policy changes, and by structural changes in U.S. bond markets. Bond market liquidity today is only a fraction of what it was before the financial crisis; dealers are reluctant to hold inventory, leading to significant swings in prices and yields day to day. We are maintaining a maximum exposure to equities for all clients where we have the ability to allocate between stocks and bonds, but we are emphasizing sectors with significant consumer exposure and significant domestic sales.

> In isolation, we continue to be positive on domestic US economic conditions, and we anticipate that economic growth in 2015 will be approximately 3%.

FIRST QUARTER 2015 RETURNS

At the end of 2014, for our domestic U.S. strategies, we were positioned to emphasize companies focused on U.S. sales, with a corresponding decrease in companies with a high percentage of foreign sales. This led us to increase our holdings of small and mid-sized companies relative to larger capitalization companies. We anticipated that we would see increasing day to day volatility in both stock and bond markets. We also anticipated that stocks would return about 6% more than bonds for 2015 as a whole.

During the quarter, bonds did somewhat better than expected relative to stocks, with both stocks and bonds returning modest positive amounts during the quarter. Large capitalization stocks, measured by the S&P 500, returned just under 1% for the quarter, and 12.72% for the past twelve months. Small and Midsized Capitalization stocks, measured by the S&P 1000, were stronger for the quarter, at 4.91%, and slightly less for the twelve months, at 11.12%, with midsized companies stronger than smaller ones. The MSCI Europe, Asia, and Far East Index (EAFE) returns were surprisingly high, at 5.04% for the quarter and -0.30% for the past twelve months, aided by the European Central Bank's decision to begin Quantitative Easing. The MSCI All Country World Index (ACWI), which has an approximately 50% exposure to the U.S., and 10% allocation to emerging markets, returned 2.44% for the quarter and 6.04% for the twelve months, measured in US Dollars.

After six months of precipitous decline, oil prices stabilized during the quarter, with West Texas Intermediate oil ending the quarter at $47.60 per barrel, down from $91.45 in March 2014. U.S. stock returns varied significantly by sector, with healthcare stocks increasing by 6.2% and utility stocks falling by 6.0% during the quarter.

US ECONOMIC GROWTH CONTINUES

In isolation, we continue to be positive on domestic US economic conditions, and we anticipate that economic growth in 2015 will be approximately 3%. However, severe winter weather in the Northeast and widespread port closures on the West Coast will significantly affect first quarter economic growth, as shown in the payroll employment data for March, which was significantly below trend. While we do not expect GDP to decline in the first quarter, growth could be quite low, possibly below 0.5%. Consumer confidence continues to be strong, and more importantly, the breadth of U.S. consumer confidence is increasing, with confidence improving for both high and low income brackets. After many years of stagnation, wages are beginning to increase for lower income workers, with Aetna, Target, McDonalds, Wal-Mart, and TJ Maxx all announcing increases in wages for low-end employees to $9 per hour or more. Other recent economic indicators such as vehicle production, job vacancy rates, and national purchasing managers' indices also show a strengthening U.S. economy, bolstering our expectation that growth will improve over the remainder of 2015.

Two significant, and interrelated, factors temper our expectations for U.S. economic growth: the future direction of interest rates and exchange rates. Since 2009, the Federal Reserve has been holding U.S. short term interest rates extremely low, via its influence on the Federal Funds rate. Six years after the March, 2009 low in the U.S. equity markets, the unemployment rate is finally below 6%, GDP continues to expand, and inflation rates appear to be stable. The Federal Reserve is clearly signaling that if U.S. growth rates, unemployment, and prices continue in the same trends, it will begin to increase U.S. short term interest rates sometime in 2015. Starting from a 0.25% Federal Funds rate, we do not

view this as a negative for U.S. stock prices, as it signals that the Fed views the U.S. economy as strong enough to begin moving toward an interest rate policy more in line with historical norms. At the same time, the European Central Bank (the ECB) and the Bank of Japan are both pursuing more expansionary monetary policies, aimed at stimulating extremely slow economic growth in their regions. In the last week of March, the ECB balance sheet expanded by €93 Billion. On April 10, yields on two-year government bonds were zero in France, Germany, Portugal, Sweden, the Netherlands, Switzerland, and Japan.

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Since international financial capital can move quite freely across international borders, investors have reacted to these extremely low interest rates by moving short term assets to countries with higher interest rates. In particular, investors have been moving assets to the U.S., creating a demand for U.S. dollars and leading to significant increases in the value of the dollar relative to other currencies. As of March 31, the Euro had fallen by 11% versus the dollar in the first quarter, and 22% for the twelve month period. The Yen is close to unchanged for the quarter, but has fallen by 14% in the twelve month period. In contrast, the Swiss Franc appreciated by 2% against the dollar for the quarter. The Federal Reserve's Broad trade-weighted dollar index appreciated by 8% for the quarter and 20% for the past twelve months. U.S. manufacturing exports will face significant headwinds, both from the slowing economies of major trading partners such as China and this broad dollar strength. A stronger dollar makes U.S. exports more expensive for buyers using other currencies. For U.S. corporations, the same unit volume of sales abroad will translate into a lower dollar value of profit, as foreign currency sales are translated into an increasingly expensive dollar.

VALUATION

Currently valuations for U.S. stocks do not look excessive, but the potential sources of risk are increasing. Corporate earnings in the U.S. continue to rise, with an overall expected growth rate of 7.5%. Foreign profits for U.S. corporations may decline by 15% in 2015 compared to 2014, as a result of both the increased strength of the dollar and slowing growth in emerging markets. In contrast, profits from domestic sales should increase by about 10%, benefitting from continuing U.S. economic growth, lower corporate bond yields, and the effect of the stronger dollar in input prices. Currently, the S&P 500 index is at 17 times expected earnings for the next twelve months, a bit above the 25 year average of 15.7 times earnings. Yale Professor Robert Shiller's cyclically adjusted P/E ratio, or CAPE ratio, which looks at the average of ten years trailing earnings, is at 26.9 times earnings, 1.5 standard deviations above the average since 1881, but just slightly above the 25 year average of 25.4 times earnings. Compared to the current S&P 500 earnings yield of 5.6%, the yield on the 10 Year Treasury Inflation Protected Security is just 0.12%, indicating that stocks should return about 5.5% more than bonds over the next twelve months.

We see higher potential risk in several areas. First, while the change in Federal Reserve monetary policy is a change from an extraordinarily expansionary monetary policy to a merely extremely expansionary policy, it is still a change in policy, conducted against the backdrop of the ECB and the Bank of Japan pursuing extraordinarily expansionary policies. Second, the divergence between earnings on foreign sales and earnings on domestic sales will add uncertainty to expectations of U.S. multinational earnings, adding to stock price volatility. Third, economic slowdowns in China, much of Europe, and countries with significant energy exports, such as Brazil, Canada, and Russia, provide multiple opportunities for additional volatility in currency flows and interest rate adjustments. China now accounts for 10% of world imports, so a slowdown in China will have significant effects on trade flows. High levels of margin debt and a rising Chinese stock market seem inconsistent with slowing economic growth and declining real estate prices. Global companies with high US dollar-denominated debt are another concern, as an appreciating dollar increases the debt burden, particularly in sectors also struggling with falling prices such as mining and energy. That said, we continue to emphasize stocks over bonds, believing that the balance of risk and return for the remainder of 2015 favors high quality U.S. stocks with low international sales.