July 2013

Second Quarter Investment Commentary

After a period of relative calm, volatility returned with a vengeance to global financial markets in May and June. Core investment-grade bonds lost 3.3% from May 1 through June 30—one of the worst two-month declines in the benchmark's 37-year history. Long-term Treasury bonds, as represented by the iShares Barclays 20+ Year Treasury Bond Fund, lost 9.8% in the last two months of the quarter. Emerging-markets local-currency bonds dropped 10.4% from May 8 (their intra-quarter peak) through June 30, while emerging-markets stocks lost 11.4% and developed international stocks dropped 6.5% over the same time period. Bucking the trend to a large extent were large-cap U.S. stocks, which fell only 0.8% over that same period. Gold, which is typically viewed as a safe haven during periods of market turmoil, was not spared—losing 15% from May 1 through June 30, and melting 26.5% for the year to date. See table at right for complete benchmark returns.

June Benchmark Returns (Preliminary)

	June	2Q	YTD
Large-Cap Benchmarks			
Vanguard 500 Index	-1.4%	2.9%	13.8%
iShares Russell 1000	-0.5%	3.1%	14.1%
iShares Russell 1000 Growth	-2.1%	1.9%	11.4%
iShares Russell 1000 Value	-1.0%	3.2%	15.6%
Mid-Cap Benchmarks			
iShares Russell Midcap	-1.4%	2.0%	15.2%
iShares Russell Midcap Growth	-1.4%	2.7%	14.5%
iShares Russell Midcap Value	-1.4%	1.6%	15.7%
Small-Cap Benchmarks			
iShares Russell 2000	-0.8%	2.7%	15.4%
iShares Russell 2000 Growth	-0.9%	3.6%	17.2%
iShares Russell 2000 Value	-0.5%	2.5%	14.2%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-2.8%	-0.7%	3.1%
MSCI World ex USA Index	-3.7%	-1.4%	3.4%
Vanguard FTSE Europe ETF	-4.3%	0.1%	1.1%
Vanguard FTSE Emerging Mkts ETF	-5.3%	-8.3%	-11.6%
Vanguard REIT Index	-2.0%	-1.6%	6.3%
Vanguard Total Bond Mkt Index	-1.7%	-2.4%	-2.5%
BofA Merrill Lynch U.S. High Yield Cash Pay	-2.6%	-1.4%	1.5%
Vanguard Int. Term Tax-Exempt Fund	-2.6%	-2.9%	-2.5%
S&P/LSTA Leveraged Loan Index	-0.6%	0.2%	2.3%
Citigroup World Govt. Bond Index	-0.6%	-3.0%	-5.7%
JPMorgan GBI-EM Global Diversified Index	-4.1%	-7.0%	-7.2%
DJ-UBSCI (Commodity Futures)	-4.7%	-9.4%	-10.5%

Our commentary focuses on two second-quarter market developments that are noteworthy at both a broad macro level and given our particular portfolio positioning. We'll look at what happened in the quarter, what the impact was on our portfolios, and, most importantly, how we view these developments in the context of our long-term fundamentally driven investment approach.

The two main developments we'll focus on are: 1) the spike in Treasury bond yields, and 2) the sharp decline in emerging-markets stocks and bonds. Understanding these two developments is helped by first looking at the monetary policy backdrop.

The Backdrop: Monetary Policy and the Market's Short-Term Game

Interestingly, both of these developments had (to varying degrees) the same underlying driver: pronouncements from the Federal Reserve about the future course of monetary policy, and, specifically, the Fed's plans to begin "tapering" its QE (quantitative easing) bond-buying program. (More details about this below.)

This is a theme we've written about a lot recently: the unusually heavy influence of monetary policy on the financial markets in the aftermath of the 2008 financial crisis, and the unusually strong sensitivity of markets to perceived changes to such policy. We've noted how Fed policy—by "repressing" interest rates to all-time lows, and aggressively purchasing government and mortgage-backed bonds via QE—actively encouraged (if not forced) investors to move out on the investment risk spectrum into higher-yielding, though riskier, asset classes. In our view, this helped to boost the U.S. stock market to levels beyond what was justified by the longer-term economic (earnings) fundamentals.

We noted that this behavior could certainly continue in a self-reinforcing cycle as long as the markets believed two things: 1) that the Fed would keep up their stimulative policies, and 2) that such policies were necessarily positive for stocks rather than, say, indicative of the severity of our economic problems. If so, as the markets moved higher, more and more short-term-oriented or performance-chasing investors would feel the urge to jump on the stock market bandwagon, propelling the market still higher and further divorcing it from its underlying longer-term economic fundamentals. In other words, the market could continue to overshoot to the upside, driven by short-term but ultimately unsustainable factors.

But that is a short-term, speculative "game" we do not play with our clients' assets. That approach is not part of our investment discipline, nor is it likely to yield consistent, sustainable success for most investors.

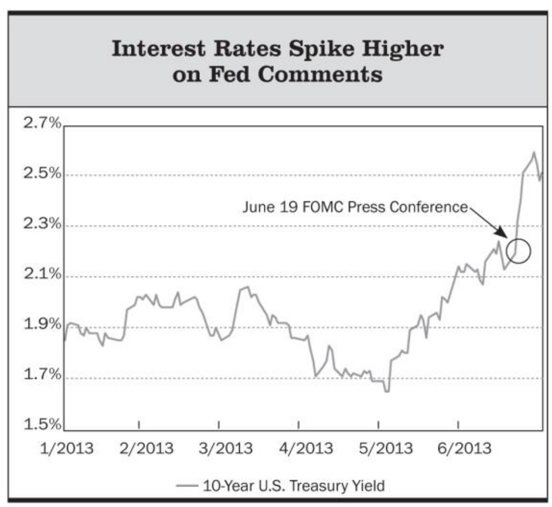
That does not mean that we ignore what the Fed is doing, how their policies might change, or what the implications might be for the economy and financial markets. But maintaining an awareness of different possible monetary policy scenarios and outcomes is very different from making portfolio decisions based on the confidence that we know which particular scenario will play out over the short-term *and* that we can get the timing right. Trying to ride the market's short-term momentum requires consistently buying at the right time and also selling before the forward momentum unwinds, typically caused by an unexpected catalyst, which can result in a swift and sharp decline.

We need only look at what happened with the recent spike in rates as an excellent example of how rapidly things can change and what can happen if you are a short-term investor and don't get the timing right.

DEVELOPMENT #1:

Interest Rates Spike Higher

On May 2, 2013, the 10-year Treasury bond yield hit a low of 1.63% for the year. The yield then rose steadily through May, ending the month at a 12-month high of 2.16%. After meandering the first half of June, the yield spiked sharply higher, hitting 2.6% on June 24—its highest level since early August 2011. As noted in the introduction, the rise in rates resulted in significant capital losses for bond investors (rising bond yields mean falling bond prices), reaching into the high single digits for long-term Treasury and TIPS bond funds, and low single-digit losses for the core bond index.



While this looks like a pretty dramatic increase, if you put it in the context of rates of the past 50 years, it is apparent how depressed rates still are relative to history. Data as of 6/30/13. Source: Board of Governors of the Federal Reserve System.

The driver of the sharp rise in yields was comments from Federal Reserve policymakers—culminating with Chairman Ben Bernanke's June 19 press conference—

indicating that the Fed might begin to slow ("taper") the pace of its monthly bond purchases sooner than had been expected, perhaps as early as this September. (As a reminder, under the current open-ended QE program, which was launched last fall, the Fed has been buying $85 billion of Treasury bonds and government agency mortgage-backed securities each month. The goal is to suppress borrowing costs, mortgage rates in particular, and ultimately stimulate economic growth and employment. While we believe this most recent QE program has goosed stocks and other financial asset prices higher, its real economic benefit appears muted.)

Specifically, Bernanke said:

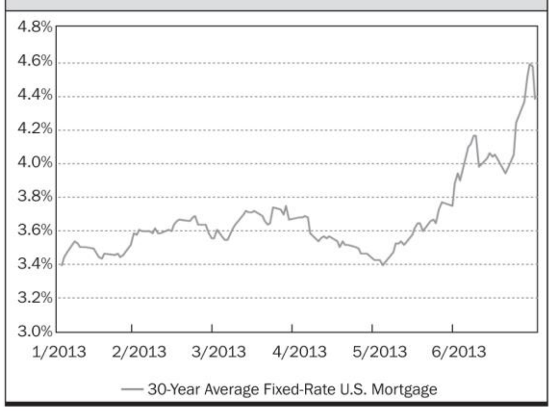
> The committee currently anticipates that it would be appropriate to moderate the monthly pace of purchases later this year; and if the subsequent data remain broadly aligned with our current expectations for the economy, we would continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around midyear. In this scenario, when asset purchases ultimately come to an end, the unemployment rate would likely be in the vicinity of 7%, with solid economic growth supporting further job gains.

Bernanke likened tapering to "letting up a bit on the gas pedal as the car [i.e., economy] picks up speed." He also tried to make it clear (again) that this tapering road map is not set in stone and would be contingent on incoming economic data. He specifically said that if the Fed's growth and employment forecasts turned out to be too optimistic (as they have consistently been since the financial crisis), the Fed could stop tapering and even increase its bond purchases again (step back on the accelerator). He also reiterated that even with a cessation of QE in mid-2014, monetary policy would remain stimulative for a considerable period because the Fed would not begin to increase short-term interest rates (i.e., step on the brakes) from their current near-zero percent level until unemployment fell to *at least* 6.5%, as long as inflation and inflation expectations remain low (in the 2%–2.5% range). The current consensus among the Federal Reserve Board members is that such a rate hike won't happen until 2015.

Despite Bernanke's best efforts to manage market expectations and communicate that the process of ending QE does not mean an actual tightening of monetary policy, investors saw it a different way, resulting in the bond market sell-off and a spike in interest rates. In a nutshell, investors' fears that rates would rise (and bond prices fall) as a result of a less-expansive Fed policy caused them to sell bonds, thereby causing rates to rise just as they feared. As TrimTabs Investment Research recently reported, bond mutual funds and exchange-traded funds had $72.8 billion in outflows from June 1 through June 25, smashing the previous record monthly outflow of $41.8 billion in October 2008, during the depths of the financial crisis. Prior to June, bond funds had registered net inflows for 21 consecutive months.

Thirty-year fixed mortgage rates, which are a specific target of QE, also jumped sharply from a low of 3.4% on May 1 to 4.6% on June 25. Thus, the Fed's optimism about economic growth/recovery, which led Fed policymakers to conclude they could begin ending QE, might in fact become a headwind to that growth. Rising borrowing costs and falling asset prices could ultimately short-circuit the economic recovery and, in turn, the tapering process.

Mortgage Rates Also Jumped

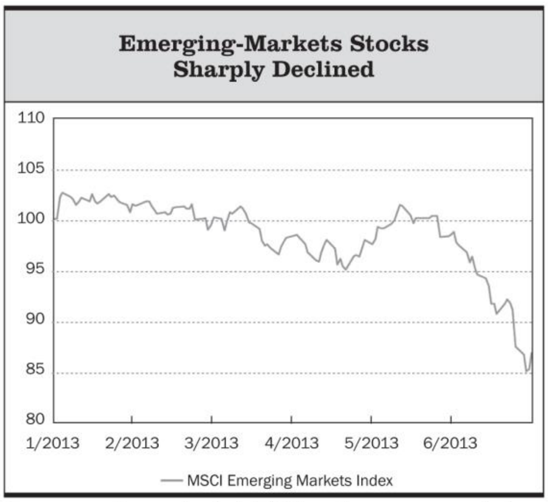


Data as of 6/30/13. Source: Bankrate.com.

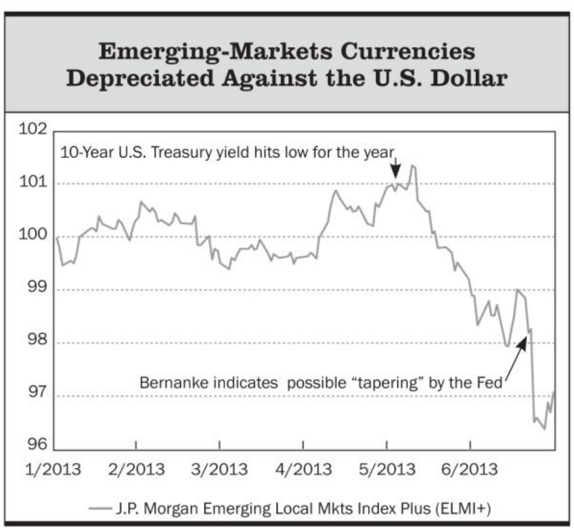
This is just part of the broader challenge the Fed faces as it tries to unwind its unprecedented post-crisis monetary policies without causing any major market or economic disruptions. At best, we are confident in saying, the "exit" will be a very bumpy road, with meaningful risks of policy errors and unintended consequences.

DEVELOPMENT #2:
Emerging-Markets Bonds and Stocks Sharply Declined

The second key development last quarter was the sharp sell-off in emerging-markets stocks and emerging-markets local-currency bonds, and their continued underperformance this year relative to U.S. stocks. From their intra-quarter high in early May through their low in late June, the emerging-markets stock index lost 15% and emerging-markets local-currency bonds dropped 14%. In comparison, U.S. stocks fell just 2.5% over that period.



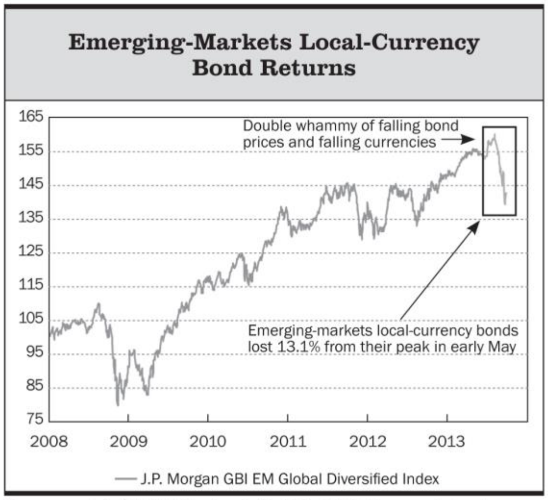
Emerging-markets stocks shed 15% from their intraquarter high in early May. Data as of 6/27/13 (Index 1/1/13=100). Source: Morningstar.



Emerging-markets currency index lost 4.9%, peak-to-trough. Higher interest rates caused an unwinding of the carry trade, contributing to the depreciation of emerging-markets currencies against the U.S. dollar. Data as of 6/27/13 (Index 1/1/13=100). Source: Morningstar.

As always, there were numerous drivers of the performance of emerging-markets assets during the quarter, but clearly the rise in interest rates in the United States, and the Fed's tapering announcements were key factors. These developments, along with news that the Japanese central bank was not planning to further expand its own QE program, triggered a general unwinding of the "carry trade," in which investors (mostly short-term traders and hedge funds) borrow the currencies of countries with low-yielding debt and/or depreciating currencies (such as the Japanese yen) and invest in higher-yielding/appreciating currency investments, such as emerging-markets local-currency bonds. As the carry trade unwound, prices on emerging-markets local-currency bonds dropped, yields rose, and emerging-markets currencies depreciated against the dollar. Thus, emerging-markets local-currency bonds were hit with the double whammy of falling bond prices *and* falling currencies.

In addition to the markets' worries about reduced central bank liquidity, ongoing concerns about a general slowdown in emerging-markets growth and disappointing economic data out of China in particular, as well as fears of a liquidity/credit crunch there (with interbank short-term lending rates



Data as of 6/27/13 (Index 1/1/13=100). Source: Morningstar.

spiking to record highs), weighed on emerging-markets stocks during the quarter. In contrast, investors seemed to be getting more optimistic about U.S. economic and growth prospects, lending support to the U.S. market.

How Did These Key Market Events Impact our Portfolios in the Second Quarter?

These two market developments had opposite effects on our portfolios: we were helped by the first and hurt by the second.

Higher Interest Rates and Our Bond Allocations

As we've discussed in previous commentaries, for the past few years the fixed-income portion of our balanced portfolios have been positioned for what we expect to be a longer-term trend of rising interest rates. We have been tactically underweight to core bond funds and have a large allocation to more flexible, unconstrained and/or absolute-return-oriented fixed-income funds. We've also held a position in floating-rate loan funds in our most conservative portfolios to further reduce those portfolios' exposure to interest-rate risk.

As a result of this positioning, our fixed-income portfolios held up better than the bond benchmark through the sell-off in the core fixed-income markets. As an example, the average second quarter loss for the non-core bond funds that we use in our portfolios (PIMCO Unconstrained, Osterweis Strategic Income, Loomis Bond) was 0.9%, and our floating-rate loan funds dipped 0.1%. This compares to a 2.5% loss for the core bond index.

Although our portfolios are underweight to core bond funds due to our expectation for a sustained period of rising rates, we have maintained exposure to core bonds in our balanced portfolios as a hedge against an economic downturn, deflation, or some unforeseen event that would lead to increased risk aversion among investors and a flight to quality assets (as core U.S. bonds are traditionally perceived to be). Of our two actively managed core bond fund holdings, PIMCO Total Return significantly trailed the benchmark in the second quarter (by its exposure to emerging-markets bonds and TIPS), while DoubleLine Total Return beat the index.

Putting it all together, our overall domestic fixed-income positioning added value again for the quarter versus the benchmark. This has also been the case over the longer-term multi-year periods we've owned these funds, and this is the time horizon over which we are most focused for our investment decisions.

Emerging-Markets Sell-Off

Turning to the developments in the emerging markets, our positioning was a negative for the quarter. First, we were hurt by the tactical position in emerging-markets local-currency bonds that we hold in our balanced portfolios (initially added to our strategies in 2009). Our emerging-markets local-currency bonds position is being funded from U.S. and international stocks because we view these bonds as having less risk than global equities (although significantly more risk than our other bond funds), but more attractive return prospects from current levels in our base case scenario. In most multi-month periods when emerging-markets local-currency bonds post significant negative returns, we would expect global stocks to perform at least as badly and likely worse, as has been the case historically. But as noted above, emerging markets meaningfully underperformed developed stock markets in the second quarter. We don't expect this trend to persist.

Second, we have also been tactically overweight to emerging-markets stocks as a share of our overall global equity exposure compared to the emerging-markets' share in our strategic equity allocations. Put differently, our balanced portfolios are tactically underweight to equity risk *overall*, but all of that underweight is coming from an underweight to U.S. and developed international stocks, while we have a full allocation to emerging-markets stocks. This was a major headwind to performance given the wide differential in returns for emerging-markets stocks versus U.S. stocks during the quarter.

These two opposing forces combined with other aspects of our positioning, such as our overall equity underweight, resulted in more muted short-term results overall for our portfolios. However, as we will discuss in the next section, we view this short-term performance in the context of our longer-term views and objectives for our portfolios.

Time Arbitrage—Taking Advantage of the Market's Short-Term Focus

Having spent most of this commentary talking about what happened in the last quarter and how it impacted our short-term portfolio performance, we now want to turn to what we view as the much more important topic, which is to put these *short-term* developments in the context of our *long-term* investment discipline and portfolio management approach. Often our inclination is to not even discuss short-term (quarterly) portfolio performance because we think such a short-term focus for many people is a major impediment to attaining long-term investment success. That is, by constantly reacting to every jump, dip, and wiggle in the markets and their own portfolio's performance, many investors lose sight of their long-term investment objectives. As such, they risk becoming part of the emotional investing herd—jumping into areas of the market that have already had a run of strong performance, or panicking and selling out of assets *after* they have had a sharp downturn, i.e., being "whipsawed" by the markets—also known as "buying high and selling low."

In order to try to inoculate ourselves against these natural behavioral tendencies, our investment approach evaluates investment opportunities over a multi-year time horizon. We think this is an important part of our investment edge. Other successful long-term, value-driven investors have referred to this as "time arbitrage"—meaning having a long enough investment time horizon to be able to take advantage of the market's short-sightedness and mispricing of assets due to transitory factors, greed, and fear. This happens both on the upside when assets become overvalued due to irrational exuberance, and on the downside when an asset class may become a compelling long-term investment due to extreme short-term pessimism.

In order to benefit from time arbitrage one must move away from the market herd (because by definition the short-term herd behavior is what is creating the long-term opportunity). And to do that successfully requires discipline, analytical ability to accurately assess the opportunity, confidence to act independently from the herd, and patience and conviction to maintain one's positions—*as long as one's analysis suggests the long-term opportunity remains compelling*—during the inevitable periods of portfolio underperformance.

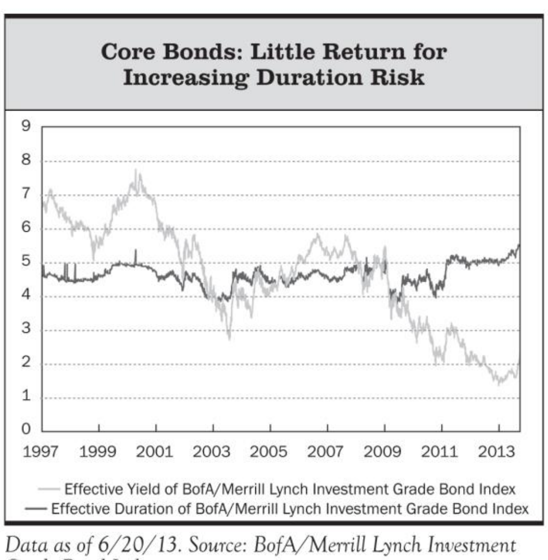
We think it also requires being intellectually honest about what we can and cannot know— when to have the conviction to act on our analyses, but to not be overconfident given that the future is inherently uncertain. So we consider a number of different potential scenarios or outcomes in our analysis, what the potential risks are (both in terms of probability and magnitude), and where our analysis could turn out to be wrong. If the facts and circumstances and our analysis do change, we have the intellectual flexibility to unwind a position and move on. In such circumstances it's important not to dig in one's heels and become contrarian for contrarian's sake—crossing the fine line from "discipline" into "stubbornness." We reiterate all of these aspects of our strategy, which likely sound very familiar to our clients, because in times of market volatility it is all the more important to step back and see the broader context and goals of our strategy.

HAVE OUR VIEWS OR PORTFOLIO POSITIONS CHANGED AS A RESULT OF THE SECOND QUARTER DEVELOPMENTS?

As we write this, the events of the past quarter have not materially changed our longer-term asset class views or risk assessments. Consequently, our tactical portfolio positioning has not changed. To the extent the recent market volatility continues, our analysis of the relative risks and returns may change, and we are currently evaluating this with respect to emerging-markets asset classes in particular. But first let's recap our fixed-income views in light of the recent bond market upheaval.

Our Fixed-Income View: The recent spike in interest rates is consistent with our longer-term expectation that rates will rise and that returns to core bonds will be extremely low, if not slightly negative over the next five years, across all of the scenarios we think are likely to play out. (Even if rates don't rise, starting from a roughly 2% yield for the core bond index basically guarantees a very low total return.) Our underweight to core bonds was driven by our five-year expected-returns analysis, and that remains our view today even after the recent yield spike, with core bonds still likely to deliver very low single-digit returns over the next five years.

The following chart further illustrates the unattractiveness of core bonds currently. It shows that while yields are near all-time lows, duration—which measures how sensitive bond prices are to changes in interest rates—has never been higher. This is due to high levels of new debt issuance coming to market with low coupons and long maturities. This combination of low coupons and long maturities is adding interest-rate risk to the core bond index at a time when potential returns are depressed. In other words, the interest-rate risk of owning the core bond index has never been higher and the return potential for taking on this risk is very, very low.



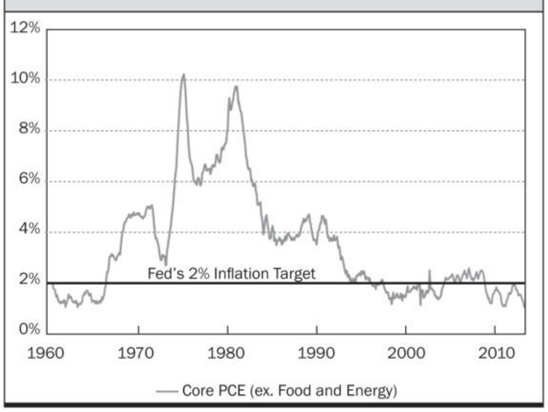
Data as of 6/20/13. Source: BofA/Merrill Lynch Investment Grade Bond Index.

We want to emphasize that while we continue to expect rates to be higher five years from now, we do not try to precisely predict when or by how much rates will increase or what the trigger might be (e.g., an earlier than expected tightening of Fed monetary policy, stronger economic growth, higher than expected U.S. inflation, a weakening in investor perception of the creditworthiness of the U.S. government, some combination of the above, or something else completely unexpected). Although predicting (i.e., guessing) where the 10-year Treasury yield will be at year end or month end might be a fun game (at least for some people!), we don't think anyone can consistently get it right and we don't base our investment decisions on such prognostications.

We would also note that within the context of a longer-term uptrend, we won't be surprised if rates come back down somewhat from current levels in the near term as markets further digest the Fed's message and intentions. A key data point driving Fed policy is inflation, so it is worth highlighting that the Fed's preferred inflation measure—the PCE (personal consumption expenditure) price index—has dropped to a year-over-year rate of just 1.1%, which is the lowest inflation rate in its 50-plus year history and well below the Fed's 2% long-term target. There is still significant slack in the economy (U.S. GDP is well below its potential) and wages—a key driver of inflation—are stagnant. The U.S. dollar has also strengthened recently, which is another disinflationary factor.

Therefore, we don't see any strong drivers of inflation in the near term; and much more importantly, neither does the Fed—they are currently projecting core inflation to be at or below 2% through at least 2015. As such, we would not expect rates to continue their sharp spike higher from here based on the economic fundamentals. There is also the self-correcting mechanism of the markets as higher bond yields start to attract buyers back into the market creating upward pressure on prices (and downward on yields). In fact, several bond managers we respect have said they view the recent market sell-off as overdone and creating some attractive bond-picking opportunities. If rates do reverse course, that would be a short-term headwind for some of our absolute-return-oriented bond funds—and we are fine with that given our longer-term outlook—but it would benefit our core bond holdings. On the other hand, it is certainly possible that short-term market momentum/investor sentiment carries rates higher in the near term, in which case we'd expect our overall fixed-income position to continue to perform relatively well in the short term (as we've seen), as well as over our tactical five-year time horizon.

Inflation is at a 50-Year Low



Data as of 5/31/13. Source: U.S. Department of Commerce, Bureau of Economic Analysis.

Our Emerging-Markets View: Just as interest rates might continue to spike higher driven by investor sentiment and market momentum, the negative impact on emerging-markets stocks and emerging-markets local-currency bonds could continue as well over the shorter term. But in this case we think the markets are overreacting to short-term developments that we don't think take into account the longer-term, positive economic fundamentals and attractive absolute return potential for these emerging-markets asset classes. We also continue to view them as more attractive than U.S. stocks on a relative risk and return basis across our scenarios. Therefore, we are maintaining our positions in emerging-markets stocks and local-currency bonds in the face of their recent performance pressures.

With regard to emerging-markets local-currency bonds, our longer-term assessment remains that the asset class should generate returns at least in the high single digits in our base case scenario of slow global economic growth with downside risk of roughly half that of stocks. The key driver of our return expectation is their mid- to upper-single-digit current yield. We also are assuming a modest (roughly 1%) additional return from emerging-markets currency appreciation versus the dollar. In addition to their attractive longer-term return potential, we continue to view emerging-markets local-currency bonds as a good hedge against the risk of a general dollar decline and/or unexpected inflation in the United States. We continue to implement our emerging-markets local-currency bond position via the PIMCO Emerging Local Bond fund.

Our discussions with global fixed-income investors whom we respect have supported the view that much of the recent sharp decline in emerging-markets local-currency bonds has been driven by negative supply/demand "technicals" (i.e., the rapid unwinding of the carry trade in relatively illiquid emerging-markets debt markets) rather than due to any significant degradation of their underlying fundamentals (e.g., their superior long-term economic growth, productivity, and better balance sheets), which are our focus.

For example, Mike Gomez, portfolio manager of PIMCO Emerging Local Bond, told us, "We've had a great deal of investment in emerging markets in the last four years and when the markets start to get rattled, the window for those who want to exit gets significantly smaller. Generally speaking, I think some of the moves we've had in emerging markets are consistent with a technical purge." Similarly, Matt Eagan of Loomis Sayles observed, "When you start to see that unravel—levered investors just unwinding those [emerging-markets currency] trades—the fundamentals go out the window." Both Loomis Sayles and PIMCO see attractive longer-term opportunities in emerging-markets local-currency bonds, as do we. We did not/do not own this asset class as a short-term carry trade, so we did not rush for the exits as the events last quarter unfolded.

Moving on to emerging-markets stocks, our base-case scenario analysis indicates potential annual returns in the low double digits over the next five years. This is an attractive potential return in absolute terms (taking into account emerging-markets equity risk) and significantly better than our low single-digit return estimate for U.S. stocks in that scenario. In our First Quarter Investment Commentary we outlined how we derive our return estimates for both U.S. and emerging-markets stocks, and that analysis still applies.

While we believe the emerging-markets stock market sell-off this year is overdone and shortsighted, we are cognizant of potential fundamental risks to our emerging-markets thesis that could turn out to be more severe or longer lasting. For example, the risk of a sharp economic slowdown in China is something we have written about frequently over the past few years and it continues to factor into our decision making. Thus far, it has prevented us from having a larger overweighting to emerging-markets asset classes. If this risk scenario plays out—e.g., if China's credit bubble and related excesses in real estate and infrastructure spending were to unwind violently, similar to what happened in the United States and Europe in 2008—then our base-case scenario assumptions and emerging-markets equity return estimates would likely prove optimistic.

Another risk we are keeping an eye on is the potential for high inflation or stagflation in emerging markets. This is not a material concern in our minds right now, but we are alert to this possibility, which if it played out would likely cause us to reduce the valuation multiple we place on emerging-markets earnings (and therefore likely reduce our estimated five-year returns).

As we weigh these and other potential risks against the attractive return potential for emerging-markets stocks and emerging-markets local currency bonds across a range of scenarios (including some more positive outcomes than our base case), we continue to believe that our overweight to these asset classes will add return over our five-year horizon. At the same time we are not ready to increase our dedicated emerging-markets exposure at current market levels given these risks.

Brief Comments on Our U.S. Stock Exposure and Rising Interest Rates: We are also maintaining our underweight to U.S. stocks in our balanced portfolios. (The underweight ranges from 9%–11%, depending on the portfolio.) The S&P 500 fell 4% in the day and a half after Bernanke's June 19 press conference—a reaction many market commentators compared to the withdrawal symptoms of an addict hooked on the drug of QE. Whether or not that is just a short-term overreaction to the Fed statements, or the beginning of a longer-term trend of rising interest rates and stock market declines, we'd reiterate that our underweight to U.S. stocks is not driven by a short-term view of the market, or by a specific concern that interest rates will continue to spike higher in the near term or that even a moderate but sustained rise in rates should cause a sharp market downturn. In fact, we don't think a moderate rise in rates from their currently very depressed levels would be reason in itself to become defensive about U.S. stocks. Rather, our underweight to U.S. stocks is driven by our analysis that at current levels the market is implicitly discounting too high a growth rate in corporate earnings over the next five years, and therefore is overvalued and likely to deliver subpar returns over that time horizon.

One other point regarding our U.S. stock exposure is the impact of rising rates on different sectors within the market. Specifically, as Empirical Research Partners recently noted, "High-dividend-yielding issues generally perform worse than the [overall] market during periods of rising rates, and that's been true again this time." Since the bottoming of Treasury yields at the beginning of May, stable, high-dividend-yielding stocks, such as utilities, have done very poorly. Should this trend continue, it may be a tailwind for our active U.S. stock fund managers in aggregate (as was the case in May). Many of them have been telling us for a while that they viewed these "defensive" sectors as generally overvalued because investors had bid up prices in search of higher-yielding equity alternatives to the suppressed bond yields. Instead, many of our managers were finding better stock-picking opportunities among companies with strong cash-flow yields and share buybacks (as well as dividends) within more economically sensitive (cyclical) sectors, such as financials, technology, and consumer discretionary.

Concluding Comments

While it can be uncomfortable to see short-term losses in one's portfolio and financial markets falling across the globe, we actually welcome this recent market volatility as it has the potential to create more attractive, if not outright compelling, *long-term* investment opportunities if the investing herds overreact and cause markets to overshoot to the downside. We would like nothing more than to see riskier asset classes, such as U.S. stocks, fall back to levels where our analysis indicates they are at least reasonably valued relative to their fundamentals and therefore likely to deliver returns at least commensurate with their risk. We are not there yet.

We are confident, however, that by remaining aware of overall portfolio-level risk and setting allocations accordingly, taking tactical allocations only when highly compelling opportunities are presented to us, and using managers we believe to be highly skilled, we can strive to earn above-average long-term returns while keeping shorter-term downside risk within our loss thresholds.

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