Investment OUTLOOK

AUGUST 2016

FRAGASSO
FINANCIAL ADVISORS

Dear Valued Client:

Though the tone of this Investment Outlook will be a more somber one, the message is that of resilience. We want to continue our duty of care to you by providing valuable information on our current portfolio strategies so that you feel confident in your financial plan.

Most recently, the Investment Committee completed the quarterly investment review. With a spirited debate and analytical thinking, strategic investment decisions were made with our clients' goals at the forefront of our mind. Whether it was discussing the persistently low interest rates on fixed income securities, the global impact of Brexit, or the opportunities in the global economic landscape, the following pages address those issues and more with our current portfolio positioning. Regardless of the current investment climate, we continue to actively manage risk on a full-time basis through time-tested, textbook principles.

- Maintain asset allocation in line with client objectives.
- Manage portfolio risk.
- Hedge riskier positions to protect against worst-case scenarios.
- Adjust tactfully within market dynamics.

If you find our methodology helpful and believe others may also benefit, please don't keep us a secret. We have a dedicated and experienced team that stretches across multiple disciplines to generate the insights to help other people, organizations and businesses that are important to you.

We sincerely appreciate your business.

DANIEL DINGUS, AIF®, MBA
PRESIDENT AND EXECUTIVE DIRECTOR OF PORTFOLIO MANAGEMENT

MAJOR ASSET *Class Returns* 2016

6.6% EMERGING MARKETS	5.3% *fixed income*	4.0% U.S. EQUITY SMALL/MID CAP
3.8% U.S. EQUITY LARGE CAP	0.0% CASH	-4.0% DEVELOPED INTERNATIONAL MARKETS

As of June 30, 2016

U.S.EQUITIES

U.S. Equities are more than fairly valued according to our analysis, making market cap selectivity very important. *Read more about areas for investing opportunity on page 4.*

INTERNATIONAL EQUITIES

International Equities continue to drag on global allocations, but emerging markets have been a positive note this year. *Read more on page 6 to see why it might be time to start favoring them.*

FIXED INCOME

Fixed income investing continues to be a struggle in the search for yield. *Read more on page 7 to see which surprising asset class was the best performer so far this year.*

Source: Morningstar Direct

PORTFOLIO MALADIES AND *The Duty of Care*

Between terrorist attacks, natural disasters and political upheavals, it is fair to say that 2016 will be emblazoned in our memories as one of those years we wish we could start over. With the weight of the world so heavy for many, it seems almost callous to write yet another article about the importance of diversifying and staying invested. Though we can't stress those tenets enough, perhaps the better question to answer is: what do we, the wealth managers, do when it seems the markets are ungovernable?

We have to divorce ourselves from our emotions regarding the market swings, but what about when an investment in our portfolio is running astray from the rest of the pack? It is not uncommon to have some investments that are performing relatively well and then some that are not. It is also not uncommon to see top-performing investments have a couple of bad years. We owe our clients a duty of care in swiftly diagnosing any portfolio problems and changing direction when necessary.

***Here** are the steps we take when tackling these situations:*

MONITOR: It might seem obvious that the first step is to monitor our investments, but the critical piece of this step is the "what" of monitoring. It is not enough to look solely at returns. There are additional quantitative factors such as risk and dividend yields and also some qualitative factors. Some examples that may send up red flags for us are abrupt changes in management personnel or a radical change in decision making processes.

DIAGNOSE: Like doctors, we aim to determine the root cause of the investment malady. We want to avoid simply treating the symptoms (in our case bad performance). We don't want to make the mistake of selling out of an investment that has been kicked down only to see it rebound shortly after. Therefore, we perform an attribution analysis and interview the managers. Through attribution, we uncover what drivers within asset allocation and stock selection are to blame for the aberrant performance. Through interviews we can determine if this is a breakdown in the fund, cyclical change in the market, or a short-term change that is likely to correct itself.

TREAT: After we have finished our assessment we have two options: hold or replace. Though frustrating, there are times when underperformance is not due to an underlying breakdown in the management process or fundamentals, and we can expect the investment to reverse course. In these cases, we want to ride out the storm and not get caught chasing performance of the current in-trend investment. When we do conclude that replacement is best, we start at the beginning of our investment evaluation process.

INVESTMENT *Opportunities*

At Fragasso, we maintain investment portfolios diversified across all asset classes to reflect a global allocation and a long-term focus on balancing return and risk objectives. We seek to outperform the markets through both tactical asset allocation and investment selections. Here's where we see and don't see those opportunities in 2016:

› CO-VARYING ASSET CLASSES

UNDERWEIGHT — OVERWEIGHT

We continue to maintain an allocation to strategies that help mitigate volatility in our client's portfolios. As we saw with the results from the Brexit vote, equity markets can suffer from wild swings. Holding funds that employ market neutral strategies helps protect assets in the event of these downturns.

› U.S. EQUITIES: LARGE CAP

UNDERWEIGHT — OVERWEIGHT

The U.S. economy continues to be the most stable developed market in the world. Unemployment is relatively low and GDP growth remains somewhat respectable. However, equities are more than fairly valued, and once the Fed raises interest rates again, we would expect to see some downward pressure on U.S. equities. Given our outlook, we continue to believe that remaining biased towards large cap companies is prudent from a conservatism standpoint.

› U.S. EQUITIES: SMALL/MID CAP

UNDERWEIGHT — OVERWEIGHT

Mid cap securities have been a remarkably strong area in which to invest over the last year, which makes the area somewhat hard to remain heavily invested in for the coming years. We believe weakness in the U.S. markets, particularly small cap equities, could make for an interesting time to consider tilting more towards small cap stocks.

› INTERNATIONAL EQUITIES

UNDERWEIGHT — OVERWEIGHT

The Brexit vote sent international equities into a tailspin. On a relative basis, international equities are less expensive than their U.S. counterparts. But given the vast uncertainty surrounding the rest of the world, we are maintaining our neutral weighting to this asset class for the time being.

U.S. *Equities*

WRITTEN BY
MATTHEW KARR, CFA, MBA
and
MADISON NESTOR, CFA

For the first half of 2016, the S&P 500 posted a total return of 3.8 percent, with most of that coming in the second quarter. Small-mid cap stocks beat large cap, driven by the Russell Mid Cap Index posting a total return of 5.5 percent.[1] Value stocks sizably outperformed, buoyed by higher weights to utilities, telecommunications and energy stocks – the three best performing sectors for the year. Crude oil prices put in a bottom below $30 per barrel early in 2016, and have rallied steadily since.[2] Fundamentally, we expect the commodity price to track global economic conditions more closely going forward. This could create some more volatility in these securities.

All in, the trends in data seem to suggest that economic conditions are holding somewhat steadily, but not improving.

Consumer incomes and spending are still growing, but at slower rates than a few months ago.

Consumer confidence has been trending a bit lower for most of the last year.[3]

Inflation has remained somewhat elevated versus last year.

Labor data's recent choppiness has put the Federal Reserve on hold for another interest rate increase in the next few months.

On this basis, U.S. equities do concern us, particularly after a period of pronounced strength compared to other global indices. We still believe that equity valuations in the U.S. are on the expensive side, largely given our fear that earnings may remain under pressure for a few quarters. With the second half of the year starting with a 16.6x P/E ratio,[4] multiples may not seem overly high versus longer-term historical averages, but we would caution that multiples remain extended versus where they were earlier in the business cycle. We believe that the latter is a more relevant comparison, as "long-term averages" contain years' worth of elevated multiples into the tech bubble.

We recognize, however, that ongoing declines in interest rates, as measured by the 10-year yield on U.S. Treasury bonds, could enable U.S. stocks to outperform global stock indices, particularly amidst higher international volatility. This is referred to as a "flight to quality" move by market participants. We view this as a temporary phenomenon rather than a structural investment thesis. As long-term asset allocators, we believe there is likely going to be an opportunity to invest more money into cheaper regions of the world further along the business cycle and we are proceeding with care in the process.

1 Thomson Reuters. Accessed July 7, 2016.
2 Thomson Reuters. Accessed July 8, 2016.
3 The Conference Board, Consumer Confidence Survey via Thomson Reuters Datastream.
4 Thomson Reuters Datastream. Accessed July 8, 2016.

U.S. *Equities*

Telecommunications piques our interest. While utilities and consumer staples have mostly received the benefit of investors chasing higher yield over the last few years, telecommunications companies have not participated as much until the first half of 2016. We believe this is an area that could see relative outperformance, as the starting P/E level of 14.1x is below cycle averages.[5]

Healthcare stocks are not exactly cheap, but they are much less expensive than they were from a valuation perspective at the start of the year (P/E of 15x vs. 16.1x at the end of 2015).[6] Drug regulation is certainly on investors' minds heading into a new presidential administration, but we believe there are still opportunities in the sector, particularly for diversified businesses with necessary products.

Financials remain somewhat of a head scratcher. After a period of rising valuation multiples, banks particularly are under pressure of late as the Fed delays rate increases, lending officers are a bit more cautious, customer demand is not necessarily accelerating and income from the investment portfolios faces lower investment yields. Helping the group has been real estate investment trusts (REITs), but these companies are getting their own sector later in 2016. We believe there could be potential further volatility ahead for the banks, and we would not advocate overweighting yet.

5 Thomson Reuters Datastream. Accessed July 8, 2016. "Cycle averages" defined as trailing 10 years.
6 Thomson Reuters Datastream. Accessed July 8, 2016.

INTERNATIONAL *Equities*

WRITTEN BY
LISA BRIGNONI, CFA, AIF®

It was hard to ignore the fallout from the surprising Brexit vote on June 23, 2016. In what will go down as a historic day in global politics, British citizens voted to end their 43-year relationship with the European Union. Global markets began tumbling as soon as the news broke and now the speculation has begun as to what short- and long-term effects investors can expect to see. Uncertainty is driving this process. Because of the numerous unknowns at this point, we remain cautious on changing international equity allocations in either direction.

HERE'S HOW VARIOUS REGIONS SHAKE DOWN FOR THE REST OF 2016:

● NEUTRAL ● POSITIVE

JAPAN

Economic growth was higher than expected for the first quarter of 2016, which gives us confidence going into the second half. Prime Minister Abe is carefully considering policy so as not to crush already struggling demand. Rising commodity prices is also a short-term headwind.

EUROPEAN UNION

Following the surprising Brexit vote, EU stability will remain a question mark in both the short term and long term. Discontent with the EU is not isolated to the U.K. and the growing security concerns and refugee crisis will continue to stretch resources. Any recovery will most likely be led by the strength of consumers. Credit demand is strong and regional goods and services will be cheaper relative to the U.S. This attractively priced sector is responding well going into the second half of the year, but much remains to be seen.

UNITED KINGDOM

The U.K., so far, fared slightly better than mainland Europe following Brexit, but there is still a big unknown over the details of the "exit" process and this will likely take a long time to sort out. In the short term, expectations for growth are lowered as many business leaders will put a hold on new investments until this is all sorted out. The Bank of England has made it clear that they are willing to cut interest rates in support of the economy during this time.

EMERGING MARKETS

We are starting to favor emerging market equity heading into the second half of the year. Though the early year rebound may cause concern of performance chasing, double-digit return territory is not uncommon for this highly volatile asset class. Most of the damage from an appreciating U.S. dollar has been done. Confidence in Brazil's structural reforms is rising under temporary President, Michel Temer and China's economic growth is starting to regain traction as it transitions to a service economy.

FIXED *Income*

WRITTEN BY
MICHAEL GODWIN, CFA

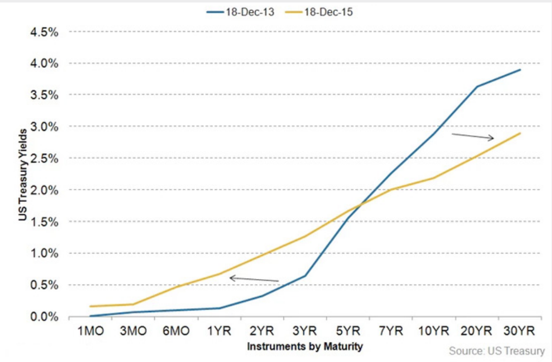
By the end of June, there was a total of $11.7 trillion worth of bonds that had negative yields.[1] Two of the most profound countries sporting negative yields are Germany and Japan, where their respective 10-year government bonds are yielding -0.13 percent and -0.23 percent.[2] All things equal, if you invested $1,000,000 in 10-year Japanese government bonds and held to maturity, at the end of the horizon, you would be left with $977,237—and somehow people think this is a good investment right now!

It's not much better in the U.S. On July 6, 2016, the 10-year U.S. Treasury bill yielded 1.34 percent,[3] the lowest it's ever been. Unfortunately for investors, it seems to have been the same story for a few years now; yields are so anemic that investors relying on income feel they have nowhere to turn. But over the past six months, yield only tells part of the story. **Would you be surprised if I told you that one of the best performing assets this year was long dated U.S. corporate bonds?** Even with government bonds offering such a small coupon, U.S. long-term corporate bonds have returned 14 percent year to date.[4] Most of this return has come from price appreciation of the bonds as investors continue to "search for yield." Even if these bonds are more than fairly valued, investors are still willing to pay up for them in order to capture the higher coupon. This could spell trouble for investors down the line.

Turning back to government bonds, this market is comprised of a number of different maturities, from bonds maturing in three months, six months, one year, three years, and even the 10-year. The current yield for a given bond tells you how much you will earn per year for holding that bond until maturity. The one-year U.S. T-Bill is currently 0.435 percent while the three-year is yielding 0.647 percent.[5]

One area that we are monitoring is the shape of the yield curve. As illustrated below, the curve has been flattening over the past couple of years and continues to flatten today. Short-term bonds continue to yield roughly the same amount while long-term bonds, like the 10- and 30-year, continue to yield less as investors pile into them. This can lead to an inverted curve, in which longer dated bonds actually yield less than short-term bonds. This can signal a recession on the horizon. While we're not suggesting that a recession is imminent, we still want to protect our clients' assets in the event of a downturn in the credit markets.

We have positioned fixed income holdings in a more conservative manner in the event that bonds sell off. We understand that many of our clients are reliant on interest income, which is why we hold funds that invest in a diverse set of bonds in order to increase overall yield while keeping risk low.



FLATTENING YIELD CURVE
Morningstar Direct

1 http://www.cnbc.com/2016/06/29/there-are-now-117-trillion-dollars-worth-of-bonds-with-negative-yields.html
2 Thomson Reuters
3 Thomson Reuters
4 Barclays US corporate 10+ year TR—Thomson Reuters
5 Thomson Reuters

A word about risk: Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in the bond market is subject to certain risks including market, interest rate, issuer credit and inflation risk; investments may be worth more or less than the original cost when redeemed. Investing in foreign denominated and/or domiciled securities may involve heightened risk due to currency fluctuation, economic and political risk, which may be enhanced in emerging markets. Mortgage and asset–backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and their value may fluctuate in response to the market's perception of issuer credit worthiness; while generally supported by some form of government or private guarantee, there is no assurance that private guarantors will meet their obligations. High-yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risks than portfolios that do not. Alternative strategies such as arbitrage, hedged equity, market neutral or long/short may result in higher internal transaction costs and tax consequences of short-term gain. Funds may engage in option transactions and short sales. Option transactions involve special risks that may make it difficult or impossible to unwind a position when the fund desires. With short sales, you risk paying more for a security than you received for its sale. In addition to the normal risks associated with investing, merger arbitrage strategies may realize losses if the proposed reorganizations in which the strategy invests are renegotiated or terminated. Other arbitrage strategies may include but are not limited to convertible risk, synthetic convertible risk, convertible hedging risk, and covered call writing risk. In hedged equity strategies, selling index call options can reduce the risk of owning equities, but it limits the opportunity to profit from the increase in the market value of equities in exchange for the upfront cash at the time of selling the call option. Additionally hedged equity strategies may lose part or all of the cash paid for purchasing index put options. Unusual market conditions or the lack of a ready market for any particular option at a specific time may reduce the effectiveness of a hedged strategy. Diversification does not ensure against loss. There is no guarantee that these investment strategies will work under all market conditions or are suitable for all investors. Each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market.

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