Investment OUTLOOK

MAY 2016

FRAGASSO
FINANCIAL ADVISORS

Dear Valued Client:

I'd like to welcome you to the next stage in the redesign of the Investment Outlook. We are carrying over the momentum from the refreshed look of *The Advisor*, Fragasso's seasonal magazine that offers industry insights and firm news, to this latest edition. We know your time is valuable and want to give you the information you need on current market events in a format that is enjoyable to read.

In this edition, the portfolio management team looks back on the wild start to 2016 that rattled the nerves of many investors. The team considers what to expect for the remainder of the year. As always, we emphasize that through good and bad markets, maintaining a long-term focus on portfolio allocations will help you achieve your financial goals.

We actively manage risk on a full-time basis through time-tested, textbook principles. Our philosophy is to:

- Maintain asset allocation in line with 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

5.8%
EMERGING MARKETS

3.0%
fixed income

1.4%
U.S. EQUITY LARGE CAP

0.4%
U.S. EQUITY SMALL/MID CAP

0.0%
CASH

-2.9%
DEVELOPED INTERNATIONAL MARKETS

As of March 31, 2016.

1933

The last time large cap equities have had as dramatic of a turnaround after falling so steeply at the beginning of the year. *Read more about prospects for the economy in U.S. Equities on page 4.*

6.5%

Average yield of a high-yield bond during Q1 2016. High correlation to the price of oil has brought this asset class to the front burner of news desks. *Read more in Fixed Income on page 6 to see why these investments may make a comeback.*

28.6%

Q1 2016 returns for Brazilian equities. With all economic indicators pointing to continued recession, the upturn in equities markets came as a surprise to investors. *Find out why in International Equities on page 5.*

Source: Morningstar Direct

WEATHERING THE *Storm*

The classic story of the *Wizard of Oz* tells the tale of Dorothy who is whisked away to Oz and attempts to make her way to the *Emerald City* so that she may return home to Kansas. As you most likely recall, the journey was not an easy one, filled with misguided friends, winged monkeys and an evil witch trying to kill her.

This was all a fantasy (and quite a terrifying one), but sometimes the latest headlines can lead investors to feel like Dorothy during volatile times. It also feels like a broken record when the experts remind us about investing for the long term. Though that is the strategy we recommend at Fragasso, perhaps the story of four hypothetical investors following the yellow brick road to the Emerald City of Retirement can bring that advice to life. **In this example,** our four investors begin on Jan. 1, 2016 with $100,000 each and invest in the same investment portfolio with a growth and income-oriented allocation.[1] However, they react differently to market news throughout the course of the first quarter and consequently, they end the quarter with different results. Let's take a look at how our investors fared:

COWARDLY LION: Not happy at all with the start to the year and concerned about further drops in the market due to lowered economic forecasts, the Cowardly Lion decides to pull his money from the market on 1/15/2016 and sit in cash until the outlook improves. By the end of the first quarter, he has $95,220.

THE TINMAN: Also feeling nervous after a rocky start, the Tinman holds out a little longer but by 1/29/2016, decides to also put his money in cash and wait for clearer skies. At the end of the first quarter, he has fared slightly better and has $96,790.

THE SCARECROW: Feeling slightly motivated by the small upturn in the market at the end of January, the scarecrow makes it all the way until 2/29/2016 when he decides he can't bear it any longer and is only slightly worse for wear at $96,740.

DOROTHY: Determined as ever and prepared to make it over the rainbow, Dorothy stays invested throughout the entire period. She finishes the quarter with $101,190.

Ending portfolio values for each investor were calculated based on the select period of time they were fully invested in the model portfolio.

Once the stormy markets subsided, the Cowardly Lion, the Tinman and the Scarecrow are now ready to join Dorothy and reinvest in the market. The only problem is that Dorothy is well ahead of them on the yellow brick road and in order to catch up, they would have to earn on average an additional 5 percent in returns assuming they all invested in the same portfolio as before. That is a tall order in today's market and a hurdle no investor should have to worry about jumping. Though this example is simplified, it is a powerful illustration of the impact of not staying invested.

1 Portfolio is based on the following allocations: Large cap equity – 25.5 percent, Small/Mid cap equity – 13.5 percent, Developed international equity – 19 percent, Emerging markets equity – 7 percent, liquid alternatives – 7.5 percent, fixed income – 27.5 percent.

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

Though not an easily defined asset class, these strategies are an effective investment tool used to mitigate volatility through low correlation with traditional asset classes. We will increase our use of these strategies, such as market neutral and put/call to temper the expected swings and keep Dorothy and her friends on the yellow brick road towards the Emerald City.

› INTERNATIONAL DEVELOPED

Europe and Japan both look fundamentally cheaper than the U.S. on an earnings multiple.[1] More concerning however, given central bank policies, is that the equity markets have failed to rally despite cheap credit and negative interest rates. We still believe the backdrop for economic improvement is greatest in Europe as corporate balance sheets are healthier and profit margins are on the upswing. We will adjust our allocation to this asset class to be equal with a global allocation and seek outperformance through advantageous investment selection.

› U.S. SMALL/MID CAP

Typically, small cap stocks outperform large caps in rising rate environments. But given that there are more concerns surrounding the U.S. economy than assurances, we believe it's best to reduce our exposure to this asset class.

1 JPMorgan Asset Management

U.S. *Equities*

WRITTEN BY
MATTHEW KARR
and
MADISON NESTOR

There has been no shortage of volatility in U.S. equity markets thus far in 2016. *The S&P 500's unremarkable 1 percent return is an unfair representation of how eventful the first three months of the year have been*. After falling by 11 percent by mid-February, the large cap index came roaring back to inch into positive territory for the quarter.[1] This has been the most violent large cap equity turnaround since 1933. Once the dust settled, the S&P 500 traded at a P/E ratio of 16.6x, in line with the 25-year average.[2] On the market cap spectrum, large cap and mid cap equities outperformed small cap equities for the quarter.

In contrast to the growth style factor's noteworthy outperformance of value in 2015, value equities have outpaced growth in 2016.[3] This can be attributed to commodity prices finding a potential floor, capitulation of the U.S. dollar relative to a basket of foreign currencies and a slight uptick in short-term interest rates. The best-performing U.S. equity asset class in 2016 has been mid cap value, posting a gain of 3.9 percent.[4]

The broad consensus of analysts believes that the American economy remains on stable footing and will continue its slow but steady trajectory of economic growth. Consumer spending accounts for 68 percent[5] of U.S. gross domestic product, helping to insulate the U.S. economy from uncertainty abroad. The consumer balance sheet has been bolstered to the healthiest levels since the Great Recession after consumers have effectively banked a subsidy from lower energy prices throughout the year. Unemployment remains low at 5 percent,[6] labor markets have shown an uptick in participation and wage growth is slowly but steadily gaining traction. Inflation has marginally increased in recent months, and continuation of that trend would likely be motivation for the Fed to continue its pursuit of tighter monetary policy. Nothing happens in a vacuum, and the effects of such divergent monetary policy versus that of other major central banks adds a potential wrinkle to what happens in the currency markets.

While there are no visible dark, ominous clouds on the horizon, the U.S. economy is entering the later stages of the business cycle, which is often accompanied by more mixed asset class performance than any other stage. Corporate profit margins have begun to deteriorate, and the inventories-to-sales ratio has climbed to begin the year, suggesting the economy may have peaked.[7] While equity markets are trading at reasonable multiples on a long-term average, we are concerned about the trends in underlying earnings growth being sufficient to drive the stock market in the short term.

Investors are prudent to position with a conservative tilt for the volatile remainder of 2016. We recommend overweighting high-quality names with lower betas, as they should provide some insulation in the event of continued volatility. Likewise, overweighting large cap equities relative to small and mid counterparts should further stabilize the domestic equity portion of a portfolio.

1 http://www.bloomberg.com/news/articles/2016-04-05/lockstep-moves-ease-futility-doesn-t-for-u-s-equity-managers
2 J.P.Morgan Guide to the Markets Q2 2016
3 Morningstar Direct Data
4. Morningstar Direct Data
5 J.P.Morgan Guide to the Markets Q2 2016
6 http://data.bls.gov/timeseries/LNS14000000
7 https://www.census.gov/mtis/www/data/pdf/mtis_current.pdf

INTERNATIONAL *Equities*

WRITTEN BY
LISA BRIGNONI

Will Brazil's Rebound Last?

If there was a contest for the most unpredictable equity market, Brazil would be a serious contender. With expectations for positive returns for this market being a mere pipedream amid the continued economic contraction and pervasive political corruption in Brazil, *it comes as a shock that this market managed to return 28.6 percent in the first quarter of 2016.*[1] Initial momentum came from lightened currency headwinds from an appreciating dollar, but the real magic started happening in Brazil after speculation of government reform following the formal filing of corruption charges against former President Luiz Inácio Lula da Silva and increased likelihood of impeachment of President Dilma Rousseff.

In mid-April 2016, the Brazilian government voted to begin the impeachment process. Though this development is applauded by the markets, the path to economic recovery is not without its obstacles.

With political reform speculation being the main driver behind these positive returns for the year, *it's highly unlikely that this performance will continue in the absence of economic catalysts*. Brazil's deteriorating manufacturing indices suggest that this long-sought economic growth may still be elusive. The expectation for Brazilian equities is to remain volatile throughout the year.

As such, we are minimizing exposure to Brazilian equities.

1 Morningstar Direct

Europe continues searching for upward momentum

And if there was a contest for the most frustrating equity market, Europe gets my vote. Europe has all of the trade winds in its favor with lower oil prices, a weakening Euro to support exports and Mario Draghi, president of the European Central Bank, rolling along consistently with quantitative easing. Unemployment continues to tick downward and consumers demonstrate confidence with an increasing demand for loans. Even with all of that momentum and a late quarter uptick, *the MSCI Europe ex UK index was down 2.41 percent in Q1 2016.*[2]

Though patience is wearing thin with investors in this asset class, the economic fundamentals outlined above continue to give us reason to be optimistic.

2 Morningstar Direct data

What happened to China?

At the beginning of 2016, China was the main instigator for global equity market volatility following a string of trading halts on Chinese exchanges due to panic selling. This set off concerns for global investors that drove equities into a downward spiral and led to one of the worst starts to a year since 2008.[3] Later in the quarter, China dropped into the background as investors began refocusing on other issues – the upcoming U.S. elections, U.S. growth concerns and commodity prices.

As it currently stands, China is still transitioning from a manufacturing to a service-oriented economy, thus revising down its growth projections. Absent any major commodity shocks or any other external factors, Chinese equity markets are expected to stabilize over the course of the year as investors gain more comfort with this planned downshift in growth.

3 CNBC News: http://www.cnbc.com/2016/02/01/china-stocks-post-worst-monthly-performance-since-2008.html

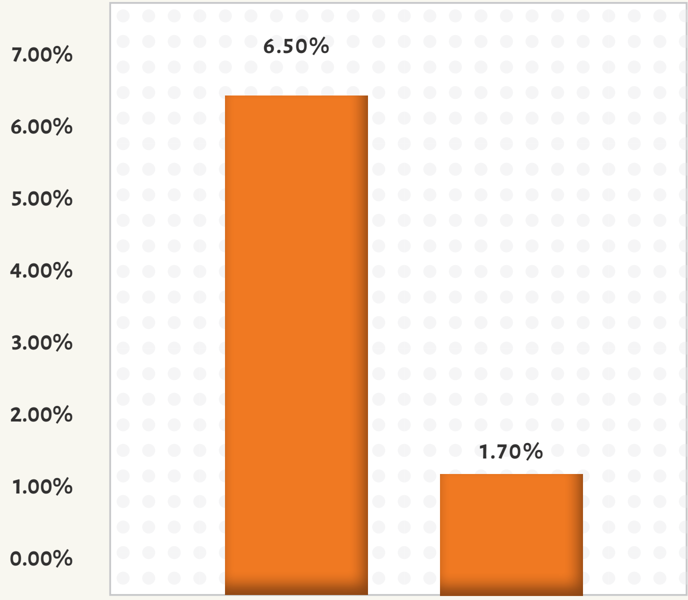
FIXED *Income*

WRITTEN BY
MICHAEL GODWIN

If you're anything like me, you're probably getting sick of hearing the word "volatility" on a daily basis. Unfortunately, there aren't too many alternative ways to describe the market's behavior thus far in 2016. While equities sustained a nice rally in the last month and a half of the first quarter, we shouldn't be complacent or forget about the market's performance to start the year—recall that equity markets were down 10 percent through the first six weeks of the year.[1] There was a lot of panicked selling by investors and a "flight to quality" ensued, which is a reason why U.S. Government and high quality corporate bonds have done so well this year. There's a caveat though as these bonds yield, on average, around 2.3 percent, not leaving much in the way of a hefty coupon payment.[2]

At Fragasso, we realize that we have to be smart, yet creative, when constructing our fixed-income allocation because 2 percent coupons typically aren't sufficient enough for our clients. Fortunately, we believe there will be other opportunities in the fixed-income space to generate adequate income in an otherwise low interest rate world. The average high-yield bond fund currently yields 6.5 percent, almost 5 percent higher than a U.S. 10-year Treasury bond.[3] These high-yield bonds have made headlines over the past six months as they have recently been correlated to the price of oil. Though energy companies have suffered significantly over the past two years, most other industries have seen their profits remain relatively stable. Barring a recession, we believe that total returns in the high-yield space will be attractive over the medium term.

We are currently researching and interviewing portfolio managers who invest in the global high-yield market. These managers typically invest in higher quality below investment grade bonds helping to reduce volatility when compared to some of their peers. Though we believe that these securities have rallied too far too fast in the past couple of months, we foresee an opportunity arising in the next few months to increase our allocation to this sector.



AVERAGE HIGH-YIELD SPREAD OVER 10Y U.S. TREASURIES
Morningstar Direct

1 Morningstar Direct
2 Barclays U.S. Aggregate bond index yield
3 Morningstar Direct

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Follow the yellow brick road...

Though we see more calm in the market forecast for the moment, it's only a matter of time before the next storm comes our way. We are facing an eventful year with elections, slow growth as a new normal and uncertainty in markets abroad. By actively monitoring the equity and fixed-income markets for both opportunities and traps, we are confident the investment advice we provide will smoothly guide you along the yellow brick road to retirement.

We look forward to continuing to provide you an exceptional client experience and sharing our latest thoughts on developments in the market next quarter.

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Investment advice offered through Fragasso Financial Advisors, a registered investment advisor.