Investment OUTLOOK

FEBRUARY 2016

FRAGASSO FINANCIAL ADVISORS

DEAR VALUED CLIENT:

I'm excited to present our most recent edition of the Investment Outlook. At Fragasso we continuously strive towards excellence in portfolio research and analytics to help you achieve your goals. In this edition of the Investment Outlook, the portfolio management team takes a critical view of the recent volatility in the market and addresses the current challenges and opportunities for investors.

After our most recent quarterly investment committee meeting, the Fragasso portfolio management team addressed critical questions about the world economy. Is this a correction in the markets or the beginning of a bear market? How does China play a role in the turmoil? And how do we strategically position in this market environment. The following Investment Outlook dives right into these pressing questions.

As always and continuing as we move forward, Fragasso's portfolio management team believes that a broadly diversified portfolio that is not overly exposed to any one risk is the best strategy to achieve solid, risk-adjusted returns. How we strategically position the portfolio for increasing volatility is a theme within the following pages. Market pullbacks and normal corrections in the market can be unnerving, but they are not abnormal. Since 1980, the S&P 500 has finished positive in 27 of 36 years despite some market pullback in almost all 36 years.[1]

Equity markets' softness in recent months reinforced additional disciplines that the appropriate risk/reward is implemented in your financial plan and carried through to your portfolio. With an ever-changing economic environment, it is our responsibility to consider each client's circumstances with a fresh approach couched in holistic financial planning.

As these market conditions change, we actively manage risk on a full-time basis through time-tested, textbook principles:

- 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.

DAN DINGUS, AIF®
PRESIDENT AND CHIEF OPERATING OFFICER

Q1 2016 Strategic Changes

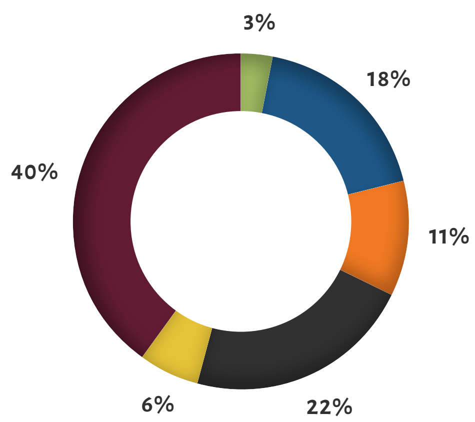
Though each individual's return and risk objectives are different, thus requiring different asset class allocations, our strategic allocations within the main classes of equities and fixed income are constantly reviewed and adjusted to respond to market conditions by our dedicated Portfolio Management Department.

Starting off 2016 we are positioning for three major themes to play out: investor uncertainty and market volatility, slow and steady rise in interest rates and weakness in economies dependent on commodity exports.

1. To provide downside protection against market volatility we are increasing exposure to non-correlating asset classes, specifically within our alternative equity.
2. Within the fixed-income allocation, we are shifting away from riskier emerging market debt and shifting towards higher quality corporate debt to provide more favorable returns in a low but rising interest rate environment.
3. With continued struggles in China and other commodity dependent economies threatening a global slowdown, we are decreasing exposure to the more volatile emerging market equity asset class.

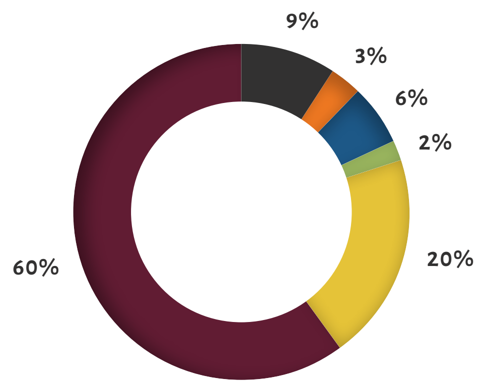
FRAGASSO MODERATE ALLOCATION

(60% Equity | 40% Fixed Income)



FRAGASSO CONSERVATIVE ALLOCATION

(40% Equity | 60% Fixed Income)



- U.S. EQUITY - LARGE CAP
- U.S. EQUITY - SMALL/MID CAP
- DEVELOPED INT'L EQUITY
- EMERGING MARKET EQUITY
- ALTERNATIVE EQUITY
- FIXED INCOME

The start to 2016 could not have been more disappointing for investors weary after volatility ramped in the latter half of 2015. Each new year often brings feelings of hope and change, but this year for global investors, it is more like a test of patience. Realizing that we have all the tools we need to navigate these turbulent times is the first step we need to take, but that's never the easiest one. So let's break down the current market situation and take it from there.

Are we experiencing a correction or the beginning of a bear market?

Though we won't know for certain which market condition we're experiencing until it happens, it is our assessment that the rocky start to 2016 is a correction and not the beginning of a bear market. Certainly the reminder that markets selling off and rallying back is a normal part of investing is not as comforting when we hear that this January is the worst start to a year on record. However, if we break down our current environment into common characteristics seen in bear markets, that reminder becomes a little more reassuring.

According to a study by JPMorgan Asset Management, there are four characteristics that have been common to bear markets throughout history: commodity price spikes, an aggressive Federal Reserve, recessions and excessive valuations. Describing our current environment, we do not see any of these attributes. First, though we see volatility in commodity prices, the price levels are clearly the opposite of peak prices. Second, in delaying the rate hike several times in 2015, the Fed has shown that it is perhaps being overly cautious. Third, while we are expecting slower growth, GDP has not been negative for two consecutive quarters, which is one definition of a recession. And finally, we are not even close to excessive valuation territory. Valuations of broad market indices at 27x were characteristic of the dot-com crash in 2000, and today those valuations are hovering around 16x, which is near the historical average.[2] With all of these factors considered together, we have confidence that the market is experiencing a correction and not a more sustained bear market.

So even though we feel comfortable that the big bear is still sleeping right now, the prospect of riding through a correction doesn't seem like much better of an alternative. So why should a correction make investors feel better? Starting with the definition, a correction is short term in nature and represents a pullback in broad market indices of 10 percent. The key word in that definition is short term. This means that these market conditions are enticing for opportunistic investors. Professional fund managers have been quick to take advantage. For those who are fully invested in the market, holding your current positions is the best course of action, as accurately timing the bottom of the market is not something even the best managers can do with any consistency.

What if it does turn out to be a bear market?

While the fundamentals of the economy suggest otherwise, the biggest wild card in the market is investor sentiment. Selling due to fear can become a self-fulfilling prophecy. There is no way to combat this market force of emotions except with calmed reassurances. This is an uncertainty with which no one is comfortable. In this situation it is best to think of the options. If you do sell out of the market now and it turns out to be a correction, you'll be challenged to recoup the losses already realized. If you sell out and it does turn out to be a bear market, you still realize current losses and then face the daunting task of trying to time the bottom of the market. These first two scenarios are what have led to the startling fact that the average annualized investor return over a 20-year period has been 2.2 percent.[3] For those investors that choose the third option and stay invested in a balanced portfolio, their average annualized return over the same period was north of 8 percent.[3]

To avoid the first scenario, the first step is to have a conversation with a trusted financial advisor. Review your investment plan and gain confidence in your short-term and long-term strategies. If you are invested in accordance with your personal situation, you can make it through the bear market. One of the best things going for your portfolio now is diversification because it is important to remember that even now, not all markets are falling. As of the end of January, the S&P 500 was down 3.6 percent, while the Barclays US Aggregate Bond Index was up 1.3 percent.[4]

Key Takeaways

- On Dec. 16, 2015, the Fed voted to increase the federal funds rate by 0.25 percent, the first rate hike in 9 years. As global growth remains weak and U.S. economic data sends mixed signals, we believe the Fed will raise rates 2 to 3 times this year; the next increase coming in June.

- Oil and other commodities continue to struggle to find a bottom, with oil dropping below $30 per barrel in January before rebounding slightly. This is the lowest a barrel of oil has cost since 2002. The steep decline in oil is more a result of oversupply than a decrease in demand. As many U.S. shale producers have reduced the number of wells they are drilling, we believe the supply of oil will ratchet down and prices should stabilize around $40 per barrel.

- China's growth slowdown continues to be a main concern for equity markets. China's transition from an industrialized economy to a service economy will take many years to complete and investors should expect a bumpy road for the time being. China will continue to attempt a slow devaluation of their currency as it has appreciated significantly against many other emerging market currencies. Doing so has incited increased market volatility in the past and will most likely elicit similar reactions going forward.

Key Takeaways

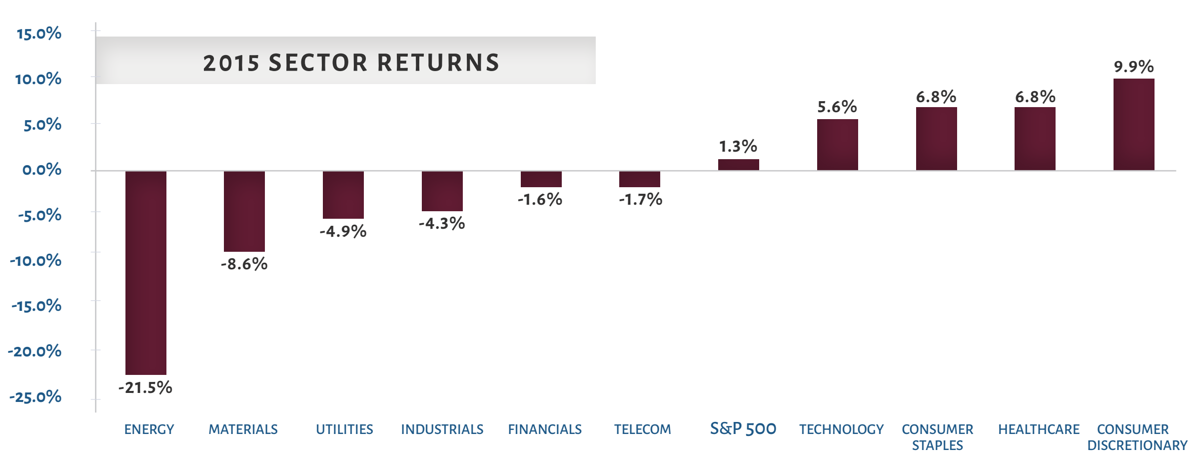
- We will continue to see monetary policy divergence between developed market economies as Japan and Europe will maintain cheap credit while the U.S. continues to tighten the monetary spigots. The flow of cheap money in Europe and Japan will help support equity prices in their respective markets.

- Oil and basic materials represent less than 20 percent of the high-yield bond market.[5] Because these high-yield bonds have sold off in recent months, we believe a buying opportunity will present itself in the near future as the markets have priced in too much pessimism surrounding defaults.

U.S. Equities

Different equity styles can produce very different returns at times, even when belonging to the same asset class, making this an important consideration in portfolio construction. A dramatic example is the divergence exhibited between U.S. large cap growth and large cap value equities since the financial crisis in 2008. Large cap growth has outperformed large cap value by more than 20 percent over the past five years,[6] as the Fed embarked on a massive quantitative easing policy to lower interest rates and stimulate economic growth. This created 'easy money' that further fueled the expansion and success of growth style equities, as potentially riskier companies with higher costs of capital were able to borrow money at lower rates.

This divergence between styles was most pronounced in 2015 when growth outperformed value by over 8 percent for the year.[7] Simultaneously, the U.S. economy experienced a rapidly strengthening dollar and falling commodity prices. This includes oil prices, which fell to $32 to finish January 2016[8]. These events caused profits to slow for domestic large cap equities, leading the growth style to outperform. Earnings of large cap value companies were hit particularly hard, especially companies whose revenues are highly dependent on commodity prices. As a result, the energy and materials sectors fell 21 and 9 percent in 2015, respectively.[9]



Federal Reserve. http://www.federalreserve.gov/boarddocs/snloansurvey/201511/fullreport.pdf

In the short period of time since the Fed raised interest rates on Dec. 16, value equities have kept pace with growth counterparts.[10] The period of marked underperformance of value in 2015 has set the stage for stronger performance in the remainder of 2016, provided that the U.S. dollar and commodity prices begin to revert from extremes reached during the year, allowing corporate profits to pick up from slowing levels seen in 2015. Volatility has proven to be another key theme for the new year, caused by uncertainty surrounding interest rate increases, the presidential election cycle and tepid global growth, which we believe will allow quality securities with solid balance sheets and steady dividends to outperform.

While the rate increase of 25 basis points itself is minimal, the message it signaled to the economy is important: policymakers at the Fed finally believe the U.S. economy is healthy enough to warrant applying restrictive monetary policy. (1 basis point equals 1/100th of a percent.) We anticipate that the pace of future increases will be 'low and slow' and still accommodative to domestic equity markets as a whole, but the decision is not without its critics. This particular rate hike took place during the sixth year of the current expansion, an unusually late point in time. In U.S. history, no expansion has ever lasted more than ten years.[11] In an effort to reassure the markets at the Federal Open Market Committee press conference following the rate increase, Janet Yellen stated,

"I think it's a myth that expansions die of old age."

We would agree with Ms. Yellen that time alone is insufficient to turn the economic cycle, so it is important to keep an eye on key economic data. We observe that growth across a variety of indicators remains relatively steady on an absolute basis, but the pace of improvement in key variables is beginning to slow from levels earlier in the year.

As an example, we will focus on U.S. consumption, which accounts for approximately 68.6 percent[12] of gross domestic product and has recently been the key driver of economic growth.[13] We observe that December 2015 employment grew 1.9 percent year-over-year,[14] well off of the 2.3 percent growth posted in February 2015 and the lowest in the last two years.[15] Also, overall consumer spending has now slowed to 2.6 percent year-over-year growth as of December 2015, the lowest levels since spring 2014.[16] Further, consumer confidence has begun to decline from previous high readings.[17]

Further, from a credit perspective, we note that overall loan quality conditions in the U.S. are still solid, as loan delinquencies continue to trend lower[18] based on most recently available data. However, the most recent Senior Loan Officer survey does show the first raising of credit standards for riskier loans since the first quarter of 2012.[19] Historically, when lenders begin to raise credit standards in these categories, other types of loans to business and individual customers tend to see credit standards raised as well. Taken together, we must be mindful that while credit conditions appear stable now, lenders' outlooks have become marginally more cautious than they were a few months ago.

Based on our analysis and past experience in early stages of a rate hike cycle, we believe that the Fed's decision to raise interest rates may have further motivation in the early part of 2016, as inflation could look to be accelerating off of lows. However, given the policy divergence between the Fed and global central banks, any decline in the U.S. dollar could prove to be only a temporary phenomenon.

We recognize, however, that forecasting economic data is an inherently complex effort, and data points should not be taken out of context. Further, we also note that reported growth rates can vary from month-to-month for a variety of factors, and can sometimes provide 'false alarms.' Changes in investor expectations do beget volatility, which is a factor that we consider in constructing portfolios for clients. Accordingly, we remain committed to the belief that long-term investors should maintain a neutral U.S. equity allocation in a diversified portfolio, including a mix of large cap and small / mid cap investments.

International Equities

Once again international equities proved to be a frustrating asset class for investors in 2015. The positive returns earned by the MSCI EAFE Index during the first half of the year were basically wiped out by the end of the year returning -0.4 percent.[20] Though returns were negative, this was one of the better performing asset classes in a year of negative returns across several categories, giving us confidence that the continued growth story in Europe and Japan remains on track. Specifically, we saw outperformance in Japanese and European small cap stocks. Going into 2016, developed economies have some tailwinds. Central banks have declared that quantitative easing will continue as will weakness in commodity prices. These are two themes that will propel companies' bottom lines in these economies that rely on importing basic materials. The strength of consumers is also expected to continue with demand for credit rising steadily for the last two years. Volatility trickling over from uncertainty in China should be no stronger in Europe than it would be in the U.S. financial markets. As such, we believe that an overweight to developed international equities is appropriate at this time. The same however, cannot be said for emerging markets.

When discussing emerging markets, it is important to remember that as an asset class, China represents about a quarter of the market. However, given the influence that China has on global investors and the heightened media attention, it is worth our time to discuss at length. What's unfolding right now in China's economy is not an uncommon situation. The rapidly growing economy is taking steps to ensure continued growth in the future and is having a series of growing pains as it transitions from an industrial-based economy to a service-oriented one. After years of GDP growth north of 7 percent, the prospect of slowing down to a steady 4-6 percent is unsettling for investors.[21]

However, the slowdown in the economy alone should not be a top concern for global investors. The linkages between the economy and the financial markets are not as strong in China as they are in developed economies. Of greater concern are the actual financial markets, to which we feel direct exposure in this current market environment, should be limited until there is more stability. In 2014, annual returns on the Shenzhen Index were 30+ percent. In 2015, at the peak of the market in June, returns were 122 percent YTD. Over the course of the following six months, the index dropped 44 percent before recovering 30 percent and ending the year with 63 percent returns.[22] That's one bumpy ride and though double-digit annual returns are enticing, it's prudent to keep a minimal exposure.

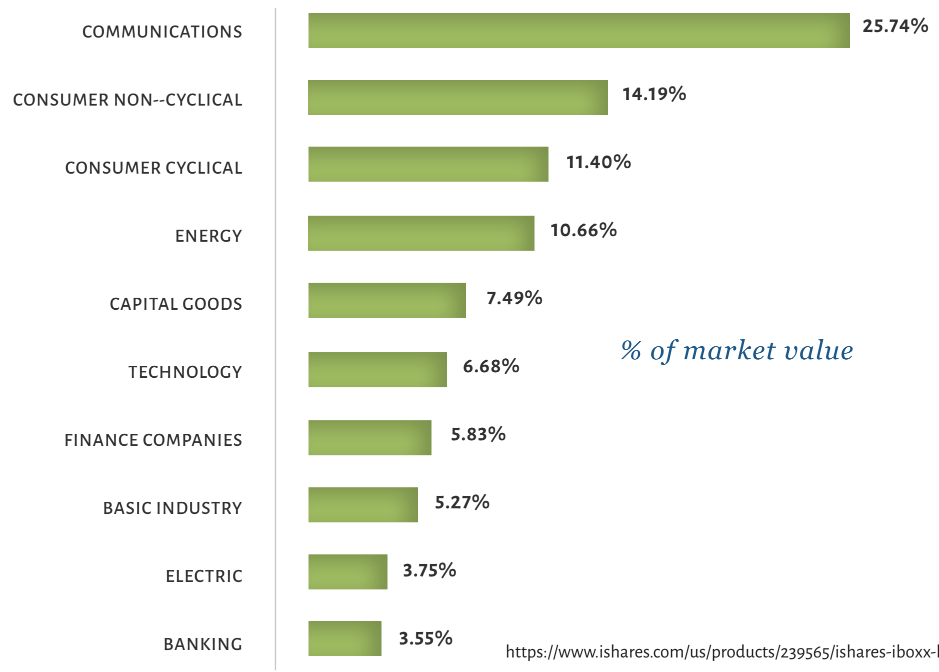
Though China does have far-reaching tentacles, we should not forget the opportunities for divergence amongst other economies. Vietnam and Mexico come to mind when thinking about two economies that may prosper regardless of what happens in China. Vietnam has long benefitted from the decrease in competitiveness of manufacturing in China and stands ready to propel its growth with its government's long-term plans focused on service industries. Mexico finds itself in good position with political reforms and linkages to the continuing growth of the U.S. economy. These are just two examples of the opportunities that do remain in emerging markets and why we look for money managers who understand these opportunities.

Fixed Income

The divergence in monetary policy between the United States and the rest of the world has been widely written about over the course of 2015. The Fed's Dec. 11 decision to raise interest rates for the first time in nine years sent a signal that the U.S. economy was on stable footing and able to withstand monetary tightening. This stands in stark contrast to other developed economies as both the European Central Bank (ECB) and the Bank of Japan (BoJ) continue with quantitative easing measures. In fact, only a week before Janet Yellen and the Fed decided to raise interest rates 25 basis points, the ECB announced an additional 10 basis point reduction in deposit rates to a fresh low of -0.3 percent.[23] The cut effectively means that banks must pay the ECB nearly one-third of a percent to hold money there; if European banks actually had the ability to hold their excess reserves "under their mattresses," this is one time when we would be inclined to tell them to do so.

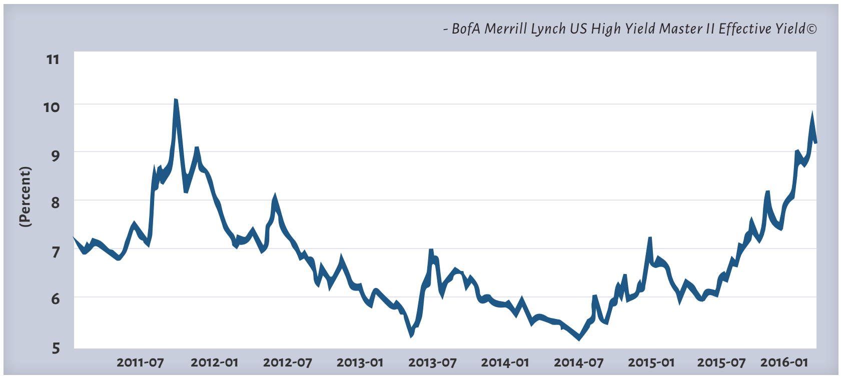
As the saying goes, hindsight is 20/20; and only time will tell whether this past December was the right time for the Fed to begin raising interest rates. Though the Fed and the rate hike decision stole most of the December headlines, much has been written about the struggles surrounding the high-yield bond market, also known as high-yield bonds. One culprit for high-yield bonds underperforming over the past six months is that the price of oil continues to struggle to find a bottom – in July the price for a barrel of oil was $63, as of this writing the price has been nearly halved and trades for $32 per barrel.[24] Since energy companies represent nearly 11 percent of the high-yield bond market, this is arguably one of the bigger reasons for the sector's underperformance.[25]

HIGH YIELD BONDS - SECTOR EXPOSURE



https://www.ishares.com/us/products/239565/ishares-iboxx-high-yield-corporate-bond-etf

Additionally, weak economic conditions continue to persist in the manufacturing segment and within other commodity markets, which has led investors to withdraw funds from the high-yield sector. Throughout 2015, Fragasso had maintained minimal exposure to high-yield bonds as we believed the risk of holding these assets far outweighed the reward. However, we believe that opportunities will begin to present themselves within the high-yield space. High-yield spreads (the difference between the average yield on high-yield bonds and similar maturity Treasury bonds) are at levels not seen since October 2011.[26]

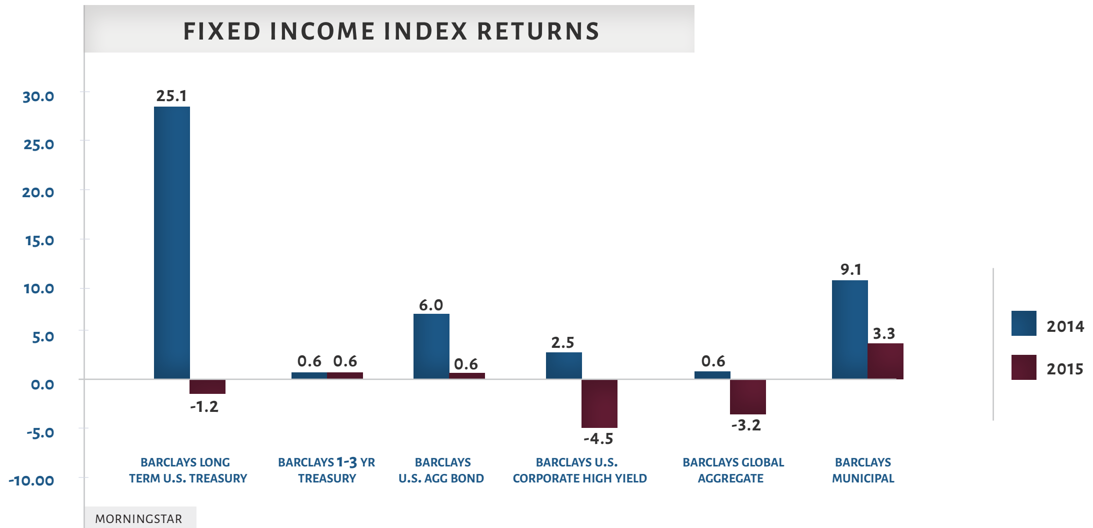


https://research.stlouisfed.org/fred2/series/BAMLH0A0HYM2EY

The current state of the high-yield market is sending a bearish signal that is typically associated with recessions. While Fragasso's portfolio management team is not overly bullish on the U.S. economy, we aren't forecasting a recession. We believe 2016 will present opportunities to add exposure to higher quality high-yield bonds as the default rates amongst these companies will remain low. As many investors look to cut their losses in the high-yield bond space, we are reminded of a famous Warren Buffett quote,

"Be fearful when others are greedy and greedy when others are fearful."[27]

Looking back at returns in 2015, municipal bonds were the best performing asset class within fixed income finishing the year up 3.3 percent, while high-yield bonds fared the worst returning -4.5 percent.



Investors continued to seek safety by piling into municipal bonds and bidding up the price of many funds. Municipal bond funds currently yield around 2 percent providing continued shelter for investors but not much in the way of returns.[28] In a world of still extremely low interest rates, it will be imperative to seek opportunities with mispriced assets that can offer a respectable return while also trying to mitigate risk. Lower yielding assets such as treasuries and municipal bonds will continue to play a diversifying role in portfolios as these bonds will be able to hedge against adverse equity moves. However, slightly increasing exposure to higher yielding assets will prove to be advantageous in order to boost returns in 2016.

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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.

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

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1 FactSet, Standard and Poor's, JPMorgan Asset Management

2 JPMorgan Asset Management

3 Morningstar Direct, Dalbar Inc., JPMorgan Asset Management

4 Yahoo Finance

5 https://www.ishares.com/us/products/239565/ishares-iboxx-high-yield-corporate-bond-etf

6 Yahoo Finance. http://finance.yahoo.com/echarts?s=IWF+Interactive#{"range":"5y","allowChartStacking":true}

7 Morningstar Direct Data as of December 31, 2015.

8 Bloomberg.com. http://www.bloomberg.com/markets/commodities

9 Sector SPDR. http://www.sectorspdr.com/sectorspdr/Pdf/All%20Funds%20Documents/Document%20Resources/10%20Year%20Sector%20Returns

10 Yahoo Finance. https://finance.yahoo.com/echarts?s=VOOV+Interactive#{"customRangeStart":1450242000,"customRangeEnd":1454216400,"range":"custom","allowChartStacking":true}

11 Bloomberg.com. http://www.bloomberg.com/news/articles/2015-12-21/yellen-bull-markets-and-extinction-in-a-seven-year-stock-rally

12Bureau of Economic Analysis. http://www.bea.gov/newsreleases/national/gdp/2016/gdp4q15_adv.htm

13Bloomberg.com. http://www.bloomberg.com/news/articles/2015-11-18/goldman-the-u-s-economy-will-need-more-than-just-consumers-in-2016

14 Bureau of Labor Statistics. http://www.bls.gov/news.release/empsit.a.htm

5 St. Louis Federal Reserve. https://research.stlouisfed.org/fred2/series/PAYEMS

6 Bureau of Economic Analysis. http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=83

7 Conference Board. https://www.conference-board.org/data/consumerconfidence.cfm

8 St. Louis Federal Reserve. https://research.stlouisfed.org/fred2/series/DRALACBS

9 Federal Reserve. http://www.federalreserve.gov/boarddocs/snloansurvey/201511/fullreport.pdf

20 Morningstar Direct

21 World Bank, http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

22 Bloomberg.com, http://www.bloomberg.com/quote/SZASHR:IND

23 http://www.bloombergview.com/quicktake/negative-interest-rates

24 https://research.stlouisfed.org/fred2/series/DCOILWTICO

25 https://www.ishares.com/us/products/239565/ishares-iboxx-high-yield-corporate-bond-etf

26 https://research.stlouisfed.org/fred2/series/BAMLH0A0HYM2EY

27 http://www.goodreads.com/quotes/29255-be-fearful-when-others-are-greedy-and-greedy-when-others

28 http://www.bondsonline.com/Todays_Market/Composite_Bond_Yields_table.php