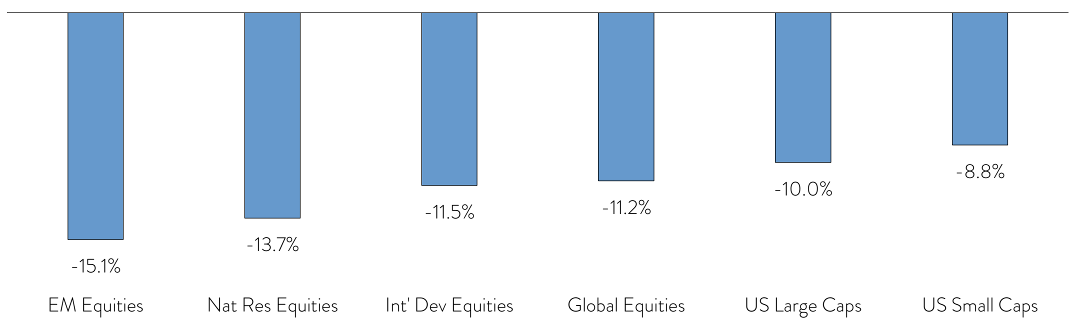
SPECIAL REPORT: Q3 MARKET VOLATILITY

August 25, 2015

Dear Partners,

We are writing in response to the recent volatility in global financial markets. As of the close of business yesterday, global equities had experienced double digit declines in the span of approximately two weeks, with emerging markets and natural resource equities experiencing the most severe losses.

Figure 1: Select Equity Indices
August 10, 2015 to August 24, 2015



Source: Bloomberg. Return data reference the following securities; iShares MSCI Emerging Markets Index ETF (Emerging Markets), SPDR S&P Global Natural Resources ETF (Natural Resources Equities), iShares MSCI EAFE ETF (International Developed), iShares MSCI All Country World Index ETF (Global Equities), SPDR S&P 500 ETF (US Large Caps), iShares Russell 2000 ETF (US Small Caps).

The selloff was instigated by uncertainty regarding the health of the Chinese economy and broader concerns of slowing growth and deflationary pressures globally. On August 10th, Chinese officials altered the country's exchange rate mechanism in order to allow its currency, the yuan, to depreciate, which led to its largest one day decline against the dollar in more than 20 years. The decision was ostensibly part of a broader package of market-oriented reforms designed to gradually liberalize China's capital markets, but was viewed by many as a selective and opportunistic use of markets to achieve the aims of the Chinese policymakers. Devaluing the yuan makes China more export competitive, and therefore helps Chinese officials in their pursuit of two competing objectives; (1) sustaining the level of economic growth needed to support continued urbanization and job creation, and (2) enacting market-oriented reforms in an effort to gain international clout.

China's devaluation came with little warning, and reinforces investor concerns regarding weakening economic data. In July, Chinese exports declined more than 8% year-over-year, and producer prices experienced their largest 12 month decline since November 2009. Meanwhile, a recent private survey of Chinese manufacturing activity indicated a level of weakness which is widely believed to be inconsistent with the country's officially published GDP data. To that end, we believe that a portion of the recent selloff is a function of broad risk aversion resulting from, among other things, a lack of transparency and reliable public data regarding the condition of China's economy.

We mentioned in our Q1 Capital Markets Update that China's ability to meet its growth objectives would profoundly impact the global economic and investment landscape throughout the balance of the year. Given China's share of global exports and its role as the world's largest consumer of several industrial commodities, those most vulnerable to a growth disappointment in China are (1) commodity-producing nations (Brazil, Australia), (2) countries that export to China (Japan, South Korea, Taiwan), and (3) China's trade competitors throughout the world, to include many neighboring countries in southeast Asia as well as select European economies.

The forthcoming Federal Open Market Committee (FOMC) meeting is another source of consternation for investors. A rate hike by the Fed would be regarded by some as premature in light of the disinflationary impact of falling commodity prices and a strong dollar. Meanwhile, a decision not to raise rates could stoke concerns regarding the fragility of global growth. Furthermore, coupled with a slowdown in China, the eventuality of a Fed rate hike puts added pressure on emerging economies, many of which have benefited from favorable credit conditions resulting from 6 years of extraordinarily loose monetary policy, but now face a combination of slowing growth and tightening credit.

While China's impact on global markets is notable, investors should keep several things in mind. For starters, dramatic swings in the Chinese stock market throughout the past several quarters have been largely liquidity-driven and at least partially instigated by the actions of Chinese officials. Therefore, just as the 151% increase in the Shanghai composite in the year leading up to the June 12th peak was not supported by fundamentals, the 43% decline since is not indicative a corresponding weakening of the Chinese economy. It also bears mentioning that the recent run-up and collapse of Chinese equities occurred within a relatively brief span of 14 months and impacts only a narrow segment of the population (according to estimates we've seen, less than 10% of the Chinese populous owns equities), so the potential spill-over effects on the Chinese consumer balance sheet are contained. In addition, Chinese policymakers have an array of policy tools at their disposal including interest rate cuts, changes in reserve requirements and lending rules, and fiscal stimulus. While China's leadership may be behind the curve in their efforts to prevent a hard landing, they have the tools for the job, a demonstrated willingness to utilize them, and considerable economic and political incentive to support continued growth in China and elsewhere.

Finally, we note that the portion of our client portfolios which is most significantly impacted by recent events—equities—should be viewed as a long-term driver of portfolio growth, but inherently susceptible to occasional bouts of volatility. The key to investment success is a portfolio architecture that balances the need for long-term growth with the reality that corrections and bear markets are part of investing. To that end, the defensive elements of our client portfolios which are designed to provide liquidity for spending and rebalancing during turbulent times have performed as expected. Furthermore, as opportunistic, value-oriented investors, we believe that we're well positioned to capitalize on opportunities that arise from occasional market dislocations. To the extent that such opportunities arise in the near term, we will elaborate on them in future communications. In the meantime, we welcome your questions and feedback.

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