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EYE ON THE MARKET

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COMMENTARY ON SPECIFIC MARKET ISSUES AND ACTIONABLE IDEAS TO CONSIDER

2016 THIRD QUARTER REVIEW:

A firm constitution and mint condition!

As investors look back on the last nine months, they may recall facing a wide variety of opportunities and challenges, many of which required a firm constitution. During the third quarter, interest rates rose modestly across most of the U.S. Treasury yield curve. This occurred despite the Federal Open Market Committee's decision not to raise the federal funds rate at its September meeting. Looking back at the last nine months, there were rocky periods for the S&P 500, such as the first few weeks of the year. That being said, the index recovered and ended the first quarter up just over 1%, much like an underdog coming back for the win in a boxing match. Gold, which many view as a store of wealth, and prior to 1971 had backed the U.S. dollar, rebounded from multi-year lows. In fact, the NYSE Arca Gold Miners Index, which tracks the performance of gold mining companies (and not gold itself), generated a year-to-date total return of 94% as of September 30, 2016. *Eye on the Market* ("EotM") will examine these trends and how they may impact investors going into the final quarter of the year.

YOU AIN'T SO BAD

Rocky Balboa faced a relentless barrage of hits from Mr. T's Clubber Lang in *Rocky III*, yet still came out victorious. In a similar manner, investors encountered a myriad of headwinds this past quarter causing many to question their underlying investment assumptions. This includes the lack of a rate increase and arguments around elevated valuations in the equity markets. Despite the flurry of jabs, many asset classes, including some of the most widely-followed, performed reasonably well over the last three months and even over the year-to-date ("YTD") period ended September 30, 2016.

As Table 1 indicates on the following page, high-yield fixed income, U.S. small-capitalization stocks, and emerging market equities generated the highest total returns in the third quarter with many generating double-digit total returns YTD. It is worth noting that the aforementioned asset classes lagged the S&P 500 during calendar years 2014 and 2015. Will 2016 be the year these riskier asset classes reign supreme as the bell just rang to start the fourth quarter? Investors will have to wait and see.

Table 1

CATEGORY	INDEX	Q1 2016	Q2 2016	Q3 2016	YTD 2016
TOTAL RETURN (%) (AS OF SEPTEMBER 30, 2016)					
High Quality Bonds	Barclays US Agg Bond TR USD	3.03	2.21	0.46	5.80
High Yield Bonds	BofAML US HY Master II TR USD	3.25	5.88	5.49	15.32
Global Bonds	Citi WGBI USD	7.09	3.41	0.30	11.07
Emerging Market Bonds	JPM EMBI Global TR USD	5.22	5.40	3.73	15.04
Large-Cap U.S. Stocks	S&P 500 TR USD	1.35	2.46	3.85	7.84
Mid-Cap U.S. Stocks	Russell Mid Cap TR USD	2.24	3.18	4.52	10.26
Small-Cap U.S. Stocks	Russell 2000 TR USD	-1.52	3.79	9.05	11.46
Developed International Stocks	MSCI EAFE NR USD	-3.01	-1.46	6.43	1.73
Emerging Market Stocks	MSCI EM NR USD	5.71	0.66	9.03	16.02

Source: Morningstar Direct.

FOLLOWING THE CROWD OR BEING THE LEADER

There seems to be two types of investors in the market today: Those who choose to blaze their own path and those who prefer following the crowd.

To illustrate this, Table 2 shows estimated fund flows for both mutual funds and exchange-traded funds ("ETFs") across many of the most widely-utilized asset classes.

Whether investors are mitigating equity-market risk or diversifying away from other fixed-income assets, investors continue to increase allocations to intermediate-term bonds. YTD through September 30, the asset class received more than $103 billion in estimated net flows, with approximately 79% of the flows going to mutual funds and 21% to ETFs.

While EotM has addressed the debate between active and passive management in the past (here & here), recent trend data indicates that investors are directing most of their equity investments towards a combination of factor-based and passive ETFs. For example, of the $20 billion in flows directed to diversified emerging-market equities in 2016, 96% went to ETFs and only 4% to mutual funds. The comparison is even more striking for U.S. large-cap value strategies, as investors redeemed mutual fund positions, but meaningfully purchased ETFs in this space, as shown on Table 3 on the following page.

Table 2

CATEGORY		JAN-16	FEB-16	MAR-16	APR-16	MAY-16	JUN-16	JUL-16	AUG-16	SEP-16
ESTIMATED NET FLOWS FOR MUTUAL FUND & ETFS (AS OF SEPTEMBER 30, 2016)										
U.S. BONDS	INTERMEDIATE-TERM BOND	+	+	+	+	+	+	+	+	+
	HIGH YIELD BOND	-	+	+	+	-	-	+	+	+
GLOBAL BONDS	WORLD BOND	-	-	+	+	-	-	-	-	+
	EMERGING MARKETS BOND	-	-	+	+	-	+	+	+	+
U.S. EQUITY	LARGE BLEND	+	+	+	+	-	+	+	+	+
	MID-CAP BLEND	-	-	+	-	+	-	+	+	+
	SMALL BLEND	-	-	+	+	-	-	+	+	+
INTERNATIONAL EQUITY	FOREIGN LARGE BLEND	+	+	+	+	+	+	+	+	-
	DIVERSIFIED EMERGING MKTS	-	+	+	+	-	+	+	+	+

Source: Morningstar Direct.

Table 3

YTD ESTIMATED NET FLOWS AS OF SEPTEMBER 30, 2016		
NAME	MUTUAL FUNDS AS % OF TOTAL	ETFS AS % OF TOTAL
Diversified Emerging Mkts	3.6%	96.4%
Foreign Large Blend	70.7%	29.3%
Large Blend	21.8%	78.2%
Large Value	-81.5%	181.5%
Real Estate	12.1%	87.9%
Corporate Bond	42.2%	57.8%
High Yield Bond	65.5%	34.5%
Intermediate-Term Bond	78.5%	21.5%
Muni National Interm Bond	90.3%	9.7%
Short-Term Bond	66.5%	33.5%

Source: Morningstar Direct.

LAYING THE GROUND WORK

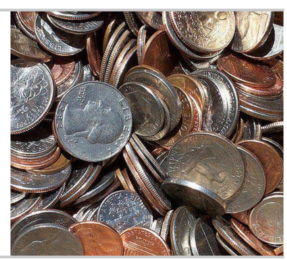
Looking ahead, it is important to remember that developing a sound and well-grounded investment approach will likely allow an investor to successfully meet her objectives. EotM does believe in active management and, as such, would encourage investors to seek out portfolio management teams that have a demonstrated track record of providing clients with attractive results. Based on current data, it appears that many investors are ignoring this as it relates to equity strategies, as noted on Table 3. The data clearly shows that investors are more inclined to use ETFs in their equity allocations.

What is even more apparent is that investors have only modestly utilized fixed-income ETFs. This is partially a function of the fact that fixed-income, as a whole, is far less efficient from a liquidity and replication standpoint relative to equities. Additionally, there are fewer fixed-income ETFs as compared to equity strategies. Will this continue in the future? Only time will tell. It is likely that ETF providers are paying attention to this trend and are seeking ways of providing investors with more fixed income–oriented strategies. WisdomTree, one of the larger ETF providers, demonstrated its interest in the space by launching a suite of fixed-income strategies that were rules-based rather than being purely passive.

Current sales trends – an indicator of investor demand – will lay the groundwork for future product development. Just as shoppers do not always buy the season's "it" item as anticipated by retailors, investors do not always buy the hype of a new product, leaving only a subset to succeed in the market.

SIDE NOTE

The city of Philadelphia is often associated with *Rocky I-V*, the Founding Fathers, the U.S. Constitution, the Declaration of Independence, and the delectable Philly cheese steak. What is not widely know is that Philadelphia became home to the U.S. Mint in 1792 and is now the largest Mint location in the country. You will know if your change came from the "City of Brotherly Love" if it is stamped with a capitalized "P."



DEFINITIONS

The **Barclays US Aggregate Bond Index** is composed of the Barclays Government/Corporate Bond Index, the Barclays Mortgage-Backed Securities Index, and the Barclays Asset-Backed Securities Index, and is generally considered to be representative of the U.S. bond market.

The **Bank of American Merrill Lynch High Yield Master II Index** is an unmanaged representation of the performance of below investment-grade U.S. domestic bonds.

The **Citigroup World Government Bond Index (WGBI)** is a market-capitalization weighted index consisting of fixed-rate government bonds with a remaining maturity of at least one year and is generally considered to be representative of the global government bond market.

The **J.P. Morgan Emerging Markets Bond Global Index** is an unmanaged index, which tracks the total returns for external-currency dominated debt instruments of emerging markets: Brady bonds, loans, Eurobonds, and U.S. dollar-denominated local markets instruments for 33 countries.

The **S&P 500 Index** is a market-capitalization weighted index of 500 stocks, and is generally considered representative of the U.S. stock market.

The **Russell Mid Cap Index** is a subset of the Russell 1000 Index and measures the performance of the mid-cap segment of the U.S. equity universe. It includes approximately 800 of the smallest securities based on market cap and current index membership.

The **Russell 2000 Index** measures the performance of the small-cap segment of the U.S. equity universe.

The **MSCI EAFE Index** is a market-weighted index of non-U.S. companies and is widely used as a benchmark for international investments.

The **MSCI Emerging Markets Index** is a market capitalization-weighted index of stocks from 26 emerging markets that only includes issues that may be traded by foreign investors. An index cannot be directly invested in. Past performance is no indication of future results.

Large-value portfolios invest primarily in big U.S. companies that are less expensive or growing more slowly than other large-cap stocks. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as **large cap**.

Intermediate-term bond portfolios invest primarily in corporate and other investment-grade U.S. fixed-income issues and typically have durations of three and a half to six years.

High-yield bond portfolios concentrate on lower-quality bonds, which are riskier than those of higher-quality companies. These portfolios generally offer higher yields than other types of portfolios, but they are also more vulnerable to economic and credit risk. These portfolios primarily invest in U.S. high-income debt securities where at least 65% or more of bond assets are not rated or are rated by a major agency such as Standard & Poor's or Moody's at the level of BB and below.

World bond portfolios invest 40% or more of their assets in foreign bonds. Some world bond portfolios follow a conservative approach, favoring high-quality bonds from developed markets. Others are more adventurous, and own some lower-quality bonds from developed or emerging markets. Some portfolios invest exclusively outside the U.S., while others regularly invest in both U.S. and non-U.S. bonds.

Emerging-markets bond portfolios invest more than 65% of their assets in foreign bonds from developing countries. Large-blend portfolios are fairly representative of the overall U.S. stock market in size, growth rates, and price.

Stocks in the top 70% of the capitalization of the U.S. equity market are defined as **large-cap**. The blend style is assigned to portfolios where neither growth nor value characteristics predominate. These portfolios tend to invest across the spectrum of U.S. industries, and owing to their broad exposure, the portfolios' returns are often similar to those of the S&P 500 Index.

The typical **mid-cap blend portfolio** invests in U.S. stocks of various sizes and styles, giving it a middle-of-the-road profile. Most shy away from high-priced growth stocks, but aren't so price-conscious that they land in value territory.

Small-blend portfolios favor U.S. firms at the smaller end of the market-capitalization range. Some aim to own an array of value and growth stocks while others employ a discipline that leads to holdings with valuations and growth rates close to the small-cap averages. Stocks in the bottom 10% of the capitalization of the U.S. equity market are defined as **small-cap**.

Foreign large-blend portfolios invest in a variety of big international stocks. Most of these portfolios divide their assets among a dozen or more developed markets, including Japan, Britain, France, and Germany. These portfolios primarily invest in stocks that have market caps in the top 70% of each economically integrated market (such as Europe or Asia ex-Japan).

Diversified emerging-markets portfolios tend to divide their assets among 20 or more nations, although they tend to focus on the emerging markets of Asia and Latin America rather than on those of the Middle East, Africa, or Europe. It is not possible to directly invest in a category or index.

Value is defined based on low valuations (low price ratios and high dividend yields) and slow growth (low growth rates for earnings, sales, book value, and cash flow).

Real estate portfolios invest primarily in real estate investment trusts of various types. **REITs** are companies that develop and manage real estate properties. There are several different types of REITs, including apartment, factory-outlet, health-care, hotel, industrial, mortgage, office, and shopping center REITs. Some portfolios in this category also invest in real estate operating companies.

Corporate Bond portfolios concentrate on bonds issued by corporations. These tend to have more credit risk than government or agency-backed bonds. These portfolios hold more than 65% of their assets in corporate bonds, hold less than 40% of their assets in foreign bonds, less than 35% in high yield bonds, and have an effective duration of more than 75% of the Morningstar Core Bond Index.

Muni national intermediate portfolios invest in bonds issued by various state and local governments to fund public projects. The income from these bonds is generally free from federal taxes. To lower risk, these portfolios spread their assets across many states and sectors. These portfolios have durations of 4.5 to 7.0 years (or, if duration is unavailable, average maturities of five to 12 years).

Short-term bond portfolios invest primarily in corporate and other investment-grade U.S. fixed-income issues and typically have durations of 1.0 to 3.5 years. These portfolios are attractive to fairly conservative investors, because they are less sensitive to interest rates than portfolios with longer durations. Morningstar calculates monthly breakpoints using the effective duration of the Morningstar Core Bond Index in determining duration assignment. **Short-term** is defined as 25% to 75% of the three-year average effective duration of the MCBI.

Investors should carefully consider the investment objectives, risks, charges and expenses of mutual funds and ETFs before investing. The prospectus contains this and other information about mutual funds and ETFs. The prospectus is available by contacting the fund family and should be read carefully before investing.

Diversification and strategic asset allocation do not ensure a profit or protect against a loss. The process of rebalancing may carry tax consequences.

The views expressed in this newsletter are subject to change, and no forecasts can be guaranteed. Information contained in this report was received from sources believed to be reliable, but accuracy is not guaranteed. Material is provided for informational purposes only and does not constitute recommendations, investment advice or an indication of trading intent. Investing always involves risk and you may incur a profit or loss. No investment strategy can guarantee success.

Past performance does not guarantee future results. There is no assurance these trends will continue.

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