MARKET
PERSPECTIVES

STC Investment Committee

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In this newsletter, I offer our perspectives on July's market activity, some insights into our actions given the more recent August market turmoil (for which we were well positioned), and thoughts about how our investment philosophy and process help reduce the risks associated with market volatility.

Global equities ended July in positive territory after a volatile month that witnessed a last-second "solution" for Greece and collapses in crude oil prices and any other commodity, currency or equity linked to a faltering Chinese economy. The US dollar reached a three month high as reasonably strong US growth, consumer spending and housing data supported a growing consensus view that the Federal Reserve Board was likely to initiate a cycle of rate hikes in September. Bond investors felt that such a move would be pre-emptive and the Treasury curve flattened, with longer-term bonds gaining the most.

Given the unusual number of major cross-currents in the capital markets, there was a significant divergence of performance across and within asset classes. So, overall portfolio performance was heavily dependent on positioning. Europe's 3.1% gain paced equity markets, once again well ahead of the 1.7% US equity return. Developed-market international equities boosted their 2015 outperformance to 7.0% versus 3.6% for domestic equities. At the other extreme, emerging markets fell 6.9% as the sector was hard hit by the 21% fall in crude oil prices and the direct and indirect effects of a slowdown in China's growth. Mainland Chinese equities fell 10.9%. The Treasury market gained 0.8% in anticipation of a near-term rate increase, with longer-term Treasuries up as much as 3.5%. Credit spreads continued to widen, with investment grade corporate bonds not keeping pace with Treasuries. High-yield bonds declined 0.6%, dragged down by the large energy weight in the lowest rated issues. Municipal bonds underperformed the strong Treasury market, with higher yielding municipal bonds actually declining after Puerto Rico defaulted on a bond issue.

To re-cap our portfolio positioning as of the beginning of July, US stocks remained unattractive because they were expensive in the face of a potential September interest rate hike (20% overvalued even if earnings estimates are achieved); international equities were much more attractive and were fairly priced, but already reflected much of an expected earnings recovery (cyclical in Europe and a longer-term recovery in emerging markets); relative valuation in municipal bonds and corporate debt was decent as spreads were reasonable, but unfortunately, benchmark Treasury yields were unsustainably low. With investor complacency high and long-only bargains hard to find, we remained defensive at the asset class level, with significant overweights to hedged strategies and to cash.

August Developments

While a full-blown discussion of August capital market developments will be the subject of our next write-up, given August's intra-month declines of as much as 11%for U.S. equities, an additional 20% in crude oil and 20% in Chinese equities, some summary comments are appropriate.
Our defensive positioning at the asset class level has been fortuitous given August's market turmoil. Cash may yield nothing, but when markets are collapsing, its value becomes appreciated. Maintaining an overweight position in hedge funds given a dearth of attractive opportunities elsewhere creates potential for returns from managers who successfully conduct strategies that profit from volatility or hedge against it. Most importantly, when valuations are excessive, underweighting equities (particularly US equities) simply makes sense.

Despite the turmoil thus far in August, I anticipate only incremental changes in portfolio positioning at this time. We will look for opportunities to take advantage of significant market declines; potentially modestly boosting our positions within some asset classes' tactical bands (see discussion below).

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How Our Investment Philosophy and Process Copes with Risk

Given the recent volatility in the markets, fear certainly is understandable. Unfortunately, most investors make the wrong investment decisions at times like these. Understanding Sentinel's investment philosophy and how we implement it can help reduce the natural urge to make knee-jerk investment decisions out of fear.

As further explained below, Sentinel strives to enhance the risk/reward tradeoff in many ways, including:

- **Diversification** – Modern portfolio theory teaches that diversification is key to reducing risk. We develop a strategic asset allocation that is specific to your objectives and risk tolerance. We focus on spreading your risk among a wide range of asset classes. We further diversify your risk with a wide range of investments within each asset class.

- **Valuation sensitivity** – Our strong belief is that valuation matters. Owning something that appears to be overpriced by the market is riskier than owning something that appears to be underpriced by the market. Over time, we believe you can make more money by buying low and selling high than by following the crowd, which often pushes prices over an asset's intrinsic value, thereby increasing the risk of a significant price decline.

- **Tax sensitivity** – Because our clients pay taxes, we make all investment decisions with an awareness of that substantial cost. Risk-adjusted, after-tax returns are the name of the game.

Basically, a strategic asset allocation represents the percentage of a client's investment assets that is to be invested in each asset class. The allocation is determined for each family (and each individual and entity owned by the family) considering individual objectives, risk tolerance, income and estate tax circumstances, existing exposures (like real estate, operating businesses and legacy asset positions) and any other factors specific to the family.

With the client's permission, we then set what we call "tactical bands" around each asset class' strategic percentage. These bands allow us to increase or decrease the overall exposure to the asset class based upon our views of the asset class at any particular point in time. Those views are substantially affected by our fundamental assessment of the valuation appeal of the asset class and our assessment of the macroeconomic environment.

One advantage of this approach is the flexibility it affords in terms of portfolio construction and how it changes over time. For example, we may not like an asset class at the overall level, but find compelling opportunities within it. An obvious example would have been attractively valued old-economy stocks at the peak of the tech bubble in 2000 when we believed the market was way overpriced. The tactical band allowed us to reduce clients' overall exposure to the market, while our valuation work (described below) allowed us to select stocks that were relatively underpriced in the market. More generally, it is not unusual for us to be defensive (and underweight) at the asset class level, but to find some of the less defensive stocks within the asset class to be the most attractively valued.

This has been the case in the US and global equity markets for some time. Investors have been worried about the stock market risks and have piled into "safe" sectors such as pharmaceuticals and consumer staples, making them even more overvalued than the market with little long-term investment return potential. While our stock-by-stock valuation process once led to 15-20% pharmaceutical sector weights, today our healthcare weight is close to zero.

How do we determine value? As an example, our domestic equity research team transforms consensus earnings estimates into a projected future stream of economic cash flows. Ultimately, we believe future cash flows are the best way to determine the value of a company. We discount those cash flows at an appropriate discount rate to arrive at an intrinsic fair value for a given stock. While judgement is exercised in this analysis, there are no implicit or explicit market, commodity or economic views in the fair value estimate. Expected pre-tax investment returns are estimated for each stock by comparing its current market price to our estimated fair value, making important adjustments to reflect the quality of each stock, as measured by our proprietary multi-factor (30 factors) model.

Domestic equity sector weights largely reflect an aggregation of this "bottoms-up" stock-by-stock analysis. At any time, one would expect our most significant sector overweights to be in sectors where we can find stocks that are attractively valued both in absolute terms against our fair value estimates, and in relative terms against the valuation appeal of other stocks. Put another way, we do not have a "view" on a given stock - our "edge" is through our process of estimating a fair value and then acting upon that information to assemble a domestic equity portfolio.

While the portfolio will always be based upon valuation considerations, it may appear to be either a "value" or "growth" portfolio at a given time. For example, we moved from 50% underweight technology in 2000 to 50% overweight technology in 2003 - that is where our process took us. Risk management is based upon diversification at the stock level and quality constraints at the portfolio level. Significant departures from benchmark sector weights are expected and desired, but absolute hard caps are employed to cap risks in more volatile sectors.

Changes over time in individual stock and sector weights are a direct function of how the quantitative relationship between a given stock and its fair value has changed, both on a standalone basis and in comparison to changes in other stocks. For example, if intrinsic fair values were unchanged, our strategy would appear be quite contrarian, as we would always be purchasing stocks and sectors that had underperformed peers. In real life, of course, our fair values are always changing. We update our fair values, the price/value relationship and our model equity portfolio on a weekly basis.

The fluctuating energy sector weights in our equity model and in client accounts illustrate how our process has responded to the violent changes (downward) in both the price and intrinsic fair value of energy sector equities. While both have plunged since last September, the relationship between price and value has not been stable. In late fall, energy stocks were attractively priced in a market where it was hard to find compelling value; but, we hard-capped energy sector exposure at 20% for risk-management purposes. Despite the rally in crude oil prices this spring, we felt that energy stocks had rallied excessively and we sold them in client accounts in April down to a 15% sector weight. Despite the subsequent precipitous fall in exploration, production and service stock prices, our fair value estimates have fallen even faster. Given the less attractive price/value relationship, particularly after quality adjustment downgrades, our current target energy exposure is only 10%, with increased weights to the financial and retailing sectors. While energy stocks could certainly spike back up, that more likely would be driven by an increase in commodity prices than any fundamental undervaluation at today's forward oil prices. While energy stock purchases will be part of overall purchases of equities and may be effected as part of a "double-down" tax-loss harvesting strategy, most client accounts are around this 10% current model portfolio target. Future sector positioning will continue to reflect the best fundamental opportunities presented by the market.

No one can consistently and accurately predict the movements of the markets. While it may be tempting to panic and sell everything when things look dicey, studies indicate that the chances of accurately timing your exit and then re-entry are very slim. Modern portfolio theory teaches that a more effective approach to managing risk is to appropriately determine your strategic asset allocation based upon your risk tolerance and circumstances. We overlay our concepts of tactical bands and valuation sensitivity to reduce exposure to asset classes and sectors that appear to be most risky (meaning overpriced in the market) and then overweight the more attractively priced sectors and specific investments within the asset classes. Overtime, we believe that this approach reduces downside risk and increases investment returns.

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