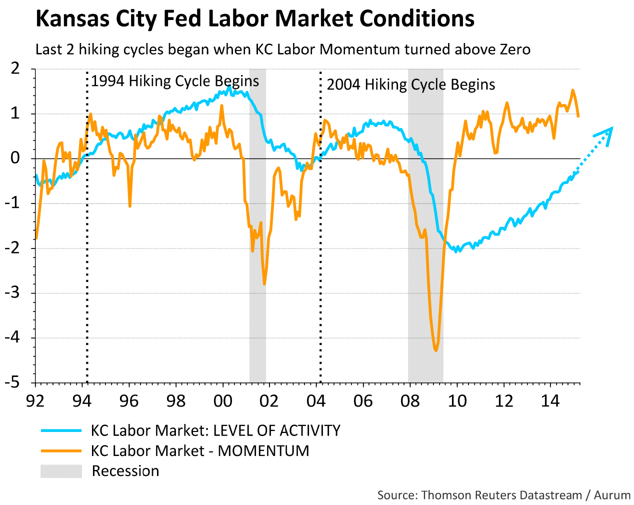
Strategy Newsletter
2nd Quarter 2015

- Can the U.S. economy handle an interest rate hike?
- International equity markets rallied strongly in the first quarter.
- Beware of prices and yield on municipal bonds, falling rates pulled returns forward.
- Alternative managers added value across strategies.

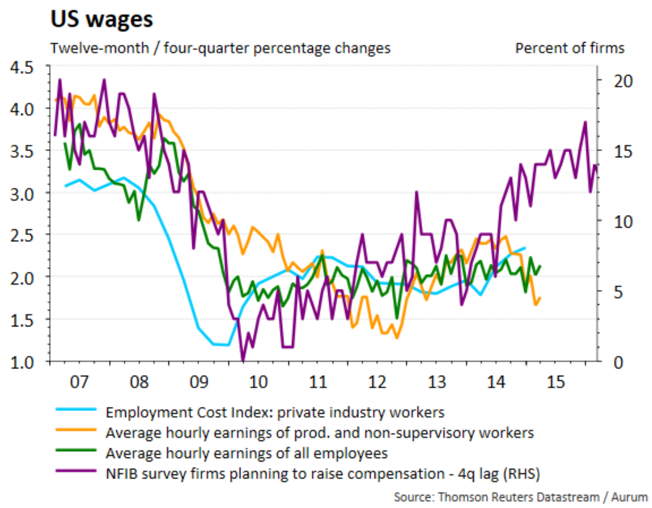
Economy

Similar to the first quarter of 2014, the harsh winter weather put a damper on economic data during the first quarter of 2015. GDP will likely be modest when it prints at the end of April. Most long-term series across industrial production, employment, and retail sales still show a positive uptrend.

This is one reason the Federal Reserve is comfortable with priming markets for an interest rate hike later in 2015.



The question for the Fed is whether inflation is at an acceptable level for a hike to begin, or if it matters at all. Fed Chairman Janet Yellen and many research notes from the Fed point to labor market wage pressure as important. Anecdotally, just this past quarter, many companies such as Wal-Mart and McDonald's announced hikes to minimum wage for employees and highly specialized industries are noting increased competition for talent. It has been a highly debated topic over the last year given the attention on income disparity.



The chart above highlights that wage growth over the past several years is hovering in the 2% range, while during the previous cycle it was closer to 4%. The percent of companies indicating wage gains increased from 5% to the low teens over the last year, which is often a strong leading indicator for wage gains. We will see whether it holds true again over coming quarters.

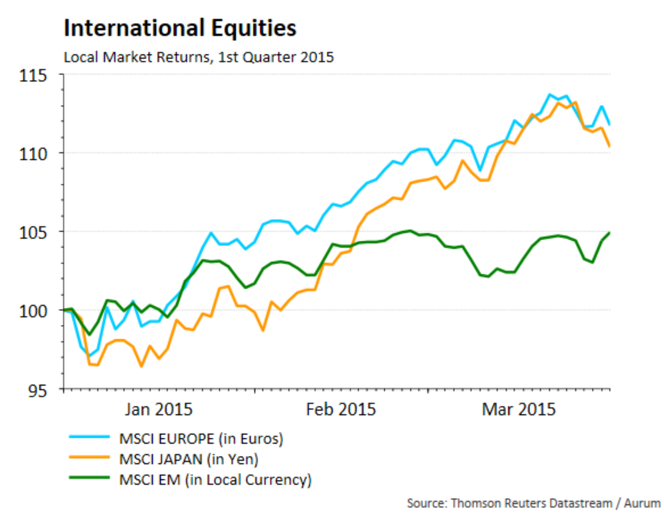
Equity

International equities made up ground from last year against U.S. markets, and did even better in local market terms since nearly all foreign currencies fell against the U.S. Dollar.

US Equity	1Q 2015
Large Cap Stock	
Dow Jones Industrial Average	0.33%
S&P 500	0.95%
Small & Mid Cap Stock	
Russell Mid Cap	3.95%
Russell 2000	4.32%
Style Indices	
Russell 3000 Value	-0.51%
Russell 3000 Growth	4.05%

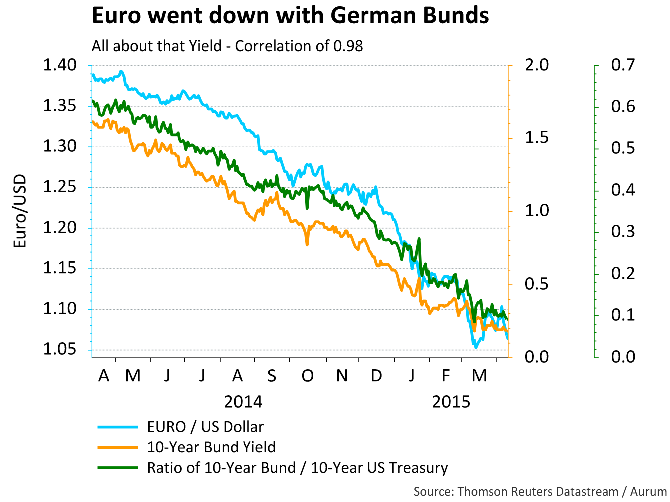
International Equity	1Q 2015
MSCI EAFE	5.00%
MSCI EAFE Value	4.00%
MSCI EAFE Growth	5.97%
MSCI Europe	3.58%
MSCI Japan	10.34%
MSCI Emerging Markets	2.28%

For example, MSCI Europe was up 10% for hedged investors compared to 3.6% for U.S. Dollar based investors, while MSCI Emerging Markets was up 5% compared to 2.3%. In contrast, Japan had similar local market returns as the Yen was flat against the U.S. dollar.



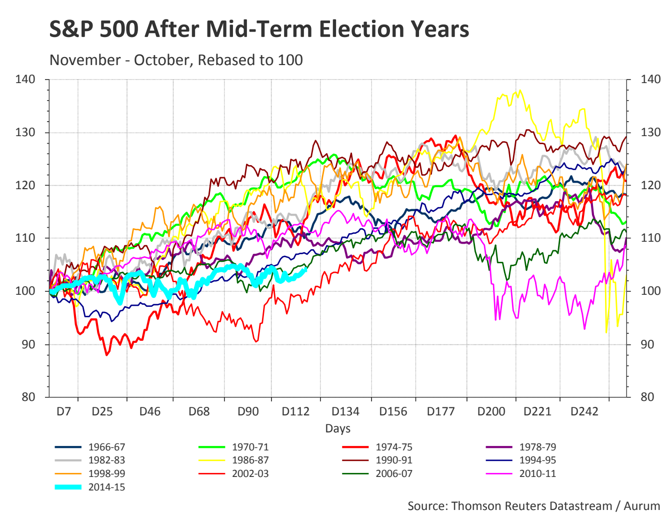
The Euro fell by 11% in the quarter (a huge move that built on the fall in the second half of 2014) thanks to the negative interest rates set by the

European Central Bank and the QE (quantitative easing) program announced in January. The chart below shows the relationship between the Euro falling (left) and falling yields (with the German 10-year yield and a ratio of the Bund yield divided by the Treasury yield)



This leaves many international markets moving towards the high end of historical valuation ranges on metrics like Price to Cash Flow and Price to Earnings. The monetary policy easing will need to translate to earnings and cash flow gains to support these levels. This is the case with expectations, as analysts are upgrading European equities at the fastest pace in four years, since exporters will reap the benefits of a weaker currency.

Turning to the U.S., since 1966 there have been twelve periods without a down year following the mid-term election with an average gain of 17%. At nearly the halfway point of the 3rd year of the Presidential cycle, U.S. markets are clipping along at the low end of history.



There has been some volatility in several of these periods, particularly in the second half, most notably being the yellow line for 1987 and pink line for 2011. Still, equity markets tend to perform favorably leading up to a Federal Reserve interest rate hiking cycle, which many economists forecast for the second half of 2015.

Portfolios maintain the strategic equity allocation with an underweight to U.S. small caps and an overweight to emerging market equities.

Fixed Income

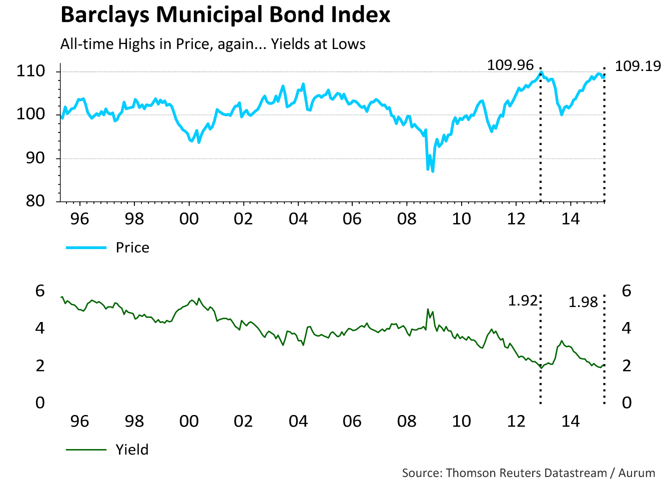
Bonds built on last year's strength turning in a positive quarter to start the year.

Fixed Income	1Q 2015
Barclays U.S. Aggregate Bond	1.61%
Barclays Corporate Inv. Grade	2.32%
Barclays High Yield Bond	2.52%
Barclays Global ex. U.S. Tres.	-3.70%
Barclays Municipal Bond	1.01%

Bonds yields fell in the quarter, accounting for about 2/3rd of the price gain for the index. Over the last year, the index is up 5.8% or more than double the 2.4% yield-to-maturity from a year ago. Since yield-to-maturity is a strong proxy for future return expectations, bond markets pulled forward a few years of returns.

Unless negative yields come to the U.S. like the rest of the world, the chances of keeping pace with mid-single digit returns are nearly impossible since the 10-year Treasury is around 2% today.

Unlike Sweden, Switzerland, Denmark and the European Central Bank, the Federal Reserve is looking to go come off the 0% rate level into the black rather than into the red (each of the European central banks all have negative policy rates). Should yields stay lower for longer, pension funds at home and abroad will have a difficult time of meeting long-term obligations.



Aurum sold high yield municipal bond positions during the quarter as prices matched the record highs seen in late 2012.

With yields at the lows, the future expected returns is back below 2%. While this tax-free yield is okay given the world's low yield opportunity set, we think there are stronger opportunities in the taxable market for those willing to take credit risks. While non-agency mortgages had a strong run the past several years as the housing market recovers along with the bond prices, there still seems like room to run with a continuous falling supply of bonds available in the space. We opted to marginally increase this exposure with a new manager addition in the quarter. The manager also has some exposure to foreign bonds from Mexico, Russia, and Brazil, which sold off materially due to the decline in oil prices. While not a strategic allocation, we like the tactical trade and flexibility of the manager to express these views. In addition, a few of our managers are taking advantage of the sell-off in floating related assets.

The Aurum Asset Allocation Frameworks maintain a small underweight to the strategic targets.

Alternative Investments

Hedge fund strategies outperformed thanks to strong trends for managed futures and stock selection for equity long/short. REITs and TIPs (Treasury Inflation Protected Securities) also posted positive performance on the back of falling interest rates.

Alternative Assets	1Q 2015
HFRI Hedge Fund of Funds	2.51%
Dow Global Select REIT	4.05%
Barclays TIPS	1.42%

Hedge funds come in many shapes and sizes. Long/short equity funds seek to provide exposure to equity markets with less volaility. Alternative beta exposures seek to improve porfolio diversification with lower correlation. While compared to the bull market in stocks the last six years, the 'recency bias' of behavioral finance makes maintaining diversifying strategies in portfolios counterintutive. This past quarter may be the first sign that the pendulum is swinging in alternatives' favor.

Diversified alternative strategies remain a core allocation with a slight overweight while the lofty valuations of REITs leave us less excited about the forward looking risk/return proposition. Outflows from TIPs funds and the high level of deflation talk perk up the contrarian in us. It remains a research focus as we look at this cycle maturing.

Conclusion

The trend for global equity markets remains up with relative strength shown abroad this past quarter. Fear of rising interest rates leaves many investors worrying about bonds, yet we still believe a barbell approach to portfolio construction is a nice way to position in this market without a 'timing call.' Alternative strategies rallied as cross asset class volatility and stock dispersion picked up. We maintain a balanced approach near the long-term strategic targets across the Asset Allocation Frameworks.

Aurum Asset Allocation Frameworks

	Conservative Income		Conservative Balanced		Moderate Balanced		Aggressive Balanced		Aggressive Growth	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	20%	35%	35%	50%	50%	70%	72%
U.S. Equity	0%	0%	12%	8%	20%	14%	30%	22%	42%	35%
Int'l - Develop. Markets	0%	0%	6%	6%	12%	12%	16%	16%	21%	21%
Int'l - Emerg. Markets	0%	0%	2%	6%	3%	9%	4%	12%	7%	16%
Fixed Income	65%	58%	45%	40%	30%	28%	17%	16%	10%	9%
U.S. Fixed Income	56%	57%	39%	39%	26%	27%	15%	15%	7%	8%
Global Fixed Income	9%	1%	6%	1%	4%	1%	2%	1%	3%	1%
Alternative Invest.	25%	26%	28%	26%	30%	26%	30%	26%	19%	17%
Diversified Strategies	19%	26%	22%	26%	24%	26%	24%	26%	15%	17%
Real Estate & REITs	2%	0%	2%	0%	3%	0%	3%	0%	4%	0%
Inflation-Indexed Sec.	4%	0%	4%	0%	3%	0%	3%	0%	0%	0%
Cash/Equivalents	10%	16%	7%	14%	5%	11%	3%	8%	1%	2%
U.S. Dollar	10%	16%	7%	14%	5%	11%	3%	8%	1%	2%

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.

AURUM

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