30 September 2016: Portfolio Review & Outlook

Following a volatile close to the second quarter resulting from Brexit, most global markets performed well in the third quarter. In the U.S., markets extended their gains despite an increasingly contentious presidential election, volatile oil prices, and continued uncertainty surrounding fiscal policy. Outside the U.S., many foreign central banks, including the European Central Bank, maintained their aggressive monetary policies. While ambiguity surrounding the outcome of Brexit seemed to have little effect on investor behavior, Britain's decision to leave the European Union has led to speculation that other countries may soon follow. This, coupled with continued weakness in China and Asia, has led some to believe that global growth outside the U.S. will slow in the coming months.

For the quarter ended September 30, 2016, global equities outperformed domestic equities as measured by the MSCI ACWI ex U.S. (+5.3%) and S&P 500 (+3.9%) respectively. Fixed income assets continued their upward trend with another strong quarter. Notably, global high yield ended the quarter up +5.3% as measured by the Barclays Global High Yield Index. Elsewhere in fixed income, returns were strong for emerging market corporate and sovereign debt and U.S. high yield. Commodities fell in the third quarter, amid continued volatility in oil prices. REIT returns were mixed for the quarter. In the U.S., REITs, fell due to valuation concerns and uncertainty about interest rate movements. Outside the U.S., REITs rose as demand continued to outweigh supply and valuations remained attractive.

Our portfolios entered the third quarter of 2016 in a moderately defensive position as volatility and correlations amongst asset classes spiked after Britain's surprise decision to leave the European Union. Early in the third quarter, it became clear that macro concerns were driving investor decisions and that geopolitical risk had once again taken center stage. In these environments, diversification becomes a less effective tool to manage portfolio risk and we used this opportunity to shift heavily into defensive assets. As is typically the case, the summer months brought about a period of relative calm in the markets. During this period, it became clear that markets had stabilized and that the near-term risk of a significant drawdown was minimal. We took this opportunity to increase allocations to risk assets in the portfolios. On September 13th, despite relatively low levels of volatility, our measures indicated that the risk of an equity market sell-off had increased and we responded by increasing our allocation to global fixed income and reducing our allocation to global equities, global real estate[1], and commodities.

Our portfolios' exposure to international small-cap and emerging market equities contributed positively to absolute returns as accommodative monetary policy around the globe led to continued strength in equities. Our portfolios' exposures to global ex-U.S. treasury bonds, global ex-U.S. REITs, and bank loans also contributed positively to absolute returns during the quarter. Our portfolios' exposure to commodities detracted from absolute returns during the quarter.

We expect continued uncertainty in global markets as we move into the final quarter of 2016. In the U.S., economic indicators including low unemployment and high levels of consumer confidence point to a strong economy that should continue to grow. However, the upcoming presidential election and another interest rate announcement from the Federal Reserve have the potential to send the economy into a tailspin. Outside the U.S., we expect that low interest rates will help to keep economies growing at a muted pace. However, we expect that political fallout from Brexit and upcoming elections in France and Germany will keep investors on edge and poised to sell at the first sign of instability in the markets. As a result of the uneasiness and instability in the markets, we will continue to favor fixed income exposure over riskier assets. As of the end of the quarter, our fixed income allocation includes exposure to global ex U.S. treasuries, short-term U.S. investment-grade debt, and U.S. floating rate bonds. Despite relatively low levels of volatility in global markets, the risk of an equity market sell-off has increased significantly. Consequently, based on our measures, we maintain a defensive position.

[1]Global real estate includes U.S. real estate, foreign real estate, Master Limited Partnerships, infrastructure.