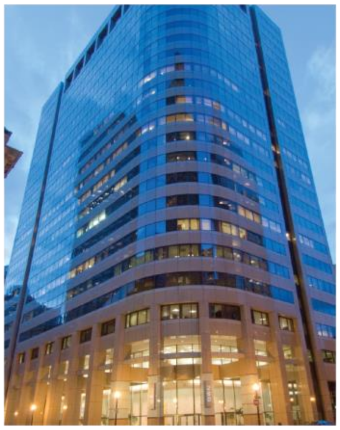
TFC FINANCIAL
The Financial Counselors

COMMENTARY | 2Q
JULY 10, 2015

OUR VIEW



What Drives Economies and Financial Markets?

Since the days of Tulipmania in the seventeenth century, investors, speculators and pundits have searched for the answers to the question of what ultimately drives financial markets, and it remains so today. Is it investor sentiment, government policy, geopolitics, economic expectations, or the corporate earnings outlook? Or is it a combination of all of these?

In the early 1960s, economics as a discipline in academia was dominated by the idea that mainframe computerized econometric models could explain, and even predict, economic outcomes. At Harvard, Professor Otto Eckstein, a key figure in this movement to reduce the complex economic equation to computer logic and algorithms which replicate the interaction of some 2,700 dependent variables in the U.S., founded Data Resources, Inc. (DRI). But in the classroom, he had to admit that when it came *to investor sentiment, government policy and geopolitics*, he and his staff of Ph.D. candidates were unable to develop logic and write code to accurately model the U.S. economy, never mind to generate possible outcomes in a global context.

More or less accepting this glitch in his model's theoretical framework, Professor Eckstein punted, left room for users to manually input their own outlook and valuation assumptions, skillfully marketed the model's weakness as its strength, (i.e., promoting the user's "control" over the model's operation), and a few years later sold DRI to McGraw Hill for $120 million (roughly $511M in today's purchasing power).

Government Policy, Geopolitics and Investor Sentiment Becoming More Important

In the mid-1960's, econometric modeling was the rage; institutional money managers boasted that with this technology they were suddenly able to accurately predict the macroeconomic outlook, and ipso facto produce better portfolio investment results. Predictably, such claims were never realized. Since then, following a number of iterations, today the proliferation of computerized financial modeling software, broker-promoted high-frequency trading programs, and "robo" investment management providers continue to advance the notion the vendor has found the key to superior investment performance.

Most of these automated "investment" programs, in the last analysis, turn investors into short-term speculators, pandering to a user's impression that increased turnover equates with improved performance (i.e., in behavioral terms indulging the user in his/her "activity bias"). Absent from almost all of these computer-based financial modeling tools, there continues virtually no attention to the "soft inputs" which Professor Eckstein early on identified as more or less impossible to model.

But as global markets have become more complex and interactive, and governments and policymakers more intrusive, the necessity for investors to understand the implications of capricious policy decisions, and shifts in sentiment and geopolitical developments, becomes ever more essential. In this era of central bankers as rock stars and spin doctors managing the public's need-to-know, all leveraged by instantaneous information transmission from endless sources, a skeptical awareness of this background will serve investors well.

In the portfolio strategy context, paying attention to the global policy and geopolitical scene continues a top priority. However, as David Swensen, Yale's Endowment Manager has always opined, and we continue to abide by, ". . . the choice between broad classes of assets such as equities and bonds is the only investment decision that adds value." A globally diversified list of holdings will modify the risk inherent in equities. Even though in the U.S. our central bank's *quantitative easing* (QE) program has boosted all asset prices, and narrowed the correlation patterns amongst most asset classes, prudence dictates broad exposure to a variety of liquid equity and fixed income investments.

Grexit Possible, But Developments in China Continue As the Main Event

The Greek Tragedy Continues to Unfold, but the Drama in China May Take Center Stage

In early Greek writings and drama, the more the literary characters attempted to avoid their fate, the closer it brought them to the inevitable. If you were a Greek looking in the mirror today, or Puerto Rican contemplating your financial future at the moment, the outlook would be grim. The prospect of post-exit chaos doesn't seem to have entered the Greek voters' minds. Politically, other European leftist parties are waiting off-stage, polishing their advocacy rhetoric hoping for Greek debtor relief without reform. Putin, ever lurking and agitating, awaits a Greek spin-out from the Eurozone. If he can split the European alliance, his visions of Russian warships in Greek ports may be realized.

For Puerto Ricans, the journey back to financial stability has yet to begin. The parallels are striking. Their resolution is locally important, but any economic effect can probably be absorbed in a broader regional context. However, the drama unfolding in China which has been pushed off the front pages by the Greek and Puerto Rico fiascos remains, for investors, the main near-term event.

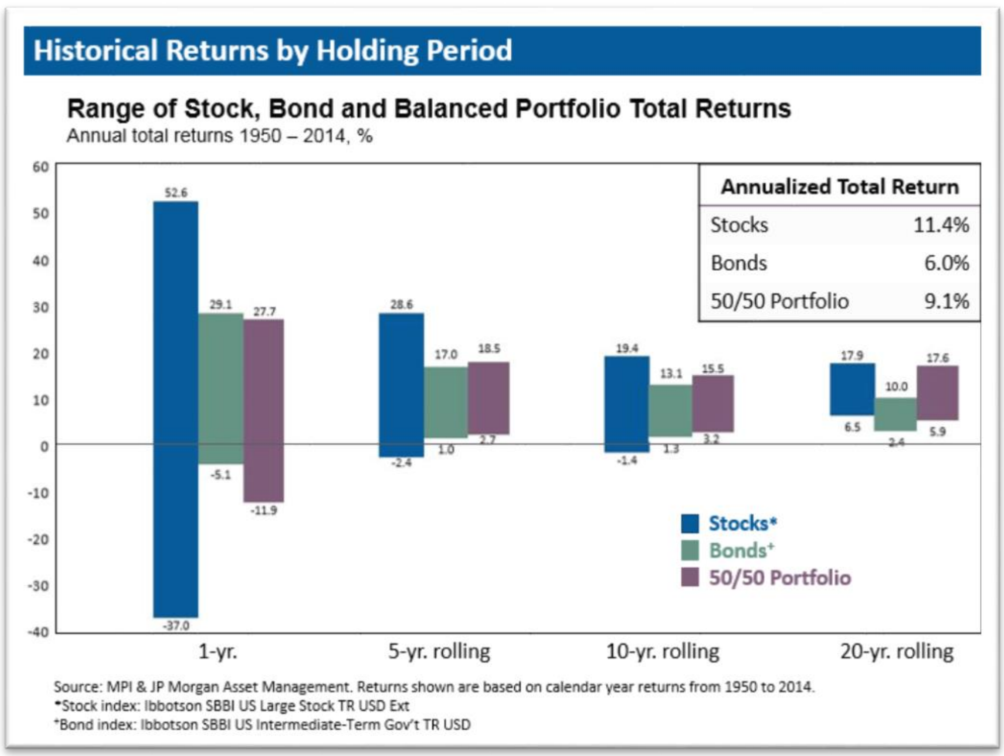
Now the world's second largest economy (measured by GDP), China strives to shift its economic mix toward a consumer-driven mode. Translating this into a wealth-building financial market system for the individual investor has proven to be difficult. China's stock markets, launched in 1990, have remained tightly wound up with officialdom. Micromanaged by central planning policymakers, Chinese equity markets seem to have been set up to accommodate the needs of its power elite, who on the surface advocate stability and status quo, but manipulate to maintain Communist Party control. As such, the present stock market volatility is an embarrassment to Chinese Party functionaries.

Chinese individual investor demographics are compelling (i.e., 280 million broker accounts, opening at a rate of one million per week; $21.0 trillion individual savings with only real estate or domestic equity markets in which to invest). But the lack of transparency, absence of an independent judiciary and shareholder protection statutes, as well as the arbitrary disregard for contractual obligations, all undermine this national experiment in state capitalism. At the moment, although nearly 18% of global GDP, China's stock markets remain less than 2% of world stock market capitalization, and seemingly are relegated to continue so. In the long run, rigged markets do not attract sophisticated participants with options to place capital elsewhere in a relatively free market environment.

The Role of Fixed Income Securities in Balanced Accounts

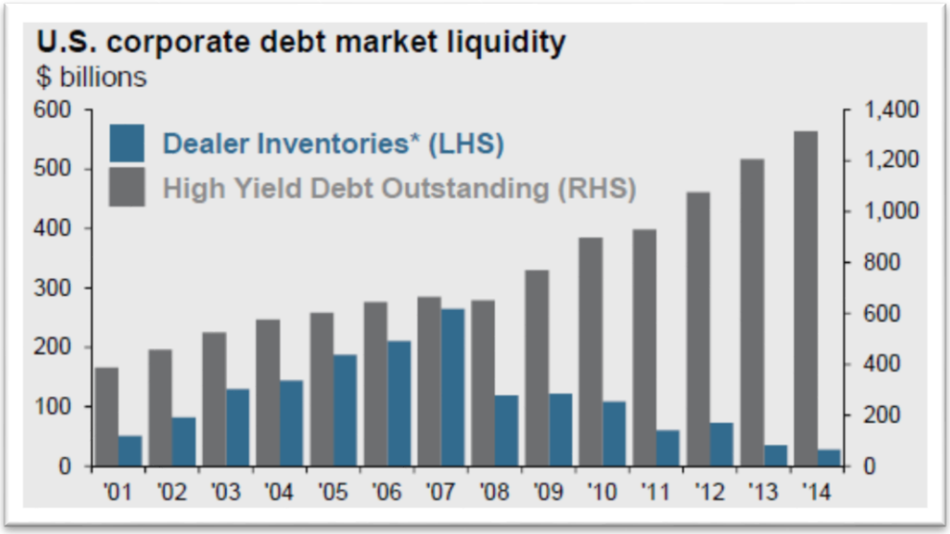
The purpose of bonds in a balanced portfolio is to diversify away and moderate the risk of broader and larger price swings on the equity side of your portfolio. The chart below shows the range of returns of stocks, bonds, and a blended 50/50 portfolio over a variety of time periods. For instance, the best one-year return for stocks was 52.6%. But the worst return was -37.0%, while the 50/50 portfolio range of yearly returns was a high of 27.7% and low of -11.9%. Bonds clearly reduced portfolio volatility over short time periods. What is interesting is that over the longer 10- and 20-year time frames, the 50/50 portfolio looks similar to an all stock portfolio when measured by highest and lowest returns.

Bonds as Portfolio Risk Modifiers



While stock valuations would not appear to be in bubble territory, one might argue they are at least at fair value. The current economic recovery is now over six years old and tied for the fifth longest expansion over the last century. Weak corporate earnings comparisons of Q1 this year seem to be behind us with better prospects ahead for the second half of 2015, and further improvement is expected in 2016. Prudence would suggest a correction is somewhere between possible and probable.

A popular theme for 2015 has been the reduced liquidity in the bond market due to increased regulations emanating from Dodd-Frank legislation. Post crisis 2008-2009, dealer bond inventories have continued to shrink (see chart on next page). Dealer inventories now represent $23 billion, or 0.6% of the total corporate debt outstanding vs. a record high of $286 billion, or 10.6% of corporate market prior to 2008. The total value of bonds traded each day has also declined on average from $238 billion in 2007 to around $108 billion today.



*Dealer Inventories for all corporate securities including: Investment grade, below investment grade, and commercial paper.

TFC Chart: JPM, Federal Reserve, Barclays Capital data

Lower Expected Returns from Fixed Income and Potentially Higher Risk

Lower inventories and the reduced appetite of banks to take on additional inventory have led to smaller trade sizes and more time required to execute orders. In periods of market stress, this can cause bond prices to swing materially more than in prior periods with similar conditions. For example, last October the U.S. 10-year Treasury yield plunged 0.34 percentage points in five minutes and then recovered over the rest of the day. This was a massive move in one of the largest and deepest markets in the world. Yields typically move less than 0.1% on any given day.

Currently, low starting bond yields explain and indicate diminished expected fixed income returns over longer timeframes ahead. Today, current yields for the U.S. 5-year Treasury of 1.7% and a 10-year bond yielding 2.3% *suggest total annualized returns for intermediate term, high quality bonds in the 2.0% range* would not be surprising.

Given the outlook for lower returns in fixed income, as well as possibly more volatility risk, what should an investor do? First, view your bonds in the context of your total portfolio. Risks in fixed income are elevated, but still materially lower than possible risks owning stocks. Second, shorter duration and higher quality bonds and bond funds should help weather any market stress from greater trading volatility and reduced market liquidity.

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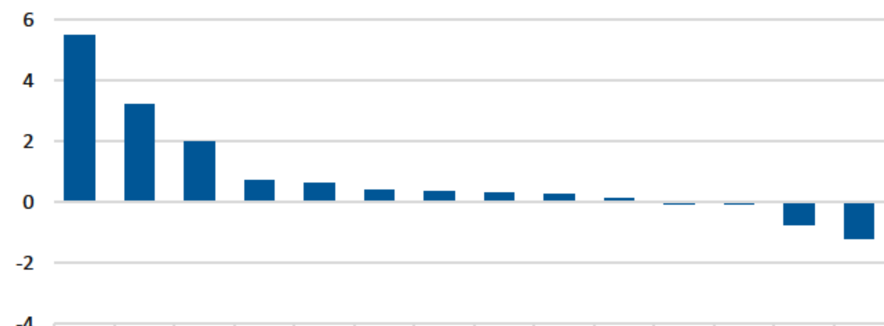
Global Equity Recap

Historical Asset Class Returns (USD)

As of June 30, 2015



	Intl. Small Growth	Intl. Small Value	US Small Growth	Emerging Markets	Intl. Large Core	Europe Stocks	Global Stocks	S&P 500	Intl. Value	US Large Value	Frontier Markets	Short Term Bonds	Short Term Muni Bonds	US Small Value
QTD	5.5	3.2	2.0	0.7	0.6	0.4	0.3	0.3	0.2	0.1	(0.0)	(0.1)	(0.7)	(1.2)
YTD	11.6	8.7	8.7	2.9	5.5	3.8	2.7	1.2	4.1	(0.6)	(3.2)	0.9	(0.4)	0.8
Full Cycle*	2.0	2.1	8.2	(1.8)	(0.5)	(1.0)	2.1	6.1	(1.3)	5.0	(3.5)	3.0	-	5.8

TFC Chart
Source: Bloomberg Data
* Full Cycle is the annualized return from October 2007 peak to present.

International Developed Country Equity Markets Outpaced U.S. Markets during First Half of 2015

In this second quarter just ended and the first half of 2015, International Small Cap Growth stocks (+11.6% through 6/30/15) and International Small Cap Value stocks (+8.7%) were the top-performing global equity asset classes. With the negative impact of a strong U.S. dollar on corporate earnings of multi-national companies, flattening profit margins and elevated valuation multiples weighing on future expected returns in U.S. Large Cap stocks, the S&P 500 index return was muted, +0.3% for the quarter and +1.2% through 6/30/15. Frontier Markets performance has lagged other global equity asset classes during the current cautious, risk-averse investment climate and continued weakness in energy and commodities prices.

As the differential in global regional equity valuations and expected returns remain favorable to International Equities as reflected in the chart below, we are maintaining our current regional weightings; 53% in U.S. equities (vs. 52% in the MSCI All Country World Index (ACWI)), 18% in Developed Europe (vs. 16%), 11% in Emerging Markets (vs. 10%) and 3% in Frontier Markets (vs. 0% in ACWI).

Current Global Equity Market Valuations	
Index	P/E Ratio (12 Months Forward)
MSCI USA	16.7
MSCI ACWI ex. US	13.8
MSCI Europe	14.7
MSCI Emerging Markets	11.0
MSCI Frontier Markets	9.9

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As an addendum to this Commentary, please note that effective this quarter, we are changing our equity benchmark from the MSCI All Country World Index (ACWI) to the MSCI ACWI Investable Market Index (ACWI IMI). The MSCI ACWI IMI is a more comprehensive index covering approximately 99% of the global equity investment universe, including small-capitalization stocks, which better represents our equity portfolio strategy.

TFC Wins Awards

TFC is pleased to announce that we have been named one of the *Financial Times* 300 Top Registered Investment Advisers for 2015. The list recognized top independent RIA firms from across the U.S. This is the second annual FT 300 list, produced independently by the FT in collaboration with Ignites Research, a subsidiary of the FT that provides business intelligence on the investment management industry. More than 2,000 RIA firms were invited to apply for consideration, based initially on assets under management (AUM). The 630 RIA firms that applied were then graded on six criteria: AUM; AUM growth rate; years in existence; advanced industry credentials; online accessibility; and compliance records.

Also, for the third time, Renée Kwok was named a “Five Star Wealth Manager” which was recently published in *Boston* magazine. Award recipients are selected based on 10 objective eligibility and evaluation criteria associated with wealth managers who provide quality services to their clients. The recipients represent fewer than 7% of the total wealth managers in the area. Wealth Managers do not pay a fee to be considered or placed on the final list of the FT 300 or Five Star Wealth Managers lists.

As always, we welcome your comments and questions.

Sincerely,

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Chairman & CEO

Renée Kwok, CFP®
President

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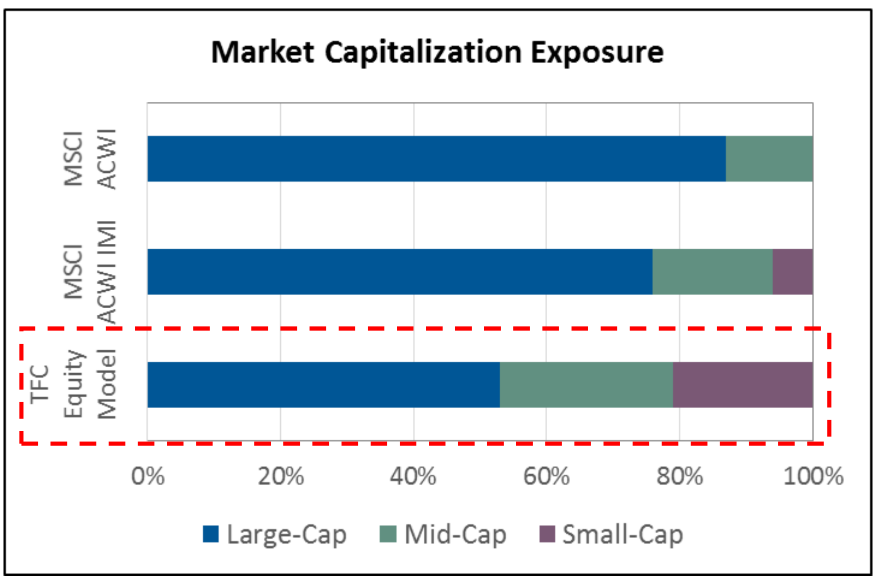
Notice of Equity Benchmark Change

Although this may strike the reader as a distinction not worth making, effective this quarter, we are changing our equity benchmark from the MSCI All Country World Index (ACWI) to the MSCI ACWI Investable Market Index (ACWI IMI). The MSCI ACWI IMI is a more comprehensive index covering approximately 99% of the global equity investment universe, *including small-capitalization stocks*, which better represents our equity portfolio strategy. Investment performance of the MSCI ACWI IMI has closely tracked that of the MSCI ACWI both over the long term and since TFC began benchmarking to the MSCI ACWI on January 1, 2013. Please refer to the charts below for a comparison.

Annualized Performance	5 Year	10 Year	01/01/13-06/30/15
MSCI ACWI	11.9%	6.4%	11.5%
MSCI ACWI IMI	12.2%	6.7%	11.9%

Characteristics		
	MSCI ACWI	**MSCI ACWI IMI**
Number of Constituents	2,483	8,645
Percent of Global Equity Investment Universe (%)	85%	99%
Avg Mkt Cap (USD Millions)	$ 15,173	$ 5,046



TFC Chart: MSCI data