TRIVANT

CUSTOM PORTFOLIO GROUP, LLC

October 2015

Quarterly Insights

EXECUTIVE SUMMARY

Third Quarter 2015

Stocks Fall And Bonds Rise In Q3

In the Third Quarter, the domestic S&P 500 Index fell 6.44%, yet fared significantly better than foreign markets. Europe gave up its relative out-performance year-to-date versus the U.S. after coming out of the gate strong in the First Quarter. China (-22.71%) and Brazil (-33.60%) brought down Emerging Markets. The bond market had positive performance as the Barclay's Aggregate Bond Index rose 1.31% and is now up 1.13% for the year.

Don't Fear The Fed

Is the massive fear that the Fed will raise its current target rate (0 - 0.25%) from the level it has been since December 2008 warranted? We don't think so. Don't fear the Fed!

There are three reasons to welcome a rate hike:

1. The Fed will send a confidence signal that the U.S. economy is alright.
2. Companies will be less likely to misallocate capital.
3. Retirees will benefit from higher fixed income yields.

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In This Issue

2 Don't Fear The Fed

4 Stock Market Spotlight

5 Bond Market Spotlight

6 Your Portfolio

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Don't Fear The Fed

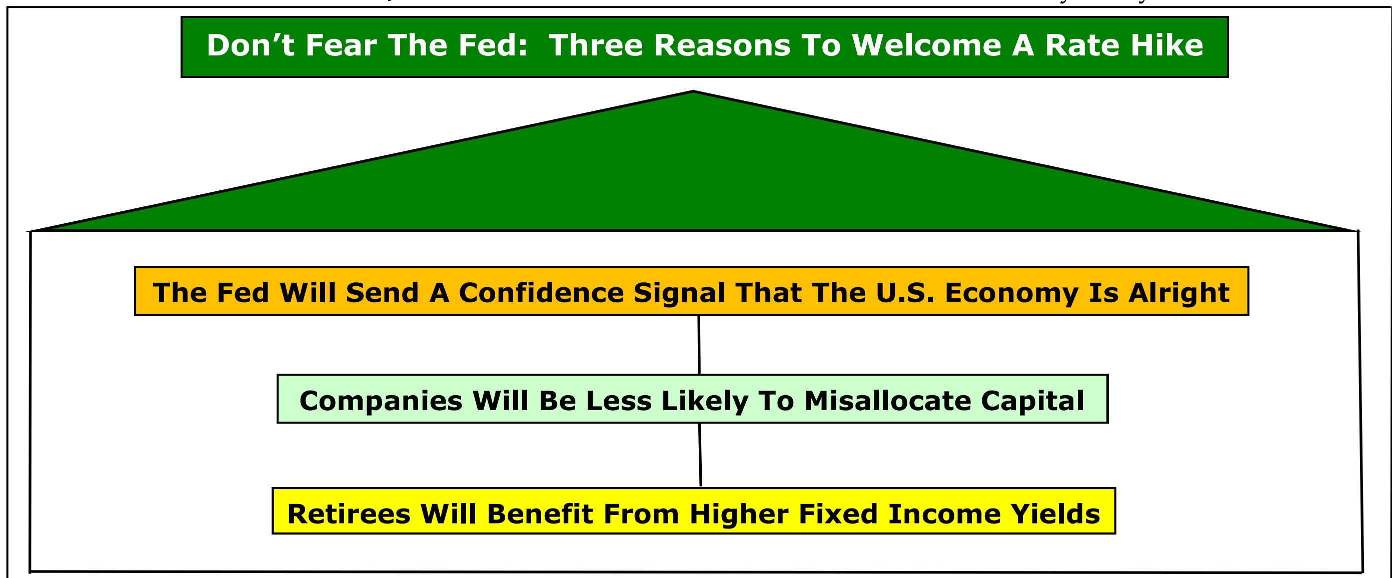
The Fear Mania Regarding A Potential Fed Rate Hike Is Unprecedented

We are in an age of relentless social media including print, television, smart phones and Twitter. The mania regarding a potential Fed rate hike is unprecedented. Every comment by the Fed is examined word-by-word. Every facial expression and language inflection from Fed Chair Janet Yellin is thoroughly scrutinized. All this attention is devoted in the hopes of concluding future Fed actions. Is the massive fear that the Fed will raise its current target rate (0 - 0.25%) from the level it has been since December 2008 warranted? We don't think so. Don't fear the Fed!

The Fed Dual Mandate Should Allow A Rate Hike, Which We Would Welcome

The Fed dual mandate is full employment (widely considered a 5% unemployment rate) and price stability (inflation at 2% or lower). Right now, the August U.S. unemployment rate is 5.1% and inflation is a mere 0.4% (source: The Economist). Since the economy is growing (GDP increased at a rate of 3.9% in the Second Quarter according to the Bureau of Economic Analysis), a rate hike is feasible and arguably warranted.

In its September meeting, the Fed decided to maintain its target rate. The main reasons were lower-than-desired inflation and the global economy. In a statement issued after its meeting ended, the Fed said that while the U.S. job market is solid, global pressures (specifically China) may "restrain economic activity and further slow inflation". Chair Janet Yellin also stated that a rate hike was still likely this year.



1. The Fed Will Send A Confidence Signal That The U.S. Economy Is Alright

The first rate hike in years is more about psychology than finance or economics. The Fed has kept rates so low for so long that people are scared of any change. You have likely noticed the recent wild stock market swings at every hint that the rate will increase. This is not healthy. It can be argued that these Fed "hints" have been going on since 2012. A rate hike sends the following messages:

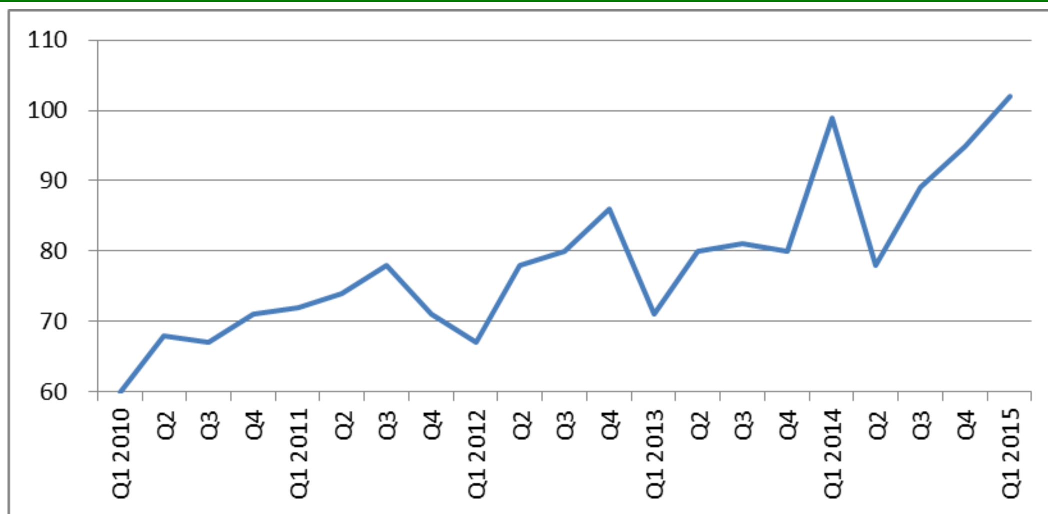
- The U.S. economy is better and does not need the "crutch" of 0% rates any longer
- The Fed will not be swayed by stock market blips or global headlines (it will stick to its dual mandate)
- The Fed has taken the first step in bringing interest rates back to normal levels

2. Companies Will Be Less Likely To Misallocate Capital

In the midst of persistent accommodative policy (zero target interest rates), companies cannot gauge the true level of U.S. economic growth. Consequently they are holding off committing capital investment pending greater certainty regarding underlying economic conditions.

To propel growth in earnings per share (EPS) in the absence of organic business growth, companies have been using low cost debt issuances to aggressively buy back their stock or pay dividends. In fact, dividends and repurchases have recently exceeded operating earnings.

S&P 500 Quarterly Share Repurchases Plus Dividends As A % Of Operating Earnings (2010 - 2015)



Source: Bloomberg

The irony is that the accommodative Fed policy initiated in 2008 was intended to help companies strengthen their balance sheets to survive the Great Recession. Indeed, this was what happened up until recently. But now companies have weakened their balance sheets (taken on more debt) because of this same aggressively-accommodative Fed policy (zero interest rates). A rate hike would lower the incentive for companies to borrow money (weaken their balance sheets) for purposes not related to capital investment. A better allocation of capital will result.

3. Retirees And Close-To-Retirees Will Benefit From Higher Fixed Income Yields

Older workers are delaying retirement and staying in the workforce. Excessively low rates are making it expensive for individuals to retire, as potential retirees view investment income generation from fixed income as too meager to support a reasonable standard of living. As the older people are staying in the workforce longer, they are "crowding out" younger workers.

The massive Fed stimulus has handicapped investors who require retirement income. Interest rates remain far below historical levels. In our capacity as your portfolio manager, the current low-yield environment has presented unusual challenges. We seek safe and adequate income-producing assets that, for the moment, are very tough to find. Many investors have been hurt by chasing high yield investments that have faltered.

An initial Fed rate hike and the prospect of future rate hikes will allow for better portfolio positioning regarding disciplined asset allocation, risk control, and meeting income needs.

Stock Market Spotlight

Stocks Fall In Q3

In the Third Quarter, the domestic S&P 500 Index fell 6.44%, yet fared significantly better than foreign markets. Europe gave up its relative out-performance year-to-date versus the U.S. after coming out of the gate strong in the First Quarter. China (-22.71%) and Brazil (-33.60%) brought down Emerging Markets.

Equity Index Performance

Index	Q3 2015	YTD 2015
S&P 500 (Domestic)	(6.44%)	(5.29%)
The US Dollar Index*	0.91%	6.73%
MSCI EAFE (Foreign)**	(10.23%)	(5.28%)
MSCI Emerging Markets	(17.90%)	(15.48%)
MSCI EMU (European Monetary Union)	(8.40%)	(4.84%)
MSCI Japan	(11.80%)	(0.21%)

* Source: Telemet

** Europe, Australia and the Far East

Growth Companies Are Relatively Out-Performing Value Companies So Far In 2015

In our previous report (see Quarterly Insights July 2015, pages 2 to 4), we explained why we rotate towards companies with stronger balance sheets (lower levels of borrowing) and more "secular" earnings (less dependent on the economy) as the economic cycle matures. In a point of the cycle where it is harder to achieve sales growth, high quality companies tend to lead in a mature market and a downturn.

Indeed this phenomena has been observed so far in 2015. Growth companies (those with secular growth) are leading value companies (those more sensitive to the economy). Sector performance may partially explain the disparity between growth and value. The three best performers year-to-date - Consumer Discretionary (+2.90%), Consumer Staples (-2.94%), and Healthcare (-3.27%) - are "growth" sectors. The two worst performers year-to-date - Basic Materials (-17.81%) and Energy (-15.32%) - are "value" sectors.

Growth Versus Value Performance: 2015 Year-To-Date

Region	Index	Q3 2015	YTD 2015
U.S.	Russell 1000 Growth	(5.65%)	**(2.67%)**
U.S.	Russell 1000 Value	(8.98%)	**(10.61%)**

Source: Telemet

Style Rotation: We Continue To Favor High Quality Secular Earnings Companies

We continue to favor high quality secular earnings companies, as evidenced by our portfolio over-weights (Discretionary, Health Care, Consumer Staples) and under-weights (Basic Materials, Energy). We view the Third Quarter as a market correction, and believe the market still has some room to move up. Although we now have greater confidence in Europe and have increased exposure accordingly (to roughly 14% of the portfolio), the tangible benefit to doing so (realized through Q2) disappeared by the end of Q3.

Bond Market Spotlight

Bonds Rise In Q3

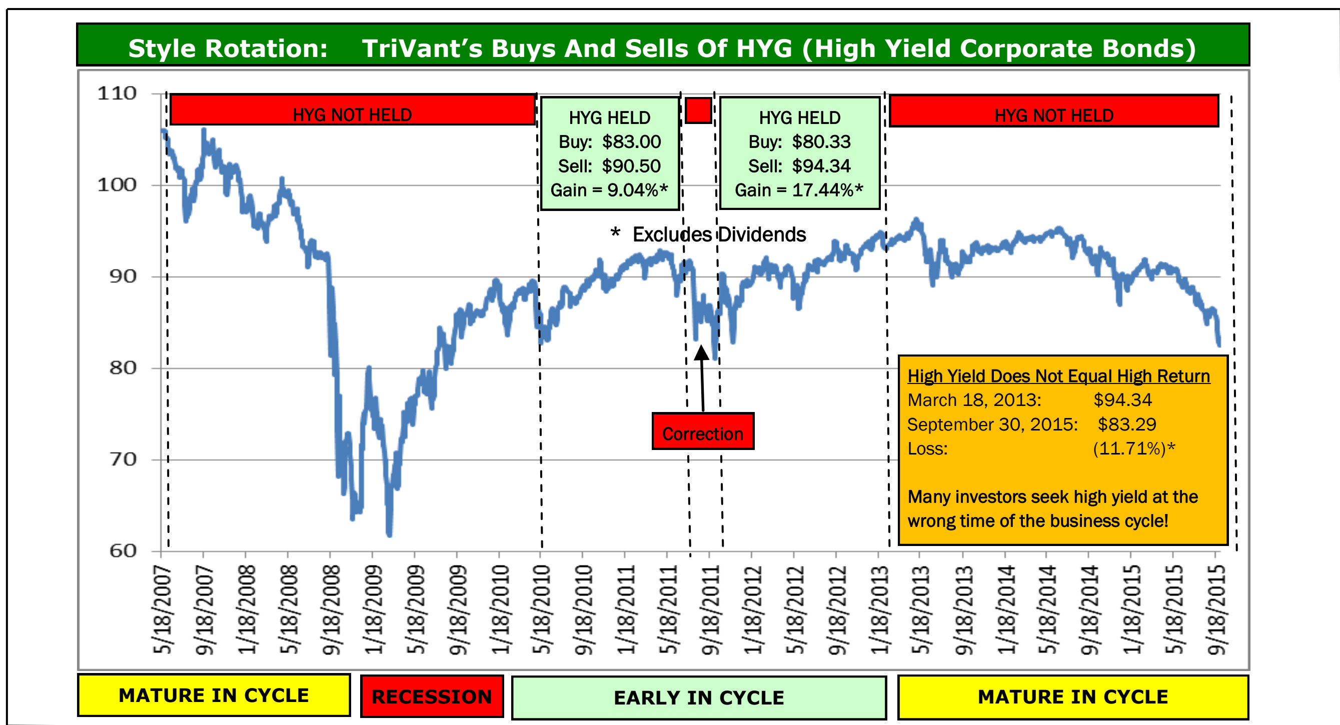
The Barclay's Aggregate Bond Index, a broad-based representation of fixed income performance, rose 1.31% in the Third Quarter and is now up 1.13% for the year. Interest rates fell in the Third Quarter due to GDP growth concerns related to the global economy (China).

Key U.S. Interest Rates	December 31, 2014	Sept. 30, 2015	Change
Federal Reserve Board Funds Target Rate	0-0.25%	0-0.25%	No change
5-Year Treasury (Constant Maturity)	1.66%	1.38%	- 28 basis points
10-Year Treasury (Constant Maturity)	2.17%	2.05%	- 12 basis points
30-Year Treasury (Constant Maturity)	2.75%	2.86%	+11 basis points

Note: 100 basis points (bp) = 1.00% Source: Telemet

Style Rotation Shown Through Our Buys And Sells Of High Yield Corporate Bonds

Regarding style rotation strategy for bonds, the general rule is to buy "low quality" (high yield) bonds early in the market cycle and then rotate to higher quality bonds as the market cycle matures. This is not a perfect exercise as shown by our buys and sells of high yield corporate bonds (symbol: HYG). Fortunately we avoided HYG leading up to the 2009 recession (we deemed the cycle mature and stressed high quality bonds). In our "first round" of transactions (May 20, 2010 through July 12, 2011), we missed the HYG price bottom by a full year and sold a little too early into the cycle. In our "second round" (October 4, 2011 through March 18, 2013), we bought back HYG in what we viewed as a 10% market correction and sold at a time we viewed the market cycle as maturing. While far from perfect, these trades worked very well.



We maintain our view of holding higher quality bonds with shorter maturities at this point in the business cycle. Consequently we have not held high yield corporate bonds for well over two years.

Your Portfolio

We realize that it is not easy to watch the market go down as it did in Q3. It is during times like this where strategic discipline is key. We believe the market went through a normal correction versus a structural change. The U.S. economy remains healthy and we will welcome a Fed rate hike. We believe stocks remain best weighted towards U.S. high quality secular earnings (growth versus value) and bonds remain best weighted towards high quality short maturity. Above all, we believe in sticking to your target asset allocation, even when it may appear tempting not to do so.

During the quarter, we bought Express Scripts (symbol: ESRX), the largest pharmacy benefit manager (PBM) in the United States. Through its mail order pharmacy, ESRX administered around 1.3 billion prescriptions in 2014. This gives ESRX dominant supplier pricing power and scale advantages. Given demographic shifts (an aging population) and the expanded medical coverage, we anticipate considerably higher pharmaceutical spending over the next several years. As specialty drug spending continues to increase, we anticipate payers will look to PBMs to help control spending on these products. ESRX is a large growth company with a market cap of $60 billion.

We sold eBay (symbol: EBAY), an online retailer. We held EBAY for almost two years, and EBAY did quite well (up close to 40%). However, we are concerned that eBay will have trouble retaining market position.

As we approach year-end, you may see transactions in your portfolio geared towards tax loss selling.

We will continue to closely monitor the market and adjust your portfolio as needed. Please feel free to contact us anytime to discuss questions or comments you may have. We will keep you informed of portfolio progress.

Respectfully submitted,

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Disclaimer

The information presented herein is intended for informational purposes only. All views are subject to change based on updated indicators. The recommendations made in this publication are made without regard to individual suitability. Investors should consider their own needs and objectives before making any investment decision.

Commentary in this review reflects our portfolio strategy. Many of our clients have different objectives and circumstances which are reflected in unique portfolio considerations. Please note that accounts may not contain all elements of the strategy discussed here. Additionally, individual client customizations and start dates may preclude certain elements of this strategy from being implemented.

Past performance is no guarantee of future results. A risk of loss is involved with investments in stock markets.