SECOND QUARTER 2017

Matt's Market Update

IN THIS REPORT

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Market Review

It was another strong quarter for global equity markets. With little fanfare after many years of lagging performance, foreign stocks have been the leaders so far in 2017. The MSCI ACWI ex USA index was the standout in Q2 with a gain of +5.78%. The index also leads the pack YTD with a gain of +14.10%. Of the major mutual fund peer groups we track from Morningstar, foreign stock categories occupy the top six slots with gains widespread across styles and market caps. Generally speaking, funds focused on small- and mid-cap stocks have been the best performers while those managers emphasizing growth stocks have outperformed their value stock competition. It was also another strong quarter for the Emerging Market equity group as the average fund in this category rose +5.88%. In the U.S., the NASDAQ index continues to be the best performer YTD (+14.07%) after logging a solid gain in Q2 (+3.87%). The index is being driven higher by large-cap tech stocks like Facebook and Amazon which have both gained over 30% YTD. Incredibly, the NASDAQ index has logged 38 all-time high closing price marks so far in 2017. Further behind in the YTD return standings are the Dow Jones (+9.35%) and the S&P 500 (+9.34%). The Russell 2000 index of small-caps has notably lagged with a return of +4.99% this year, with most of those gains coming in June as the index rose +3.46% to finish the quarter on a high note. Small-caps did extremely well in 2016, especially following the election, so lagging performance this year is not a great surprise.

The economy continues to grow at roughly a modest 2% pace. Not terrible considering this is the third longest recovery on record. That being said, it's hard to say what might get the economy moving on a higher growth trajectory. Hopes from earlier this year of significant legislative reform to taxes, trade and healthcare seem to have stalled. While there remains hope that something can be passed in Congress before year-end, the odds are getting longer as the days pass by. Despite a very low 4.3% unemployment rate, wages are still not growing, much to the chagrin of the Fed which in June raised interest rates for the third time since December. At least one more rate hike is expected in 2017. There can be no doubt that the Fed is shifting from being the market's best friend (by providing massive amounts of liquidity to support stock prices) to being a detriment by slowly raising rates. So far the equity market has taken the rate hikes in stride, but for how much longer?

Active Management Rebounds

The ever growing popularity of low-cost index fund investing has had a major influence on equity markets and asset flows in recent years. In addition to holding a significant cost advantage, index funds have also outperformed the majority of their actively managed mutual fund competitors (over most time periods) since the great recession of '07-'08. While it's too early to definitively say this trend is changing, we've witnessed a rebound in the performance of active "long only" mutual funds in 2017. According to a recent report from Bank of America, Q2 and the first half of this year were tops in active management performance over the prior eight years. Specifically "over half (54%) of large cap fund managers beat their benchmarks in the first half of the year for the first time since 2009."

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In the second quarter, 60% of the managers outperformed their benchmarks, the highest hit rate since Q1 2009, and one of only six quarters in which over half of fund managers outperformed their benchmarks during the quarter (see the chart on this page). In the first half of this year, 54% of large cap fund managers outperformed their benchmarks—the first time in the data's history where more than half of managers beat their benchmarks in the first half of the year. The outperformance was largely driven by style funds, as 71% of Value managers and 64% of Growth managers beat their respective benchmarks in the first half, compared to just 36% of Core managers. The implication being that sector and company positioning for active managers in both the Value and Growth categories was key to their success. After all, this is what is expected from active management. Fund managers have remained consistently overweight in the best-performing sectors in the first half of this year—Technology, Consumer Discretionary and Health Care—with a record-setting overweight in Technology (the S&P Info Tech sector was up +17.2% YTD). Managers have also set record low underweights in Consumer Staples, Utilities, and Telecom, all of which have underperformed so far this year. Whether this very short-term trend of active management outperformance continues will depend heavily on the dispersion of returns for individual stocks and sectors. Higher volatility and greater differentials in performance (thus more reward for picking winners and avoiding losers) should benefit active strategies. On the other hand, should sector performance start to converge with less difference in returns across stocks and sectors (the tide moving all boats in the same direction), index fund performance may start to assume superiority again.

Less Stress

We've often commented over the years on stock buybacks and their impact on pushing prices higher during the current bull market. As a reminder, when companies buy back their own stock on the open market with corporate cash, it serves to reduce the shares outstanding in the company and leads to higher earnings per share (assuming companies are earning profits). As you can see from the chart on the next page, companies in the S&P 500 have bought back trillions of dollars worth of stock since the market lows of 2009. As an example of just one company, Home Depot earlier this year announced a plan to buy back another $15 billion of company stock. With the market cap of the company around $175 billion at the time, this new buyback plan amounted to nearly 9% of the outstanding shares. Hardly insignificant. The chart's red line, which shows the trailing 4 quarters of cumulative dollars spent on buybacks, started to decline in 2016. Looking back in time you'll also note the major decline in buybacks during the financial crisis from '08-09.

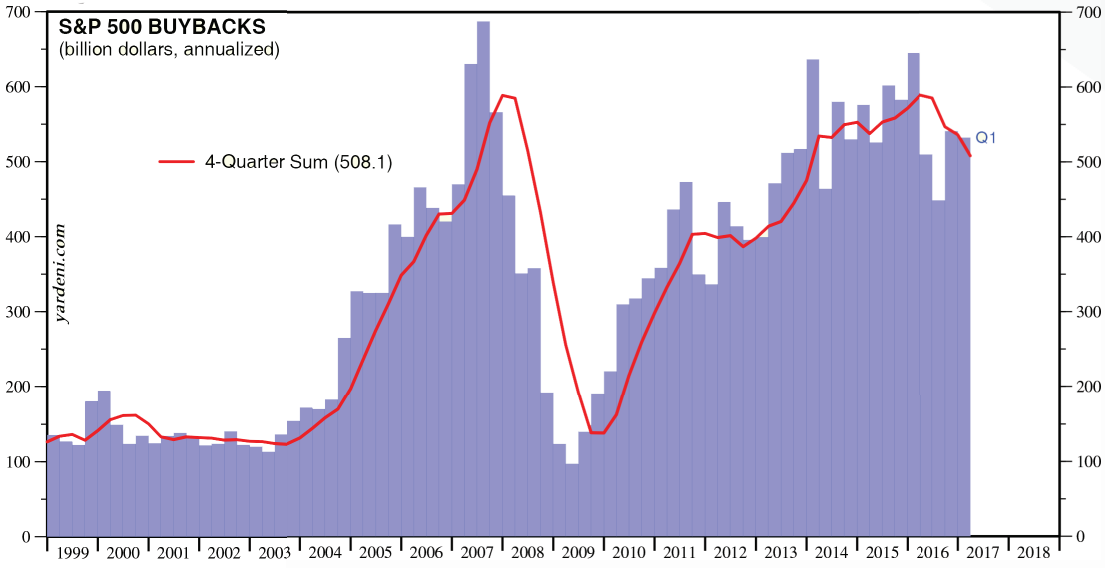
Should we expect the decline in company stock buybacks to continue? One argument in favor of the buyback trend marching higher is the recent round of "stress tests" conducted by the Federal Reserve on large banks and other publicly traded financial institutions. These tests are meant to model out how a financial firm would be able to operate under highly adverse economic or financial market conditions. Essentially a test of the firm's financial reserves and other resources necessary to survive another crisis. The simulations included assumptions of a 10% national unemployment rate, a 50% decline in stock values and a 25% drop in home prices. As you're aware, financial firms of all stripes have been under extreme scrutiny

HIGHEST QUARTERLY HIT RATE BY LARGE CAP FUND MANAGERS SINCE 2009*

*% of funds outperforming the benchmark is based on Russell 1000 benchmark for all funds prior to 2015 and the fund's respective benchmark (R1000 for Core funds, R1000 Value funds and R1000 Growth for Growth funds) in 2015 and onward

Source: Lipper, BofA Merrill Lynch US equity & US Quant Strategy

BUYBACKS & DIVIDENDS
Source: Lipper, BofA Merrill Lynch US equity & US Quant Strategy



by the govenrnment since 2009 to enhance their financial strength in advance of anything ranging from a mild recession to a severe depression. At the end of Q2, the Fed announced that the vast majority of financial firms passed the stress tests. As a result, many large financial institutions are expected to begin or significantly enhance their own stock buyback and dividend programs. Previously, this sector of the market was very limited in this regard. Some estimates have the financial sector contributing an additional $800 billion to new buybacks. Of course, these stress tests are academic in nature and done through quantitative modeling. The Fed can't possibly test every possible scenario lurking in the market. The next crisis likely won't originate in the residential mortgage market.

Nevertheless, more fuel to the buyback boom is likely to come from the financial sector and this will likely be another supportive factor for equity prices.

Hitting the Target

Target Date Fund Definition: *A target-date fund is a mutual fund that automatically adjusts the asset mix of stocks, bonds and cash equivalents in its portfolio according to a selected time frame that is appropriate (based on the fund company's research) for a particular investor. Funds are offered in vintages according to a target retirement date in the future (2030, 2040, 2050, etc.) and investors typically choose a fund that matches their expected retirement date. The percentage in risky assets (stocks) at the retirement date will either remain constant going forward or continue to drift lower over time past the retirement date according to the strategy defined by the fund company.*

Target date funds are very popular among our retirement plan clients. As the definition above states, these portfolios are managed to adjust over time from a more aggressive, i.e. higher % in equity, asset mix to a more conservative, i.e. lower % in equity and higher % in fixed-income, asset mix over time. Retirement plan participants often find these diversified portfolios attractive as the investment is managed for them with little need to make adjustments. For example, a retirement plan investor who expects to retire in the year 2040 might choose the target date 2040 fund for their sole investment option.

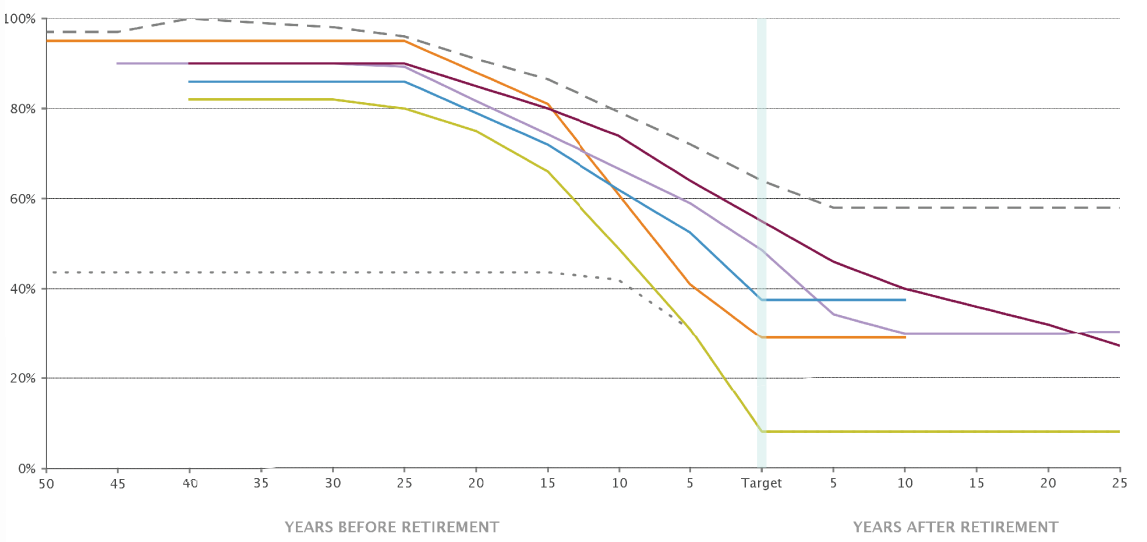
Please note the chart on the next page. The left axis shows the percentage in stocks held by the target date fund at any given time while the horizontal axis depicts the time remaining before retirement. The colored lines illustrate the investment glide path constructed by 5 different fund companies (all brand name firms). The glide path shows the target date fund's strategy for changing the asset mix over time as the investor approaches the retirement date (vertical blue bar). What should jump out immediately is that the 5 lines on the chart are very different in design. While they're similar in the early years (far away from retirement) in that they have a high percentage allocated to stocks, the glide paths start to diverge significantly once

an investor is within 25 years of retirement. Some glide paths reduce their equity holdings gradually, while others show a very steep decline in equity as the retirement date approaches. Key to analyzing these strategies is what percentage in equity does the strategy have at the retirement date? As you'll note from the chart, there are 5 different views expressed here. The glide path shown in yellow has only 8% in stocks in the portfolio at the retirement date. Clearly very conservative with the overall philosophy being that this company wants maximum safety for their investors at the retirement date. Guarding against a potential large market drawdown (which can't be made up for with new contributions once a worker retires) is the main goal for this fund manager. The glide path in dark purple takes a completely different view with over 50% of the portfolio still in equity at the retirement date. This fund company is clearly willing to have a more aggressive portfolio in place for an investor who reaches the retirement date. The main thought process here is that while an investor may retire at age 65, they're likely to live to 85 or beyond. Therefore, a higher allocation to equity is needed for long-term growth so that the investor has lower odds of outliving their savings. Of course, the big assumption here is that not only will the investor retire, but that they will also leave their money in the plan after they've stopped working.

We've only highlighted two examples here in the chart, but there are over 50 glide paths from established fund providers in the industry to choose from. Which is the best fit for your retirement plan? Unfortunately, the answer isn't simple. While most plan sponsors tend to default to a comparison of long-term performance, this isn't the best approach for target date funds simply because there is no set standard across the industry for how these portfolios are constructed. You may compare two funds with the same retirement date (2040 for example) that have completely different performance profiles. Is the fund with the better performance the best selection for you? Possibly, but it likely indicates (especially now) that the strategy had more exposure to equity. We've been in a multi-year bull market for equity so it's no surprise that the most aggressive glide paths are the best performers today. What will happen though if we see a significant stock market correction or bear market? Will those same aggressive glide paths be the best performers and protect capital during the next downturn?

The subject of analyzing target date funds could easily consume this entire report. Choosing the correct target date strategy for the plan is more involved than simply picking the lowest cost provider or best performing fund. Plan fiduciaries and their advisors are held to a very high standard of due diligence for these funds as they often are chosen as the QDIA or default investment for plan participants who don't make their own investment selections. Over the coming quarters, we'll be rolling out more tools and due diligence aides for our plan clients to help them in their process of oversight for these investments.

WHICH GLIDE PATH IS BEST?
Percent of equities vs. years before/after retirement



Source: JPMorgan Chase & Co.

To wrap up on this topic for now, here are five key considerations for reviewing target date funds:

1. Glide path construction: How does it change over time? How quickly does it de-risk? What is the amount of equity at the retirement date?

2. Plan demographics: What is the median age of plan participants? What is the median savings rate? Do most participants leave the plan at retirement or leave their money in the plan?

3. What risks are the funds trying to avoid: Longevity risk? Risk of large market drawdowns? Does the philosophy of the fund company align with the opinions of the plan sponsor?

4. What's in the target date fund portfolio: Does the fund hold individual securities or is it a fund of funds? Which asset classes are used? How does the asset mix shift over time? Are the funds actively managed or index funds or a combination of both?

5. Cost: The easiest data point to analyze. What is the expense ratio and how does it compare to peer funds? Keep in mind that the lowest cost fund isn't necessarily the best choice.

Our Portfolio Strategy & Allocation Outlook

First a quick housekeeping note. As most of you are likely aware, the investment team at Sentinel Pension Advisors manages portfolios for both individual and institutional retirement plan clients (Lifestyle Portfolios). The specific portfolio ideas mentioned in this report will always refer to what we're doing with our individual client portfolios unless specifically noted otherwise. While these ideas and changes often mirror what we're doing within retirement plans, this isn't always the case. Due to differences in trading platforms, fund availability, etc. there are differences in how the portfolios are positioned. In addition, we've recently started to convert our retirement plan portfolios to a Collective Investment Trust (CIT) portfolio structure in order to lower costs and make the management of these portfolios as efficient as possible. So far, the adoption and feedback from clients has been great. For those retirement plan clients utilizing the CIT Portfolios, we have a specific portfolio commentary piece that will be a part of your quarterly reporting package. This separate review piece is the best source of current information regarding our positioning and thoughts related to the retirement plan portfolios. No matter what type or style of portfolio we're managing now, we are at a neutral or small underweight position (versus our long-term targets) in terms of U.S. equity exposure. As the markets continue to march higher, our caution continues to build. In no particular order, here are some of our top concerns regarding the U.S. equity market at the halfway point of 2017.

1. The Fed is raising rates. With the Fed hiking rates three times over the past 6 months, there can be no doubt that the punch bowl is being taken away from the equity market. Per research from Gluskin Sheff, over the prior 13 Fed rate hiking cycles, 10 of those periods led to recession. Recessions typically lead to lower stock prices. The current Fed seems hell-bent on raising rates even if this action is not supported by current economic data. Ultimately, the market reaction will likely be negative.

2. Gridlock in DC. We're nearly 8 months into the Trump administration with no significant legislative progress on tax reform, trade agreements or healthcare reform. Yet, the stock market has seemed to price in these possible policy changes as done deals. We continue to remain skeptical that these reforms will be enacted soon or that they'll be as market pleasing when the fine print is finalized.

3. Valuations. No matter what metric we look at, it's hard to make a case that the U.S. equity market is anything but expensive. The P/E multiple on trailing earnings is the second highest in the last 30 years. As we've mentioned in the past, high valuations don't keep a market from moving higher, but they do limit the appreciation potential for the marginal dollar invested. Even foreign equity markets (which we have over weighted) are not cheap on a historical basis. They are more reasonably priced than domestic markets.

4. Leverage. Margin debt on the NYSE (money borrowed to buy stocks) has soared recently to $540 billion according to Barron's. This is an amount nearly double from the height of the tech bubble in 2000.

5. Complacency. Most sentiment surveys at mid-year show investors with optimistic or bullish forecasts. From a contrary perspective, when the majority is of one opinion (combined with the other factors listed above), it's best to keep an eye an alternate possibilities.

6. Portfolio manager cash levels.
Per data from Ned Davis Research, cash and money market fund assets relative to stocks has fallen below the marks of 2000 and 2007. If the managers are already fully invested, who is left to push prices higher?

Please let us know if you'd like to discuss your personal investing goals and financial planning needs.

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Market Scoreboard

Index Returns (%)	Q2 2017	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	3.09	9.34	17.90	9.61	14.63	7.18
DJIA	3.95	9.35	22.12	11.01	13.45	7.57
NASDAQ	3.87	14.07	26.80	11.68	15.91	8.96
Russell 2000	2.46	4.99	24.60	7.36	13.70	6.92
MSCI ACWI Ex USA	5.78	14.10	20.45	0.80	7.22	1.13
Barclays Aggregate Bond	1.45	2.27	-0.31	2.48	2.21	4.48
Bloomberg Commodity TR	-3.00	-5.26	-6.50	-14.80	-9.25	-6.49

Source: Morningstar

S&P 500 TR: A market capitalization-weighted index of 500 widely held stocks often used as a proxy for the large-cap segment of stock market.

Russell 2000 TR: Consists of the smallest 2000 companies in the Russell 3000 Index, representing approximately 7% of the Russell 3000 total market capitalization often used as a proxy for the small-cap segment of the stock market.

Barcap Aggregate Bond TR: The Barclays Capital Aggregate Bond Index is a market capitalization-weighted index, meaning the securities in the index are weighted according to the market size of each bond type. Most U.S. traded investment grade bonds are represented. The index includes Treasury securities, Government agency bonds, Mortgage-backed bonds, Corporate bonds, and a small amount of foreign bonds traded in U.S.

MSCI EAFE NR USD: Widely accepted as a benchmark for international stock performance, the EAFE Index is an aggregate of 21 individual country indexes that collectively represent many of the major markets of the world.

DJ US Industrials TR USD: Computed by summing the prices of the stocks of 30 U.S. companies and then dividing that total by an adjusted value--one which has been adjusted over the years to account for the effects of stock splits on the prices of the 30 companies.

NASDAQ: Measures the performance of all issues listed in the Nasdaq Stock Market and is often used as a proxy for the large-cap technology segment of the U.S. stock market.

DJ/UBS Commodity: The DJ-UBSCI is composed of futures contracts on physical commodities and is often used as a proxy for broad-based exposure to the commodity markets.

A Collective Investment Trust fund (CIT) is not registered as an investment company under the Investment Company Act of 1940. The Fund is not FDIC-insured, may lose value, and is not guaranteed by a bank or other financial institution. Participation in CITs is limited primarily to qualified defined contribution plans and certain state or local government plans. CITs may also be suitable investment for participants seeking a diversified retirement savings program. Investors should consider the investment objectives, risks, charges, and expenses of any pooled investment company carefully before investing. The Portfolio Disclosure Document (PDD) contains this and other information about a CIT and is available from your financial advisor. The PDD should be read carefully before investing. Diversification neither assures a profit nor guarantees against a loss in a declining market.

*Past performance is no guarantee of future results. It is not possible to invest directly in an index. See appendix for important index information. Assets represented by: Commodities – Bloomberg Commodity Index; Emerging-Market Bonds – JP Morgan EMBI Global Index; Emerging-Market Stocks – MSCI EM Index; Gold – Gold Bullion, LBMA PM Fix; High Yield Bonds – Bank of America Merrill Lynch (BofA ML) High Yield Bond Index; Investment-Grade Bonds – Bloomberg Barclays U.S. Aggregate Bond Index; Non-U.S. Developed-Country Stocks – MSCI EAFE Index; Non-U.S. Small-Cap Stocks – MSCI EAFE Small Cap Index; Real Estate Stocks – FTSE NAREIT Equity Index; U.S. Corporate Bonds – Barclays U.S. Credit Index; U.S. Large-Cap Stocks – S&P 500 Index; U.S. Mid-Cap Stocks – Russell Midcap Index; U.S. Small-Cap Stocks – Russell 2000 Index; U.S. Treasury Bonds – Bloomberg Barclays U.S. Treasury Index. Sources: Bloomberg Finance L.P., Haver Analytics, Fidelity Investments (AART), as of 12/31/16.

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