KPF GLOBAL INVESTMENT STRATEGIES LLC

Quarterly Market Outlook & Strategy Letter

Second Quarter of 2013

July 2013

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Executive Summary

- Global financial markets lost ground in the second quarter of 2013. Only US equities showed positive results; virtually all other foreign equity, fixed income, real estate and commodity markets declined. Even traditionally "safe" investments fell in value.

- The trigger for these broad-based declines was a series of remarks by Federal Reserve Chairman Ben Bernanke, indicating that the US central bank would soon begin to taper its large-scale purchases of US Treasury and government-guaranteed mortgage bonds. The markets responded with a "taper tantrum," sending yields on long-term bonds soaring, and creating knock-on effects across an array of other markets.

- We are pleased with the performance of our clients' US bond portfolios, given difficult market conditions. Both we and our bond managers took defensive steps to protect client portfolios, containing the damage. We continue to limit interest rate and credit risk, which is poorly rewarded—even though we do not anticipate a rapid retreat from the Fed's easy money policies.

- We believe that emerging bond markets continue to offer good long-term value, with yields that both cushion and compensate investors for periodic volatility. Notably, even after a rough quarter, emerging market government bonds returned nearly 5 percentage points *more* than US Treasury bonds of the same maturity, over the past year.

- With continued moderate growth, and supportive monetary policy, we believe US equities can sustain returns in the mid-single digits. However, we see more upside potential in overseas equity markets, given their lower current valuations and the greater financial leverage that comes from deploying unused capacity. Economic conditions in Europe and Japan are improving at last. Typically, the emerging markets follow changes in the mature economies with a 6-12 month lag.

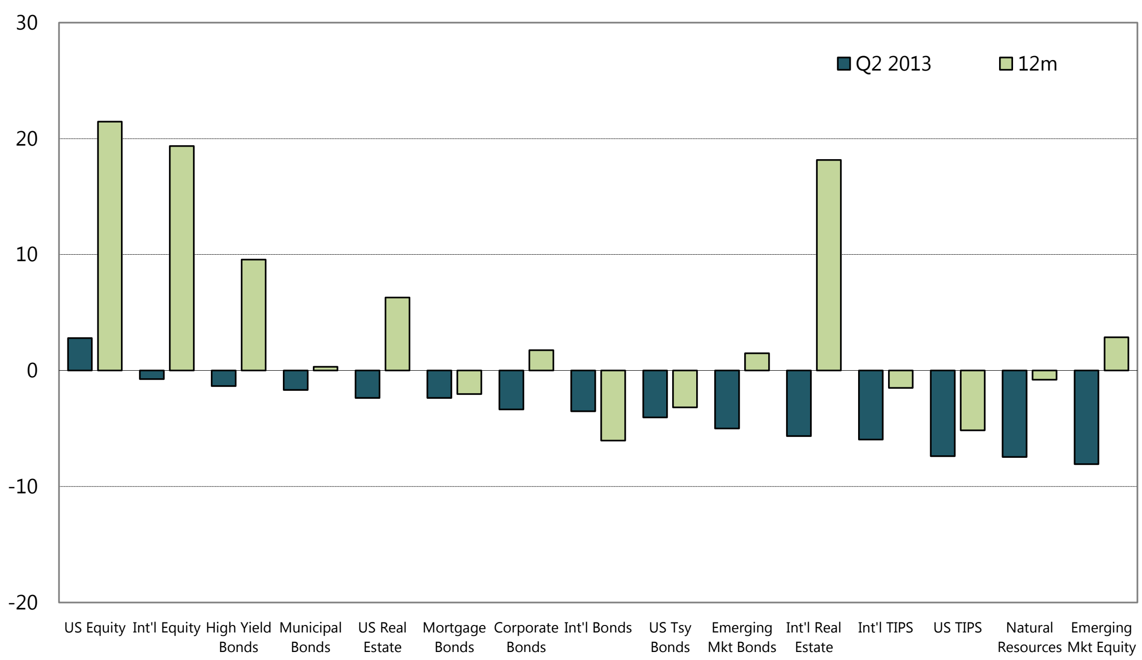
- The second quarter of 2013 educated investors on the difference between volatility and principal risk. Because investors have been avoiding risk over the past five years, the least-volatile assets have become the most expensive—and therefore can no longer be considered safe. By contrast, more volatile assets typically offer better value, and a greater margin of safety for long-term investors. Volatility can be unsettling, but it also creates opportunities for investors to purchase assets more cheaply. The key is to have cash available—and to be willing to deploy that cash when others are desperately in need of it.

Market Roundup

Global financial markets lost ground over the second quarter of 2013 (Figure 1). Only US equities showed positive results; virtually all other foreign equity, fixed income, real estate and commodity markets declined. Even some traditionally "safe" investments fell in value, including long-term US Treasury bonds (down 2.3% on the quarter and 3.2% over the past 12 months), US government-guaranteed mortgage bonds (down 2.4% on the quarter and 2% over the year) and US Treasury inflation-protected securities (down 7.4% on the quarter and 5.2% on the year). Foreign financial markets underperformed those in the United States as the dollar rallied—as typically occurs during a market correction. Commodity markets experienced substantial losses, led by precious metals.

The trigger for these broad-based declines was a series of remarks by Federal Reserve Chairman Ben Bernanke, indicating that the US central bank would soon begin to taper its large-scale purchases of US Treasury and government-guaranteed mortgage bonds. Financial liquidity, which has been expanding rapidly since the Fed began its "quantitative easing" of monetary policy back in 2009, will be growing a bit more slowly from 2014 onward. The markets responded with a "taper tantrum," sending yields on long-term bonds soaring, creating knock-on effects across an array of other markets. The market's reaction to the Fed comments underscores once again that a rising tide of liquidity has been lifting all boats.

Figure 1. Benchmark Asset Class Returns



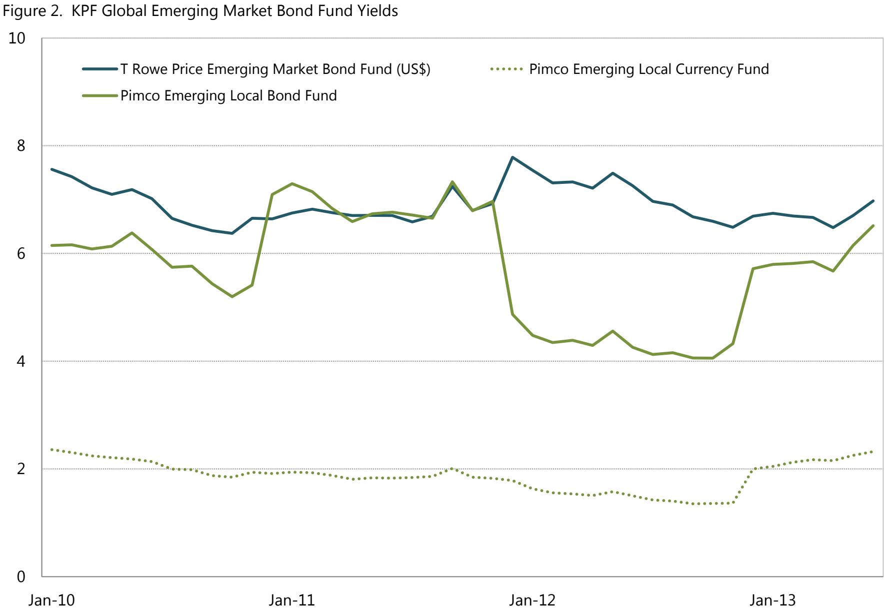
Source: Bloomberg

Global Bond Markets

In anticipation of heightened volatility in bond markets (a theme highlighted in our last quarterly letter), we continued to shorten the average maturity (duration) of our clients' fixed-income portfolios, and reduced or eliminated entirely exposure to some pricey and interest rate-sensitive assets. These included US Treasuries, inflation-protected bonds, and government-guaranteed mortgages, as well as investment-grade corporate bonds, foreign inflation-protected bonds, and international real estate. All of these sectors experienced substantial declines over the quarter. For clients with municipal bond ladders, we sought higher-coupon (premium) bonds, which are less sensitive to rising interest rates.

Fortunately, our US bond fund managers were well aware of the risks of higher interest rates, and took defensive actions to protect their portfolios. Our preferred high-yield manager, the Osterweis Strategic Income Fund, reported only a slight 0.2% decline on the quarter (the fund gained 7.5% over the past 12 months), while our mortgage-backed bond fund (DoubleLine's Total Return Bond) declined 1.5% over the quarter (and is still up 3.9% on the past 12 months). Our US real estate fund (Fidelity's Real Estate Income fund, which has significant fixed-income exposure) fell by just under 2%, maintaining a 12 percent gain over the past year. The value of our clients' municipal bond ladders fell by an average of 1.0-1.5% over the quarter. All of these fixed income investments performed considerably better than their respective benchmarks. Overall, we are very pleased with the performance of our clients' US bond portfolios, given challenging market circumstances.

Figure 2. KPF Global Emerging Market Bond Fund Yields



Unfortunately, our emerging market bond funds did not fare as well, declining by over 5% on the quarter. In contrast with the US, rising interest rates were not the principal culprit; yields already were and remain relatively high (Figure 2). It appears that currency depreciation and transitory liquidity conditions, rather than fundamental factors, drove the declines. We believe that emerging bond markets continue to offer good long-term value; economic fundamentals are supportive, and their yields both cushion and compensate investors for periodic volatility. Indeed, even after a rough quarter, emerging market government bonds returned nearly 5 percentage points *more* than US Treasury bonds of the same maturity over the past 12 months.

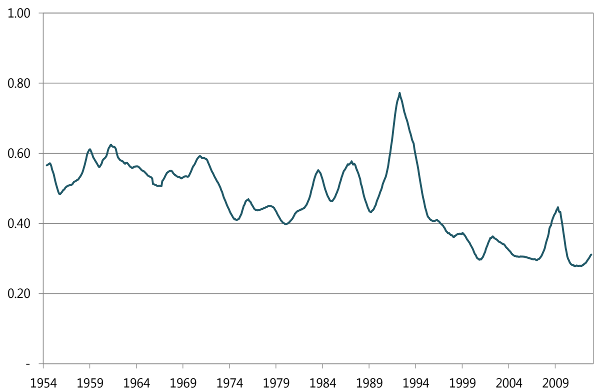
US Equity Markets

Although overseas markets wobbled during Q2, US equities took the prospective shift in Fed policy in stride. Only materials and some interest rate-sensitive sectors (REITs and utilities) experienced losses. Interestingly, financial stocks performed extremely well, suggesting that the Fed's low interest rate policy has been having a negative effect on bank profit margins. Normalization of monetary policy will be good for financial stocks.

Dividend-paying stocks lagged other sectors of the equity market, as opportunities improved in other income-generating investments. Even so, they performed considerably better than bonds, and their long-term potential remains good. Dividend yields and corporate payout ratios remain low by historical standards (Figure 3), and we expect these to move higher as retirees demand more stable income sources. Investors have rewarded with higher price-earnings multiples those companies that pay a higher share of their earnings out in dividends (Figure 4). Moreover, the tax treatment of dividend income is still superior to that of bonds. Thus, we continue to view dividend-paying stocks (both in the US and abroad) as a core component of our clients' equity portfolios.

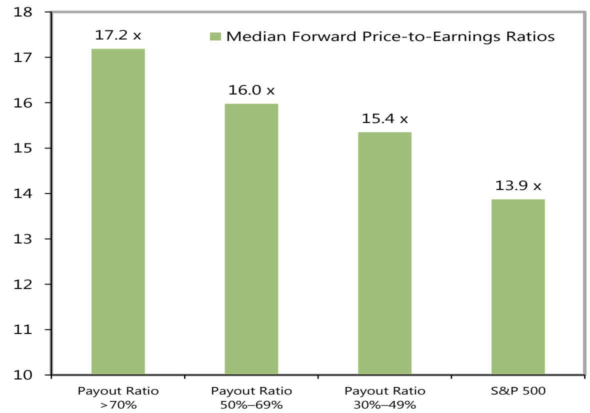
The KPF Global low-volatility equity income strategy continues to deliver high risk-adjusted returns. Since inception in February 2012, the strategy has captured 94% of the return of the Russell 3000, with just 75% of the volatility—delivering an annualized return of 17.4% and a Sharpe Ratio of 1.8. That compares favorably both to the broad equity markets, and to the US fixed income market (where returns have been flat, and for which the strategy was conceived as a partial substitute). In addition to dividend-paying stocks, we continue to favor value and smaller-capitalization equities, although we trimmed our small-cap allocations earlier this year as valuations had become elevated.

Figure 3. S&P 500 Dividend Payout Ratio (% of earnings paid out as dividends)



Source: Haver Analytics and author's calculations

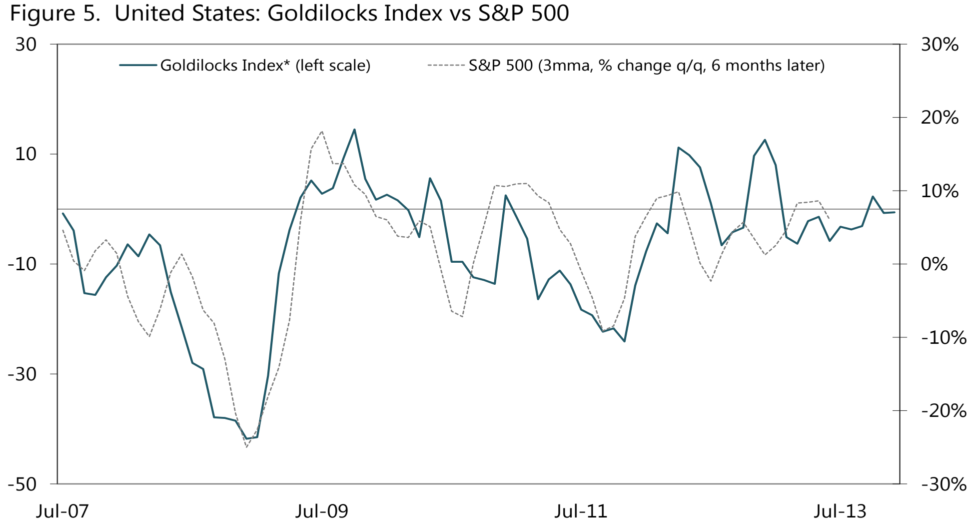
Figure 4. S&P 500 Valuations



Overseas Equity Markets

The necessary catalyst for sustained recovery in overseas equity markets is a synchronized upturn in the global economy. The US has been enjoying a steady, though slow, recovery from the crisis of 2008-09. The housing sector continues to gain strength, while job creation is picking up. Higher taxes and government spending cuts have dampened growth, but the economy is showing its customary resilience, helped by flexible labor and capital markets. To be sure, the quantity and quality of jobs created leaves a lot to be desired; and it is apparent that US corporate earnings are decelerating. Higher interest rates could stall the recovery of the housing market, but the Fed is acutely conscious of this risk, and has pledged to ease *gently* off the accelerator. In sum, the signs point to continued modest growth in the US. Our "Goldilocks" indicator of corporate profitability has stabilized, suggesting US equity returns in the mid-single digits are feasible (Figure 5).

Figure 5. United States: Goldilocks Index vs S&P 500



** Institute for Supply Management New Orders Index/Prices Paid Index*

However, we believe there is more upside potential in overseas equity markets, given their lower current valuations and the greater financial leverage that comes from deploying unused capacity. The European economy, which has been struggling under the weight of excess debt, financial instability, rigid labor markets, and budget austerity over the past three years, is finally showing signs of improvement. Business new orders are rising relative to inventories—a leading indicator of future production gains (Figure 6).   And the Japanese economy, which investors all but left for dead after two decades of stagnation, is at last showing glimmers of hope. Typically, the emerging economies follow changes in the mature (G10) economies with a 6-12 month lag. As Figure 7 illustrates, economic data "surprises" (mostly in Europe and Japan) have been improving over the past few months, with the emerging markets poised to follow.

Figure 6. European Manufacturing Purchasing Managers New Orders Index minus Inventories Index

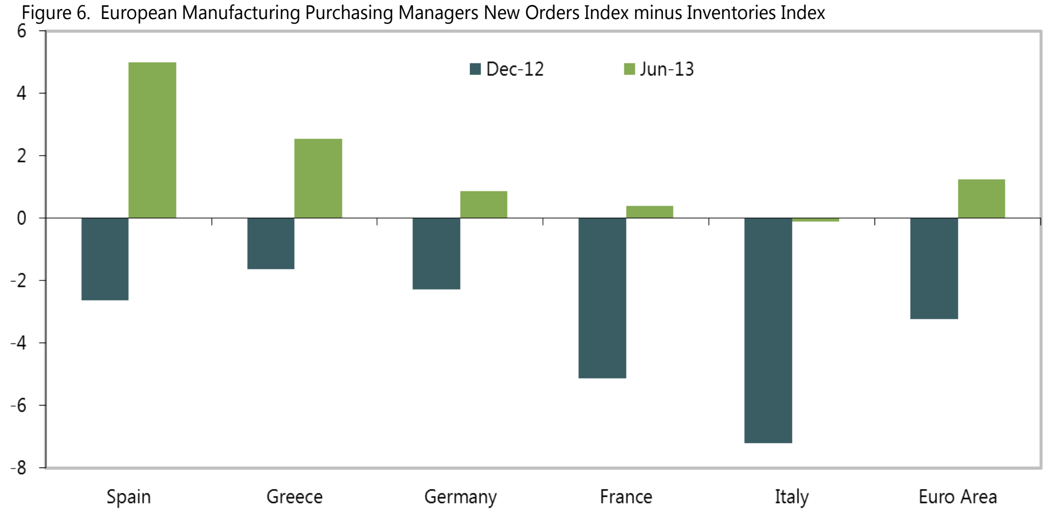
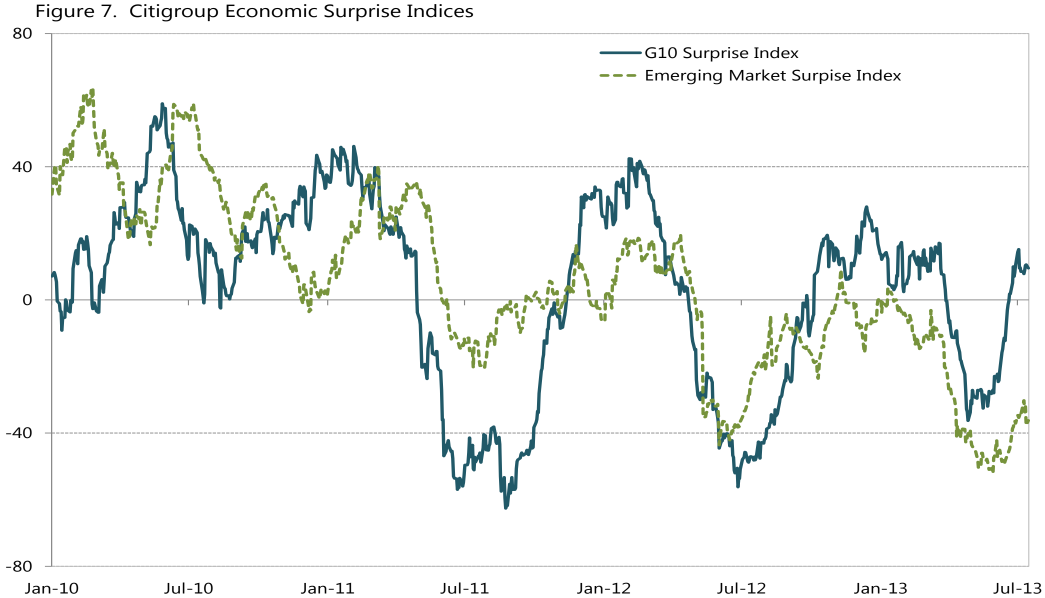
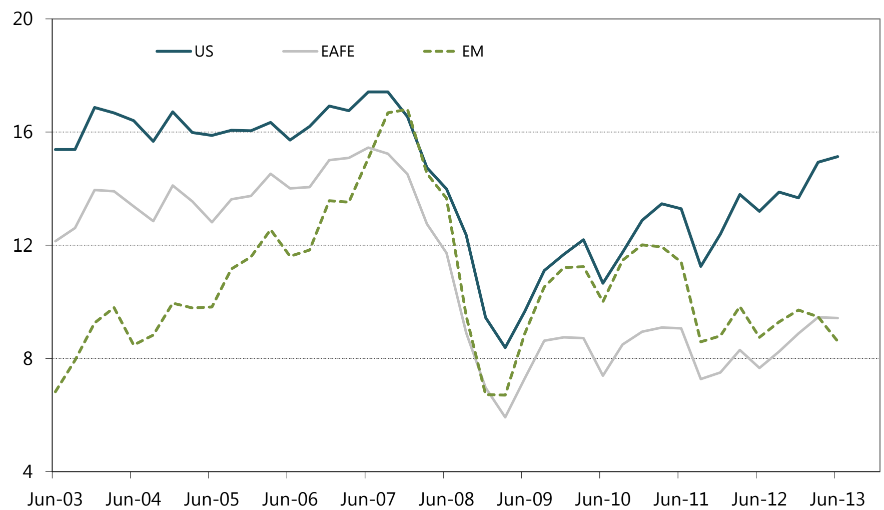


Figure 7. Citigroup Economic Surprise Indices



Emerging equity markets experienced sizable declines in Q2 (down 8-10% on average), as investors worried that tightening monetary conditions might contribute to renewed weakness in global growth. Corporate earnings in these cyclically-sensitive markets have been hurt by sluggish demand in the mature economies, on which they depend heavily for exports. They used to say that when the US catches a cold, Mexico gets the flu—and the same is still true for many emerging economies today. Historically, corporate earnings have grown much faster overseas than in the United States. Yet persistent weakness in the US and Eurozone, coupled with slowing Chinese growth, has restrained earnings in the emerging markets. And, as is common when earnings are slowing, the price multiples attached to those earnings have also declined. As a result, emerging equity markets are more attractively valued (both in relation to their own history, and relative to the developed equity markets) than they have been in over a decade (Figure 8).

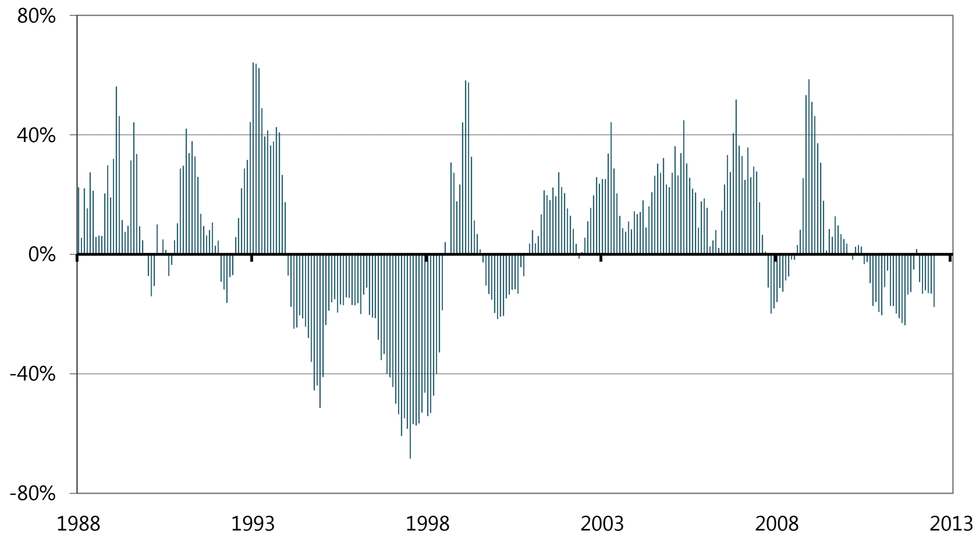
Figure 8. Normalized* Price-Earning Ratios



** Using 5-year average earnings, 1954 P/E=100)*

The past two years have witnessed the longest stretch of underperformance for the emerging equity markets since the crisis-prone 1990s (Figure 9). Yet macroeconomic and corporate fundamentals in these countries are considerably better than they were in those days (I know, because I used to work in emerging market crisis management!) Structural economic conditions (debt and deficits, macroeconomic management, institutions, education, and infrastructure) have improved greatly and in many cases are better than in the mature economies. We believe the current cyclical weakness has created an excellent investment opportunity in emerging market equities for long-term investors.

Figure 9. Relative Performance of MSCI Emerging Markets vs S&P 500
(% change y/y, in US$)



Source: Bloomberg

Developments in China are the "wild card" for global financial markets. Now the second largest economy after the US, China continues to depend heavily on foreign demand to support its growth. China is, in turn, the principal export market for many commodity-producing countries (such as Australia, Brazil, and South Africa) as well as smaller emerging markets that are deeply integrated into China's production chain. Over the past two years, the Chinese authorities have been trying to steer the country away from excessive dependence on export-led growth, toward a more consumer-oriented economy. The government has allowed a faster pace of currency appreciation, taken steps to rein in credit to heavily-indebted borrowers, scrapped controls on bank lending rates, encouraged bank lending to smaller firms, and increased social benefits for migrants to urban areas, among other things.

This process has a long way to go; so far, China has accepted slower growth without much to show in terms of economic restructuring. The marked deceleration in the Chinese economy has been both a cause and consequence of slower global growth. Developments in China have contributed to periodic market convulsions, as investors fear there can be no "soft landing." The emerging markets have been particularly hard hit by the fall in demand for their exports.

We believe that the changes underway in China are meaningful, but reflect a shift in emphasis, rather than a wholesale change in strategy. Yes, Chinese policymakers are serious about getting a grip on the runaway credit that fueled overcapacity in key export industries and a bubble in domestic real estate markets. Yes, they are trying to find ways to support consumers and smaller businesses, so as to achieve self-sustaining growth. Even so, China needs to maintain a relatively rapid pace of activity in order to absorb the millions of rural laborers that stream into the urban economy every year. The export-led growth model that has served China well over the past 30 years is not dead—just dormant. Chinese authorities are making a virtue out of necessity by encouraging domestic sources of demand, since external demand is limited at present. It serves China politically to eschew an obvious dependence on exports supported by an artificially cheap currency. But policymakers will take this strategy only so far—growth in 2013 is coming perilously close to what the authorities consider the "stall speed" of 6-7%. Even at that pace, given its present size, China will remain one of the principal sources of global economic growth, and of demand for vital natural resources.

We believe that emerging equity and debt markets have fully discounted the slowdown in China, and its spillover effects to the global economy. Although China's economic restructuring process has a long way to go, and will contribute to periodic volatility in markets, we do not anticipate a full-blown crisis. The recovery of Europe in Japan is well timed, and will help to buffer the effects on the global economy of slower Chinese growth.

A Lesson in Risk vs. Return or: How I Learned to Stop Worrying and Love the Vol

The second quarter educated investors on the difference between volatility (known in industry parlance as "vol") and long-term risk to principal. US Treasury bonds, which typically exhibit little fluctuation, and which are generally viewed as safe investments, experienced material declines—10-year Treasuries fell 7% at their lows.[1]

[1] Conventionally, volatility and risk have been treated as synonymous, and for good reason. Given a finite investment horizon, assets that experience greater price fluctuations are statistically more likely to be trading at a discount (to the purchase price or a more recent reference price) when the investor needs to draw funds from the portfolio. Selling those assets turns a decline on paper into a realized loss, depleting the portfolio of capital and reducing its potential for future compounding. For this reason, financial advisors typically increase the proportion of "safe" (i.e., less volatile) assets in a portfolio as its owner approaches retirement. That time-honored approach no longer works when the "safe" assets become meaningfully overvalued. When yields are extremely low, a conventional portfolio's return may fall short of what is required to fund a secure retirement. Moreover, even if the volatility of these assets remains subdued (which cannot be assumed given current high valuations) there is a greater likelihood that the value of the "safe" assets will be trading at a loss when it comes time to draw from the portfolio.

Because investors have been avoiding risk over the past five years, the least-volatile assets have become the most expensive—and therefore can no longer be considered "safe." By contrast, more volatile assets offer better value, and a greater margin of safety for long-term investors.

A simple graphic (Figure 10) illustrates the point. Suppose a retiree can invest in two distinct assets, with different (known) risk and return characteristics. Asset B is attractively valued and offers the prospect of a higher return than asset A, but with considerably greater volatility. Thus, there is *some chance* that the value of Asset B will be at or below its purchase price by year 5. By contrast, low-volatility Asset A is very highly valued. It will have probably earned a positive, though slight, return over the same period. However, it is *more likely* that Asset B will have accrued a higher return by year 5, and *very likely* that it will have done so by year 10.

Figure 10

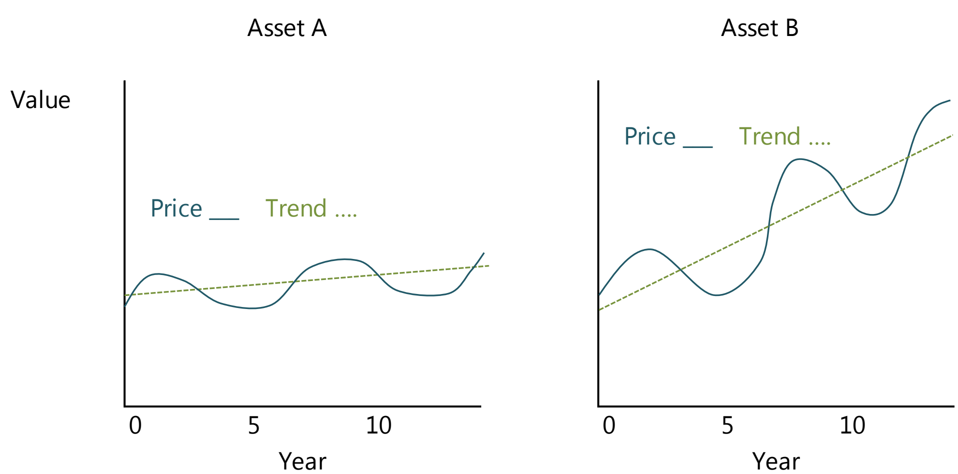
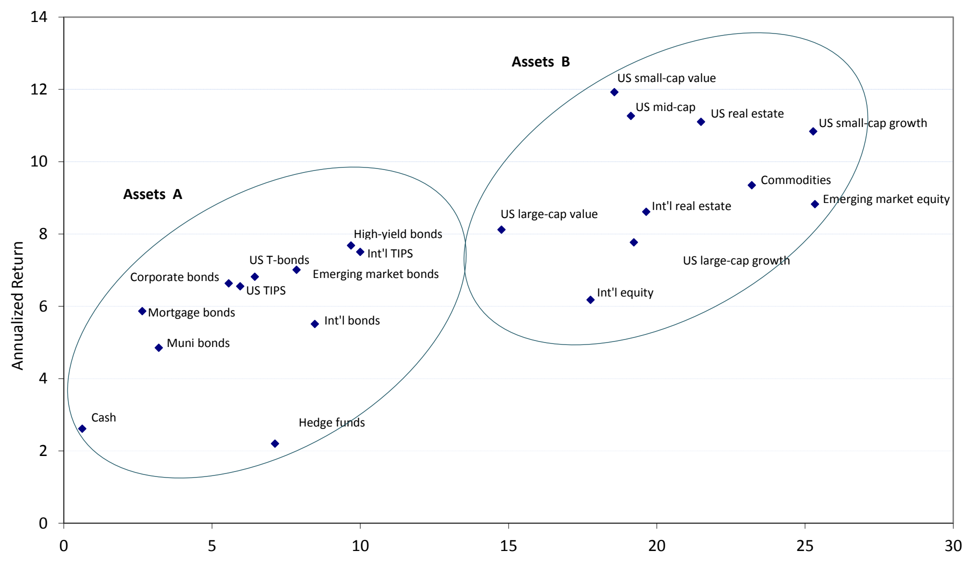


Figure 11 below shows the annualized returns and volatilities (the standard deviation of returns) of all the major asset classes since 1997, identifying which assets fall into category A and which in category B. As is evident from the chart, risk and return go hand in hand. However, the data in Figure 11 overstate the prospective returns that will come from taking market risk, as those figures represent *averages* over the 1997-2013 period. At the end of that period, virtually all of the assets in category A are overvalued—with a likelihood of low or even negative future returns. Those in category B are more attractively valued and offer higher prospective returns. Even so, these will likely deliver returns that are several percentage points lower than in that earlier period. In other words, the risk-return curve going forward will be both lower and flatter than it has been in the past.

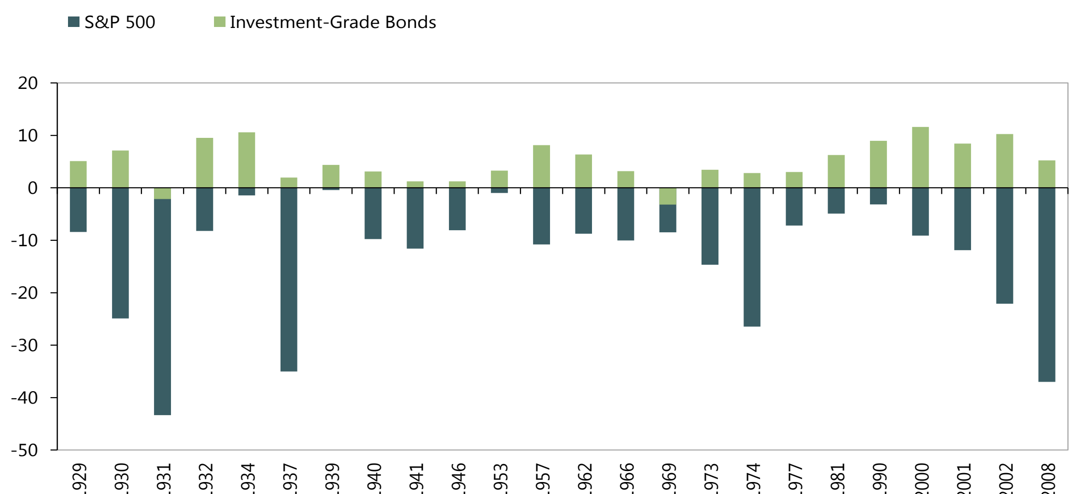
Figure 11. Asset Class Returns and Volatility, 1997-2013*



** Source: Bloomberg. Data through June 2013*

Bonds will and should continue to play an important role in investment portfolios. For one thing, it is difficult to determine precisely what the "fair value" of a bond is—or of any investment, for that matter. Second, bonds typically gain when stocks and other risky assets decline—even if the offset is not as large as it has been in recent years (Figure 12 below). Third, some sectors of the fixed income market, such as emerging market debt, remain attractive, even if these investments entail somewhat greater short-run volatility. Having said all that, valuations argue for a smaller proportion of bonds, and more cash, in portfolios over the next 5-10 years than has been optimal historically.

Figure 12. Bond Returns in Years Stocks Were Down, 1926-2012



Bond returns are represented by the performance of the Barclays Aggregate Bond Index from January 1976 through December 2012 and by a composite of the IA SBBI Intermediate-Term Government Bond Index (67%) and the IA SBBI Long-Term Corporate Bond Index (33%) from January 1926 through December 1975. Stock returns are represented by the performance of the S&P 500 Index. Source: Morningstar EnCorr, Fidelity Investments (AART) as of 6/30/13.

The monetary policies of the past two decades—which have created a perception that central bankers are willing and able to put a floor under asset prices, thus curbing market volatility—has lulled many investors into a false sense of security. There is no free lunch in investing. Without risk there is no possibility of return; indeed, returns are the compensation investors receive for accepting volatility and uncertainty in their portfolio.

Does this mean one must simply accept a higher level of portfolio volatility as the inevitable price of an adequate return—and hope that all will turn out ok? To some extent, the answer is yes. Volatility can be unsettling, but it also creates opportunities for investors to purchase assets more cheaply. For long-term investors, price declines should not be viewed as painful losses, but rather attractive discounts. The key is that one have cash available to make such investments—and to be willing to deploy that cash when others are desperately in need of it.

Besides holding cash, there are other ways to mitigate portfolio volatility. One is by focusing on investments that are so attractively valued that there are no short-term investors left to sell them. Another is by pursuing markets and opportunities that have been overlooked, and which add an uncorrelated source of return to the portfolio. Finally, one can consider a variety of prisms with which to understand (and diversify) portfolio risk, comprising not only asset classes and regions, but other dimensions of investment quality, liquidity, horizon, and popularity.

KPF Global Portfolio Strategy

Federal Reserve officials have given us a taste of what two-way risk in the bond market looks like—and the degree to which US monetary policy has been supporting asset prices. Over the longer term, there is little doubt we will be seeing much higher interest rates. However, we believe that the US economy remains sufficiently fragile, and inflation sufficiently subdued, that the central bank will not retreat quickly from the easy money policies of the past several years. Moreover, central banks around the world (in the UK, Europe and Japan) have reiterated their commitment to providing ample liquidity until the global economy is on a firmer footing. These policies are beginning to bear fruit: there are increasing signs that Europe and Japan are finally turning the corner, with positive spillovers to the smaller and emerging market economies. While we remain cautious on the US markets—where valuations are high and where monetary policy is closest to being tightened—we do see attractive opportunities in the overseas equity and bond markets.

One drawback of investing abroad is that liquidity is typically less than in the large and well-funded US markets. As a result, many investment vehicles are geared toward companies and countries that are larger and more liquid—which tends to push up valuations and increase the sensitivity of these markets to changes in investor sentiment. To mitigate this problem, we have selected instruments and managers who employ value criteria in choosing their investments. We are looking for investment vehicles, particularly in the emerging equity and debt markets, that are more broadly diversified, regionally and otherwise.

We are not making any changes at present to our fixed income portfolio strategy, which has performed well amid difficult market conditions. Over time, as opportunities in international equity markets improve, we will continue to rotate exposure out of bonds. The recent market correction afforded an opportunity to begin this process, and we anticipate additional buying opportunities in the months ahead.