Quarterly Newsletter

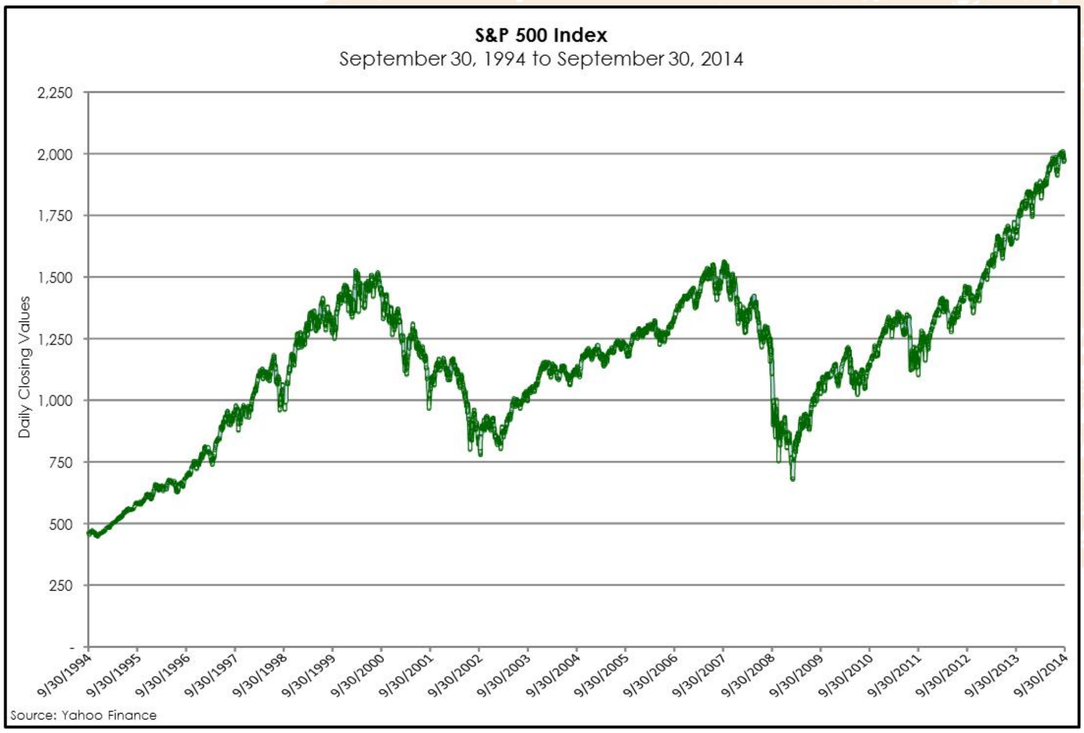
October 2014

CAPITAL MARKETS UPDATE | Geopolitical risks, softer economic data and central bank uncertainty unsettled global markets in September and led to negative returns across most asset classes for the quarter. The S&P 500 returned a scant 1.1% while the U.S. Aggregate Bond Index broke even. Emerging Market (-3.5%), International (-5.9%) and U.S. Small Cap (-7.4%) Equities all struggled while Commodities fared the worst (-11.8%) given the spike in the U.S. Dollar.

REVISITING INVESTMENT RISK AND RETURN

RECENT AVERAGES | It's instructive to look back at Capital Market results from time to time. Seeing averages over time helps smooth out our short-term knee-jerk reactions and gives us valuable investment perspective. As shown in the enclosed Summary of Index Returns, the S&P 500 has averaged 8.1% over the past ten-year period (in spite of the financial collapse in 2008). Over the last five years, the annualized return was an eye popping 15.7%. This has been a remarkable run—though we were coming out of an unprecedented financial crisis, the current 5½ year bull market is among the strongest in recent decades. Coupled with these excellent five year stock returns has been a period of declining volatility. In fact, recent measures of volatility are comparable to the lows of the last 20 years. It's tempting for us as investors to assume that the recent period is normal—**it is not**.

MARKET CYCLES | Markets move in cycles. Investors are well-versed in stock market volatility after the roller coaster ride over the last 20 years (pre tech bubble, post tech bubble, pre financial crisis and post financial crisis). The chart at right tracks the closing value of the S&P 500 Index during this period. After reaching similar peaks in 2000 and 2007, the S&P 500 has vaulted to new all-time highs. Since mid-2012, the line is a steady march higher with just a few small dips along the way.



The chart on the next page tracks the closing value of the CBOE Volatility Index, more commonly referred to as the VIX. The VIX measures the expected volatility in the S&P 500 Index for the next 30 days. Often referred to as the "fear index," it is an indicator of market sentiment. As you can see, sentiment moves in cycles too. Note that spikes in the VIX coincide with market drops, periods of intense fear and shaken investor confidence. After the extreme spike in 2008/2009 and a couple of aftershocks, market volatility has continued to drop. This summer, the VIX nearly reached the two decade low point of 10%. When the VIX is low, fear is low—strong markets buoy investor confidence.

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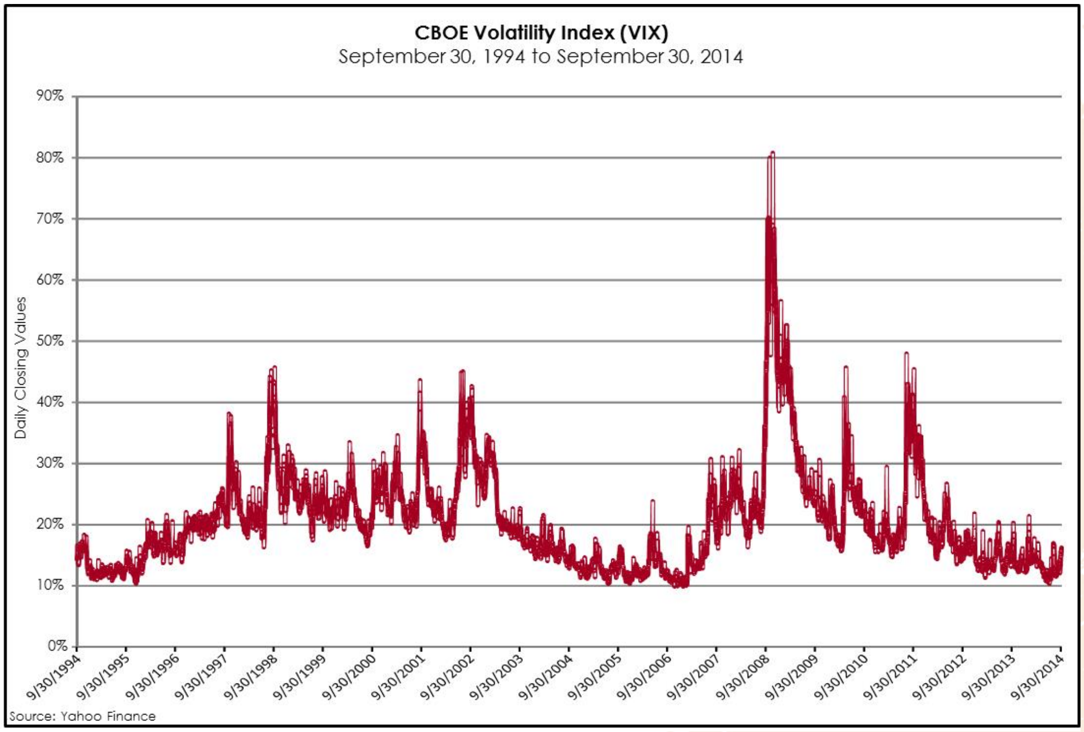

We know that periods of high return and low volatility are always followed by rough seas at some point. But as Arbor clients know, we don't predict when this turn will occur. We are disciplined long-term investors who manage diversified portfolios, rebalance to targets and introduce new fund strategies when compelling.

PORTFOLIO CONSTRUCTION | Global equities continue to be an important long-term growth engine for client portfolios. However, since they are prone to bouts of extreme volatility, it is important to include other more stable assets in the portfolio to temper overall risk. In a low yield environment, bonds are still an important holding. By definition, bonds are contractual and therefore much more dependable in generating income and returning principal to the investor. However, when interest rates are low as they are today, interim fluctuations in price tend to dominate the total return from bonds, especially for longer maturities. The key is to be more selective—by tilting bond portfolios toward shorter maturities, floating rate securities and diversifying globally, investors can benefit from an inevitable rise in yields without giving up much income in the interim.

Alternative investments like ***absolute return*** and ***arbitrage strategies*** can also play the role of bond surrogates with compelling potential returns and low correlation to traditional stocks and bonds. Many of these strategies focus on fixed income—they simply have more investment flexibility and do not anchor the portfolio to a low yield bond index that is subject to potentially punitive price declines. Other alternative investments like ***tactical funds*** and ***managed futures strategies*** provide the opportunity for higher returns with volatility in between that of traditional stocks and bonds. By diversifying broadly and including strategic weightings of bonds and alternative investments, we expect portfolios will be more resilient when the next stock market cycle turns.

PIMCO UPDATE | Bill Gross, PIMCO's founder and Chief Investment Officer, surprised the investment community with his announcement to leave PIMCO at age 70 and join Janus Investments to manage a global bond fund. A succession plan for Gross has been in place for some time. As expected, Dan Ivascyn (16 year PIMCO veteran) was the unanimous choice to be the new Chief Investment Officer. PIMCO has a deep bench and a disciplined investment process that is driven by the Investment Committee rather than independent decisions by individual fund managers. We expect PIMCO's record of disciplined risk management and good performance to continue. We will continue to follow PIMCO closely as we do all of the fund managers in client portfolios and will be in touch with any recommended changes should they arise.