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November 7, 2014

Dear Clients, Colleagues, and Friends;

"October: This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February". – Mark Twain

Thank you for your continued trust in our firm. We are pleased to provide you with our latest thoughts on the capital markets and hope that our commentary below will prove insightful.

As broad equity indices such as the S&P 500 rebounded from the recent pullback to record highs, many investors have become apprehensive. They fear another major decline is likely to occur and are eager to find strategies that may preserve principal during an extended downturn while providing the opportunity to profit in positive markets. One such approach which has attracted considerable attention in recent years is to adjusting portfolios based on the CAPE ratio–the Cyclically Adjusted Price / Earnings ratio.

Developed by Robert Shiller of Yale University and John Campbell of Harvard University, the CAPE ratio seeks to provide a road map of stock market valuation by comparing current prices to average inflation-adjusted earnings over the previous 10 years. Their methodology seeks to smooth out the peaks and valleys of a particular business cycle and derive a more stable measure of corporate earning power. Shiller suggests that investors can improve their portfolio performance relative to a static equity allocation by overweighting stocks during periods of low valuation and underweighting stocks during periods of high valuation.

A CAPE based strategy has the benefit of using clearly defined quantitative measures rather than vague assessments of investor emotion, whether exuberance or despair. From January 1926 through December 2013, the CAPE ratio has ranged from a low of 5.57 in June 1932 to 44.20 in December 1999, with an average of 17.54.

The CAPE ratio appears to offer a sensible way to improve portfolio results by periodically adjusting equity exposure, many financial writers have recently focused on this methodology. Earlier this year, a well-known newsletter catering to market timers observed, "For the S&P 500, this ratio currently exceeds 25.6, which is higher than what prevailed at 29 of the 35 tops since 1900."

Many investors find such an approach very appealing – but does it work? The challenge of profiting from CAPE metrics or other quantitative indicator is to translate the raw data into a trading strategy which correctly identifies when to underweight or overweight stocks. It is not enough to know that stocks are above or below their long-run average valuation. How far above average should the indicator be before investors should reduce equity exposure? At what point will stocks be sufficiently attractive for repurchase at a "below average" price point? It is relatively easy to find rules that have worked in the past, but much more difficult to achieve success following the same guidelines in the future.

This implementation challenge appears to be the Achilles' heel of timing-based strategies. A study in 2013 by professors at the London Business School applied CAPE ratios to time market entry and exit points. "Sadly," they concluded, "we learn far less from valuation ratios about how to make profits in the future than about how we might have profited in the past."[1]

For example, consider the CAPE data as of year-end 1996. The CAPE ratio then stood at 27.72, 82% above its long-time average of 15.23. Three weeks earlier, Federal Reserve Chairman Alan Greenspan had delivered his much-discussed "irrational exuberance". The last time the CAPE ratio had flirted with this number was October 1929 (it stood at 28.96) and stock prices were about to head over the cliff. It seems plausible that followers of the CAPE strategy would have been easily persuaded that investing at year-end 1996 would be a painful experience.

The actual result was more cheerful. The next three years were especially rewarding, with a total return of over 107% for the S&P 500 Index. For the period January 1997–June 2014, the annualized return for the S&P 500 Index was 7.67%, compared to 2.42% for one-month US Treasury bills. Stock returns were modestly below their long-run average for this period, but the equity premium was still strongly positive.

By comparison, a timing strategy over the same period that was fully invested in stocks only during periods when the CAPE ratio was below its long-run average produced an annualized return of 3.09%. All timing strategies face a fundamental problem: Since markets have generally gone up more often than they have gone down in the last 90 years, avoiding losses in a down market runs the risk of avoiding even heftier gains associated with an up market.

A successful timing strategy is one of the "Holy Grails" of the investment world. For decades, financial researchers have explored dozens of quantitative indicators as well as various measures of investor sentiment in an effort to discover the ones with predictive value. The performance record of professional money managers over the past 50 years offers compelling evidence that this effort has failed.

Despite this evidence, the potential rewards of successful market timing are so great that each new generation sees a fresh group of market participants eager to try. Searching for the key to outwitting other investors may be fun for those with a sense of adventure and time on their hands. For those

[1] John Authers, "Clash of the CAPE Crusaders," *Financial Times*, September 3, 2013.
Adapted from "CAPE Fear: Valuation Ratios and Market Timing" by Weston Wellington, Down to the Wire column on Dimensional's website, September 2014

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seeking the highest probability of a successful investment experience, maintaining a consistent allocation strategy is likely to be the sounder choice, a foundation of CDAM's investment approach.

In spite of the volatility, most markets have strong results year-to-date. The following table provides a comparison of capital market returns:

Asset Class Performance (Period ending 10/31/2014)	YTD (%)	1-Year(%)	3-Year (%)	5-Year(%)
US Large Cap Equity (S&P 500)	10.99	17.27	19.77	16.69
US Small Cap Equity[1]	1.89	8.06	18.18	17.39
Commodity Total Return[2]	-6.33	-5.94	-7.59	-2.17
US Real Estate[3]	27.01	20.69	14.83	19.25
US Municipal Bond (3 Years)[4]	1.47	1.58	1.77	2.19
US Aggregate Bond[5]	5.11	4.14	2.73	4.22
International Equity: Developed[6]	-2.43	-0.17	10.17	7.00
Emerging Markets[7]	3.96	0.98	3.59	4.98

1) Russell 2000 2) Bloomberg Commodity Total Return Index 3) Dow Jones US Select REIT Index 4) Barclays Municipal Bond Index 3 Years 5) Barclays US Aggregate Bond 6) MSCI EAFE Index 7) MSCI Emerging Markets Index (gross div.) Source: CRSP Data

Interest Rates and Fed Policy

We have borrowed liberally from policy commentary on the Federal Reserve's website, most recently expressed at their late October meeting (please note their language has been italicized):

"How does forward guidance about the Federal Reserve's target for the federal funds rate support the economic recovery?"

The Fed's forward guidance indicates that they will continue their accommodative stance. They are ending new Quantitative Easing purchases, yet remain committed to reinvesting funds from maturing bonds. With domestic equity markets at record highs (what pullback?); is their refusal to begin deleveraging creating an extraordinary bubble in other sectors and creating the prospect of even greater long term problems? Further, is the maintenance of such extraordinary accommodative policy politically motivated? Finally – and this is most disconcerting, there may be no logical endgame except cross your fingers and hope the next generation will solve our mess.

"By providing information about how long the Committee expects to keep the target for the federal funds rate exceptionally low, the forward guidance language can put downward pressure on longer-term interest rates and thereby lower the cost of credit for households and businesses, and also help improve broader financial conditions."

We frequently discuss the availability of various types of financing with bankers and other financial service providers. Newsflash – there is plenty of money available at favorable terms, but access seems to be limited to a modest percentage of households and businesses. Since many qualified borrowers have already taken advantage of the protracted low interest rate environment, they don't need or want new funds or refinancing. The growing liquidity trap has contributed to stronger bank balance sheets, but only questionable (if any) increase in small business and residential lending.

Is there value in Fixed Income? With the 10 year US Treasury Yield hovering between 2% - 2.3% – we have found relative value in intermediate high quality taxable bonds and municipal bonds. Here, FDIC Insured Bank CD's and Government Sponsored Entities typically yield greater than 2.6%. High quality municipals continue to provide "Gross" yields in excess of Treasuries with comparable duration; tax adjusted yields make these securities even more attractive.

"When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 %. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run."

Criteria that support a decline in Interest Rates:

Both US and Global economic weakness, unemployment rises, modest to low inflation, low global interest rates and weak housing.

Criteria that support Stable Interest Rates:

Europe opens the printing presses, spurring demand for US Securities which blunt any trend toward higher interest rates. Banks maintain tighter lending policies, purchases are lukewarm and rentals finally become chic again. Mild inflation and a flat labor market.

Criteria that support a rise in Interest Rates:

Global economic growth synchronizes, unemployment declines, inflation rises, energy costs decline, and winter grants us a break.

Despite myriad of cause and effect factors, our fixed income directive remains simple: take advantage of pockets of relative value and maintain a high degree of safety.

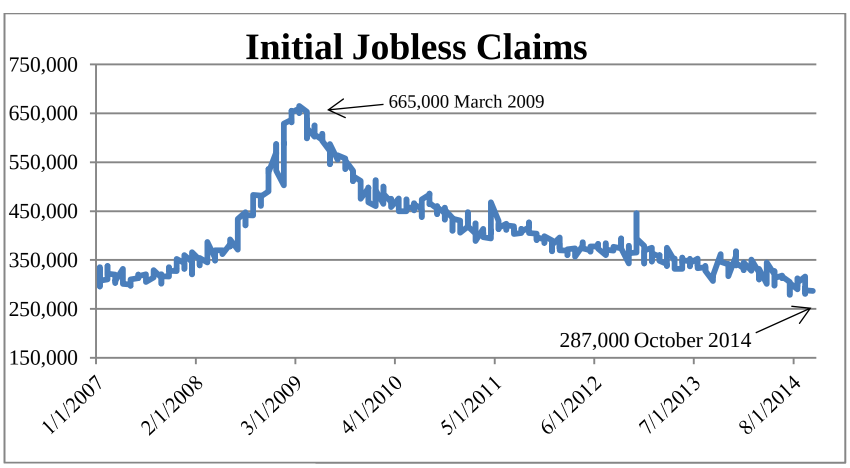
Employment Picture

Employment is the key to economic growth and a significant factor on inflation and in-turn interest rates. The table below illustrates an improving picture for US employment:

Seasonally Adjusted	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*
Unemployed of the civilian non-institutional population	4.6	5.8	9.3	9.6	8.9	8.1	7.4	5.9
U-5 = Unemployed, plus discouraged workers, plus all other persons marginally attached to the labor force, as a percent of the civilian labor force plus all persons marginally attached to the labor force	5.5	6.8	10.6	11.1	10.4	9.5	8.8	7.7
U-6 = Unemployed, marginally attached, and part time for economic reasons as a percentage of labor force plus marginally attached	8.3	10.6	16.3	16.7	15.9	14.7	13.8	12.3

Source: Bureau of Labor Statistics

As you can see above the often watched U-6 Rate has also declined but less quickly. This type of divergence suggests there is slack in the labor market.



Source: Bureau of Labor Statistics

Using auto sales as a proxy for a healthy economy, the picture is brighter. US Auto sales year-to-date reached 18.1 million through the end of October, a 7.4% rise from last year's sales.

Commodities & Oil

The catalysts for the June decline oil prices were hiding in plain sight: growth in US production, sputtering demand from Europe and China and a de-escalation of Middle East violence causing disruptions never materialized.

After three-and-a-half months of slow decline, the tipping point for a steeper drop arose on October 1, when Saudi Arabia cut prices for its biggest customers. The move signaled that the world's largest exporter would rather defend its market share than prop-up prices.

The 29% drop since June of the international price caught traders and forecasters by surprise. After a steady buildup of supply and weakening demand, the outbreak of an Organization of Petroleum Exporting Countries (OPEC) price war is casting doubt on investments in new oil resources, at the same time it is helping the global economy, keeping inflation in check, and giving motorists a break at the pump.

Brent Crude, the global benchmark for the price of oil, declined to $82.60 a barrel on October 16, the lowest in almost four years, from $115.71 on June 19. In the US, West Texas Intermediate, another measure of the price of oil, touched $79.44 on October 27, the lowest since June 2012. US regular unleaded gasoline is averaging close to a four-year low of $3.023 a gallon nationwide, according to AAA.

The recent bear market in this significant natural resource (liquid gold), has its price down almost 30% from this year's peak!

Supply Increases around the globe

Although Libya's production tripled since June to about 900,000 barrels a day, it is still 40% lower than two years ago. War has not stopped production in Iraq, which is pumping 3.1 million barrels a day, which is 10% of February's thirteen-year high. OPEC boosted September production to an 11-month high of 30.9 million barrels a day.

Forecasters from Barclays and Goldman Sachs Group slashed oil-price forecasts citing a global surplus. 2015 forecasts range from $85 a barrel to $100 for Brent, down from a September prediction of $105.50, according to an average of 46 analyst estimates compiled by Bloomberg. In the US, technological breakthroughs -- hydraulic fracturing and horizontal drilling -- have enabled domestic production to replace imports at a historic pace. Output surged 14% in the past year to 8.97 million barrels a day, the highest since the US Energy Information Administration's weekly estimates began in 1982.

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Demand Decline

This summer, macroeconomic data indicated weakening demand in Europe and Asia. The International Monetary fund this month cut its forecasts for global growth in 2015 to 3.8% from 4%. The Paris-based International Energy Agency predicted world oil consumption would expand at the slowest pace since 2009 after chopping its forecast in October for the fourth time since June.

Consumer Celebration

Consumers **Do** have cause to celebrate. Citigroup estimates that recent drop in the average oil price, amounts to a $1.1 trillion annual stimulus for the global economy – 0.4% to domestic annual economic growth.

International and Emerging Markets

Global equity investing continues to challenge even the most long tenured and emotionally detached investors. If one had invested ONLY in US equities since the financial crisis, one would have done better than a global investor. However, a global investor has benefitted over longer periods of time. If we look at 7 year rolling returns or longer, one would be better off excluding US equities. US equities have outperformed international developed markets four consecutive years (five if we include 2014, which looks to be a given). At the end of the 3rd quarter of this year, the outperformance is almost 9% annually. The outperformance vs. emerging market (EM) is even larger, standing at over 11% annually. Interestingly, US equities have squeaked out a 3 to 2 victory when comparing them on an annual basis. If risk and reward are truly related, then one would assume equities outside the US to generate more in return. After all, they carry more risk. Geographical, political, economic, and other risks are higher outside the US, but, the increased risk investors have accepted has not paid out over the last five years. What makes investing outside the US appealing now? What has changed outside the US to improve the probability that Int'l & EM stocks will outperform? Let’s look at a few of the countries that are larger components of the EM index to find out.

If we did a word association test and said; “emerging markets” most would respond by listing Brazil, Russia, India, or China, the “BRIC” countries. Yet only two of those countries made the top five list when it comes to highest country weightings in the MSCI Emerging Market index. While China is the largest component of the MSCI Emerging Market index at 18.7%, three of the next four largest countries are South Korea (14.3%), Taiwan (12.1%) and South Africa (7.7%). In fact, Mexico has a higher weighting than the last BRIC, Russia!

MSCI Emerging Markets Country Weightings Top 10 List	
Country	**Weighting**
China	18.70%
Korea (South)	14.30%
Taiwan	12.10%
Brazil	10.00%
South Africa	7.70%
India	7.20%
Mexico	5.00%
Russian Federation	4.50%
Malaysia	3.90%
Indonesia	2.60%

Source: www.ishares.com

India and Brazil appear to be heading in opposite directions. India, under Prime Minister Narendra Modi, is undergoing true reform. Labor laws in place date back to when the country was under British rule. The goal is to increase manufacturing from its current 15% of GDP to 25%. The Global Purchasing Managers Index (PMI) for manufacturing has held above 50 for 12 consecutive months (A reading above 50 signals expansion). Another significant change is to allow employees better access to their savings, currently under government control. The funds will link to their bank accounts and can be moved when they change jobs. Investors expect these changes and others to help move India forward. This is reflected in the 22% return YTD through the end of October. Brazil, on the other hand, is dealing with a World Cup hangover and political concerns. There was tremendous infrastructure build up leading to the FIFA World Cup that appeared to make Brazil an enticing investment. Investors who bought at the start of 2004 and held through the end of 2007 enjoyed an annual return of over 50%. In 2009 Brazilian investors enjoyed a return of over 120%. But, as is typical, most investors got in AFTER the run up and since the end of 2009; Brazil has been one of the WORST countries to invest in. Those that invested at the end of 2009 and held through the end of 2013 LOST over 18% annually! Today, the political environment is still cloudy. Dilma Roussef fought off Aecia Neves in the tightest race in the history of Brazil. While unemployment is near record lows and wages are rising, the economy has not grown (three of the last four quarters have seen Brazil's economy shrink) and inflation is high, running at over 6.5% annually. As discussed earlier, Brazilian stocks have performed poorly over recent years; peaking with a negative 20% September. However, the silver lining is the longer-term opportunity. Real GDP growth is expected to turn positive in the second half of 2015. While the Global PMI manufacturing index remains weak, there is anecdotal evidence of reform that may prove beneficial to investors willing to endure the expected near term volatility.

As for the other top EM countries, China's Purchasing Managers Index has held above 50 for the last four months and Taiwan has readings in excess of 52 for 13 consecutive months. South

Korea's readings have held at or near 50 for the last twelve months. The Bank of Korea forecasts GDP growth of 3.8% this year, with their benchmark interest rate currently at 2.25% they still have room for monetary easing. In addition the government recently announced an $11.7 trillion won (US$ 11.5 billion) spending plan. These indicators provide a more optimistic outlook than investors seem to recognize.

Valuations

Prior to the last decade, Emerging Markets had sported higher multiples whether it be price to earnings ("PE"), price to book ("PB"), or price to just about anything, compared to US and International Developed markets. That was due to explosive growth and a real lust from investors who couldn't pay enough for each dollar of earning's growth. Today, emerging stocks look quite cheap on a relative basis as they are sporting a PE ratio of just under 13 (ttm) and a price-to-book ratio of 1.5. This compares with US stocks trading with an 18+ PE ratio and a PB ratio of 2.6. Crazy as it sounds, US equities are priced at higher valuations than China or Russia PE and PB ratios. Both China and Russia are valued at levels not only attractive relative to their own history but also cheap relative to the world.

Comparative Worldwide Valuations

Country	P/E Ratio (TTM)	P/B Ratio
iShares MSCI China	9.1	1.3
iShares MSCI Russia Capped	5.6	0.7
iShares MSCI Emerging Market	**12.8**	**1.5**
S&P 500 Stocks	**18.4**	**2.6**

Source: www.ishares.com

Future Growth

According to most forecasters, the US economy is expected to grow at 3% annually over the next few years. Emerging markets are expected to grow at rates below their peaks, but over 4% and higher into the second half of 2015. So, if EM overall growth performs in line with these modest forecasts, this could result in EM stocks performing better than their US brethren over the next several years as risk is once again rewarded appropriately.

Emerging equity markets now represent 12% of the worldwide equity markets. The significant growth has improved liquidity as these markets have developed and matured. In 2005, there were 26 countries represented in the EM index, but today there are only 21. However, during that

Source: www.yahoo.com/finance

same time period, the number of stocks in the index has increased from 825 to just over 2600, over a 300% increase. This has resulted in a significant reduction in the concentration in the top stocks of the index. Who would have thought that the S&P 500 would have a higher concentration of stocks in the top 25% vs. the EM Index(18 stocks vs. 21 stocks)! Samsung Electronics of South Korea, the largest weighting in the index has a market capitalization ($US) of $186 billion vs. Apple with a market cap of $640 billion. Samsung's balance sheet has 60% more in cash and short-term investments than Apple; $60 billion v. $30 billion. These facts do not make Samsung a better investment than Apple but highlight the global market opportunity.

Using October as a microcosm for the long-term markets experience, we learn that market timing is impossible; emotions need to be replaced with discipline; a diversified investment strategy reduces risk; and all investors should plan for continued investment market volatility. Our clients' personal financial objectives are the only focus we have as an advisor, so please let us know if you have any changes to your financial situation. We look forward to hearing from you, so please call to discuss at 914-304-4766.

With our kindest regards,

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This letter was written with contributions from John Bannan, Craig Marson, and Kevin McCabe.