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In February the S&P 500 posted its best monthly performance since October 2011, up 5.8%. Smaller-cap stocks did slightly better, up 5.9% for the month. A key catalyst for the rally was Federal Reserve Board Chair Janet Yellen's mid-month testimony before Congress. In her testimony she indicated that the Fed is on track to potentially raise rates later this year, depending on the economic data. She cited positive trends in the labor market, noting (among other measures) the improvement in jobs creation over the past year. New jobs data for January (released in February) came in at a robust 227,000, and wages rose slightly after their decline in January. While lower oil prices have depressed many inflation measures (another key variable in the Fed's assessment of the economy's health), Yellen suggests this factor is transitory. Oil rallied in February, though prices remain lower than they were at the start of the year. Overall, the market took the Fed's reiteration of its measured pace as a positive, even as short-term indicators of consumer confidence, spending, and manufacturing appeared a little wobbly.

International stocks posted a second straight month of gains with the benchmark MSCI EAFE up 5.99%. In Europe, the focus was on negotiations between Greece's new governing party and the "troika" (which includes the International Monetary Fund, European Commission, and European Central Bank) over the fate of the country's bailout funds and the economic reforms required to receive them. Ultimately, the parties agreed to a four-month extension of the current aid program, essentially "kicking the can down the road" for now. Economic data released during the month was generally viewed as positive for the Eurozone. For example, Eurozone GDP for the fourth quarter 2014 and the full year came in slightly ahead of expectations, powered in large part by stronger growth in Germany, and bank lending grew year over year for the first time in three years. Japan's release of fourth quarter 2014 GDP data showed the economy emerging from recession and posting moderate positive growth (though lower than what forecasters were expecting). Export growth was a modest positive contributor, helped by a weaker yen. China's central bank cut interest rates at month-end, the latest step as the government seeks to sustain economic growth while also cooling the real estate market and credit expansion. Emerging-markets stocks rose 4.7% for the month. For the year to date, the developed international and emerging-markets benchmarks are ahead of the S&P 500.

"Core bonds were down about 1% for the month as investors were willing to take on more risk versus flocking to the perceived safety of investment-grade bonds."

Core bonds were down about 1% for the month as investors were willing to take on more risk versus flocking to the perceived safety of investment-grade bonds. This was evidenced by the strong performance from high yield (Junk) bonds, up 2.4%. Municipal bonds were down about 1% for the month as interest rates rose and investors sought greater risk in other bond categories. Last month we discussed our increased allocation to foreign stocks, this month we will touch on our longer term outlook for U.S. stocks and a few other timely topics.

U.S. Stocks: What Can we Expect Going Forward?

History tells us that stocks tend to outperform other financial asset classes over long periods of time. However, there have been some rather lengthy periods when this was not the case, usually occurring after stocks became extremely overvalued. This happened not that long ago when stock prices peaked in March

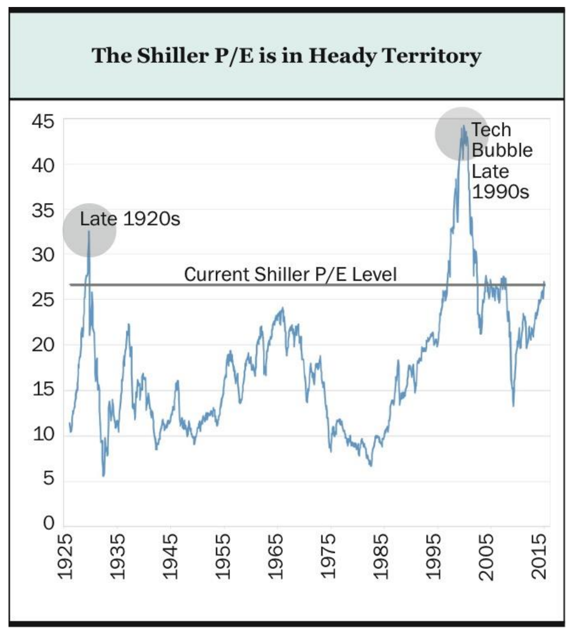
2000. There were two nasty bear markets in the decade that followed, leaving investors in the S&P 500 underwater until November 2006, nearly seven years after the peak. Even after a powerful market rebound post-2008, annualized returns are only 3.8% over the last 15 years.

Overall, stock valuations are not as bad today as they were in 2000. The tech bubble of the late 1990s made that market, in aggregate, the most overvalued of all time. Nevertheless, based on our analysis and common valuation metrics, today's stock market looks a little pricy. Lower returns over the next five to 10 years seem probable, and that also suggests higher volatility. That being said, we recognize that valuation is a poor predictor of near-term performance and given current conditions of low interest rates and volatility, investors may continue to drive valuations even higher.

We review many different metrics when evaluating the stock market's valuation, below we highlight two of the most commonly used metrics:

1. Price-to-Earnings Ratios

The P/E ratio is probably the most commonly used valuation metric. It measures what an investor pays to own a dollar of earnings, and can be applied to the stock market as a whole to get insight into the overall level of stock prices.



The Shiller P/E has only been higher than its current level (27x) in two other periods: 1929 and the late 1990s. It is on par with P/E levels in 2007–2008, immediately before the bear market. Source: Robert J. Shiller. Data as of 1/31/2015.

There are many different ways of measuring earnings when calculating a P/E ratio. One method we like is the Shiller P/E (named after Yale professor Robert Shiller). It "normalizes" earnings by using a 10-year average of reported earnings (which include write-offs). Normalizing eliminates the potential for funny business that is common when companies use leeway in various accounting standards to dump certain expenses into the write-off category that don't belong there. And, importantly, Shiller's approach acts to smooth out the impact to earnings of sizable cyclical peaks and troughs that occur during the economic cycle. Normalizing earnings isn't a perfect measure but it's a useful one, and a normalized P/E ratio has done a pretty good job of indicating future stock return ranges. With that context, here are some telling facts about the current S&P 500 P/E level compared to history:

- As of the beginning of 2015, the Shiller P/E was at 27.1. That puts it in the 92nd percentile, or the 10th and most expensive valuation decile. In other words it has been higher only 8% of the time going back to 1926 (the period for which we have data).
- The only times the Shiller P/E was significantly higher than it was at the end of last year was during the tech bubble, when it surged much higher, and just prior to the 1929 stock market crash. It was equally as high prior to the 2008 stock market crash.

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S&P 500 Returns From Different Starting Shiller P/E Deciles

	Median Returns	
P/E Decile	**5-Year**	**10-Year**
1 (Lowest P/Es)	17.5%	16.2%
2	15.3%	15.4%
3	13.8%	15.3%
4	13.2%	13.4%
5	10.4%	12.6%
6	9.5%	9.5%
7	10.1%	8.7%
8	7.9%	7.7%
9	4.0%	4.2%
10 (Highest P/Es)	-0.2%	2.9%

Source: Robert J. Shiller and Litman Gregory Analytics.

A high market P/E ratio is only a concern if it foreshadows poor stock market returns. Does the record suggest that is the case? With respect to the Shiller P/E the answer is yes over the intermediate to long term. It is less reliable over shorter periods.

The table to the left shows the data broken out into groups of the lowest P/E ratios ranging up to the highest P/E ratios. There are 10 P/E groups. What we see is that the lowest group of P/E ratios preceded the highest subsequent 10-year returns, and the highest P/E ratios (most expensive) preceded the lowest subsequent 10-year returns. The ordering was perfect. Low P/E ratios preceded high returns and high P/E ratios preceded low returns. The same ordering pattern is nearly present over five-year periods as well with just two of the 10 P/E groups in reverse order.

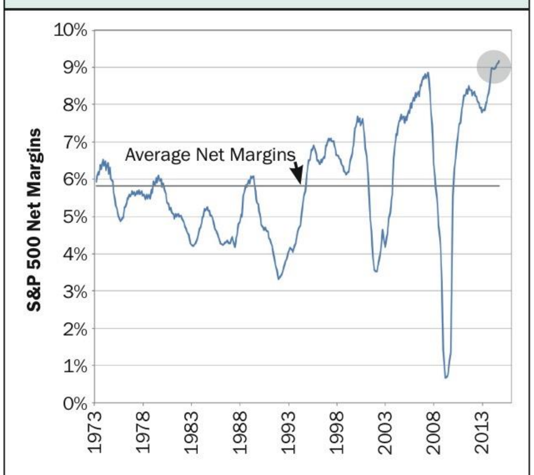
So far we've focused on median returns within each P/E group. There are some examples of decent return periods that occurred in spite of preceding high P/E ratios. For example, the best five-year annual return from the highest (most overvalued) P/E group was 10.7% and the best 10-year return was 8.9%. These are decent returns. However, they were the exception from the highest P/E group and happened only because stocks surged to extremely overvalued levels that in turn were followed by major stock market collapses in the early 2000s and in 2008. *So capturing decent returns from already high valuations required stocks to move to excessive and unsustainable valuations and levels.*

The historical range of outcomes from current valuation levels warrants reduced expectations. We looked at the range of historical P/E ratios from 25.1 to 29.1 (the current P/E is 27.1). From these levels future returns tended to be in the low to mid-single digits.

2. Profit Margins Are Near Record Highs

Since the P (price) of P/E ratios looks high, we also wanted to evaluate the growth rate of E (earnings). Currently, the S&P 500 is near record-high profit margins compared to the past 40-plus years, as shown in the chart to the right. Profit margins tend to be mean-reverting and, historically tend to be inversely correlated with five-year earnings growth. So when margins are high, subsequent earnings growth tends to be low, and vice versa. And while there are many arguments, some of them credible, for why profit margins might not revert back to long-term averages, we believe we will see some margin slippage over the next five years. That is because high margins encourage businesses to expand, increasing supply that pushes down prices and reduces margins. And, high margin industries attract competition that also ultimately brings margins back down. Moreover, most of the rise in margins has been driven by lower interest rates (borrowing costs) and declining taxes. Those

Profit Margins are Far Above Long-Term Averages

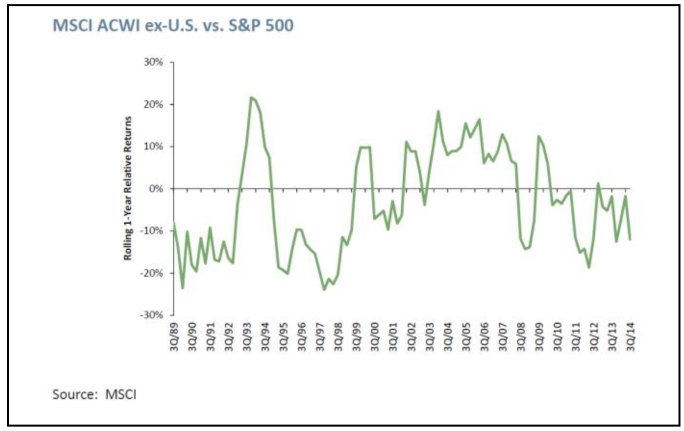


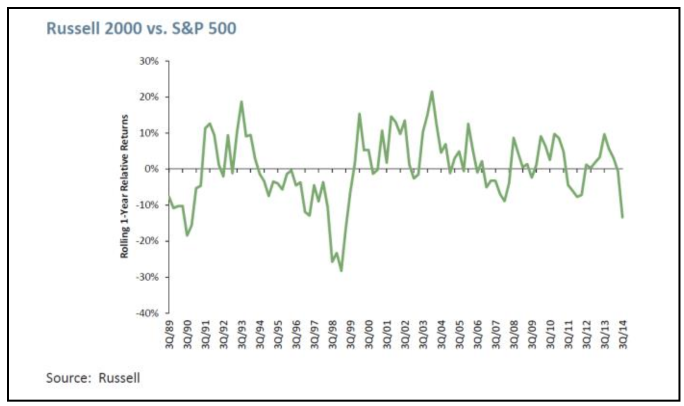
Historically, very high profit margins have been followed by sharp declines in company profitability. Source: Robert J. Shiller and Standard & Poor's. Data as of 9/30/2014.

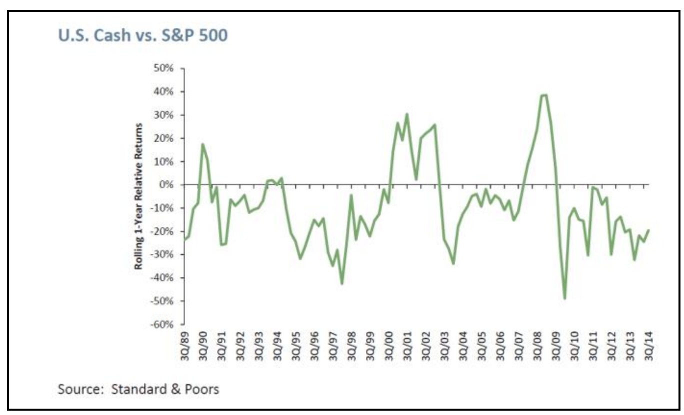
will not immediately turn into headwinds, but at some point that will likely happen. So record margins suggest slower future earnings growth. If earnings growth slows down, the E part of the P/E ratio could make valuations look stretched and weigh on future returns.

Is Active Management Dead?

We have highlighted the poor performance of active managers in the U.S. for several years. According to Standard and Poor's Mid-Year 2014 SPIVA report over 85% of active managers lagged their performance benchmark over the previous five years. Based on different studies we have seen for year-end 2014, it looks like more of the same, with between 80 to 90% of managers underperforming their benchmark last year. The investment management firm GMO recently did a study of the common factors that contribute to the out or underperformance of large-cap active managers relative to the S&P 500. Their conclusion was that 3 common factors heavily influence whether active managers as a group have success or failure relative to the S&P 500. They are the performance of foreign stocks relative to the S&P 500; the performance of small-cap stocks relative to the S&P 500 and the performance of cash relative to the S&P 500. The belief being that most active large-cap managers have some exposure to all of those asset class. The three charts below show that each of those asset classes have significantly lagged the S&P 500, contributing to underperformance for active managers. Our expectation is that active management performance will improve going forward. Of the three items listed we believe foreign stocks and cash (in a correction) are likely to be the biggest contributors to active manager's relative performance. In sum, we don't think it's time to give up on active managers. As always, manager selection will be crucial and focusing on the best managers that are disciplined, have exceptional cultures, low fees and tend to invest heavily in their own funds will help.







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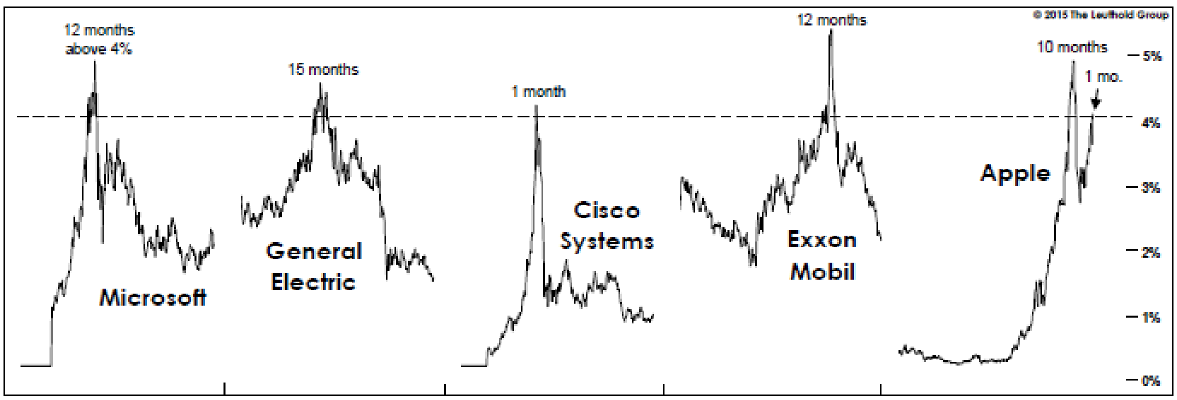
AWM

The Law of Large Numbers

One of our research providers, the Leuthold Group, recently published an interesting study of individual companies whose market value has grown large enough to comprise more than 4% of the S&P 500's market value. Something that has only happened 5 times, with Apple being the most recent addition to that club. The chart below shows how long the previous members of the "4% club" stayed at that level and how they performed afterwards. The Leuthold Group concludes that the law of large numbers will combine to drive Apple below the 4% threshold. We have been long time holders and admirers of Apple the company and the stock, however with a market capitalization well over 700 billion it is hard to argue with Leuthold's logic.

Companies To Have Reached A Four Percent Weight In The S&P 500, 1990 To Date
(...and how long they were able to stay there)



Summary

As investment managers, it's our responsibility to make thoughtful, well-researched, and unbiased investment decisions. Staying true to our investment philosophy and process, while always acting in the best long-term interests of our clients. Looking forward, we anticipate returns from the traditional asset classes of stocks and bonds to be lower than their long-term averages. We shared some thoughts on our outlook for stocks above, and today's low level of interest rates pretty much assures relatively modest bond returns for the next several years. Fortunately, we are experienced investors and able to design successful strategies to add value to expected returns in these type of markets, both from an absolute and risk-adjusted perspective. Some of the ways we expect to add value are through disciplined and timely tactical asset allocation decisions, selecting managers and securities that can outperform over a full market cycle, selectively adding alternative strategies and limiting overall portfolio costs. By executing our disciplined investment philosophy and process we have demonstrated the ability to navigate challenging markets in the past and expect to navigate them well in the future on behalf of our clients.

—AWM Investment Team