Quarter in Review

With U.S stock markets initially range-bound, for most of the quarter the big story in financial markets was bonds. That was until June, when the relative calm in global stock markets came to an abrupt end. As the month unfolded, trading became increasingly influenced by shifts in sentiment and polls predicting the outcome of the United Kingdom's so-called "Brexit" referendum on continued European Union membership. Finally, contrary to the majority of forecasts and taking most of the world by surprise, the United Kingdom voted to leave the European Union on June 23.

June Benchmark Returns (Preliminary)			
Large Cap Benchmarks	**Jun**	**2Q**	**YTD**
Vanguard 500 Index	0.2%	2.4%	3.8%
iShares Russell 1000	0.3%	2.5%	3.7%
iShares Russell 1000 Growth	-0.4%	0.6%	1.3%
iShares Russell 1000 Value	0.8%	4.5%	6.1%
Mid-Cap Benchmarks			
iShares Russell Mid-Cap	0.5%	3.2%	5.5%
iShares Russell Mid-Cap Growth	0.0%	1.5%	2.1%
iShares Russell Mid-Cap Value	0.9%	4.7%	8.8%
Small-Cap Benchmarks			
iShares Russell 2000	0.0%	3.9%	2.4%
iShares Russell 2000 Growth	-0.4%	3.4%	-1.3%
iShares Russell 2000 Value	0.4%	4.4%	6.3%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-2.0%	-0.1%	-1.9%
MSCI World ex USA Index	-3.0%	-0.8%	-2.6%
Vanguard FTSE Europe ETF	-4.0%	-1.9%	-4.0%
Vanguard FTSE Emerging Markets ETF	4.9%	2.6%	8.6%
Vanguard REIT Index	6.9%	6.8%	13.4%
Vanguard Total Bond Mkt Index	1.9%	2.3%	5.5%
BofA Merrill Lynch U.S. High Yield Cash Pay	1.1%	5.9%	9.3%
Vanguard Intermediate-Term Tax-Exempt	1.4%	2.1%	3.8%
S&P/LSTA Leveraged Loan Index	0.0%	2.9%	4.5%
Citigroup World Govt. Bond Index	3.7%	3.4%	10.7%

In the wake of the vote, the British prime minister resigned. Overnight, British pound sterling fell 11% to its lowest level since 1985 and the euro fell 2.4%. U.S., developed foreign and emerging-markets stocks all plummeted on the news. The S&P 500 fell by 3.6%, while foreign markets dropped by 8.7%. Financial stocks fared the worst, with defensive dividend-paying utility and telecommunications sectors fared best. Away from equities, investors fled to "safe haven" investments: gold, Treasury bonds, and certain currencies, such as the Swiss franc, Japanese yen, and U.S. dollar. Days later, ratings agency Standard & Poor's stripped the United Kingdom of its triple-A credit rating and downgraded the European Union's rating.

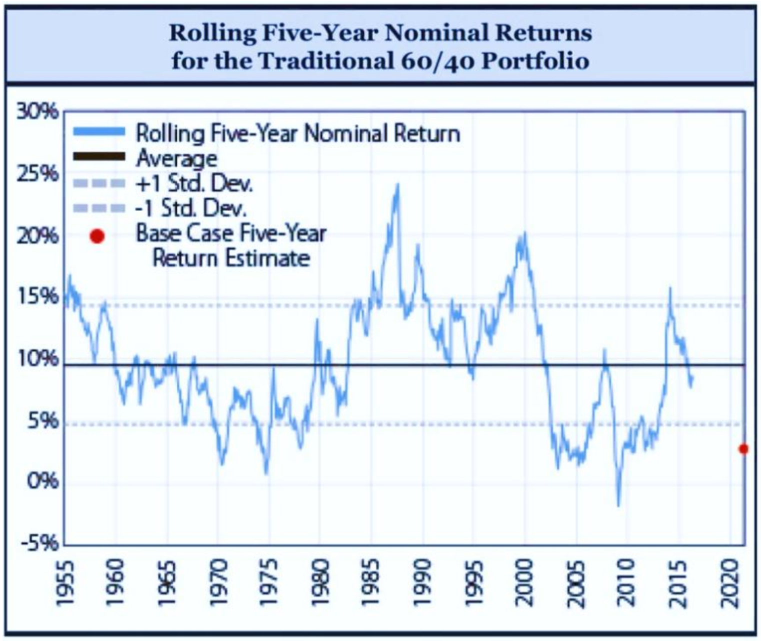
However, in the week following Britain's historic vote, global stock markets rallied as the quarter ended, despite still significant uncertainty regarding the economic, political, and financial market implications of a Brexit. When the dust settled, Developed Foreign Markets were down just 0.1% for the quarter and down 1.9% YTD. U.S. 10-year Treasury bonds ended the quarter with a yield of 1.48%, close to their low-water mark reached in July 2012. Falling yields have been driven by economic growth concerns; central banks' ongoing low/negative interest rate policies, and heightened demand for perceived risk-free assets as a reaction to the uncertainty surrounding Brexit's impact. They have been joined by expectations of imminent rate cuts from the Bank of England, additional bond buying by the European Central Bank and a growing consensus that the Federal Reserve will further delay raising U.S. rates.

While we do not expect a sharp rise in interest rates any time soon, at such low starting yields, expected returns to core bonds and all other "safe investments" are extremely low. With that said, every investor's circumstances are unique, and each portfolio will call for its own appropriate mix of potential investments.

STOCK MARKETS

After a multiyear period of significant underperformance versus larger-cap stocks, we no longer view smaller stocks as being overvalued. That said, we still believe that U.S. stocks may struggle to match historical returns over the next five years, mostly due to current valuations and the length of the current bull market.

While quarterly and year-to-date returns for global developed stocks continued to be dragged down by financial sector holdings, performances for emerging-market stocks were strongly positive. This again points to the value and historical benefit of diversification.



Source: Morningstar Direct. Data as of 5/31/2016.

Though downside risks remain significant, we view the initial market reaction to Brexit as a short-term shock that does not change our longer-term five-year return expectations for European equities. Accordingly, as we analyze the range of possible outcomes stemming from the British vote to exit the European Union, we will weigh potential changes to our views from that perspective, while incorporating the likelihood of increased shorter-term market volatility.

Why Diversify? Asset Class Performance Over the Last 25 Years (12/31/1990–12/31/2015)				
	—Times Delivered—			
	Best Return	**Worst Return**	**Annualized Return**	**Volatility**
Large Cap (S&P 500)	7	7	9.7%	18.0%
Small-Cap (Russell 2000)	6	3	10.4%	20.0%
Developed Foreign	1	5	5.4%	19.5%
Emerging Markets	11	10	8.0%	33.9%

Bond Markets

We saw strong performance for non-core fixed-income over the quarter, with most sectors beating the core bond index for both quarter and year-to-date periods. While we continue to favor diversified bond exposure with careful attention to tax favored municipal bonds and shorter maturity/duration bonds where applicable; bonds still remain an important risk reducer as underscored by recent events. Given the current investment environment, the trade-off—reduced risk of losses versus longer-term upside—is worth it for most conservative portfolios.

Putting It All Together

Given current yields, valuations, and earnings fundamentals, standard 60/40 portfolios should not be expected to generate returns as high as the long-term historical average, even when taking into account the benefits of rebalancing and above average investment selection. Our base case expected five-year annualized return for a 60/40 portfolio is currently in the 5.5%–6% range. That is meaningfully higher than the return projections used in client financial plans, but much lower than historical norms since WWII.

Of course, there is no guarantee the base case will play out. There is a wide range of potential returns, depending on what scenarios actually unfold over the next several years. But we view our base case as being the most likely, and we believe our asset class assumptions are reasonably conservative. *U.S. profit margins have been coming down, but are still high relative to history and are likely to continue lower as the labor market tightens.* Another important message is that, as always, investors should have realistic return expectations as they look out over the next five or so years at least. These return expectations should be based on current valuations and starting yields, and they should encompass a range of reasonable economic, fundamental, and financial market scenarios. Similarly, investors should also be cautious in assuming returns will mirror their long-term averages. There is no economic law that says 60/40 investors are owed that historical 9.5% annualized return.

Closing Comments

We believe patience, discipline, flexibility and expertise in investing across a broad opportunity set will be important attributes for navigating the next five years. We doubt investors will be able to simply rely on the U.S. market tailwinds of declining interest rates and rising P/E multiples that have boosted returns for core bonds and stocks over the past several decades.

Volatile markets, will likely also challenge investors' convictions and emotions. As always, it is critical to do an honest self-assessment to understand your temperament, risk tolerance, and objectives, and to invest in a portfolio that is managed in a manner that is consistent with those attributes *before* market volatility strikes rather than in the heat of it, when emotions are likely to cloud judgment and lead to poor investment decision-making.

Successful investing requires patience and the understanding that investing is a part of a *process*, not a one-off decision, toward achieving your long-term financial goals. Remaining focused on the *long-term* objective is key, as is maintaining a consistent investment discipline to guide your decisions over time. Our valuation-driven discipline means we can use short-term market volatility to our long-term benefit, by taking advantage of the investment opportunities created from other market participants' *lack* of discipline, patience, and flexibility

-We thank you for your continued support!