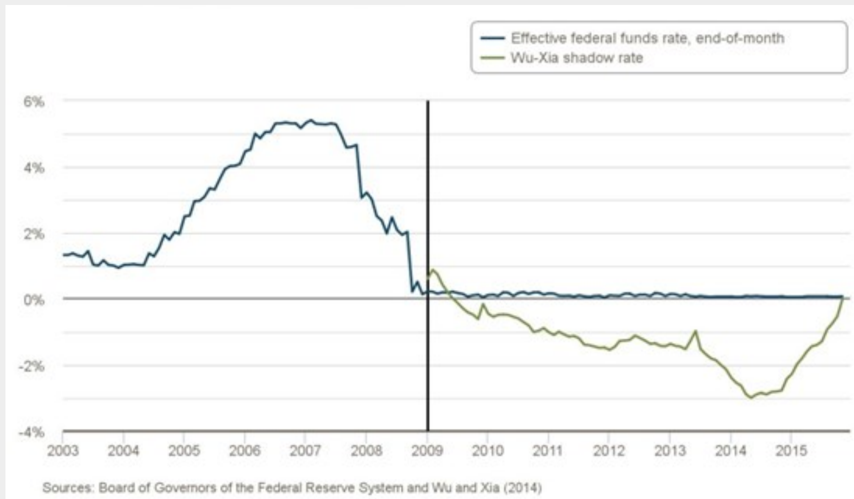
fourth quarter 2015

INVESTMENT *perspective*

The late summer equity market correction reversed course in the fourth quarter with the S&P 500 and Russell 2000® index gaining 7.04% and 3.59%, respectively. Equity markets continue to digest falling earnings estimates, declining profit margins, rising credit costs, weak commodity prices, and monetary policy divergences among developed and emerging economies. The short term market direction remains uncertain and we expect market volatility to remain elevated given stress in high-yield markets, tighter lending standards, and less overall credit availability all having the potential to weigh on risk assets.

The Federal Open Market Committee (FOMC) began communicating to the market their desire to raise the Federal Funds rate in 2014; ending the bullish U.S. dollar (USD) liquidity fundamentals and bull market for global risk assets. Implied market rates began rising in mid-2014 and have significantly tightened global liquidity conditions.

Wu-Xia Shadow Federal Funds Rate

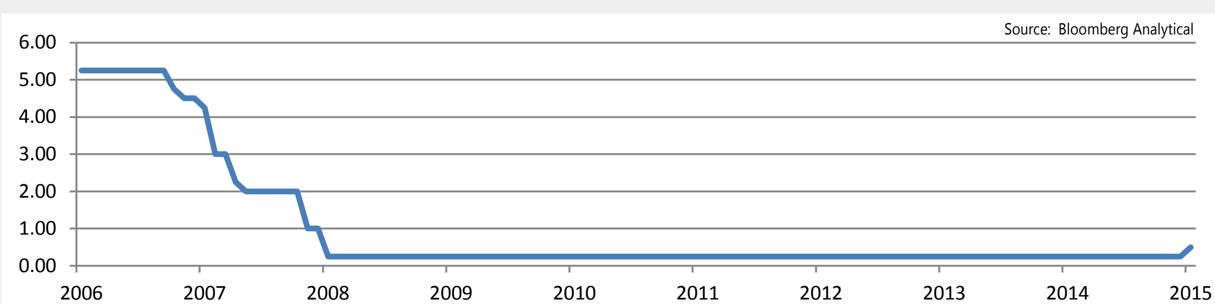


The U.S. dollar's appreciation pressured commodity prices and tightened liquidity conditions for non-U.S. private and public entities borrowing in USD. The summer of 2014 witnessed emerging market equities and fixed income as the first markets to correct from the shift in the Federal Reserve's monetary policy. The correction spread further into commodity markets, then in early 2015 U.S. high yield markets and U.S. small cap equities began to correct. Finally, in the second half of 2015 U.S. large cap equities corrected.

We would not expect a material change in the USD exchange rates with developed economies, but emerging market fundamentals remain precarious and any further strengthening in the dollar versus emerging market currencies will continue to reduce dollar liquidity, negatively impacting risk assets.

The FOMC voted to raise the Federal Funds target in December, its first rate hike in over 9 years. While the FOMC deemed this move appropriate in the context of prudent long-term monetary policy, we continue to believe this interest rate cycle will be materially different from prior cycles. Prior rate increase cycles began while the economy was accelerating and beginning to overheat, not while the economy was in a fragile (current) state. Given the already substantial rate increase implied by market conditions, we do not believe the Federal Reserve will be able to increase the federal rate significantly unless inflation expectations and economic growth accelerate.

Fed Funds Rate (12/31/06 - 12/31/15)



For several years, risk asset pricing was driven by expectations of central bank liquidity and the ongoing "hunt for yield". Markets will remain volatile and prone to sudden corrections as liquidity expectations are modified and if the need for a policy shift from monetary policy support to fiscal policy support becomes necessary both domestically and abroad. In order to end the current correction in risk assets several conditions need to be met, including:

- stability in credit markets
- stability in currency markets
- rising end demand or a shift by world governments from monetary to fiscal policy support
- an end to deleveraging domestically and internationally

As the nature of the market continues to change, there are still individual stocks that will perform well over the medium term despite the increasing market headwinds. Our outlook has become more balanced, stock-specific, and not reflective of opportunities in specific industries, regions of the world, or broader market indices.

Investors in 2015 were also not rewarded by the fixed income market. The asset class struggled with delays in the Fed's much publicized beginning of the end of its zero interest rate policy. They finally delivered what they promised with a hike in the Federal Funds Rate on December 16th. Reaction was muted as much of the move had been priced in over the previous two months and the Fed communicated that future increases would be gradual and remain "data dependent".

The Barclays Aggregate Index returned a disappointing 0.6% while high yield bonds were the most stressed, posting a nearly 5% decline. The Treasury market was also lackluster with the 10-year Treasury returning 0.9% and the 30-year Treasury returning -3.2%.

Bond investors that focused on intermediate duration faired better than longer dated bonds, as the longer end of the curve began to price in the Federal Reserve's first rate hike.

Vaughan Nelson's taxable fixed income portfolios generally outperformed the Barclays Aggregate thanks to our stance of being selective in the commodity sectors (avoiding energy and mining) and to our overweight position in Financials. In addition, portfolios benefited from being more concentrated in the 5 to 10 year portion of the maturity curve and by maintaining a slightly shorter duration versus the benchmark.

We start 2016 with many of the factors impacting the markets last year still in place. Our focus, therefore, remains the same; maintain a shorter relative duration target, overweight high quality corporates and in particular the Financial sector, avoid merger and acquisition risks, and take advantage of liquidity-driven weakness in good credits.

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