INVESTMENT REPORT

LYNCH FINANCIAL GROUP LLC
— Retirement Wealth Management —

April 2015 www.LynchFinancialGroup.com

Investment Review and Outlook

The strength of the dollar is a significant force affecting the economic landscape.

International stocks led U.S. stocks, even with currency movements eating into foreign returns for U.S. dollar-based investors**.**

The bond market was also positive as Treasury yields declined over the quarter.

When investing the stock portion of our portfolio strategies, we are mindful of risk factors, primarily that U.S. stocks are expensive.

We think European stocks are priced to generate attractive returns if we look out five years.

We welcome questions or comments regarding this newsletter at jlynch@lynchfinancialgroup.com. Lynch Financial Group provides Retirement Wealth Management Services to individuals within 15 years of retirement, retirees, and surviving spouses. We also provide specialized assistance to professionals, fiduciaries and heirs in wealth transfer situations.

Benchmark and Mutual Fund Performance

The box below contains benchmark (capital market and investment style) performance results. The performance results of our recommended mutual funds and their benchmarks are shown on page 5. U.S. stocks had small gains for the quarter. After trailing U.S. stocks for an extended period, international stocks outperformed during the quarter and had good returns. The underweighting in U.S. stocks in client portfolios led to returns that trailed their benchmarks.

First Quarter 2015 Investment Commentary

The strength of the dollar is a significant force affecting the economic landscape. The dollar has appreciated 23% over the past 12 months. Moreover, based on the concept of purchasing power parity (PPP), the dollar now looks to have significantly overshot its longer-term fundamental value relative to the basket of other major currencies in the dollar index. The converse is true as well—other currencies have undershot their fair value versus the dollar.

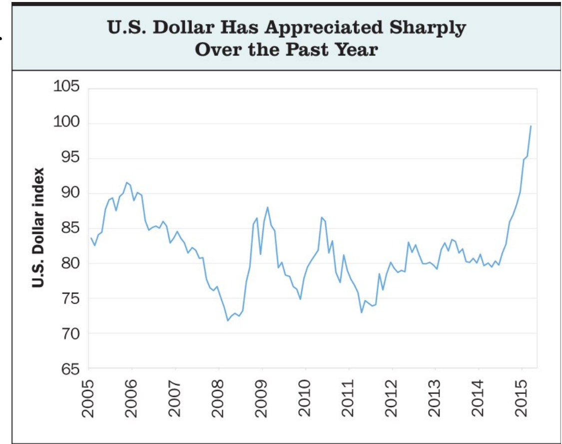
There are several cross currents from the rise in the dollar in terms of its impact on both the real economy and financial markets. On the positive side, a strengthening dollar reduces the cost of imported goods and is also associated with falling oil and commodity prices that are priced in dollars on the global market. This will tend to depress domestic inflation—a positive result unless an economy is at risk of a deflationary spiral, which the United States is not. All in all, these things benefit U.S. consumers, increasing their purchasing power and leaving them more money available for spending (or saving). A stronger dollar also tends to attract more foreign investment. To the extent this foreign capital flows into U.S. Treasury bonds or corporate debt, it helps keep interest rates lower, and it may also

Benchmark Returns (Periods Ended 3/31/15)

	Quarter	12 Months
Large-Cap Benchmarks		
Vanguard 500 Index	0.9%	12.6%
Russell 1000 Growth iShares	3.8%	15.9%
Russell 1000 Value iShares	-0.8%	9.1%
Mid-Cap Benchmarks		
Russell Midcap iShares	3.9%	13.5%
Russell Midcap Growth iShares	5.3%	15.3%
Russell Midcap Value iShares	2.4%	11.5%
Small-Cap Benchmarks		
Russell 2000 iShares	4.3%	8.3%
Russell 2000 Growth iShares	6.7%	12.3%
Russell 2000 Value iShares	2.0%	4.3%
Other Benchmarks		
Vanguard Developed Mkts Idx	5.5%	-1.0%
Vanguard Emerging Markets	2.1%	2.9%
Vanguard REIT Index	4.7%	24.0%
Vanguard Total Bond Mkt Index	1.6%	5.5%
Credit Suisse High Yield Index	2.6%	1.4%

Mutual Fund Performance - See Page 5

support higher U.S. stock prices. All of these factors are reasons why investors cite the stronger dollar as another reason for optimism about U.S. stocks. However, a dollar that is too strong is not necessarily good for U.S. stocks, as investors start to weigh the negative impacts more heavily. So far this year, the daily correlation between the dollar and U.S. stocks has been negative.



The DXY Index constituents include Euro (57.6%), Yen (13.6%), Pound (11.9%), Canadian Dollar (9.1%), Swedish Krona (4.2%), and Swiss Franc (3.6%). Data as of 3/17/2015. Source: Bloomberg, L.P.

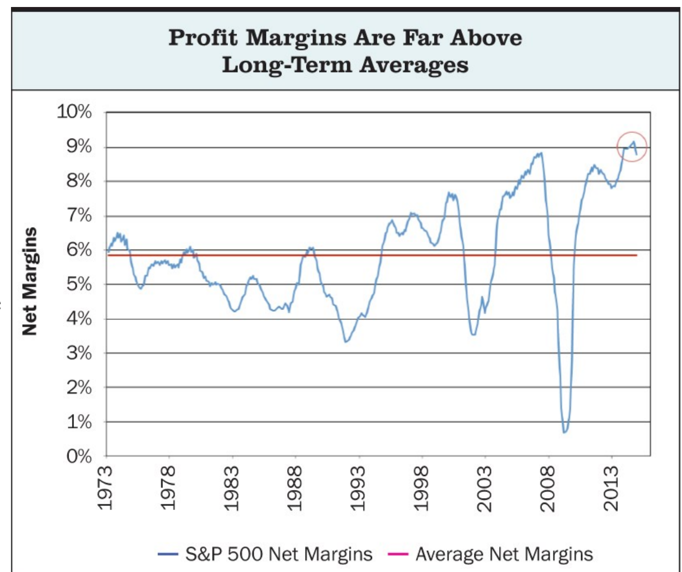
On the negative side, a stronger dollar has a negative impact on U.S. exports, U.S. manufacturers, and U.S. multinational company profits. And by also making imported goods more attractive it typically leads to a worsening of our trade deficit. This has a negative effect on overall economic growth, because GDP is defined as the sum of consumer spending, investment spending, government spending, and net exports. Also, from a dollar-based investor's perspective, a rising U.S. dollar hurts foreign asset class returns as they are translated back into dollars from weaker currencies.

All of these impacts are reversed for the investors, consumers, and economies whose currencies are depreciating versus the dollar. When we talk to our international stock managers, for instance, most of them echo a few key points with regard to the recent currency volatility. First, they acknowledge that the negative currency translation effect creates an immediate negative impact on their dollar-based returns. But the managers typically do not try to hedge against this translation risk. Several of them state (as do we) that they don't believe they have an edge in predicting currency movements, so they are doubtful they would add value to client returns over time from doing so. Second, while they rarely hedge currencies, our international managers do consider potential currency impacts as part of their fundamental, company-specific analysis and valuation. For example, they say that over the medium term a weaker currency should begin to positively impact the profit margins and earnings of foreign companies that do business globally.

Asset Class Views and Portfolio Positioning

U.S. Stocks—Our five-year outlook for U.S. stock returns is quite subdued. This reflects our view that (1) corporate earnings are substantially above their long-term "normalized" trend; and, (2) stock market valuations are also above normal. We don't think either trend is sustainable.

Profit margins are a key driver of earnings and earnings growth. The adjacent chart shows profit margins for the S&P 500 are at all-time highs. The chart is also very clear in showing that profit margins are cyclical. That is, neither the trend nor the level of margins is sustained for very long. Moreover, history has shown that high profit margins are negatively correlated with subsequent five-year earnings growth (i.e., foretell lower future earnings growth). We don't think this time will be different. We believe margins and earnings growth



Historically, very high profit margins have been followed by sharp declines in company profitability. Data as of 12/31/2014. Source: Robert J. Shiller and Standard & Poor's.

will come down from their current levels and revert toward their longer-term norms.

In addition to the natural forces of competition, a big reason profit margins are likely to decline is from increased labor and wage costs, which have yet to really kick in. Another factor is the sharply rising dollar, which, as we highlighted earlier, is hurting the profits of U.S. multinational companies.

We seem to be seeing this impact already, as earnings-per-share estimates for the first quarter have dropped sharply to a 5% year-over-year decline, compared to the positive 4% growth that was expected for the first quarter at the beginning of the year. The plunge in oil prices, which hurts earnings for energy companies specifically, is also a significant driver of these negative results.

The second key piece to our negative view on U.S. equities is elevated valuations. We measure valuations in a number of ways and across many different metrics, and they all tell pretty much the same story: U.S. stocks are expensive. While valuations are not a good short-term market indicator—overvalued markets can get even more overvalued for a while—history shows that high valuations are a deterrent to future long-term returns, which is our focus.

If our view on earnings is correct, we'd expect a meaningful market correction at some point. All else equal, we would view such a decline as an opportunity to shift some capital back into U.S. stocks (which at that point should be offering attractive return potential commensurate with their risk) and out of our more defensive fixed-income holdings.

In the meantime, many of our active equity managers are still able to find some great stock-picking opportunities within what we (and many of them) see as an overvalued and relatively unattractive overall market opportunity set. One area where many of our managers are carefully picking amongst the rubble is energy—the S&P energy sector is down 22% compared to a 9% gain for the overall market over the past three quarters.

European Stocks—Moving to developed international stocks, and Europe in particular, our top-down asset class view is almost a mirror image of the United States. Unlike in the United States, where we see unsustainably high profit margins, earnings growth, and valuation multiples, in Europe we see earnings that are below trend and relatively attractive valuations.

Over the next five years, we think European stock market earnings growth will be higher than the market is currently expecting, and more in line with its long-term trend, as the economy recovers and companies benefit from operating leverage, cost cutting, and the weaker euro currency. We also believe European stock market valuation multiples will at least be in line with their longer-term norm, consistent with an economic and earnings recovery. As such, when we model out expected five-year returns for developed international stocks, we get numbers around 10%–11% (annualized) in our most likely scenarios. This is an attractive spread relative to the low single-digit expected return for U.S. stocks. And it is the type of absolute return we want to see in order to take on full equity-risk exposure in our portfolios. As such, we are at or near a full weighting to international/European stocks in our balanced portfolios.

Emerging-Markets Stocks—Our top-down analysis for emerging-markets stocks is similar to Europe, in that their valuations look attractive and earnings appear to be depressed relative to our longer-term expectations. Of course, emerging markets face some unique risks, which we have discussed frequently in past commentaries. These include most prominently:

1) the potential for a sharper-than-expected economic slowdown in China, as the authorities try to gently deflate their infrastructure/credit bubble and engineer a transition to a consumer-led economy.

2) the potential negative contagion effects from the impact of continued strong dollar appreciation on the high levels of dollar-denominated debt on emerging-markets companies' (and some governments') balance sheets.

While we don't claim to have unique insight into how these complex and multifaceted (and, really, unknowable) situations will unfold, we look at emerging markets—as we do all the asset classes we evaluate—across a range of scenarios that try to take into account a number of eventualities that could result from combinations of these and other macro factors. Moreover, in determining our emerging-markets allocation, we seek a high margin of safety before overweighting the asset class. In other words, we'd want to have such a strong positive case that we could have a lot of things go wrong or differently and we'd still expect good investment results. Today, as we weigh what we believe are the most likely scenarios, we derive expected five-year annualized returns for emerging-markets stocks in the mid-single to low double digits. The low end of that range incorporates what we believe to be pretty bearish assumptions, yet if they played out we would still earn at least decent returns. The upside in the more neutral or positive scenarios is significant. Therefore, we maintain a full allocation to emerging-markets stocks in our balanced portfolios.

Investment-Grade Bonds—With the U.S. core bond index yielding only 2%, any reasonable interest-rate or macro scenario implies very low returns over the next five years. There is no refuge to be found looking to core bond markets outside the United States either. In Europe, the comparable index has a yield of only 0.5% and almost a third of European government bonds actually have a negative yield-to-maturity, meaning investors who hold these bonds to maturity are locking in a certain loss.

We think there are relatively more attractive—and more durable—options within pockets of the bond market, and we've tilted the portfolios to take advantage of these. Specifically, we have shifted some of the fixed-income exposure in our balanced accounts into active funds that have significant flexibility to manage their interest-rate risk as well as other risk exposures, and that we believe are run by skilled, proven managers. The fund's much lower duration means they face less of a negative price impact from rising interest rates.

Concluding Comments—In this commentary we highlighted a few of the investment opportunities we are seeing as we look out over the next five years. But broadly speaking, we continue to view this as a low-return environment across most asset classes and we don't think our portfolios will being rewarded by taking on additional risk at this time.

As market prices, valuations, and fundamentals change, our views and positioning may change. We expect (rationally so, we believe) that markets will be volatile in the future. And when market prices and underlying asset values diverge due to the inevitable and enduring cycles of investor herd behavior driven by greed and fear (or excessive optimism and pessimism), our disciplined, patient, tactical, long-term investment approach will be in prime position to take advantage of those cycles.

This article utilizes research from Litman/Gregory Analytics, LLC.

LFG Recommended Mutual Funds
Performance Results for Funds and Benchmarks

Fund Name[1]	Benchmark (BM)[2]	% Returns For The Periods Ended March 31, 2015 — 3 Months		12 Months		3 Yrs Annlzd		5 Yrs Annlzd	
		Fund	BM	Fund	BM	Fund	BM	Fund	BM
Baron Emerging Markets[3]	Vanguard Emerging Markets Index	-0.3	+2.1	+1.6	+2.9	+8.3	+0.4	NA	NA
Parametric Emerging Markets[3]	Vanguard Emerging Markets Index	-0.6	+2.1	-5.4	+2.9	+0.1	+0.4	+1.6	+1.7
Tweedy Browne Global Value	Vanguard Developed Markets Index	+3.6	+5.5	+3.7	-1.0	+11.0	+8.8	+9.3	+6.0
Artisan International	Vanguard Developed Markets Index	+4.2	+5.5	+5.2	-1.0	+12.0	+8.8	+10.3	+6.0
Litman Gregory Masters Select International	Vanguard Developed Markets Index	+5.5	+5.5	+2.9	-1.0	+9.7	+8.8	+7.3	+6.0
Rainier Small/Mid Cap Equity	Russell Midcap iShares	+6.5	+3.9	+9.3	+13.5	+13.4	+17.9	+14.3	+16.0
Harbor Capital Appreciation	Russell 1000 Growth iShares	+5.6	+3.8	+16.2	+15.9	+15.8	+16.1	+15.1	+15.4
Jensen[3]	Russell 1000 Growth iShares	+1.7	+3.8	+13.4	+15.9	+15.7	+16.1	+12.9	+15.4
BBH Core Select[3]	Vanguard 500 Index	-1.2	+0.9	+5.2	+12.6	+13.2	+15.9	+13.0	+14.3
Selected American Shares	Vanguard 500 Index	+2.1	+0.9	+6.0	+12.6	+13.4	+15.9	+10.8	+14.3
Dodge & Cox Stock	Russell 1000 Value iShares	-1.2	-0.8	+6.5	+9.1	+18.2	+16.2	+13.8	+13.5
Vanguard Windsor II	Russell 1000 Value iShares	-0.1	-0.8	+8.0	+9.1	+14.7	+16.2	+12.7	+13.5
FPA Crescent[3]	60% Russell 2500 Index; 40% Vang Tot Bd	+0.2	+3.8	+4.7	+8.2	+10.5	+11.4	+9.7	+11.0
PIMCO All Asset	Barclays TIPS Bond iShares	+0.1	+1.4	-1.4	+3.0	+3.4	+0.5	+5.9	+4.2
PIMCO All Asset All Authority[3]	50% S&P 500/50% Barclays TIPS Bond iShares	-0.3	+1.2	-4.8	+7.8	+0.4	+8.2	+3.9	+9.2
Westwood Income Opportunity[3]	25% S&P 500, 25% NAREIT All Equity, 25% Citigroup Treasury Bill 3 mo., 25% Citigroup Treasury 10 Yr	+0.4	+2.0	+6.8	+11.3	+9.1	+8.5	+9.8	+9.4
Osterweis Strategic Income[3]	Vanguard Total Bond Index	+2.0	+1.6	+1.1	+5.5	+5.0	+2.9	+5.9	+4.2
Doubleline Total Return[3]	Vanguard Total Bond Index	+1.6	+1.6	+5.9	+5.5	+4.8	+2.9	NA	NA
PIMCO Total Return	Vanguard Total Bond Index	+2.2	+1.6	+5.6	+5.5	+4.0	+2.9	+5.0	+4.2
Vanguard Intermed Tax-Exempt	Vanguard Total Bond Index	+0.8	+1.6	+5.3	+5.5	+3.6	+2.9	+4.6	+4.2
Loomis Sayles Bond	1/3 CSFB HY, 2/3 Vang Tot Bond	-1.0	+1.9	+0.7	+4.1	+5.8	+4.3	+7.2	+5.6

[1]Funds were selected using the LFG Proprietary Mutual Fund Rating System℠. This system is based on extensive research using both quantitative and qualitative factors. The system seeks to identify top funds in each asset class and investment style. LFG typically combines 8 to 10 funds in client investment portfolios.

[2]iShares exchange traded funds were used where available and respective Russell indices were used for the other periods.

[3]Funds which were not recommended for entire 5 year period.

The above table reflects past performance and should not be considered indicative of future results. The results contained in this schedule were obtained from sources we believe to be reliable. We cannot, however, guarantee the accuracy of this information.