CAPITAL MARKETS REVIEW
3rd Quarter 2014

September 30, 2014

OVERVIEW

During Q3 2014, market performance became increasingly varied across the globe, as some markets continued to solidify their economic recoveries, while others backtracked due to declining demand and weakening commodity prices. Segments of the U.S. equity market generated positive returns for the quarter, aided by increased M&A activity and an upward revision of a previous GDP reading. Generally, global equity markets were weaker due to growing concerns about deflationary pressures in the Eurozone and deteriorating economic indicators in emerging markets. The 10-year U.S. Treasury yield remained flat in the third quarter at 2.5%, as the Federal Reserve maintained its commitment to end quantitative easing, while also signaling a slight bias toward maintaining an accommodative interest rate policy.

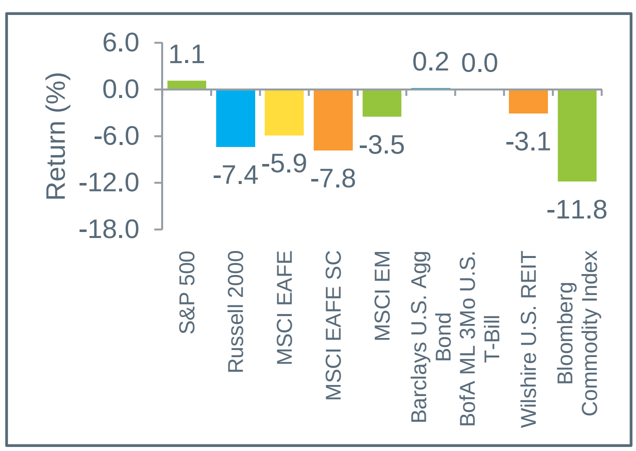
In the U.S., most economic data released during the quarter suggested continued economic expansion at a moderate rate. The IMF increased its 2014 U.S. GDP growth forecast to 2.2% from a prior forecast of 1.7% in July, and is currently projecting 3.1% growth for 2015. Jobs data in the U.S. was also encouraging, with the unemployment rate falling to 5.9% in September on the back of strong non-farm payroll job growth. Thus far in 2014, the U.S. has averaged job growth of 227,000 per month, which is on pace to be the fastest annual job growth rate since 1999. Another key economic indicator, the ISM PMI, continued its upward trajectory and averaged 57.6 during the quarter, indicating an expansion in the manufacturing sector. While investors continue to closely analyze statements from the Fed, many market participants see continued flexibility to maintain low interest rates due to limited wage pressure, coupled with an elevated level of long-term unemployment.

Disappointing economic reports continued to flow out of the Eurozone, as the September PMI reading ended at 50.3, indicating only slight expansion, and CPI growth slowed to 0.3% year-over-year. The Targeted Long-term Refinancing Operation (LTRO) program announced in Q2 began poorly, with banks taking just over half of the initial 150 billion EUR offering. In Q3, the European Central Bank (ECB) announced additional measures to stimulate the economy, the most notable of which was the possibility of an asset-backed securities (ABS) purchase program. In Japan, a devalued Yen and new consumption tax were blamed for weaker than expected industrial and retail sales. On the mainland, pro-democracy protesters in Hong Kong rattled Chinese markets. Meanwhile, Russia responded to economic sanctions with import bans, while also enacting a 50 point interest rate increase in an effort to stabilize the currency and stem capital flight.

TRAILING PERIOD MARKET PERFORMANCE (%)

	QTD	CYTD	1 Year	5 Years	10 Years
S&P 500	1.1	8.3	19.7	15.7	8.1
Russell 2000	-7.4	-4.4	3.9	14.3	8.2
MSCI EAFE	-5.9	-1.4	4.3	6.6	6.3
MSCI EAFE SC	-7.8	-2.7	3.0	8.9	8.1
MSCI EM	-3.5	2.4	4.3	4.4	10.7
Barclays U.S. Agg Bond	0.2	4.1	4.0	4.1	4.6
BofA ML 3Mo U.S. T-Bill	0.0	0.0	0.0	0.1	1.6
Wilshire U.S. REIT	-3.1	14.5	13.5	16.0	8.3
Bloomberg Commodity Index	-11.8	-5.6	-6.6	-1.4	-1.0

QUARTER-TO-DATE PERFORMANCE (%)



KEY ECONOMIC INDICATORS

		As of	6/30/2014	3/31/2014	10 Year Average
Federal Funds Rate	0.07%	9/30/2014	0.09%	0.06%	2.08%
Treasury - 1 Year	0.10%	9/30/2014	0.10%	0.11%	0.63%
Treasury - 10 Year	2.49%	9/30/2014	2.53%	2.72%	4.05%
Treasury - 30 Year	3.20%	9/30/2014	3.36%	3.56%	4.69%
Breakeven Inflation - 1 Year	-0.19%	9/30/2014	1.46%	1.79%	1.09%
Breakeven Inflation - 10 Year	1.97%	9/30/2014	2.24%	2.14%	2.11%
Breakeven Inflation - 30 Year	2.11%	9/30/2014	2.35%	2.28%	2.45%
Barclays US Corp: Hi Yld Index - OAS	4.24%	9/30/2014	3.37%	3.58%	6.00%
Capacity Utilization	78.80%	8/31/2014	79.10%	79.10%	76.50%
Unemployment Rate	5.90%	9/30/2014	6.10%	6.70%	6.40%
ISM PMI - Manufacturing	56.60%	9/30/2014	55.30%	53.70%	52.10%
Baltic Dry Index - Shipping	1,063	9/30/2014	850	1,362	3,487
Consumer Confidence (Conf. Board)	86.00	9/30/2014	86.40	83.86	81.93
CPI YoY (Headline)	1.70%	8/31/2014	2.10%	1.50%	2.40%
PPI YoY - Producer Prices	2.30%	8/31/2014	2.70%	1.80%	2.90%
US Dollar Total Weighted Index	$81	9/30/2014	$76	$77	$84
WTI Crude Oil per Barrel	$91	9/30/2014	$105	$102	$60
Gold Spot per Ounce	$1,208	9/30/2014	$1,327	$1,284	$687

ASSET CLASS COMMENTARY

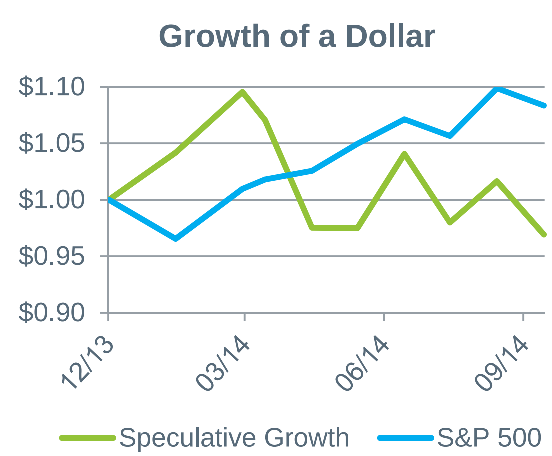
U.S. Equity

After a pullback in September, the U.S. stock market ended the third quarter relatively flat, with the bifurcation between large and small cap stocks continuing to widen. Investor risk appetite remains low due to geopolitical concerns and looming interest rate increases; however, consumer spending and M&A activity supported U.S. equity returns.

The spread between the Russell Top 200 Index and the Russell 2000 Index was over 900 basis points for the quarter, extending to nearly 1300 basis points year-to-date through September 30th. Volatility in the market has also picked up, benefitting larger cap and higher quality companies. The increase in volatility, coupled with lower correlations, provided a tailwind for active managers. During the quarter, 48% of active large cap managers beat the Russell 1000 and 69% of active small cap core managers outperformed the Russell 2000. Mid cap active managers continued to lag with only 22% of active core managers beating the Russell Midcap Index.

Figure 1 illustrates the current market preference for high quality stocks. U.S. companies with less stable profit generation that have consequently been labeled as speculative growth stocks by Morningstar, on average, underperformed the general market as represented by the S&P 500 Index since March 2014.

Figure 1: Speculative Growth Stock Returns



From a sector perspective the gains in Healthcare and Technology spurred by M&A activity and consumer spending, generally offset the losses in Energy, Utilities and Industrials. These sectors were impacted by the slowing growth in China which depressed commodity prices, while the prospect of interest rates rising faster than expected and the strength of the dollar impacted overseas end-market potential. Growth reclaimed style leadership for the quarter, outperforming value across the market cap spectrum. In general, value stocks appeared more expensive relative to their long-term averages when compared to growth stocks.

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Non-U.S. Equity

Developed international markets experienced a strong downturn during the quarter, which pushed them into negative territory for the year. Generally, small cap stocks and value stocks underperformed their larger and more growth-oriented counterparts. Europe was the worst performing region in the MSCI EAFE Index. Second quarter GDP numbers showed Italy falling back toward a recession; consequently it was one of the worst performing countries in Europe. Overall, inflation for Europe was below target and the ECB responded by lowering deposit rates and pledging to increase ABS purchases.

Japan outperformed on a relative basis compared to other international markets, but performed poorly on an absolute basis. Household consumption fell precipitously in Japan due to an increase in the consumption tax, which led to a second quarter GDP drop of nearly 7%.

Emerging markets fared better than developed international markets, but still generated negative returns. Brazil saw a turbulent market due to the upcoming presidential elections. As the incumbent, Dilma Rousseff, rose in the polls, the market declined due to her reputation of being less business friendly. China posted slightly positive returns for the quarter despite reduced growth expectations reported by analysts. One major concern highlighted by analysts is that the property sector makes up 13% of Chinese GDP, but could represent as much as half of the collateral for all Chinese bank loans.

Fixed Income

Strong performance in August offset an otherwise poor quarter for U.S. fixed income. The Barclays U.S. Aggregate Index slightly increased in the third quarter with a return of 0.2% bringing the year-to-date return to 4.1%. Yields on T-bills and long-term Treasury securities declined for the quarter while 1-year to 7-year yields increased. Accordingly, the U.S. Long Treasury Index has continued its run of strong performance ending the quarter up 2.7% and 15.1% for the year. U.S. government bonds outpaced corporate bonds for the quarter.

The Utilities sector continues to drive returns for corporate fixed income. High yield underperformed investment grade credit as corporate yield spreads rose during the quarter. Bank loans slightly declined, but outperformed high yield bonds due to the general rise in yields over the quarter. MBS and ABS finished the quarter with modest gains while CMBS finished with slight losses.

The strengthening of the U.S. Dollar contributed to the poor performance of global fixed income. The Barclays Global Aggregate Index returned -3.1% for the quarter. Additionally, the strengthening of the U.S. Dollar continued to increase the significant performance disparity of hard currency emerging market debt above local currency offerings.

Hedge Funds

Based on early estimates, most hedge funds were flat to slightly negative in the third quarter. However, dispersion was high across managers and strategies due to a lack of broad performance trends. The quarter opened on a weak note, with July hedge fund returns down roughly 1% amid an equity market selloff with pronounced weakness in small cap stocks. Many hedge funds recovered those losses in August, as small caps led an equity market rally that benefitted many long-biased long/short equity funds. The positive results proved fleeting as the trend reversed in September amid broad-based weakness across asset classes, fueling negative results for long/short equity managers.

A notable development in the quarter was the improved performance of macro strategies, and systematic macro strategies in particular. While the majority of global asset classes lost value towards quarter-end, systematic macro strategies delivered strong returns in September due to currency and commodity positions.

Credit hedge funds, in contrast to their strong results during the first six months of 2014, were generally flat to modestly negative in Q3, as credit spreads widened and lower-quality bonds sold off. Taking the quarter's performance into account, multi-strategy hedge funds with high RVK client exposure have posted year-to-date returns in the range of up 2% to 4%.

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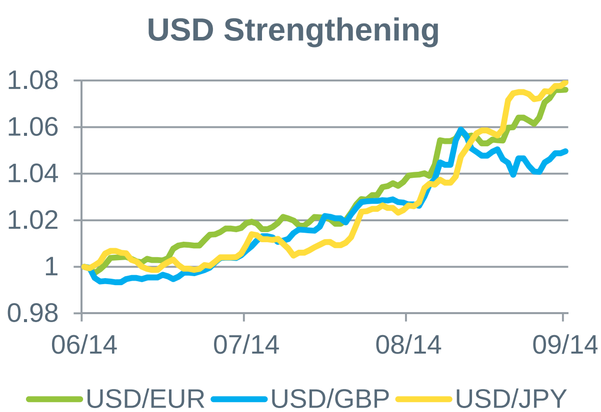
Global Tactical Asset Allocation (GTAA)

GTAA strategies posted negative returns as most risk assets fell during the quarter. Managers that strategically focus more heavily in U.S. markets outperformed on a relative basis, as the U.S. provided one of the few bright spots in an otherwise choppy market. Long duration fixed income assets and large cap equities posted positive returns in the U.S., while small caps and lower quality credit suffered. Managers that focus on longer-term valuations were able to sidestep some of the harder hit areas domestically, such as small cap stocks, but the relative attractiveness of valuations in the Eurozone left these strategies susceptible to the significant drawdowns abroad.

Return dispersion across GTAA managers during Q3 was mainly driven by exposure to non-dollar denominated assets. As markets began to price in the likelihood of U.S. monetary policy tightening, the dollar rallied significantly against most foreign currencies, causing non-dollar assets to lose value on a relative basis. **Figure 2** illustrates this movement of the U.S. Dollar versus other major market currencies.

Figure 2: Increasing Dollar Strength



The dollar hedged Citi Non-US WGBI, returned 2.0% during Q3 with the local currency version returning a dismal -5.4%; the fourth largest spread since the indices were incepted in 1985. Managers that have been adding to cash positions, short duration fixed income, or lower-volatility absolute return oriented strategies preserved capital better than peers. Finally, Risk Parity strategies reversed their positive trend in the first half of the year with negative returns in line with a global 60/40 portfolio.

Diversified Inflation Strategies (Real Return)

Diversified Inflation Strategies (DIS) experienced a difficult third quarter, erasing much of the gains realized in the first half of the year. Market implied inflation expectations fell dramatically at the shorter end of the curve. The 1-year breakeven rate, which ended the second quarter at 1.5%, fell to -0.2% during the third quarter, and core CPI declined to 1.7% over the same period.

Given the market environment, assets typically most sensitive to changes in inflation, commodities and natural resource equities, were the worst performers. Indeed, returns for these two asset classes are now negative in 2014 after posting solid returns through June. TIPS, REITs, and floating rate debt markets fared better, but were also negative. As a result, managers who maintain strategic allocations to these assets outperformed peers on a relative basis. MLPs were the only real asset to yield positive performance during Q3, but most DIS managers lack MLP exposure given the low inflation sensitivity of the asset class. Longer-term, the outlook for inflation remains subdued with recent 10-year breakeven rates implying inflation just under 2%.

Real Estate

Core U.S. Real Estate continued to experience strong returns, as evidenced by the 3.2% preliminary return of the NCREIF-ODCE index during Q3. Trailing one-year return for the index was 12.4% as of September 30th. Publicly-traded real estate took a step back during the third quarter as demonstrated by the -2.6% return in the FTSE NAREIT All REITs Index.

The U.S. commercial real estate market improved broadly during the third quarter, with the most notable boon in the office sector following a decline in the vacancy rate from the previous quarter. The retail sector availability rate fell to 11.5% during the quarter. The industrial sector saw a decline in its availability rate for the 17th consecutive quarter. Rental rates in the multifamily sector are up 3.3% on a year-over-year basis. Private real estate fundraising remained strong with 28 funds closing representing $17 billion in aggregate capital raised in Q3, with a majority of the capital flowing to European-focused funds.

Data Sources: Bloomberg, Morningstar Direct, www.REIS.com, www.ncreif.org.