

Investment Outlook Report

Have you ever found yourself getting dizzy after trying to read on a moving bus? That's one of the side effects of motion sickness, and it happens when we get competing signals from different parts of our bodies. Our inner ear feels a lot of back-and-forth motion from the moving bus, but our eyes are steadily fixed on a non-moving page in a book or on our phone screens.

That dizzy feeling is never a pleasant one but fortunately, we have a good remedy to turn to when it happens: We take our eyes off the page or screen and look out at the horizon. That way, our eyes get the same signal as our inner ears, and our body can adjust.

Investors may find themselves feeling their own market-induced "motion sickness" lately. Volatility returned to markets in a big way in August and September, with some of the largest day-to-day moves for stocks we have seen in a while. At the same time, however, the U.S. economy has continued on a stable path: GDP has grown 2.7% over 12 months, unemployment is down to just 5.1% and the housing market has continued to stabilize (Source: Bloomberg).

Market Swings in Perspective

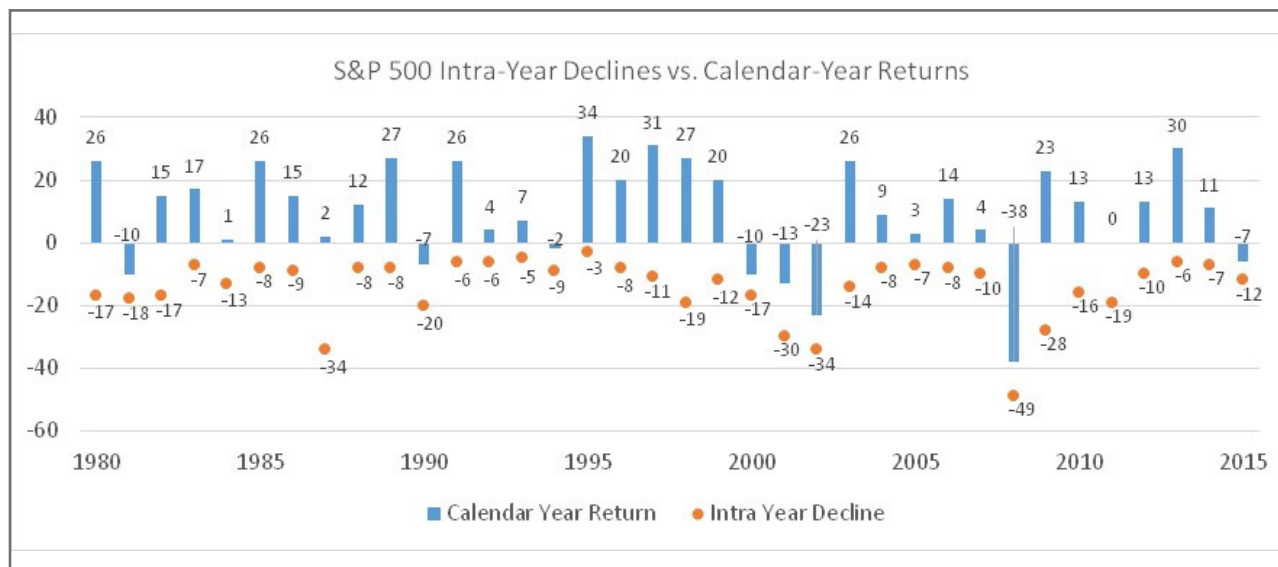
The dizziness investors feel in response to all this is completely understandable. We feel as if we're getting very diverse signals coming from the markets compared to our economy. However, it's worth asking: How unusual are the market movements from August and September and how do they fit into a bigger context?

Stock investors are prepared to experience some level of volatility every year, because it is the nature of markets to move up and down over the short-term. The chart below plots the experience of investors in the S&P 500 year by year. On average since 1980, the market has experienced a decline of 14% from a year's high-water mark to that same year's lowest value. In more than two out of three years, those declines have more than fully recovered by the end of the year, with the average yearly gain being over 9% in spite of any intra-year declines.

A significantly larger than average intra-year decline is not a recipe for a loss in a single year, with many examples pointing the way. In particular, two examples stand out: A 34% decline in 1987 occurred in a year that actually closed up 2% overall, and a 28% drop in 2009--driven by recessionary fears--ended in a full recovery and then some. That year, the market closed up 23%.

Investors feel dizzy from the recent market swings because we have gone for several years in a row without a large stock market decline. Before 2015, the last decline of 10% or more was in the summer of 2011. That is an uncharacteristically long stretch. This was an easy year for volatility to return. Investors are coming to terms with fears about a slowdown in China, slow earnings growth this year in the United States and falling oil prices taking a bite out of energy company profits quickly but being slow to benefit consumers.

Putting this year's 12% decline in context, though, it is actually very much in line with a typical year. It's a level of volatility that, while we do not want to experience it and find it uncomfortable when it happens, is completely in the range of normal.



Source: Bloomberg

Asset Class Return Cycles

The year 2015 has seen more than just a return of volatility: It has also seen a return of performance diversification, with different asset classes posting very different returns through the end of September. Small companies in foreign developed markets posted a modest gain in response to economies that have largely averted major recessions and are now returning to growths in profitability from cheaper currencies. Meanwhile, energy pipelines (labeled “Infrastructure” in the table below) have struggled due to volatility in energy prices.

The table below stresses several important qualities in a good portfolio. The first is diversification. In any given year, you can see that an asset class can have outsize returns or significant losses, deviating a lot from the other investment options. However, a well-diversified portfolio that represents a prudent long-term mix of asset classes plots a line through the middle of the different possibilities and avoids being an outlier.

The table on the following page also stresses that asset-class returns year by year have very little association with prior years. An asset class like Frontier Markets can exceed all expectations and post a 71.7% return in 2005, only to become the lowest performer in 2006, with a 9.9% loss (Source: Bloomberg).

Sometimes the asset classes that make up a diversified portfolio can enter longer periods of strong or weak performance. Large-cap U.S. stocks have had a stronger run since 2011, but they struggled from 2005 to 2010. Over that same period, a diversified investor could have tempered the low returns that U.S.-focused investors experienced by allocating more of their portfolio to Emerging Markets, which posted very strong gains over that period.

It’s important to maintain a long-term perspective on the different asset classes. Infrastructure and Emerging Markets have experienced lower returns in 2015, but that has not stopped them from having the two highest annualized returns since 2000. Also, in the table below you may note that in each of the past five years, a simple portfolio of just large-cap U.S. companies posted a higher return than a more diversified portfolio. Even accounting for those five years, though, diversification has worked over the long term. Since 2000, the Hypothetical Diversified Portfolio (the “Diversified Portfolio”)* has still outperformed the S&P 500 by 1% per year.

Annual Asset Class Total Returns through 9/30/15

2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	YTD 2015	Annualized Starting 2000
Frontier Markets 71.7%	Real Estate 32.3%	Frontier Markets 41.1%	Hedging Strategies (19.6%)	Emerging Markets 77.6%	Infrastructure 34.9%	Infrastructure 13.0%	Int'l Small Cap 19.0%	US Small Cap 37.8%	Real Estate 27.0%	Int'l Small Cap 1.9%	Infrastructure 10.2%
Emerging Markets 32.4%	Emerging Markets 31.2%	Emerging Markets 38.5%	US Small Cap (34.8%)	Infrastructure 75.5%	Real Estate 26.9%	Real Estate 7.3%	Real Estate 18.7%	US Large Cap 31.4%	US Large Cap 12.6%	Hedging Strategies (2.8%)	Emerging Markets 7.3%
Int'l Small Cap 26.0%	Int'l Large Cap 26.0%	Infrastructure 11.7%	Commodities (37.6%)	Int'l Small Cap 46.4%	US Small Cap 25.9%	US Large Cap 1.1%	Emerging Markets 17.02%	Int'l Small Cap 28.8%	Frontier Markets 5.6%	Real Estate (5.5%)	Int'l Small Cap 7.2%
Commodities 16.5%	Infrastructure 24.8%	Int'l Large Cap 10.8%	Infrastructure (37.8%)	Diversified Portfolio 34.6%	Int'l Small Cap 21.6%	Hedging Strategies (0.2%)	Int'l Large Cap 16.3%	Infrastructure 26.6%	Diversified Portfolio 4.7%	Int'l Large Cap (5.8%)	Real Estate 6.8%
Int'l Large Cap 13.1%	Int'l Small Cap 19.3%	Commodities 10.1%	US Large Cap (38.0%)	Int'l Large Cap 31.4%	Frontier Markets 21.1%	US Small Cap (5.2%)	US Small Cap 15.4%	Frontier Markets 24.9%	US Small Cap 3.9%	US Large Cap (6.3%)	US Small Cap 5.7%
Diversified Portfolio 12.4%	Diversified Portfolio 18.8%	Diversified Portfolio 8.3%	Real Estate (38.4%)	Real Estate 27.3%	Emerging Markets 18.0%	Diversified Portfolio (5.3%)	US Large Cap 15.0%	Int'l Large Cap 22.6%	Infrastructure 3.7%	Diversified Portfolio (8.4%)	Diversified Portfolio 4.3%
Hedging Strategies 10.3%	US Small Cap 17.4%	US Large Cap 4.5%	Diversified Portfolio (40.4%)	US Small Cap 26.2%	Diversified Portfolio 16.6%	Int'l Large Cap (12.7%)	Diversified Portfolio 14.2%	Diversified Portfolio 21.4%	Hedging Strategies 0.7%	US Small Cap (8.7%)	Frontier Markets 3.8%
Real Estate 5.7%	US Large Cap 14.8%	Hedging Strategies 4.1%	Int'l Large Cap (44.1%)	US Large Cap 25.5%	Commodities 15.7%	Commodities (14.4%)	Frontier Markets 7.5%	Hedging Strategies 6.8%	Emerging Markets (2.9%)	Frontier Markets (14.6%)	US Large Cap 3.3%
Infrastructure 5.3%	Hedging Strategies 8.7%	Int'l Small Cap 1.3%	Int'l Small Cap (47.7%)	Commodities 17.7%	US Large Cap 14.1%	Int'l Small Cap (16.6%)	Infrastructure 3.8%	Real Estate 1.9%	Int'l Large Cap (5.3%)	Emerging Markets (16.3%)	Hedging Strategies 2.8%
US Large Cap 3.9%	Commodities (3.7%)	US Small Cap (2.6%)	Emerging Markets (54.5%)	Frontier Markets 10.7%	Int'l Large Cap 7.4%	Emerging Markets (19.4%)	Hedging Strategies 3.5%	Emerging Markets (3.3%)	Int'l Small Cap (5.5%)	Commodities (16.8%)	Int'l Large Cap 2.7%
US Small Cap 3.6%	Frontier Markets (9.9%)	Real Estate (16.2%)	Frontier Markets (55.1%)	Hedging Strategies 6.5%	Hedging Strategies 0.9%	Frontier Markets (19.6%)	Commodities (2.1%)	Commodities (10.5%)	Commodities (18.0%)	Infrastructure (31.7%)	Commodities (2.7%)

The Diversified Portfolio shown is a hypothetical portfolio. It is not an actual portfolio and is not intended to show the return that any RegentAtlantic client achieved or could have achieved. It is intended to show the potential benefits of a diversified portfolio over investing in a single asset class. Diversified Portfolio returns show the total returns of a portfolio composed of the following proportions of asset classes - 36% US Large Cap, 12% Int'l Large cap, 10% US Small Cap, 8% Int'l Small Cap, 12% Emerging Markets, 2% Frontier Markets, 6% Real Estate, 4% Commodities, 6% Hedging Strategies, 4% Infrastructure. All figures shown are net of 1% management fee, and include total returns, with dividends and interest reinvested.

What Investors Can Do About Market Volatility

A return of volatility after four years without a big decline may worry investors and be cause for concern. However, investors can do a lot to help to position themselves to come out ahead during a volatile market. RegentAtlantic has responded to the market activity in a number of ways. The most visible way is through rebalancing. We regularly review the portfolios we manage and place trades when appropriate, and in particular when asset classes stray from their target weights.

One of the keys to success in investing is to buy low and sell high, but that seemingly simple strategy is very hard to execute. Buying low often means buying something significantly out of favor in the markets. A consistent rebalancing discipline helps take the emotion out of the decision, and helps investors trim asset classes that may be getting ahead of themselves, while investing in parts of the market that offer better relative values. The chart above illustrates why this may work. It's very rare for an asset class to stay near the top or near the bottom of the market for an extended period, so a disciplined process to trim the winners and reallocate can be helpful.

More important, market swings create opportunities for thoughtful financial planning. Many financial-planning tactics that may bear fruit over the long term can be executed after a market decline. For example, a Roth IRA conversion could make sense during a down market. This strategy converts a tax-deferred IRA investment into a tax-exempt Roth IRA, potentially saving significant taxes over the long term. It could be particularly opportune after a market decline due to lower current values and better potential returns in the future.

Another strategy to consider at this time is a Grantor Retained Annuity Trust (GRAT). GRATs are estate-planning tools that can help investors transfer assets out of their estate--free of estate and gift tax. Please contact your Wealth Advisor today if you're wondering about the benefits of any of these strategies.

To recap, it's clear that recent market turbulence has investors feeling dizzy. However, the positive news is that there's a remedy to their woes. Just as bus riders can ease their motion sickness by looking out and focusing on the horizon, investors can reduce the dizziness they feel from recent market swings by taking a longer-term perspective. By doing so, they may find that the volatility of August and September, while not pleasant, is in line with historical norms. Investors will also find that a prudent approach to diversify their portfolios across many asset classes helps temper the potential for extreme outcomes and can add great financial value over time. Finally, investors may find that a market dip actually may be an ideal time to plan for the future and embark on valuable financial-planning strategies that could benefit from a future rebound.



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Important Disclosure Information

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The index returns shown above show the total return for various investment indices and include the impact of the reinvestment of dividends. A comparison to indices may not be a meaningful comparison. Comparisons to benchmarks have limitations because benchmarks have volatility and other material characteristics that may differ from the performance of a client's portfolio. The investments in a client's portfolio may differ substantially from the securities that comprise each index and are not intended to track the returns of any index. One cannot invest directly in an index, nor is any index representative of any client's portfolio. Actual client accounts will hold different securities than the ones included in each index. The index returns are gross of applicable account transaction, custodial, and but net of a 1% investment management fees. The actual investment results would be reduced by such fees and any other expenses incurred as an investor. Please below for definitions of the indexes used.

Indexes Shown

US Large Cap – S&P 500 Index - The S&P 500 is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe. Each constituent in an index is weighted by its market-capitalization, as determined by multiplying its price by the number of shares outstanding after float adjustment. The price return of an index is a measure of the cap-weighted price movement of each constituent within the index.

Int'l Large Cap – MSCI EAFE Index - The MSCI Europe, Australia and Far East (EAFE) Index is a free float-adjusted market capitalization weighted that is designed to measure equity market performance in foreign developed markets. The index represents about 85% of the market capitalization of developed markets outside of North America.

US Small Cap – Russell 2000 Index - An index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

Int'l Small Cap – MSCI EAFE Small Cap Index - The MSCI EAFE Small Cap Index Fund targets 40% of the eligible small cap universe in each industry group of each country represented by the MSCI EAFE Index. MSCI defines the small cap universe as all listed securities that have a market capitalization in the range of \$200 - \$1500 million USD. In addition to this capitalization range, MSCI uses a specialized framework of foreign inclusion factors to adjust the market capitalization of securities for free float available to foreign investors.

Emerging Markets – MSCI EM Index - The MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance in the global emerging markets. The MSCI Emerging Markets Index consists of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Frontier Markets – MSCI FM Index - The MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of the following 25 frontier market country indices: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Qatar, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, United Arab Emirates, and Vietnam

Real Estate – FTSE NAREIT Index - FTSE NAREIT All REITs Index represents the full universe of publically traded REITs, including those companies that do not meet minimum size rule, liquidity criteria or free float adjustments. Stocks are free-float weighted to ensure that only the investable opportunity set is included within the index.

Commodities – Dow Jones UBS Index - The Dow Jones-UBS Commodity IndexSM (DJ-UBSCISM) is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The DJ-UBSCISM is composed of futures contracts on physical commodities. The index is designed to minimize concentration in any one commodity or sector. It currently includes 19 commodity futures in five groups. No one commodity can comprise less than 2% or more than 15% of the index, and no group can represent more than 33% of the index (as of the annual reweightings of the components).

Hedging Strategies – Bloomberg OE Market Neutral Index - Bloomberg's Active Indices for Funds (BAIF) are used to measure a fund's performance against its peers. BAIF Indices represent a composite of funds in the same peer group. This index represents open-end, market neutral equity funds domiciled in the United States.

Infrastructure – Alerian MLP Index - The Alerian MLP Index ("Index") is a market-cap weighted, float-adjusted index created to provide a comprehensive benchmark for investors to track the performance of the energy MLP sector. It is a composite of the 50 most prominent energy master limited partnerships calculated by Standard & Poor's using a float-adjusted market capitalization methodology. The Index components are selected by Alerian Capital Management, LLC.