GRESHAM

2015 Mid-Year Update

Roller Coasters

Earlier this year in our 2015 Annual Outlook, we observed that the previously synchronized global economy was now becoming increasingly divergent, driven by the changing policy outlook for a few central banks around the world, particularly the U.S. That observation is proving true. In this desynchronized world, we expect to see more volatile markets and more frequent market disruptions that lead to meaningful investment opportunities.

Importantly, the strong investment returns of the last several years, driven largely by one-way markets, appear to be giving way to volatility and episodic opportunities that require a more flexible investment approach to capture strong returns in the future. The capital markets roller coaster has been in a straight-up phase since the global financial crisis. But that phase is ending and investors now need to be prepared to take advantage of the peaks and valleys ahead.

Summary

Modest world equity market returns do not adequately convey the recent volatility investors have experienced. This was highlighted by Greece's third major rescue and restructuring over the last six years and the roller coaster ride of the Chinese stock market, which declined over 30% in less than a month. Given these significant events, this Mid-Year Update provides our views on China and Greece. We also discuss observations from our recent trip to Brazil and the opportunities that may (or may not) exist there in response to a growing recession, government scandals and a significant currency devaluation.

In the U.S., economic growth dipped in the first half of the year due to several temporary factors that are likely to dissipate in the back half of the year. The U.S. is likely to remain the strongest economy in the developed world. Nonetheless, we expect economic growth to remain muted, as consumer spending remains somewhat restrained despite the benefits of lower energy prices and the end of structural deleveraging. As a result, the Federal Reserve may choose to slow the pace of its planned rate increases, although it recently reaffirmed its commitment to begin raising rates before the end of the year.

In Europe, after remaining mired in stagnation for multiple quarters, economic growth has started showing positive signs due to the currency-debasing and liquidity enhancing effects of aggressive European Central Bank policy measures and lower oil prices. Longer-term, structural reforms are needed to sustain any significant measure of growth and avoid further imbalances within and strain on the European Union. Greece may not be the outlier most observers currently perceive it to be, but is rather the proverbial canary in the coal mine for further problems absent significant structural reforms.

Emerging market investments remain a focus. But, as we have cautioned clients, these markets remain volatile and subject to disruption. Many investors tend to generalize emerging markets, treating them as a homogeneous, monolithic group. However, as we discussed in our Annual Outlook, naively grouping these countries and markets together can be a misleading lens for viewing opportunities and risks. The recent volatility in Chinese markets illustrates this challenge.

These differences and divergences also highlight one of our important investment principles, which is to have a local perspective when investing in markets beyond the U.S. For example, over the last nine months, Chinese market volatility was driven more by government policy than by investment fundamentals. Many of our local Chinese managers fared relatively well given their understanding and appreciation of local dynamics. As we have experienced over the last few years, investment opportunities remain prevalent in these markets. However, local knowledge and a long-term perspective are crucial to successfully navigate events that may seem unusual from a Western perspective.

Capital market valuations remain elevated across most markets and appear to be creating headwinds to easy investment gains. The Federal Reserve's commitment to begin raising rates in the near future will create an additional headwind for markets. In response, we explore the question of U.S. equity market valuations in greater detail in this Mid-Year Update.

Despite recent volatility, our secular investment themes remain largely unchanged. We recommend clients and investors implement the following themes in their portfolio:

- Fixed income allocations should remain at zero or near the low-end of an appropriate range for a given investor. While we think the risk of a rapid rise in interest rates remains low, current yields provide an uninspiring risk/reward proposition for investors.

- U.S. equity market valuations remain above their historic averages. While the U.S. market likely deserves a premium relative to other developed and emerging markets, other markets appear to be relatively more attractively valued.

- In developed equity markets, we are moving into a stock-pickers environment in which simple exposure to equity markets will likely yield less positive results than during the five-year bull market we have experienced since the global financial crisis.

We advocate eliminating traditional benchmark-centric, inflexible equity strategies in favor of more concentrated global stockpickers to navigate through periods of volatility and market declines that could be significant.

- We continue to emphasize emerging equity markets, taking advantage of more flexible active managers who can effectively exploit the meaningful inefficiencies that exist in these markets. Investors must take a long-term view of these markets to ride through their inevitable volatility and capture the opportunities they offer. The recent Chinese A-share market declines, after nearly three calendar quarters of strong gains, illustrate this well.

- Private equity remains a powerful driver of long term returns, as our long standing clients with exposure have witnessed over the last few years. We have concerns about valuations in the most competitive areas of the private equity market. Relatedly, venture capital valuations appear high by historical standards, but some have argued that structural changes in the market that are allowing companies to remain private longer justify these values. Smaller, more nimble, experienced managers will continue to do well and select managers will continue to develop unique franchises and drive investment returns.

Capital Markets in Review

Most markets felt the weight of high valuations and uncertainty during the first half of 2015, which dampened returns as shown in Chart 1. The U.S. markets, after increasing nearly 14% in 2014 and 17% per year over the last five years, fought to squeeze out a modest 1.2% gain. Now, in the middle of August, even this modest gain has nearly disappeared. The healthcare sector continues to be the best performing sector, increasing 9.6% in the first half and over 23% annually over the last five years.

International developed markets performed modestly better, increasing 4%. Without the effect of declining currency included, these markets in local currency terms increased a healthy 7.5%. Emerging markets performed slightly better than U.S. markets, and actually increased nearly 6% in local currency terms. Unfortunately, like U.S. markets, emerging markets gave back much of their year-to-date gains as we progressed through July. Chinese markets have been the most interesting story over the last few quarters, increasing over 125% since October of last year before declining over 30% in just several weeks since the middle of June. We discuss our views on this market volatility, the policies that contributed to

Chart 1. Returns Table

		Performance			Valuations	
			Annualized		Forward P/E	
Market	Index	1st Half 2015	3 Year	5 Year	June 2015	Dec. 2014
US Equity	S&P 500	1.2%	17.3%	17.3%	16.9x	16.2x
International Equity	MSCI AC World ex U.S.	4.0%	9.4%	7.8%	14.2x	13.2x
Emerging Market Equity	MSCI Emerging Markets	3.0%	3.7%	3.7%	11.8x	10.6x
					Spreads vs. Treasuries	
10-Year Treasury	Citi Treasury Benchmark 10-Year	-0.5%	0.8%	4.1%	-	-
Municipal Bonds	Barclays Mgd Money Short/Int	0.4%	1.9%	3.2%	67bps	72bps
U.S. HY Bonds	Barclays High Yield Corporate Bond	-0.4%	6.8%	8.6%	490bps	477bps
Emerging Market Bonds	JP Morgan Emerging Market Bond	-1.6%	3.4%	6.5%	344bps	318bps
Hedge Funds	HFRI Fund Weighted	2.3%	6.4%	5.1%		
Conservative Hedge Funds	HFRI FOF Conservative	2.7%	5.5%	3.7%		
Commodities	Bloomberg Commodity Index	-23.7%	-8.8%	-3.9%		
Gold	Spot Price of Gold	-11.7%	-9.8%	-2.0%		

Source: Bloomberg, MSCI, JP Morgan

it and its future possibilities in a dedicated section later.

Fixed income markets, as expected given their lofty valuations, continued to perform below their historic averages. U.S. Treasury markets, particularly longer maturity bonds, declined as investors become more concerned about a Fed tightening later this year. International sovereign bonds, such as German bunds, also declined. The most apparent rationale for these losses is a partial return to sanity, as some of these bonds had been trading at negative yields. Municipal bonds were relatively flat as well.

Global Economy

Global economic growth remains muted, as large portions of the world continue to deleverage from the debt-fueled economic growth and market rally that led to the global financial crisis. As a result, a persistent shortfall in aggregate demand continues to be the defining feature of this anemic economic recovery.

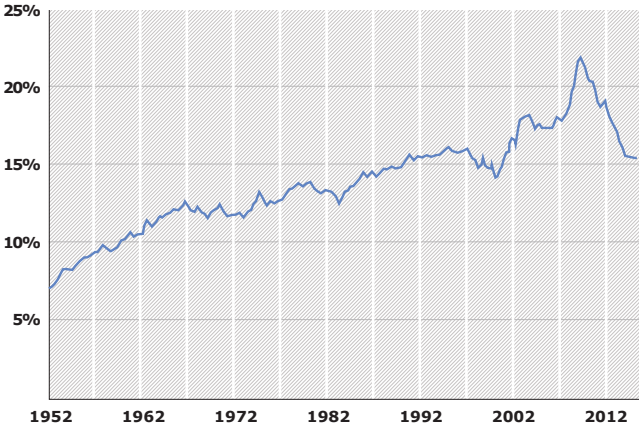
U.S. Economy

During the second quarter, the U.S. economy, which along with China had been a relative bright-spot in the global economy, grew at a modest annualized rate of 2.3%. On a positive note, consumer spending, which is critical to U.S. GDP growth, may be showing signs of revitalization as it increased a healthy 2.9% during the quarter. The U.S. will remain among the strongest developed economies in the world over the next few years, particularly if consumer spending continues to grow supported by improving employment and disposable income.

Further, the U.S. will benefit from a few structural tailwinds that will continue to support GDP growth. First, oil prices are likely to remain low for some time, which should contribute to increased consumer spending over the next few years. Second, the U.S. appears near to ending the structural deleveraging that has dampened economic growth over the last six years, as shown in Chart 2. When combined with the recovery of the U.S. banking system, which is significantly further along in the U.S. than in most other countries, these tailwinds should provide a relatively solid foundation for the U.S. economy.

Chart 2. Consumer Deleveraging Nearing an End

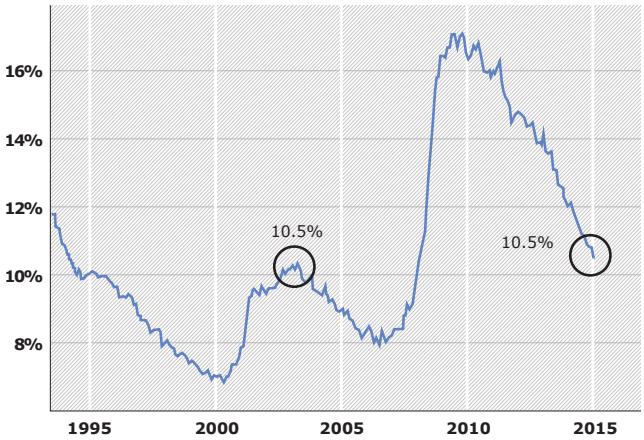
(Household Liabilities, % of Total Assets)



Source: Federal Reserve

Chart 3. Unemployment Still High When Underemployed are Included

(U-6 Unemployment Rate)

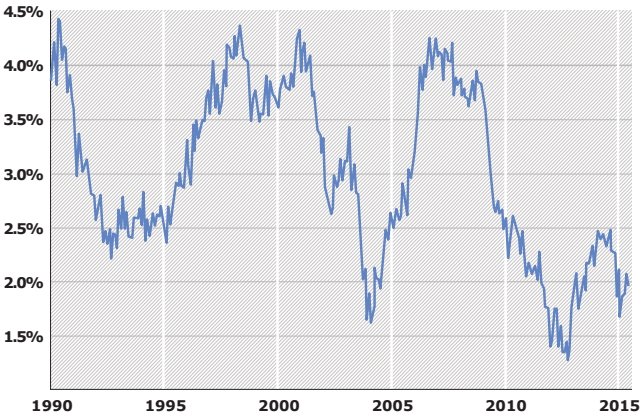


Source: BCA Research

The U.S. is a consumption-driven economy and growth will remain subdued until employment and wages pick-up. While the official unemployment rate is approaching what the government has historically considered "full employment," the true employment picture is significantly worse. Chart 3 shows the U6 unemployment rate, which includes workers who are working part time not by their choice and those who are discouraged and have stopped looking, but still want to work. This is a better measure of productive workers still not fully employed. As a result, average hourly earnings have yet to increase significantly, as shown in Chart 4. The good news for the U.S. economy is that we are starting to see some improvement in

Chart 4. Wage Growth Still Low Despite Increased Hiring

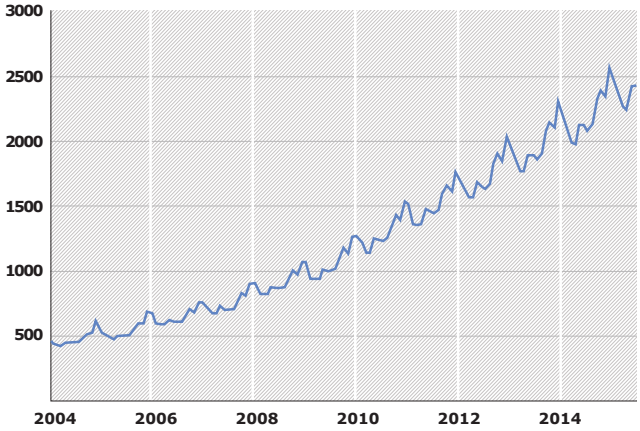
(Avg. Hourly Earnings of Productions and Nonsupervisory Employees: Total Private, YOY Change)



Source: U.S. Bureau of Labor Statistics. St. Louis Federal Reserve

Chart 5. Chinese Consumers Still Spending

(China Retail Sale, Billions CNY)



Source: Bloomberg

these measures, which should lead to stronger wage growth and consumption.

International Economies

Chinese growth remains strong despite the challenges of shifting to a more consumption-driven economy. Based on our recent meetings with local managers who manage assets for our clients, stories portending the imminent implosion of the Chinese economy make good headlines, but appear to be greatly exaggerated. While down from earlier levels, reported year-over-year real GDP growth is running at 7% and consumer spending, albeit off a low base, continues to grow strongly as shown in Chart 5.

European growth has been reasonably strong over the first half of the year, at least by their standards. In addition to lower energy prices, much of the improvement can be attributed to effects of the ECB interest rate cut late last year, which caused the euro to decline from $1.40 to a low of $1.05 over the past 15 months. As a result, European economies and European goods have become more competitive globally.

Greece

The most noteworthy event in Europe in 2015 might have been the drama surrounding the addition of a new vocabulary word, "Grexit," referring to the possible Greek exit from the common currency and even the European Union. Regardless of Greece's final settlement details with creditors, the root cause of the problem has yet to be solved and this may evolve into Europe's version of *Groundhog Day,* unless structural reform is enacted.

In the spring of 2010, Greece entered into the largest sovereign restructuring in history, requiring a €110 billion rescue package that supposedly solved Greece's problems. Roughly 18 months later, Greece beat its own record, requiring a €130 billion bailout from creditors. Yet, here we are, just a few years later and Greece is once again in need of a rescue.

Since the inception of the European Union many economists have warned that the creation of a common currency administered by a supranational central bank was a bad idea. The European economies have very little in common, with cultural and language barriers making the free flow of labor across national borders difficult, which inhibits the natural rebalancing of growth within the EU. Additionally, the common currency eliminates the monetary policy and exchange rate flexibility individual countries need to remain globally competitive by devaluing their local currency and effectively managing growth through their local cycles that do not synchronize with other European nations.

The long-term solution for Europe is to either create a full fiscal and monetary union or recognize that the

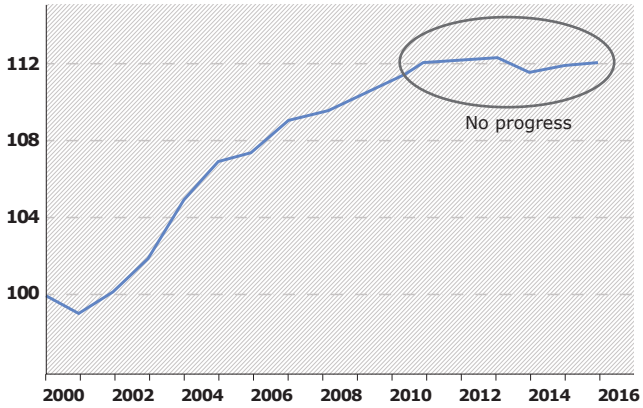
current common currency is nothing more than an impediment to effective management of nation-state economies and disband the euro experiment. The current middle ground will continue to foster imbalances and periodic crises. Without reform, the Greek rescue will likely not be the last in Europe. Many peripheral European countries such as Italy, Spain and Portugal, continue to struggle with high unemployment, high and/or increasing debt burdens, and uncompetitive labor to varying degrees making them susceptible to similar crises as show in Chart 6.

We are not suggesting that another crisis is imminent. On the contrary, in the near term, the opposite is more likely as Europe's recent growth spurt and the bailout discussions for Greece will likely divert the market's attention from the lack of structural reforms and the other potential weak links in Europe… at least for a while.

Chart 6. Italy Unemployment Very High, But Still Uncompetitive to Peers

(Italy Youth Unemployment Rate)

(Italian Labor Costs)



Source: BCA Research

Inflation and Central Bank Policy

The Federal Reserve appears poised to begin raising U.S. interest rates later this year. Indeed, Chairwoman Janet Yellen reaffirmed as much in her recent testimony before the House Financial Services Committee. Further, the Fed indicated some concern about "valuation pressures," particularly in commercial real estate, while also noting that underwriting standards at banks have been "loosening." Chairwoman Yellen's sensitivity, unlike past Chairmen, to increasing valuations and potential bubbles should be comforting to investors in the long-run.

While the commitment to begin normalizing interest rates should the economy continue to progress appears firm, the pace at which normalization occurs will likely be slow. First, inflation appears under control with only modest wage inflation in recent quarters. Additionally, the slow recovery of the U6 unemployment number, due to the high number of underemployed workers, will keep wage growth under control and provide another factor to keep inflation within the Fed's comfort zone.

We agree that the Fed needs to begin normalizing interest rates, but caution is required. Interest rate tightening would likely manifest itself in further appreciation of the dollar, which is already viewed as overvalued by many analysts after the recent 20% increase against other major currencies, as shown in Chart 7. The IMF recently estimated that each 5% appreciation in the dollar could reduce U.S. GDP growth by 0.5%, due to reductions in the overall competitiveness of the U.S. economy and the dampening of its export growth. Normalizing interest rates in the U.S. will be a delicate balancing act.

While the U.S. struggles with the timing and pace of interest rate increases, other central banks around the world are on diverging paths, still in various stages of enhancing or maintaining their accommodative policies. We do not expect that the Fed will be aggressive in its normalization, nor do we expect that other major central banks will reverse course and begin to tighten monetary policy. As a result, we expect global monetary conditions to remain accommodative, despite plans to increase rates in the U.S.

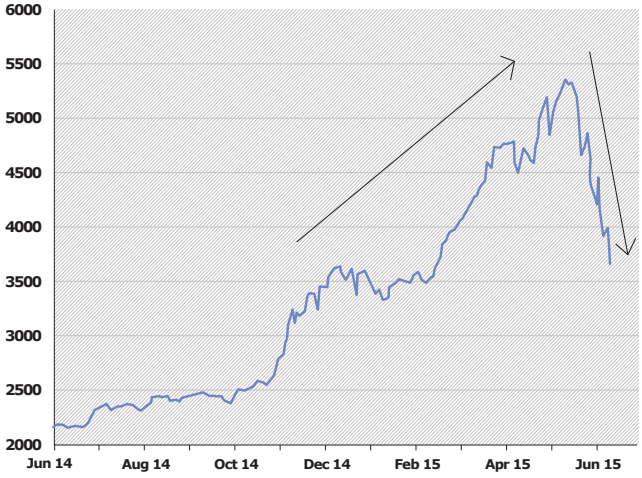
Chart 7. U.S. Dollar Has Been Strong Against Major Trading Partners

(US Dollar Index, DXY)

Source: Bloomberg

Chart 8. Despite Recent Volatility, Chinese Equities Still Performing Well

(CSI 300 Index)



Source: Bloomberg

Chinese Equity Markets

Before a broader discussion of capital market valuations, we want to discuss the extraordinary volatility in Chinese equity markets, which have been on a roller coaster ride over the last year. Between June 30, 2014 and June 12, 2015, the CSI 300 Index, a broad index of A-share stocks listed on the Shanghai and Shenzhen exchanges, increased 150%. In the subsequent four weeks, the index lost over 30%, registering the sharpest decline since the global financial crisis, as shown in Chart 8. To put this in perspective, one analyst estimated this decline wiped out nearly $3 trillion of investor equity or over 10 times the entire GDP of Greece. However, even after the correction, the index was up 75% over the last one-year period.

Many analysts attribute the initial market rise to the Chinese government's commitment to capital reforms, including the globalization of the RMB, the maturation and institutionalization of China's capital markets, and the potential for the related inclusion of Chinese markets in the MSCI equity market indices. Analysts and investment managers in the region have stated that the current administration was also hopeful the market would make it easier for local companies to raise capital, potentially swap debt for equity and even assist in the ongoing process of privatizing many state-owned enterprises. The policy, at least from a market appreciation perspective, was more successful than anticipated, to say the least.

Large portions of the Chinese equity market are not yet included in the major global equity indices and institutional investor portfolios. The lack of currency convertibility keeps most index providers from including domestically-listed Chinese companies, except those listed on the Hong Kong, U.S. or other foreign exchanges. Additionally, less than 40% of A-share listed company stocks freely float on the exchange, with the rest being owned by individuals and the state, as compared to nearly 95% on the NYSE. As a result, China's weight in the MSCI All Country World index is just 2.7%, or less than that of Switzerland.

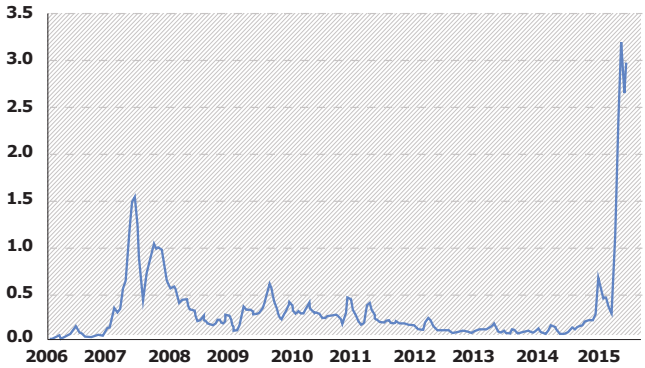
Notably, when most domestically-listed Chinese companies are included in the indices, index funds and benchmark-hugging institutions will be required to purchase these shares, dramatically boosting demand. Initial estimates suggest that this development could triple the ownership of these local companies upon their inclusion in the benchmarks and be far larger over time as the free float is increased.

At the moment, domestic Chinese markets are dominated by retail investors who, as the market began to rise in 2014,

jumped onto the speculative bandwagon at a record pace, far exceeding the frenzy of 2007 as shown in both new account openings and margin balances in Chart 9 and Chart 10. Margin lending rose to over $2 trillion or 20% of total market capitalization. In the U.S., the equivalent percentage is 2% to 3%. Further, the Epoch Times reported on April 26th that 67% of new brokerage account applicants lacked a high-school diploma. This lack of sophisticated investors is one of the key risk factors in this market, but it also creates significant opportunities for astute investors.

Chart 9. Chinese Equity Market Speculation

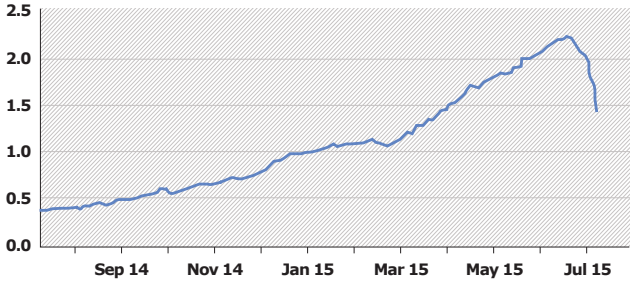
(Weekly New A-share Accounts, 4-Week Average, in Millions)



Source: Bloomberg, UBS, U.S. Global Investors

Chart 10. Another Example of Speculation

(Margin Lending, Trillions Chinese Yuan, 1 Trillion Yen = $161bn)



Source: Wind Information, Wall Street Journal, U.S. Global Investors

Given the strong desire in Beijing for a deep and robust stock market, it shouldn't be surprising to see government intervention to curb obvious excesses. The initial market decline can be partially attributed to the government's restriction on margin lending in April and a large, pending IPO calendar, whose implied additional supply was beginning to weigh heavily on the market. In the first half of 2015, Deloitte estimated that roughly 190 IPOs raised a total of $24 billion. For comparison, during the first half of 2014, which was viewed as a robust IPO market in China, the market absorbed only 52 IPOs that raised $5.7 billion.

After the declines became large enough to potentially cause spillover effects in the broader economy, the Chinese government once again intervened through a series of measures, including lowering interest rates, halting trading in numerous companies, direct intervention by a state investment fund and the country' largest brokerage firms, and temporarily halting new IPOs. This intervention was initially successful in halting the decline and sparking an 18% rally. Some of these rebound gains have since evaporated and the market remains unsettled.

Longer-term, we think this correction is helpful from a valuation perspective and the thinning out of risk-taking speculators with bloated margin balances. One of our managers, who has significant holdings in China and actually was able to produce positive returns[1] during the difficult months of June and July. Another manager reminded us that it's the unsophisticated buying and selling of the retail investor that leads to good investment opportunities; eventually, fundamentals will win out.

What is now clear to investors, even if it wasn't as recently as two months ago, is that the Chinese equity markets have a long way to go on the path to institutionalization. Investment opportunities exist, but to withstand the volatility of these markets they should be reserved for long-term investors with conviction in the underlying fundamentals of the companies in which they invest. Gresham's investments weathered this period well[1], and we continue to see the long-term opportunity in China in both the public and private markets.

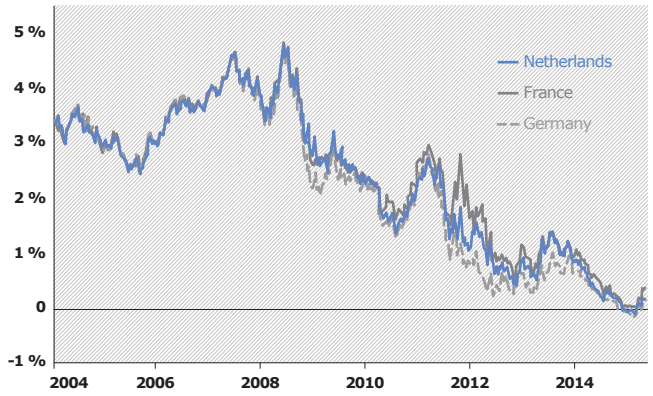
Capital Markets and Valuations

As we discussed in our Annual Outlook, diverging economies and central bank policies were likely to provide both more volatility and investment opportunity. We certainly witnessed both of those in the first half

of 2015. With markets feeling the weight of elevated valuations and as the U.S. central bank prepares to begin normalizing interest rates, the questions of valuations, market resiliency and longterm expected returns are taking center stage.

Chart 11. European Funding Costs are at Historic Lows

(5 Year Bond Yields)



Source: Bloomberg

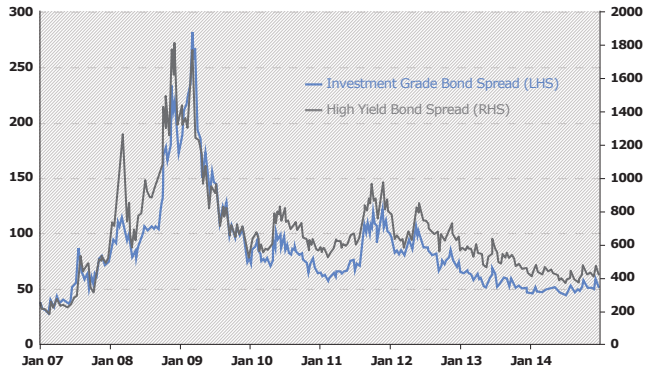
Fixed Income

Fixed income markets are ground zero for capital market distortions created by central bank policies over the last several years. During the second quarter, Switzerland became the first sovereign to issue a 10-year bond carrying a negative yield. Despite some recent back-up in bond prices, as shown in Chart 11, yields remain near historic lows.

Spread markets, such as corporate and high yield bonds, remain unattractive as credit spreads for most sectors outside of energy remain very tight as shown in Chart 12. Corporate bond issuance this year has already surpassed the total issuance from 2014 and underwriting standards continue to slip, providing higher risk for investors willing to go along with these low yields. As evidence, the eight below-investment grade defaults in May were the highest number of defaults since October 2009.

Chart 12. Credit Markets are Richly Valued

(Basis Points)

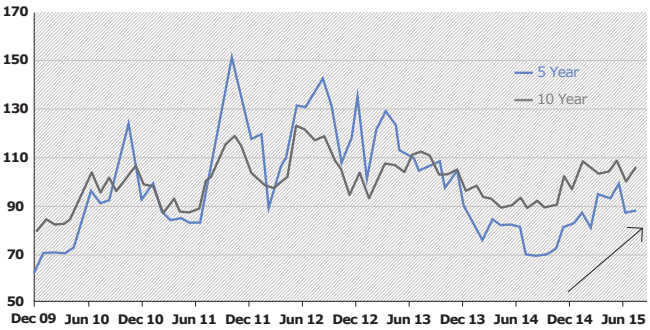


Source: Bloomberg

During the first half of the year, high-quality municipal bond yields increased, which was compounded by spread widening for lower rated securities. The heaviest new issue supply in over ten years weighed on the market, as issuers attempted to lock in low rates before the Fed began its tightening cycle. Further, highly visible credit problems in Illinois, Chicago, and Puerto Rico weighed on the market. Yield spreads are now more attractive, but only relative to the highly inflated Treasury market as shown in Chart 13.

Chart 13. Munis Becoming More Attractive to Treasuries

(Municipal Bond to Treasury Yield Ratio)



Source: Bloomberg

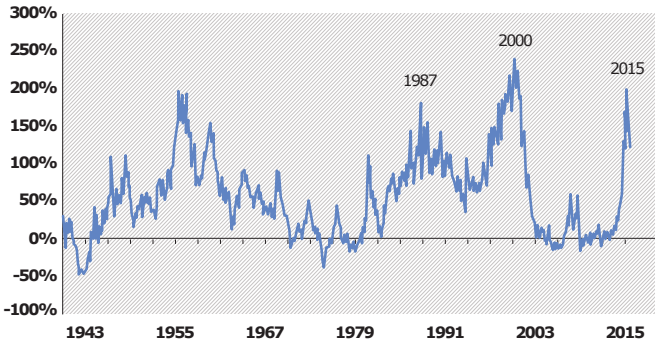
Equity Market Valuation

We continue to be asked about equity market valuations after one of the strongest bull markets on record. With apologies to those who want the quick answer to this question, we felt it was important to take a deeper look than our Mid-year Update would typically warrant. We focus this analysis on U.S. equity markets since most valuation-related concerns are centered there.

Based simply on past performance, the current rally is extending into dangerous territory as shown in

Chart 14. U.S. Stock Market Rally is Mature

(S&P 500 Rolling 6-Year Total Return)



Cumulative performance using daily data

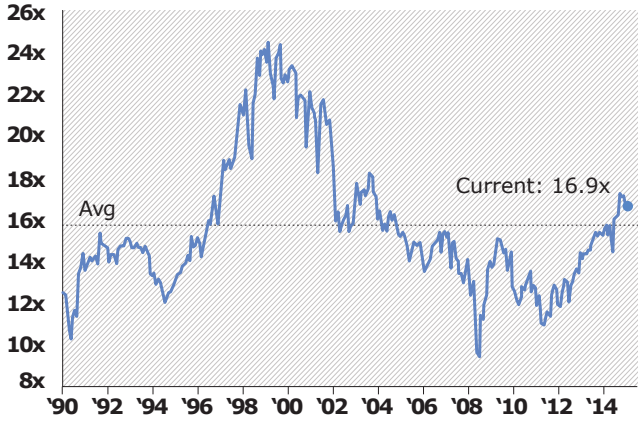
Source: Bloomberg

Chart 14. Further, the rally has gone quite some time without a significant correction. Through history, the only rallies that encompassed longer periods without a 10% correction occurred during the tech bubble and just prior to the global financial crisis.

While past performance statistics are interesting, they tell us nothing about equity market valuation and their potential vulnerability to a decline. There are several ways to look at valuation and none tells the entire story. But perhaps a mosaic of measures can provide more clarity.

Chart 15. U.S. Equity Valuations Continue to Rise

(S&P 500, Forward PE)

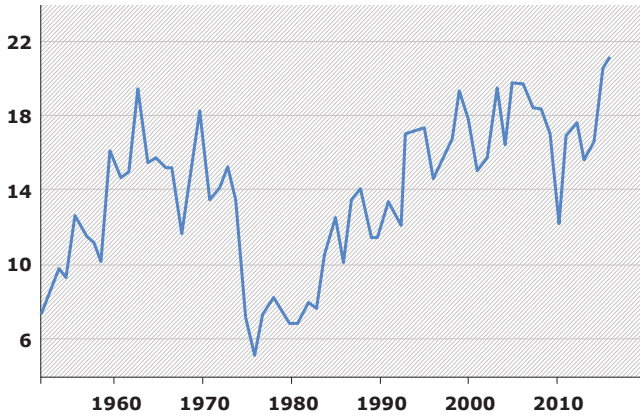


Source: JP Morgan

At the simplest level, the S&P 500 currently trades at 16.9x the forward looking, bottoms up consensus earnings forecast, the highest level we have experienced outside of the technology bubble as shown in Chart 15. This would seem to indicate that the current market may be modestly overvalued, but not materially different than the 15.7x average over this period and certainly well below the valuations seen in the late 1990s tech bubble.

Chart 16. Median Stock Valuations Appear Expensive

(NYSE Median Based PE)



Source: Kenneth French Database, Dartmouth Tuck School of Business. 2015 are BCA Estimates

During the tech bubble, high valuations were concentrated in the very large segments of the market, while other sectors were reasonably valued, allowing careful investors to avoid or mitigate the ensuing market crash. Today, elevated valuations are more broad-based, as seen by examining median-based valuation indicators, shown in Chart 16, rather than capitalization-weighted benchmark metrics that are more typically used. These metrics would seem to indicate that today's market is actually more expensive than even the tech bubble period of the late 1990's and possibly the most expensive in history.

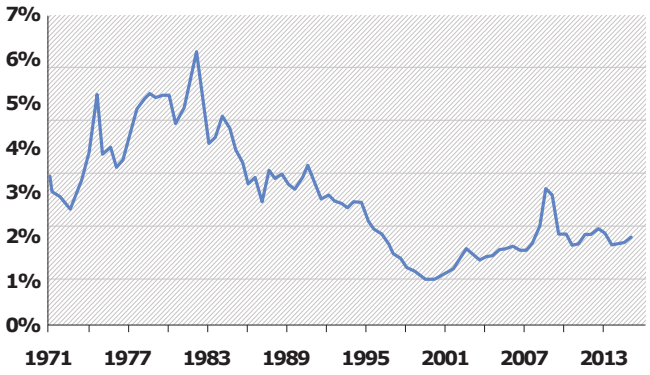
Some analysts argue that these high levels are justified given today's record low interest rates. After all, stock values are simply the discounted present value of future cash flows and assets. If so, discounting these future cash flows at very low interest rates, justifies higher equity market values. While this may (or may not) justify current valuations, what happens when interest rates start to rise? As mentioned earlier, we do not expect interest rates to rise quickly, but beginning the rate tightening process will create a new headwind for stock markets to overcome.

Another way to examine market valuation is to look at the components of return and attempt to understand the

possible future directions of these variables. By definition, stock market returns can be broken into three components: change in P/E ratio, earnings growth and dividend yield. We have already discussed different views on P/E ratios above, but what about earnings growth and dividend yield?

Chart 17. Dividend Payouts are Low

(S&P 500 Dividend Yield)



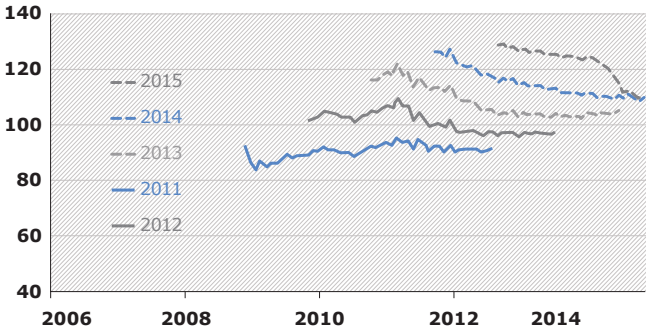
Source: Bloomberg

Let's start with the simpler of the two, dividend yield. Chart 17 shows that dividend yield to investors has decreased over the last 40 years. The good news is that currently low dividend yields are not likely to change quickly so investors should be able to count on this element of return going forward.

The earnings growth picture is less clear. Over the last few years, we have documented the disappointing performance of both corporate revenue and earnings. These estimates continue to underwhelm relative to analysts' forecasts as shown in Chart 18. Most analysts attribute this to the structural deleveraging that has

Chart 18. Earnings Forecasts Continue to Decline

($ U.S. FY Consensus EPS for S&P 500)



Source: JP Morgan

continued to dampen employment and consumer spending. However, with deleveraging well underway, U6 employment finally beginning to normalize and modest improvement in wages beginning to appear, the prospect of future corporate revenue and possibly earnings growth is brightening relative to the dim performance of the last few years.

One caveat on earnings growth: If oil prices remain low, we expect earnings in the energy sector to remain weak in the near-term. The silver lining is that we expect a corresponding uptick that will benefit other economic sectors as consumers spend this energy dividend. The other risk to this optimistic scenario is the well-documented view that corporate margins are already at record highs and most expect some mean reversion over time. This would have a dampening effect on earnings growth.

When we combine these three components of future equity returns, the picture implies that investors should be cautious. The most concerning element of future return potential are elevated P/E ratios, which are either above average or at all-time highs depending on the view one takes. On the other hand, dividend yields will likely remain stable and earnings growth has the potential to improve relative to its lackluster performance of the last few years.

So where does that leave us? Equity returns over the next five to ten years, given today's beginning conditions, are likely to be below their long-term average. How much below is difficult to determine with any precision. On the other hand, equity markets may not decline, and we may simply grow out of the current valuation problems with increased earnings growth over the next few years.

Private Investments

Private equity remains an important component of long-term growth and, particularly in the last few years, a powerful driver of returns for many long standing Gresham clients[1]. However, many managers in the private equity arena, particularly in the markets for middle and larger buyout transactions, have commented on how expensive deals have become. This is somewhat

consistent with increases in public market valuations, which often serve as a source of liquidity for private equity investors.

Venture capital ("VC") has been especially productive for many of our long standing clients over the last few years, including our China VC portfolio. However, many analysts have commented on the amount of capital being invested by VC firms and the lofty valuations of several visible venture backed companies. Some commentators are even drawing parallels to the technology bubble of the late 1990s in the U.S.

As risk-conscious investors, we are always sensitive to valuations and valuations in venture, particularly later stage venture, have become elevated. However, this may be less of a risk than some have speculated.

One of the interesting dynamics emerging from this environment is that companies are choosing to stay private much longer. There is simply no reason for smaller technology companies to go public and in fact there are many reasons to avoid the additional cost and scrutiny of being a public company. As a result, a significant portion of invested dollars are going into relatively mature companies, whose prospects are much clearer and whose businesses are more developed and deserving of higher valuations.

Further, the prospect of mobile computing has dramatically increased the addressable market for many companies. One of our VC managers recently estimated that over the 20 year period from 2000 to 2020 the number of people online in the world will increase 10x, from 400 million to over 4 billion. The transformative effect of cheap mobile computing providing access to the internet will continue to be a powerful driver of this trend, particularly in emerging markets.

In real assets, the story is short; commodities continue to perform poorly. However, this dynamic does provide interesting niche opportunities to acquire high quality assets primarily in private markets that will likely produce attractive returns over the long-term without relying on significant commodity prices increases. We remain cautiously interested in these opportunities globally.

What Should Investors Do?

There are no simple solutions to investing in an increasingly challenging market. While many markets are overvalued by some measures, these markets may continue to climb for years to come, making market timing nearly impossible. Here is our current guidance for our clients and other long-term investors:

Fixed Income

Our long-standing underweight to fixed income remains firmly in place. This has served clients well over the last few years enabling them to earn higher returns in lower volatility alternative investments that suit their portfolios and risk tolerances. The risk/reward proposition for fixed income based on low interest rates and tight spreads remains uninspiring.

Equities

Valuations of equities in the U.S. have become high or extremely high depending on the metric used. It would be foolish for investors to count on further increases in P/E multiples to generate returns in the future, but it would not be unprecedented for that to happen. Our expectations for returns in U.S. equities remain modest and well below historical averages.

Further, if higher returns continue, we do not expect them to follow the nearly uninterrupted path to which investors have become accustomed over the last few years. This will clearly become more of a stock picker's market, benefiting active managers who take advantage of opportunities produced by increased market volatility.

We recommend that investors treat U.S. equity investments with caution, rebalance gains frequently and perhaps reduce exposure in favor of less correlated alternative strategies.

Better valuations and investment opportunities can be found in non-U.S. markets after years of U.S. market outperformance have left the U.S. market relatively overvalued. Non-U.S. markets also tend to be less efficient and the potential for value-added active management further enhances the relative attractiveness of these markets at this point in the cycle.

Global competitors are often headquartered in different geographies, traded on different stock exchanges and included in different benchmarks. The globalization of capital markets has reduced the traditional U.S. vs. developed international stocks decision to more of a security selection decision, than an asset allocation decision. The decision to invest in these companies should be based on stock valuation measures and the competitive positioning between these companies, not on some high-level, often very blunt, asset allocation process.

As most traditional investment firms continue to reduce active risk and tighten tracking error in a bid to avoid underperformance, the percentage of active managers that beat benchmarks after fees continues to decline. These restrictions often force managers to unnecessarily eliminate more attractive investments from their universe. Global managers with more concentrated, best-idea portfolios that are unconstrained by traditional geographic limitations will likely provide better relative results over the long-run, particularly during this period when stock selection will be at a premium. Accordingly, we are making adjustments to our investment strategies to accommodate this change in the investment environment.

Concluding Thoughts

The world remains an uncertain place for investors, whether through high valuations across a wide range of markets, the roller-coaster ride of Chinese markets, a possible Grexit, or any number of unknown risks that we will face in the coming quarters and years. Thoughtful investors understand the appropriate response to increasing uncertainty is seeking broad diversification to build balance into a portfolio that can better withstand future volatility.

In this market environment, having an absolute sense of valuation rather than a benchmark-relative view, being willing to accept illiquidity only in exchange for appropriate rewards, and investing with more flexible best-in-class active managers will help preserve capital and capture opportunities in difficult markets.

[1] Footnote: Past performance for Gresham clients as referenced is not a guarantee of future results. Investments in emerging markets, private equity, and venture capital are subject to a number of risks and substantial losses could be incurred.

Notes from the Road: Brazil

Observations from a recent investment team trip.

Background

The age old adage that one should "buy when there is blood in the streets" is typically a good starting place for the exploration of an investment idea. The recent carnage in Brazil was compelling enough for us to spend several days in the country exploring investment opportunities and understanding the political, economic and capital market landscape. Over a three-day period we met with 17 managers across a wide range of investment strategies, including traditional equities, long-short hedge funds, private equity and real assets. However, what we found may best be summed up by a recent comment from one of our broader Latin American ("LATAM") managers, "Blood by itself is a poor investment strategy."

"Blood in the Streets"

Brazil is mired in a dreadful recession with GDP declining 3.0% year-over-year through June. And the end is not in sight, as the consensus forecast for full-year GDP growth is now at -1.7%, with most analysts expecting further contraction in 2016. The Brazilian real has lost -16.5% against the dollar this year alone, furthering its multi-year decline from 1.6 BRL/USD to over 3.25 BRL/USD. Inflation has increased to 9%, primarily on increasing energy costs, but even the consensus for non-energy inflation is surprising analysts to the high side now as well. Unemployment has jumped nearly 40% to a five year high of 6.7% and real income has declined 5.0% year-over-year. Not surprisingly, consumer confidence has plummeted nearly 20% from its peak.

In the short-term, monetary policy is making matters worse. The Brazilian central bank has now raised interest rates 15 times over the past two years to 13.75% in an effort to combat inflation, but higher rates are further dampening growth and employment prospects. Fiscal support and reforms are also unlikely to improve conditions, as the political system is nearly paralyzed from corruption scandals involving both the current and former presidents. The governing coalition is discussing ending their alliance and the threat of impeachment is real. There is blood in the streets of Brazil!

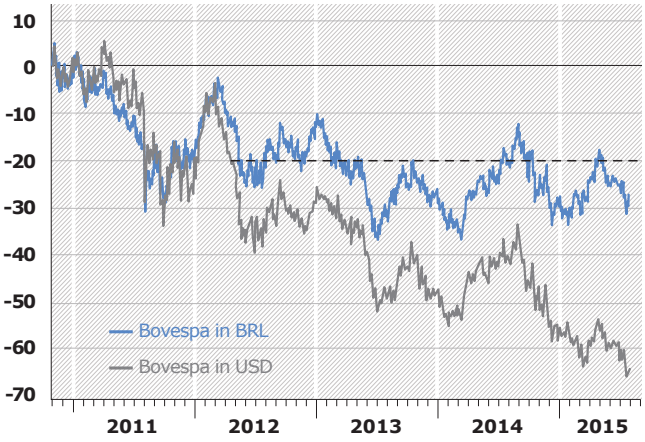
Equity Market Opportunity

In our typically contrarian manner, we are interested in markets and assets that have declined significantly. As part of our analysis, we attempt to understand the root cause of the decline, the attractiveness of assets post-decline and if there are potential catalysts to recognize potential value.

Brazilian equity markets have declined nearly 30% over the last twelve months, causing significant losses for U.S. investors. However, it is important to understand that the market has actually increased 0.5% in local currency terms, so it is the collapse of the Brazilian real that caused most of these recent losses. Similarly, since late 2010, Brazil's Bovespa index has declined a cumulative 65%. However, nearly 50 percentage points of that decline have been caused by currency devaluation. In local currency terms, after the sharp declines in mid-2011, equity returns have been roughly flat as shown in Chart 19.

Chart 19. Brazilian Real Weakness Hurt U.S. Based Investors

(Cumulative Performance Beginning Nov. 2010)



(BRL/USD Exchange Rate)

Source: Bloomberg

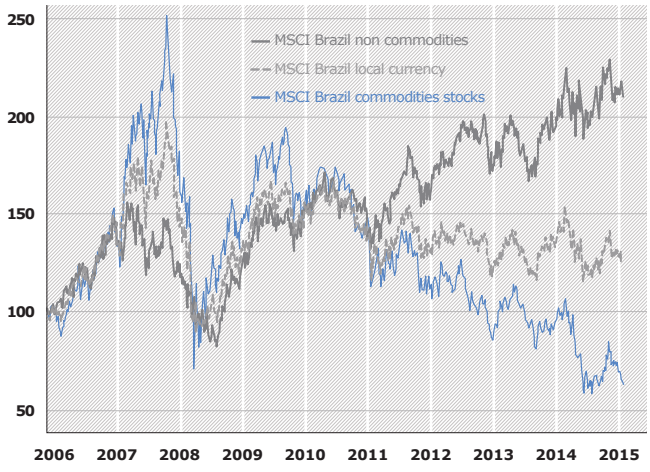
Are Brazilian equities cheap? At a high level, the MSCI Brazil index trades at a 14.2X forward P/E compared with its 10 year average of 10.8X. How can there be so much economic trouble and investor's returns be so poor and yet there be no value in public equity markets? One answer might be that earnings are cyclically depressed during this recession, which would artificially inflate traditional P/E measures. While that is possible, we concluded that there is a structural reason the broader equity market is not attractively priced.

As we canvassed public market managers in Brazil, one characteristic became increasingly evident; the active management industry appears to be extremely overdeveloped compared to the relatively small number of investable names in the market. Most managers estimated that the investable universe of stocks was between 60 and 90 names, despite several hundred companies being listed on the exchange. This creates the potential for crowding in these names, which is indeed what we witnessed.

As the bloom came off Brazil's commodity export story, many managers rotated aggressively into the market's non-commodity sectors. One of our investment managers recently performed an analysis and concluded that these non-commodity stocks have nearly tripled since 2008 as a result of this crowded rotation as shown in Chart 20. A different Brazilian manager commented that the market now consists of stocks that can be classified as either growth-at-an-expensive price or value traps, as deep value stocks rarely survive in Brazil given their high interest rates and cost of capital, creating a grow or die dynamic. The non-commodity companies face a grow-or-die environment and are now priced to near perfection. As another manager put it, if one can get comfortable with the currency risk, which is inherent in all Brazilian investments, perhaps the best equity investments are actually not equities at all, but rather bonds yielding mid-teens percent.

Chart 20. Returns for Non-Commodity Sectors Have Been Strong

(Performance in BRL)



Source: Bloomberg

Our conclusion was that the broad, public equity markets do not currently provide an attractive opportunity for investment. The commodity sector, including national champions such as Petrobas, is cheaply priced and poised for an incredible rally when the commodity cycle turns, but the timing of such a recovery is difficult to forecast. There may be smaller companies and opportunistic investments that a pan-LATAM manager can make, but there does not appear to be a broad investment opportunity in public equity markets in Brazil…yet.

Private Investment Opportunities?

What about private markets? Often private investment opportunities arise in difficult economic conditions due to an inability to service debt, which will force the sale of assets at distressed prices. As expected, we did witness oversupply issues in commercial and residential properties, as the recession has softened demand. Office vacancy is expected to exceed 20% in major markets.

However, debt in the Brazilian financial system remains relatively low and, as a result, we witnessed few indications that forced sales due to financial distress would become more prevalent. One possible cause is that investors remain risk averse given the historically volatility cycles in Brazil. The reason may also be structural. Brazil has experienced relatively high nominal and real interest rates over the last few decades creating a simple, economic deterrent to using debt financing for investments. As a result, the majority of investors appear poised to simply hold onto their assets through this difficult period.

Conclusion

On a positive note, buried beneath the worst economic conditions in 20 years, Brazil continues to exhibit the classic signs of structural growth typical of emerging economies. Entire industries, such as hotel chains and logistics infrastructure, are in the midst of being created and/or rationalized. While we did not find assets being sold at distressed prices, we may still be able to capture opportunistic investments created by the structural tailwinds of Brazil's continued long-term economic progress, despite the cyclical headwinds that are currently blowing.

About Gresham

Gresham Partners, LLC is a nationally recognized, independent investment and wealth management firm that serves its clients as an outsourced chief investment officer and a multi-family office. Gresham has been serving select families, family offices, foundations and endowments since the firm was established in 1997. Today, we advise on over $4.3 billion for about 80 clients, many of whom have been Gresham clients since the firm's inception.

We seek to utilize difficult-to-access managers located globally across the full range of asset classes. We make these managers available to our clients in a flexible format well suited to achieving a broad spectrum of investor goals. As a multi-family office, we integrate this investment approach with client-specific wealth planning strategies and other personalized wealth management services.

Gresham is wholly owned by its senior professionals, we do not offer proprietary investment products, we are not paid to sell or recommend products, and client fees are our sole source of compensation. We act as a fiduciary for our clients dedicated to serving their best interests and we avoid conflicts of interest that affect many other firms. To learn more about us, please visit www.greshampartners.com.

Gresham Partners, LLC | 333 W. Wacker Dr., Suite 700 | Chicago, IL 60606
312.327.5020 | info@greshampartners.com