January Portfolio Manager Report

Looking Back

Last year brought a wide variety of returns. Table 1 provides returns for some commonly followed areas of the market. As can be seen below, European and Japanese stocks were at the head of the pack for 2015. U.S. equities were very much a mixed bag as measured by the Russell indices with large, mid, and small caps stocks up 0.92%, down 2.44% and down 4.41%, respectively. At the bottom of the list of equity returns were emerging markets at -8.22%.

Table 1

Index	Asset Class	2015 Return
Nikkei 225 Average TR JPY	Japanese Equity	11.00
STOXX Europe 600 GR EUR	European Equity	10.16
DB Long US Dollar TR USD	U.S. Dollar	7.80
Russell 1000 Growth TR USD	U.S. Large Growth Equity	5.67
MSCI EAFE 100% Hedged NR USD	International Equity	5.02
FTSE NAREIT All REITs TR	Real Estate Trust	2.29
S&P 500 TR USD	U.S. Blend Equity	1.38
Barclays Global Aggregate TR Hdg USD	Global Bonds	1.02
Russell 1000 TR USD	U.S. Large Equity	0.92
Barclays US Agg Bond TR USD	U.S. Bonds	0.55
Barclays US Treasury US TIPS TR USD	U.S. Inflation Bonds	-1.44
STOXX Europe 600 NR USD	European Equity	-1.61
DJ US Select Dividend TR USD	U.S. Dividend Equity	-1.64
MSCI ACWI NR USD	Global Equity	-2.36
Russell Mid Cap TR USD	U.S. Mid. Equity	-2.44
Barclays Global Aggregate TR USD	Global Bonds	-3.15
Russell 1000 Value TR USD	U.S. Large Value Equity	-3.83
Russell 2000 TR USD	U.S. Small Equity	-4.41
EURO STOXX 50 NR USD	European Large Equity	-4.47
Barclays US Corporate High Yield TR USD	U.S. High Yield	-4.47
MSCI ACWI Ex USA NR USD	International Equity	-5.66
MSCI EM 100% Hedged NR USD	Emerging Market Equity	-8.22
MSCI EM NR USD	Emerging Market Equity	-14.92
Bloomberg Commodity TR USD	Broad Commodity	-24.66
Alerian MLP TR USD	Energy	-32.59

**Source: Morningstar Direct*

*** TR= Total Return, USD = U.S. Dollar, JYP = Japanese Yen, EUR = Euro*

Bonds had a challenging year as well. Across the globe, fixed income was slightly positive at a little over 1%, while bonds in the U.S., on average, gained 0.55%. More credit sensitive bonds, specifically high yield were down 4.47%.

In the alternative space, commodities were down 24.66% for the year and MLPs were down 32.9%. However, on a positive note, REITs were up a modest 2.29%.

Last but not least is one asset class that is often overlooked – currency. Table 1 shows that the U.S. dollar, on a trade weighted basis, increased by almost 8%. This matters to investors in international markets who are not "hedged." Simply put, hedging means reducing or eliminating the effects of relative currency movements. The reason an investor would hedge is that profits in an international security can be reduced, eliminated, or even reversed by a strengthening of the home currency. A good example above is the STOXX Europe 600, which was up 10.16% in euros; however, when translated back into U.S. dollars was down 1.61%. This is a function of the euro depreciating by about 12% relative to the dollar.

Going Forward

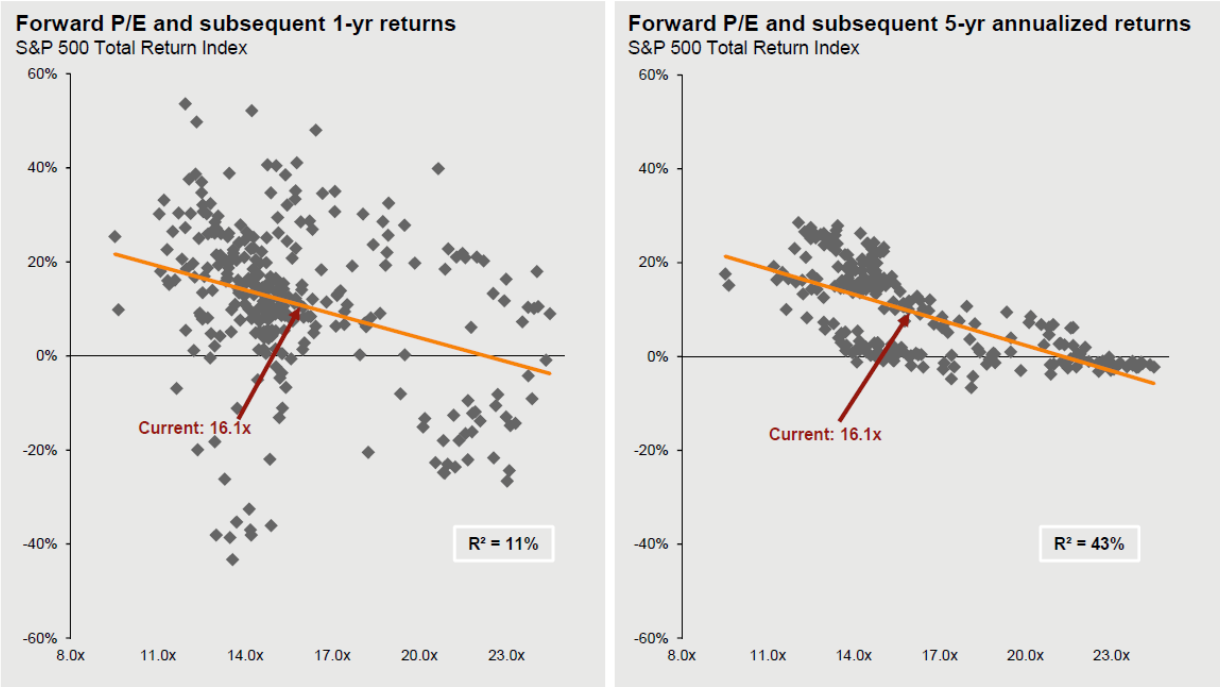
Happy New Year! As of this writing (mid-January) equity markets are off to a rough start. Thus far for the year, the global stock market is down in excess of 7% and has retreated as much as 15% from its peak back in May 2015. Although it's a new year, the concerns are the same. Specifically, investors are struggling with becoming comfortable with global growth given the perceived slowdown in China, an increasing Federal Funds rate, and the impact of exceptionally low oil prices.

That all said, it's that time of the year when we use this monthly report to share our outlook for various areas of the investment universe. As always, we will focus on what we find to be the three broadest asset categories – stocks, bonds, and alternatives.

Stocks

Valuations are without a doubt the most highly weighted variable in our decision making process. The reason we give so much credence to valuations is that historically there is a very strong correlation between future prices and current valuations. Said differently, when valuations are low, future returns are likely to be both positive and above average. Indeed, the opposite is true when valuations are high. Please understand this is certainly not a guarantee, but historically it has been a very good predictor of the future. In addition, we believe it also has the virtue of passing the common sense test of "buy low/sell high." Graph 1 from JP Morgan Asset Management is something we refer many investors to as evidence of the strength of the relationship between future prices and valuations within the S&P 500.

Graph 1



Source: FactSet, Reuters, Standard & Poor's, J.P. Morgan Asset Management.
Returns are 12-month and 60-month annualized total returns, measured monthly, beginning December 31, 1990. R^2 represents the percent of total variation in total returns that can be explained by forward P/E ratios.
Guide to the Markets – U.S. Data are as of December 31, 2015.

J.P.Morgan
Asset Management

This chart shows 1 year returns on the left side and 5 year returns on the right. The vertical axis displays returns and the horizontal axis shows valuations. As can be easily seen, valuations are a very good, but not perfect, indicator of future returns. Impressively, as the length of time increases, the strength of the relationship increases.

Currently, we find most areas of the stock market to be fairly valued. The most commonly used metric to value stocks is the PE ratio. This ratio is simply the current price divided by either the last 12 months earnings or the expected earnings over the next 12 months. We prefer using forward earnings for the denominator simply because we are buying future, not past, earnings.

Chart 1 shows a portion of our Market Navigator which is updated at the beginning of each week on our website (www.baystatewealth.com). Using the ACWI (All Country World Index) as a proxy for the total stock market we can see that the PE ratio is approximately 15x the next 12 months earnings. *This ratio is very similar to the historical average which is why we find valuations to be fair.*

Chart 1

Major Indexes as of 1/8/2016	Last Week	Prior Week	Year to Date	Trailing 12 Months	12 Month Volatility	Index Level	Forward P/E[4]
DOW Industrial	-6.13%	-0.72%	-6.13%	-5.54%	18.66%	17,663.54	15.22
S&P 500	-5.91%	-0.80%	-5.91%	-4.00%	18.74%	2,079.36	15.75
NASDAQ	-7.24%	-0.80%	-7.24%	-0.13%	20.56%	5,053.75	17.65
Russell 2000	-7.88%	-1.57%	-7.88%	-10.55%	20.37%	1,161.86	15.72
MSCI ACWI	-6.14%	-0.65%	-6.14%	-7.17%	15.79%		15.10
MSCI EAFE	-6.14%	-0.16%	-6.14%	-4.47%	17.19%		
BarCap Agg	0.64%	-0.03%	0.64%	0.32%	4.50%		

So what? The reason that fair valuations matter is that it can give us some insight into return expectations. Over time, when valuations are fair, there have been many instances in which stock investors have received mid to high single digit returns.

In addition to using history as a guide, there is also a pricing model that suggests returns going forward may average high single digits. One of the many pricing models we are comfortable with is combining the earnings yield with the dividend yield to produce an estimate for future returns. This model is actually relatively straightforward and simple. The first component, dividend yield, is quoted daily and is just the weighted dividend yield of the stocks composing an index. In the case of the ACWI the dividend yield is about 2.5%. The second component, earnings yield, is the reciprocal of the PE ratio – earnings divided by price. In other words, it is the amount of future earnings you are buying for the current price. If the PE on the ACWI is 15.1, the earnings yield is 1/15.1 which equals 6.6%. Adding the two components suggests that going forward returns for the ACWI could be 9.1% (6.6% + 2.5%).

Bonds

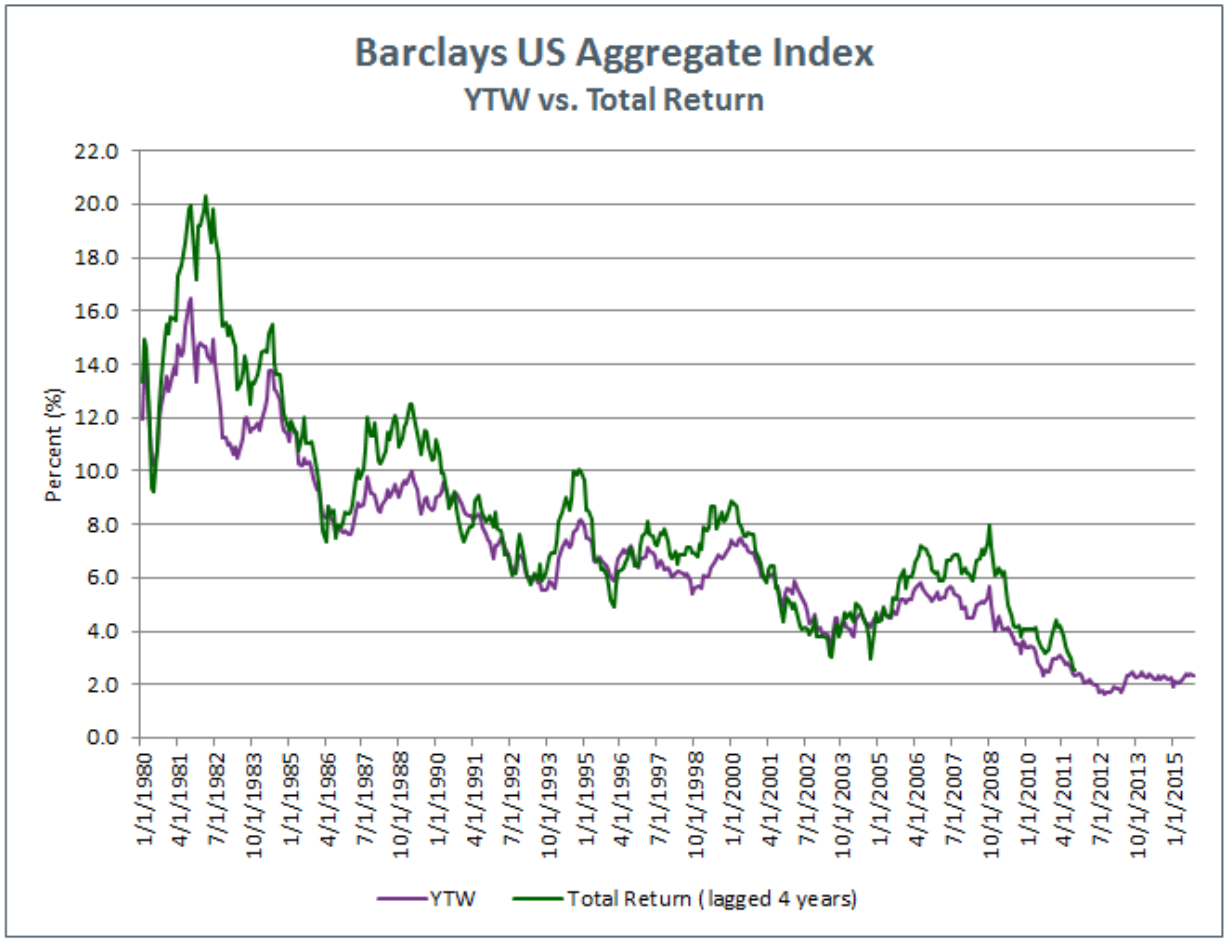
Whereas our outlook for stocks is favorable, our forecast for most areas of the bond is less than exciting. Predicting bond returns is a function of *current yield*, *yield relative to other yields (spreads)*, *changes in interest rates*, and *changes in perception of credit risk.*

Going forward, we believe that current yield is a good predictor of the future returns of many bonds. The reason is that spreads in this area are similar to their historic norms so we don't feel return forecasts need to be adjusted accordingly. At the same time, although we do expect interest rates in the U.S. to move higher, we don't expect the speed of change or magnitude to be significant in the near term. This means that

for bonds that are not credit sensitive, current yield is our expectation. It's that simple.

The good news is that this methodology is simple and has historically proven to be reliable. The bad news is that current yields are historically low and thus returns are likely to be low; we found this to be expressed best by David F. Lafferty, CFA. David is the Chief Market Strategist of Natixis Asset Management and recently presented at a conference we held for Financial Advisors in Newport, RI. In his presentation, David titled a section on bonds, *"You get what you get and you don't get upset."* For those of us with kids, we have more than likely used this phrase for a variety of reasons. However, we agree it is more than appropriate as a description of returns for many areas of the bond market. As can be seen below in Graph 2, bond yields in the aggregate have fallen substantially with yields hovering between 2% and 3%.

Graph 2

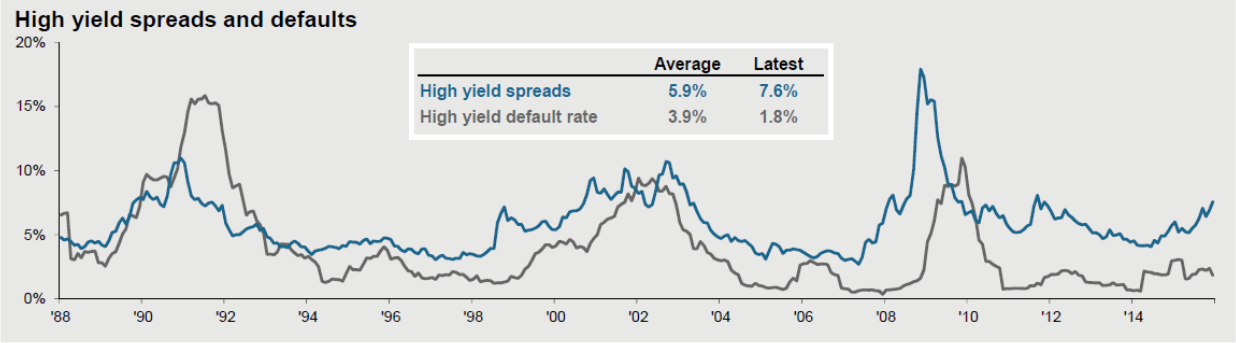


Source: Barclays Live, Morningstar, and NGAM ISG (1/1/1980 – 9/30/2015)

In short, given that we believe rates are likely to be anywhere from stable to modestly higher, by definition we believe many types of bonds will return low single digits in the near term.

We do see one bright spot in the fixed income area. Please note that in the preceding paragraphs I wrote "many," not "all" to describe bonds for which we have low return expectations. High yield bonds, which are highly sensitive to changes in the perception of credit conditions have recently sold off and thereby have increased spreads relative to history, increasing the current yield. Taking into consideration a higher yield and a higher spread relative to history our return expectation increases accordingly.

Graph 3



Source: JP Morgan Asset Management

In the graph above (Graph 3) it can be seen that the average high yield spread to comparable treasuries is 5.9%. Today, investors are receiving 7.6% above treasuries which is 1.7% higher than the average.

So what? Adding this all up means that we believe future high yield returns could be higher than the current yield of 7.6% because of our belief that sooner or later spreads will revert to their mean levels. To be clear, it could absolutely be the case spreads widen before they trend back to the mean. Yet, for investors with patience who are not looking to "time the market," high yield looks attractive based on valuations.

Alternatives

In our parlance, alternatives are simply investments that are not stocks or bonds. Ideally, these types of investments should reduce risk and possibly enhance returns relative to a traditional portfolio consisting of only stocks and bonds. Some examples of these securities are REITs, commodities, MLPs and absolute return funds.

Valuing and forecasting returns for some alternatives is somewhat straightforward. For example, REITs and MLPs have the classic data points (sales, expenses, earnings and dividends) that are helpful to an investor attempting to calculate a fair value. On the other hand, some alternatives like commodities and absolute return strategies do not possess those attributes thereby making them much more difficult to forecast.

In the aggregate there are three reasons to allocate a portion of the portfolio to alternatives:

1. Reduce risk
2. Enhance returns
3. Some combination of #2 and #3.

Our current alternative asset class exposure in our strategies consists entirely of absolute return strategies. Two of them are subjectively and actively managed by firms we trust with processes that we understand and one is an ETF that follows a quantitative strategy we have confidence in.

So what? Our goal and expectations for our clients' alternative investments is to generate performance that falls somewhere between stocks and bonds while reducing volatility in the overall portfolio. It is that straightforward.

Given our outlook for stocks, bonds and alternatives we do believe diversified portfolios can yield solid returns in the near term. Nonetheless, we caution investors to be aware that lower than average yields on many types of bonds may dampen performance for blended portfolios relative to the past when interest rates were considerably higher - meaning pre-2008.

As always, we appreciate your trust and faith in our service. Please call on us if we can of service.

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measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1,000 of the largest securities based on a combination of their market cap and current index membership. The Russell 1000 represents approximately 90% of the U.S. market. The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 8% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership. The Russell Midcap Index represents approximately 27% of the total market capitalization of the Russell 1000 companies. The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom. You cannot invest directly in an index All performance figures per Morningstar Direct™ Past performance is not a guarantee or indication of future results. Investments fluctuate in value based on changes in market conditions and other factors such that there is a risk of loss.

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