

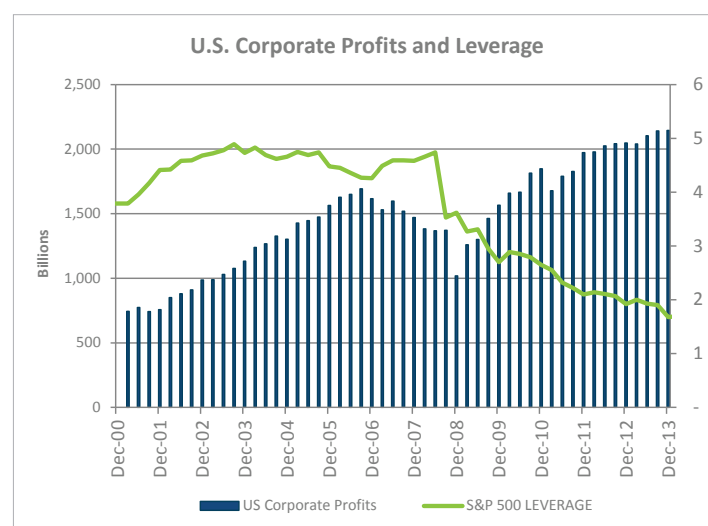
Highlights

As we look forward to 2015, we believe we are entering the early stages of a mature bull market. We expect US equities will outperform the domestic bond market as continued economic and earnings growth allows tighter monetary policy and the risk of higher short term interest rates. As prudent investors, our outlook is informed by independent research of the economy and the sectors in which we invest. Importantly, each year presents its own challenges and surprises that impact performance. Accordingly, we will touch on some of the risks identified relative to our base case market outlook.

Sustainable Economic Growth

Despite the continuing economic challenges facing the global economy, we believe the pace of economic growth in the United States has become self-sustaining. We expect stronger labor market inputs and higher personal consumption expenditures will be important potential contributors to U.S. Real GDP growth of 3% in 2015. Higher levels of government spending and positive contributions from domestic investment should also be additive to growth. Near term U.S. fiscal challenges are diminishing as strong hiring has helped to cut the country's annual deficit from a record \$1.4 trillion in 2009 to just \$483 billion for the twelve months ending in September. In addition, we would expect further increases in corporate profits to spur additional corporate investment and hiring activity. While the relative growth in profits has been slowing, corporate balance sheets and liquidity remain very healthy on a historical basis.

as seen in recent declines in energy and commodity prices. While the impacts of these deflationary forces will be uneven, from a U.S. consumer standpoint, lower energy prices should stimulate consumption and US Real GDP growth. We expect the housing market will continue to recover, although housing inflation should remain well contained. Wage pressures should increase over the next several years but they do not present a near term risk to our outlook.



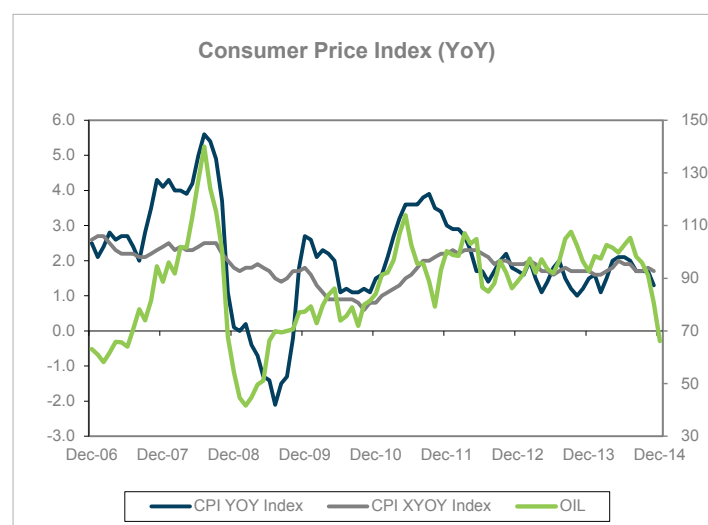
Source: Bloomberg

Tempering our economic outlook is the reality that much of the rest of the developed world remains stuck in below trend growth. Complicating that fact is the potential for diverging international interests as uneven economic growth, varying monetary policy regimes, the oil crisis and geopolitical tensions introduce potential volatility to the economy and markets more generally.



Source: Bloomberg

Certainly inflation is the prudent investor's biggest fear as it erodes the value of future investment returns. We continue to believe inflation remains well contained in the near term. The deflationary forces following the financial crisis have been massive and continue today



Source: Bloomberg

Believe the Fed

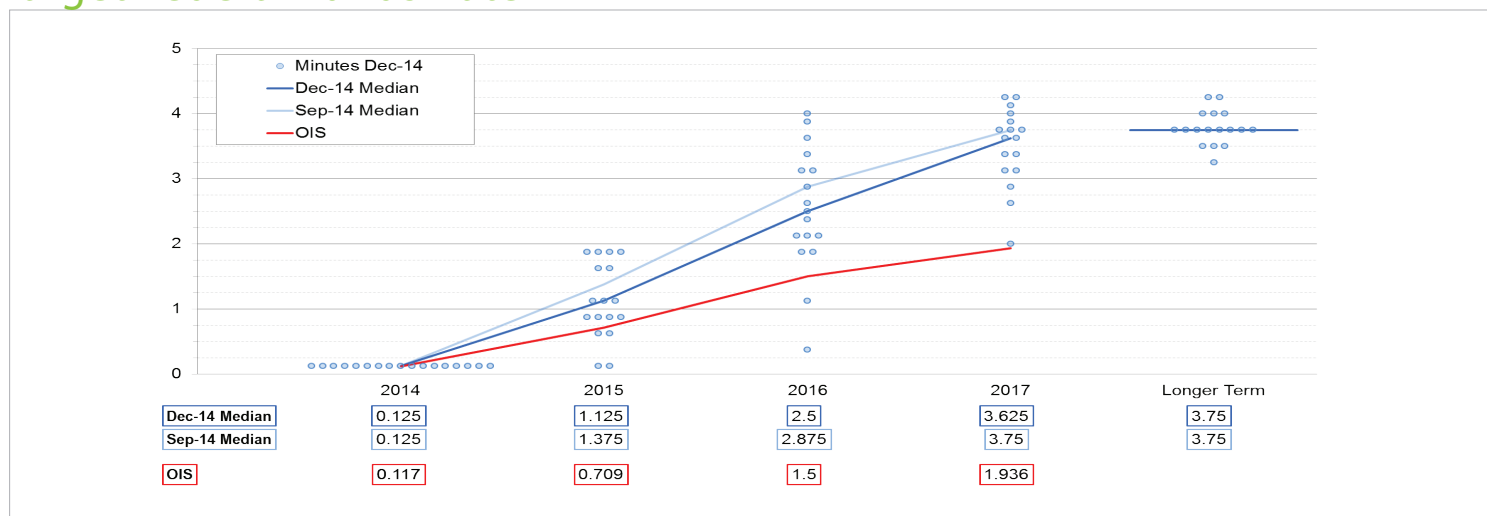
When analyzing Federal Reserve policy, it's generally better to watch the middle of the Fed than the edges. While the extremely dovish or hawkish committee members often get the headlines they too often don't accurately reflect what the Fed is going to do. So as the Fed maintains its commitment to telegraphing interest rate moves, the most prudent way to handicap where policy is headed is to analyze the Fed's forecast. The December forecasted target federal funds rate at year end 2015 is expected to be 1.125%, slightly lower than the 1.375% rate forecasted during the September meeting. While this forecast implies that short term rates are headed higher in 2015, market expectations continue to lag the Fed's forecast, best evidenced in overnight fed fund swap levels (OIS). Should the Fed tighten monetary policy by slowly lifting the federal funds rate to a more modest target at or below 1%, the market should be able to digest the change and continue its bullish trend. If the Fed tightens more aggressively, in timing or degree, we believe the market will respond negatively. We don't believe the Fed wants to risk cutting off the current expansion by excessive tightening. All things being

equal, the Fed would presumably like to have higher interest rates in the short term so they can utilize the monetary policy tool as needed should the economy slow in the future.

The recent decline in energy prices introduces another wildcard in predicting policy changes for the coming year. Despite the negative impact of oil prices on the US energy industry, we would expect the broader domestic economy to benefit from lower energy prices. Some research predicts that for every \$10 fall in oil prices, it could potentially add a tenth of a percent to US GDP. Higher growth than currently predicted should ensure higher rates at some point this year. Conversely, the deflationary impacts of lower oil prices may provide the Fed cover to delay tightening altogether.

The Fed stated in its most recent December statement that "the committee can be patient" in normalizing monetary policy. The Fed further goes further to define "patience" as the next couple of meetings. Keeping our eye on the middle of the Fed, we believe short interest rates should finally rise in 2015.

Target Federal Funds Rate



Source: Bloomberg. The latest economic projections were released on 12/17/14

Low Expected Returns for Treasuries

While short term rates should head higher next year, predicting the direction of intermediate and long term interest rate is especially difficult. We don't believe forecasters and active managers can persistently predict interest rates with any real accuracy. The past year was a perfect example of what can go wrong for market timers. Virtually everyone predicted much higher rates in 2014 while the exact opposite occurred. Far more money has been lost by investors preparing for changes in interest rates than the value lost in the change itself. However, that is not to suggest we do not analyze the possible future path of interest rates. The prudent investor simply shouldn't rely on rate anticipation as a primary means for making money. Understand your liability, assume realistic return goals and invest accordingly.

Similar to our process in understanding Fed policy, we key off of current interest rates to inform us about future rates. We specifically analyze forward rates as the primary means to drive expected returns. The forward market is telling us that we should expect a much flatter yield curve in 2015 as short rates move higher with tighter monetary policy. This follows on a year where investors have already experienced a much flatter curve, although one of a significantly different variety. Short term interest rates were relatively well anchored and long bond yields declined by over 1%.

	YIELD	1 YR FORWARD
Cash	0.10	0.66
1 Year	0.20	0.95
2 Year	0.55	1.39
3 Year	0.99	1.62
4 Year	1.34	1.87
5 Year	1.53	2.00
6 Year	1.72	2.09
7 Year	1.84	2.19
8 Year	1.92	2.24
9 Year	1.98	2.29
10 Year	2.06	2.31
20 Year	2.38	2.55
30 Year	2.70	2.82

Source: Prudent Man Advisors, Inc. and Bloomberg

Here is a good example of how forward yields might be helpful to your investing success. Let's assume you have a two-year investment horizon and are limited to Treasury investments. One year Treasuries are expected to yield 0.95% one year from now. Importantly, this is already baked into the current yield curve cake. Investing for one year at 0.20%, then rolling that into a new one year bond when it matures at 0.95%, would earn you 0.55% over the next two years. This is the same return as investing in a two year Treasury today at 0.55%. If you think the forward rate is too high, you might want to consider buying the two year Treasury. The opposite holds true as well. We would recommend you stay invested. Don't get cute.

In the type of environment we experienced in 2014, with the front end of the curve remaining steep, roll return can meaningfully impact fixed

income total returns. This is the price return an investor earns as bond yields decline with an approaching maturity. This strategy has been a strong contributing factor to fixed income returns since the crisis and throughout much of history. Rolling down the yield curve works best in a steep and falling interest rate environment. However, rolling down the yield curve doesn't work as effectively in an environment where rates are rising or the curve flattens significantly.

So this begs the question, where are we now in terms of expected returns given the steepness of the curve, implied forward rates and our view on the direction of interest rates? Well we believe US Treasuries will exhibit low, albeit positive total returns in 2015. Lower oil prices and a dovish Fed will delay policy rate increases until the latter half of the year. Short term rates will move higher but not as much as the forward market is predicting.

			Expected Returns (Rates Unch)		
	Yield	Duration	Income	Roll Down	Total Return
Cash	0.10	0.00	0.10	-	0.10
1yr	0.20	1.07	0.20	-	0.20
2yr	0.55	1.98	0.55	0.54	1.09
3yr	0.99	2.92	0.99	1.07	2.05
4yr	1.34	3.95	1.34	1.21	2.55
5yr	1.53	4.85	1.53	0.83	2.36
6yr	1.72	5.91	1.72	1.04	2.77
7yr	1.84	6.64	1.84	0.76	2.60
8yr	1.92	7.29	1.92	0.56	2.48
9yr	1.98	8.08	1.98	0.42	2.40
10yr	2.06	9.04	2.06	0.68	2.74

Source: Prudent Man Advisors, Inc. and Bloomberg

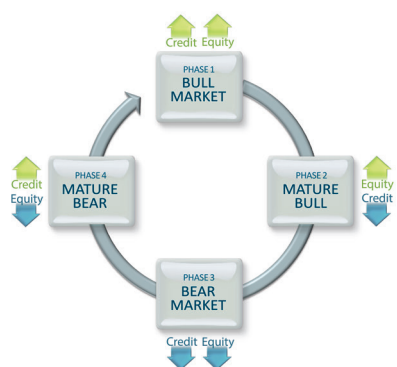
			Expected Returns (Forward Curve)		
	Yield	Duration	Income	Roll Down	Total Return
Cash	0.10	0.00	0.10	-	0.10
1yr	0.20	1.07	0.20	-	0.20
2yr	0.55	1.98	0.55	(0.60)	(0.05)
3yr	0.99	2.92	0.99	(0.99)	(0.01)
4yr	1.34	3.95	1.34	(0.97)	0.37
5yr	1.53	4.85	1.53	(1.51)	0.02
6yr	1.72	5.91	1.72	(1.50)	0.23
7yr	1.84	6.64	1.84	(1.56)	0.11
8yr	1.92	7.29	1.92	(1.82)	(0.11)
9yr	1.98	8.08	1.98	(1.99)	(0.02)
10yr	2.06	9.04	2.06	(1.99)	0.05

Source: Prudent Man Advisors, Inc. and Bloomberg

Love-a-Bull

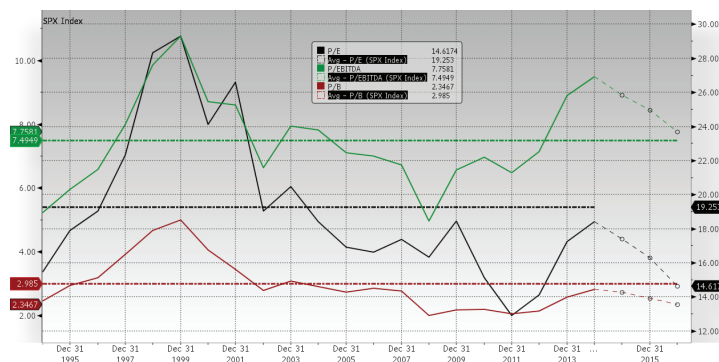
We believe we are entering the early stages of a mature bull market for the credit and equity markets. Today's bull market started in 2009 and is the fourth longest in history. Given the low returning alternatives previously discussed, we don't believe it will end in the near future. Stronger economic fundamentals and earnings growth will also support risk markets in 2015.

CREDIT CYCLE



The U.S. equity market continues to exhibit fair relative values versus most valuation metrics on a historical basis. On an expected return basis, equities look attractive versus bonds in 2015. With a dividend yield of 2%,

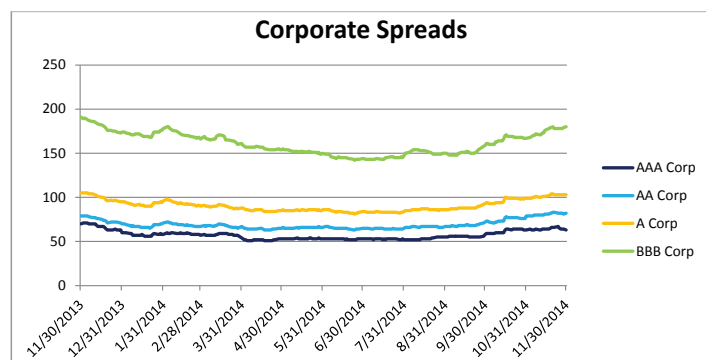
high single digit earnings growth and stable multiples, we could eke out double digit returns in the coming year. This is not our base case scenario however. We would expect U.S. equity markets to return something closer to 4-7% range given our economic and interest rate outlook. While earnings growth will likely be positive, top lines could disappoint and we wouldn't be surprised to see multiples contract slightly as interest rates rise. Uneven economic performance globally will also impact risk asset performance more generally in our view. Our equity market return estimate is also grounded in our economic expectations for 3% GDP growth and inflation in the 1-2% range in the United States.



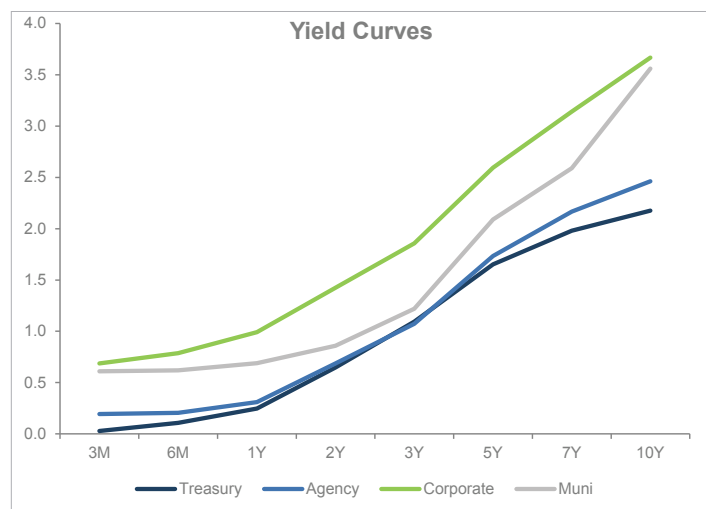
Source: Bloomberg

Within the fixed income market, we continue to emphasize higher quality investments within the corporate, mortgage and municipal sectors. Investment grade credit spreads, the yield differential between a corporate bond and a similar maturity Treasury bond, have widened out significantly during the past several months. A global flight to quality has pushed intermediate and longer term Treasury prices higher and other sectors have not been able to keep pace. Continued economic growth, positive operating performance and low rates should allow investment grade sectors to outperform Treasuries. Increased mergers and acquisition activity, higher levels of share buybacks and other shareholder enhancement activity are of some concern. Given where we are in the credit cycle, higher liquidity and quality considerations are critical.

Similarly, while taxable municipal bonds continue to trade rich to their recent levels, there is opportunity for selective value. Credit fundamentals have been improving on a lagged basis with the overall economy. Traditional agency mortgages are not as attractive from a total return standpoint. That said, the market continues to like the nominal carry and the regulatory capital treatment within the sector. We remain very selective in this sector and want to guard against extension risk should interest rates rise more than forecast over the next several years. The agency commercial mortgage backed sector continues to trade rich versus historical levels. Given the cheapening in certain parts of the swap curve, there is selective value in the sector currently. Overall, we recommend strategically diversified portfolios emphasizing high quality income producing fixed income and, as possible, a balanced allocation to low cost U.S. equity index funds.



Source: Bloomberg



Source: Bloomberg

Risk to Our Outlook

One thing you can count on every year is to expect the unexpected. Tail risks are, by definition, very hard to predict. However, managing identifiable risk is the prudent investor's fiduciary obligation. As such, we have found such extrapolation useful within our investment process.

- **Innovation** – On occasion, an idea or technology shifts that fundamentally changes the economy and markets. Some examples might include the iPhone or shale gas exploration. Automation is one area where we would expect to see dramatic changes over the next several decades.
- **Russia / Putin** – When we got together to discuss our outlook, we were thinking less in terms of the oil crisis than we were of Putin's geopolitical ego. With the Rouble in trouble we expect to see Russia in the news quite a bit in 2015.
- **Terrorism / Cyber Disruption** – The school shooting tragedy in Pakistan is a stark reminder of how quickly things can change. Cyber disruptions (i.e. Sony and Target) are becoming more common.
- **Western European Recession** – Deflationary forces potentially push ECB to QE and risk assets respond positively.
- **China Bubble** – A perennial worry. Slowing economic growth following years of overleveraged investment is cause for concern.
- **Weather Induced Volatility** – See 1Q14 GDP for potential impact. The cold start to Winter 2015 is all too familiar.
- **Pestilence** – Ebola concerns have faded but infectious diseases can spread to markets as well.

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John Huber, CFA, leads Prudent Man Advisor's asset management business and investment process. He is responsible for portfolio management and directs the advisor's research and trading efforts. Mr. Huber is a proven investment leader with over 20 years of experience managing institutional portfolios. He received his Bachelor of Arts from the University of Iowa and earned an MBA in Finance from the Carlson School of Management at the University of Minnesota. He is a Chartered Financial Analyst (CFA) charter holder and a member of the CFA Society of Minnesota.



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