PMA™
PRUDENT MAN ADVISORS

PRUDENT MAN ADVISORS

MARKET OUTLOOK

WINTER 2016

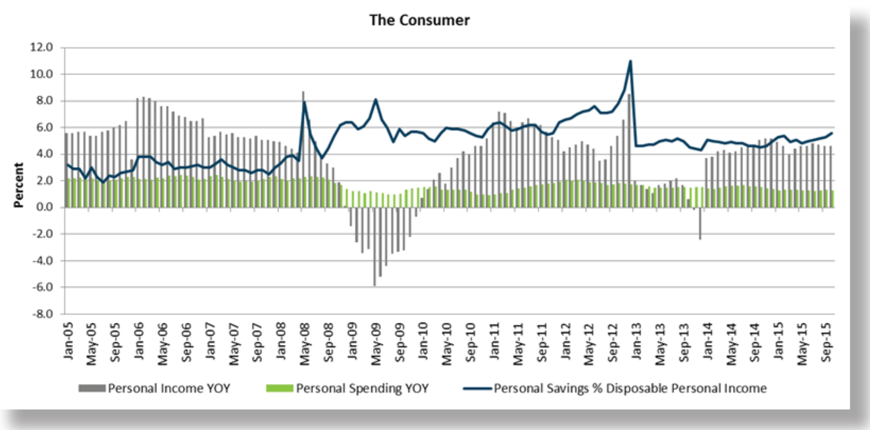
Highlights

Market returns have remained in line with our expectations thus far in 2015 as total returns have remained positive across most sectors. While U.S. equities have outperformed their bond counterparts through November, single digit absolute returns are well below recent and historical levels. With increased volatility expected next year, we forecast the U.S. market to earn similarly low return levels yet again in 2016. Modest positive economic growth, tighter monetary policy, slowing revenue growth and an election year will make it difficult for the markets to generate significantly higher returns. At the same time, a stable domestic economy and continued slow earnings growth provide support to our expectation for low positive returns. As we have entered the mature bull stage of the credit cycle, we anticipate that equities will continue to outperform bonds as interest rates normalize. During this phase of the cycle, particular attention should be paid to quality, as merger, acquisition and shareholder enhancement activity present challenges to the prudent investor. Our outlook calls for higher volatility and a wider range of potential returns in 2016.

Importantly, the future path of monetary policy presents a significant wildcard to these estimates. While U.S. economic growth has disappointed versus typical expansions, sufficient progress has been made toward achieving the Fed's dual mandate of full employment and price stability to allow monetary policy to tighten. While we expect the Federal Reserve to begin the tightening process in December, we don't believe they can tighten policy significantly without presenting downside risks to the market.

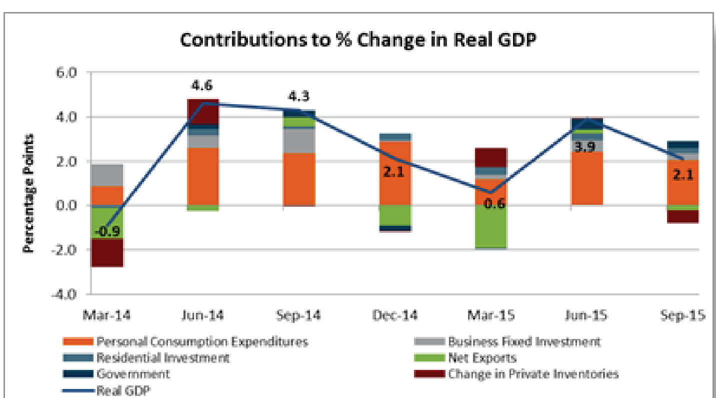
Economic Outlook

We continue to believe that U.S. economic growth is not likely to return to pre-crisis levels in the years ahead. We estimate the economy will continue to grow in the 2.0-2.5% range during 2016. Higher personal consumption levels will be offset by continued weak global growth and the negative effects of a stronger dollar on exports. Given continued gains in the job market, higher asset values, wage growth and the stimulus created from lower energy prices, consumer psychology and sentiment has stabilized in recent years. Credit standards have also been easing which could spur consumption. However, the consumer continues to hold back spending for savings as memories of the credit crisis remain firmly entrenched.



Source: Bloomberg

Similarly, business fixed investment has not returned to pre-crisis levels given the economic and political uncertainties facing most corporations. Growth in nonresidential fixed investment remains well below levels seen during prior expansions. While business fixed investment should pick up in 2016, corporations continue to prefer spending free cash flow on buybacks and other shareholder enhancement activity. Seeing a sustained increase in business fixed investment is important for the economy to move back to its pre-crisis growth rate. Unfortunately, policy conditions and cheap borrowing rates make financial gearing more attractive than the risk associated with increasing capital investment. The election year provides additional complexity to the fixed investment decision.

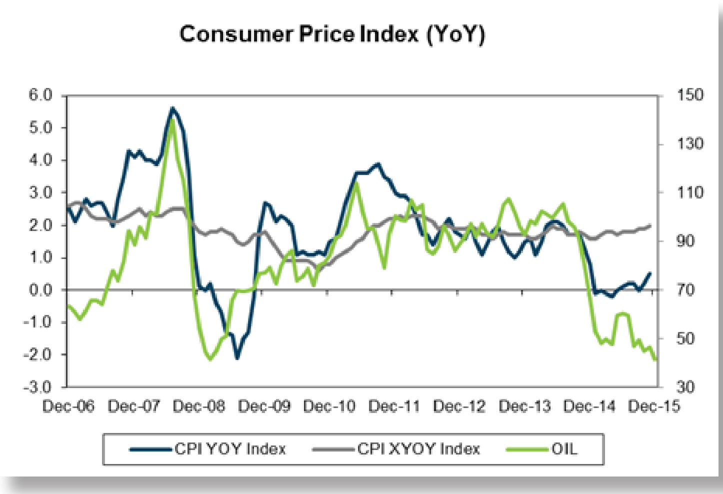


Source: Bloomberg

The housing sector should remain strong in 2016, although we would expect the pace of growth to moderate as the market normalizes. U.S. residential and commercial real estate values have recovered sharply since the crisis. Commercial investment activity remains robust as capital continues to move into the market. While capitalization rates are stretched in many segments of the market, modestly levered mid-teen returns remain attractive versus investment alternatives. The potential for higher interest rates over the next several years present risks, although we don't anticipate a problem in 2016. Single family mortgage rates should remain relatively stable with an upward bias as the curve flattens with tighter monetary policy. We do not expect interest rates to create a large "negative feedback" loop into the broader economy just yet.

Government spending, a drag on growth early in the recovery, has more recently been a positive contributor to GDP. National, state and local revenue levels are recording some of the largest growth rates since 2006. The economic recovery is bolstering personal and corporate incomes, positively impacting government finances and fiscal surpluses.

Net exports should continue to present challenges to domestic growth as U.S. dollar strength and slower global growth create a drag. We would expect these trends to continue in the year ahead as tighter monetary policy acts as a headwind.



Source: Bloomberg

Turning an eye toward inflation risks, deflationary forces have proved powerful following the credit crisis. This force, along with the massive repricing of the commodities market, pushed headline inflation into negative territory during portions of 2015. We are somewhat surprised that the impact of oil prices hasn't yet provided more of a positive impact on consumption. However, we expect headline inflation to move back toward the Fed's 2% target as economic growth remains positive and the unemployment rate continues to fall. A tighter labor market, bottoming energy prices and higher housing costs should push inflation higher during the year.

Interest Rate Outlook

While U.S. economic growth has disappointed versus typical expansions, we believe sufficient progress has been made toward achieving the Fed's dual mandate of full employment and price stability to allow monetary policy to tighten. The risk of tighter policy certainly increases the likelihood for higher market volatility in the year ahead. Our research indicates the bond market has largely priced in the risk of higher rates relative to our forecast. However, current yield levels don't provide investors with a significant income cushion to offset lower bond prices if the Fed decides to act more aggressive in tightening policy.

Our experience informs us that the front end of the yield curve tends to trade off of economic expectations, while the long end of the curve tends to value itself based on inflation expectations. Federal Reserve policy certainly plays an important role in the setting of short-term rates as well. The Fed's own forward rate guidance indicates much higher rates in the year ahead than what either the market or our own forecast currently anticipate. Our view is that while short-term rates will likely move higher, the Fed will be unable to tighten policy beyond 1% without introducing higher market volatility, risking the economic gains accomplished thus far in the recovery. It's a twofold problem for the Fed as the market has become accustomed to low financing rates. As short rates rise, bond prices will fall, but not precipitously given their shorter duration and the fact that short rates are much higher than they were earlier this year. As the Fed increases interest rates, inflation risk premiums will be reduced and the long end of the curve should remain relatively well anchored. In addition, the relative attractiveness of the U.S. bond market should persist as global growth remains constrained and global rates are less attractive, especially during periods of market anxiety. We forecast short Treasury total returns to remain modestly positive with less downside risks versus longer maturity Treasuries.

Expected Returns (PMA Forecast)

	Yield 12/4/15	Yield 10/1/15	Yield Change	PMA	1 Yr Forward
Cash (Net Yield)*	0.05	0.01	--	0.30	--
1 Year	0.70	0.29	0.41	1.00	1.22
2 Year	0.94	0.64	0.30	1.40	1.55
3 Year	1.23	0.91	0.32	1.70	1.74

	Yield	Duration	Income	Roll Down	Expected Return
Cash	0.30	0.00	0.03	--	0.30
1 Year	0.70	0.97	0.70	--	0.70
2 Year	0.94	1.98	0.94	(0.09)	0.85
3 Year	1.23	2.92	1.23	(0.42)	0.81

**Cash Yield/ Expected Return is an Estimate Net of Fees*
1 Year Investment Horizon
Source: Bloomberg/Prudent Man Advisors

Expected Returns

Credit

Our outlook calls for continued positive operating performance for U.S. corporations in the year ahead with slightly weaker credit metrics. While revenue and earnings growth continue to slow, S&P 500 earnings, margins and balance sheets remain healthy. Despite relatively decent overall credit metrics for most U.S. corporations, credit spreads are materially higher during the past year which has hurt relative performance versus Treasuries. Shareholder enhancement activity, wider liquidity premiums and ongoing supply were primary concerns for the market. In addition, as we move forward in this long economic expansion, each year brings renewed concern that the cycle ends and the eventual progression into a recession. The risk of the Fed tightening beyond what is necessary to achieve their dual policy mandate has also been a concern for credit investors.

History reinforces our belief that managing credit risk and paying particular attention to market liquidity is of particular importance at this point in the credit cycle. In the year ahead, we would expect high quality corporate bonds to slightly outperform similar maturity Treasuries as spreads provide good compensation at these wider levels. Higher quality investment grade issuers will likely outperform lower quality companies in 2016. Short-term credit will likely outperform long-term credit. As was the case this year, sector considerations will be of particular importance in generating excess returns.

Sector	Spreads 11/30/2015	12/31/2014	Δ
Communication	198	139	59
Consumer Discretionary	159	104	55
Consumer Staples	129	92	37
Energy	267	197	70
Financial Sr	120	90	30
Financial Sub	199	157	42
Healthcare	139	96	43
Industrials	138	89	49
Materials	271	166	105
Technology	136	86	50
Utilities	161	109	52
All Sectors	165	118	47

Source: Bloomberg

Municipals

Municipal spreads also widened during 2015 in sympathy with the broader credit markets. Current spreads are selectively attractive for many high quality issuers. Our research indicates that positive credit fundamentals and negative net supply should allow municipal spreads to remain stable in the year ahead. Similar to what we've seen in certain sectors of the corporate market, liquidity gaps have been developing for certain distressed municipalities. While we expect continued fundamental improvement in government credit quality overall, there is significant variance in credit risk across the U.S. with certain state and local governments at higher risk for further credit downgrades. Liquidity in this sector of the bond market can be challenging at times. As a result, we have a strong preference for larger deals and higher quality issuers when possible.

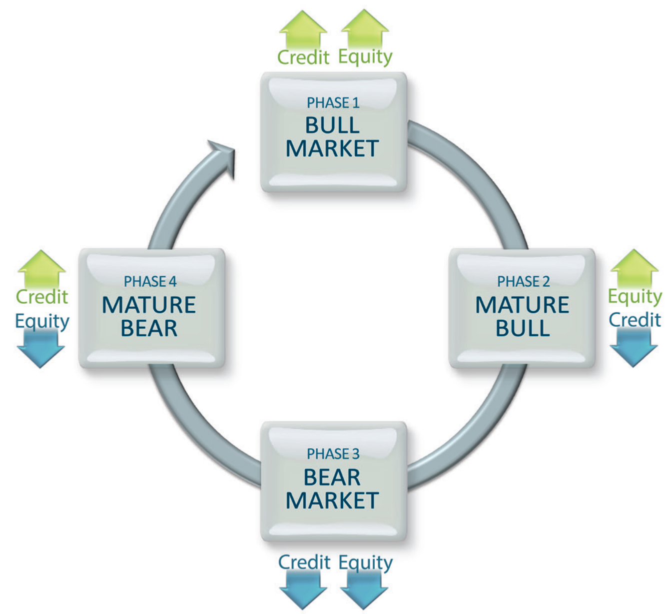
U.S. Agencies

Agency spreads have tightened over the past year as supply has decreased. The large agencies have preferred issuing callable agency debt to fund their portfolios versus issuing global bullet debentures further out the curve. Callable agencies generally trade rich versus comparable maturity bullet agency issues when one accounts for the value of the imbedded call option. As a result, we don't find much value in traditional callable agency paper versus high quality alternatives. Diminishing supply and the lack of high quality investment alternatives have combined to push bullet agency spreads tighter to similar maturity Treasury paper. While we don't see a lot of value on agency spreads at present, we prefer longer agency spreads as their curves appear too steep. Generic global benchmark agency bonds are most attractive during the new issue period as secondary spreads tend to tighten quickly to the curve following new issue. We are neutral on agency mortgages as we remain concerned on potential supply and extension risk which could negatively impact returns.

U.S. Equities

We would expect to see higher volatility and some large price swings in the equity markets as the Fed begins to lift short-term rates. While stocks ultimately traded higher during the past three rate hiking cycles, stocks traded lower initially as policy firmed. That said, we remain cautiously optimistic for stock returns given our economic outlook and the lack of compelling investment alternatives for most long term investors. While market valuations have moved higher, valuations and investor behavior do not appear overly extended at this point in the expansion. We are in the mature bull stage of the credit cycle and would expect stock returns to remain compelling versus bonds in 2016. Utilizing a conservative earnings growth estimate of a 0-2%, a dividend yield of 2% and a flat P/E multiple, we would expect returns for U.S. stocks in the 1-4% range. Returns could be materially higher or lower if earnings materially surprise or market multiples expand or contract.

CREDIT CYCLE



Summary Outlook

We believe an investment process informed by in-depth research and guided by risk management leads to a diversified portfolio solution that can generate value-added investment returns. As experienced fiduciaries, our philosophy has consistently emphasized the safety of principal, provision of suitable liquidity and the generation of yield – in that order of importance. Within that framework, PMA seeks to preserve its clients' principal and maximize income through disciplined bottom-up security selection and strong risk controls. Our fundamental research opinion is grounded within an expected returns framework.

Overall, we continue to emphasize higher quality portfolios strategically diversified across allowable sectors. Credit markets have become more attractive as spreads widened materially in 2015. We would modestly overweigh high quality agency, corporate and municipal credit versus comparable Treasuries. While domestic equities should outperform most fixed income sectors, low single digit return levels are forecast for 2016.

Asset Allocation and Historical Returns

While financial markets are efficient, there are persistent opportunities to add value across fixed income sectors through an actively managed approach. Our experience and independent research indicates overall portfolio risk can be reduced by strategically diversifying across non-correlated sectors of the market. Our investment approach relies on tactically overweighting sectors that have exhibited persistently attractive risk adjusted return profiles.

Toward that end, our research professionals analyzed historical performance across various U.S. fixed income sectors to identify persistent sources of excess returns. In the table shown, we have calculated information ratios for each sector for the analysis period. Information ratios are calculated by comparing the sectors historical excess returns versus the volatility of those excess returns. Higher information ratios indicate higher risk adjusted returns for the period in question.

Fixed Income Sectors	10 Year Annualized Return	Excess Returns	Std Dev of ER	Information Ratio	Duration
US Treasuries	4.48%	0.00%	0.0%	-	5.8
US Aggregate	5.06%	0.30%	1.8%	0.2	5.6
US Agg AAA	6.91%	0.21%	1.0%	0.2	5.0
US Agg AA	6.76%	0.38%	3.4%	0.1	5.9
US Agg A	7.52%	0.40%	5.2%	0.1	6.9
US Agg BAA	8.57%	0.95%	6.7%	0.1	7.5
US Agg 1-3yr	**5.45%**	**0.28%**	**0.8%**	**0.4**	**1.9**
US Agg 3-5yr	6.99%	0.34%	1.5%	0.2	3.7
US Agg 5-7yr	7.53%	0.47%	2.2%	0.2	4.5
US Agg 7-10yr	8.41%	0.64%	2.6%	0.2	6.1
US Agg 10+ Yr	8.22%	0.13%	3.4%	0.0	14.5
US Agg Agencies	**6.73%**	**0.36%**	**0.8%**	**0.4**	**4.0**
US Corp Inv Grade	5.51%	0.57%	5.4%	0.1	7.1
US Corp Intermediate Inv Grade	5.23%	0.72%	4.6%	0.2	4.4
US Corp Long Inv Grade	6.25%	0.25%	8.0%	0.0	13.5
CMBS	10.69%	1.21%	8.8%	0.1	4.8
ABS	5.33%	0.41%	4.7%	0.1	2.4
US MBS Fixed Rate	**5.01%**	**0.45%**	**1.2%**	**0.4**	**4.2**
1-3 Yr Credit	**3.88%**	**0.78%**	**2.2%**	**0.4**	**2.0**
1-5 Yr Credit	**4.43%**	**0.73%**	**3.0%**	**0.2**	**2.8**
5-10 Yr Credit	7.87%	0.62%	5.4%	0.1	6.5

Source: Barclays. 10/31/2005 – 09/30/2015.

There are several observations we can draw from this analysis:

1) U.S. Agencies have been attractive – Both agency debentures and agency mortgages have provided strong risk adjusted returns historically.

2) Short-Term credit risk has been attractive – Investors have historically been well compensated for investing in high quality short-term corporate bonds. Credit spreads are too high for undertaking short-term default risk. We see this in attractive information ratios for the short-term credit sectors.

3) Credit Curves have been too flat – Information ratios decline from US Aggregate 1-3yr index at 0.36 to US Aggregate 10yr index at 0.04. Investors need to receive additional compensation to take long-term credit risk.

4) Higher quality sectors have been attractive – AAA and Agency sectors tend to outperform other sectors on a risk adjusted basis.

Contact Information

JOHN H. HUBER, CFA

Senior Vice President, Chief Investment Officer
Prudent Man Advisors, Inc.

Tel: 630.657.6510
Email: jhuber@pmanetwork.com

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.

PMA™
PRUDENT MAN ADVISORS
Integrity. Commitment. Performance.™