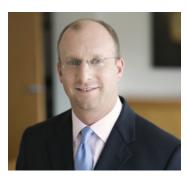
The Colony Group The Smart Choice in Wealth Management™

In This Report

Colony Market Perspectives



Brian Katz, CFA
Chief Investment Officer

Introduction

The second quarter of 2015 was not as kind to investors as the first. Several concerns bubbled to the surface during the quarter, including the standoff between Greece and its creditors, a Chinese stock market

rout, slower U.S. economic and earnings growth, and the perception that the Federal Reserve was more likely than not to increase interest rates. It served as a reminder to investors that the world continues to be confounding. U.S. equities, as proxied by the S&P 500, declined on a price basis after nine consecutive quarters of increases but eked out a positive total return of 0.28% for the quarter. The real action was in the fixed-income markets, however, as the 10-year US Treasury yield increased to 2.34% from 1.93% at the end of the first quarter, representing the first quarterly increase in yields since the end of 2013. Investors finally seemed to accept that the Fed is committed to raising rates sooner rather than later. A fleeting belief that the European Central Bank would end its quantitative easing program early, after the European Union reported a handful of positive economic surprises, caused German 10-year government bond yields to spike to 0.74% from 0.18%. As a result of higher

Timing versus Pace China Bubbles

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global interest rates, equity returns worldwide were well below first quarter levels. These shallow equity returns have made the performance of alternative investment strategies stand out thus far in 2015.

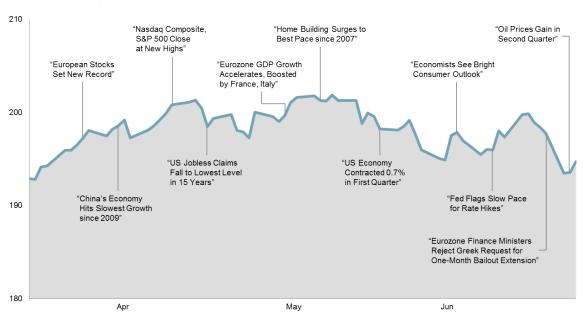
Timing versus Pace

In our view, investors have grown far too concerned about the timing of the Fed's first interest rate hike. We believe that a more meaningful contributor

to future investment returns will be the pace and magnitude of subsequent hikes.

It has been more than six years since the Fed slashed the federal funds target rate to between 0% and 0.25% in an effort to stem the financial crisis. As time has passed, investors have grown increasingly apprehensive, which is understandable considering that this is the longest period between rate hikes on record.

MSCI All Country World Index with selected headlines from Q2 2015



Graph Source: MSCI ACWI Index. MSCI data © MSCI 2015, all rights reserved.

Both the severity of the past recession and the slow pace of recovery have had an impact on the interest rate cycle. The 2007 – 2008 financial crisis resulted in the worst economic downturn since the Great Depression in the 1930s. U.S. gross domestic product (GDP), the broadest measure of U.S. economic growth, contracted 4.3% between 2007 and mid-2009; the unemployment rate rose to 10% by late 2009 from 5% in 2008; and the S&P 500 declined 57% peak-to-trough. Since the recession ended in June of 2009, the U.S. economy has grown at a subpar rate. In fact, with an annualized real growth rate of approximately 2.2%, it is the weakest recovery from a recession in the post-World War II era.

Since the Fed has not had to contend with a robust economy, the urgency to normalize interest rates has been almost nonexistent. Core consumer price inflation, a measure of the change in prices of a broad basket of goods that excludes the more volatile food and energy sectors, has averaged 1.7% since the recovery began, comfortably below the Fed's stated inflation target of 2%. Recent declines in energy and commodities should keep a lid on prices for now. As a result, consensus expectations for the timing of the first rate hike keep getting pushed out.

What this means – Historically, the start of Fed interest rate increases has not been bad for equity market returns. Looking at the past six rate-hike cycles dating back to 1983, the average S&P 500 return was 2.6% one year later and 14.4% after two years. Of these six cycles, half began after the Fed was on hold for at least a year. During these three cycles the numbers are even more compelling, with the S&P 500 up an average of 15.3% after year one. Those stellar returns were also accompanied by higher volatility, with pullbacks ranging from 8% to 10% in the months surrounding the initial rate increase.

In short, investors need not necessarily fear the first interest rate hike. We believe that how quickly the Fed raises rates will have the most influence on future returns. The Fed and most prognosticators expect a prolonged and gradual cycle of interest rate increases, which should support equity returns moving forward. Should economic growth run hotter than expected, we could see a steeper trajectory of rate hikes and a more difficult environment for risk assets.

China Bubbles

While the majority of media attention has been focused on Greece, we believe that China deserves top billing. The future direction of the world's second largest economy should have a more lasting influence on the investment landscape than the outcome of the Greek crisis.

The Chinese stock market corrected in spectacular fashion during the last couple of weeks of the second quarter and into July. Between June 12th and July 8th, the Shanghai A-Share Composite Index declined more than 32%. This pullback follows a meteoric rise over the past year that saw the index increase 158% between May 19, 2014 and June 12, 2015.

Last year, the Chinese stock market touched multiyear lows as returns severely lagged the rest of the world. The government, through a series of interest rate cuts and regulatory changes, hoped to rouse China's moribund stock market. Historically, real estate was the primary destination for investors' cash, and this market was overheating. Presumably, Beijing saw this as an opportunity to redirect speculators away from real estate and into the stock market, an endeavor that proved all too successful. New brokerage accounts surged to record highs as millions of first-time investors opened accounts.

Gambling has long been a part of Chinese culture and has been manifested in China's stock market over the past year. Retail investors account for 80% of all transactions in Chinese stock markets, a far higher level than in most developed markets, which are dominated by institutional investors. These retail investors used margin debt, loans collateralized by the value of brokerage accounts, to buy more stock. By June of this year, margin debt had increased more than 450% to 2.27 trillion yuan (\$365 billion), accounting for more than 8.7% of total free-float market capitalization. This compares with only 2.8% for the U.S. Margin can work well when stock prices are rising; but when stock prices decline, margin loans are called, which forces investors to sell stock and can result in a vicious circle of selling, the likes of which we are currently seeing in China.

What this means – First, it is important to place the recent decline in China's stock markets, which have reached bear market levels, in context. Through July 9, 2015, the Shanghai A-Share Composite Index was up 14.7% year-to-date, ranking as one of the best performing equity markets in the world. At current levels, the index is back to levels last seen in March of this year. Many investors that only recently opened accounts have suffered losses, but many longer-term investors are still in the black.

Whether China's response to the panic selling will be effective has yet to be determined; however, Beijing's resolve and means should not be underestimated. Chinese policymakers have the ability to enact rules that free-market policymakers do not. Moreover, China has repeatedly shown it will go to great lengths to ensure social stability and that it views the current bear market as a direct threat due to retail investors' high participation rate.

Most Colony Group client portfolios have very little direct exposure to Chinese equities. Nevertheless, investors fear that China's stock market slide could have a contagion effect on the rest of the world. China's share of global GDP has increased from 5% in 2005 to 15% today. It consumes more than half of the world's supply of copper, steel, and aluminum and is a significant buyer of crude oil. Finally, it is an important end market for many emerging market exports. As

such, its importance as a global economic growth engine should not be underestimated.

We do not expect the troubles in the stock market to have a material impact on China's economy. Households' equity-market exposure as a percent of total wealth is low relative to the rest of the world. Therefore, the economy did not experience an increase in consumption as the market went up and should not be expected to see a decline on the way down. China's corporate sector is not reliant on the equity markets the way more developed economies are. Indeed, equity accounts for only 4% of total corporate financing, with bank loans continuing to account for the vast majority. Of course, if selling pressure does not let up soon, it could impact consumer and corporate confidence, which would be a headwind for spending. We do not expect that to happen at this point.

The impact of the bear market in China on the investment landscape should be relatively limited

in our opinion. While select commodity markets and emerging market equities may experience headwinds should the selling persist, we believe the broader economy and global risk assets should be somewhat immune.

Conclusion

In the second quarter, investors were reminded how pervasive uncertainty is throughout the world today. Greece, China, Ukraine, Syria, and Iran are today's focal points. Former Secretary of Defense Donald Rumsfeld referred to these focal points as "known unknowns." By definition, it is impossible to know what tomorrow's "unknown unknowns" are. Certainly, Fed interest rate policy will be top of mind, along with how the crisis in Greece and the Chinese stock market meltdown resolve themselves.

COLONY SPOTLIGHT

- Over 100 clients, business partners, and friends joined us at our first Richmond-area event, held at the Virginia Museum of Fine Arts.
- We introduced our Women & Wealth Connect initiative with a Boston launch event focused on philanthropic involvement.
- Our firm was recognized In the Financial Times' annual list of Top Registered Investment Advisors.
- In *Financial Advisor's* Annual RIA Ranking, we ranked in the top 10% out of over 550 firms.
- Our institutional practice received CEFEX certification from the Centre for Fiduciary Excellence.



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Financial Times' Top RIAs – This list is based on assets under management, assets under management growth rate, firm's years in existence, compliance record, and industry certifications. The Financial Times ranking included The Colony Group for 2014 and 2015.

Financial Advisor annual ranking – This ranking is based on assets under management. The Financial Advisor lists included The Colony Group for 2008-2015. The Colony Group was ranked in the top 10% of registered investment advisor firms for 2015.

CEFEX Certification: The Colony Group's institutional practice, based in Richmond, VA, joined The Colony Group in March 2015 when CapGroup Advisors, LLC, merged with and into The Colony Group. CapGroup Advisors received the CEFEX investment advisor certification from the Centre for Fiduciary Excellence each year from 2010-2014, and as a part of The Colony Group, the institutional practice received the certification in 2015.