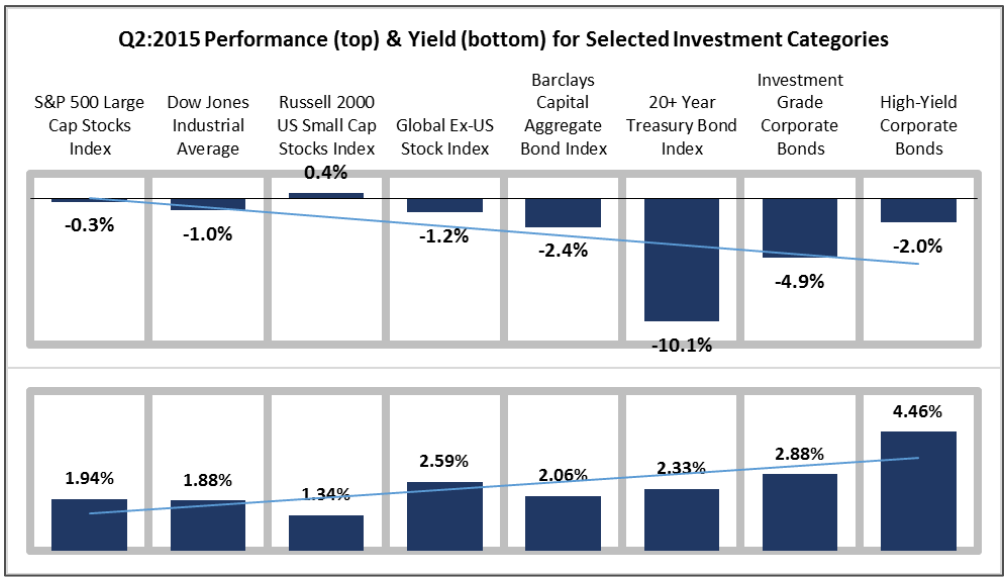
PENDLETON STREET
BUSINESS ADVISORS

Pendleton Street Advisors
2nd Quarter 2015 Investment Commentary
July 20, 2015

Index Returns	2nd Quarter	Year To Date	Trailing Twelve Months
S&P 500 Large Cap Stocks Index	-0.2%	0.2%	5.2%
MSCI All Cap World Stocks Index	-0.9%	1.6%	-1.3%
Barclays Capital Aggregate Bond Index	-2.4%	-1.2%	-0.6%
US Core Consumer Price Index - (Inflation)	0.6%	1.0%	1.7%

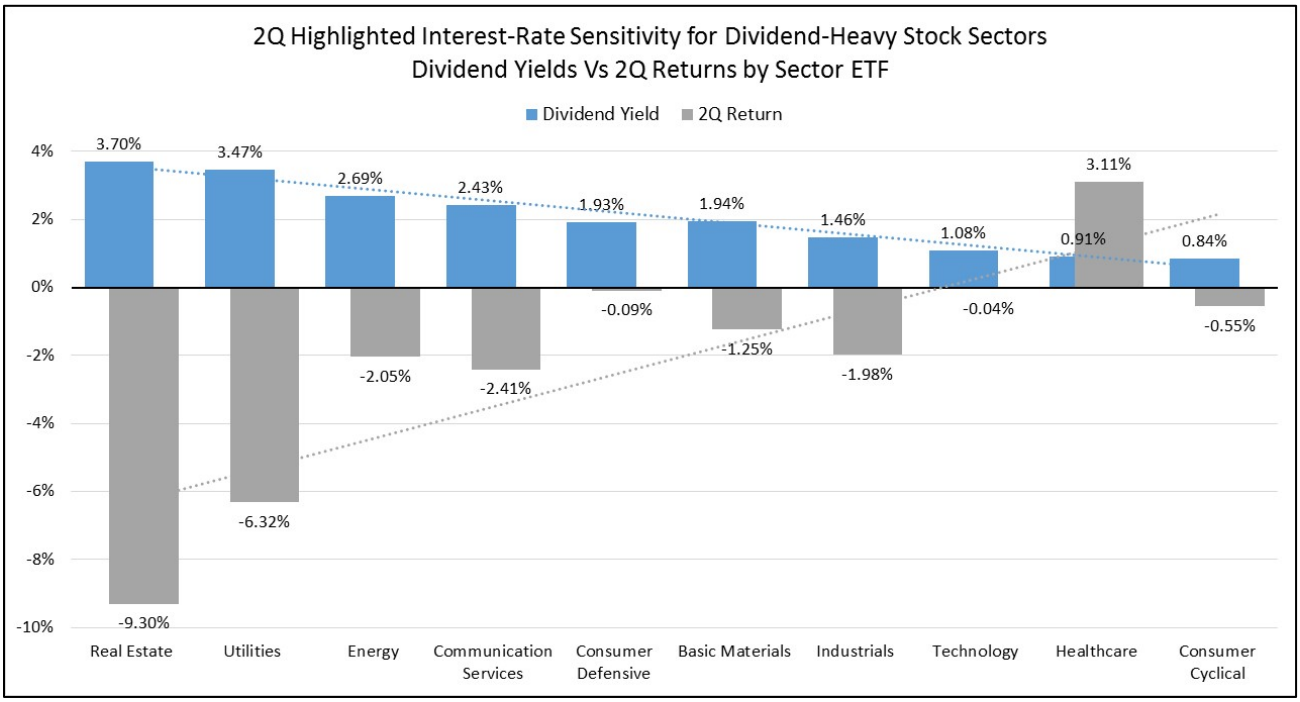
During the second quarter of 2015, global equity and bond indexes declined as markets weighed prices against the uncertainty of domestic and global economic conditions. In this quarter's commentary, we outline a few observations from the markets that we believe have been overlooked so far, and discuss our approach going forward.

1) **Flight FROM Quality:** Investments perceived as riskier based on historical measures of volatility declined with the broader markets during the quarter, but many of the market sectors considered to be less volatile suffered more significant declines. We view this as the result of over-crowding in the flight to quality movement that has taken hold over the past few years, with quality being too-narrowly defined as income-generating investments. Income-focused investments, however, are sensitive to the expected rise in yields as the US begins a cycle of interest rate increases. For example, while US Treasury Bonds are seen as a risk-free asset class in terms of default risk, the Barclays Capital 20+ Year US Treasury bond index declined by 10.1% during the quarter.[1]



[1] All analysis by Pendleton Street Advisors, LLC. Data from publicly-available sources unless otherwise noted.

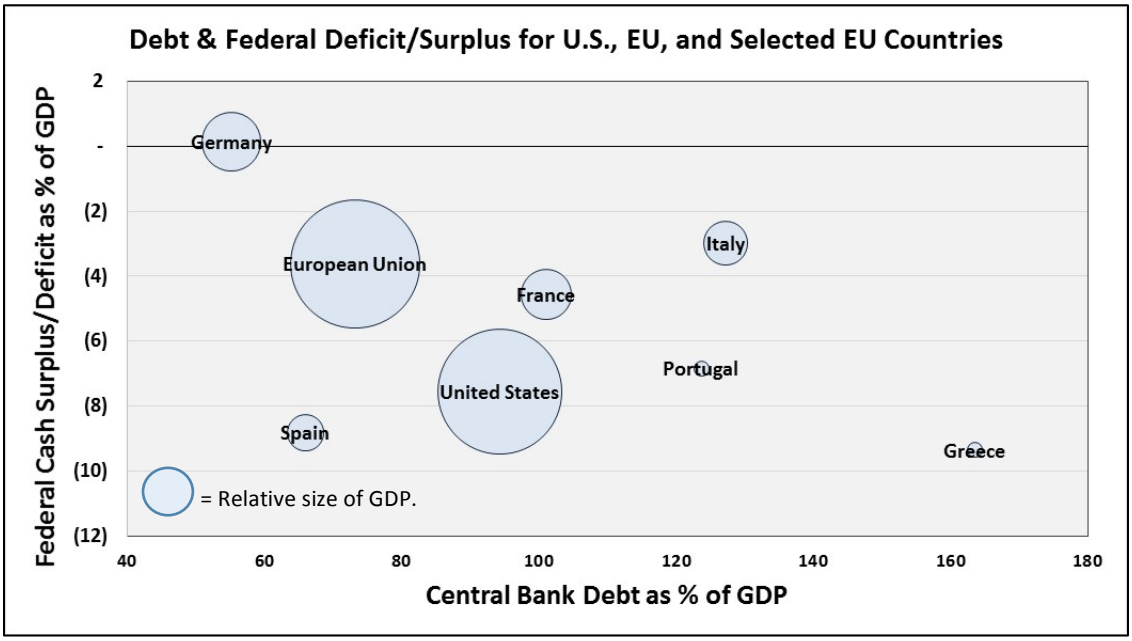
Within the US stock market, we found a similar dynamic: Higher-yield sectors declined more than sectors with lower yield during the 2nd quarter (See chart below).



2) **Sovereign Debt Crisis**: Greece defaulted on an interest payment to the International Monetary Fund on June 30, which was followed by a citizens' vote not to adopt austerity measures required by the EU that would allow it to continue receiving financial support. Prior to defaulting, the country's government froze the banking system, severely limiting citizens' ability to withdraw deposits as an attempt to prevent a run on banks. Since then, the EU and Greece seem to have come to an agreement on continued financial support, resolving the immediate threat of Greece exiting the EU, but the greater concern resulting from the situation will be what precedents the events set for how the union deals with other economically weaker countries.

As far as the country's impact on the global economy and markets is concerned, Greece represents less than 0.50% of the world's Gross Domestic Product, and less than 1% of global combined central bank debt. By contrast Germany and France, the EU's two largest member-economies, represent approximately 8.6% of Global GDP, and 10.8% of global central bank debt.

While Greece presents a challenge, the EU is in some ways stronger than the United States from a solvency and debt coverage perspective. The chart below illustrates that, on a consolidated basis, the EU has less debt relative to GDP, and operates at a smaller deficit of income to expense than to the US. This demonstrates to us that despite its lack of real unity, the European Union as a whole is not on the verge of economic collapse. If the EU falls apart or its currency fails, it will not be because member countries could not afford to save it.



3) **Biased Viewpoint:** International stocks have continued to outperform US stocks so far in 2015, even with deteriorating market conditions in China and the seemingly never-ending economic issues in the European Union. This marks a reversal from the last couple of years, during which US stocks, specifically large-cap US stocks, outperformed international stocks.

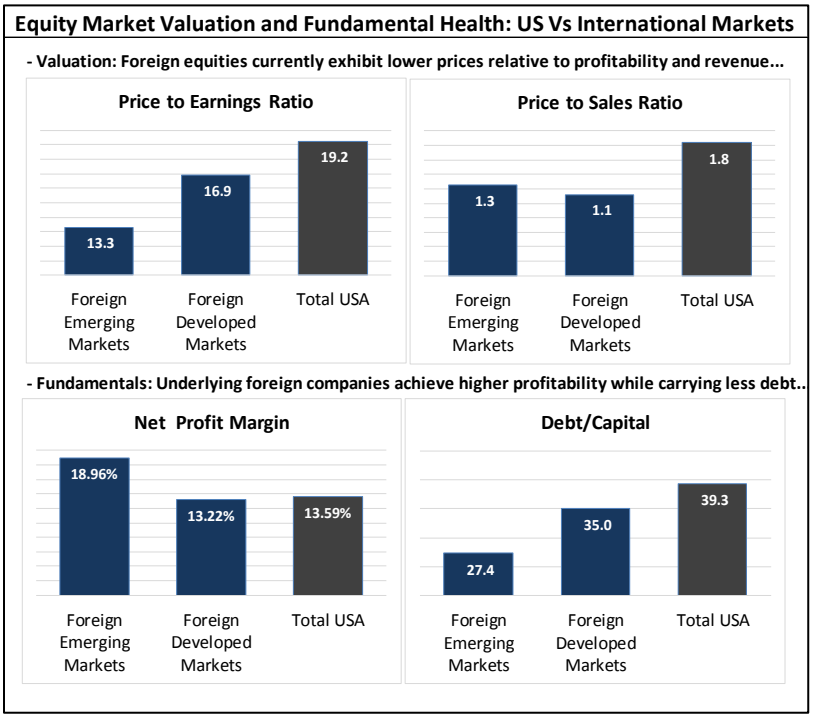
U.S. Vs. Global Stock Performance: YTD 2015			
	U.S.	Global Ex-US	Vs Global
Total Stock Market	**1.79%**	**4.24%**	**-2.45%**
Energy	-4.10%	-4.57%	0.47%
Communication Services	1.24%	5.12%	-3.89%
Utilities	-10.77%	-7.85%	-2.91%
Real Estate	-6.08%	-2.84%	-3.25%
Industrials	-0.49%	0.70%	-1.18%
Consumer Defensive	1.09%	1.62%	-0.52%
Healthcare	10.62%	10.02%	0.60%
Consumer Cyclical	4.41%	7.92%	-3.51%
Technology	0.76%	1.38%	-0.62%
Basic Materials	-1.62%	0.86%	-2.48%
Financial Services	3.00%	2.83%	0.17%

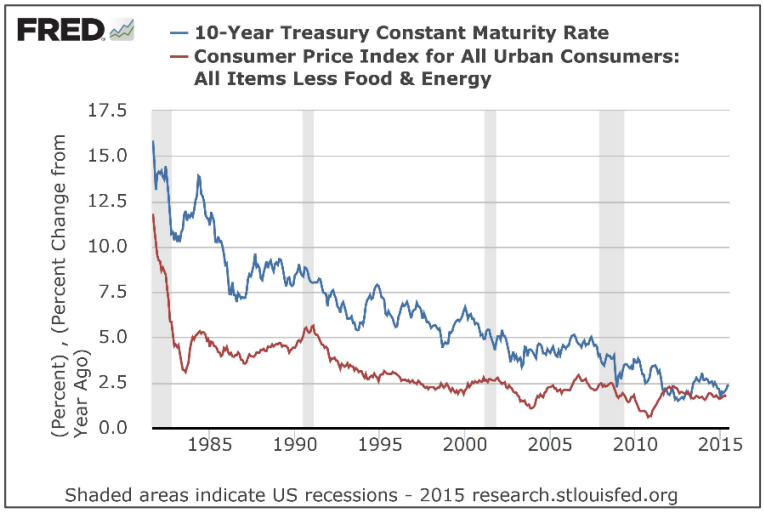
Diversification provides benefits to portfolios by reducing volatility and return correlations. Yet, as a result of the tendency to assume that the future will mirror the past, and the well-studied phenomenon that investors subjectively prefer home-country investments, many portfolios have little to no allocation to international investments.

If an aversion to non-US economies is the implied objective of domestic-only portfolios, investing only in US stocks is definitely counter-productive. Standard & Poor's estimate that 46% of sales of S&P 500 companies, which are all US companies, are derived overseas. As a result, a portfolio invested only in stocks of S&P 500 companies would have about that amount of *economic* exposure to non-US economies, even though the portfolio's US *market* exposure would be 100%.

Our Approach: When we combine foreign markets' currently low valuations relative to the US market with comparable profitability, and stronger balance sheets, we conclude increased exposure to international stocks should benefit client portfolios in the long-term. That is why, early in the third quarter we increased allocations to international equities across most client portfolios.

We also view it as likely that increasing volatility in bond markets will continue, along with bond yields trending higher. Bond prices move inversely to yields, so as yields trend higher prices will come down resulting in low to negative returns in many segments of the bond market.





Since 10-Year Treasury yields peaked in 1981 at close to 16%, bond investors have experienced decent yields and the tail-wind of rising prices. Yields are now at a point where the yield on 10-Year Treasuries is only slightly higher than inflation at 2.34%. This means that those bonds, if held to maturity, are good for little more than maintaining purchasing power. We are not convinced that markets are pricing bonds with fundamentals in mind, as yields have historically stayed above percentage growth in nominal GDP; yet, GDP is expected to grow by about 2.5% annually, over and above the rate of inflation, for the next 10 years.

We have positioned portfolios for this evolving environment across asset classes, and continue to adjust as necessary based on our clients' objectives. We appreciate the trust you place in us as advisors, and look forward to speaking with you soon.

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