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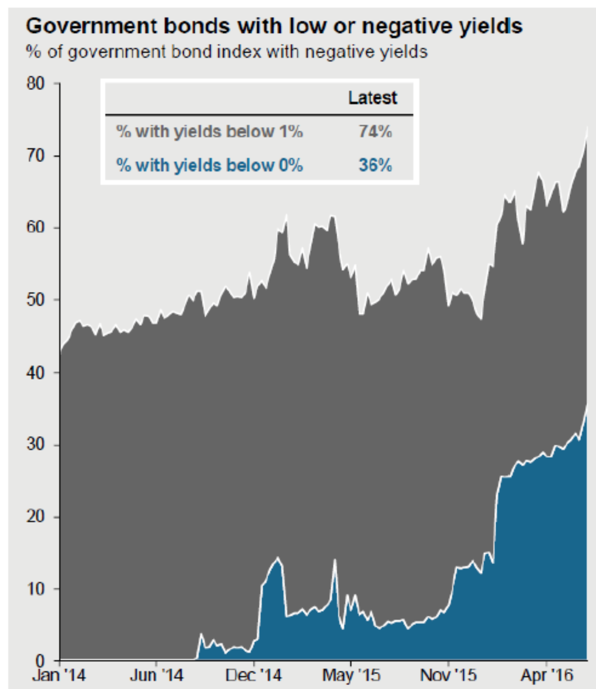
For the past few years, headlines of quantitative easing, zero interest rate policy, and the "reach for yield" have consumed many financial news cycles. The fact that we are in a low interest rate environment is not news. However, the prevalent interest rate headline in 2016 is truly remarkable: negative interest rates. If you are an investor in Japan, Switzerland, and most recently Germany, you must now pay the government for them to borrow money from you. This shift in investment protocol is affecting multiple dimensions of the investable universe and consequently affecting how we are assessing client portfolios. Specifically, we are continuing to conservatively position our Capital Preservation allocations by keeping interest rate risk low and continuing to focus on United States debt. We are cautious of the effect interest rates are having on developed equity market valuations, and as we communicated in June, have begun to reduce equity market risk within our Growth allocations. We are also searching for opportunities created by this rate environment and have increased our inflation protection assets, such as gold miners and Master Limited Partnerships (MLPs), as well as reworked our emerging market exposure. We are confident in our inability to predict short-term market events, but maintain that a disciplined valuation-oriented approach will best serve clients long term.

**A Brief Background of Negative Rates**

Switzerland first issued negative yielding debt 5 years ago this month. Denmark, Finland, and Sweden were also among the first governments to issue negative yielding debt, arguably to keep their currencies stable against the Euro. Then the European Central Bank (ECB) began its negative interest rate policy in 2014 to reinforce its policy of quantitative easing and stave off concerns of deflation. However, the real trend of negative rates picked up speed in early 2016. The Bank of Japan began a negative rate policy in January of this year, and now half of the global balance of negative rate debt is Japanese. The ECB extended its quantitative easing program to include purchasing corporate debt, which pushed some corporate rates below 0%. And finally, Germany also began issuing negative rate debt this year. The cumulative amount of outstanding negative interest rate debt is up by 50% in Q2 2016; representing $11.8T in government bond principal, up from $7.8T in March. *Currently 36% of ALL sovereign debt has a yield below 0%!*




Source: JP Morgan

**Domestic vs. International Rates**

The 10 year US Treasury bond hit a low of 1.37% for the first time in history this July. The "flight to quality" the markets exhibited post-Brexit as well as the Fed's statements in the June FOMC meeting pushed rates down to this 250+ year low. The two times in our nation's history the 10 year bond rate has come close to this level was post-WWII and then again post-financial crisis during the height of quantitative easing. Even still, the majority of positively yielding government debt in the world is issued by the United States.

Though low in absolute terms, our domestic rates are some of the best high quality returns available in comparison to the global alternatives. As of the end of June, on a look through basis, our Capital Preservation allocation is 96.7% US exposure. As evident from the current G10 government bond rates, the United States has one of the more attractive sovereign debt offerings, and we anticipate remaining US focused in our bond allocations.

| Country | 10 YR Rate | Moody's Rating | Rating Description |
|---|---|---|---|
| **United States** | **1.46%** | **Aaa** | **Highest Quality** |
| Italy | 1.17% | Baa2 | Medium Quality |
| Canada | 1.03% | Aaa | Highest Quality |
| United Kingdom | 0.69% | Aa1 | High Quality |
| Belgium | 0.14% | Aa3 | High Quality |
| France | 0.11% | Aa2 | High Quality |
| Netherlands | -0.01% | Aaa | Highest Quality |
| Germany | -0.12% | Aaa | Highest Quality |
| Japan | -0.17% | A1 | Upper-medium Quality |
| Switzerland | -0.58% | Aaa | Highest Quality |

Source: Bloomberg and Investing

**Interest Rate Risk and the Reach for Yield**

Perhaps one of the most common themes in this low-to-negative interest rate environment is the “reach for yield” many investors are exhibiting. Investors only have two options if higher bond yields are desired.

1. Increasing interest rate risk

Debt with longer dated maturities typically pays higher interest rates. An easy solution for investors with minimum yield targets is to increase the maturities on their bond holdings. Unfortunately, increasing the maturity also increases interest rate risk. When interest rates eventually rise, the prices of longer dated bonds will be more negatively impacted than the prices of shorter dated, lower yielding bonds. Investors adopting this yield strategy are explicitly taking the view that interest rates will remain at current lows long term. We are not comfortable taking this view, and have kept our bond allocations defensively positioned. Our goal in the Capital Preservation allocation is just that, preserving capital, not reaching for yield.

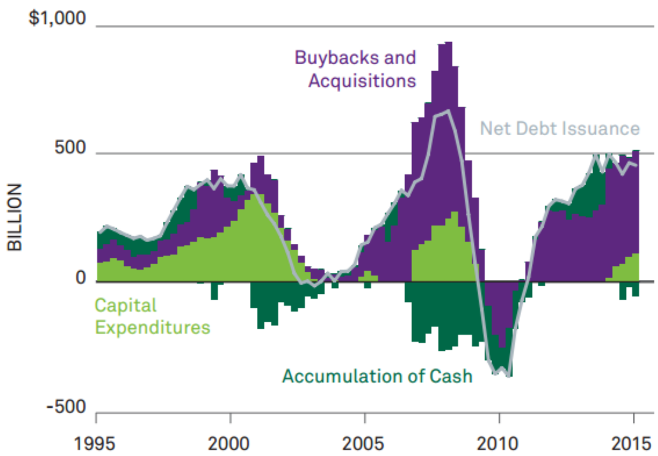
2. Increasing the credit risk of the portfolio

Another solution is to take on greater credit risk in the portfolio. Loaning money to United States government pays much lower yields than loaning money to a small biotech company or a struggling energy company. However, the high-yield bond space has exploded with capital inflows the last couple years. It is easy to argue these lower quality issuers have become overly leveraged from the increase in capital flows, and the valuations on these higher risk bonds may not accurately reflect the true risk investors are undertaking. Again, this is not a space we feel comfortable allocating to client portfolios.

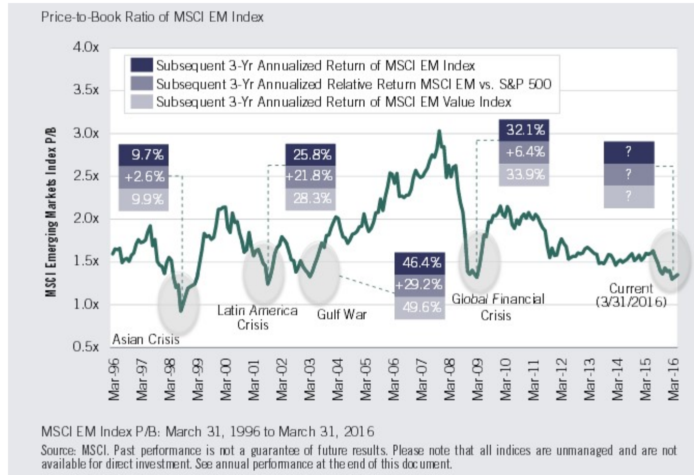
**Impact on Equity Market Valuations**

While zero interest rate policy and now negative interest rate policy have increased the challenges of fixed income investing, they have also had a meaningful impact on stock market valuations. Corporations have been able to leverage their balance sheets at historically low costs. While this presents the opportunity for further economic growth through long term capital investments and research and development, most US corporations have instead chosen to use this cheap debt to buy back shares or make acquisitions. The purple shading in the graph below represents the portion of debt being utilized for buybacks and acquisitions, clearly illustrating this trend. We believe this method of debt utilization could be putting future earnings power at risk, despite propping up near term valuations. As we mentioned in our June communication, we are concerned with equity market valuation levels and recently began trimming exposure in our Growth allocation.

U.S. Non-Financial Firms' Use of Debt, 1995–2015




Sources: BlackRock Investment Institute, Federal Reserve and IMF, October 2015. Notes: Capital expenditures represent the portion funded by debt only (capex minus internal funds). Buybacks and acquisitions are net of any new share issuance by companies. Cash includes other financial assets.




MSCI EM Index P/B: March 31, 1996 to March 31, 2016

Source: MSCI. Past performance is not a guarantee of future results. Please note that all indices are unmanaged and are not available for direct investment. See annual performance at the end of this document.

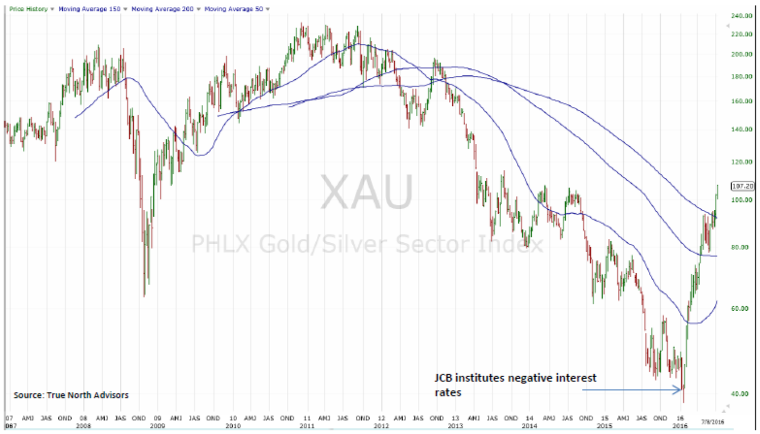
**Opportunities for Growth / Current Market Opportunities**

Emerging market equities are a different story. Emerging Markets were out of favor the last several years with a cumulative negative return of -19% from 2013-2015. They underperformed their developed counterparts by almost 15% in 2015 alone. However, with developed market stocks continuing to be bid up (arguably without the fundamental data to support their continued rise), emerging market stocks seem relatively undervalued. The Price/Book ratio illustrates the difference between the value the stock market is placing on a company and the value of that company on its own balance sheet. A lower P/B ratio indicates a more attractive market valuation level. The Q2 Price/Book multiple of the MSCI Emerging Market Index was only 1.47x. For comparison, the quarter end Price/Book of the S&P 500 was at 2.7x. While we expect to see a valuation premium on developed markets, the current difference in these P/B ratios is almost 30% higher than the historical average, suggesting EM may still be relatively undervalued. The chart below illustrates how Emerging Market equities have meaningfully outperformed the S&P 500 after prior periods of similar undervaluation.

We approved a new manager for our emerging market exposure last December that focuses on companies with sustainable growth and limited reliance on external capital markets; in other words the portfolio consists of largely self-funding companies. Our thesis is that a skilled manager may be able to create more stable performance in markets where the gap between top performing companies and under performing companies is wide, and where capital market access is somewhat unpredictable. Both of our emerging market funds are up more than 11% YTD as of the end of June, and we continue to see opportunity in this space.

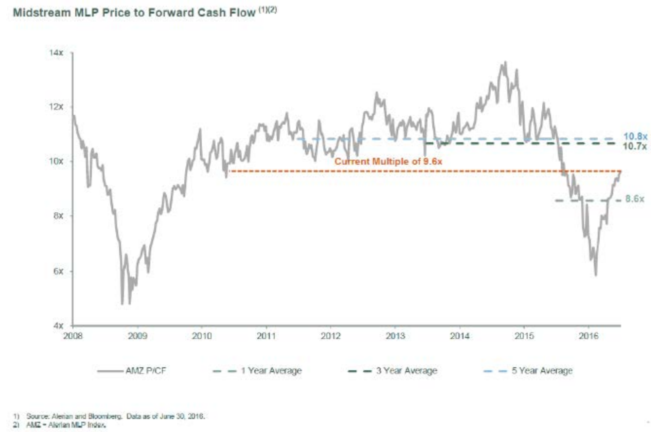
We also see opportunity for growth in inflation protection assets, specifically gold miners and MLPs. Gold mining stocks hit a multi-year low last July, at which point we began our extensive due diligence process on several gold mining funds. We prefer to invest in gold mining companies over physical gold for several reasons. Physical gold can only appreciate by the amount of physical gold. Gold mining companies have additional operating leverage that results in the stocks typically moving at least twice the price of the bullion. In other words, it is a cheaper way to get increased gold exposure with less capital. Given the level to which gold has fallen over the last few years, we like the leverage these mining stocks provide.

Gold exposure has also historically served as a hedge against geopolitical, market, and currency risk. As the graph below illustrates, the price of gold directly responded to the announcement of Japan's central bank in January to institute negative interest rates. Even with the strong YTD gold performance and high expected volatility, we like both the valuation and hedging characteristics gold miners provide.




Master Limited Partnerships (MLPs) are another area of current market opportunity. Because of tax regulations, MLPs are almost exclusively oil and gas investments that are pass-through entities. In other words, they must pass-through, or distribute, the income generated from underlying assets to the investors of the MLP. Currently the yield on a typical midstream MLP is around 7.5%, a stark contrast to the <2% 10 Year Treasury yield or the 2.05% dividend yield on the S&P 500. As the opportunity set for bonds has weakened, demand for MLPs has increased and has pushed valuations higher. We believe that this increase in the demand for higher yielding assets is a dynamic that will not revert soon. MLPs are positioned to benefit from further yield compression, despite having experienced high levels of volatility given this yield supply/demand dynamic as well as the underlying energy exposure.

We have had a MLP position within client portfolios since 2010. However, we stopped adding MLPs for clients in 2012 and trimmed our existing MLP exposure in late 2014 as we felt the valuations levels at that time were unsustainably high. The Alerian MLP index fell -32.6% in 2015. Then in January of this year, our Investment Policy Committee voted to add MLPs back into client portfolios given their new depressed valuation level. As illustrated below with the Alerian MLP index chart, even with the extremely strong performance YTD, MLPs are still trading below their 3 and 5 year average valuation levels.




To reiterate, we are confident in our inability to predict short-term market events, but believe a disciplined, valuation-oriented approach will best serve investors long term. Negative interest rates and historically low domestic rates are having unprecedented effects on various asset classes. As an investment team, our goal is to methodically analyze these effects and come to reasonable asset allocation decisions. Our most recent decisions include beginning to de-risk our Growth allocations, maintaining a conservative Capital Preservation allocation, and increasing our Inflation Protection assets.

As always, we welcome your comments and questions. Thank you for your continued trust and confidence.

The True North Investment Team

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