I|S|G
Investment Security Group, Inc.

Celebrating Our Third Decade of Providing Unbiased Financial Advice

> *"You've got to go out on a limb sometimes because that's where the fruit is."*
> Will Rogers

Third Quarter Review and Commentary

Equities

Increasing concern about China's economy, accompanied by a surprise albeit modest devaluation of the Yuan currency, helped trigger a drop in global equity markets in late August. The S&P 500 fell 12% from its July high. This marked the first 10%-plus correction for the U.S. market since 2011, an unusually long stretch given that historically a correction occurs roughly once a year. The S&P 500 has had a 10%-plus correction 52 times since the end of World War II. They are not unusual. Investors should be prepared to experience such drops repeatedly over their investment lifetime.

It's also worth noting in this context that, since 1950 the S&P 500 has suffered a 20%-plus decline nine times—the common definition of a bear market. Put differently, bear markets have historically happened about once every five years on average. The current market has gone more than six-and-a-half years without one. The longest stretch without a 20%-plus decline was a little over 12 years ending with the bursting of the tech stock bubble in 2000.

Coming back to the present, the S&P 500 bounced back briefly from its August 25th low but then dropped an additional 2.5% in September, ending the quarter down 6.5%. This marks the first negative quarterly return for the index since 2012; again, an unusually long span of positive market returns. Developed international stocks, as measured by the Vanguard FTSE Developed Markets ETF, were down 9.7% for the quarter. Emerging-markets stocks fared the worst, dropping 18% for the quarter.

With that said, as of this writing (October 15th), many global equity markets have recovered some of last quarter's losses. Most market strategists maintain that developed equity markets will be in positive territory before year-end.

Bonds

The core bond index gained about 1% during the U.S. stock market's 12% intra-quarter drop. The events of the latter part of the third quarter did not lead to any material changes in our fixed-income asset class views or positioning. We continue to view the expected returns for core bonds to be very low (1%–2%) over the next several years in most economic scenarios. This is why we have invested a large portion of our fixed-income allocation in more flexible bond strategies and event-linked bonds (reinsurance). Based on our analysis of each fund's strategy and our positive assessment of the managers', we think these funds have the potential to generate returns several percentage points above core bonds over the next several years. This is true across a broad range of economic scenarios. Nevertheless, we still maintain exposure to core bonds in our portfolios because of the risk management role they play. Core bonds smooth the overall portfolio volatility and mitigate some of the downside risk of the market.

News Notes

Long Term Care Seminar (LTC)

Please join us for ISG's LTC seminar on Thursday, November 5th at 3:30 for drinks and appetizers followed by a presentation by Tammey Sullivan at 4:00. The seminar will be held offsite at the 7595 Technology Way-Cross Roads Bldg. (which is a few blocks away from the ISG office).

Please let us know if you'd like to attend.

Open Enrollment for 2016 Health Insurance

November 1, 2015: Open Enrollment starts — first day you can enroll in a 2016 Marketplace plan
January 1, 2016: First date 2016 coverage can start
January 31, 2016: 2016 Open Enrollment ends

Let us know if you have questions or need a referral to an enrolled agent to assist you in selecting a health plan.

Medicare Open Enrollment

Medicare's annual open enrollment started on October 15th and goes through December 7th. Don't miss this once-a-year opportunity to evaluate your current Medicare plan. We can answer your questions and provide you with a referral to an insurance agent that will help you understand your plan options.

Hybrids

We continue to see long-term value in terms of diversification benefits and expected contribution to overall portfolio risk-adjusted returns from exposure to a select group of hybrid strategies. The alternative strategies we own are intended to generate long-term returns that are better than core bonds, with much lower downside risk and lower volatility than stocks. The hybrid strategies' should exhibit low to no correlation to the stock and bond markets. These strategies include Commercial Real Estate, Reinsurance, Floating-rate Loans, and Tactical Allocation Funds. Several of these strategies had positive returns for the quarter. Beyond this strategic rationale for owning select hybrids, our current view is that they can generate returns close to those of U.S. stocks across our most likely scenarios and with less risk.

Economic Outlook

The outlook for economic development has been mostly in line with expectations. The U.S. economy is still likely to experience some further drag from a decline in energy investment and a stronger U.S. dollar. The decline in equity markets may also dent consumer confidence and household wealth. However, lower gasoline prices, rising employment and income, and improved household balance sheets should enable the U.S. consumer to move the economy forward, with additional strength from the housing market. Consumer confidence remains strong. In August, both the housing market and vehicle sales continued to set a very strong pace. Real consumer spending should track another solid 3% advance in Q3. The consumer is essential to driving U.S. economic growth into a comfortable 2.5% to 3% pace over the coming quarters. Stable growth will result in a continued reduction of economic slack and some increased inflationary pressures over time.

The labor market should continue to churn out jobs at a healthy pace keeping the unemployment rate close to full employment as measured by the Federal Reserve. The Fed has a dual mandate of full employment and stable inflation. They remain on the fence, as inflation continues to be persistently low and could weaken further given the uncertainty in many foreign economies particularly China.

While international headwinds are blowing stronger than before, domestic fundamentals remain strong. This will be sufficient to keep U.S. growth above its trend rate and cause further tightening in the labor market. The outlook for most developed economies is for modest growth, considering negative output gaps (the difference between actual economic output and potential output), low inflation and monetary policy by most central banks that will remain supportive of economic growth.

Below are a few *Investment Principles* that help frame our investment decision process

Investment Fundamentals Ultimately Drive Returns

This gets down to the economics of an investment. Specifically, whether we're evaluating stocks, bonds, real estate, or another asset class, the value of an investment is generally determined by the cash flows the investment generates over time. We also assess the risk & trajectory associated with those cash flows.

Acknowledge We Can't Confidently Predict the Outcomes

Our use of scenarios reflects our acknowledgement that in an uncertain world we cannot confidently predict the outcome. But we can more confidently evaluate a range of possible outcomes in order to understand the full scope of potential returns for one investment or asset class relative to another. Our objective is to always emphasize undervalued investments and de-emphasize overvalued investments when structuring a portfolio.

Investment Opportunities Come to Those with Patience

Of great importance is our understanding and acceptance that this fundamental approach is a long-term one. This is to say, we are confident in its soundness and likely success over the long run while knowing prices can get out of whack relative to their fundamentals over short time periods, sometimes longer. This reality is the basis for our philosophy, which is to build well diversified portfolios that skew towards undervalued assets. In implementing our approach, it sometimes requires that we wait patiently for markets to normalize. We also must be intellectually honest as we reassess and question our decisions on an ongoing basis.