The Colony Group

The smart choice in wealth management™

July 31, 2014

We expect that ultimately the trend of improving data should reverse the decline in interest rates, boost the value of the U.S. dollar and provide support to the valuations applied to risk assets (e.g., stocks).

Brian Katz
Chief Investment Officer

Q2 2014 Market Update and Economic Review

Introduction: As 2014 began, it was widely expected that global economic growth would accelerate, fueled by improving momentum in the industrialized world. Regrettably, these expectations have not been fully realized thus far in 2014. The U.S. economy actually contracted by an annualized rate of 2.9% in the first quarter, impacted by a confluence of negative factors, including an extremely harsh winter, an inventory correction, and a slowdown in the housing market. This performance highlighted once again the fragility of the current recovery cycle.

Inferences drawn from the reaction of the financial markets have been conflicted. Bond prices generally rallied due to a continuation of slow U.S. economic growth and concerns of deflation in Europe. Conversely, equity markets, considered a leading economic indicator, posted gains, possibly predicting an acceleration in future economic activity.

We believe the fundamentals are falling into place for stronger economic growth in the quarters ahead. Job growth has accelerated in recent months. At the same time, demand for credit from businesses and consumers continued to gain speed, growing at its fastest pace since the recovery began. This positive momentum seems set to continue over the rest of the year and probably into 2015. We expect that ultimately the trend of improving data should reverse the decline in interest rates, boost the value of the U.S. dollar and provide support to the valuations applied to risk assets (e.g., stocks).

Inside This Issue

Capital Markets Update

Equity markets continued to advance in the second quarter, with many major stock market indices approaching new record highs by quarter-end. The S&P 500 Index returned 5.2% for the quarter and 7.1% year-to-date. Impressively, these gains followed a contraction in economic activity in the first quarter. The weak economy and terrible weather continued to impact the markets in April. The headline stock market indices were flat for the month, but more economically sensitive segments, such as small-cap and growth stocks, fell sharply. As we entered May, investors became more confident that the economic decline experienced in the first quarter was an aberration; and improving retail sales and manufacturing data reported in the month helped confirm that view. A consistent message of sustained low interest rates coming out of the Federal Reserve and meaningful action from the European Central Bank also helped investors' confidence. As a result, the equity markets rebounded in May and June.

Looking beneath the surface of the equity markets, value stocks generally outperformed growth stocks, while large- and mid-cap stocks generally outperformed small-cap stocks. This is a reversal from 2013, which saw small-cap stocks take the lead. During the quarter, more defensive, income-oriented U.S. equity sectors were up sharply, while financials and consumer discretionary stocks lagged. The energy sector posted an eye-popping total return of +12.1% as turmoil in the Middle East caused oil prices to spike. All U.S. equity-market sectors turned positive on a year-to-date basis.

In the bond markets, the yield on 10-year U.S. Treasury bonds continued to hover around 2.6%, keeping intact the bond rally that began in January. The Barclays U.S. Aggregate Index was up 2.0% for the quarter and 3.9% year-to-date. Fixed-income markets across the globe posted positive total returns as investors responded positively to the combined easy money policies of major central banks and relatively low inflation. The current environment of modest economic growth and low inflation is constructive for fixed-income investment returns. Credit spreads for investment grade and high-yield bonds remain historically tight, narrowing modestly during the quarter. The Barclay's U.S. Credit Index returned +2.7%, and the Barclays High-Yield Index returned +2.4%. International and emerging market bonds also posted meaningful gains.

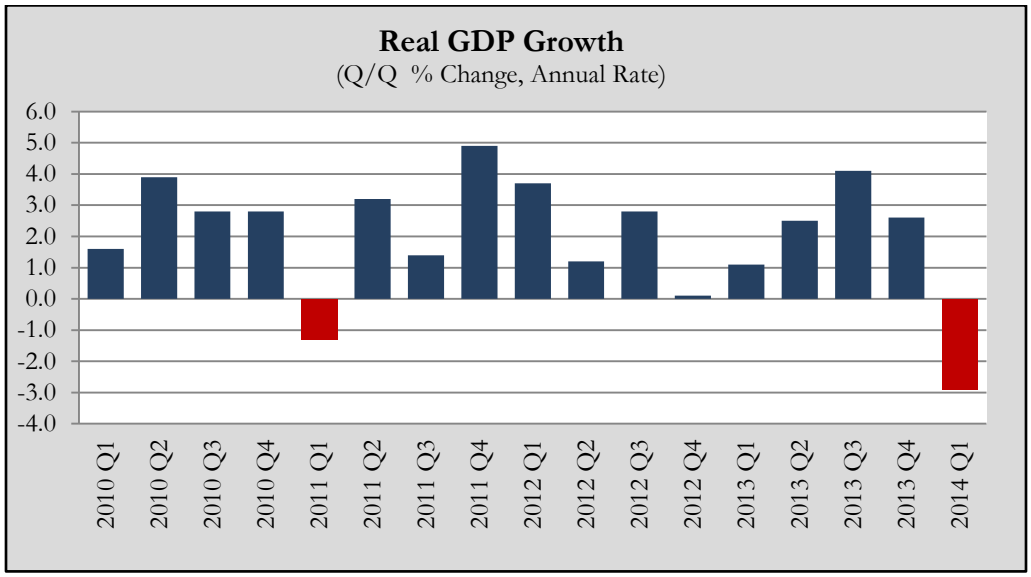
Within the non-traditional asset class, energy-related investments generally posted sizable returns. The S&P North American Natural Resources Index rose 13.4%, but commodity prices were flat overall (+0.1%), led by higher oil prices due to geopolitical events in Russia and Iraq.

Economic Review

GDP: U.S. real GDP growth in Q1 2014 was revised down from -1.0% (annualized) to a decline of -2.9%. Most of the downward revision was related to weaker consumer spending, with personal consumption expenditure growth slowing to just 1.0% (previously reported as 3.1%). This shaved 1.4 percentage points off the previous GDP estimate. Exports were also revised downward.

The magnitude of this downward revision caught many by surprise. Looking forward, economic activity should reaccelerate in the second quarter. Indeed, Q2 data has shown a substantial pick-up in economic momentum that could bring economic growth in excess of 3% for the last three quarters of the year.

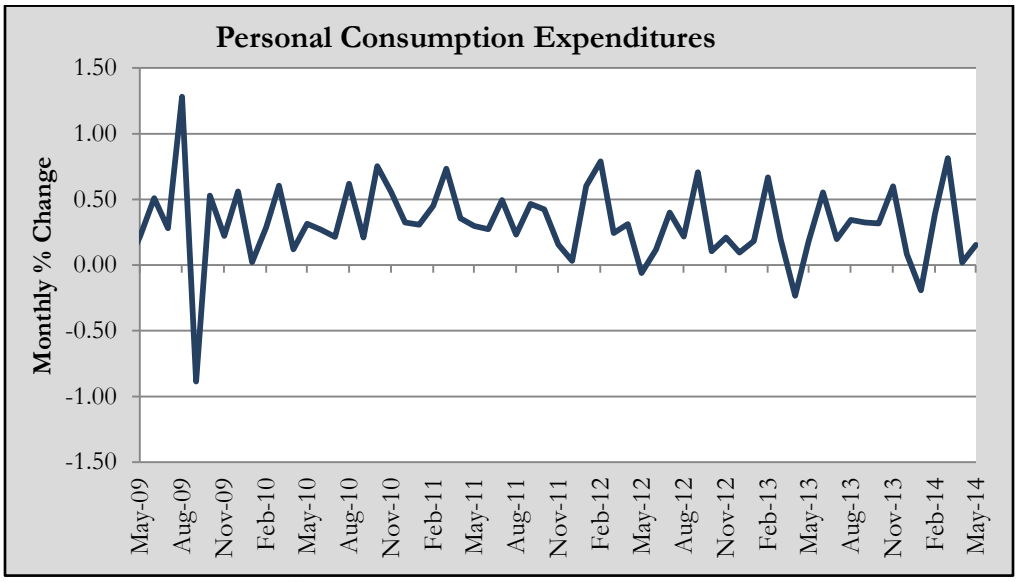
Personal Income: Personal income rose 0.4% in May, while nominal personal consumption rose by 0.2%. In real terms (i.e., net of inflation), however, spending dropped -0.1%, falling for a second straight month. Inflation as measured by the year-over-year change in the personal consumption expenditure (PCE) price deflator rose to 1.8% from



U.S. Department of Commerce Bureau of Economic Analysis

1.6% in April, while core PCE inflation (excluding food & energy) rose to 1.5% from 1.4% in April. The personal saving rate rose to 4.8% from an upwardly revised 4.5% in April.

The declines in spending in April and May were disappointing. Real spending growth in the second quarter is tracking below 2.0%, which is considerably below expectations of near 3.0%. Despite the disappointing pace of spending growth, cause for optimism remains. The continued improvement in income growth and upward revision to the saving rate implies more room for spending growth over the remainder of this year. In addition, inflation has been technically below the Federal Reserve's target, and recent increases were influenced by temporary factors, such as drought and geopolitical tension, which have driven up food and energy prices. These factors should fade in the coming months.

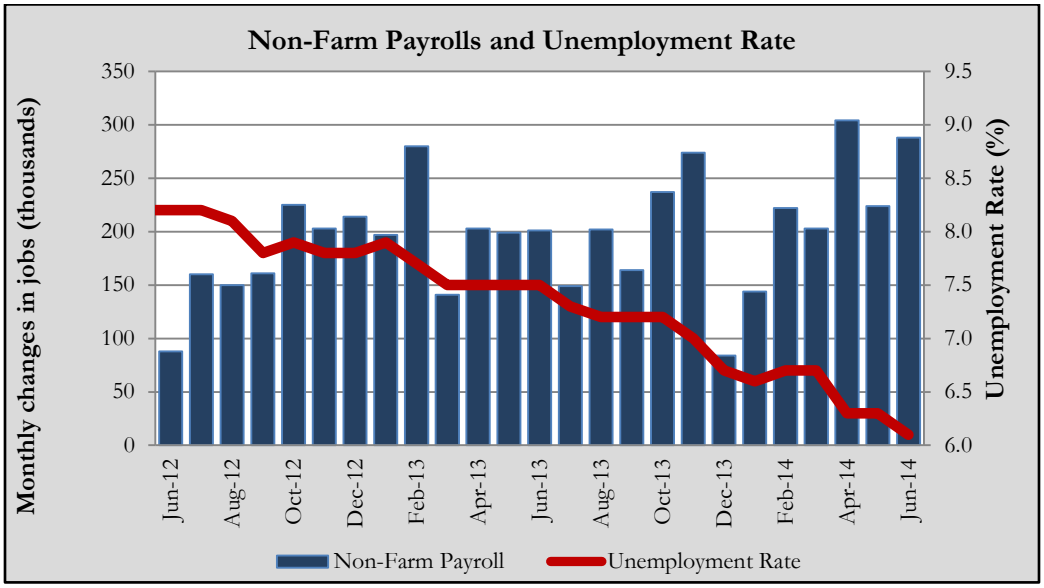


Source: Federal Reserve Bank of St. Louis

Inflation: The headline consumer price index (CPI) rose by 2.1% on a year-over-year basis, a slight acceleration over April's upwardly-revised 2.0% gain from year-ago levels. This was the fastest year-over-year pace of headline inflation in almost 2 years. Excluding food and energy, core prices were up an equally firm 2.0% from last year. The gain in both the headline and core indices was broad-based as most of the sub-indices reported pricing pressures.

While CPI inflation ostensibly reached the Federal Reserve's 2.0% inflation target, the Fed's preferred metric, the core PCE deflator, is currently running about half a percentage point lower and is not expected to reach the 2.0% target until early next year. It is, however, clear that inflation is approaching the Fed's target faster than anticipated. If growth accelerates significantly through the remainder of this year and price pressures continue to mount, then conditions could favor an earlier start to Federal Reserve interest rate hikes. At this point, it seems likely the Fed will leave short-term interest rates on hold until 2015.

Labor Market: One of the most encouraging trends in recent months has been the improvement in employment conditions, with non-farm payrolls adding an average of 215,000 jobs per month so far this year and the unemployment rate falling to 6.3 percent. The stronger pace of job growth should ultimately translate into higher wages. The mix of job gains has been better, with higher-paying jobs, such as construction, energy extraction, and professional services, accounting for a larger proportion. Nonetheless, job gains in lower-paying sectors, such as retail trade, temporary staffing, and home health care, have also been growing rapidly.



Source: U.S. Department of Labor Bureau of Labor Statistics

Housing: Part of the rationale for expectations of an acceleration in economic growth in the second quarter were based on an improving housing market, and recent news has been encouraging. Both new and existing home sales grew faster than expected. Existing home sales were up 4.9% in May, rising to the highest level in eight months. New (single-family) home sales were even stronger, rising 18.6%. New home sales have not grown this swiftly in a single month since 1992. Rising home sales indicate that demand and confidence are recovering due to a decline in mortgage rates and better weather. Maintaining this newfound momentum will depend on continued strength in the job market.

ECB: After frustrating investors with months of inaction, the European Central Bank (ECB) finally took extraordinary measures in an effort to stave off the risk of deflation. The ECB cut its key refinancing rate from a historic low of 0.25% to 0.15%. Moreover, in an unprecedented move for a developed country central bank, the ECB cut its deposit rate, which it pays banks for holding their funds overnight, into negative territory. The idea of charging banks for depositing their cash at the central bank was intended to encourage banks to lend money to households and businesses instead. This action should help boost output and the price of goods and services.

Global Growth: The world economy continues to show uneven growth across countries and regions. Parts of the developed world are starting to see stronger rates of growth, with the U.S. and U.K. economies leading the charge, while other regions, most significantly the Eurozone, are still showing few signs of improvement. On the positive side, the Eurozone posted a better-than-expected industrial production number in April that, if sustained, could improve prospects for the region.

The most significant difference between the century's first decade and second is the growth profile of emerging markets, which generally has deteriorated. Indeed, the IMF noted in a recent report that "the external conditions that supported developing and developed market convergence over the last decade—namely, buoyant global trade, high commodity prices, and easy financing conditions—are not expected to prevail in the coming years." Certainly, emerging markets are expected to continue to grow during the next several years; however, this growth may not be as strong as during the previous decade.

Outlook: Moving forward, conditions for stronger U.S. economic growth are falling into place. Some economic headwinds have begun to lessen, most notably within the labor markets. The outlook for housing is brightening as mortgage rates have fallen, home price growth has slowed, and new home construction is trending below household formations. This is bullish for the real estate market and related economic activity, which is a vital building block of our economy.

Meanwhile, fiscal drag is diminishing, state and local government finances have improved, manufacturing sentiment is trending higher, the energy sector is booming, and there is seemingly significant pent-up demand for consumer spending. We believe that the combination of these factors should boost growth in the coming quarters.

The expected improvement in the economy seems to be arriving at just the right time to allow the Federal Reserve to complete the tapering of its bond purchase program and, ultimately, begin increasing short-term interest rates around the middle or second half of next year.

Sources: Capital Market Consultants, Department of Commerce, The Conference Board, Institute for Supply Management, Department of Labor, Bureau of Labor Statistics, National Federation of Independent Business

The Colony Group

July 31, 2014

Index Performance as of: 6/30/2014

	1 Week	1 Month	QTD	3 Month	YTD	1 Year	3 Year	5 Year
Russell								
3000 Value	-0.31	2.75	4.89	4.89	7.95	23.71	16.73	19.29
3000	0.06	2.51	4.87	4.87	6.94	25.22	16.45	19.33
3000 Growth	0.43	2.27	4.86	4.86	5.98	26.75	16.11	19.34
1000 Value	-0.40	2.61	5.10	5.10	8.28	23.81	16.91	19.23
1000	0.00	2.27	5.12	5.12	7.27	25.35	16.62	19.25
1000 Growth	0.40	1.95	5.13	5.13	6.31	26.92	16.26	19.24
Mid Cap Value	0.37	3.46	5.62	5.62	11.14	27.76	17.56	22.98
Mid Cap	0.36	3.29	4.97	4.97	8.67	26.85	16.09	22.08
Mid Cap Growth	0.35	3.13	4.37	4.37	6.51	26.04	14.53	21.16
2000 Value	0.80	4.42	2.38	2.38	4.20	22.54	14.64	19.88
2000	0.74	5.32	2.05	2.05	3.19	23.64	14.56	20.21
2000 Growth	0.69	6.20	1.72	1.72	2.22	24.73	14.49	20.50
Standard & Poors								
S&P 500	-0.08	2.07	5.23	5.23	7.14	24.61	16.58	18.84
Consumer Disc	0.90	1.99	3.50	3.50	0.60	20.16	20.44	25.76
Consumer Staples	-0.74	-0.19	4.65	4.65	5.18	15.21	15.78	17.46
Energy	-1.28	5.05	12.09	12.09	12.98	28.73	11.59	16.74
Financials	-0.64	2.42	2.30	2.30	4.97	19.14	16.20	15.66
Health Care	0.60	2.19	4.51	4.51	10.59	30.09	22.19	20.65
Industrials	-1.14	0.32	3.85	3.85	4.00	28.58	15.80	22.28
Information Technology	0.66	2.33	6.51	6.51	8.94	31.55	17.25	18.62
Materials	-0.07	1.68	5.60	5.60	8.62	32.59	10.96	17.68
Telecom Services	-0.86	-1.14	3.78	3.78	4.27	5.13	10.92	14.55
Utilities	2.19	4.47	7.77	7.77	18.65	22.19	14.37	14.40
Other U.S. Equity								
Dow Jones Industrial Avg.	-0.65	0.75	2.83	2.83	2.68	15.56	13.56	17.83
MSCI USA	-0.05	2.14	5.21	5.21	7.15	24.98	16.59	18.95
Wilshire 5000 (Full Cap)	0.16	2.68	4.83	4.83	6.87	25.14	16.46	19.44
International Equity - Broad Market								
MSCI EAFE	-0.34	0.99	4.34	4.34	5.14	24.09	8.59	12.27
MSCI Emerging Markets	0.90	2.70	6.71	6.71	6.32	14.68	-0.06	9.58
MSCI Frontier Markets	0.61	-0.11	12.10	12.10	20.54	36.62	12.80	11.06
MSCI AC World	0.00	1.93	5.23	5.23	6.50	23.58	10.85	14.88
MSCI AC World ex USA	0.04	1.72	5.25	5.25	5.89	22.27	6.21	11.59
MSCI AC Asia ex Japan	2.00	2.37	7.30	7.30	6.57	16.67	3.42	11.28
International Equity - Country Region								
MSCI Brazil	-1.21	5.45	7.66	7.66	10.74	13.50	-9.35	2.47
MSCI BRIC	0.88	4.25	7.97	7.97	4.85	15.84	-3.35	5.27
MSCI China	2.19	3.30	5.70	5.70	-0.50	15.94	0.99	5.22
MSCI Europe	-0.57	-0.07	3.65	3.65	5.95	29.95	9.33	13.72
MSCI India	1.88	3.97	12.67	12.67	21.86	27.40	0.45	7.64
MSCI Japan	0.07	5.24	6.69	6.69	0.85	10.12	7.80	7.43
MSCI EM Latin America	-0.74	4.15	6.99	6.99	7.40	9.32	-5.86	5.79
MSCI Russia	-0.41	5.53	10.84	10.84	-5.17	8.19	-6.94	8.26
Fixed Income								
Barclays U.S. Aggregate	0.50	0.05	2.04	2.04	3.93	4.37	3.66	4.85
BofA Merrill Lynch 3-Month T-Bill	0.00	0.01	0.01	0.01	0.02	0.05	0.07	0.11
Barclays U.S. Government	0.50	-0.13	1.34	1.34	2.66	2.08	2.88	3.46
Barclays U.S. Credit	0.63	0.08	2.71	2.71	5.70	7.44	5.88	7.65
Barclays High Yield Corporate Bond	-0.08	0.84	2.41	2.41	5.46	11.73	9.48	13.98
Barclays Municipal	0.41	0.09	2.59	2.59	6.00	6.14	5.35	5.81
Barclays TIPS	0.76	0.30	3.81	3.81	5.83	4.44	3.55	5.55
Barclays Global Aggregate ex US	0.98	1.18	2.72	2.72	5.59	9.42	1.75	4.37
Barclays Global Aggregate	0.78	0.73	2.47	2.47	4.93	7.39	2.57	4.60
BofA Merrill Lynch Emerg. Mkt. Credit	-0.52	2.95	8.34	8.34	10.43	13.70	11.60	17.20
Alternative Investments								
Alerian MLP	2.01	5.91	14.18	14.18	16.31	21.57	18.95	26.19
Bloomberg Commodity	-1.12	0.60	0.08	0.08	7.08	8.21	-5.17	1.99
FTSE NAREIT Equity REIT	0.23	1.11	6.98	6.98	17.66	13.21	11.83	23.53
S&P Global Natural Resources	-0.57	3.36	6.90	6.90	6.88	21.72	-1.05	6.31
S&P North American Natural Resources	-0.53	6.91	13.37	13.37	16.43	33.14	6.73	14.76

Sources: MPI, Morningstar, Barclays, HFR