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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

"Summertime, an' the livin' is easy," is the opening line from George Gershwin's famous aria composed in 1934 for the opera, *Porgy and Bess*. The lyrics, by Dubose Heyward, are considered among the best in musical theater. If we were to propose a theme for the current U.S. stock market, "Summertime" would be our first choice.

Like the song, the U.S. stock market appears to have everything going for it. Major indices are hitting new highs. Fundamentals are strengthening with higher jobs data, better consumer confidence, and stronger new and existing home sales supporting continued economic growth. **But it is less about fundamentals and more about the supply of, and demand for, stocks which are driving our markets.**

Since the financial crisis in 2008, companies have behaved defensively, cutting costs, directing discretionary spending toward share buybacks and paying out dividends. **This is beginning to change, with merger and acquisition (M&A) activity replacing buybacks in lifting stock prices, even as the fear of higher market valuations looks to be slowing the bull market.**

Companies are merging at a pace not seen since 2007, the biggest year on record for mergers. Year to date, $2.15 trillion in M&A offers and deals have been announced, compared to $4.3 trillion for the entire year 2007. The pace is accelerating due to managements' fear of being left behind. Indeed, the competitive landscape is changing dramatically in the health care, technology, and health insurance industries, which have seen the greatest M&A activity. **As companies merge into bigger more efficient enterprises, rivals become concerned that they will either face stronger competition or be acquired themselves.** This has forced boards to consider whether to embark on an acquisition strategy or how to respond to one.

The dynamics of recent deals is substantially different from those of past cycles. First of all, the transaction currency is different. Debt is cheap and available to companies planning to make an acquisition. Corporations have an abundance of cash, which generates low returns and weighs on measures of profitability such as return on equity and return on capital. With stock prices up, partial stock deals appear cheaper. **With companies seeing stable but sluggish growth for the next few years, managements have the incentive and confidence to be less defensive and pursue strategies to enhance profitability.**

During the last boom in M&A activity, roughly half of the deals were done by private equity firms in big leveraged buyouts. These deals brought little but leverage, and a penchant for cost cutting, to the party. Three quarters of the volume this year has involved companies buying other companies. **Although the dynamics of each deal are different, presumably these deals are being done to access new sources of revenue and the opportunity to enhance profitability by reducing costs.** While some of these cost reductions involve merger-related job cuts, workforce reductions are much lower this time than they have been in the past. This year to date, it is estimated there have been 8,800 merger-related job cuts announced, with an increase to 21,000 expected by year end. This compares to 77,000 jobs in 2006, the peak of the last cycle. In part, this is due to companies having shed so many employees during the recession. Indeed, in some industries, acquisitions are considered because companies are having a difficult time finding the skilled workers they need to grow.

At a recent board meeting, I was asked if I thought this increase in M&A activity was a good thing. I'm not used to applying public policy values to investment decisions, so I had no ready answer. From a stock market perspective, however, for the right deal the market will reward both the target and the acquirer. **This year, the stock prices of acquiring companies were up an average of 4% in two thirds of the transactions worth more than $1 billion. During the last cycle, from 2008 to 2011, the average acquiring company's stock dropped.**

The Gershwin song, "Summertime," in spite of the idyllic lyrics of the first stanza, is shrouded in melancholia, foreshadowing, and juxtaposed against the changing circumstances in the musical. So, too, markets evolve. For now, most of the combinations make economic sense for the merging companies and for shareholders. **Since most of these transactions involve significant amounts of cash, the entire market benefits as the proceeds are re-invested.**

Fixed Income Market

On the bond front, the second quarter has been characterized by rising rates (falling bond prices) at both the short end and long end of the yield curve. **The rise at the short end can be largely explained by anticipation that the Federal Reserve will raise interest rates later this year in response to lower unemployment and potentially higher inflation.** We expect this rate hike to occur at the Fed's meeting in September or possibly in early 2016.

However, the Fed has minimal impact on longer term rates. **The recent rise in long term rates is attributed to a variety of macro factors such as expectations regarding long-term economic growth, inflation, and returns on competing investments such as equities and foreign bonds.**

Long-term bonds are more sensitive to changes in interest rates than short-term bonds. We use fixed income to reduce portfolio volatility for our clients by owning high grade bonds that mature in one to five years. This five year "laddered" approach enables us to reinvest proceeds from maturing bonds each year at current prevailing rates. **When rates rise and prices fall, as they did this quarter, we are able to reinvest in the new higher yields to increase future returns for our clients.**

International Market

On the stage of the World Poker Tournament, all cameras are on you, and the final card has been dealt. You're holding a hand with absolutely nothing, and your opponent has just called your bluff. This, we believe, is how Alexis Tsipras, Greece's Prime Minister, and his left-wing SYRIZA government feel right now. **Indeed, the Greek government has been playing a high-stakes game of poker with its creditors, and until today, this financially-strapped Mediterranean nation's creditors have folded on every single hand in order to keep the widely feared "ripple effects" from happening.**

Are there really ripple effects? Of course markets are never at ease with uncertainty, and investors naturally fear the unknown. But in reality, based on fundamentals, it would be extremely difficult to conclude that such an economically insignificant country would have significant impact on the world economy. **To put it into perspective, the gross domestic product (GDP) of Greece accounts for no more than 0.3% of world GDP, and the country represents roughly 0.2% of global trade; this is statically zero when rounding down to a single digit.**

There isn't much to debate about the insignificant size of the Greek economy, so arguments similar to "it is not the size of its economy that matters; it is the domino effect that the market fears" have recently begun to flood the mainstream media. Some commentators even link the Greek issue today with the fall of Lehman Brothers back in 2008. **Headlines like this no doubt sell subscriptions and panic novice investors, but with detailed analysis of the situation, it is unconvincing that the current scenario could constitute the next domino fall.**

"Counterparties' risk" and the use of heavy leverage were the main cause of why the insolvency of Lehman Brothers snowballed out of control into chaos. Because of the fall of Lehman Brothers, its counterparties could not fulfill their own obligations as a result. However, the situation with Greece sharply differs as the super majority of the country's 240 billion euro debt is owed to what is known as the troika – the European Central Bank (ECB), the International Monetary Fund (IMF), and the European Union (EU). **The major difference between missing a payment to ordinary bond investors such as financial institutions or insurance companies and to an international institution such as the troika is that the counterparties' risk is almost nonexistent in the latter case.** The three major credit-rating companies have even stated that failure to pay the IMF would not, in their opinion, constitute a formal default; the official term for countries that have missed payments is that they are "in arrears."

Some worry that private loans to Greek companies by European banks could spell trouble. This could be true if the size of exposure is of any significant amount, but that is far from the truth. **Ever since the European Sovereign Debt Crisis, European banks have been aggressively unloading Greek assets down to a manageable level.** According to Bank of America's estimates, European banks have a total exposure of $45 billion to Greek companies, with HSBC Holdings Plc having the most at $5.5 billion. The exposure accounts for less than 4% of the bank's total net asset value, and they are mainly comprised of loans to Greece's shipping industry. Equating missed payment from the Greek government to the default of any Greek companies is irresponsible in our opinion; but even in the worst case, we would not expect the value of the collaterals, e.g. ships, to be much different whether it is priced in euro or in Greek Drachmas.

The bottom line is that the SYRIZA government was elected on a fundamental contradiction, to end austerity but to remain in the monetary union, and unfortunately, the campaign slogans which won the election cannot be delivered in the real world. Therefore, in order to dig himself out of the political ideology trap, Prime Minister Alexis Tsipras has called for a referendum urging voters to vote "no" to the country's creditors, while knowing that 8 out of 10 Greeks prefer to stay in the euro zone. Needless to say, the long lines in front of ATMs in Greece have already cast the vote of the Greek people's preference between euro and Drachmas.

Therefore, despite all the circus acts that have evolved so far, severe market volatility could serve as a wake-up call for Greece and its creditors in forcing compromise. We do not like to invest based on isolated binary outcomes because, even if the probability is favorable, there is always a real chance of a painful end. **But if there is meaningful market dislocation resulting from the Greece situation, it could be viewed as a buying opportunity. The impact, if there is any, is at best short-term.**