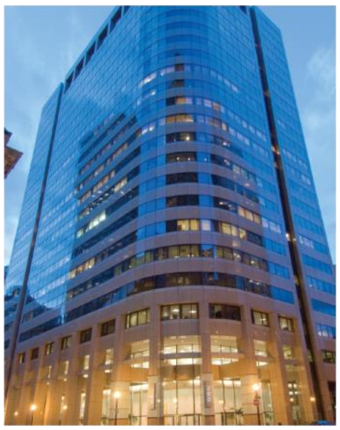
TFC FINANCIAL
The Financial Counselors

White Paper
September 15, 2015

OUR VIEW



Background on TFC's International Allocation

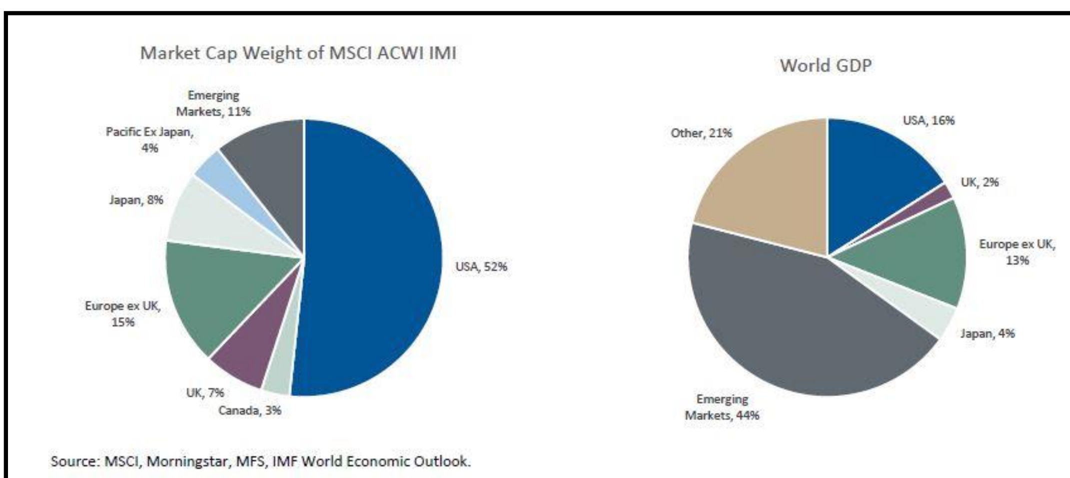
We occasionally receive questions on how our portfolio allocations change over time and what parameters go into making those changes. This paper seeks to address the U.S./international allocation decision for the TFC portfolio.

TFC's core investment philosophy is to create broadly diversified portfolios, maintain a long-term perspective, keep costs low, be disciplined, and rebalance as market conditions warrant. The financial media seems full of articulate "experts" proclaiming to know where the markets are heading. Our own crystal ball is admittedly cloudy and reviewing other track records, we have not found an expert who has perfect foresight. TFC evaluates each asset class allocation in the context of the total portfolio. What seems like the most probable outcome over the market cycle? How can we maximize diversification potential without sacrificing return? What if our investment thesis is wrong? What makes sense? These are the questions we spend the most time evaluating.

Diversification as a broad concept is widely accepted, but how much is needed often creates different opinions. Currently, U.S. equities account for just over half of the global equity market. (Figure A) Companies from other developed countries like Japan, the United Kingdom, and the Eurozone as well as Emerging economies of Korea, China, Brazil and India account for the other half of the global equity investment universe. It is also informative to see the breakdown of world GDP (Figure A).

Globalization Continues

Figure A: World Market Weights and GDP Composition



Source: MSCI, Morningstar, MFS, IMF World Economic Outlook.

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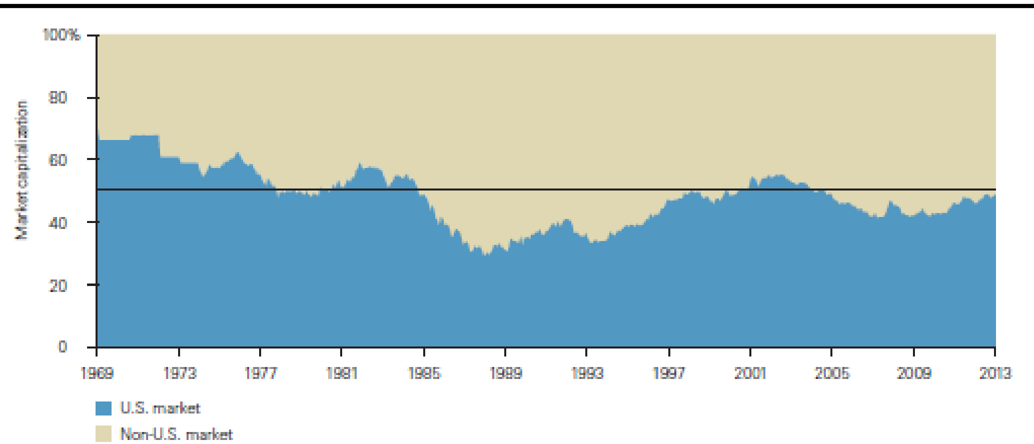
While U.S. companies comprise over half of the value of equities, the U.S. economy is a much smaller slice relative to the rest of the world. Aspiring for diversification, TFC will cast the net as wide as possible to seek out investment opportunities that behave differently.

TFC stock investments have exposure to the U.S., Europe, Asia Pacific region and Emerging Markets (EM) like China, India, Russia, and Brazil. Even small Frontier Markets (FM) including Vietnam, Pakistan, Ghana, Kenya, Morocco, Nigeria, etc. are represented in the portfolio. We should note, while we are interested in getting exposure to the full measure of foreign economic growth, we also seek to construct a portfolio of investments in which the component parts will be as uncorrelated as possible.

Globalization continues to make the world more interconnected and appear smaller which has pros and cons. On the one hand, companies are able to sell their goods and services in more markets. On the other hand, companies face more global competition. Emerging countries make up 44% of the global economy. It is not surprising to see consumer products from companies like Procter & Gamble (U.S.) and Unilever (UK) are widely sold in emerging markets. Apple and Samsung smart phones are pervasive in most cities worldwide. Even though Toyota, Ford and Mercedes-Benz are headquartered on three different continents, each sells globally. While informed portfolio managers may have opinions as to which of these competitors are better investments, we include the full global opportunity set as our starting point.

The value of the U.S. stock market relative to the world has deviated substantially over longer time frames. Figure B shows the history of the U.S. market relative to the rest of the world over the last 45 years. The U.S. was over 60% of world stock market starting in the 1970s and fell steadily to approximately 30% at the peak of the Japanese stock market in 1987. The U.S. crested again shortly after the Technology bubble and fell again during the emerging market bubble in the 2000's. The strong U.S. bull market since 2009 has raised the U.S. share of the global equity market recently. Investing internationally has historically provided both currency and economic diversification to U.S. investors.

Figure B: Historical Mix of Global Equity Market Capitalization



Notes: U.S. market represented by MSCI USA Index; non-U.S. market represented by MSCI World Index ex USA from 1969 through 1987 and MSCI All Country World Index ex USA thereafter. Data as of December 31, 2013.

Source: Vanguard, Thomson Reuters DataStream & MSCI.

Each region has led over different cycles

Figure C shows how different regions have led global equity markets in different cycles. Allocating to each of these regions allows an investor to benefit from the cycling of leadership.

Figure C: Global Equity Performance

Global Equity Annualized Performance
Sorted by best performers

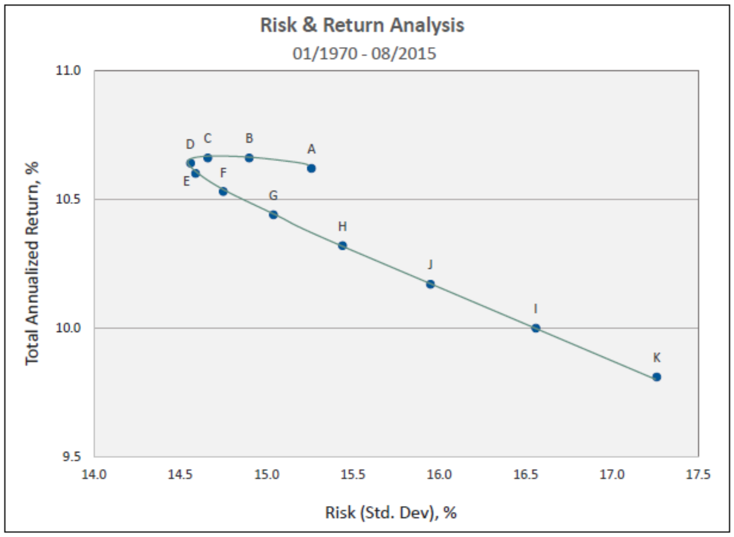
	1970-75	1975-80	1980-85	1985-90	1990-95	1995-00	2000-05	2005-10	2010-15
USA					20.9	29.0	7.0	16.7	15.0
Japan	15.2	17.0	17.8	41.5	8.1	22.1	2.0	4.7	5.5
Europe	-2.2	16.7	12.8	31.3	6.5	2.1	-2.3	0.7	5.5
EM	-4.4	11.1	4.4	18.7	-3.6	2.0	-5.2	0.2	2.9

Source: MPI as of July 31, 2015
USA = MSCI USA; Europe = MSCI Europe; Japan = MSCI Japan; EM = MSCI Emerging Markets

After deciding to allocate to different regions, the next important question is how much? One approach would be to allocate to the market value weight of each region and allow weightings to fluctuate with market performance. Essentially, buy the global stock market portfolio at each company's market value weight. This would be efficient from a trading standpoint as turnover and tax costs on realized gains would be lower. However, we feel this approach reduces some of the diversification benefit. To truly capture the diversification, you need to rebalance periodically, or sell some of the winners and buy some of the losers.

Figure D illustrates the benefit of diversification. Over the 45+ year period from 1970 to present, U.S. stocks slightly outperformed foreign stocks with less volatility. At first cut, more return and less volatility would lead one to prefer only U.S. stocks. Adding any exposure of global stocks looks like it would lower the historical return and increase volatility. However, as the chart shows, portfolios with foreign exposure (both Developed and Emerging Markets) ranging from 20-50% and annually rebalanced back to target had similar returns to U.S. stocks with less volatility. We find this result compelling. Adding an asset class with lower returns and more volatility can improve the portfolio's risk adjusted returns by virtue of the low correlation. Investors can have investment horizons greater than 45 years, but most actually contemplate changes more frequently. Over shorter time periods, like rolling 5 years, you see similar results. While the U.S. has slightly outperformed over this timeframe, we know that past performance does not guarantee future results.

Figure D: Risk & Return Analysis



Portfolio	S&P 500	Int'l
A	100%	0%
B	90%	10%
C	80%	20%
D	70%	30%
E	60%	40%
F	50%	50%
G	40%	60%
H	30%	70%
I	20%	80%
J	10%	90%
K	0%	100%

Source: MPI as of July 31, 2015. Int'l includes both Foreign Developed and Emerging Markets stocks

Correlations

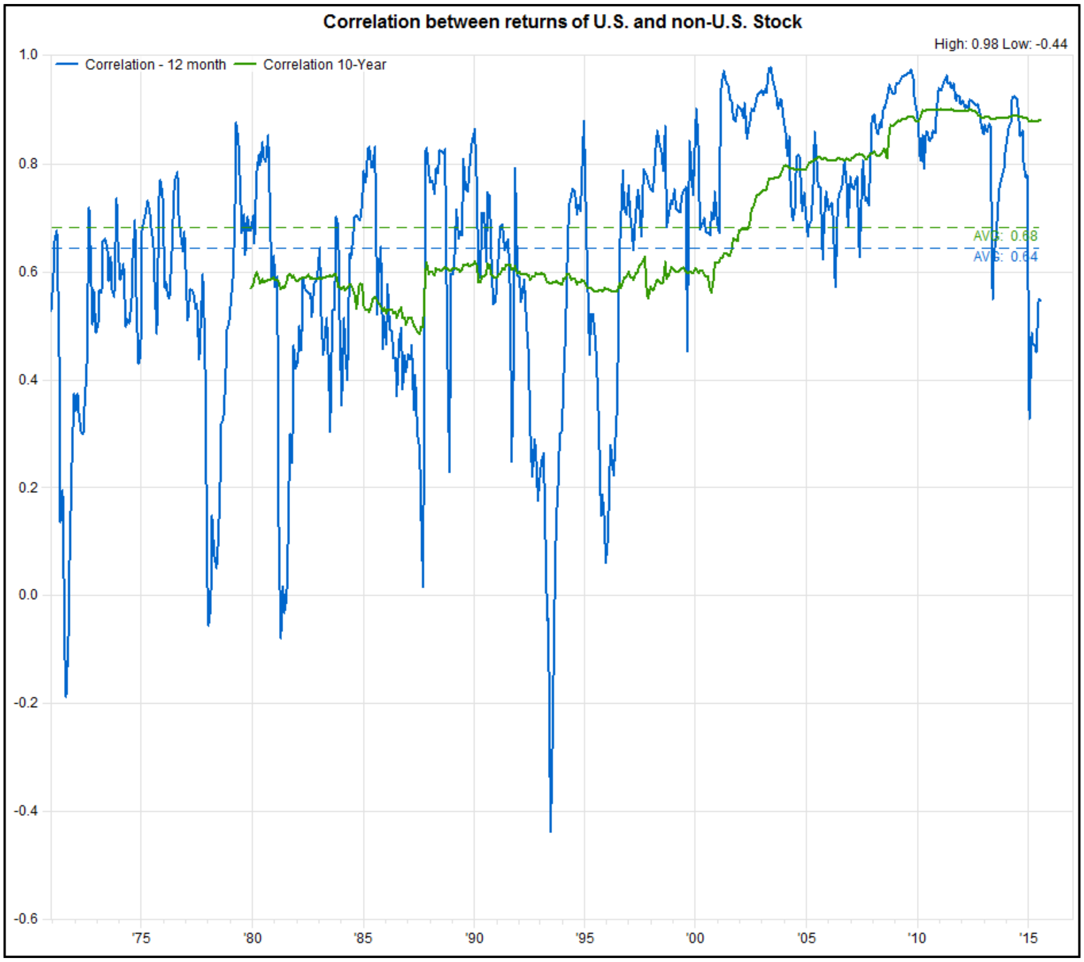
Returns, volatility and the behavior of global stock markets vary and can change over time. Globalization by definition will make the future look different than the past. As companies compete globally, the location of a company's headquarters does not matter as each company manufactures and sells globally. Auto companies, for example, whether based in the U.S., Europe or Japan, are subject to the same macroeconomic forces which should move their stock prices in similar directions.

Small companies are less correlated to international competitors

People argue that the impact of the Japan stock market bubble and subsequent collapse in the 1980's distorted the historical benefit of global diversification. Europe and the U.S. have behaved similarly in the past and account for the majority of global stock market value. Figure E shows how longer term rolling 10 year (green line) correlations have increased substantially in the past 15 years. Increased global trade, capital flows, and multinational corporations have caused the world to become more synchronized. However, it seems highly likely that regional macro factors will prevent all stocks or all countries from being perfectly correlated all the time. The recent Greek debt crisis, the Bank of Japan QE program which includes purchasing stocks and ETFs, and most recently, the Chinese government stock market interventions are examples of local companies trading in sync with the local markets and not their global competitors. The rolling 12-month correlation (blue line) on Figure E makes this point that over shorter periods of time, performance can deviate.

TFC also over weights smaller companies in each regional market. Generally, small companies tend to derive more of their business in the home country and thus exhibit less correlated behavior of returns to small companies in other countries. For context our U.S. small company investments tend to derive 80-90% of revenues in the U.S. vs. 50% for large U.S. companies. When viewed from the total portfolio context, the higher volatility for small company stocks are compensated by the potential enhanced returns and global diversification benefits.

Figure E: Correlation between Returns of U.S. and non-U.S. Stock



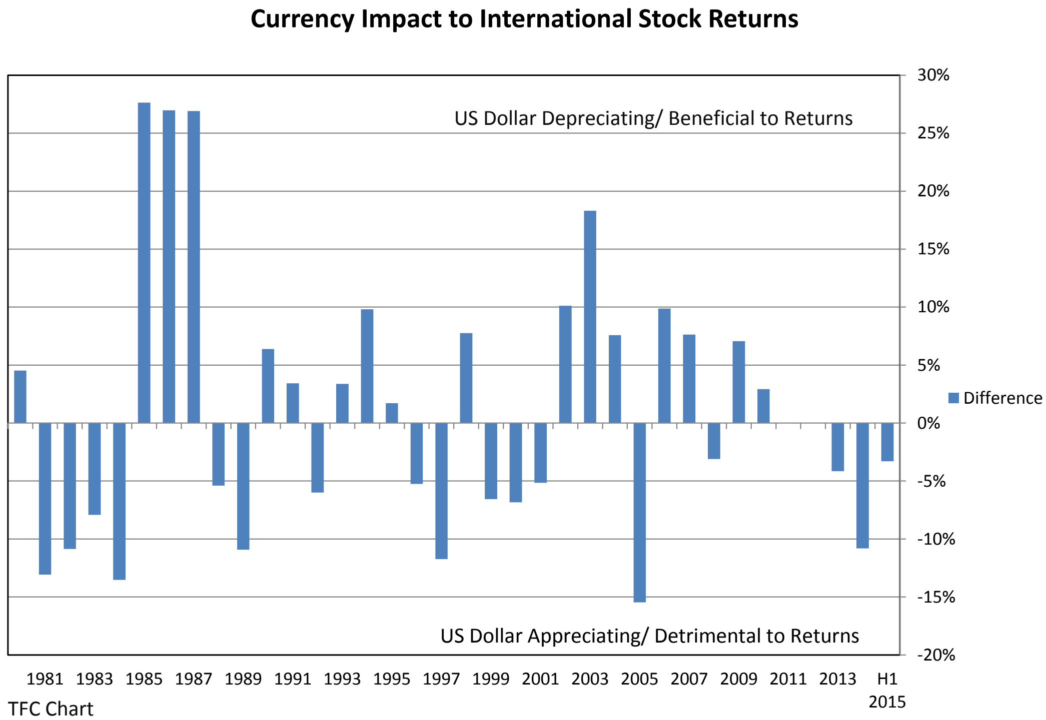
Source: Factset as of August 28, 2015

Currency

Another aspect of diversification is the fluctuations of currency exchange rates. We discussed the dollar's recent rise in our Q1 Investment letter, but it is worth repeating. Going back 35 years, (Figure F) in any given 12-month period, currency has added up to 25% to foreign stock returns, but has also been as much as a 15% headwind to performance. This currency impact is one of the reasons why U.S. stocks and foreign stocks are not perfectly correlated. Since leaving the gold standard in the early 1970's, the dollar has been in a long-term downward trend. Even including the recent dollar rally, the long-term dollar decline has added approximately 1.0% per year to U.S. investor's foreign stock returns over the 45-year period. Looking forward, the structural deficits in the U.S. argue for a continued long-term downtrend for the U.S. dollar as the more probable outcome. *Generally, TFC does not hedge currency exposure of the international equity positions.*

Half of the investment opportunity universe are international companies

Figure F: Currency Impact to International Stock Returns



TFC Chart
Source: Bloomberg. MSCI EAFE USD vs. Local Returns

How Did We Get to Our Current Allocation?

A review of history informs us that global equity regions behave differently in various market cycles. Approximately half of the investment opportunity universe is comprised of international companies. Allocating between 20% and 50% of equities to foreign stocks can increase diversification and lower volatility. We consider this range to be a core holding within the portfolio. For much of the 2000's our allocation to foreign stocks was in the middle of that neutral range. Our current 46% allocation is close to our top range. Reviewing the previous portfolio changes over the last 5 years is also informative of TFC's decision-making process:

1) Q4 2010: TFC added an exposure to Frontier Markets. This was funded from U.S. Equities. Frontier countries vary greatly, but generally have high economic growth rates (similar to Emerging), low cost manufacturing, positive demographic growth trends, and large diversification potential as each market has low correlations with emerging and developed markets. In addition, there are low cross-correlations among the Frontier Markets. Due to increased uncertainty, FM also tend to trade at lower valuations to both Emerging and Developed markets.
2) Q4 2011: TFC increased Emerging Market equity opportunistically as the Greek crisis drove down foreign equity markets. At the time, Emerging Market countries had less public debt than developed countries, improved balance sheets, favorable demographics and strengthening currencies. All of these things pointed toward higher economic growth.
3) Q1 2013: TFC reduced our global real estate equity holdings after the asset class returned twice the global equity and U.S. markets in 2012 and valuations appeared elevated. TFC also reduced U.S. equities in favor of the growth story of EM. (Less debt, stronger balance sheets, faster GDP growth, favorable demographics, and increasing income levels). To focus more on the EM growth, we added EM small stock exposure. The EM underperformance had also led to lower valuations for EM small stocks versus U.S. equities.
4) Q4 2013: Increased European equities and reduced global real estate. European equities were trading at a 20% discount to U.S. equities after lagging during the bull market from 2009 to 2013. REITs had outperformed global equities by 225% vs. 156% since TFC's investment in 2009. Valuations appeared slightly extended and the yield component of REITs made them vulnerable to the Fed rising rates, so TFC liquidated the exposure.
5) Q1 2015: TFC liquidated our remaining global natural resources equity position and lowered EM equities by 25%. The allocations were applied to U.S. large companies. The natural resources position was originally initiated in 2004 to play the commodity demand/economic boom from the growth in China and India. EM markets economic data was turning negative after the large drop in energy prices, so TFC reduced exposure to both.

Looking Forward

Currently, EM and International Developed Markets valuations look most compelling; the U.S. markets less so. When looking at the Cyclically Adjusted Price-to-Earnings ratios (CAPE P/E), the U.S. has only been materially higher in the heart of the Technology bubble (Figure G). Economic growth and company margins to date have been stronger in U.S., but the price one pays for a dollar of earnings in U.S. companies and the dividend yield seems more expensive than the added growth and profit margin expectations. Circumstances could change, but we are close to the minimum strategic weighting for U.S. equities due to the current valuations.

Both Europe and Japan are below their average P/E multiples. While the valuations for Europe have gotten more expensive this year, we still have not seen an uptick in economic conditions or earnings. We continue to wait for margins to improve in Europe before we would reduce our dedicated exposure. Greece is a negligible weighting in our portfolio and the risk to the overall European economy is quite small. We don't see a major risk to the common Euro currency as a result. However, Greece has made so many people pessimistic that the economic data only needs to slightly improve for the market sentiment to change.

Figure G: Regional Valuations

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Japan may look inexpensive from a valuation standpoint, but the macro conditions prevent us from overweighting the country. Prime Minister Abe's QE program is interesting, but we feel this is a short-term phenomenon that could reverse quickly. In fact, the recent economic data is starting to look like some of the gains from Abenomics appear transitory. At some point things will change, but we feel the massive demographic headwind will not help corporate earnings and equity prices in the long run.

Asian consumers will be the majority

Our decision to reduce EM in January due to slowing economic data has clearly helped the portfolio in the recent market softness. Year to date, the economic growth has continued to slow in China, Brazil, Russia, and others. The bearish news headlines are making this feel more and more one-sided, which could be a contrarian sign we are near a point of capitulation. The long-term economic growth story remains intact. As the IMF projects, 60% of the world's consumption by 2030 will be from Emerging Asian consumers (compared to just 25% today). While the valuation data is supportive of an allocation increase, we continue to monitor the macroeconomic conditions for improvement before making a change.

Over shorter timeframes, investor sentiment, momentum and headlines seem to drive stock market movements. However, over the longer-term, starting point valuations and economic cycles are much more informative as to the possible outcomes of the asset classes. As previously mentioned, we don't profess to have a crystal ball, nor have we seen evidence that others can consistently call market directions. Instead, our approach is to consider valuations over full market cycles when allocating capital globally. In addition, we will also consider current monetary policies, macroeconomic conditions, relative currency comparisons, transaction costs, sector and issuer concentration, as well as other risk factors.

As always, we welcome your comments and questions.

Sincerely,

Tom

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