Pilot Capital Management
195 Stock St., Suite 124
Hanover, PA 17331
717-633-9541 (Phone)
717-633-9741 (Fax)
Greg.Staub.PCM@comcast.net
Matt.Staub.PCM@comcast.net
www.PilotCapitalManagement.com

Pilot Capital Management
Quarterly Investment Commentary

Date:	July 13, 2015
From:	Greg Staub, CFA, Ph.D.; Matthew Staub, CFA
To:	Pilot Capital Clients & Friends

Dear Clients and Friends,

Your reports for the second quarter of 2015 are enclosed. This letter gives a review of the quarter and briefly summarizes our current investment views.

Second Quarter 2015 Key Takeaways

As the quarter ended, Greece was making headlines for its June 30th default on a debt payment to the International Monetary Fund amidst increasingly fraught negotiations with its Eurozone creditors, China was in the news for its very sharp short-term stock market decline and surprise interest rate cut, and Puerto Rico announced it would be unable to fully repay its municipal debts. Notwithstanding a dramatic last couple of days, though, the second quarter was generally positive for investors in diversified portfolios.

While U.S. stocks were barely positive for the quarter, overall they are broadly positive for the first six months of the year with larger caps rising 1.2% and smaller caps increasing 4.7%. On the economic front, first quarter U.S. GDP growth was revised higher in June though it remained in slightly negative territory after a harsh winter depressed economic activity. Job growth remained strong and the housing market appeared in decent shape as average home prices hit levels not seen since 2006.

Developed international stocks were roughly even with U.S. stocks in the second quarter and maintain a lead for the year so far. We added a tactical fat pitch to European stocks across our balanced portfolios in the second quarter, funded primarily from our Alternative Assets and Emerging-Markets stock allocations. As we discuss in the commentary that follows, our view of potential returns rests on the assessment that European stock market valuations are attractive and European earnings are depressed relative to their long-term normalized potential. The recent turmoil in Greece has not changed our longer-term view of the potential of this asset class.

Emerging-markets stocks rose during the quarter and are also outpacing U.S. stocks for the year despite a mixed bag of economic outlooks as well as concerns that higher U.S. interest rates could be harmful to countries with heavier amounts of U.S.-dollar-denominated debt. (This is a risk we monitor closely and it is our view that overall emerging markets are less vulnerable to negative downstream effects from U.S. rate rises than in the past.) Among larger emerging markets, China was a strong positive contributor for the quarter, despite its June decline.

After five consecutive quarters of gains, core bonds declined 1.8% over the last three months as yields on 10-year Treasury bonds rose 40 basis points. Our estimate of core bond returns remains low over our five-year forecast. Consequently, we continue to favor a variety of credit strategies that we believe will outperform our core bond benchmark in flat and rising interest-rate scenarios. These flexible credit strategies have broad mandates, which we believe will allow them to benefit from rising interest rates. That said, we retain a partial allocation to high-quality core bonds as we view them as a source of portfolio protection in the event of a stock market decline.

We also own positions in diversified, high-quality floating-rate loan funds in order to benefit from attractive yields as well as protect against rising short-term rates and unexpected inflation. Below-investment-grade bonds (a market segment that includes high-yield bonds and floating-rate loans, among others) performed well relative to core bonds in the second quarter, and floating-rate loans outperformed core bonds by nearly three percentage points.

Second Quarter 2015 Investment Commentary

We are regularly asked for our take on the broad macroeconomic topics of the day. In most cases, we don’t believe we have new insights to add beyond the reams of commentary these topics typically inspire. As we come to the end of this quarter, one of the more noteworthy big-picture subjects we are being asked about is the Greek debt crisis.

As we write this, Greece is in the headlines as the deadline ticks closer for a broader debt default, if not outright exit from Europe’s Economic and Monetary Union, and the parties appear far apart in reaching a compromise. It’s possible that significant uncertainty will remain at least until July 20, the date Greece owes the European Central Bank a €3.5 billion bond payment. And even if there is a default at that point, the full implications (political as well as economic) will remain unclear for a long time to come.

This latest Greek crisis provides us with an opportunity to highlight how we think about these types of overarching, large-scale, and often complex events in the context of our investment process and portfolio management approach. (Other examples include the potential impacts and outcomes from national elections, central bank actions, and geopolitical conflicts). These situations fall into the category of *important but unknowable*. As such, they warrant some attention from us but not, in most cases, a specific reaction. Our approach is to instead consider a range of potential outcomes (or macro risks) and then build portfolios that we believe are resilient and robust across this range.

Using the Greece situation to illustrate, our overall portfolio positioning is based on our expectations for returns and risk across a range of broad economic scenarios we consider to be reasonably likely. The range of scenarios includes best, worst, and baseline cases and, as a result, implicitly incorporates a range of outcomes from the negotiations with Greece. In other words, our current allocation is not based on an assumption that Greece would or would not default, nor on the duration of their tenure in Europe's Economic and Monetary Union. The market reactions to recent negative developments in Greece were already subsumed within the scenarios we evaluate. So as the events currently play out they have not led us to change our asset allocation positioning, although we expect some of our active bond and stock fund managers are responding more tactically to the recent events and attendant market volatility.

It's important to keep Greece's economic impact in perspective and to note that the risk of a Greek default in terms of its broader economic impact is reduced today relative to prior flare-ups of this question (though not eliminated, of course). As economist David Rosenberg wrote in his June 16, 2015, "Breakfast with Dave" column, "Remember that we are talking about a $240 billion economy here or 2% of the eurozone GDP [0.3% of global GDP]." Moreover, more than 80% of the total €315 billion Greek debt is held by government-related/taxpayer-supported entities, such as the ECB, IMF, and the European Financial Stability Facility, according to data from Capital Economics. From a financial standpoint, these entities could handle a default although there would be political ramifications (just as there will be ramifications if Greece is bailed out again). Only 18% of Greek debt is held by the private sector and private banks, which is where the potential for financial contagion was a big concern just a few years ago.

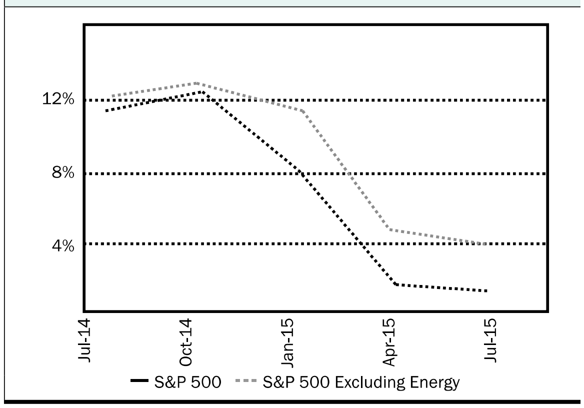
So for now we agree with the assessment that even if Greece exits the eurozone the risk of a financial contagion (e.g., "another Lehman" or a repeat of the subprime mortgage crisis) is low. However, markets may overreact if Greece looks increasingly likely to exit, and European stock prices could take a short-term hit. Indeed, the blue-chip EURO STOXX 50 Index has already dropped around 9.1% in local currency (euro) terms (as of 6/30/15) from its April high as concerns about the Greece negotiations have amplified.

That's not to say that our assessment of the impact of Greece on our European asset class analysis can't or won't change. If, for example, Greece does default and leaves the currency union, and this leads to a significant increase in our assessment of the contagion risk that other peripheral European countries (such as Spain or Portugal) might do the same, then that could impact our scenario assumptions and/or expectations for risk and return, which would likely lead us to adjust our portfolio positioning. Of course, the financial markets will be reacting to (and pricing in) these developments in real time as well.

Asset Class Views and Portfolio Positioning

U.S. Stocks — Another source of uncertainty and potential market volatility is Fed monetary policy. While we acknowledge that central bank actions (as well as Fed governors' speeches) obviously do impact financial markets on a day-to-day basis, we also firmly believe it's foolhardy for long-term investors to base investment decisions or portfolio allocations on short-term predictions of central bank behavior. We remain conservatively allocated to U.S. stocks in our balanced portfolios as the potential returns looking out across our five-year investment time period are not high enough to fully compensate us for the risks. (Our positioning is not a short-term bet that stocks will drop when the Fed starts raising rates.)

Earnings Growth Expectations Steadily Declining

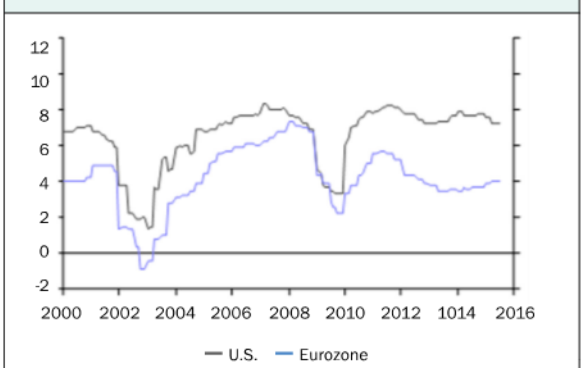


Source: Thomson Reuters. ©2015 BCA Research.

We evaluate the attractiveness of stocks by analyzing the five-year outlook for company earnings relative to stock prices across a variety of economic scenarios we believe are plausible. By this standard, stocks look less attractive, offering only low single-digit return potential over the next five years in our base case scenario. As we've discussed in prior newsletters, with corporate profit margins at historically high levels and stock market valuations expensive, the potential for earnings to disappoint the market's expectations (as reflected in those high valuations) is meaningful. We think that is a likely outcome over our five-year time horizon, and it could happen sooner rather than later. Counterintuitively, it might even be improved economic growth that is a negative catalyst for stocks to the extent that a strengthening labor market leads to accelerating wage growth, which in turn puts downward pressure on profit margins and earnings. Looking back at what we've seen so far this year, S&P 500 profit margins, while still high, have turned down over the past two quarters. Further, S&P 500 earnings growth expectations have been steadily coming down since last year.

We know U.S. stocks may continue to deliver attractive returns over short- or intermediate-term periods (supportive monetary policy can be a powerful influence, as we've seen), and we expect the actively managed stock funds we own to outperform the broad market over multiyear periods. So we own U.S. stock funds in all of our portfolios but at a lower allocation than if return potential were higher. We continue to believe there are better opportunities for our clients outside the U.S. market.

Wide Profit Margin Gap Between the Eurozone and U.S.



Source: Capital Economics.

EUROPEAN STOCKS — Our assessment remains that expected returns for European stocks are very attractive relative to U.S. stocks looking out over the next five years. Despite a rebound earlier this year, European stock market valuations and corporate earnings (which are well below their long-term trend) still have room to improve, both on absolute terms and relative to the United States. For example, the following chart shows the wide gap in net profit margins of non-financial companies in the Eurozone compared to the United States. We don't believe this wide a disparity is sustainable and believe it will adjust in favor of Europe over the next several years, whether or not Greece defaults or remains in the euro currency union.

The Greek situation may clearly lead to more market volatility over the near term, certainly on the downside if events unfold worse than the market currently expects. (Of course there is also potential for the market to be surprised on the upside if there is an unexpected agreement. Even if that happens, we think there is value to our clients in sharing our thought process and approach in the midst of the extreme uncertainty over the outcome of the negotiations.) However, we believe we have adequately factored a reasonable worst case outcome into our 12-month downside stress test scenarios for our portfolios. (Specifically, in one such scenario we assume European stocks drop 25% over the 12-month time frame.) And we have not changed the longer-term assumptions that underlie our five-year expected return calculations.

Emerging-Markets Stocks — We continue to like emerging-markets stocks on a longer-term strategic basis and on a more intermediate-term tactical basis, where we have an equal weighting relative to our strategic allocation. Our top-down analysis for emerging-markets stocks is similar to our analysis for European stocks, in that their valuations look attractive and earnings appear to be depressed relative to our longer-term expectations. We also take into account specific risks to emerging markets, namely the potential for a sharper slowdown of growth in China and the risk from a stronger U.S. dollar. However, even when taking these risks into consideration, over our five-year investment time horizon, our analysis still shows low double-digit annualized returns in our base case scenario and mid-single-digit returns in our most bearish scenario.

Investment-Grade Bonds — On the fixed-income side of the portfolios, given our base case scenario assumes that we'll be in a longer-term trend of moderately rising interest rates, which would be a negative environment for investment-grade bonds, we are maintaining a significant underweight to core bonds and interest rate risk, in favor of flexible core bond funds, absolute-return-oriented bond funds, and floating-rate loan funds that we believe can generate higher returns and better manage their interest rate sensitivity. We continue to own positions in diversified, high-quality floating-rate loan funds in order to benefit from attractive yields as well as protect against rising short-term rates and unexpected inflation. Below-investment-grade bonds (a market segment that includes high-yield bonds and floating-rate loans, among others) performed well relative to core bonds in the second quarter, and floating-rate loans outperformed core bonds by nearly three percentage points. We continue to have a positive outlook for the asset class as our research indicates that floating-rate loan fundamentals remain healthy.

Concluding Comments

Looking ahead, we know there are inevitably going to be shorter-term surprises, including negative ones. This should not be surprising, and yet we know they will still feel uncomfortable for many investors. In those moments, it's useful to remember that volatility is the shorter-term discomfort an investor must often experience in order to earn attractive longer-term returns from owning stocks. For it's exactly those volatile market movements that can create compelling longer-term investment opportunities: tactical asset allocation fat pitches for us, and great stock- and bond-picking opportunities for our active managers.

Thank you for your continued trust and confidence in Pilot Capital Management. As always, should there be any questions, please don't hesitate to contact us.

Sincerely,

Greg Staub, CFA, Ph.D.
President

Matthew Staub, CFA
Vice President