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Wealth Advisers, LLC

Polaris Educational Series

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Market Correction!

It's official. The S&P 500 has finally dropped more than 10%, or what is officially deemed to be a market correction. According to JP Morgan, the markets had gone 1,418 trading days without having a 10% correction. The S&P 500 reached 2132 on July 20th and closed today at 1893 for an 11.2% intra-year decline.

This is the largest decline that the S&P 500 has experienced since summer of 2011

Increased Volatility

This market correction has seen an increase in market volatility, as expected. The VIX is the most widely used volatility index. Over the past 25 years the VIX has averaged a 20 reading. Anything below 20 would be considered below average volatility and anything above 20 would be above average. The VIX has moved from the low teens earlier this year to over 40. In fact, last week was the biggest increase in volatility (week over week) in the VIX index's history.

A 40 reading, however, is far below the all-time 89.43 reading experienced in October of 2008

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Why Is The Market Correcting?

Pinpointing a single reason the U.S. markets have corrected is impossible. There are several macro contributing factors for this current correction. The major contributors are:

CHINA

The Chinese economy has been slowing down over the past year. The Chinese government claims that their economy is growing at a 7% per year rate, down from over 10% in recent years. Many analysts believe that this is an overstated rate. Their markets, on the other hand, had been going up dramatically until mid-May. The run up was due, in part, to the deregulation of margin in China and also due to the possibility of the opening of A share ownership of Chinese companies by foreign investors. By mid-July the Chinese markets were falling dramatically. The Chinese government made an unprecedented move to protect their markets from further decline. The Chinese government froze trading on more than half of all publicly traded companies. They also restricted all officers and all board of trustee members from selling their own company stock. In addition, they infused their markets with almost $100 billion in government sponsored purchasing of Chinese stocks (please see July's educational e-mail for all of their steps). These measures unfortunately have not stopped further decline. The Shanghai Index is down over 40% from its highs.

GREECE

Greece's debt issues are not new news. The new Greek government, elected in November, came into power with the platform that they would fight the austerity measures placed on them by the European Union. The Greek government threatened to default on their debt during negotiations. European lenders cut off liquidity to Greek banks during these negotiations. As a result, Greek banks closed their doors as Greek citizens attempted to pull their cash reserves from their banks, averting a "run" on their banks. In the end, Greece's debt crisis was averted in mid-July when the Greek government agreed to most of the terms set by their lenders, but the uncertainty at the time suppressed the market's growth.

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THE FED

The U.S. Federal Reserve has publicly announced their intention to raise Fed Fund rates as soon as their proprietary economic indicators will allow for the move. Their goal is to raise Fed Fund rates to 3% (from near 0%) by the end of 2017, according to the minutes from their meetings. Unlike prior years, investors don't have to guess at the Fed's intentions. The question is not if rates will be raised, but when. This remaining question of when has been weighing on the markets. As long as the Federal Reserve raises rates slowly and methodically it shouldn't have a long-term impact on stocks. The real concern revolves around currency valuations (also known as a currency war). There is concern that the Fed's actions will further increase the strength of the dollar while the European Central Bank, the Bank of Japan, and the People's Bank of China are all devaluating their currency. This could impact U.S. companies that derive their earnings from international sources and impact the U.S. economy.

CONFLICTING ECONOMIC INDICATORS

Over the last several weeks there have been several economic indicators that have conflicted with each other. Leading economic indicators and new jobless claims were weaker than expected. The Chicago Fed National Activity Index showed average economic growth. New Home sales were very strong. The Consumer Price Index showed virtually no inflation. These data points offered no direction and were confusing the markets.

THE U.S. MARKETS WERE OVERVALUED

As of March 31st the S&P 500 was at 2067.89, trading at 16.9 times current earnings. This was slightly above its 25 year price-to-earnings average of 15.7, which would price the S&P 500 at 1921. The S&P 500's correction has brought the index down to 1893, slightly below the 25 average year price-to-earnings ratio.

IT WAS OVERDUE

We have not seen the S&P 500 correct 10% since the summer of 2011. That's over 5 years without a significant correction in the market. Throughout the market's history, the market has corrected 20% every 2 ½ years on average. We have been overdue for a correction.

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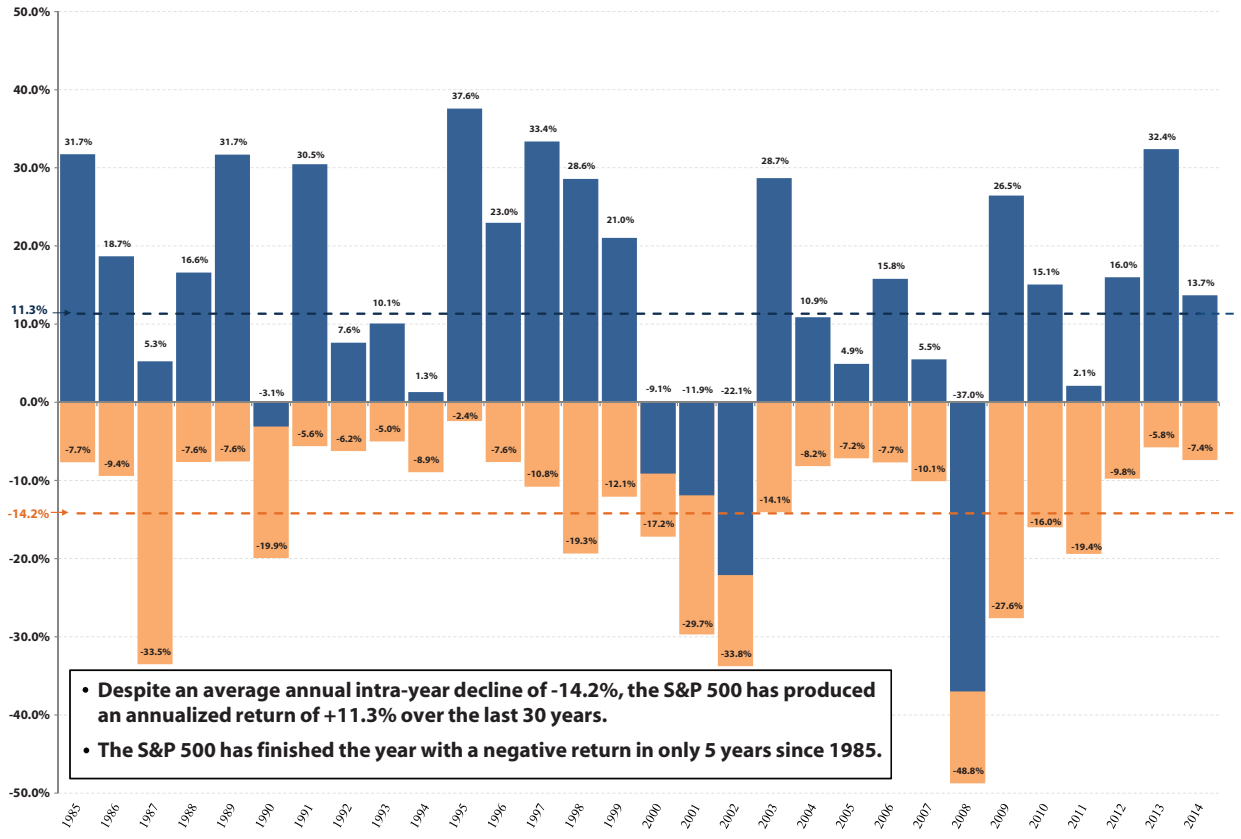
This Market Correction is Not Unusual

- **Historically, the markets have corrected 5% four times a year.**
- **The markets typically have had one 10% correction per year.**
- **Once every 2 ½ years the markets correct 20%.**
- **Over the last 30 years, the S&P 500 has averaged an intra-year decline of 14.2% while still growing at an average annual return of 11.3% (as seen below).**
- **Our current situation, as scary as it feels, is normal.**

S&P 500 Annual Returns vs. Intra-Year Declines
1984-2014



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What Has/Is Polaris Doing?

We lowered stock exposure – We currently are under-weighted to stocks in all of our investment strategies. We began lowering our stock exposure in all strategies in June. On July 8th we made further cuts to our equity exposure in all strategies. All of these moves were done well in advance of the downturn in the stock market. Our under exposure to the stock market in all of our investment strategies has mitigated our losses during these volatile times.

If needed, we will lower our exposure even more – We are prepared to continue to lower our exposure to the stock market, if warranted. We will remain clinical in our decisions to protect and grow your portfolio. At the moment, the economy remains strong. The broad based fundamentals have not changed. While technical evaluations have broken down, this downturn is not like the 2008 markets. We should not see the same impact to the broad based markets.

We are ready to buy back in when the markets settle – Lowering your exposure to the stock market is half of the equation. Limiting loses during bad times during downturns in the markets can place investors ahead of the indexes. For example, if an investor losses 10% in the markets they need a little over 11% to get back to break-even. If their portfolio loses 20%, by comparison, they would have to recover 25% to get back to break-even. Limiting these additional losses puts an investor in a greater position to recover their losses quicker. A good investor must also be willing to buy back into the markets, typically at a time when few people are willing to risk their money in the market. We are currently holding a very high cash position waiting for the right time to buy back into the market.

These types of markets are when Polaris shines. We know these are trying times. We know that you are concerned about your portfolio and your financial security. Polaris is proactively managing the risk in your portfolio. We are prepared to take further steps to protect your portfolio, if necessary. Additionally, we are prepared to invest back into the market in the attempt to recoup the minor losses you've experienced in your portfolio.

As always, your Polaris team is available to discuss your portfolio with you. Please feel free to call us to discuss your portfolio and the current market environment. As always, I welcome your comments and questions.

Sincerely,

Jeffrey J. Powell
Managing Partner

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