# 2016 SEMI-ANNUAL UPDATE

## SUMMARY

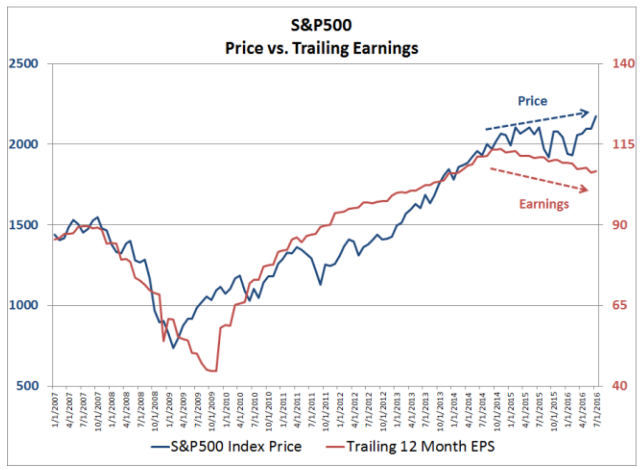
Global equities reached new highs in the summer of 2016 on expectations of continued loose monetary conditions in a low growth environment. The Central Banks of Europe and Japan pursued negative interest rate policies, causing government bond yields to drop worldwide. Up to $13 trillion of sovereign debt issues now trade at negative yields. The US dollar unexpectedly weakened against the Euro and Yen as the US Fed turned dovish in the face of market volatility and slowing economic conditions. In Europe, the United Kingdom's vote to leave the European Union (Brexit) shocked markets, raising doubts about the future of European integration. Commodities rallied, led by gold as investors flocked to safe havens. Oil surprised on the upside as production issues constrained supply, and markets started to rebalance. Investors reacted to the return of macro-economic fears by seeking yield and safety over long term growth, exacerbating valuation imbalances.

## REVIEW OF MARKET CONDITIONS

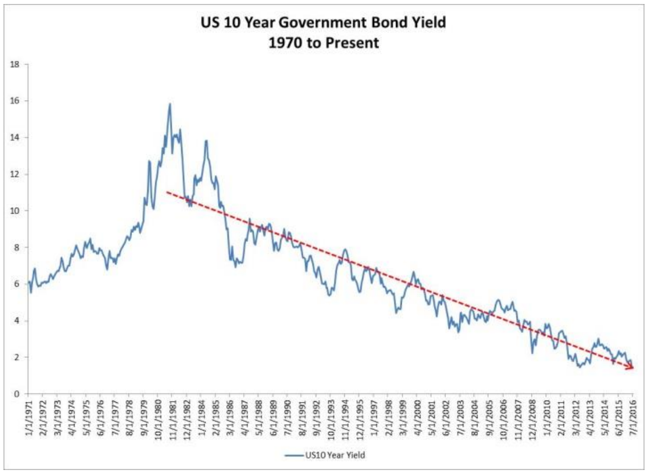
US equities staged a powerful rally after it became clear in late February that the Federal Reserve would delay interest rate hikes.

The volatility caused by the UK vote to leave the European Union (Brexit) proved short term in nature, as expectations of additional stimulus increased.

Equity markets reached new highs despite a continuing slowdown in earnings as the liquidity injected by Central Banks inflated multiples.

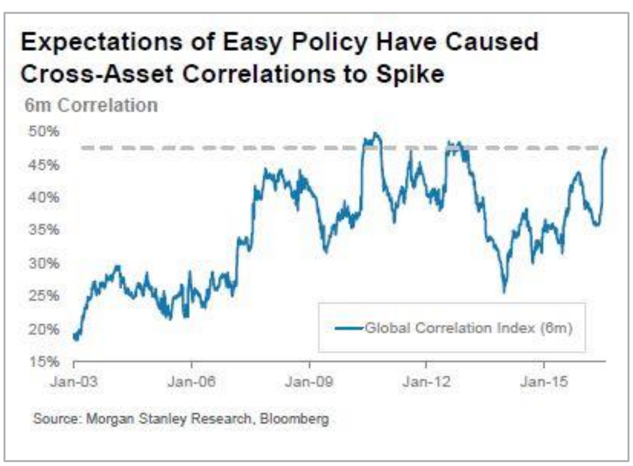


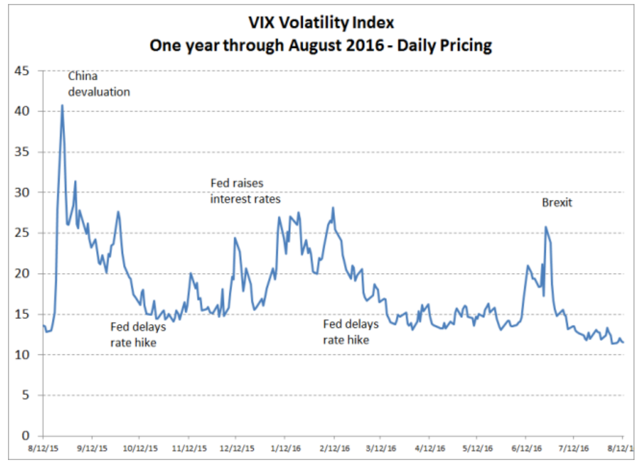

Despite the traditional expectation of a negative correlation between stocks and bonds, government bonds continued to rally alongside stocks, as yields reached historic lows (1.45% on the US 10 year at the end of July).




The liquidity-induced rally across multiple asset classes caused cross-asset correlations to spike, reducing the benefits of diversified portfolios as valuations seemed to matter little to investors.

Central bank actions also worked to tamper volatility (VIX volatility index reached a 12 month low of 11.9 at the end of July). Lack of divergence and low volatility worked against active management in general.




Unsurprisingly, the top categories of mutual funds attracting assets over the past 12 months include taxable fixed income, municipal debt and managed futures as investors sought safety and insurance in their portfolios.

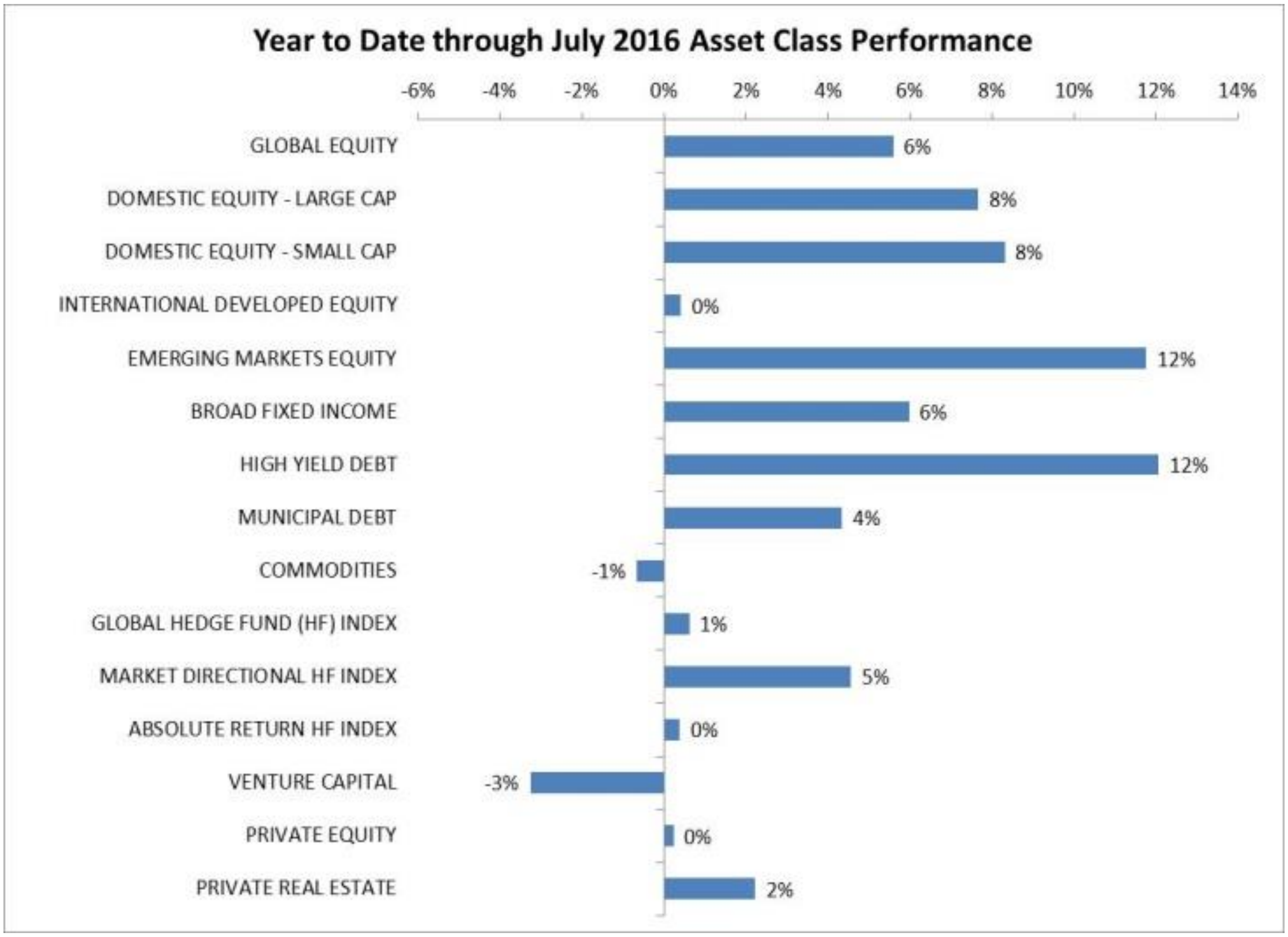
Most asset classes were up year to date through July. Some of the best returns were found in public assets that recovered from last year's losses,

**Top 10 Open-End Mutual Fund Categories by Monthly Flows ($MM)**

| 6/16 | 1 Mo. | 3 Mo. | 12 Mo. |
|---|---|---|---|
| Intermediate-Term Bond | 7,393 | 29,954 | 45,230 |
| Foreign Large Blend | 2,527 | 8,317 | 73,179 |
| Muni National Interm | 2,097 | 7,956 | 22,723 |
| High Yield Muni | 1,579 | 4,209 | 9,774 |
| Corporate Bond | 1,540 | 3,287 | 5,129 |
| Muni National Short | 834 | 1,332 | 1,023 |
| Muni National Long | 665 | 2,275 | 2,988 |
| Managed Futures | 631 | 2,580 | 11,910 |
| Preferred Stock | 593 | 1,326 | 3,065 |
| Option Writing | 437 | 476 | 715 |

*Source: Eaton Vance*

particularly emerging market equity and high yield debt, which benefited indirectly from the recovery in oil markets. International equities struggled as negative interest rate policies and uncertainty linked to the Brexit vote weighed on performance. Hedge funds lagged public markets, but Directional hedge funds rebounded from last year. The returns for private assets are reported with a lag and shown here through March. The valuation of venture funds declined in the first quarter, reflecting the broad market decline earlier this year.




See page 6 for index key.

## GROWTH ASSETS

Growth assets include investments that generally benefit from favorable economic conditions such as sustained growth and controlled inflation. Our definition includes equity and equity-like (credit) assets across public and private markets in long only, hedged or draw-down structures. The following discussion considers these various components in turn.

### LONG ONLY EQUITIES

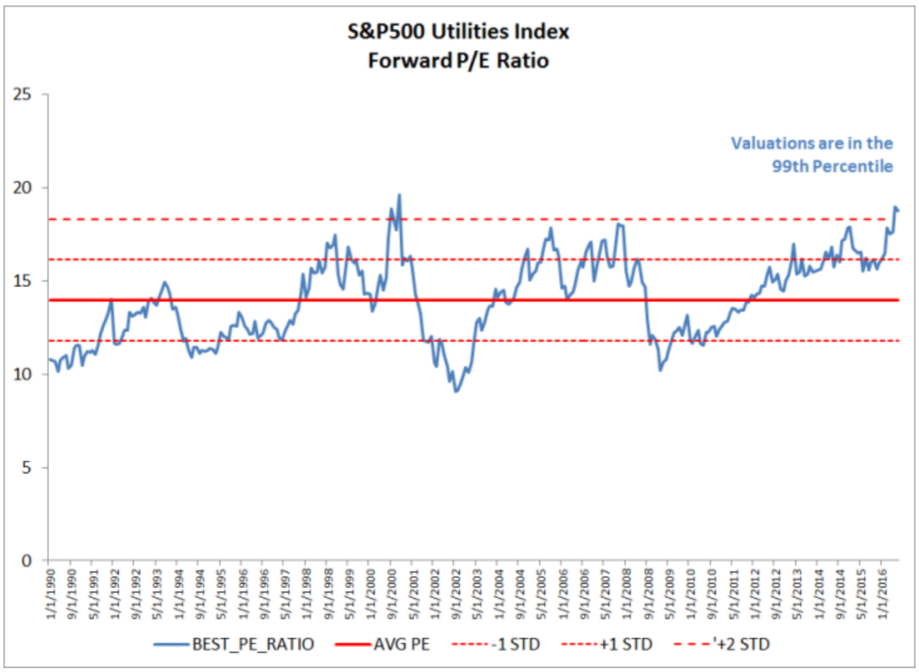
Global equities, as represented by the MSCI All Country World Index (ACWI), gained 5.6% in U.S. currency year to date. Within regions, Emerging Markets were the best performers, returning 11.8% (MSCI EM), compared to 0.4% for international developed markets (MSCI EAFE) and 7.7% for US equities (S&P500), in U.S. dollar terms. Globally, small caps outperformed large caps. The best performing sectors included Energy (+14.6%) and Materials (+17.1%) as commodities rallied, and bond proxy equities, including Utilities (+14.3%) and Telecom (+11.2%). The worst performing sectors included Financials (-2.1%), due to negative interest rates, and cyclical stocks in Consumer Discretionary (+1.9%).

Foreign equity investors benefited from currency translation effects as currencies in both developed and emerging markets appreciated against the US Dollar. Within the U.S., value dominated growth, particularly in smaller capitalization stocks.

| YTD Return | USD | Local |
|---|---|---|
| S&P500 | 7.66% | |
| MSCI EAFE | 0.42% | -4.75% |
| MSCI EM | 11.77% | 6.12% |
| MSCI ACWI | 5.59% | 2.44% |
| **YTD Return** | **Growth** | **Value** |
| S&P500 | 6.27% | 9.13% |
| Russell 2000 | 4.84% | 11.81% |

On July 1st, Windrose Advisors launched the WA Global Equity investment sleeve, which combines our long only equity allocations across global, domestic, international and emerging markets mandates. As we ponder rebalancing opportunities, we are enclined to trim US exposure based on rising valuations, and particularly the high yielding, low volatility sectors that act as fixed income proxies.

As shown in the chart below, the forward P/E of Utility stocks (using the S&P500 Utilities as a proxy) stood at an extreme high at the end of July: two standard deviations above normal, in the 99th percentile of observations over the past 26 years.




We see better long term opportunities in developed market equities where negative sentiment is extreme, valuation multiples lower, and which continue to benefit from accommodative Central Bank policies.

## DIRECTIONAL HEDGE FUNDS

Directional hedge funds include strategies that typically show high correlation to equities, such as long short equity, event-driven and distressed credit.

Directional Hedge Funds (+4.6%) benefited from the rally in equity markets. Distressed strategies led the pack as energy credit rebounded sharply with gains in oil prices. Event-Driven strategies also outperformed, while Equity Hedged (long/short) strategies struggled with the market's rotation into defensive sectors. High correlation and low dispersion of returns among stocks hindered active strategies such as Equity Hedged so far this year. In addition, the performance of technology and health care stocks, two sectors typically favored by hedge fund managers, lagged this year, creating performance headwinds.

On July 1st, Windrose Advisors launched the WA Market Directional investment sleeve, which combines our more aggressive return-seeking hedge fund strategies. Performance in our directional hedge fund portfolio was mixed so far this year. While distressed managers delivered solid performance consistent with markets, a number of equity hedged strategies were challenged in January by concentration in underperforming sectors such as financials and health care. However, performance has improved as the year progressed. Year to date, we have made no changes to our manager line-up. Looking forward, we are likely to seek more diversification by working to reduce overlapping exposures among our funds.

## OPPORTUNISTIC CREDIT

Equity-like fixed income markets exposed to credit risk rallied, including high yield (+12.1%) and emerging debt (+14.8% for bonds denominated in local currencies). We continue to favor high yield municipals (+8.7%, or +15.3% on a taxable-equivalent basis for the highest tax bracket) over taxable alternatives for high net worth investors. Although valuations have become slightly less attractive, we think that the underlying fundamentals are better for municipal issuers than many corporate sectors, and they continue to benefit from strong demand.

## PRIVATE EQUITY

Private equity (+0.23%) and venture capital (-3.25%) offered lower returns than public markets. However, because of the lag in reporting, these figures are through March 2016. Valuation write-down in Venture Capital companies seeped into performance figures in the first quarter as investors sought safety and liquidity. The subsequent rally in risk assets likely implies stabilizing performance for private equity as write-downs are avoided.

So far this year, our funds have realized significant liquidity events, including Dollar Shave Club, sold to Unilever for $1bn.

## INFLATION PROTECTION

Commodity prices rallied following a trough in February as slow growth and negative interest rate policies lifted demand for gold, oil prices were supported by supply disruptions in Nigeria and Canada and stimulative measures in China helped industrial metals. Valuations for public real estate look increasingly stretched following strong performance. We favor private real estate funds with select partners, which can patiently deploy capital across specific opportunities.

| INFLATION PROTECTION | YTD Return |
|---|---|
| BROAD COMMODITIES | -0.65% |
| COMMODITIES - ENERGY | -3.55% |
| COMMODITIES - INDUSTRIAL METALS | 9.43% |
| COMMODITIES - PRECIOUS METALS | 29.24% |
| COMMODITIES - AGRICULTURE & | -3.51% |
| ENERGY EQUITY | 14.57% |
| PUBLIC REAL ESTATE | 17.45% |
| PRIVATE REAL ESTATE | 2.22% |

We remain bullish on the energy sector as we expect supply and demand to continue to rebalance and oil prices to be well supported. Commodity futures price long term WTI oil contracts at $53 by the end of 2017 and $55 by the end of 2019 versus current spot price of $48. While a reasonably moderate assumption, we think this underestimates the potential for prices to shoot upwards over the coming years as long term project cancellations and well declines work to contain supply. We are most bullish on unconventional US oil producers with access to low cost reserves and are bearish on refiners.

## RECESSION PROTECTION

The yield on the benchmark 10-year Treasury initially fell from 2.27% at the end of December 2015 to 1.45% by the end of July 2016. A more dovish stance by the Fed, acknowledging economic weakness in the US and abroad, and the uncertainty unleashed by negative interest rate policies and the Brexit vote led to a flight to the safety of government bonds.

Taxable fixed income markets, as represented by the Barclays Aggregate Index, posted positive returns year-to-date (+6.0%). Within the major components of the Aggregate, corporate debt (+9.1%) outperformed both government securities (+5.3%) and securitized debt (+3.8%). Municipal markets also benefited from the decline in rates and strong demand returning +4.4%. With fair valuations, positive fundamentals, strong demand and a tax advantage, we continue to favor municipal debt. We are bearish on government securities.

| RECESSION PROTECTION | YTD Return |
|---|---|
| BROAD FIXED INCOME | 5.98% |
| US GOVERNMENT DEBT | 5.29% |
| US INFLATION LINKED | 7.09% |
| US CORPORATE DEBT | 9.11% |
| US SECURITIZED DEBT | 3.83% |
| MUNICIPAL DEBT | 4.34% |

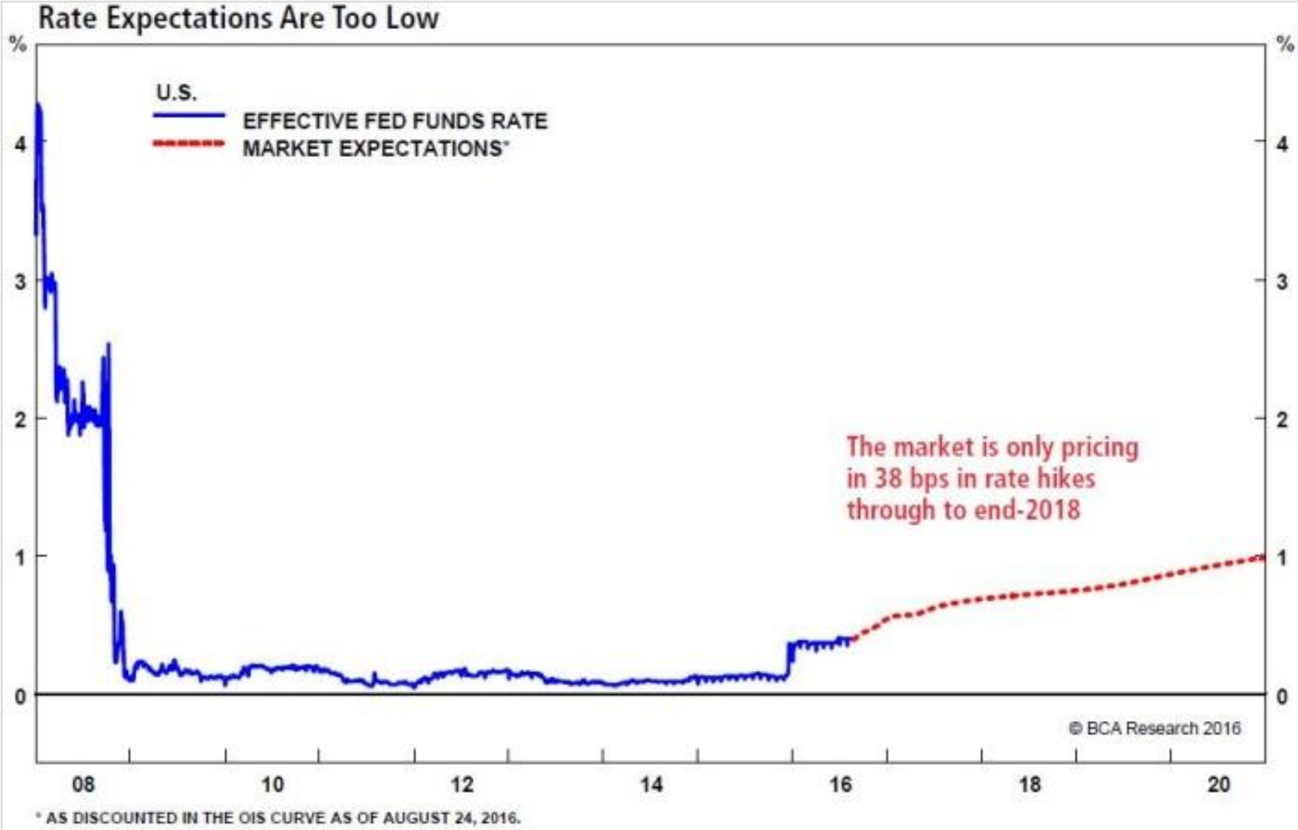
## ABSOLUTE RETURN HEDGE FUNDS

Absolute Return Hedge Fund strategies (+0.4% YTD), led by arbitrage strategies. However, the group slightly underperformed the Global Hedge Fund index.

On July 1st, Windrose Advisors launched the WA Absolute Return investment sleeve, which combines our more conservative or risk-diversifying strategies. Performance in our absolute return hedge fund portfolio was excellent across all sub-strategies. In particular, multi-strategy funds benefited from exposure to distressed credit and arbitrage while our global macro managers successfully navigated the recent choppy markets. Looking forward, we expect to expand our fund line-up by adding complementary strategies.

## OUTLOOK FOR REMAINDER OF 2016

In a world beset by low growth and generally expensive valuations across most asset classes, markets will remain extremely sensitive to macro-economic developments and particularly the pace of future rate hikes in the US. As of August 24th, traders




were still only pricing 0.38% of rate hikes through the end of 2018.

Financial markets stability and strong employment figures are increasing confidence in the Federal Reserve's ability to raise interest rates. We anticipate that a 0.25% is likely in December, following the presidential election. Barring new market developments, subsequent increases should also be expected in 2017.

The main unknown will be the direction of the US Dollar. A strong dollar acts as a tightening of financial conditions, importing deflation into the US. Increasing rate hike expectations would work to lift the US Dollar against foreign currencies, offsetting the need for interest rate increases to some extent.

Rising rates and a stronger Dollar could provide headwinds to stocks, bonds and commodities (particularly gold). This reinforces our conviction to pursue active management, favoring assets with more attractive valuations, and to emphasize absolute return strategies.

## INDEX KEY

Global Equity (MSCI All Country World-USD), Domestic Equity Large Cap (S&P500), Domestic Equity Small Cap (Russell 2000), International Developed Equity (MSCI EAFE), Emerging Market Equity (MSCI EM), Energy Equity (MSCI ACWI Energy) Broad Fixed Income (Barclays Aggregate), US Government Debt (Bank of America Merrill Lynch US Government), US Inflation-linked (Bank of America Merrill Lynch US Inflation-linked), US Corporate Debt (Bank of America Merrill Lynch US Corporate), US Securitized Debt (Bank of America Merrill Lynch US ABS & CMBS), Emerging Debt US Dollar (JP Morgan Emerging Market Bond Index Global), Emerging Debt local currency (JP Morgan Global Bond Index Emerging Markets), High Yield Debt (Bank of America Merrill Lynch US High Yield), Municipal High Yield (Bank of America Merrill Lynch US Municipal High Yield), Municipal Debt (Bank of America Merrill Lynch US Municipal), Commodities (S&P/Goldman Sachs Commodity Index), Public Real Estate (MSCI US REIT), Global Hedge Funds (HFRX Global Hedge Fund Index), Market Directional HF Index (HFRX Market Directional Index), Absolute Return HF Index (HFRX Absolute Return HF Index), Venture Capital (Cambridge Associates Venture Capital Index), Private Equity (Cambridge Associates Private Equity Index), Private Real Estate (Cambridge Associates Private Real Estate).

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# 2016 SEMI-ANNUAL UPDATE

Current view | Previous view

| Global Asset Allocation | - | | | | + | |
|---|---|---|---|---|---|---|
| Equities | | Current | Previous | | | Slowing world growth, fair to high valuations |
| Credit | | Current | Previous | | | Slow growth favors income strategies but fundamentals are deteriorating |
| Government Bonds | Current | Previous | | | | Low yields, negative in an increasing number of issues but strong demand for safe haven assets |
| Commodities | | Previous | Current | | | Oil market rebalancing, precious metals more attractive, negative technicals |
| Currencies | | Current | | | | Expect renewed US Dollar appreciation |
| Hedge Fund Strategies | | | Current | Previous | | Prefer absolute return strategies |
| Private Strategies | | | Current | | | Illiquidity premium available in select opportunities |
| Cash | | | Current | | | Would benefit from rising rates and increasing option value in case of a market downturn |

| Equities | - | | | | + | |
|---|---|---|---|---|---|---|
| Global | | Current | | | | Mixed valuations, prefer international developed exposure |
| US | | Current | | | | Relatively high valuations, monetary tightening, peaking growth, favor quality |
| Europe | | | Current | | | Lower valuations, monetary easing, prefer domestic exposure over exporters |
| Japan | | | Current | | | Lower valuations, monetary easing, domestic strength but impacted by China |
| Emerging Asia | | Current | | | | China struggling with transition to consumption-led economy, weak global growth |
| Emerging Other | | Current | | | | Challenged by weak global growth, low commodity prices, high leverage |

| Government Bonds | - | | | | + | |
|---|---|---|---|---|---|---|
| US Treasuries | | Current | Previous | | | Safe haven asset, higher yield relative to DM peers, but expensive valuation |
| US Inflation-Linked | | | Current | | | Lower than usual break-even rates make TIPS attractive relative to Treasuries |
| German Bunds | Current | | | | | Low real yields, exposed to reflationary policies |
| Japanese GB | Current | | | | | Low real yields, exposed to reflationary policies |
| EM Debt Local Currency | | Previous | Current | | | Attractive spreads, cheap currencies but exposed to a rising US Dollar |
| EM Debt Hard Currency | | Previous | Current | | | Lower return potential but less volatile due to reduced currency risk |

| Credit | - | | | | + | |
|---|---|---|---|---|---|---|
| IG Corporates | | Current | | | | Median spreads, rising shareholder friendly activity |
| IG Securitized | | | Current | | | Rising collateral values, lower pre-payments |
| High Yield Corporates | | Current | | | | Median spreads but deteriorating liquidity |
| High Yield Loans | | Current | | | | Median spreads, some interest rate protection |
| IG Municipals | | | Current | Previous | | Fair valuations but strong demand |
| High Yield Municipals | | | Current | Previous | | Credit spread cushion but liquidity conditions may create volatility |

| Commodities | - | | | | + | |
|---|---|---|---|---|---|---|
| Energy | | | | Current | | Low oil & gas prices have likely troughed but volatility remains |
| Industrial Metals | Current | | | | | Exposed to China slowdown |
| Precious Metals | | Previous | Current | | | Benefit from negative interest rates but upside limited by potential Dollar strength |
| Agriculture | | Current | | | | Farming down cycle, bumper crops versus recovering cattle herd |

| Currencies (vs. US Dollar) | - | | | | + | |
|---|---|---|---|---|---|---|
| Euro | | Current | | | | Ongoing monetary stimulation |
| Yen | | Current | Previous | | | Bank of Japan is likely to act to curb Yen appreciation |
| British Pound | | Current | | | | Similar dynamics to US, peaking economy may prevent tightening |
| Emerging Markets | Previous | Current | | | | Generally cheap currencies have adjusted but volatility remains |
| Commodity currencies | Previous | Current | | | | Benefit from stronger oil prices, but exposed to end of commodity supercycle |

| Hedge Fund Strategies | - | | | | + | |
|---|---|---|---|---|---|---|
| Long-Biased L/S Equity | | Current | | | | High equity valuations a risk, prefer sector specialists |
| Event-Driven | | | | Current | | Favorable environment for activist strategies |
| Distressed | | | Current | | | Poised for next distressed cycle but postponed by central bank support |
| Arbitrage | | | Current | | | Good spreads but mergers |
| Low Net L/S Equity | | | | Current | | Higher short exposure a valuable hedge against possible equity downturn |
| Global Macro | | | | Current | | Able to capitalize on rate uncertainty, currency volatility |
| CTA/Trend Following | | | | Previous | Current | Able to capitalize on market dislocations, best insurance |

| Private Strategies | - | | | | + | |
|---|---|---|---|---|---|---|
| Venture | | Current | | | | IPO market cooling down, high valuations |
| Buy-Out | | | Current | | | Tighter lending standards and market volatility increase appeal of private capital |
| Distressed | | | Current | Previous | | Tightening credit spreads preventing expansion of opportunity set |
| Natural Resources | | | | Current | | Depressed cyclical valuations increasing long term opportunities |
| Real Estate | | Previous | Current | | | Focus on value add strategies and co-investment deals |

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