ABBOT DOWNING STRATEGY REPORT

Predicting the Unpredictable
# ABBOT DOWNING STRATEGY REPORT — Predicting the Unpredictable

## Contributors:

### Abbot Downing Strategy Team

- **Douglas W. Evans**, CFA  
  Senior Managing Director, Asset Management
- **Philip W. White**, CFA  
  Senior Managing Director, Asset Management
- **Carol M. Schleif**, CFA  
  Deputy Chief Investment Officer, Asset Management
- **Todd F. Rabold**, CFA, CAIA  
  Regional Chief Investment Officer, Asset Management
- **Jeffrey R. Erickson**, CFA  
  Managing Director, Asset Management
- **Robert B. Farrington**, CFA, CAIA  
  Senior Portfolio Manager, Asset Management
- **Daniel P. Burke**, CFA  
  Senior Portfolio Manager, Asset Management
- **Doug R. Beath**  
  Portfolio Manager, Asset Management
- **Thomas J. Raymond Jr.**, CFA  
  Portfolio Manager, Asset Management
- **Roger W. Adams**, CFA  
  Business Support Consultant, Asset Management

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2  Abbot Downing Strategy Report – Predicting the Unpredictable
Predicting the Unpredictable

“One of the funny things about the stock market is that every time one person buys, another sells, and both think they are astute.”
S&P 500 earnings history
William Feather

Market participants have certainly had much to grapple with in recent weeks, even as the earnings season wrapped up with results that came in better than even the most optimistic forecasts had foreseen. (According to Bloomberg, consensus had expected S&P 500 Index (S&P500) earnings to come in with a mid- to upper-teens growth rate; instead they registered nearly 23%—the strongest showing in eight years.1) From our perspective, plenty of other news served to distract investors, though, and kept markets moving choppily through much of the past month. Refer to Chart A: S&P 500 Index Recent Daily Price History on page 6.

- The potential for tit-for-tat trade actions not just with China, but with key partners like Canada, Mexico, and the European Union as tariffs on a broad array of imports were suspended, reinstated, and renegotiated.

- The off- and then on-again summit between President Trump and North Korean president Kim Jung Un.

- Surprising Geopolitical instability in the wake of Italian elections that roiled bond markets around the globe given the highly indebted nature of the country and the inability of the newly elected leadership to form a coalition.

- Continued concern in the U.S. about the pace of inflation—especially given the strengthening employment markets and rising commodity costs—and whether or not companies and sectors would be able to pass along price increase that stuck.

- A keen watch on Federal Reserve action and rhetoric, especially with the 10-year U.S. Treasury bond vacillating around what many media outlets have labeled as the psychologically important 3% level.

While these headlines appear to have made many investors nervous and potentially moved markets—sometimes by hundreds of points—on a near term basis, we believe it’s important to cut through the noise and tease out what, if anything, is potentially impactful over the longer haul. As we’ve noted on numerous occasions, market timing is a fool’s game, particularly for taxable investors where a substantial amount of documented research shows the more active an individual is, the lower their returns are likely to be. Missing even a few of the best days can substantially reduce overall returns. Refer to Chart B: Missing the Best Days in the Market on page 7.

In addition to being whipsawed by surprising headlines, markets can be driven by structural factors that have little or nothing to do with fundamentals, in our opinion. Examples include supply/demand imbalances driven by large inflows into mutual funds (especially passive market-mimicking index funds) after corporate bonuses or 401(k) matches are made; large redemptions made en masse to make tax payments; large actively traded funds “rearranging” sector exposure or taking profits to “window dress” for a quarter end; or simply the increasing preponderance of algorithmic trading that can push stocks around in a given hour or on a given day.

While markets are often unpredictable in the short run, that volatility tends to even out and expose a trend line over longer periods. Refer to Chart C: S&P 500 Index – 20 Years of Price Movement page 7. Interesting to note that the daily moves of the past few months—which can feel so excruciating when we are in the midst of them—form a barely imperceptible blip when viewed from a multi-year context.

Those investors with a long-term, multi-generational focus can actually benefit by navigating volatile markets, especially if they are able to accurately dial into overarching trends that take time to play out. We feel that being able to build into, or ease out of, sectors and individual holdings is an important
portfolio construction skill set to hone. With that in mind, we thought it would be helpful to take a step back and outline a few thoughts regarding how recent headlines may impact portfolio construction and positioning.

**What’s Going Right**

**Corporate Fundamentals** – A number of factors in the Tax Cut and Jobs Act passed in 2017 are, in our opinion, obviously beneficial for corporate America including accelerated depreciation, reduced overall corporate rate, and encouragement to repatriate cash stashed overseas. Investment in capital (CapEx) has picked up, regulations have been rolled back, and consumers and business leaders are optimistic—and by our observations illustrating that optimism with new plants, new hires, and new initiatives. A less talked about factor is that most of corporate America is still in recession-leaned fighting shape meaning each incremental dollar of surprisingly strong top lines can drop in a magnified fashion to the bottom line. This can tee up a virtuous cycle that is tough to dislodge. Our economy, once fired up is like accelerating a battleship, not a Ferrari.

**Pricing Power** – While in the near term pundits seem to be stressing about any uptick in wages or inflation, we believe a bit of each is actually quite helpful. It allows companies to have a little room to pass along price increases which allows them to pay workers more. And we believe workers with higher wages tend to purchase more goods and services, be more optimistic, and have the confidence to “trade up” in houses, careers, etc. In a simplistic sense, the fact that high end retailers surprised to the upside, while dollar stores and packaged goods companies surprised on the downside when announcing first quarter results is a further indication of this notion.

**Capital Spending (CapEx) is Accelerating** – Governments all along the spectrum from the national to the local level seem to be stepping up their CapEx budgets after a long period of underinvestment. Similarly, corporate America appears to be using some of its recently repatriated and lower taxed cash flow to reinvest in itself. Many of these expenditures have been allocated toward enhanced technology, supply chain management, and automation as a way to circumvent or alleviate the tight labor supply. Theoretically, these investments should be additive to corporate productivity over the longer pull.

**Regulatory Equilibrium** – A delicate balance between necessary rules, laws, and domestic growth does appear to be healthier than it has been for many years.

**Green Shoots in the Deal Markets** – While it’s early, increasing evidence points to a quickened pace of mergers and acquisitions both from strategic buyers and from cash-rich private capital funds. Further, a number of unicorns are rumored to be contemplating public listings later this year or in 2019.

**What Could Go Awry**

**Escalating Trade Tensions** – We tend to presume that saner heads will prevail in averting the potential for a full-blown trade war. Should things escalate and current tariffs be extended, accentuated, or broadened, the impact to business psyches and global partner relationships could possibly be long lasting. The world’s supply chains are so intricately woven and complicated, we believe it will be tough to fully assess specific impacts until after some time has passed. We are watching actions closely here but it is premature to make portfolio shifts based on what-ifs that seem to sway minute by minute.

**Fundamental Bottlenecks Accelerate** – U.S. unemployment is at multi-decade lows; selected commodity prices are up; and key portions of global supply chain logistics such as shipping are tight. Yet global supply/demand and plentiful capacity in key industries seem to be in decent balance so far.
Predicting the Unpredictable (Continued)

Recent Softening in Global Trends – Economic activity in some places, particularly in the EU seems to be flattening. If Central Bank Policies run afoul; if Brexit goes badly; if Italy fails to assemble a coalition or the one that does emerge opts to ease constraints and deemphasize debt repayment; or if DM economic softening gains momentum, it could lead to tweaks in our tactical weighting.

Investors Hate Information Vacuums – It will be another four- to six- weeks until markets can focus primarily on earnings results, which we suspect will continue their solid uptick. In the meantime, we expect participants will parse economic, political, and Fed Policy headlines in fine detail for hints on the health of the overall economy.

In conclusion

We believe current valuations, which are not excessive, appear to be pricing in the both the positives and negatives, but we also expect ongoing volatility in the markets to continue going forward.

Sources:

1 Standard & Poor’s Dow Jones Indices.
2 The technology industry accepted definition of a unicorn is a privately held startup company valued at over $1 billion.
3 The Financial Times.

Chart A: S&P 500 Index Recent Daily Price History

Source: FactSet
Predicting the Unpredictable (Continued)

Chart B: Missing the Best Days in the Market


<table>
<thead>
<tr>
<th>Year</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>1989</td>
<td>8.12%</td>
</tr>
<tr>
<td>2008</td>
<td>0%</td>
</tr>
<tr>
<td>2011</td>
<td>1%</td>
</tr>
<tr>
<td>2012</td>
<td>2%</td>
</tr>
<tr>
<td>2007</td>
<td>3%</td>
</tr>
<tr>
<td>2010</td>
<td>4%</td>
</tr>
<tr>
<td>2017</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Morningstar Direct, Wells Fargo Investment Institute. 12/31/2017. For illustrative purposes only. Past performance is no guarantee of future results. An index is unmanaged and not available for direct investment.

Chart C: S&P 500 Index – 20 Years of Price Movement (1998 to Current)

Source: FactSet
Client Discovery: Discovering What Risk Means

“We think in generalities, but we live in detail.”
Alfred North Whitehead

For the second month in a row we’ve chosen a quote from a British philosopher. This doesn’t reflect a deep study of the history of British philosophers, but it does appear they had a knack for stating complex things in relatively simple terms. Whitehead founded ‘process philosophy’ meaning he viewed the world as being made up of a series of processes “of which we are integral parts, so that all of our choices and actions have consequences for the world around us.”

As investors, there is a preference and a tendency to want to analyze things as distinct concepts; but in reality, every investment, every asset class, every security must be thought of in the context of its relationship to the rest of the market. While an understanding of the historical behavior of markets is useful, each individual investor lives through their own unique, detailed experience of the markets. In those instances, it’s not the generalities that matter but the details.

Ready, Willing, and Able?

In the September 2017 Abbot Downing Strategy Report, we talked about our detailed, five-step, client discovery process: ask questions, listen, set expectations, execute, and repeat. In this report we will talk about setting expectations around risk and return. Each client defines success differently. So, it is our job to work with our clients to understand what that success looks like. Reaching your financial goals is important, but how you get there can be just as important.

To properly set expectations we need to discover each client’s ability and willingness to take on risk. In some ways ability to take on risk is easier to gauge; most of its determinants are quantitative. Some of the factors that tend to create a higher ability to take on risk are: cash inflows from a high income or operating business, a large portfolio size, or a multi-generational time horizon. Some of the factors that can reduce the ability to take on risk are: sizable future liabilities, high annual withdrawals from the portfolio, or unfavorable tax circumstances.

Willingness to take on risk can be harder to assess, however as the drivers tend to be more qualitative in nature. Each client’s willingness to take on risk is distinct and is often driven by how that client has experienced the markets in the past. In a recent meeting with a new client that had just experienced a $350 million liquidity event, he expressed anxiety that he would now be more stressed by movements in the markets and wanted to invest more conservatively than he had in the past. “Now a 10% correction might cost me $35 million.” While his wealth event made him mathematically much more likely to achieve his financial goals—and those of the next generations—this greater level of wealth didn’t raise his willingness to take risk—it reduced it.

To help focus in on a family’s willingness to take on risk, it is important to understand that family’s background. The data would tell you that building a successful business is very risky. But most of our clients don’t think about these generalities, they’ve lived in the details of having created success. They often see their businesses as the LEAST risky part of their portfolio. Knowing where a family has come from, what risk factors have been present during the creation of the wealth and how they’ve managed those risks can help inform portfolio construction. Our team in the Institute for Family Culture (IFC) help drive this very unique part of our discovery process.

Once we have properly established ability and willingness to take risk, we then work to set expectations. Most often this requires moderating unrealistic expectations. One of our clients recently segregated a $50 million portion of her portfolio. Her goal with these funds is to “double the money in 10 years”. She wants to write a $100 million check to her alma mater. She also expressed that the most she was willing to lose in any given year was 10%. Unfortunately, this required a difficult conversation that these two goals were not compatible. The annualized return required to reach her goal is approximately 7.25%. A portfolio designed to
generate that approximate level of return over the long term most likely would have experienced a draw-down in 2008 greater than 20%. We walk through these types of examples and listen very closely to how clients react, and then determine which of their goals is the true priority. The end result of our discussions was that she was willing to withstand much larger draw-downs because reaching that $100 million milestone was that important to her.

After having these complex discussions around expectations, it is important to formalize them in the client’s Investment Policy Statement (IPS). This establishes the long-term asset allocation designed to match the client’s stated risk and return expectations. The IPS holds everyone accountable to achieving the goals. We have found the IPS to be most useful when an investor has to ‘live in the details’. When rough markets hit—and they always do—the IPS is what helps investors navigate safely and effectively.

**Conclusion**

Client discovery is hard; and it can be very uncomfortable at times, but it is a CRITICAL part of the process and must be ongoing. Client discovery is one of the harder parts of our process to enunciate. It often comes down to our ability to actively listen, which only really comes from experience. The reason it is so difficult is precisely because investing is so complex. Markets are constantly evolving. Whitehead would suggest that the processes are dynamically interacting. Anytime someone suggests they have a simple process for determining a client’s risk and return expectations tread carefully. Take Whitehead’s advice, “Seek simplicity and distrust it.”
Key Market Events

Listed below are key upcoming events and/or accelerating trends we’re watching especially closely, as well as a few comments related to how they may impact short-term markets.

The Return of Volatility

Global equities remain volatile, as the February bottom on the S&P 500 was tested on April 2, and has since rebounded slightly. Perhaps too early to decipher, but recent market action appears to be a sign that investors are beginning to focus less on issues that produced anxiety during the first quarter (trade conflict with China, fears of excessive regulation within the internet and social media sector, geopolitics) and are turning toward positive news stemming from Q1 earnings that significantly exceeded expectations—and stronger forward estimates, versus potential headwinds of rising interest rates and an uptick in inflation due to a tight labor market.

Inflation, deficits, regulation, fiscal spending, and tariffs could all add to market volatility at least through the mid-term elections in November and likely beyond. Economic data must be thoroughly monitored for signs of overheating and the potential for bottlenecks.

Global Trade

While negotiations will likely win out over all-out trade war, the risks of a damaging trade conflict between the U.S. and the rest of the world have risen. President Trump is unlikely to back down from his stance on intellectual property abuses, while China has targeted counter-tariff efforts on the U.S. farm belt and floated the idea of selling their Treasury holdings and weakening the Yuan as further retaliatory measures. Trump left the G7 meeting early to head to North Korea. That’s an important mission as well, but the timing was not lost on the remaining G6 members that have vowed to hold together on trade.

This all comes in advance of the mid-term elections. If markets weaken considerably on trade concerns, you can be sure Democrats are going to be ready to highlight.

Global trade negotiations have evolved into a political chess match that is highly unpredictable and we feel they thus carry a greater than average risk of “surprising” investors and markets.
Domestic Geopolitical Concerns

The new U.S. tax bill and reduced regulatory constraints appear to be having a salutary effect on corporate psyches. From our perspective, spending and hiring plans are firm and corporate optimism is running high. So high in fact, that some bottlenecks appear to be emerging in selected industries. We still believe that on balance, we can expect potentially more economic stimulus and equity-market support than forecasted even a few months ago.

With permanently lower corporate tax rates, immediate write off of capital expenditures for the next five years, and a host of devilish details, the law in full bloom is liable to yield a number of modifications in business behavior, many with a growth bias.

We feel that investor consternation is rising over the potentially inflationary/growth aspects of the law: Can we get enough growth without overheating an already arguably fully employed populace?

In our opinion, partisan battles over the budget, immigration, an infrastructure plan, and trade will dominate headlines in coming months making heightened volatility a likelihood—even as the economy continues to perform solidly amidst the noise.
Central Bank Meetings – The Fed and The ECB

As expected, the U.S. Federal Reserve increased the range on the federal funds rate by 25 basis points to 1.75% to 2.00% at the June meeting, after holding rates steady at the May meeting.

A key question remaining in our mind: Will they move preemptively to tame inflation, or let it run on a bit? U.S. headline and core inflation, as well as employment cost indices, will be under extra scrutiny in months ahead. Expectations for rate increases as indicated by futures markets suggest one, possibly two, additional hikes in 2018. QE tapering will also be a focus, as the Fed reduces the bond purchasing program initiated in the wake of the financial crisis and the U.S. Treasury increases its issuance of T-bills, notes, and bonds to pay for an expanding deficit, investors will be watching closely to see if yields are forced upward given the extra supply.

Employment cost index releases should continue to spawn market volatility; the latest monthly unemployment report reached the lowest level since year 2000. This is likely to be a much-watched statistic for the remainder of the year along with its inferred implication for Fed monetary policy decision.

The European Central Bank (ECB) is expected to phase out QE (currently running at 30 billion euro a month) by the end of this year and start raising interest rates around the second quarter of next year. However, Mario Draghi’s cautious rhetoric, calling for “prudence, patience, and persistence” in reducing stimulus further, suggests the ECB could still delay a decision to phase out its QE program.

We feel that markets will continue to micro-analyze early commentary from Chairman Powell as well as any and all speeches individual governors give in the next few months for hints related to pacing and number of increases in 2018. Progress and commentary around the pace of balance sheet unwind will also bear watching for its impact on market levels of liquidity and pricing.

Markets will also continue to scrutinize ECB President Mario Draghi’s comments; the ECB has risen, slightly, its 2018 GDP forecast for the euro area to 2.4%.
Commodity Prices

Based on historical data, commodities are knee-deep in a bear super cycle (a cycle that lasts 15- to 20-years where price moves typically occur in the first five years) that commenced in 2011 with, we suspect, the bulk of the damage having already occurred. Six years into the cycle, individual commodities in aggregate are likely to be range bound—providing potential opportunities for investors. For example, according to the Wells Fargo Investment Institute, oil is expected to trade in a range of $50 to $65 over the next two years. This is also consistent with recent fluctuations in WTI oil due to record U.S. production combined with output constraints from OPEC.

Commodities price volatility, especially to the upside, could further stoke investor nerves regarding inflationary pressures.

Progress on President Trump’s Economic Initiatives

In addition to the recently passed tax initiatives, market expectations are also high for further progress on rolling back regulations and possibly an infrastructure plan. President Trump’s political problems associated with potential interference in the U.S. elections and legal issues with his former associates threaten to undermine the aforementioned initiatives deemed to be pro-growth by the markets.

From our perspective, the details will prove important to watch as even recent presidential orders contain sweepingly different outcomes for different segments of the economy (witness environmental, energy, and military initiatives).

Techlash

In view of high profile hacks/data misuse announcements by companies from Facebook to Under Armour, to Aptiva and Experian, Congressional scrutiny of the technology sector is likely to increase.

The European Union is far ahead of the U.S. on this front and has already lodged fines on affected companies from Facebook to Apple.

U.S. Economic Data Heading into 2018

The U.S. economy expanded 2.3% in 2017, followed by another 2.3% annualized gain in Q1 this year. We believe the latest data inputs support continued growth through 2018: leading economic indicators (LEI), quality corporate bond spreads, and manufacturing surveys are all forecasting solid expansion (Sources: Bloomberg, FactSet).

Although output has clearly accelerated throughout 2017, we believe monitoring incoming data late in a business cycle for signs of acceleration and deceleration is prudent.
Notable Observations

“We are closely monitoring both key cost input bottlenecks and business confidence for their potential influence on business behavior. Decisions regarding CapEx, hiring, new initiatives, etc, are all rooted in how confident business leaders are about the next few years. As such, the steep increases in quarter over quarter and year-over-year shipping rates (as highlighted in the table below) and the pressure on Global business sentiment are worth watching. Further, the percentage of countries with expansionary manufacturing sentiment readings has dipped. Oil, transport and labor costs vary by industry, with logistics-type companies among the hardest hit.”

### Global Economic Health Scorecard

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Current Value</th>
<th>Quarter-Over-Quarter Change</th>
<th>Year-Over-Year Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Real GDP*</td>
<td>3.7%</td>
<td>0.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Global Unemployment Rate*</td>
<td>5.1%</td>
<td>-0.2</td>
<td>-0.7</td>
</tr>
<tr>
<td>Global Composite Leading Indicator*</td>
<td>100.0</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Industrial Production</td>
<td>124.3</td>
<td>0.6</td>
<td>3.7</td>
</tr>
<tr>
<td>World Trade Volume</td>
<td>123.0</td>
<td>-0.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Container Shipping Rates</td>
<td>532.0</td>
<td>19.8</td>
<td>32.7</td>
</tr>
<tr>
<td>Raw Material Shipping Rates</td>
<td>1395.0</td>
<td>17.1</td>
<td>69.3</td>
</tr>
<tr>
<td>Global House Price Composite</td>
<td>121.3</td>
<td>1.7</td>
<td>5.0</td>
</tr>
<tr>
<td>Global Business Sentiment*</td>
<td>54.0</td>
<td>-0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Global Manufacturing Sentiment*</td>
<td>53.1</td>
<td>-1.0</td>
<td>0.5</td>
</tr>
<tr>
<td>Global Services Sentiment*</td>
<td>54.3</td>
<td>-0.5</td>
<td>0.4</td>
</tr>
<tr>
<td>Percent of Countries with Expansionary</td>
<td>82.9%</td>
<td>-14.4</td>
<td>-3.6</td>
</tr>
<tr>
<td>Manufacturing Sentiment Readings*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IFO World Economic Climate Index*</td>
<td>16.5</td>
<td>-9.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Citi Global Economic Surprise Index*</td>
<td>-28.6</td>
<td>-46.3</td>
<td>-31.9</td>
</tr>
</tbody>
</table>

### Business Sentiment by Region

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Current Value</th>
<th>Quarter-Over-Quarter Change</th>
<th>Year-Over-Year Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Business Sentiment*</td>
<td>56.6</td>
<td>0.8</td>
<td>3.0</td>
</tr>
<tr>
<td>U.S. Manufacturing Sentiment*</td>
<td>56.4</td>
<td>1.1</td>
<td>3.7</td>
</tr>
<tr>
<td>U.S. Services Sentiment*</td>
<td>56.8</td>
<td>0.9</td>
<td>3.2</td>
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<tr>
<td>Developed Markets Business Sentiment*</td>
<td>54.8</td>
<td>-0.6</td>
<td>0.5</td>
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<tr>
<td>Developed Markets Manufacturing Sentiment*</td>
<td>54.7</td>
<td>-1.0</td>
<td>0.6</td>
</tr>
<tr>
<td>Developed Markets Services Sentiment*</td>
<td>54.8</td>
<td>-0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>Emerging Markets Business Sentiment*</td>
<td>52.2</td>
<td>-1.1</td>
<td>0.0</td>
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<tr>
<td>Emerging Markets Manufacturing Sentiment*</td>
<td>51.1</td>
<td>-0.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Emerging Markets Services Sentiment*</td>
<td>52.5</td>
<td>-1.0</td>
<td>-0.3</td>
</tr>
</tbody>
</table>


*Designates changes measured as point change rather than percentage change.

Global unemployment rate is measured by the OECD area unemployment rate. Global composite leading indicator measured by the OECD plus six nonmember leading indicator. Global business, manufacturing and services sentiment are the Markit Global Composite, Global Manufacturing and Global Services PMI indices respectively. Container shipping rates represented by the Contex Index. Raw material shipping rates represented by the Baltic Dry Index.
Notable Observations (Continued)

Input Costs by Industry

Percent of Total Costs, At Purchaser’s Prices


PCE Deflator

Year-Over-Year Percent Change

Dynamic Allocation Summary

Global Outlook Overview

U.S. Large Cap Equities

**Outlook:** Mixed Positive

We have become more constructive on U.S. large cap equities, as the new tax bill shows potentially more economic stimulus and equity-market support than forecasted a month ago. We are also aware of elevated valuations, and in instances where clients are in need of capital we would consider taking profits in this asset class, if the client is above target weights. At the same time, if U.S. large-cap stocks were to experience additional volatility, we would consider this a potential opportunity to invest at more attractive prices.

U.S. Small Cap Equities

**Outlook:** Mixed Positive

We have a mixed positive weighting on domestic small cap equities. Valuations are deemed expensive relative to larger companies, but the new tax plan should benefit small-cap stocks by comparatively more than the large-cap indices; smaller domestic companies tend to pay higher tax rates than large, multinational companies, and generally have lower profit margins. Active management is favored to generate alpha in this space.

Developed Market Equities

**Outlook:** Positive

Stronger economic data from developed countries outside the U.S., accelerating profits, and reasonable valuations favor developed market equities in our opinion. In cases where clients have immediate funds to invest, developed equities would be one of our top considerations.

Emerging Market Equities

**Outlook:** Neutral

We have become more optimistic on emerging market equities due to strengthening currencies and stabilizing commodity prices, along with attractive valuations. Escalating trade tensions with China and future stability of the Yuan are potential risks.

Outlook Ratings

The color-coded rating system applies to specific inputs only (Macro, Fundamental, Valuation, and Market Environment) and represents the current and shorter-term (three to six months) outlook for the specific inputs based on qualitative data and recommendations from Abbot Downing Asset Allocation Committee. It is intended to provide guidance to the Abbot Downing Portfolio Construction Team. The content does not represent a buy, hold, or sell recommendation for specific asset classes.
**Dynamic Allocation Summary (Continued)**

**U.S. Investment Grade Fixed Income**

**Outlook:** Neutral

We feel that yields of investment-grade bonds (treasuries, municipals, and corporates) have moved into fair value range, and are supported by expectations that the Fed will continue to raise rates at a gradual pace; markets currently appear to anticipate one to two additional hikes in 2018.

**Non-Investment Grade Fixed Income**

**Outlook:** Neutral

We remain constructive on preferred stock securities based on healthy yield premiums versus investment-grade bonds. We feel that valuations have become expensive in the high-yield asset class.

**International Fixed Income**

**Outlook:** Negative

We believe near zero yields on many developed country sovereign debt issues warrant caution for this sector. Emerging market bond spreads are now slightly below their long-term historical averages.

**Real Estate Investment Trusts (REITs)**

**Outlook:** Positive

We remain positive on REITs. REIT fundamentals appear to be getting stronger and exhibit attractive valuations. REITs currently sell at a 7.0% discount to underlying real estate holdings.

**Master Limited Partnerships (MLPs)**

**Outlook:** Mixed Positive

Although MLPs have come under pressure recently as investors appear to adjust to lower distribution growth rates and tax-loss selling, we believe the outlook for MLPs from a fundamental perspective is improving. Current MLP yields of near 9% are also attractive on both an absolute and relative basis. Finally, active management is favored in this space due to the recent Federal Energy Regulatory Commission (FREC) ruling and risk of C-corp conversion.
Disclosures

Risk Considerations

Past performance does not indicate future results. The value or income associated with a security or an investment may fluctuate. There is always the potential for loss as well as gain. Investments discussed in this report may be unsuitable for some investors depending on their specific investment objectives and financial position.

Equity securities are subject to market risk which means their value may fluctuate in response to general economic and market conditions and the perception of individual issuers. Investments in equity securities are generally more volatile than other types of securities.

There is no guarantee that dividend-paying stocks will return more than the overall stock market. Dividends are not guaranteed and are subject to change or elimination. There are no guarantees that growth or value stocks will increase in value or that their intrinsic values will eventually be recognized by the overall market. The return and principal value of stocks fluctuate with changes in market conditions. The growth and value type of investing tends to shift in and out of favor.

Asset allocation and diversification do not assure or guarantee better performance and cannot eliminate the risk of investment losses. Your individual allocation may be different than the strategic long-term allocation above due to your unique individual circumstances but is targeted to be in the allocation ranges detailed. The asset allocation reflected above may fluctuate based on asset values, portfolio decisions, and account needs.

Investing in commodities is not suitable for all investors. Exposure to the commodities markets may subject an investment to greater share price volatility than an investment in traditional equity or debt securities. Investments in commodities may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity. Products that invest in commodities may employ more complex strategies which may expose investors to additional risks.

Convertible securities are subject to the same interest rate, price and credit risks as regular debt securities. Prices tend to be inversely affected by changes in interest rates. In addition, a convertible security is also subject to the risks associated with common stocks. The return and principal value of stocks fluctuate with changes in market conditions.

Alternative investments, such as hedge funds, carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Alternative investments are subject to fewer regulatory requirements than mutual funds and other registered investment company products and thus may offer investors fewer legal protections than they would have with more traditional investments. Additionally, there may be no secondary market for alternative investment interests and transferability may be limited or even prohibited. Other risks may apply as well, depending on the specific investment product. Please carefully review the prospectus, private placement memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as risks and other factors you should consider before investing.

Investments in fixed-income securities are subject to interest rate and credit risks. Bond prices fluctuate inversely to changes in interest rates. Therefore, a general rise in interest rates can result in the decline in the bond’s price. Credit risk is the risk that an issuer will default on payments of interest and principal. High yield fixed income securities are considered speculative, involve greater risk of default, and tend to be more volatile than investment grade fixed income securities. Municipal bonds offer interest payments exempt from federal taxes, and potentially state and local income taxes. They are subject to credit risk and potentially the Alternative Minimum Tax (AMT). Quality varies widely depending on the specific issuer. All fixed income investments may be worth less than their original cost upon redemption or maturity.

Mortgage-related and asset-backed securities are subject to prepayment risks. Changes in prepayments may significantly affect yield, average life and expected maturity.

Currency hedging is a technique used to seek to reduce the risk arising from the change in price of one currency against another. The use of hedging to manage currency exchange rate movements may not be successful and could produce disproportionate gains or losses in a portfolio and may increase volatility and costs.

Investing in foreign securities presents certain risks that may not be present in domestic securities. For example, investments in foreign, emerging and frontier markets present special risks, including currency fluctuation, the potential for diplomatic and potential instability, regulatory and liquidity risks, foreign taxation and differences in auditing and other financial standards.
Disclosures (Continued)

Master Limited Partnerships (MLPs) involves certain risks which differ from an investment in the securities of a corporation. MLPs may be sensitive to price changes in oil, natural gas, etc., regulatory risk, and rising interest rates. A change in the current tax law regarding MLPs could result in the MLP being treated as a corporation for federal income tax purposes which would reduce the amount of cash flows distributed by the MLP. Other risks include the volatility associated with the use of leverage; volatility of the commodities markets; market risks; supply and demand; natural and man-made catastrophes; competition; liquidity; market price discount from Net Asset Value and other material risks.

There are special risks associated with investing in preferred securities. Preferred securities are subject to interest rate and credit risks and are generally subordinated to bonds or other debt instruments in an issuer’s capital structure, subjecting them to a greater risk of non-payment than more senior securities. In addition, the issue may be callable which may negatively impact the return of the security. Preferred dividends are not guaranteed and are subject to deferral or elimination.

Private debt has speculative characteristics that include potential default, limited liquidity and the infrequent availability of independent credit ratings for private companies.

There are risks associated with investments in private companies. Such companies are not subject to SEC reporting requirements and are not required to maintain effective internal controls over financial reporting. These companies may have limited financial resources; shorter operating histories; more asset concentration risk; narrower product lines and smaller market shares that larger companies. In addition, securities issued by private companies are typically illiquid and there may be no readily available trading market for such securities.

Investing in real estate involves special risks, including the possible illiquidity of the underlying property, credit risk, interest rate fluctuations and the impact of varied economic conditions.

The prices of small and mid cap company stocks are generally more volatile than large cap company stocks. They often involve higher risks because smaller companies may lack the management expertise, financial resources, product diversification and competitive strengths to endure adverse economic conditions.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Treasury Inflation-Protected Securities (TIPS) are subject to interest rate risk, especially when real interest rates rise. This may cause the underlying value of the bond to fluctuate more than other fixed income securities. TIPS have special tax consequences, generating phantom income on the “inflation compensation” component of the principal. A holder of TIPS may be required to report this income annually although no income related to “inflation compensation” is received until maturity.

There is no assurance that any of the target prices or other forward-looking statements mentioned will be attained.

Index and Other Definitions

An index is unmanaged and not available for direct investment

Inflation is the change in the Consumer Price Index (CPI). The CPI measures the price of a fixed basket of goods and services purchased by an average consumer.

Core inflation is the change in the core Consumer Price Index (CPI). The core CPI measures the price of a fixed basket of goods and services—excluding the volatile food and energy components—purchased by an average consumer.

Alpha is a coefficient measuring the risk-adjusted performance, considering the risk due to the specific security, rather than the overall market. A large alpha indicates that the stock or mutual fund has performed better than would be predicted given its beta (volatility).

Beta measures a security’s or group of securities’ (portfolio’s) volatility relative to a benchmark. A result greater than 1.0 implies that the security or portfolio is more volatile than the benchmark; a result less than 1.0 suggests that the security or portfolio is less volatile than the benchmark. Betas may change over time.

Conference Board’s Leading Economic Index (LEI) is a composite economic index designed to signal peaks and troughs in the business cycle. The leading economic index is essentially a composite average of several individual leading indicators. They are constructed to summarize and reveal common turning point patterns in economic data in a clearer and more convincing manner than any individual component—primarily because they smooth out some of the volatility of individual components.

Consumer Confidence Index® (CCI) is a barometer of the health of the U.S. economy from the perspective of the consumer. The index is based on consumers’ perceptions of current business and employment conditions, as well as their expectations for six months hence regarding business conditions, employment, and income.

Markit Manufacturing Purchasing Managers Index (PMI) tracks manufacturing and service sector activity in the Eurozone. An index value over 50 indicates expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

PMI Surveys, such as the Eurozone Manufacturing PMI, track sentiment among purchasing managers at manufacturing, construction and/or services firms. An overall sentiment index is generally calculated from the results of queries on production, orders, inventories, employment, prices, etc.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output.

The Market Volatility Index (VIX) is an index designed to track market volatility as an independent entity. The index is calculated based on option activity and is used as an indicator of investor sentiment, with high values implying pessimism and low values implying optimism.
Disclosures (Continued)

The Institute of Supply Management (ISM) Manufacturing Index® is a composite index based on the diffusion indexes of five of the indexes with equal weights: New Orders (seasonally adjusted), Production (seasonally adjusted), Employment (seasonally adjusted), Supplier Deliveries (seasonally adjusted), and Inventories. An Index values over 50 indicate expansion; below 50 indicates contraction. The values for the index can be between 0 and 100.

The U.S. Dollar Index (USDX, DXY) is an index (or measure) of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners’ currencies.

Real economic growth is the change in the gross domestic product (GDP) adjusted for inflation—that is, the volume of services and goods produced in the United States.

West Texas Intermediate Crude Oil is a light, sweet (i.e., low sulfur) crude oil which is the main type of U.S. crude oil traded in U.S. futures markets.

Brent Crude Oil is a light, sweet crude oil extracted from the North Sea. It serves as a major benchmark price for purchases of oil worldwide.

Bond credit rating. A grade given to bonds that indicates their credit quality. Private independent rating services such as Standard & Poor’s, Moody’s and Fitch provide these evaluations of a bond issuer’s financial strength, or its the ability to pay a bond’s principal and interest in a timely fashion. The general meaning of these credit rating opinions are as follows:

AAA—Extremely strong capacity to meet financial commitments. Highest Rating.
AA—Very strong capacity to meet financial commitments.
A—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.
BBB—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions

Global Fixed Income Representative Indices

Global Multiverse Fixed Income: Bloomberg Barclays Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies. Standalone indices such as the Euro Floating-Rate ABS Index and the Chinese Aggregate Index are excluded. The Multiverse Index family includes a wide range of standard and customized sub-indices by sector, quality, maturity, and country. JP Morgan Global Ex United States Bond Index is a total return, market capitalization weighted index, rebalanced monthly consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.


U.S. Treasury Bills Fixed Income: Bloomberg Barclays U.S. Treasury Bills includes all publicly issued zero-coupon U.S. Treasury Bills that have a remaining maturity of less than three months and more than one month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and non-convertible.

Short, Intermediate and Long Term Fixed Income: Bloomberg Barclays U.S. Aggregate Bond Index is made up of the Bloomberg Barclays U.S. Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

U.S. Treasury Fixed Income: Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury with a remaining maturity of one year or more.

U.S. Corporate Fixed Income: Bloomberg Barclays U.S. Corporate Bond Index includes publicly issued U.S. corporate and Yankee debentures and secured notes that meet specified maturity, liquidity, and quality requirements.

U.S. Municipal Fixed Income: Bloomberg Barclays U.S. Municipal Bond Index represents municipal bonds with a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, and a remaining maturity of at least one year. The Index excludes taxable municipal bonds, bonds with floating rates, derivatives, and certificates of participation.

U.S. TIPS Fixed Income: Bloomberg Barclays Treasury Inflation Protected Securities (TIPS) Index includes all publicly issued, investment-grade U.S. TIPS with an outstanding face value of more than $250 million and that have at least one year to maturity.

U.S. High Yield Fixed Income: Bloomberg Barclays U.S. High Yield Bond Index is an unmanaged index that tracks the performance of below investment grade U.S.-dollar-denominated corporate bonds publicly issued in the U.S. domestic market.

Developed ex. U.S. Fixed Income: JPMorgan GBI Global ex-U.S. (Unhedged) in USD is an unmanaged index market representative of the total return performance in U.S. dollars on an unhedged basis of major non-U.S. bond markets.
Emerging Market Spread: Bloomberg Barclays EM USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD denominated debt from sovereign, quasi-sovereign, and corporate EM issuers. The index is broad-based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to Aggregate-style benchmarks that are more representative of the EM investment choice set. Country eligibility and classification as an Emerging Market is rules-based and reviewed on an annual basis using World Bank income group and International Monetary Fund (IMF) country classifications. This index was previously called the Bloomberg Barclays U.S. EM Index and history is available back to 1993.

Emerging Market Bond (U.S. Dollar): JP Morgan Emerging Markets Bond Index (EMBI Global) currently covers 27 emerging market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local market debt instruments issued by sovereign and quasi-sovereign entities.

Preferred Stock: S&P Preferred Stock is an unmanaged index consisting of U.S.-listed preferred stocks.

U.S. Dollar Index (USDX) measures the value of the U.S. dollar relative to majority of its most significant trading partners. This index is similar to other trade-weighted indexes, which also use the exchange rates from the same major currencies.

Global Equity Representative Indices

Global Market Equity: MSCI AC World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The Index consists of 46 country indices comprising 23 developed and 23 emerging market country indices. The developed market country indices included are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom, and the United States. The emerging market country indices included are: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

Dow Jones Industrial Average is a price-weighted index of 30 “blue-chip” industrial U.S. stocks.

NASDAQ Composite Index measures the market value of all domestic and foreign common stocks, representing a wide array of more than 5,000 companies, listed on the NASDAQ Stock Market.

Large Cap Equity: S&P 500 Index is a capitalization-weighted index calculated on a total return basis with dividends reinvested. The index includes 500 widely held U.S. market industrial, utility, transportation, and financial companies.

Large Cap Equity (Growth): Russell 1000® Growth Index measures the performance of those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values.

Large Cap Equity (Value): Russell 1000® Value Index measures the performance of those Russell 1000® companies with lower price-to-book ratios and lower forecasted growth values.

Mid Cap Equity: Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000® Index, which represent approximately 25% of the total market capitalization of the Russell 1000® Index.

Small Cap Equity: Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000® Index.

Developed Market ex. U.S. Equity: MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The Index consists of the following 21 developed market country indexes: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

Emerging Markets: MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

Frontier Market Equity: MSCI Frontier Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of frontier markets. The MSCI Frontier Markets Index consists of the following 24 frontier market country indexes: Argentina, Bahrain, Bangladesh, Bulgaria, Croatia, Estonia, Jordan, Kenya, Kuwait, Lebanon, Lithuania, Morocco, Kazakhstan, Mauritius, Nigeria, Oman, Pakistan, Romania, Serbia, Slovenia, Sri Lanka, Tunisia, Ukraine, and Vietnam. The MSCI Saudi Arabia Index is currently not included in the MSCI Frontier Markets Index but is part of the MSCI Gulf Cooperation Council (GCC) Countries Index. The MSCI Bosnia Herzegovina Index, the MSCI Botswana Index, the MSCI Ghana Index, the MSCI Jamaica Index, the MSCI Palestine IMI, the MSCI Trinidad & Tobago Index, and the MSCI Zimbabwe Index are currently stand-alone country indexes and are not included in the MSCI Frontier Markets Index. The addition of these country indexes to the MSCI Frontier Markets Index is under consideration.
Global Real Assets Representative Indices

Global REITs: FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real-estate companies and REITs in developed countries worldwide.

Domestic REITs: FTSE NAREIT U.S. All Equity REITs Index is designed to track the performance of REITs representing equity interests in (as opposed to mortgages on) properties. It represents all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets, other than mortgages secured by real property that also meet minimum size and liquidity criteria.

International REITs: FTSE EPRA/NAREIT Developed ex-U.S. Index is designed to track the performance of listed real estate companies in developed countries worldwide other than the United States.

MLPs: Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships (MLPs) that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated real-time on a price-return basis and on a total-return basis.

Commodities (S&P GSCI): S&P Goldman Sachs Commodity Index is a trade-weighted index of commodity sector returns representing unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities. The index includes futures contracts on 24 physical commodities, of which Energy represents nearly 70%.

Commodities (BCOM): Bloomberg Commodity Index represents futures contracts on 19 physical commodities. No related group of commodities (e.g., energy, precious metals, livestock and grains) may constitute more than 33% of the index as of the annual reweighing of the components. No single commodity may constitute less than 2% of the index.

Commodities (RICI): The Rogers International Commodity Index is a U.S. dollar based index representing the value of a basket of commodities consumed in the global economy. Representing futures contracts on 37 physical commodities, it is designed to track prices of raw materials not just in the U.S. but around the world.

Global Alternative Investments Representative Indices

Global Hedge Funds: HFRI Fund Weighted Composite Index. A global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net-of-all-fees performance in U.S. Dollars and have a minimum of $50 million under management or a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.

Relative Value Arbitrage: HFRI Relative Value (Total) Index. Strategy is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative, or other security types. Relative Value Arbitrage sub-strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk adjusted spread between these instruments represents an attractive opportunity for the investment manager. RV position may be involved in corporate transactions also, but as opposed to ED exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Arbitrage: HFRI RV: Fixed Income Sovereign Index. Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a sovereign fixed income instrument. Strategies employ an investment process designed to isolate attractive opportunities between a variety of fixed income instruments, typically realizing an attractive spread between multiple sovereign bonds or between a corporate and risk-free government bond. Fixed Income Sovereign typically employ multiple investment processes including both quantitative and fundamental discretionary approaches and relative to other Relative Value Arbitrage sub-strategies, these have the most significant top-down macro influences, relative to the more idiosyncratic fundamental approaches employed.

Long/Short Credit: HFRI RV: Fixed Income—Corporate Index. Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a corporate fixed-income instrument. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments, typically realizing an attractive spread between multiple corporate bonds or between a corporate and risk-free government bond. They typically involve arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated idiosyncratic developments.
Structured Credit/Asset Backed: HFRI RV: Fixed Income—Asset Backed Index. Includes strategies predicated on realization of a spread between related instruments in which one or multiple components of the spread is a fixed-income instrument backed by physical collateral or other financial obligations (loans, credit cards) other than those of a specific corporation. Strategies are designed to isolate attractive opportunities between a variety of fixed income instruments specifically securitized by collateral commitments, which frequently include loans, pools and portfolios of loans, receivables, real estate, machinery, or other tangible financial commitments. Investment thesis may be predicated on an attractive spread given the nature and quality of the collateral, the liquidity characteristics of the underlying instruments and on issuance and trends in collateralized fixed-income instruments, broadly speaking. In many cases, investment managers hedge, limit, or offset interest-rate exposure in the interest of isolating the risk of the position to strictly the disparity between the yield of the instrument and that of the lower-risk instruments.

Macro: HFRI Macro (Total) Index. Encompass a broad range of strategies predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard-currency, and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches and long- and short-term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments rather than on realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to EH, in which the fundamental characteristics on the company are the most significant are integral to investment thesis.

Systematic Macro: HFRI Macro: Systematic Diversified Index. Diversified strategies employing mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies are designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative processes which focus on statistically robust or technical patterns in the return series of the asset, and they typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean-reverting strategies. Although some strategies seek to employ counter-trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Typically have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

Discretionary Macro: HFRI Macro: Discretionary Thematic Index. Strategies primarily rely on the evaluation of market data, relationships and influences, as interpreted by individuals who make decisions on portfolio positions; strategies employ an investment process most heavily influenced by top-down analysis of macroeconomic variables. Investment Managers may trade actively in developed and emerging markets, focusing on both absolute and relative levels on equity markets, interest rates/fixed income markets, currency and commodity markets; they frequently employ spread trades to isolate a differential between instrument identified by the Investment Manager as being inconsistent with expected value. Portfolio positions typically are predicated on the evolution of investment themes the Manager expects to develop over a relevant time frame, which in many cases contain contrarian or volatility-focused components.

Event Driven: HFRI Event Driven (Total) Index. Maintains positions in companies currently or prospectively involved in corporate transactions of a wide variety including mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental (as opposed to quantitative) characteristics, with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

Activist: HFRI ED: Activist Index. Strategies may obtain or attempt to obtain representation on the company’s board of directors in an effort to impact the firm’s policies or strategic direction and in some cases, may advocate activities such as division or asset sales, partial or complete corporate divestiture, dividends or share buybacks, and changes in management. Strategies employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies that are currently or prospectively engaged in a corporate transaction, security issuance/repurchase, asset sales, division spin-off, or another catalyst-oriented situation. These involve both announced transactions and situations in which no formal announcement is expected to occur. Activist strategies would expect to have greater than 50% of the portfolio in activist positions, as described.
Managers typically do not maintain more than 50% exposure to capitalizations, and valuation ranges of typical portfolios. Exposure, leverage, holding period, concentrations of market strategies can be broadly diversified or narrowly focused on including both quantitative and fundamental techniques; processes can be employed to arrive at an investment decision, and equity-derivative securities. A wide variety of investment processes can be employed to maintain positions both long and short in primarily equity. Directional Equity:

Merger Arbitrage: HFRI ED: Merger Arbitrage Index. Strategies primarily focus on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross-border, collared, and international transactions that incorporate multiple geographic regulatory institutions, typically with minimal exposure to corporate credits. Strategies typically have over 75% of positions in announced transactions over a given market cycle.

Equity Hedge: HFRI Equity Hedge (Total) Index. Equity Hedge Investment Managers who maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. EH managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short.

Directional Equity: HFRX EH: Multi-Strategy Index. Managers maintain positions both long and short in primarily equity and equity-derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage, holding period, concentrations of market capitalizations, and valuation ranges of typical portfolios. Managers typically do not maintain more than 50% exposure to any one Equity Hedge sub-strategy.

Distressed Credit: HFRI ED: Distressed/Restructuring Index. Strategies focus on corporate fixed-income instruments, primarily corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceedings or financial-market perception of near-term proceedings. Managers are typically actively involved with the management of these companies; they are frequently involved on creditors’ committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments that are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

Merger Arbitrage: HFRI ED: Merger Arbitrage Index. Strategies primarily focus on opportunities in equity and equity-related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross-border, collared, and international transactions that incorporate multiple geographic regulatory institutions, typically with minimal exposure to corporate credits. Strategies typically have over 75% of positions in announced transactions over a given market cycle.

Equity Market Neutral: HFRI EH: Equity Market Neutral Index. Strategies employ sophisticated quantitative techniques to analyze price data to ascertain information about future price movement and relationships between securities. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies predicated on the systematic analysis of common relationships between securities. In many cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high-frequency techniques may be employed; trading strategies may also be based on technical analysis or designed opportunistically to exploit new information that the investment manager believes has not been fully, completely, or accurately discounted into current security prices. Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short.

Cambridge Associates LLC U.S. Private Equity Index® is an end-to-end calculation based on data compiled from 1,152 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2014. Pooled end-to-end return, net of fees, expenses, and carried interest. The latest published returns data are as of September 30, 2014.

Note: While the HFRI Indices are frequently used, they have limitations (some of which are typical of other widely used indices). These limitations include survivorship bias (the returns of the indices may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to indices, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indices are based on information hedge fund managers decide on their own, at any time, whether or not they want to provide, or continue to provide, information to HFRA Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.
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