ABBOT DOWNING

ABBOT DOWNING STRATEGY REPORT

What Could Go Right?

JANUARY 2019

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What Could Go Right?

> *"Do not anticipate trouble or worry about what may never happen. Keep in the sunlight."*
>
> Benjamin Franklin

Twenty-eighteen ended on a far different note than it started, with the economy stronger and markets weaker than most had projected at the outset. Contrary to much of the popular press, we hesitate to ascribe too much fundamental forethought to the trading activity during the final weeks and suspect a number of nonfundamental factors such as algorithmic trading; year-end tax loss harvesting, and dearth of traditional liquidity sources contributed to the whipsaw action. [1, 2]

As we outlined in December's Strategy Report (In Search of Clarity), none of the issues credited with causing the new found volatility in 2018's final weeks—China growth, tariff wars, Brexit, a normalizing Fed, tight labor markets, geopolitical concerns, political intransigence—were new. More perplexingly, underlying economic fundamentals, particularly for those on Main Street, remain quite strong with declining gas prices and interest rates, steady jobs and wage growth, and the best holiday selling season in nearly a decade—making the focus on the "glass half empty" story line a bit frustrating.

Toward that end, we thought it would be more interesting to accumulate a list of what could go *right* in 2019 rather than rehashing again what is most worrisome (though we do touch on many of those in the section on Key Market Events, starting on page 11). Investing for the long term is all about maintaining perspective and focusing on aspects that are in one's sphere of influence. Factors such as being attentive to taxes and turnover; insuring adequate cash flow and liquidity to meet near- and intermediate-term obligations; providing for thoughtful diversification across and within asset classes; and leaning into the opportunities presented by volatility to rebalance regularly. A firm grasp of one's long term goals is a much better driver of portfolio decisions than reactive actions prompted by near-term frenzied headlines. Remember: the press' business model is not predicated on making any of us feel comfortable about our positioning; comfort doesn't attract eyeballs, "scoops" do. So in the hopes of keeping the focus much more "in the sunlight" as founding father Benjamin Franklin admonished long ago, here's our list of things that could positively influence psyches, if not markets in 2019:

1. Market Valuations are Lower – both because of the pullback in share prices and the natural rolling ahead to looking at earnings relative to 2019 and 2020 estimates. Global stocks in particular have been hit much harder, even though growth in many other spots (particularly EM nations[3]) is projected to be higher than the U.S. We expect U.S. growth should settle into a more sustainable pace relative to last year's tax-fueled headiness which put pressure on companies given the low unemployment and supply chain issues (e.g. logistics and transportation costs). A lower rate of growth that is more sustainable over longer time horizons is a good thing, not something to be feared.

2. Dividends are Higher – (and not just because stock prices are down!). Thanks in large part to the 2017 Tax Cut Act, dividend growth across S&P 500 companies averaged 9.84% last year—the fastest growth in several years.[4] It bears repeating both that companies do not tend to issue increases that they will have to rescind in future years, and that those dividends pay out at the same rate per share—no matter what happens to the underlying stock price. A reliable income stream amidst market volatility makes that variability a bit more bearable.

3. Main Street is Optimistic – as was evident over the recent holiday selling season, which showed the best sales results in nearly a decade.[5] Employment remains strong with more folks entering the labor force as illustrated by the latest jobs report which outline 99 consecutive months of job growth and the biggest full year increase in wages in a decade.[6] Employment mobility remains high too. Consumer balance sheets are in better shape as illustrated by the Federal Reserve data shown in the charts below. Further, we suspect many consumers will be pleasantly surprised come tax day as the full impacts of 2017's tax cuts become evident.

4. Energy Prices Are Down – easing one component of potential margin pressure on high energy use companies like haulers, distributors, manufacturers, etc. Further, lower prices at the pump act like another tax cut for consumers, putting more discretionary funds in pockets.

5. The Deals Market Could be Heating Up – After a decade's long dearth, a raft of high profile IPOs are reportedly waiting in the wings to make their way into the public markets. Granted, their progress may be slowed by the fact that the SEC is one of the government entities currently shuttered, but we would not be surprised to see them reactivated once that issue is resolved. Then too, M&A has been strong with a variety of deals announced. The pullback in interest rates means financing costs remain low and many companies are still flush with tax saving thanks to the 2017 tax law.

6. Logistics Chains are Being Reassessed and Rearranged – thanks to reduced taxes and regulation in the United States and trade/tariff related disruptions with major trading partners. While frustrating and thorny to wend through in the short run, strengthening our U.S. manufacturing and delivery infrastructure could well be a long range benefit. Hubs of activity from green energy, to distributed data center and logistics hubs are popping up around the country, creating tax base and decent jobs in many locales, as well as bringing high profile/high growth tech companies into a variety of regions and providing a solid two-way flow of charitable, innovative, educational, and employment opportunities for local markets.

7. Technological Advance Continues – Think autonomous transportation, artificial intelligence, genomics, 5G networks, block chain technology, environmentally constructive food and energy production, and healthcare customized to one's personal specific genes. Industry after industry is "under attack" or "opportunity laden" depending upon one's point of view. No business model will be left untouched—creating winners and losers with dizzying speed. Leaning into this change and finding managers and companies who understand the opportunities is a key mind-set for long-term investors.

8. Infrastructure Spending Could Accelerate – one of the few issues that both sides of Congress have publically stated they could agree on is tackling an infrastructure spending bill. Already, significant funds have been freed up for key state and local projects such as light rail and more could be forthcoming if politicians look to find a "quick win" to assuage voter angst and frustration over the extended shutdown. Roads, bridges, rails, electric grids, water, and gas lines are all in various underfunded and poorly maintained states. New technologies to facilitate electric/autonomous/shared vehicles, 5G and sensor technology etc. could benefit a host of industries, create solid, long term employment for tens of thousands to complete, all with the added benefit of bolstering political goodwill as politicians deliver on key local projects.

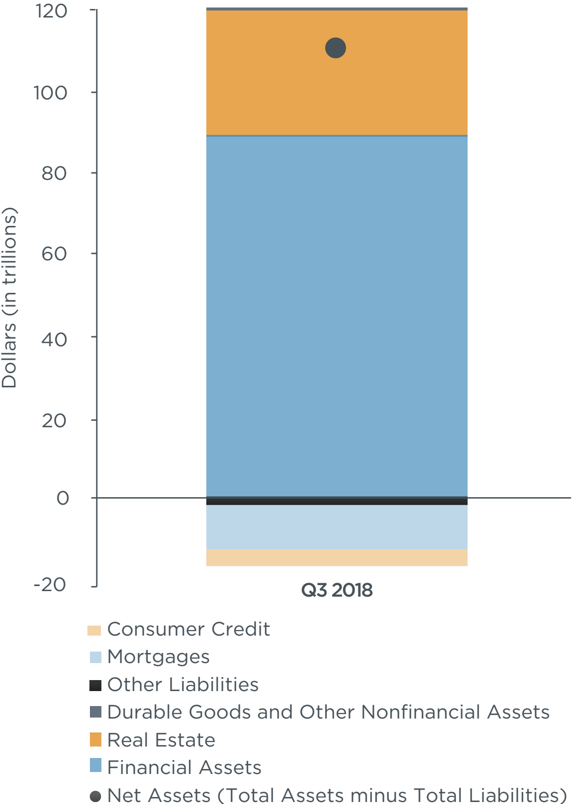
9. Geopolitical and/or Trade Tensions Could Ease – markets have been quite sensitive to ebbs and flows on China tariff negotiations, Brexit/EU machinations, and to geopolitical issues between the U.S. and North Korea, Russia, Iran, Syria, Israel, Iraq, etc. with the overarching tone seeming to presume doom on most fronts. Positive progress on North Korean nuclear pact—or particularly on China and trade could lead to a decided mood shift on Wall Street.

10. Globalization, Particularly in the Southeast Asia Region Could Stabilize – and continue apace with or without the U.S. and China. The fact that many citizens around the globe have had a taste (through education of their young abroad or access to global media/internet) of a broader perspective often means it's hard to go back to what came before. Japan and Australia's leadership in cobbling together a revised Trans-Pacific Trade Pact—without the U.S. and China is one illustration of this. While the U.S. and China are the obvious gorillas in the mist today, the longer they stay at odds and/or preoccupied with their own internal issues, the more likely we suspect it will be that other countries joining forces to facilitate smooth trade routes and routines.

While we readily admit that there is plenty to fret about on a day-to-day basis (and we do plenty of that fretting!), we also believe it's vital on occasion to pull up to take a few moments and focus on what could go right. Here's to a successful and bright 2019 for us all!

What Could Go Right? *(Continued)*

Chart 1: Consumer Balance Sheet Suggests Consumption Continues

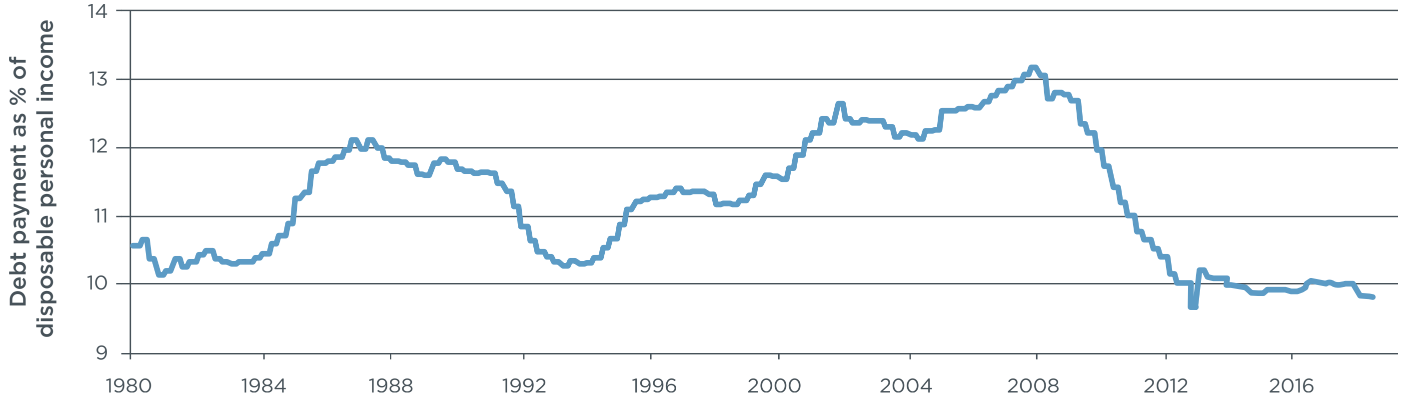


Sources: Bloomberg, Federal Reserve Board, FactSet, and Wells Fargo Investment Institute, as of September 30, 2018.

What Could Go Right? *(Continued)*

Chart 2: Household Debt Service Ratio Near All-Time Lows

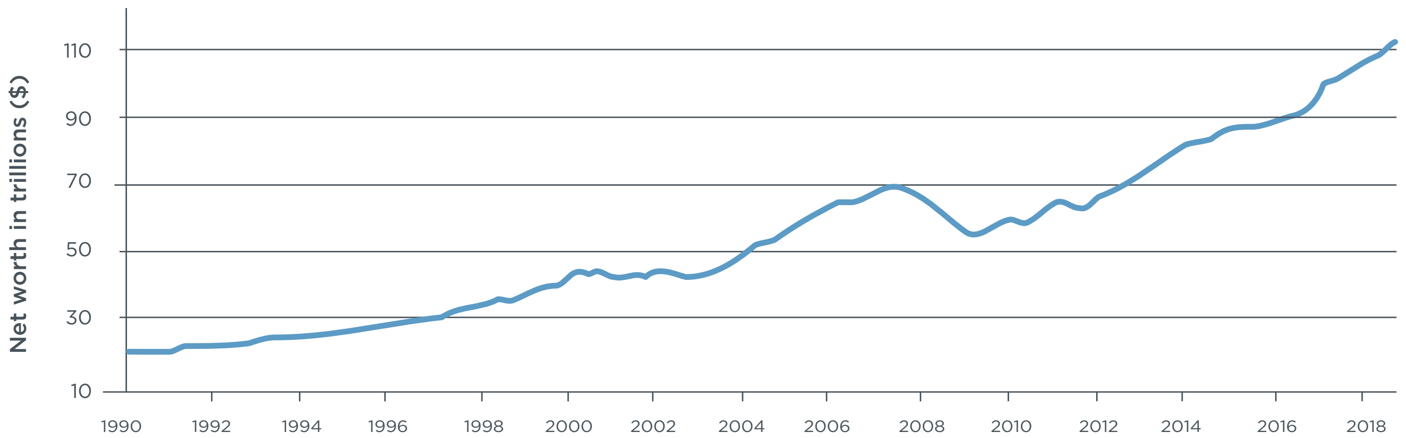
03/31/80 – 12/31/18



Sources: Bloomberg, Federal Reserve Board, FactSet, and Wells Fargo Investment Institute, as of September 30, 2018.

Chart 3: Household Net Worth at All-TIme Highs

12/31/86 – 09/30/18



Sources: Bloomberg, Federal Reserve Board, FactSet, and Wells Fargo Investment Institute, as of September 30, 2018.

Institutional-Quality Tools

> "Human beings are works in progress that mistakenly think they're finished."
>
> Dan Gilbert

If you were anywhere near a TV during the last five years chances are you saw Harvard Professor Dan Gilbert at some point. He was the face of a very successful commercial campaign for Prudential where they used unique visual and physical experiments with ribbons or balloons or giant dominoes to dramatize how most Americans feel unprepared for retirement. He's won countless awards, written several books, had a number of TV appearances and has given three popular TED talks. His quote above comes from one of those talks in which he details a study he'd done showing that most people think, regardless of age, that the person they are in the present is pretty much the person they are supposed to be, that they don't think they will change all that much in the future. But the data suggest this is very wrong. We are very much works in progress.

New Tools

We have talked several times in this report over the years about different ways in which markets evolve. This has often been in the context of how the interactions between investment factors and asset classes have evolved; but the evolution of *how* we invest is just as important as *what* we invest in. And—like humans—the tool set available to investors is a work in progress.

Because new investment strategies and tools can be costly to launch, new products are typically designed for large institutional clients first, making their way to the individual investor later once economies of scale have been achieved. Jack Bogle from Vanguard is often thought of as the inventor of the index fund; but it was actually Wells Fargo employees William Fouse and John McQuown who developed the first index fund in 1971 for their institutional client—the pension fund of the luggage company Samsonite. Bogle designed a way to bring it to the individual investor in 1976. Similar histories exist for things like private equity and venture capital, options, socially responsible investing and factor-based investing—institutions get it first, individuals get it later.
We leverage our experience and the power of our large base of assets under management to provide our clients with access to institutional-quality tools that are often unavailable to most individual investors.

Benefits of Institutional Tools

There are a number of ways that institutional tools provide value, but the most common advantages are: lower cost, greater tax efficiency, better access, and the potential to reduce risk and/or enhance returns. Using size to gain a cost advantage is not particularly new. The benefit we have is being able to leverage not only the size of Abbot Downing ($45 billion total client assets), but also the size of Wells Fargo ($1.9 trillion total assets). For example, we use the large role that Wells Fargo plays in the fixed income markets to be able to manage the majority of client fixed income assets with minimal or no additional expense (we do have fixed income only mandates that pay fees) which typically achieves roughly 30 bps in cost savings. Saving thirty basis points of cost is the same as generating thirty basis points of alpha. It all goes to the client's bottom line and works to grow portfolio value over time.

Separate accounts are another tool we can take advantage of. A mutual fund is a commingled vehicle in which all investors own an interest in a pool of securities. By contrast, in a separate account the client owns the securities in an account segregated from those of other clients. These unique instruments can generate several benefits. They can be very useful for tax planning. Each year we can reach into those separate accounts and harvest losses, or select highly appreciated securities to fund charitable contributions. Separate accounts also typically carry a lower management fee than their commingled counterparts. Similar to fee savings, each dollar of the portfolio that can be protected from inefficient taxation is a dollar that can be used to potentially grow the portfolio over time.

Institutional-Quality Tools *(Continued)*

Access to top-tier private capital managers is an additional advantage we can bring to our clients. Managers in the private space that have demonstrated a history of strong performance can often choose their investor base. When selecting clients, these managers tend to prefer investors with a long time horizon (referred to in the industry as 'patient capital'). Because our client base has a unique level of wealth designed to last several generations, we are an excellent source of patient capital. So, when these top-tier managers are selecting clients they would like to partner with we are often on that short list.

Lastly, because we are designing portfolios meant to last several generations, our view is that protecting during down markets is just as important as participating in up markets. As a result, we are constantly looking for and implementing strategies focused on providing noncorrelated return profiles that can protect in challenging markets. For example, a recently added strategy seeks to capture returns based on the performance of reinsurance contracts (insurance purchased by insurance companies). Price action in this asset is very idiosyncratic. It is influenced by factors like the frequency and severity (or lack thereof) of events like wildfires or hurricanes. Returns are also driven by the complex underwriting and contractual process in which these securities are created and repriced annually. The benefit here is that clients can own a return stream that isn't influenced by factors driving more traditional equity and bond markets. This diversification, coupled with the robust institutional analytical tools we incorporate into the process, helps improve relative performance by reducing downside exposure, helping the portfolio compound over time.

Conclusion

Portfolios, like people, are a work in progress. Yes, markets move and require rebalancing and risk management, but what is just as important is that the tools change over time. The ability to bring tools that are typically designed for and reserved for the largest institutions to our clients helps us realize large cost savings and portfolio enhancements on their behalf. We're not suggesting that you need access to each and every shiny new tool out there, just that we make sure our clients are shopping off the same menu as the largest institutions. Blockchain, micro-finance, machine learning; these are all things on the horizon. We may or may not participate in these strategies, but at least we will know they are there and available to us. Professor Gilbert extols the virtues of learning from those that have gone before, "if I wonder what it's like to become a lawyer or marry a busy executive or eat at a particular restaurant, my best bet is to find people who have actually done these things and see how happy they are."

Market Performance

Stock Market Total Returns**

Period Ending December 31, 2018

Equity Indexes	December	QTD	YTD	1 Year	3 Year*	5 Year*
Global Market	-7.0%	-12.7%	-8.9%	-8.9%	7.2	4.8%
Large Cap	-9.0%	-13.5%	-4.4%	-4.4%	9.3%	8.5%
Large Cap Growth	-8.6%	-15.9%	-1.5%	-1.5%	11.1%	10.4%
Large Cap Value	-9.6%	-11.7%	-8.3%	-8.3%	7.0%	5.9%
Mid Cap	-9.9%	-15.4%	-9.1%	-9.1%	7.0%	6.3%
Small Cap	-11.9%	-20.2%	-11.0%	-11.0%	7.4%	4.4%
Developed Market Ex. U.S.	-4.8%	-12.5%	-13.4%	-13.4%	3.4%	1.0%
Developed Small Cap (USD)	-6.4%	-16.0%	-17.6%	-17.6%	4.1%	3.4%
Emerging Markets (USD)	-2.6%	-7.4%	-14.2%	-14.2%	9.7%	2.0%
Frontier Markets (USD)	-2.9%	-4.3%	-16.2%	-16.2%	4.6%	1.1%

Source: Wells Fargo Investment Institute Market Overview, 1/10/19. Past performance is no guarantee of future results.

**Annualized returns.*

***Index returns do not reflect the deduction of fees, expenses, or taxes. Please see disclosures at the end of the report for sector representative indices and their definitions.*

Fixed Income Market Total Returns**

Period Ending December 31, 2018

Fixed Income Indexes	December	QTD	YTD	1 Year	3 Year*	5 Year*
Global Multiverse	1.9%	1.0%	-1.4%	-1.4%	3.0%	1.2%
U.S. Inv Grade Taxable	1.8%	1.6%	0.0%	0.0%	2.1%	2.5%
U.S. Treasury Bills	0.2%	0.6%	1.8%	1.8%	1.0%	0.6%
U.S. Short-Term Taxable	0.8%	1.2%	1.6%	1.6%	1.3%	1.1%
U.S. Interm-Term Taxable	1.6%	2.0%	0.9%	0.9%	1.8%	2.3%
U.S. Long-Term Taxable	3.7%	0.9%	-4.5%	-4.5%	4.0%	5.1%
U.S. Treasury	2.2%	2.6%	0.9%	0.9%	1.4%	2.0%
U.S. Corporate	1.5%	-0.2%	-2.5%	-2.5%	3.3%	3.3%
U.S. Municipal	1.2%	1.7%	1.3%	1.3%	2.3%	3.8%
U.S. TIPS	0.5%	-0.4%	-1.3%	-1.3%	2.1%	1.7%
U.S. High Yield	-2.1%	-4.5%	-2.1%	-2.1%	7.2%	3.8%
Developed Ex. U.S. (Unhedged)	-2.6%	1.6%	-1.7%	-1.7%	3.3%	0.4%
Emerging Markets (USD)	1.5%	-1.2%	-4.6%	-4.6%	4.7%	4.2%

Source: Wells Fargo Investment Institute Market Overview, 1/10/19. Past performance is no guarantee of future results.

**Annualized returns.*

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Market Performance (Continued)

Real Asset Total Returns**

Period Ending December 31, 2018

REIT/Commodity Indexes	December	QTD	YTD	1 Year	3 Year*	5 Year*
Public Real Estate	-5.4%	-5.5%	-4.7%	-4.7%	3.7%	5.3%
U.S. REITs	-7.9%	-6.1%	-4.0%	-4.0%	4.2%	8.3%
International REITs	-2.1%	-4.9%	-5.8%	-5.8%	5.1%	3.0%
S&P GSCI Commodity	-7.8%	-22.9%	-13.8%	-13.8%	0.5%	-14.5%
Bloomberg Commodity	-6.9%	-9.4%	-11.2%	-11.2%	0.3%	-8.8%
RICI Commodity	-5.9%	-13.0%	-9.2%	-9.2%	2.6%	-9.1%
Global Infrastructure	-3.1%	-5.1%	-9.5%	-9.5%	6.9%	4.1%

Source: Wells Fargo Investment Institute Market Overview, 1/10/19. Past performance is no guarantee of future results. Please see disclosures at the end of the report for index definitions.

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Alternatives Total Returns**

Period Ending December 31, 2018

Alternative Indexes	December	QTD	YTD	1 Year	3 Year*	5 Year*
Global Hedge Funds	-2.0%	-5.3%	-4.1%	-4.1%	3.2%	2.3%
Relative Value	-0.9%	-2.4%	0.7%	0.7%	4.5%	3.4%
Arbitrage	-0.6%	-1.2%	3.0%	3.0%	4.5%	3.0%
Long/Short Credit	-0.7%	-2.5%	-0.3%	-0.3%	5.9%	3.4%
Struct Credit/Asset Backed	-1.4%	-1.5%	3.1%	3.1%	5.3%	5.3%
Macro	0.9%	-1.4%	-3.2%	-3.2%	0.0%	0.8%
Systematic	2.6%	-1.7%	-5.3%	-5.3%	-1.5%	0.6%
Discretionary	-0.2%	-0.5%	-0.5%	-0.5%	0.0%	-0.2%
Event Driven	-1.9%	-4.4%	-1.7%	-1.7%	5.3%	2.6%
Activist	-5.9%	-11.3%	-10.5%	-10.5%	1.4%	2.3%
Distressed Credit	-2.4%	-5.7%	-1.7%	-1.7%	6.3%	1.7%
Merger Arbitrage	-0.5%	0.0%	3.2%	3.2%	3.7%	3.2%
Equity Hedge	-3.7%	-8.3%	-6.9%	-6.9%	3.6%	2.3%
Directional Equity	-1.3%	-7.0%	-4.9%	-4.9%	3.0%	2.2%
Equity Market Neutral	0.0%	-2.1%	-1.2%	-1.2%	1.9%	2.6%

Source: Wells Fargo Investment Institute Market Overview, 1/10/19. Past performance is no guarantee of future results. Please see disclosures at the end of the report for index definitions.

**Annualized returns.*

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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

After re-emerging in October, volatility showed no signs of letting up as year 2018 came to a close. In Q4, the Dow and S&P 500 declined -11.3% and -13.5%, while developed and emerging markets declined -12.5% and -7.6% respectively. The MSCI ACWI, a primary aggregate of all global equity markets was down -9.0% for the full year. Market gyrations have continued on a massive scale at the outset of 2019. The Dow tumbled 660 points during the second trading day, as Apple, Inc. announced that quarterly sales in China would fall short of previous estimates. Adding to traders' worry were the unexpected drop in Chinese PMI's in December and the announcement that U.S. Manufacturing PMI unexpectedly dropped from 59.3 to 54.1. Global equities abruptly reversed course to the upside after U.S. payroll gains significantly beat expectations in December, combined with a more cautious tone in comments from Fed chairman Jerome Powell on the pace of further rate hikes. Intra-day and sharp upside moves have also been part of the new reality as percentage moves applied to larger absolute index values create seemingly large absolute point moves.

Behind the broad, swift equity-market slide of 2018 is an underlying new reality: Roughly 85% of all trading is on autopilot—controlled by machines, models, or passive investing formulas.[8] While fundamentals ultimately drive capital markets in the long run, the aforementioned program-trading environment combined with an extended business cycle will likely result in continued volatility in 2019.

Global Trade

President Trump and China's leader Xi Jinping met in Buenos Aires during the G-20 summit on December 1, 2018 and announced a temporary trade truce with the U.S. agreeing to delay additional tariffs on $200 billion of Chinese goods from January to March 1st in order to allow for more negotiation time. The two countries will reportedly have 90 days to agree on more substantive issues with respect to forced technology transfers, intellectual property protection, non-tariff barriers, and cyber security. The initial market reaction was positive, but soon reversed course as investors became skeptical over the U.S.-China trade truce and subsequent arrest of Huawei Technology Co.'s chief financial officer for alleged violations of Iranian sanctions; Huawei is a leading global tech company based in China that the U.S. views as a national security threat. On a positive note, China and the U.S. recently finished three days of mid-level trade talks in early January with a commitment by President Xi Jinping's government to buy more U.S. agricultural goods, energy and manufactured products. Press reports are intimating additional talks by late January.

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. To be sure, the latest U.S.-China meeting also ended with USTR Robert Lighthizer demanding that any deal to include "ongoing verification and effective enforcement."

Domestic Geopolitical Concerns

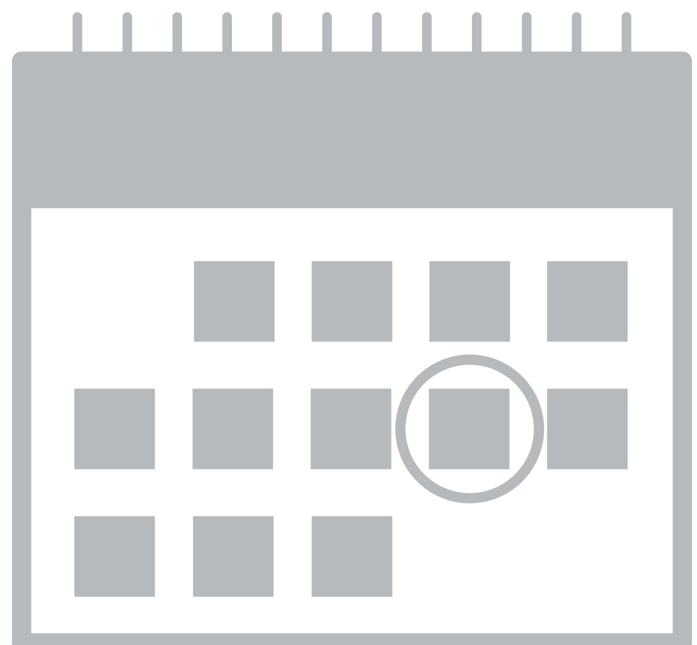
As expected, Democrats took control of the House of Representatives, and Republicans maintained the majority in the Senate. Historically, equity markets have corrected in the run-up to midterm elections, but once this uncertainty has been removed following the election, stocks have performed well over the following 12 months—regardless of which party was in charge before or after the election. Looking forward however, the new Democrat Party-controlled House of Representatives could add to market volatility in this rather hostile political environment. Although the new U.S. tax bill with permanently lower corporate tax rates and immediate write off of capital expenditures for the next five years is currently not in danger of being overturned, issues relating to deficits, regulation, the environment, and fiscal spending will likely produce added friction. Case in point: President Trump and senate Republicans are holding firm on demands for new funding on a proposed wall along the nation's southern border, while Democrats insist that there will be no discussion of border funding until those areas of the government that are currently shut down are reopened.

In addition to the ongoing uncertainties regarding the partial government shutdown, the Mueller investigation surrounding the 2016 election will undoubtedly result in partisan attacks from both political parties when a final report from the independent counsel is ultimately submitted—probably fairly soon. House Democrats have also promised hearings on President Trump's tax returns and prior financial dealings.

Commodity Prices

WTI crude prices have recently plunged from $76 per barrel to $42 per barrel in Q4—before rebounding back to $52 early this year, as the Trump Administration eased sanctions on Iran by allowing key trading partners to continue buying its oil, along with a massive unwinding of hedge-fund long positions in futures markets. Oil prices are expected to increase, and trade between $60 to $70 over the next year, due to OPEC and Russian production cuts along with a re-emergence of political risks (Iran, Venezuela). The falling prices have been beneficial in headline inflation numbers such as CPI and PPI, perhaps giving the Fed wiggle room in moderating the pace of rate hikes in 2019.

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



Central Bank Meetings—The Fed and The ECB

As expected, the U.S. Federal Reserve voted to increase the target range for the federal funds rate by 0.25%—from 2.00% to 2.25% and 2.25% to 2.50% at the December meeting. The future path of interest rates (as projected by the FOMC "dot plots") dropped from three to two rate increases expected in 2019. In the meantime, as of this writing, futures markets indicate only a 15% probability of just one additional hike in 2019.

QE tapering will remain a focus in 2019, as the Fed reduces the bond purchasing program initiated in the wake of the financial crisis. Adding to the demand/supply issue is the fact that the U.S. Treasury has begun increasing its issuance of T-bills, notes, and bonds to pay for an expanding deficit, and increased government spending. Investors will be watching closely to see if yields are forced upward given the extra supply, reduced demand and pending what happens with the U.S. Budget appropriations in coming weeks.

Employment cost index releases should continue to spawn market volatility; recent monthly unemployment reports have reached the lowest levels since year 2000 and year-over-year wage gains of 3.2% in December exceeded the prior month's 3.1% pace—the best rate since 2009. These are likely to be much-watched statistics for the remainder of the year along with their inferred implication for Fed monetary policy decisions.

The European Central Bank (ECB) reiterated that it reduced QE from 30 billion euros of assets a month in September to 15 billion in October, and confirmed it will stop purchases at the end of the year—ending almost four years of quantitative easing. It also pledged to keep interest rates unchanged "at least through the summer of 2019", now at minus 0.4%.

We feel that markets will remain focused on the progress of inflation and the Fed's comments surrounding economic health. In a joint interview with former chairs Ben Bernanke and Janet Yellen, current chairman Jerome Powell stated that mild inflation would give the central bank greater flexibility to set policy in the year and that the Fed wasn't in a "pre-set" path to push its benchmark rate higher. These statements along with comments regarding the Fed's balance sheet—having an objective of "shrinking gradually and predictably", versus a previous characterization of it being "on autopilot," were well received by investors.

Markets will also continue to scrutinize ECB President Mario Draghi's comments; in October, the ECB shaved its forecast for growth in the 19-nation currency union by 0.1 percentage points for this year and next, to 2% and 1.8% respectively. This is consistent with recent comments suggesting more caution; the ECB might delay lifting interest rates out of negative territory, and pledged to hold its 2.6 trillion euro portfolio of bonds for an extended period of time.

Techlash

After hitting all-time highs in the third quarter, with some even attaining $1 trillion market capitalizations, the tech sector has been under uniform pressure in the last few months' volatility. High profile (and continued) hacks, data misuse announcements, and potential meddling/manipulation of data feeds by a variety of bad actors continue to plague many players. Key leaders from companies like Google and Facebook are making repeat visits to testify in front of congressional panels, and moves against key global players by the U.S. and China keep the industry in the headline news flow. Scrutiny of the all-important technology sector is likely to continue and bears watching as any unexpectedly negative announcement—even if preliminary—could impact the stocks.

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. Given the high profile, and growth valuations that many individual names bear, we expect news flow and market sentiment to continue to buffet the industry on a day to day basis.

In addition to regulatory issues, tech stocks have come under pressure due to fundamentals; concerns of peak earnings, slowing revenue and high valuations have led to additional volatility for this sector. Indeed, shares of Apple, Inc. plunged after management reduced its quarterly revenue forecast for the first time in 15 years, prompted by a slowdown in sales of iPhones in China.

Tech stocks have been a key leadership group throughout the market's long term run, with many optimistic presumptions seemingly embedded in their price rise. Markets could be especially volatile as the search for broader or different leadership continues in coming months. Additionally, we expect investors will be attentively combing through commentary surrounding each company's earnings releases in coming weeks looking for positive or negative signs from trade wars, Chinese/SE Asia economic and consumer health, and margin pressure from such things as transportation and employment costs.

U.S. Economic Data Heading into 2019

According to the U.S. Bureau of Economic Analysis (BEA), the latest GDP report showed the U.S. economy accelerating 3.5% on an annualized basis in Q3, down from 4.2% in Q2—but still exceeding consensus expectations. Q4 is expected to advance around 2.5%. 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.

Although output has clearly accelerated throughout 2018, we believe monitoring incoming data late in a business cycle for signs of acceleration and deceleration is prudent as year 2019 progresses.

Further, we expect that investors will be closely monitoring corporate earnings releases in coming weeks, particularly for multi-national companies. Markets could prove volatile around individual corporate releases if themes of tariff-induced sales softness, consumer plateauing, wage cost increases, or undue transportation/distribution expenses emerged.

Non-U.S. Geopolitical Concerns

Corporate fundamentals in Europe and Japan have improved, but investors should still be aware of political risks. For example, uncertainties surrounding the Brexit endgame continue to heighten levels of market volatility. British Parliament overwhelmingly rejected Prime Minister Theresa May's proposal, crafted with her EU counterparts, to leave the European Union—throwing the entire Brexit deal into further disarray. Mrs. May subsequently survived a no-confidence vote. Still, the closer Brexit negotiations reach the March 29th deadline for the U.K. to quit the EU without an agreement (Hard Brexit), the more uncertainty it creates for European businesses and capital markets.

Riots have erupted in France sparked by new fuel taxes that disproportionately hurt workers who commute from the suburbs and rural areas. In response, President Emmaneual Macron rolled back the fuel tax and some pension taxes, while also increasing the minimum wage. Although Mr. Macron promised to continue his broader pro-business agenda (the wealth tax was not reinstated), the riots are still likely to negatively impact future reforms.

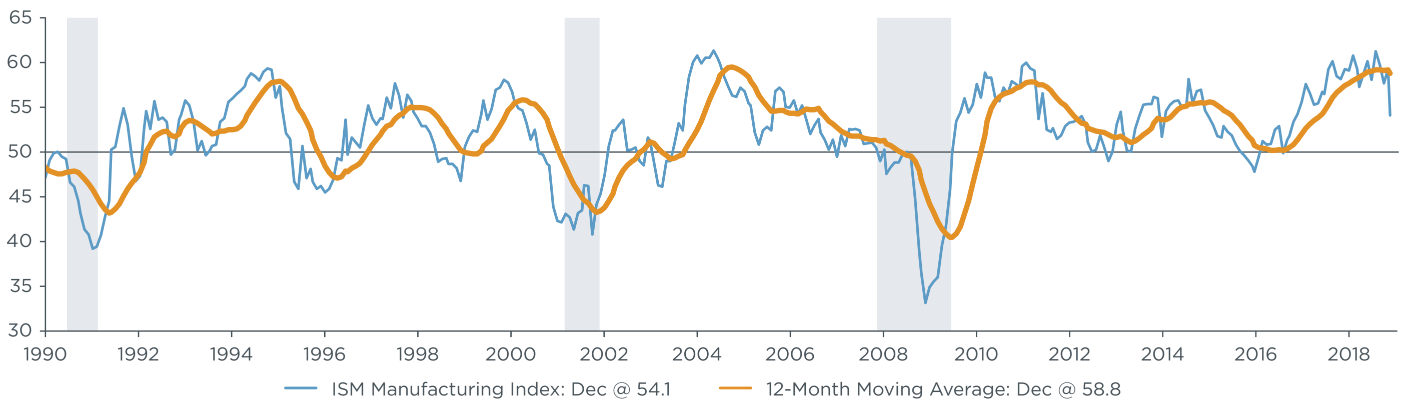
Based on election results from last March, Italy currently has a coalition government formed by two populist parties: Left wing 5 Star movement and the right-wing Lega party, which presents a complicated situation. Indeed, the Italian parliament initially produced a budget that was rejected by the EU based on spending rules and debt levels. Brussels has demanded that Italy revise and resubmit its budget. Moody's subsequently downgraded Italy's debt, while Standard and Poors has "lowered its outlook" on Italy. Italy countered with a revised deficit target proposal in line with demands by the EU (from 2.4% to 2.0% of GDP). The yield on the country's 10-year government bonds dropped below 3% for the first time since September and stocks climbed on the news.

While European governments in general have shifted toward pro-growth policies, investors are keenly aware of intense political divisions within the bloc that could be disruptive. In addition to the aforementioned examples in the U.K., Italy, and France, Spanish lawmakers recently ousted its prime minister, and Chancellor Merkel has stepped down as leader of her Social Democratic party in the wake of another regional election disappointment; her preferred successor barley won over anti-Merkel challengers.

Notable Observations

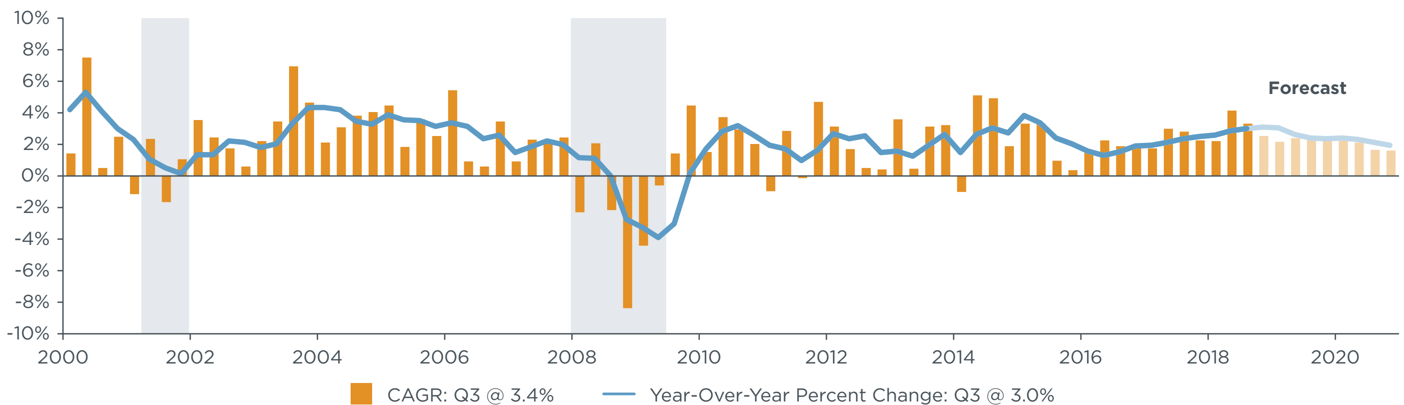
Many of the factors we've listed in the cover story as possibly going right, are predicated on the government shutdown not going on for an extended length of time. Additionally, progress on trade talks that facilitate the continuation of global business would be supportive as well. In the meantime, we will be looking to a variety of key economic factors such as inventories, manufacturing output, business sentiment, the Baltic Dry Index, and ISM reports to provide a litmus test for the solidity of the economy. It's important for investors to keep in mind, though, that economic stats and markets do not necessarily move in lock step and much of the market's recent volatility may already presume lackluster reads for much of the data.

Chart A: ISM Manufacturing Composite Index



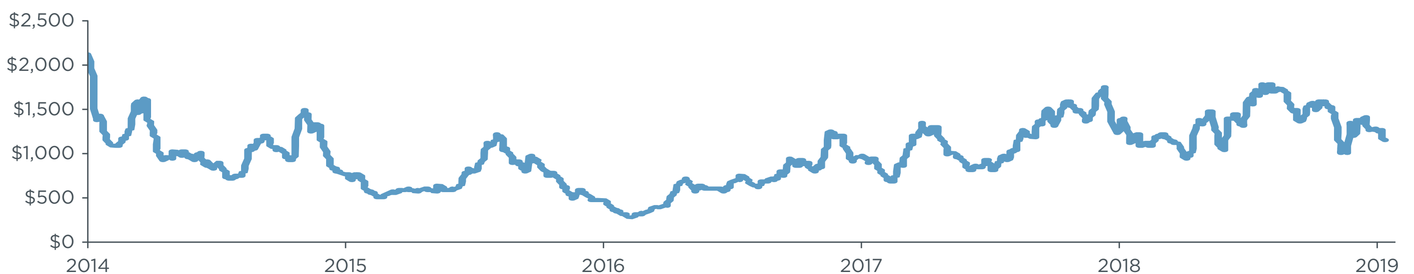
Source: Wells Fargo Securities, December 31, 2018.

Chart B: U.S. Real GDP



Source: Wells Fargo Securities, December 31, 2018.

Chart C: Baltic Dry Index Price



Source: Wells Fargo Securities, December 31, 2018.

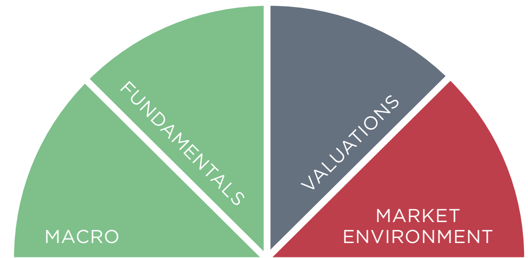
Dynamic Allocation Summary

Global Equities Outlook Overview

U.S. Large Cap Equities

Outlook: Mixed Positive

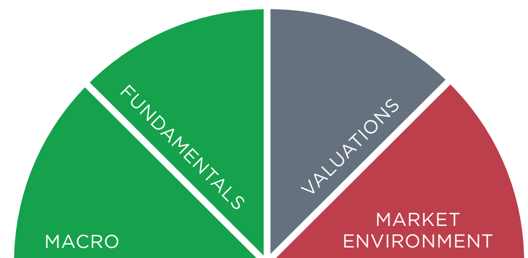
Macro and fundamental inputs continue to favor U.S. large-cap equities. We expect economic growth to remain solid, and EPS to reach record levels in 2019. Due to market volatility, valuations are now near their historical averages. If U.S. large-cap stocks were to experience additional volatility, we would consider this a potential opportunity to invest at more attractive prices.



U.S. Small Cap Equities

Outlook: Neutral

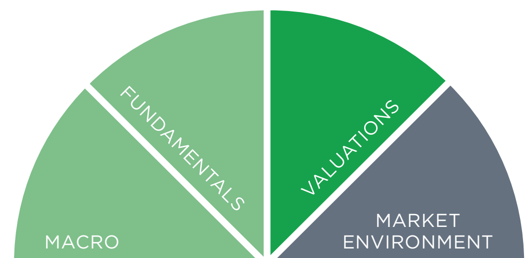
We have a Neutral weighting on domestic small cap equities. Valuations are deemed expensive relative to larger companies, but the new tax plan should benefit small-cap stocks by comparatively more than the large-cap indices; smaller domestic companies tend to pay higher tax rates than large, multinational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



Developed Market Equities

Outlook: Mixed Positive

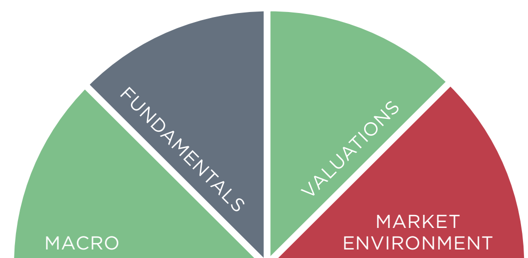
Although economic growth in developing countries outside the U.S. stalled during the first half of the year, recent data suggest stronger growth in the second half of 2018. Accelerating profits, and reasonable valuations favor developed market equities in our opinion. In cases where clients have immediate funds to invest, developed equities would be one of our top considerations.



Emerging Market Equities

Outlook: Neutral

The strengthening U.S. dollar and escalating trade tensions have pressured emerging market equities—and made valuations more attractive. Stronger balance sheets of developing countries (lower external debt) and expectations of a more stable greenback have made us more optimistic on this asset class going forward.



Outlook Ratings POSITIVE | MIXED POSITIVE | NEUTRAL | NEGATIVE

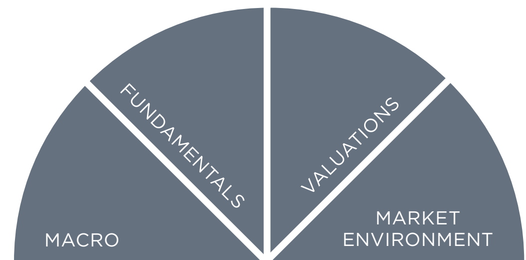
The color-coded rating system applies to specific inputs only (Macro, Fundamentals, Valuations, and Market Environment) and represents the current and shorter-term (three to six months) outlook for the specific inputs based on qualitative data and recommendations from the Abbot Downing Asset Allocation 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

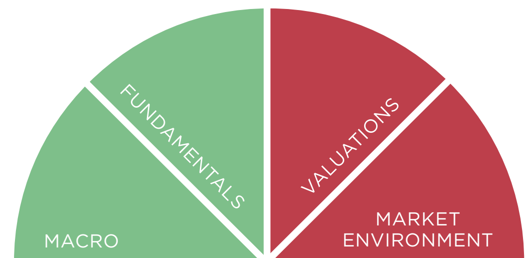
We feel that yields of investment-grade bonds (Treasuries, municipals, and corporates) have moved into fair value range, and are supported by expectations that the Fed will conclude its rate-hiking cycle in 2019.



Non-Investment Grade Fixed Income

Outlook: Neutral

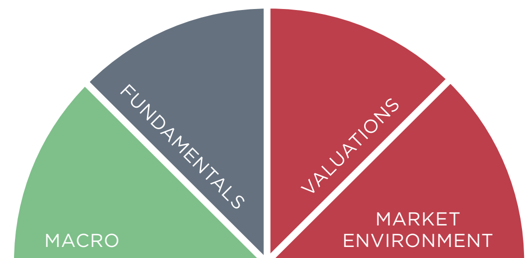
We remain constructive on preferred stock securities based on healthy yield premiums versus investment-grade bonds. Although high-yield spreads have widened in lieu of falling oil prices, valuations still remain expensive based on historical spreads.



International Fixed Income

Outlook: Negative

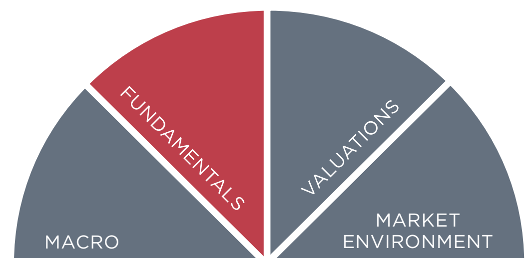
We believe near zero yields on many developed country sovereign debt issues warrant caution for this sector. Emerging market bond spreads are now above their long-term historical averages.



Real Estate Investment Trusts (REITs)

Outlook: Neutral

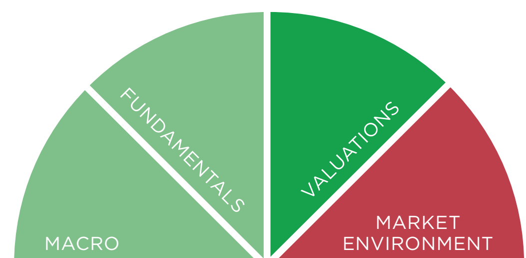
We have downgraded REITs to underweight, as they have become more sensitive to interest rate moves. REIT fundamentals remain stable despite facing late cycle headwinds and exhibit attractive valuations. REITs currently sell at a 5.0% discount to underlying real estate holdings, but exhibit average spreads compared to other income-oriented asset classes.



Master Limited Partnerships (MLPs)

Outlook: Mixed Positive

Although MLPs came under pressure last year as investors adjusted to lower oil prices and tax-loss selling, performance has rebounded based on stronger fundamentals. 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 FERC ruling and risk of C-corp conversion.



Outlook Ratings POSITIVE | MIXED POSITIVE | NEUTRAL | NEGATIVE

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 cap 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).

Baltic Dry Index is reported daily by the Baltic Exchange in London. The index provides a benchmark for the price of moving the major raw materials by sea. The Baltic Dry Index is not restricted to Baltic Sea countries or to a few commodities like crude oil. Instead, the Baltic Dry Index takes into account 23 different shipping routes carrying coal, iron ore, grains and many other commodities.

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.

Disclosures (Continued)

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.

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. Inv Grade Taxable Fixed Income: Bloomberg Barclays U.S. Aggregate Bond Index is composed of the Bloomberg Barclays Capital U.S. Government/Credit Index and the Bloomberg Barclays Capital U.S. Mortgage-Backed Securities Index, and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

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.

Disclosures (Continued)

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, Peru, Philippines, Poland, 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.

Disclosures (Continued)

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. Fixed income 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.

Disclosures (Continued)

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.

Disclosures (Continued)

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 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.

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 HFR 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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