ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

3Q2017

At the time we are penning this newsletter, the Dow Jones Industrial Average (Dow), which tends to be the most often quoted Index of equity performance, had reached a closing level of 23,000. When we started this business roughly a year and a half ago, the Dow was in the 18,000 range. We bring it up not out of excitement, or because we are going to throw a bold prediction in the pages of this newsletter about it crashing or hitting 50,000. Our job isn't to generate headlines. We bring it up because we are asked regularly if we think the market is too expensive. We also regularly talk to prospective clients that are "waiting" for a good entry point to invest. (Some have been "waiting" since our business started.) The implication of both is that the market can be timed successfully.

Here is what we know from experience – being invested when the market corrects can be costly, BUT not being invested as the market surges can be just as damaging. The latter rarely makes headlines because few will conduct an honest assessment of the investing decisions they make. Particularly the decision to "wait." Returning to the opening paragraph, and using the Dow as an illustration, "waiting" to invest has generated an opportunity cost for the "waiters" of about 28% on the equity portion of their portfolios. From this point, there would need to be a nearly 22% market correction for the "waiters" to be equal with those that have stayed invested. That cost, though intangible, can have a meaningful impact on investment goals over the long run.

So, what is our advice?

Develop a plan – Stick to it – Adjust due to circumstance, not prediction – Rationally assess results

The only other item we would suggest, particularly for the "waiters," is to consider systematic averaging to reach the portfolio allocation suited to your situation. This can reduce the point-in-time investing risk that is likely causing a good portion of the apprehension. That all may sound overly simplistic, but it is unemotional. And it is generally emotion that ruins a plan.

We hope you find a portion of this newsletter useful.

Thank you for taking the time to read it. If you have any feedback, it is always appreciated.

Bob

Market Performance

Market Notes

Equity Portfolio Comments

Fixed Income Portfolio Comments

Research Focus

Client Focus

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 9/30/17)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	18.61	10.81	14.22	7.44
Russell 1000 Index	Mid/Large Cap Stocks	18.54	10.63	14.27	7.55
Russell 1000 Growth Index	Growth Stocks	21.94	12.69	15.26	9.08
Russell 1000 Value Index	Value Stocks	15.12	8.53	13.20	5.92
Russell 2000 Index	Small Cap Stocks	20.74	12.18	13.79	7.85
MSCI EAFE Index	Non-U.S. Developed Market Stocks	19.10	5.04	8.38	1.34
MSCI Emerging Markets Index	Emerging Markets Stocks	22.46	4.90	3.99	1.32
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	19.19	8.14	9.68	3.58
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	5.91	7.57	6.30	3.98
Barclays Municipal Bond Index	U.S. Municipal Bonds	0.87	3.19	3.01	4.52
Barclays Aggregate Bond Index	U.S. Bonds	0.07	2.71	2.06	4.27
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	0.23	2.13	1.61	3.64
BofAML U.S. Treasury Master Index	Treasury Bonds	-1.74	2.19	1.33	3.78
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	0.28	2.41	1.94	4.14
BofAML U.S. Corporate Master Index	Corporate Bonds	2.27	3.99	3.52	5.67
BofAML U.S. High Yield Master II Index	High Yield Bonds	9.05	5.88	6.39	7.81
BofAML Convertible Bonds Index	Convertible Bonds	17.39	8.62	12.40	8.29
BofAML Euro Broad Market Index	European Bonds	2.80	0.00	2.33	2.87
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	6.83	0.36	-0.13	3.14

Calendar Year % Returns (QTD and YTD as of 9/30/17)

Source: Morningstar Direct

	QTD	YTD	2016	2015	2014	2013	2012
S&P 500 Index	4.48	14.24	11.96	1.38	13.69	32.39	16.00
Russell 1000 Index	4.48	14.17	12.05	0.92	13.24	33.11	16.42
Russell 1000 Growth Index	5.90	20.72	7.08	5.67	13.05	33.48	15.26
Russell 1000 Value Index	3.11	7.92	17.34	-3.83	13.45	32.53	17.51
Russell 2000 Index	5.67	10.94	21.31	-4.41	4.89	38.82	16.35
MSCI EAFE Index	5.40	19.96	1.00	-0.81	-4.90	22.78	17.32
MSCI Emerging Markets Index	7.89	27.78	11.19	-14.92	-2.19	-2.60	18.22
MSCI ACWI Ex USA Small Cap Index	6.90	23.54	3.91	2.60	-4.03	19.73	18.52
BofAML Preferred Stock Fixed Rate Index	1.27	10.11	2.32	7.58	15.44	-3.65	13.59
Barclays Municipal Bond Index	1.06	4.66	0.25	3.30	9.05	-2.55	6.78
Barclays Aggregate Bond Index	0.85	3.14	2.65	0.55	5.97	-2.02	4.21
Barclays Intermediate U.S. Gov/Credit Index	0.60	2.34	2.08	1.07	3.13	-0.86	3.89
BofAML U.S. Treasury Master Index	0.39	2.32	1.14	0.83	6.02	-3.35	2.16
BofAML U.S. Mortgage Backed Securities Index	0.92	2.30	1.67	1.46	6.07	-1.39	2.59
BofAML U.S. Corporate Master Index	1.37	5.30	5.96	-0.63	7.51	-1.46	10.37
BofAML U.S. High Yield Master II Index	2.04	7.04	17.49	-4.61	2.51	7.41	15.55
BofAML Convertible Bonds Index	4.67	13.81	11.94	-1.15	9.97	26.60	13.63
BofAML Euro Broad Market Index	4.36	12.23	0.37	-9.30	-2.48	6.89	12.95
BofAML Local Debt Market Plus Index	3.40	13.69	6.53	-12.02	-4.50	-5.75	13.87

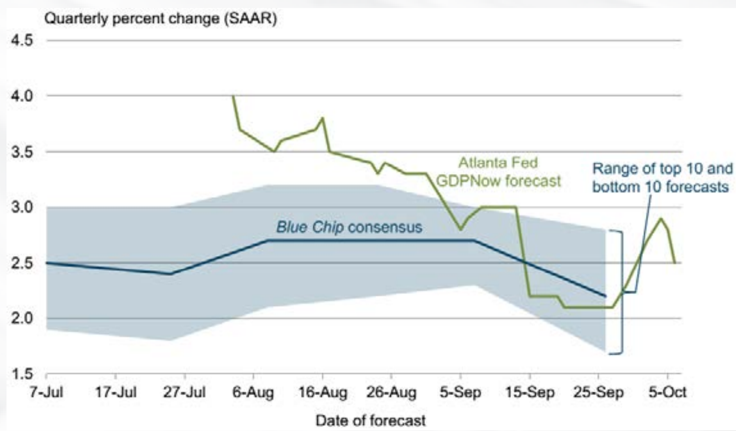
How should you use the information provided in the table?

- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Global Market Drivers

2017 is not finished yet, but three quarters of the way in, it is shaping up to be a broadly solid year for investors. A quick review of performance across a variety of market sectors shows gains in virtually every area. Equities in general have generated meaningful gains, but emerging markets and large-cap growth stocks have been the clear leaders. Fixed income returns have not been too shabby either. The combination has led to high levels of consumer confidence and low levels of volatility. In this type of environment, discipline is paramount. Over our careers we have spent considerable time defining and documenting an investment process to anchor our decision-making in times like this. As a result, we are pleased with the results in client portfolios, but our valuation and investment policy discipline does not change. We are continuing to monitor our key global market drivers and potential disruptions to the current environment – most notably the possibility of policy missteps from central banks in the U.S. and overseas – and research the most attractive opportunities for client portfolios. We will rebalance to client targets as appropriate.

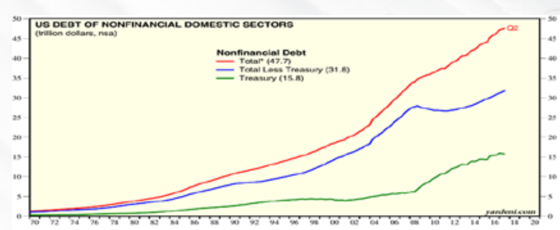
The Economy



Source: Federal Reserve Bank of Atlanta

Despite worries around rising tensions with North Korea and extreme weather disrupting many major southern cities and states, the underlying fundamentals signal the U.S. economy is healthy and on track for moderate growth. The estimate for annualized second-quarter 2017 growth was revised up from 2.6% to 3.0%, which is the strongest growth the U.S. has experienced since early 2015. The upward revision was a function of better than expected consumer spending and business investment, two key components of the U.S. growth equation. The positive backdrop resulted in initial estimates for third quarter economic growth of 3.25-3.75%. However, the extreme weather we experienced during the quarter resulted in lowered expectations. Economists are now calling for 2.25-2.75% growth, which is fairly robust considering the circumstances. See chart above. Despite that outlook and potential economic benefits from the rebuilding effort created by the destruction from the severe weather, we believe the probability of the economy struggling over the intermediate-term has increased. The three factors we are most concerned about are an aging U.S. economic expansion, high debt levels and tighter credit conditions.

1. An aging expansion. Several components of our proprietary U.S. Cycle Indicator are showing late cycle tendencies – a flattening yield curve, a tight labor market and high corporate deal volumes.
2. High debt levels. Broadly low interest rates have made debt relatively affordable to repay. As a result, governments, companies and households have all seen debt levels rise. See chart to right. If debt levels, income and interest rates evolve in unison, the economy can support the leverage. However, this rarely happens. As interest rates continue to rise, it is likely debt service ratios will become challenged potentially sparking a default cycle.



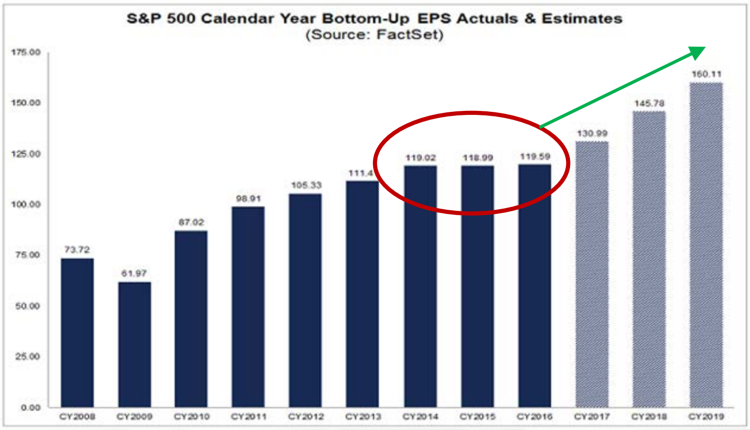
3. Tighter credit conditions. Since the U.S. Federal Reserve's (Fed) first rate hike in December 2015, credit conditions have slowly been tightening (raising rates). Its plan was to normalize policy slowly over a multi-year period, and use the combination of a strong labor market and stable inflation as cover. So far, the plan has worked. The economy has been able to adjust to four 25 basis point rate hikes over an 18-month period without a noticeable impact. Even though the Fed left rates unchanged at its September meeting, it forecasted another rate hike before the end of the year and signaled the intention to raise the federal funds rate to approximately 3.0% by 2019. Outside of traditional monetary tightening, the Fed will begin to unwind some of its crisis era policies this October by reducing the size of its balance sheet. This is concerning, considering there is virtually no historical precedent. A lot must go right for the Fed. The labor market and inflation need to continue cooperating and it must unwind the balance sheet without spooking the markets. In the absence of those events, tighter policy could put pressure on the economy.

Interest Rates

The 10-year Treasury ended the quarter at 2.33%, which was slightly below our estimate of fair value. The likelihood of one additional rate hike by the Fed in 2017 is the primary driver behind our fair value estimate. However, there are other factors that suggest rates can continue to move higher. The European Central Bank and Bank of Japan have each signaled a desire to pursue tighter monetary policy. Due to the ultra-easy policy pursued by these banks, there was substantial foreign buying of U.S. Treasuries. If the Fed reverses course it is likely the money that flowed into U.S. based yield will flow out as well. Layer on top of this the reduction in the size of the Fed's balance sheet and there is the potential for rates to move higher.

Earnings

Corporate earnings growth (year-over-year) is expected to remain in positive territory for the third quarter of 2017, although growth is not expected to be as robust as in recent quarters. Current analyst expectations are for an increase of +2.8% for the S&P 500® Index. If however, estimates from Factset prove correct, earnings growth could end up closer to +6.0% after all companies have reported. Another positive quarter of earnings growth would mean five straight quarters of year-over-year earnings growth. And current expectations suggest that trend may continue for several years. See the chart above, which shows actual calendar year earnings and estimates for the S&P 500® Index.



Slide courtesy of FactSet Research Systems – Earnings Insight October 6, 2017.

However, just because something is *expected* to happen doesn't mean that it *will* happen. Unexpected weakness in China, geopolitical shocks and policy missteps from global central banks, are among some of the risks to earnings trending as expected. But as we noted earlier, the biggest unknown is how tighter monetary policy from central banks around the world will impact corporations. Expectations are that inflation will remain low, which will allow for a gradual increase in interest rates, but if inflation were to turn more quickly than anticipated interest rates would likely follow. The impact would be negative to corporate earnings.

Equity Market Results

Three major hurricanes, ongoing rhetoric from Washington D.C., and geopolitical turmoil in Asia, among other negative headlines, all failed to derail the equity market rally in the third quarter. As has been the case for much of the year, the equity market favored “what is” as opposed to “what may be,” as investors focused on reported corporate earnings and positive economic data in the U.S. and abroad.

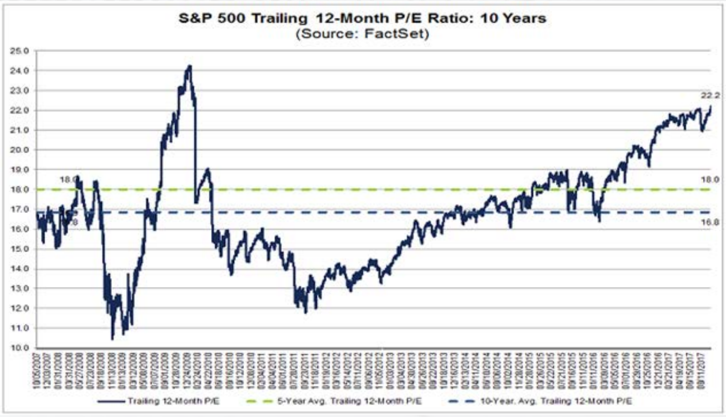
The U.S. equity market returned +4.48%, as represented by the S&P 500® Index, in the third quarter. Similar to last quarter, foreign developed and emerging markets posted larger gains. Developed foreign equity markets gained +5.40%, as represented by the MSCI EAFE® Index, and emerging equity markets increased by +7.89%, as represented by the MSCI Emerging Markets Index. The strength for all groups over the entire three-month period somewhat hid the fact that markets diverged during September as the prospect of an interest rate hike by the Fed in December gained traction. For the month of September, the divergence was most pronounced when examining U.S. equity market results (+2.06%, S&P 500® Index) relative to emerging markets (-0.40%, MSCI Emerging Markets Index).

In U.S. equity markets, third quarter performance leadership pivoted compared to the second quarter as small-capitalization stocks (+5.67%, Russell 2000® Index) outpaced large-capitalization stocks (+4.48%, S&P 500® Index). Somewhat similar to the divergence between U.S. equities and emerging market equities noted above, much of the strength from small-cap stocks came during the month of September (+6.24%, Russell 2000® Index). The short-term enthusiasm for small-cap stocks primarily centered on renewed optimism surrounding corporate tax cuts. At the margin, small-cap companies would be the biggest beneficiaries of a tax cut considering their median tax rate (33% in 2016) exceeds the median tax rate of large-cap companies (29% in 2016). One theme that persisted during the third quarter was demand for growth-oriented companies (+5.90%, Russell 1000® Growth) over value-oriented companies (+3.11%, Russell 1000® Value) as investors placed a relatively higher weight on current and expected earnings growth.

Year-to-date equity results have been impressive. The broad U.S. equity market has gained +14.24% (S&P 500® Index), developed foreign equity markets have returned +19.96% (MSCI EAFE® Index) and emerging equity markets have gained +27.78% (MSCI Emerging Markets Index). Among U.S. equities, growth-oriented stocks (+20.72%, Russell 1000® Growth) have significantly outpaced value-oriented stocks (+7.92%, Russell 1000® Value), and despite short-term small-cap equity strength, large-cap stocks (+14.24%, S&P 500® Index) are ahead of small-cap stocks (+10.94%, Russell 2000® Index).

Equity Market Comments

The S&P 500® Index’s forward P/E ratio (price-to-earnings ratio) finished at approximately 17.8x at quarter-end. 17.8x is roughly the amount that investors are willing to pay for $1 of future earnings. This amount is higher than the five-year average of 15.6x and 10-year average of 14.1x. The trailing 12-month P/E ratio is currently 22.2x, which is well ahead of the five-year average of 18.0x and 10-year average of 16.8x.



Slide courtesy of FactSet Research Systems – Earnings Insight October 6, 2017.

Based solely on price-to-earnings data for the S&P 500® Index, stock prices are expensive relative to history. Does this mean equity prices will decline in the short run? Not necessarily. As we have noted in previous newsletters, we do not believe that valuation *alone* is a catalyst for a market decline. This does not mean that we do not believe valuation matters. To the contrary, most of our investment decisions are based on relative value. We just do not think that market tops and bottoms are predicated *solely* on valuation. Valuation is critical, but any single fundamental factor is too rudimentary. We would point out the same fact to someone preoccupied with just earnings growth. We simply concede that we are not confident in our abilities (or anyone's abilities for that matter) to effectively time the market over short timeframes. And timing the market can be done consciously or by omission – the latter of which is rarely discussed.

As we noted in the opening of this newsletter, being invested when the market corrects can be costly, BUT not being invested as the market surges can be just as damaging. For example, during the bull market that spanned most of the 1990's (lasting roughly 12 years), the last four years produced a total return of more than +150% for the S&P 500® Index. Obviously, we are not saying that the current bull market will last another four years, or that investors should expect those types of returns. What we are trying to reinforce is that the implication of questions such as, "Is now the right time to invest?", "Should I wait for a pullback?", "Should I reduce my equity position?", is all the same. They are all based on the premise of market timing. There will always be negative headlines suggesting now is not the time to invest, or overly optimistic headlines suggesting to wait. But at the risk of sounding repetitive we will repeat our earlier point.

Develop a plan – Stick to it – Adjust due to circumstance, not prediction – Rationally assess results

Client Portfolio Impact

We did not make any major adjustments to the equity portion of portfolios in the third quarter. By and large, we were content to let our short- to intermediate-term overweights (relative to our blended benchmark) that we put in place at the inception of our firm and in the fourth quarter of 2016 continue to play out. These include an emphasis on domestic large-cap growth stocks, foreign small-/mid-cap equities and emerging market equities.

Our decision to overweight large-cap growth stocks has produced good returns on a relative and absolute basis. However, based on the magnitude of outperformance of growth stocks over value stocks this year (+20.72% vs. +7.92% for the Russell 1000® Growth Index and Russell 1000® Value Index, respectively), and the added strength of the active large-cap growth manager in which we chose to invest, the relative attractiveness of the opportunity has decreased somewhat. We are examining the position more closely and expect the situation to evolve over the next 12 months.

While no trades occurred in the third quarter, we were not sitting on our hands either. Since the end of the third quarter, we executed a trade to increase the amount of emerging markets equity exposure in portfolios at the expense of a portion of our domestic equity exposure. We have had an overweight to emerging market equities since the inception of our firm. We have expressed this view through a direct investment in an active emerging market manager and indirect investments in two developed foreign small-/mid-cap equity managers that have significant latitude to invest in emerging markets. As with most of our investment themes, we take a gradual approach to incorporating these views into portfolios, in part because we like to make sure that expectations are evolving as anticipated. Our Research Focus this quarter will highlight our decision to further increase our overweight to emerging markets in client portfolios.

Fixed Income Market Results

For the third quarter in a row, all major fixed income sectors posted positive returns. However, in a change from previous quarters, below investment grade sectors were not the clear winners. Domestically, many of the below investment grade sectors had returns in line with their investment grade counterparts. For example, in the below investment grade space, high-yield corporate bonds and preferred stocks generated +2.04% and +1.27% gain, respectively. Similarly, in the investment grade space, corporate bonds and municipal bonds were up, +1.27% and +1.06%, respectively. European bonds continued to outperform, increasing +4.36%.

Most credit-related fixed income sectors saw spreads tighten relative to treasuries (yields between two bonds becoming closer together), during the quarter (the only exception was preferred stocks, which widened 15 basis points). There was a brief bout of volatility related to tensions about a North Korean conflict, but as fears subsided, spreads resumed tightening. Investment grade standouts included BBB-rated corporate bonds and government agency pass-through mortgage bonds, which tightened 10 and 8 basis points, respectively. Below investment grade standouts included emerging market corporate credit and European high-yield bonds, which tightened 56 and 33 basis points, respectively.

Fixed Income Market Comments

The escalation of tensions between the U.S. and North Korea certainly had the markets attention during the quarter, but to date, it has not caused a panic. So far, most market participants believe the worst-case scenario is a low probability event. Nevertheless, the impact of a war with North Korea is potentially devastating and deserves close attention. Putting that potentially significant situation aside, there has not been a considerable change to our short-term outlook since last quarter. We continue to believe the U.S. economy is on track to grow 2-3% over the next 6-12 months, absent a shock unrelated to the fundamentals. The U.S. economic backdrop is supported by a robust labor market, tame inflation and easy financial conditions. The closely followed leading economic index suggests economic growth should exceed 2% over this period.

U.S. Interest Rates

Based on our highest probability scenarios, we believe fair value for the 10-year Treasury is 2.35% to 2.85% (see table below). The 10-year Treasury bond ended the quarter at 2.33%, which was slightly below the range, and virtually the same as last quarter when it ended the period at 2.30%. Additional rate hikes by the Fed, less demand from foreign buyers and tapering of reinvestment by the Fed remain the primary drivers of our fair value estimates.

3Q 2017 - 6 Month Scenario Analysis

10-Year Treasury - Fair Value Model		Model Inputs			Model Output
Scenario	*Weight*	*Leading Index YOY*	*Core PCE YOY*	*Effective Fed Funds Rate*	*Fair Value 10-Year Tsy*
Base Case - Status Quo	30%	1.50	1.50	-2.00	**2.72**
Growth Accelerates	25%	1.75	1.60	-2.00	**2.85**
Slow Down	25%	1.00	1.30	-2.30	**2.34**
Upside Surprise	10%	2.20	1.80	-1.75	**3.19**
Recession	10%	-0.50	1.00	-2.65	**1.63**
Weighted Average - Fair Value	*100%*				*2.60*

Yield Curve

Coming into this quarter, we anticipated that the yield curve would to continue to flatten (short- and long-term rates converging), as the market priced in tighter Fed policy. The differential between the 2-year Treasury and 10-year Treasury did just that by flattening 0.07%. Last quarter we noted the flattening between those two maturities was 0.20%. Given the ongoing change, it is now below long-term averages. Those changes are consistent with our long-term view. We remain cautious about an upward, parallel move in the yield curve, or a re-steepening of the yield curve. Both could make all parts of the yield curve vulnerable to losses.

Fixed Income Portfolio Comments

Sector & Quality Management

Despite our relatively constructive view of the U.S. economy over the short-term, we do not think we are being adequately compensated for taking excess credit risk. With few exceptions, credit valuations are historically expensive. Fundamentally, corporate leverage (debt levels compared to equity) metrics have improved recently due to fewer shareholder-friendly activities, but remain near the peak of the last two credit cycles. Despite this, interest and cash flow coverage continue to deteriorate. In addition, we have seen a consistent erosion of underwriting standards, which in the event of a default, would lead to lower recovery values. Adding this all up, reward-to-risk ratios are, in our view, poor. One area we continue to find value is emerging markets debt, as growth and inflation dynamics continue to improve in these markets. Recently, many of these markets have experienced disinflation, which gives their central banks cover to lower interest rates and stimulate growth. Typically, this combination leads to higher asset prices.

Investment Vehicle Selection

As a function of high valuations at the sector level, we see idiosyncratic opportunities as the best way to add value. Sectors that we believe offer the most opportunity are non-agency mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities and revenue-backed municipal bonds. To a lesser extent, there are select opportunities in investment grade corporate bonds. Generally speaking, this means researching high quality active managers with expertise in our areas of interest.

Client Portfolio Impact

Portfolio positioning broadly reflects the defensive view we have carried for several quarters now. We believe we are late cycle and anecdotal evidence of that, such as eroding underwriting standards and complacency in financials markets, continues to mount. In that type of environment, it is our goal to provide downside protection while we wait for better valuations in credit assets that may result from market volatility.

Our fixed income positioning in client portfolios reflects our views.

- Considering fundamentals and technical factors are signaling modestly higher rates, we intend to stay moderately short interest rate risk over the short-to-intermediate term.
- We have started moving client portfolios into strategies that benefit from rising short-term interest rates. We continue to look for opportunities that will benefit from this theme and will implement them as they make sense.
- Corporate bonds remain an area of caution for us and we have maintained our underweight position in client portfolios. Where we do have exposure, we continue to favor high quality bonds over below investment grade securities. Opportunities outside of corporate credit that we believe offer better late cycle diversification and better risk-adjusted value remain a focus. We like emerging market bonds, insurance-linked securities and short-term municipal bonds. To further emphasize this theme, we recently eliminated our use of passive credit ETF's in exchange for a short-term, actively-managed, securitized credit-focused mutual fund.
- We continue to partner with active managers that have expertise in the markets we find attractive. We are also selectively investing in individual securities in the markets we can analyze and trade efficiently. As a result, passive index-based mutual funds and exchange-traded funds are being de-emphasized broadly in client portfolios.

Research Focus

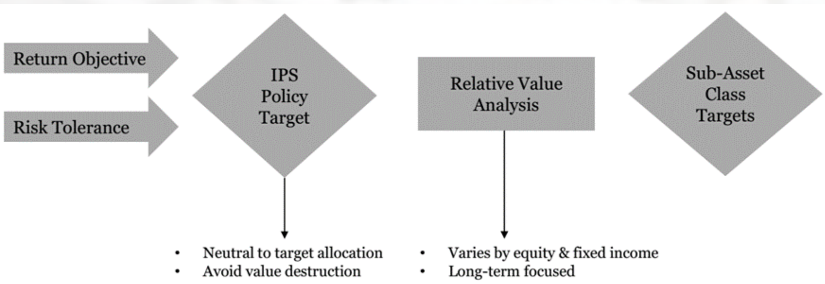
The Anatomy of an Investment Decision – Relative Value.

Last year we put together a ViewPoints called the [Anatomy of an Investment Decision], which discussed our use of active and passive strategies in client portfolios highlighting our Core/Completion philosophy. This quarter we want to take a more detailed look at how our Relative Value Analysis contributes to investment decisions.

As we noted earlier, we have concluded that we should increase the amount of emerging markets exposure we have allocated within client equity allocations. We will discuss the example in greater detail in an upcoming version of ViewPoints after we execute the trade. Please take the time to read it when we publish. Here is an overview of the process and decision.

Relative Value Analysis

Our relative value analysis is a key component of our asset allocation process, which can roughly be summarized by the following graphic.



Our relative value analysis follows a goals discussion, risk and return assumptions and broad investment policy targets, which are formalized in a written investment policy statement (IPS) with each client. The IPS is a written document that we develop to make sure all parties are on the same page about the investment strategy we plan to use prior to investment. We do not vary portfolio weights much from the broad equity and fixed income asset allocation targets we establish in the IPS. Outside of temporary allocation shifts driven by market movements, we view broad asset allocation shifts as market timing. We have always viewed market timing as damaging to a client's long-term investment goals.

However, we do maintain the flexibility to vary underlying "sub-asset class targets" in portfolios based on the outcomes of our research and relative value analysis. Sub-asset classes are asset class groupings within a broad asset allocation target. Within equities, for example, we will consider the relative value of U.S. v. Non-U.S. stocks, Developed v. Emerging Markets stocks, Large-Cap v. Small-Cap stocks or Growth v. Value stocks.

So, what does relative value mean? Simply put, it means comparing the characteristics of a sub-asset class grouping to its own history, to other sub-asset class groupings and to forward expectations to determine if it is attractively valued.

Charles (CJ) Batchelor, CFA
Chief Investment Officer – Equity

Summary

We have concluded that we should increase the amount of emerging markets exposure we have allocated within client equity allocations.

We do not vary portfolio weights much from the broad equity and fixed income asset allocation targets we establish in the IPS.

We do maintain the flexibility to vary underlying "sub-asset class targets" in portfolios based on the outcomes of our research and relative value analysis.

Our relative value analysis is a means comparing the characteristics of a sub-asset class grouping to its own history, to other sub-asset class groupings and to forward expectations to determine if it is attractively valued.

Our opinion on emerging markets is based on a mosaic of economic, currency and growth fundamentals, as well as valuation levels and examination of historical performance cycles.

Some of the underlying characteristics that we examine during the relative value process include valuation (price-to-earnings ratio, price-to-earnings growth ratio, free cash flow yields, etc.), growth (earnings growth, return on equity, etc.), capital flows, economic health (GDP growth, inflation, interest rates, debt levels, etc.) and currency (notably for foreign investments), among others.

Emerging Markets Trade

Broadly speaking, we believe that emerging market equities are relatively more attractive than domestic market equities on an intermediate-term basis (approximately 2-5 years). Our opinion is based on a mosaic of economic, currency and growth fundamentals, as well as valuation levels and an examination of historical performance cycles. Our upcoming ViewPoints will contain a more complete view of our analysis, but here are some highlights.

Fundamentals

1. Based on a variety of valuation metrics, emerging markets (in aggregate) are less expensive than developed markets (in aggregate). Chart 1.
2. There has been renewed strength in emerging markets corporate earnings growth.

Economics

1. Emerging markets GDP growth has accelerated after a period of subdued growth.
2. Emerging markets (in aggregate) have healthier balance sheets than developed markets (in aggregate).
3. During the period of quantitative easing (QE) in developed markets, emerging markets interest rates increased by +200bps, while inflation declined from 5% to 4%.
4. According to data from Ashmore, intra-emerging markets trade is the fastest growing segment of emerging markets trade.
5. It appears that emerging markets currencies have stabilized relative to the U.S. dollar.

Performance

1. Performance of U.S. equity markets and foreign equity markets diverged significantly from 2011-2016 creating the potential to narrow. Chart 2.

Based on fundamentals, economics and recent relative performance, we believe that we are at the beginning stages of a shift in market opportunity from domestic equities to emerging markets equities.

Chart 1

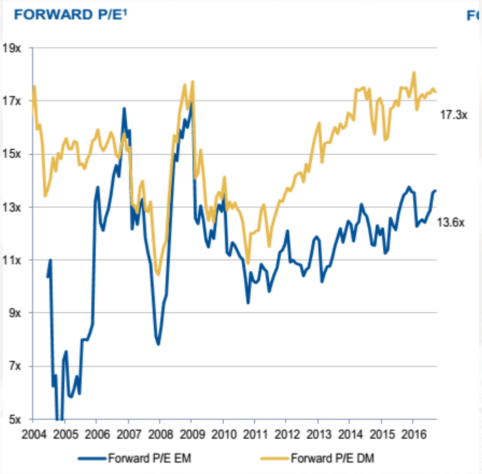
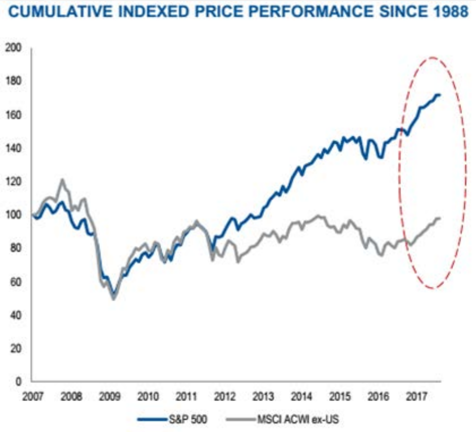


Chart 2



Charts Courtesy of Neuberger Berman – Investment Strategy and Asset Allocation September 2017. Sources: [1]Based on FY1 P/E Estimates. FactSet, Bloomberg, As of 8/31/17.

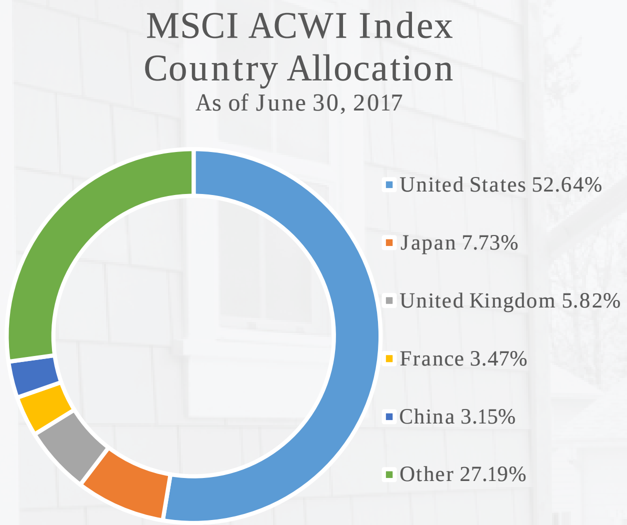
Client Focus

This quarter our Client Focus discusses Home Country Bias.

What is Home Country Bias?

Home Country Bias is the natural tendency for investors to be most attracted to investments in domestic markets. For U.S.-based investors this means having a disproportionately large allocation to investments in the U.S. The general reasons for this tend to be a higher level of familiarity with home markets and an overly pessimistic view of foreign markets.

The MSCI All Country World Index (ACWI) is an example of an equity index that tracks the performance of stocks globally. A quick review of the characteristics of the Index indicates that the U.S. is the largest component of the Index, and it makes up about half of the world's market capitalization.



A recent study put together by the International Monetary Fund (IMF) in it's *Coordinated Portfolio Investment Survey* indicated that U.S. investors allocated over 70% of their equity assets to the U.S. (Other surveys are even higher.) The implication of this is that the average U.S. investor has a 20% overweight to U.S. stocks. This may be a logical conclusion if it is supported by a thorough analysis of the facts, but there are pitfalls to this being a default conclusion in investor portfolios.

What are the pitfalls?

1) Limited opportunity set. Selecting investments should be an exercise in finding the best combination of risk and return potential. Investing based on an arbitrary distinction such as domicile greatly limits the ability of an investor to do that. Consider Apple and Samsung Electronics? Or GM and BMW? Or Proctor & Gamble and Nestle? Or Exxon and BP? Or Wells Fargo and HSBC? The examples are numerous. In each instance, one industry leader is based in the U.S. while the other is based outside the U.S. Limiting the investment opportunity set to one can limit portfolio returns.
2) Reduced diversification. General portfolio theory indicates that blending lowly correlated assets has the potential to reduce volatility and increase return potential. Using the S&P 500® Index as a proxy for U.S. stocks, MSCI EAFE® Index as a proxy for developed market non-U.S. stocks and the MSCI Emerging Markets Index as a proxy for emerging markets stocks, the five-year correlations of U.S. to non-U.S. developed and emerging markets stocks have been 0.77 and 0.58, respectively. This indicates an opportunity for diversification benefits.

Understanding these general facts, our approach in client portfolios is to begin with a review of the sub-asset class weights of a broad global benchmark such as MSCI ACWI and then let our analysis determine if the conclusions are justified, or if we should consider over or underweighting certain sub-asset classes. This work has recently led us to create a portfolio bias to emerging markets stocks.

Our Team

Bob Batchelor, CFA
CEO
Co-Founder

Bob J. Batchelor, CFA is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 19 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee.

Bob currently resides in New Berlin, WI with his wife Christine and their three children – Courtney, Sam and Charlie.

C.J. Batchelor, CFA
CIO – Equity
Co-Founder

Charles J. (C.J.) Batchelor, CFA is Co-Founder and Chief Investment Officer – Equity of Entasis Asset Management. C.J. has 14 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee, where he currently serves on the Board of Directors.

C.J. currently resides in Muskego, WI with his wife Shelly and their two children – Addison and Ethan.

Mike Peters, CFA
CIO – Fixed Income
Co-Founder

Mike Peters, CFA is Co-Founder and Chief Investment Officer – Fixed Income of Entasis Asset Management. Mike has 14 years of experience in the investment industry. Prior to founding Entasis, Mike worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Fixed Income Portfolio Manager. In his role he served as voting member of Cleary Gull's Fixed Income Strategy Group and Complement (Alternative) Strategy Group. Before Cleary Gull, Mike worked for several years at Madison Investment Advisors, a multi-billion dollar asset management firm, as a Fixed Income Analyst.

Mike holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. Mike is a member of the CFA Institute and CFA Society of Milwaukee.

Mike currently resides in Oconomowoc, WI with his wife Kristen and their two children – Evan and Eli.

IMPORTANT INFORMATION

Statements may be forward looking and are not intended as specific investment advice without further review of individual circumstances. Commentary, opinions, analysis, and recommendations may be subjective, do not guarantee future performance, and could change at any time without notice. Under no circumstances does the information contained within represent a recommendation to buy or sell any security. Charts and graphs provided are for illustrative purposes only.

This information is provided for informational purposes only and does not constitute individualized financial advice or create an advisor-client relationship. This newsletter is published for the exclusive use of our clients and friends and is not intended as investment, legal or tax advice. This newsletter was prepared using information from third-party sources, which we believe to be reliable; however, we have not audited the data from these sources and are not responsible for its accuracy.

The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S.

The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries.

Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

To learn more please visit us at
www.EntasisAM.com

CONTACT US
Entasis Asset Management
300 N Corporate Drive
Suite 220
Brookfield, WI 53045
262-794-5299
Info@EntasisAM.com

FOLLOW US

DOWNLOAD OUR APP

Download on the App Store

GET IT ON Google Play