ENTASIS ASSET MANAGEMENT
QUARTERLY NEWSLETTER
2Q2018

As a portfolio management team we had numerous meetings over the course of the second quarter discussing a variety of investment topics, but the general premise was always the same.

Is this transitory or is this secular?

At the core the debate speaks to our investment process in two key ways. First, we are long-term investors. Transitory developments, while disruptive and frustrating, are not lasting. Regular reactions to transitory developments lead to increased transaction costs and momentum chasing. Secular developments can impact portfolio results for years and because they occur infrequently enough, trading costs can be justified. As important, secular change requires a reassessment of our decisions and potentially a change, which speaks to the second relevant point about our investment process.

We are accountable for all of the investment decisions we make in client portfolios. We do not outsource research at Entasis. Therefore, we need to understand the nature of news as transitory or secular because transitory change rarely impacts an investment thesis, so they do not require changes to portfolios. They just require confidence in our research conclusions and patience. Secular change requires a reassessment of our research. We want to be correct every time, but we have been doing this long enough to know we won't be. The hardest decisions to make as an investor are the ones we make when things don't go perfectly. If something isn't working or we were wrong, the decision to endure or move on is hard and requires work, but critical to long-term success.

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 Charles Mark

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 06/30/18)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	14.37	11.93	13.42	10.17
Russell 1000 Index	Mid/Large Cap Stocks	14.54	11.64	13.37	10.20
Russell 1000 Growth Index	Growth Stocks	22.51	14.98	16.36	11.83
Russell 1000 Value Index	Value Stocks	6.77	8.26	10.34	8.49
Russell 2000 Index	Small Cap Stocks	17.57	10.96	12.46	10.60
MSCI EAFE Index	Non-U.S. Developed Market Stocks	6.84	4.90	6.44	2.84
MSCI Emerging Markets Index	Emerging Markets Stocks	8.20	5.60	5.01	2.26
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	10.57	7.94	8.98	5.77
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	1.75	6.01	6.18	5.11
Barclays Municipal Bond Index	U.S. Municipal Bonds	1.56	2.85	3.53	4.43
Barclays Aggregate Bond Index	U.S. Bonds	-0.40	1.72	2.27	3.72
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	-0.58	1.16	1.60	3.08
BofAML U.S. Treasury Master Index	Treasury Bonds	-0.60	1.13	1.65	3.04
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	0.15	1.48	2.25	3.54
BofAML U.S. Corporate Master Index	Corporate Bonds	-0.70	2.95	3.54	5.34
BofAML U.S. High Yield Master II Index	High Yield Bonds	2.54	5.56	5.51	8.08
BofAML Convertible Bonds Index	Convertible Bonds	14.49	9.61	11.76	9.81
BofAML Euro Broad Market Index	European Bonds	3.87	3.77	1.42	1.77
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	-1.58	1.82	-0.83	2.12

Calendar Year % Returns (QTD and YTD as of 06/30/18)

Source: Morningstar Direct

	QTD	YTD	2017	2016	2015	2014	2013
S&P 500 Index	3.43	2.65	21.83	11.96	1.38	13.69	32.39
Russell 1000 Index	3.57	2.85	21.69	12.05	0.92	13.24	33.11
Russell 1000 Growth Index	5.76	7.25	30.21	7.08	5.67	13.05	33.48
Russell 1000 Value Index	1.18	-1.69	13.66	17.34	-3.83	13.45	32.53
Russell 2000 Index	7.75	7.66	14.65	21.31	-4.41	4.89	38.82
MSCI EAFE Index	-1.24	-2.75	25.03	1.00	-0.81	-4.90	22.78
MSCI Emerging Markets Index	-7.96	-6.66	37.28	11.19	-14.92	-2.19	-2.60
MSCI ACWI Ex USA Small Cap Index	-2.60	-2.94	31.65	3.91	2.60	-4.03	19.73
BofAML Preferred Stock Fixed Rate Index	1.05	0.04	10.58	2.32	7.58	15.44	-3.65
Barclays Municipal Bond Index	0.87	-0.25	5.45	0.25	3.30	9.05	-2.55
Barclays Aggregate Bond Index	-0.16	-1.62	3.54	2.65	0.55	5.97	-2.02
Barclays Intermediate U.S. Gov/Credit Index	0.01	-0.97	2.14	2.08	1.07	3.13	-0.86
BofAML U.S. Treasury Master Index	0.11	-1.10	2.43	1.14	0.83	6.02	-3.35
BofAML U.S. Mortgage Backed Securities Index	0.31	-0.90	2.45	1.67	1.46	6.07	-1.39
BofAML U.S. Corporate Master Index	-0.94	-3.12	6.48	5.96	-0.63	7.51	-1.46
BofAML U.S. High Yield Master II Index	1.00	0.08	7.48	17.49	-4.61	2.51	7.41
BofAML Convertible Bonds Index	3.93	7.29	16.03	11.94	-1.15	9.97	26.60
BofAML Euro Broad Market Index	-5.52	-2.54	14.61	0.37	-9.30	-2.48	6.89
BofAML Local Debt Market Plus Index	-9.14	-5.66	14.71	6.53	-12.02	-4.50	-5.75

How should you use the information provided in the table?

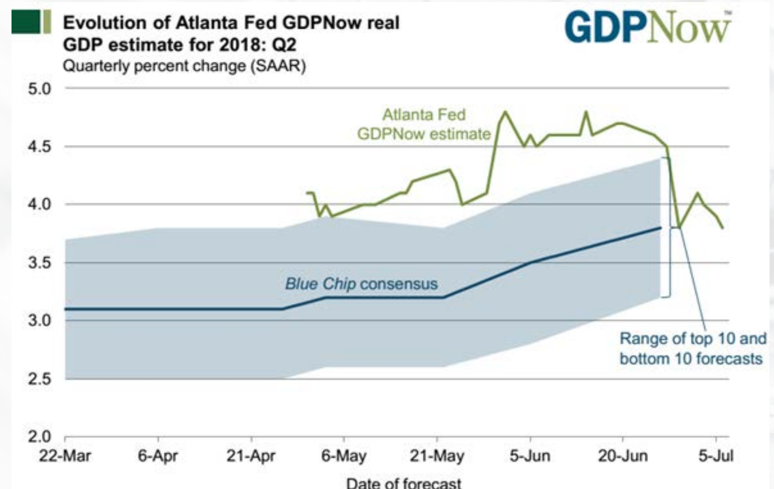
- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Global Market Drivers

Last year good news and positive returns could be found just about everywhere – equities or fixed income, U.S. or non-U.S., it didn't matter. The script has clearly shifted this year. Positive returns have been available, but returns are very different by asset class, and a number of areas have posted negative results. One of the primary drivers of performance divergences across global markets and sectors was a resurgence in the U.S. dollar relative to many foreign currencies – most notably the euro. Financial markets have also been grappling with how to digest heightened fears of trade wars, weakness in select emerging and frontier markets, political instability in Europe, a historic summit between the leaders of the U.S. and North Korea and strong U.S. corporate earnings growth.

The Economy

After a slowdown in the first quarter, the incoming data suggests the U.S. economy rebounded nicely in the second quarter. The Atlanta Fed GDPNow estimate suggests the economy will grow at 3.8% for the quarter, which would nearly double the 2.2% generated in the prior quarter. Tax cuts seem to be supporting strong consumer spending and retail sales data, but business surveys were generally upbeat as well. The Institute for Supply Management's purchasing managers' indexes (PMIs) for services and manufacturing came in ahead of forecasts, suggesting the economy's strong underlying momentum remained intact. A shrinking trade deficit is also projected to be additive.



While the U.S. has accelerated, other major economies are experiencing slower growth, effectively ending the much talked about synchronized global recovery. Growth in Europe, Japan and China has decelerated. In Japan, weak business investment and a flat consumer led to contraction in the first quarter. Based on recently released numbers, Europe eked out +0.4% growth in the first quarter, down from +0.7% in the fourth quarter. Many economists are blaming unseasonably cold weather, striking workers, short-term bottlenecks and a flu outbreak for the weakness. However, slower output growth in manufacturing, retailing and services would suggest the issues run deeper. In China, growth is expected to decline from +6.9% last year to +6.5% in 2018. The change has largely been attributed to policy makers' attempts to reduce excess leverage and industrial overcapacity. At the same time, other emerging markets such as Argentina, Brazil, Turkey, Indonesia, Philippines and India are being pressured to raise interest rates, which would put pressure on economic growth.

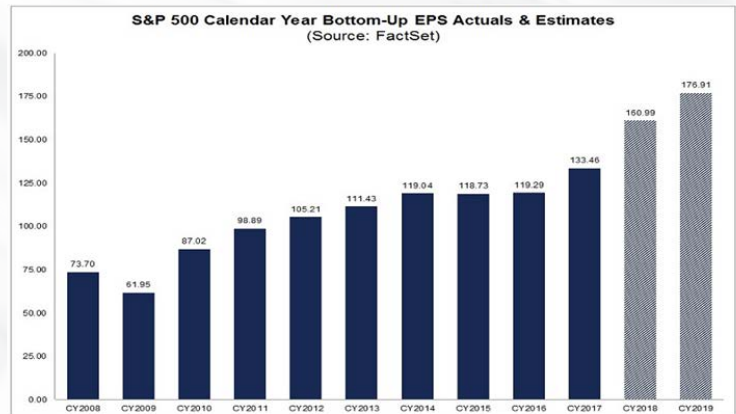
Interest Rates

During the second quarter, short-term interest rates continued to climb, as the U.S. Federal Reserve (Fed) raised the overnight Federal Funds rate by 25 basis points (0.25%) in June to 2.00%. The hike

marked the fourth such increase in the last 12 months and the second under new Fed Chairman Jerome Powell. For the quarter, short- and intermediate-term rates moved up faster than long-term rates, as the yield curve continued its longer term flattening trend (short- and long-term interest rates becoming more similar). In mid-May the 10-year Treasury yield rose to 3.11%, the highest level since 2011, before falling back below 3.00% for the balance of the quarter.

Earnings

Corporate earnings growth (year-over-year) is expected to be +20.0% (S&P 500® Index) for the second quarter. If earnings come in as expected, it would mark the second straight quarter of earnings growth in excess of 20% (1Q18 was +24.8%) and the third straight quarter of double-digit earnings growth. Based on current estimates, earnings growth is expected to continue at a double-digit rate for the remainder of 2018 (3Q18 estimated at +21.7% and 4Q18estimated at +17.9%). The relatively high levels of earnings growth at this point in the business cycle are primarily because of the added boost to earnings from the corporate tax rate cut. The large boost to corporate earnings can be seen in current earnings estimates for calendar year 2018 and calendar year 2019 in the chart below.



Slide courtesy of FactSet Research Systems – Earnings Insight July 6, 2018.

On the surface, increased earnings expectations would appear to be broadly positive for equity market results for the remainder of 2018 into 2019. However, as we have noted in past newsletters, the equity market is a forward-looking mechanism and the rosy outlook for corporate earnings may already be "priced in" to a certain degree at this point. This is especially true if we consider that equity market prices generally follow earnings over time. This was the case in the second quarter as the S&P 500® Index returned +3.4%, while forward 12-month earnings per share estimates increased by +4.4% over the same timeframe. Over short time frames this relationship is not perfect, but we believe it provides some insight into potential risks moving forward. If we are in the latter stages of the economic cycle, and growth is peaking, then current forward-looking estimates may prove to be too optimistic. Said differently, we believe the equity market is currently priced for near perfection. This increases the risk for disappointment and the potential for a decline in prices if earnings disappoint. We have gradually repositioned client portfolios for this possibility and continue to explore opportunities to improve the intermediate-term risk/return profile of portfolios.

Equity Market Results

On a year-to-date basis, the S&P 500® Index has gained +2.65% compared to losses for foreign developed markets of -2.75% (as represented by the MSCI EAFE® Index) and emerging markets of -6.66% (as represented by the MSCI Emerging Markets Index). Within the U.S. equity market, growth stocks have generated a return of +7.25% (as represented by the Russell 1000® Growth Index) and value stocks have returned -1.69% (as represented by the Russell 1000® Value Index).

Within the broad U.S. market (as represented by the S&P 500® Index), the best performers have generally been companies with certain characteristics.

1) high estimated 3-5-year earnings growth
2) high price-to-earnings ratios
3) low quality (i.e. high debt)
4) low (or no) dividend yield

Individual stock performance leadership has also been fairly narrow with the primary contributors to overall S&P 500® performance coming from a very small group of companies. In fact, the top 10 contributors to index performance account for more than the <u>entire</u> S&P 500® year-to-date return (see table below). These market dynamics are typically not sustainable over long periods.

Exhibit 3: 10 stocks have contributed more than 100% of S&P 500's YTD return
as of June 28, 2018

Ticker	Company	Cons. 2019E sales growth	Total return	Mkt cap weight	% of SPX Return
AMZN	Amazon.com Inc.	23 %	45 %	2.1 %	**36 %**
MSFT	Microsoft Corp.	10	16	2.9	**18**
AAPL	Apple Inc.	4	10	3.8	**15**
NFLX	Netflix Inc.	24	106	0.4	**15**
FB	Facebook Inc.	27	11	1.9	**8**
GOOGL	Alphabet Inc.	18	7	2.8	**7**
MA	Mastercard Inc.	12	31	0.6	**7**
V	Visa Inc.	11	17	0.9	**6**
ADBE	Adobe Systems Inc.	19	37	0.4	**5**
NVDA	NVIDIA Corp.	14	25	0.5	**5**
Top 10 contributors		**16 %**	**20 %**	**16 %**	**122 %**
S&P 500		**5**	**3**	**100**	**100**

Source: FactSet, Goldman Sachs Global Investment Research

As we noted earlier, a resurgence in the U.S. dollar relative to most currencies, has had a significant impact on the divergence in returns across global equity markets in recent months.

In the U.S., the Federal Reserve continued a path of gradual interest rate increases, while in Europe the European Central Bank (ECB) pulled back on the trajectory of their rate increases in the face of relatively weaker economic data. The result was a partial retracement of the strengthening the euro had achieved relative to the U.S. dollar in 2017. Those underlying currency dynamics were apparent in broad equity market performance as the S&P 500® gained +3.43%, while the MSCI EAFE® Index (developed foreign markets) registered a loss of -1.24%.

Outside of developed markets, politically and financially fragile emerging and frontier market countries such as Turkey, Brazil and Argentina faced a confluence of bad news during the quarter. High debt levels, rising inflation and uncertainty around how the countries would respond to these issues (largely because of volatile political leadership) resulted in large losses in equity markets and the underlying value of their currencies. The turmoil caused some investors to fear that weakness from these fragile countries would spread to other healthier emerging and frontier market countries.

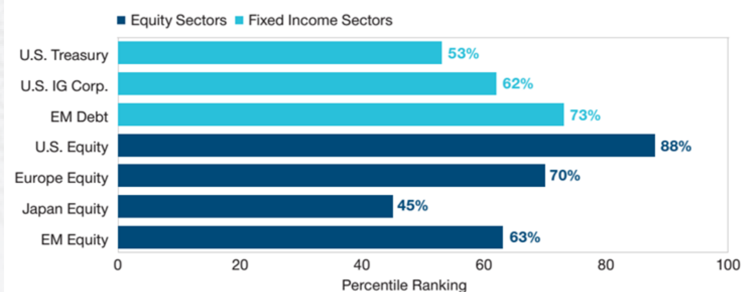
Equity Portfolio Comments

Protectionism was also front and center for much of the quarter as the U.S. looked to renegotiate existing trade agreements with European countries, as well as with North American allies Canada and Mexico (North American Free Trade Agreement, otherwise known as "NAFTA"), which the current administration believed were unfair to U.S. companies. The U.S. also enacted its first round of tariffs against China, who responded in kind with tariffs against the U.S. Escalating threats of additional tariffs caused heightened angst among investors as the prospect of a full-blown trade war increased. The combination of the prospect of further tension between the U.S. and China regarding trade and the aforementioned market fragility elsewhere, led much of the short-term "hot" money that chased strong emerging markets performance in 2017 to abruptly change course and flow back out. Currency (relative to the U.S. dollar) and equity market weakness resulted in a second quarter loss of -7.96% for the MSCI Emerging Markets Index.

The strength of the U.S. dollar and instability around foreign trade also played a major role in U.S. equity market dynamics for the quarter. This was most apparent in the performance of U.S. small-caps, which posted a return of +7.75% (as represented by the Russell 2000® Index). The main reason that investors favored small-caps is because these types of companies tend to be relatively insulated from the potential adverse effects of a strong U.S. dollar and trade wars. In general, the belief is that these companies have less reliance on foreign trade and revenues tend to be primarily denominated in U.S. dollars (i.e. reduced currency translation risk). From a style perspective, U.S. growth stocks were buoyed by strong earnings reports from a number of large technology-related companies and a continuation of investor preference for momentum stocks. This led growth stocks to a gain of +5.76% (as represented by the Russell 1000® Growth Index) while value stocks returned +1.18% (as represented by the Russell 1000® Value Index).

Equity Market Comments

Every quarter one of the key market metrics we look at is valuation levels. How much are investors willing to pay for $1 of future earnings? In the second quarter, the S&P 500® Index's forward P/E ratio (price-to-earnings ratio) contracted slightly to approximately 16.2x. This amount is the same as the five-year average of 16.2x and above the 10-year average of 14.4x. However, this quarter we also came across the chart below, which takes a different perspective on valuation levels for select fixed income and equity markets. Rather than simply look at absolute valuation levels, the chart displays percentile rankings. The percentages shown to the right of each bar reflect where current valuations lie in relation to a 15-year average. Lower percentile rankings reflect valuations that are low relative to history while higher percentile rankings reflect valuations that are high relative to their 15-year average. Based purely on the data in the chart, U.S. equity valuations are the most "expensive" relative to the 15-year average, while other equity markets (Japan) and regions (Europe and



*Indices used, from top to bottom, Bloomberg Barclays U.S. Investment Grade Corporate, Bloomberg Barclays Emerging Markets USD Aggregate, S&P 500, MSCI Europe, MSCI Japan, MSCI Emerging Markets. U.S. Treasury valuation percentile based on 10-year benchmark government bond yields. U.S. IG Corp. and EM Debt valuation percentiles based on option-adjusted spread of the Bloomberg Barclays U.S. IG Corporate Bond Index and the Bloomberg Barclays EM USD Aggregate Bond Index. U.S., Europe, Japan, and EM equity valuations based on an equal-weighted average of next 12 month price-to-earnings, price-to-book, and price-to-cash-flow ratios for the S&P 500, MSCI Europe, MSCI Japan, and MSCI EM indexes.
Source: FactSet Research Systems Inc. All rights reserved.

Slide courtesy of T. Rowe Price – Midyear Market Outlook – June 2018.

emerging markets) look relatively more attractive, albeit they are not excessively cheap either.

As we have noted ad nauseum in previous commentaries, just because something is expensive does not mean it will decline. However, as we have also noted in the past, elevated valuations may result in faster equity market declines when the market reverses course. We believe that we are entering a period where a catalyst (or catalysts) may emerge that changes equity market leadership. We will never pretend to know what the exact catalyst will be, or the exact time the catalyst will emerge. All we can realistically do is focus our attention on corporate earnings data and economic data as a means to approximate where we are in the business cycle. These views then help to provide guidance for overall portfolio construction when looking out over an intermediate- to long-term investment horizon.

Client Portfolio Impact

Last quarter we spent a significant amount of time on a recent successful trade that was made in client portfolios – the sale of a dedicated large-cap growth investment that had performed very well since it had been purchased. This quarter, we will shift gears to discuss an area of client portfolios that has performed poorly in the short run – emerging market equities. While not nearly as enjoyable to discuss as an investment that registered great results, it is important for us to be transparent with clients about our decisions (and results) and to provide insight into our investment process.

Despite some short-term challenges, we continue to have a constructive outlook for emerging market equities over the intermediate- to long-term. It is our view that the current period of U.S. dollar strength relative to emerging market currencies will prove to be transitory in nature, as opposed to the beginning of a long-term structural trend. We concede that over the short run (6-12 months), the U.S. dollar may continue to climb higher (although we do not believe at its current pace of appreciation). However, over the intermediate-term we believe that improving growth differentials (emerging markets relative to the U.S.), along with much higher fiscal deficits in the U.S., will eventually cause the U.S. dollar to weaken. The potential for a U.S. trade war with China is harder to predict, but we are operating with the belief it will end up being shorter and less severe than many pundits currently believe. Much of our opinion is based on the potential political fallout if leaders of both countries move ahead with drastic measures. The possibility of jeopardizing the pursuit of denuclearization on the Korean peninsula may also prove to be unsavory.

On the positive side of the equation, aggregate growth forecasts for emerging markets remain solid. Furthermore, as noted above, current expectations are that growth differentials between emerging markets and developed markets (including the U.S.) will widen in the coming years. A widening growth spread in favor of emerging markets has historically led to relatively attractive returns for emerging market equities. Finally, long-term secular trends continue to persist in many emerging markets (which are supportive of equity returns), such as high consumer savings rates, productivity growth, infrastructure spending and market reforms.

From a performance perspective, investors should remember that corrections occur frequently in emerging markets. In part this is because many investors still paint all emerging market countries with the same "brush" (incorrectly in our opinion) despite vastly improved economic and business fundamentals over the past two decades. While it is never pleasant to experience, we are comfortable with enduring short-term bouts of weakness because we believe the potential for long-term rewards remain favorable in these markets. We obviously cannot predict when periodic bouts of weakness will emerge, but we can control how we react to these periods by avoiding short-term emotional reactions and instead focusing on a longer-term investment horizon.

Equity Portfolio Comments

Our equity market positioning in domestic markets continues to evolve. As current clients are aware, we reduced and then sold a dedicated large-cap growth manager over the course of the past few quarters. These trades helped to move portfolios from a heavy focus on growth-oriented equities towards a more neutral stance from a style perspective. Looking ahead, we believe that we may have entered (or will be entering) a period where the market begins to favor value-oriented stocks over growth-oriented stocks. Our thinking is that this transition will become more pronounced as we progress through the latter portion of this year and into the beginning of 2019. As a result, we are currently evaluating opportunities to increase value-oriented equities in portfolios. Our expectation is that our outlook will continue to evolve over the course of the third quarter and may result in a notable shift in how the domestic equity portion of portfolios is allocated. If (or when) it does, we will discuss the impetus behind the trade in greater detail at that time.

Fixed Income Portfolio Comments

Fixed Income Market Results

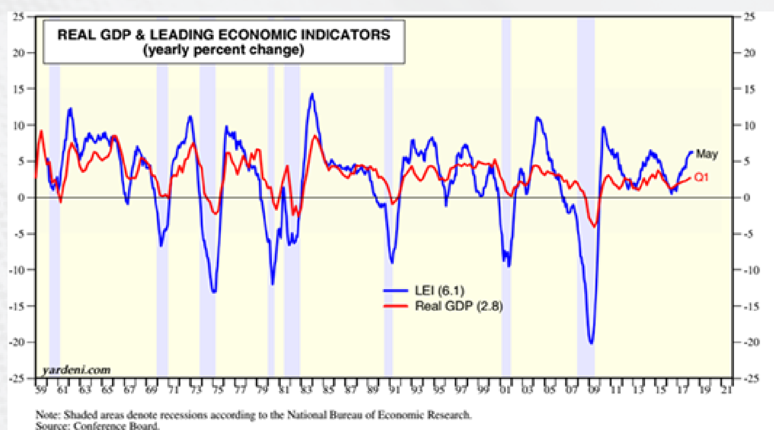
Interest rate volatility and a globally mixed credit picture led to a wide range of returns in fixed income asset classes during the second quarter. Domestically, the lowest quality assets generated the best performance, as convertible bonds, preferred stocks and high yield corporates posted solid gains. Investment grade corporate bonds were the worst performing domestic sector. Similar to equity markets, non-dollar denominated bonds saw a significant reversal, as a strengthening U.S. dollar led to dismal performance. After being up +3.83% in the first quarter, emerging market local currency bonds declined -9.14% in the second quarter. European bonds also performed poorly, declining -5.52%.

Municipal bonds delivered a sold gain of +0.87% for the period. There was also strong investor demand for municipals, as tax-free mutual funds received positive flows in each of the last eight weeks of the quarter. On the supply side, new issue volume was down in the quarter and also when viewed relative to the first six months of 2017. Overall, the supply demand imbalance was key to good results.

Fixed Income Market Comments

After a relatively strong first half of 2018, we believe growth has the potential to underwhelm in the second. We're not expecting a recessionary environment, but a slower pace of growth (less than 3%) seems likely. Despite a solid composite number, some of the underlying components in the leading economic index are showing signs of rolling over. Most notably this includes a flatter yield curve, slower manufacturing new orders and weaker housing construction data. Other components of the leading index are still showing acceleration, but overall the picture is mixed. This suggests growth will likely be lower in the second half of the year.

We continue to have concerns about the intermediate-term growth outlook. Our proprietary U.S. cyclical indicator signaled we have reached peak growth; however, it is not designed to predict the start of a recession. It is simply designed to signal the possibility. Historically, a recession follows within 12-24 months after reaching this point. Yet, considering the slow and shallow economic recovery experienced so far this cycle, it is possible that it extends beyond 24 months.



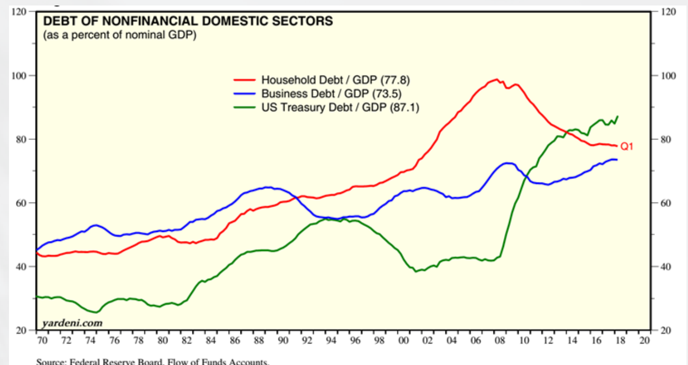
To understand how we use this tool, a good example would be to try to think of our economy as a car. Cars have many moving parts that all need to work together to make it run smoothly. In order to operate well, cars need to be maintained. Think of monetary policy as the maintenance plan. Even with the most meticulously followed maintenance schedule, if we have driven enough miles in our car, it is conceivable something may falter, but we just don't know when or what. It could be the brakes, transmission, tires, the starter, etc. (Excuse our limited car knowledge in the analogy). With our economy it could be the consumer, businesses or government. If we look at each part of the "economic growth engine" individually, we have reason to be optimistic over the short-run, but also concerned over the intermediate-term.

In regards to businesses, they are relatively healthy on the surface. They just received a huge tax cut, which has resulted in record profits, but if we look under the hood, there are potential issues.

First, businesses are carrying a fair amount of debt (see graphic below). That debt can provide leverage for growth in a positive environment, but if interest rates continue to rise, an increase in interest expense naturally follows. Second, in a higher rate environment, businesses will likely see lower demand from consumers. Both factors will eat into profits at the same time.

If we look at the consumer part of the engine, their ability to contribute to the economy hinges on access to money – earned or borrowed. Earnings look healthy as unemployment is low, jobs are plentiful and investment markets are at all-time highs. However, the ability of consumers to borrow is what is of concern. Household debt is actually at relatively healthy historic levels (see graphic below), but as the Fed continues to raise interest rates (which is their stated plan) it gets harder and harder for consumers to borrow, which turns credit growth to credit contraction. Credit contraction drives less purchases and hurts corporate profits. This process leads to slower growth.

The next cog in the engine is the government. After the great recession of 2008, the government was forced to step in to aid the economy. It introduced a large stimulus package, along with other spending, while at the same time it saw lower tax receipts. This dynamic caused a large budget deficit, which took years to lower, but never reached a point that lowered the debt-to-GDP ratio. The new tax cuts are generating meaningful new growth, but are not projected to increase growth to a point that will lower the deficit or debt-to-GDP ratio (see graphic to the right).



Source: HSBC, Markit, Havener Analytics, Yardeni

Reviewing those facts, it is clear that each component of our "economic growth engine" is showing signs of high mileage. Therefore, we continue to hold a cautious view for the intermediate-term.

U.S. Interest Rates

Based on the probabilities we have assigned to likely economic scenarios, we believe fair value for the 10-year U.S. Treasury bond is between 3.00%-3.50%. It ended 2Q18 at 2.85%, but traded at the bottom end of the fair value range for much of the second quarter. The minutes from the most recent Fed meeting indicated it expects to increase the short-term rate two more times in 2018. It is also expected the Fed will continue to let its balance sheet shrink at a moderate pace over the remainder of the year. Taking all of this into consideration, we believe it is likely interest rates will continue to rise over the short-to-intermediate term.

Yield Curve

Considering our fair value estimate for the 10-year Treasury is approximately 3.25%, and we expect the Fed to raise rates by 50 basis points (0.50%) over the next six months, we expect the yield curve to continue flattening (short-term interest rates rising more than long-term interest rates) modestly.

Sector & Quality Management

We have held a cautious view on corporate bonds for the last several quarters. By substantially avoiding them, it has benefitted client performance. Investment grade corporate bonds have underperformed considerably in the first half of 2018. The underperformance has not materially shifted our stance. We continue to believe we are not being adequately compensated for taking excess

credit risk, particularly in below investment grade corporate bonds. Last quarter, we stated that we continued to like emerging market bonds, but they had become less attractive due to significant outperformance relative to domestic securities. However, the asset class broadly underperformed in the second quarter. Therefore, the recent underperformance has once again created pockets of value that are attractive from an active management perspective. We continue to have a significant amount of capital allocated to securitized assets, which have broadly outperformed in 2018. Despite this, we still believe there are opportunities to add value, particularly in non-agency mortgage-backed securities and asset-backed securities. Due to its attractive yields and defensive nature, we believe infrastructure debt is a high-quality late-cycle diversification option.

As the municipal market advances into the second half of 2018, investment grade credit fundamentals are stable and there appear to be few obvious catalysts to spur near-term deterioration. However, caution is still warranted given our concerns about the intermediate-term economic outlook, and the potential that tax reform creates structural challenges that make pockets of the municipal market less resilient to recession.

Investment Vehicle Selection

As a function of high valuations at the sector level, we continue to see idiosyncratic opportunities as the best way to add value by investing in active managers with experience in the sectors we like. 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. We are also finding value in the illiquidity premiums offered in insurance-linked securities and infrastructure debt.

Client Portfolio Impact

Portfolio positioning continues to broadly reflect a defensive view.

- We continue to position client fixed income portfolios with less interest rate exposure than their benchmarks. At the beginning of the first quarter, we increased our defensive posture in client portfolios by reducing interest rate exposure from approximately 85% to 75% of their respective benchmarks. From a year-to-date perspective, the positioning has benefitted results, as it has better protected client capital from rising interest rates. We are also focused on specific opportunities that may benefit from rising short-term interest rates.
- We remain underweight corporate credit in client portfolios. We like opportunities outside of corporate credit that we believe offer better late-cycle diversification and better risk-adjusted value. Broadly, we like emerging market bonds, securitized assets, insurance-linked securities and infrastructure debt. As a result, we reduced our exposure to high-yield municipal bonds at the beginning of 2018 and are maintaining our bias to higher quality.
- We favor active managers that have expertise in markets we are finding value. We are also selectively investing in individual securities in markets we can analyze and trade efficiently. As a result, we continue to de-emphasize the use of passive index-based mutual funds and exchange-traded funds. We believe the best way to take advantage of the illiquidity premiums offered in the insurance-linked and infrastructure markets is through the use of interval funds.

Research Focus

Performance Swings.

"Sell Mortimer Sell!"

For those not familiar with the above reference, this quote was shouted towards the conclusion of the 1983 movie *Trading Places* starring Dan Akroyd and Eddie Murphy. The phrase is screamed by Randolph Duke to his brother Mortimer Duke as the price of frozen concentrated orange juice plummets after an unfavorable crop report (table background on the next page). The Duke brothers attempted to "corner the market" by purchasing frozen concentrated orange juice contracts in advance of the crop report (with the expectation that the price would rise significantly), but instead they suffered massive losses as the price of those contracts fell. While the specific plot line isn't particularly relevant to this quarter's research focus, the panic in the voice of Randolph Duke and the emotional reaction of other traders on the floor of the commodity exchange is relevant.

Most individuals like to paint themselves as long-term investors. Maintaining this mindset when times are good is not particularly challenging, but when prices reverse course, many investors have a difficult time not getting preoccupied with the short-term. Why does this happen? People, and investors more specifically, do not like to suffer losses. Psychologists Amos Tversky and Daniel Kahneman first sought to explain why individuals make irrational economic choices in their paper, *Prospect Theory: An Analysis of Decision Under Risk*. In one study, the pair found that individuals feel a loss about 2.25 times more severely than they experience an equivalent gain ("loss aversion"). Without going too far into the weeds of behavioral economics, the gist of it is that most individuals are hard-wired to avoid losses because losses result in a disproportionate amount of mental anguish. In effect, many people would rather not lose, than win. So, when investment losses begin to mount, people sell. And they often sell indiscriminately. Out of sight, out of mind.

This brings us to the main impetus behind this quarter's research focus – emerging market equity performance. Emerging market equities delivered excellent returns to investors in 2017. As expected, some investors succumbed to recency bias (what happened in the recent past will continue in the future) by chasing performance and pouring money into emerging market equities in January of this year. Unfortunately for those investors, January turned out to be the short-term top in emerging market equity performance. Since that time, emerging market equity performance has been weak, and has culminated in an overall loss of -6.66% (MSCI Emerging Markets Index) year-to-date. Not surprisingly, investors then yielded to another behavioral bias (loss aversion) and began to sell emerging market equities during the second quarter (June was the largest monthly outflow so far in 2018.). See estimated monthly flows from emerging market equity ETFs in the chart below.

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

Summary

Individuals feel a loss about 2.25 times more severely than they experience an equivalent gain ("loss aversion"). In effect, many people would rather not lose, than win.

Emerging market equities delivered excellent returns to investors in 2017. In January, investors poured money into emerging markets equities. (Recency bias.)

January turned out to be the short-term top in emerging market performance. In June investors began to sell emerging market equities. (Loss aversion.)

Volatility in emerging markets is not a new phenomenon. Emerging market equity corrections have occurred frequently over the past 30 years.

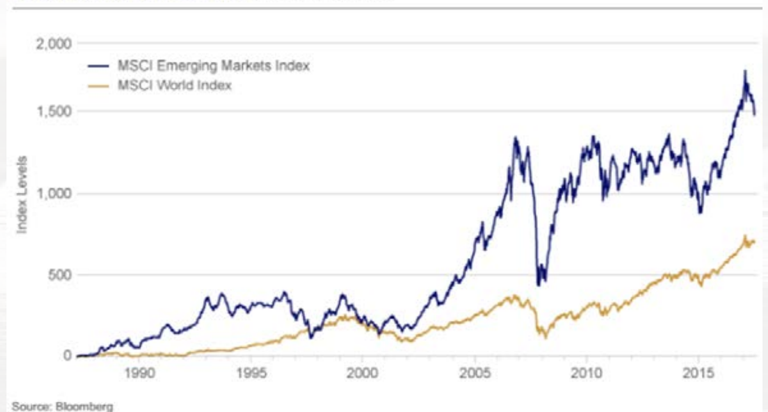
We believe the long-term investment case for emerging market equities remains quite bright, especially for investors that can avoid damaging short-term behavioral biases and maintain a long-term focus.

Research Focus

More than likely, many of the same investors that purchased emerging market equities in January were also investors that sold in June. These investors compounded one bad decision (chasing short-term performance – recency bias), by making another bad decision (selling – loss aversion). These investors effectively made temporary losses (in our opinion), permanent losses by selling.

We have not sold. However, that does not mean that we have been sitting idly at our desks, oblivious to what is occurring either. We have had numerous lengthy discussions about the factors that are driving market performance, such as the potential impact of sustained U.S. dollar strength, the likelihood of a full-blown trade war between the U.S. and China, financial and political turmoil in countries such as Brazil and Turkey and whether or not our original long-term investment case has been altered by any of it.

Source Data: Morningstar Direct



The outcome from those meetings, our own internal research and further discussions with outside asset managers, is that we believe the long-term case for emerging market equities remains firmly intact, despite a seemingly unending supply of short-term headline risk. We have not sold in our long-term asset allocation strategies, but we are aware that the next 6-12 month timeframe will most likely remain volatile and may continue to test our original investment thesis. While undoubtedly painful (loss aversion), we are also keenly aware that sometimes the best action is inaction. This is particularly true during periods of heightened uncertainty when asset prices tend to be the most volatile.

However, it is important to remember that volatility in emerging markets is not a new phenomenon. Emerging market equity corrections have occurred frequently over the past 30 years. The performance chart above compares the performance of emerging market equities since inception of the MSCI Emerging Markets Index in 1988 to the performance of the MSCI World Index, which is an index composed of 23 developed market countries (including the U.S.).

As can be seen in the chart, there are numerous periods when emerging market equities have posted sharp losses (much more severe than now). These stocks have also rallied strongly over subsequent long-term periods. In fact, over the period shown in the chart, emerging markets generated an annualized return of +10.14% compared to a return of +7.39% for developed markets. Due to the power of compounding returns, this equates to a cumulative return for emerging markets that is nearly double (index levels, left axis in chart) the return of developed markets. While past performance is not indicative of future returns, we believe the long-term investment case for emerging market equities remains quite bright, especially for investors that can avoid damaging short-term behavioral biases and maintain a long-term focus.

Client Focus

This quarter our Client Focus emphasizes the idea that Less is More.

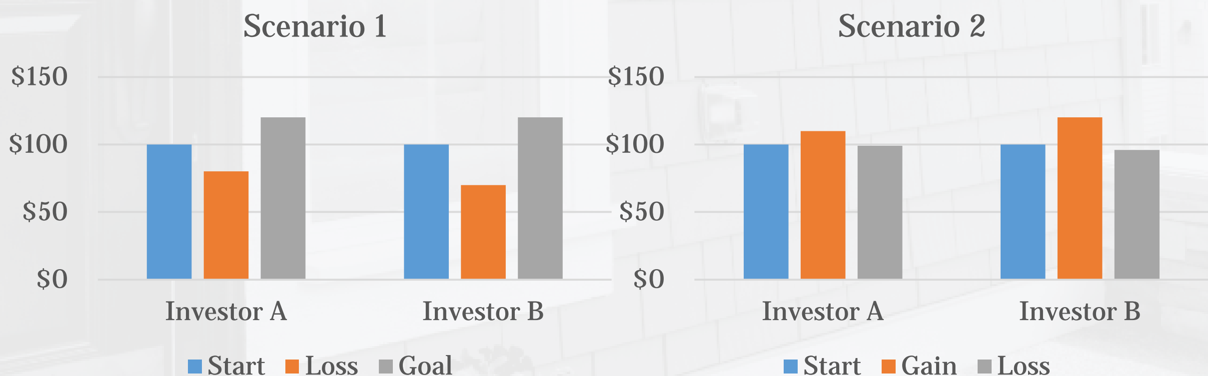
In the worlds of art or architecture, this concept is based on the notion that simplicity and clarity lead to good design. Simplicity is preferred to complexity. Easily one of the best references of this in history (at least in our minds) is the story of the Italian painter and architect Giotto. According to the story, (pardon our summary, we know as much about art as we do about cars) during the middle ages the Pope sent a messenger out to have artists draw a picture to demonstrate their skill. In response, Giotto drew a perfect circle – freehand, which amazed the Pope. Legend or fact, we still love the story.

The concept is also referenced often in communication or writing with brevity being preferred to verbosity. We reference this idea on our website page the Entasis Difference. If you can't explain it simply, you don't know it well enough. (We obviously like the concept.)

In the world of investing, we believe the concept of Less is More relates to the idea that losing Less is More valuable to long-term compounding than gaining more. Consider these scenarios.

In scenario 1 Investor A experiences a 20% loss and Investor B experiences a 30% loss. In order to achieve a goal of earning $120 for every $100 invested Investor A has to follow the loss with a 50% gain to achieve the goal amount while Investor B has to follow the loss with a more than 70% gain to achieve the goal amount. Investor B is clearly in a more difficult position. Less is More.

In scenario 2, Investor A experiences a 10% gain followed by a 10% loss. Investor B experiences a 20% gain followed by a 20% loss. Despite gaining considerably less, Investor A remains ahead of Investor B, by losing less. Less is again More.



So, what does this mean for investors?

Markets cycle. There will be periods of strong positive returns and periods of weakness and negative returns. Over the long-term, we strongly believe that participating strongly in up markets and protecting capital on the downside is a better long-term strategy than being overly focused on beating the market. In our experience, investing strategies that are leveraged to upside strength are inevitably exposed to equivalent downside weakness. And the simple math we have presented above suggests that is an inferior strategy. To be clear, we are not suggesting that investors should attempt to completely avoid losses. It would certainly be nice, but it is not realistic. At its core, loss aversion is a market timing mechanism that permanently impairs capital. What we are pointing out is that losing Less in difficult markets is More valuable than gaining more in positive markets.

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 20 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.

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 15 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.

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 15 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.

David LaCroix
Senior Financial
Advisor

David D. LaCroix is a Senior Financial Advisor at Entasis Asset Management. David has more than 45 years of experience in the investment industry. Prior to joining Entasis, David worked at Cleary Gull Advisors, a Johnson Financial Group Company, and Cleary Gull Inc., a prior affiliate of Cleary Gull Advisors, where he most recently served as Vice President, Relationship Manager responsible for high net worth clients. Before Cleary Gull, David worked in a variety of portfolio management and client relationship management positions with A.G. Edwards and M&I Capital Markets Group.

David received his M.B.A. and B.B.A. in Finance from the University of Wisconsin-Madison. He has served as a member of the Archdiocese of Milwaukee Investment Committee, as a Trustee for the Village of Shorewood and as Director/Treasurer of Milwaukee Summerfest.

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.

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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.

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