ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

3Q2018

The current U.S. equity bull market is now the longest in history. As it has gotten longer it has become increasingly narrow. We will highlight a lot of the details further throughout this newsletter, but the general point is this – the struggles of the broad market are being masked by the success of a few.

Accepting the fact that it is a moving target, at the writing of this newsletter, more than 30% of the stocks in the S&P 500® Index were down -20% or more from their recent highs and more than 70% of Index stocks were off more than -10% from recent highs. One of the hardest things to do when this happens is to avoid looking at the shiny successes of the few and focus on the opportunity that can be found amid the struggles. As acclaimed Oaktree Capital Management investor Howard Marks stated in a recent letter, "assuming you have the requisite capital and nerve, the big and relatively easy money in investing is made when prices are low, pessimism is widespread, and investors are fleeing from risk."

In our view, the quote carries two particularly important references. The first is the idea of opportunity when prices are low. In the current environment the prices of the limited group of stocks doing well are not low. In fact, valuations are particularly high for many of them. The long-term opportunity is mainly found in areas that are struggling. This is generally always true, but particularly evident in the current environment. The second important reference is the idea of having nerve. We think having nerve is only necessary in the absence of discipline. If we can assess the valuation opportunity of investment alternatives with discipline, nerve is replaced with trust in our work. We believe the long-term profits for clients can be meaningful if we follow our approach. This is how we are proceeding today, and will proceed going forward.

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

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Market Performance

Annualized % Returns (As of 09/30/18)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	17.91	17.31	13.95	11.97
Russell 1000 Index	Mid/Large Cap Stocks	17.76	17.07	13.67	12.09
Russell 1000 Growth Index	Growth Stocks	26.30	20.55	16.58	14.31
Russell 1000 Value Index	Value Stocks	9.45	13.55	10.72	9.79
Russell 2000 Index	Small Cap Stocks	15.24	17.12	11.07	11.11
MSCI EAFE Index	Non-U.S. Developed Market Stocks	2.74	9.23	4.42	5.38
MSCI Emerging Markets Index	Emerging Markets Stocks	-0.81	12.36	3.61	5.40
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	1.86	11.24	6.14	8.73
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	0.67	5.47	7.10	9.16
Barclays Municipal Bond Index	U.S. Municipal Bonds	0.35	2.24	3.54	4.75
Barclays Aggregate Bond Index	U.S. Bonds	-1.22	1.31	2.16	3.77
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	-0.96	0.91	1.52	3.22
BofAML U.S. Treasury Master Index	Treasury Bonds	-1.64	0.28	1.52	2.74
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	-0.88	1.00	2.00	3.33
BofAML U.S. Corporate Master Index	Corporate Bonds	-1.10	3.15	3.56	6.27
BofAML U.S. High Yield Master II Index	High Yield Bonds	2.94	8.20	5.55	9.40
BofAML Convertible Bonds Index	Convertible Bonds	13.77	13.79	10.91	11.60
BofAML Euro Broad Market Index	European Bonds	-1.65	2.71	0.16	2.58
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	-5.86	4.75	-0.92	2.43

Calendar Year % Returns (QTD and YTD as of 09/30/18)

Source: Morningstar Direct

	QTD	YTD	2017	2016	2015	2014	2013
S&P 500 Index	7.71	10.56	21.83	11.96	1.38	13.69	32.39
Russell 1000 Index	7.42	10.49	21.69	12.05	0.92	13.24	33.11
Russell 1000 Growth Index	9.17	17.09	30.21	7.08	5.67	13.05	33.48
Russell 1000 Value Index	5.70	3.92	13.66	17.34	-3.83	13.45	32.53
Russell 2000 Index	3.58	11.51	14.65	21.31	-4.41	4.89	38.82
MSCI EAFE Index	1.35	-1.43	25.03	1.00	-0.81	-4.90	22.78
MSCI Emerging Markets Index	-1.09	-7.68	37.28	11.19	-14.92	-2.19	-2.60
MSCI ACWI Ex USA Small Cap Index	-1.51	-4.41	31.65	3.91	2.60	-4.03	19.73
BofAML Preferred Stock Fixed Rate Index	0.19	0.23	10.58	2.32	7.58	15.44	-3.65
Barclays Municipal Bond Index	-0.15	-0.40	5.45	0.25	3.30	9.05	-2.55
Barclays Aggregate Bond Index	0.02	-1.60	3.54	2.65	0.55	5.97	-2.02
Barclays Intermediate U.S. Gov/Credit Index	0.21	-0.76	2.14	2.08	1.07	3.13	-0.86
BofAML U.S. Treasury Master Index	-0.66	-1.75	2.43	1.14	0.83	6.02	-3.35
BofAML U.S. Mortgage Backed Securities Index	-0.12	-1.02	2.45	1.67	1.46	6.07	-1.39
BofAML U.S. Corporate Master Index	0.96	-2.19	6.48	5.96	-0.63	7.51	-1.46
BofAML U.S. High Yield Master II Index	2.44	2.52	7.48	17.49	-4.61	2.51	7.41
BofAML Convertible Bonds Index	4.01	11.59	16.03	11.94	-1.15	9.97	26.60
BofAML Euro Broad Market Index	-1.18	-3.69	14.61	0.37	-9.30	-2.48	6.89
BofAML Local Debt Market Plus Index	-1.09	-6.69	14.71	6.53	-12.02	-4.50	-5.75

How should you use the information provided in the table?

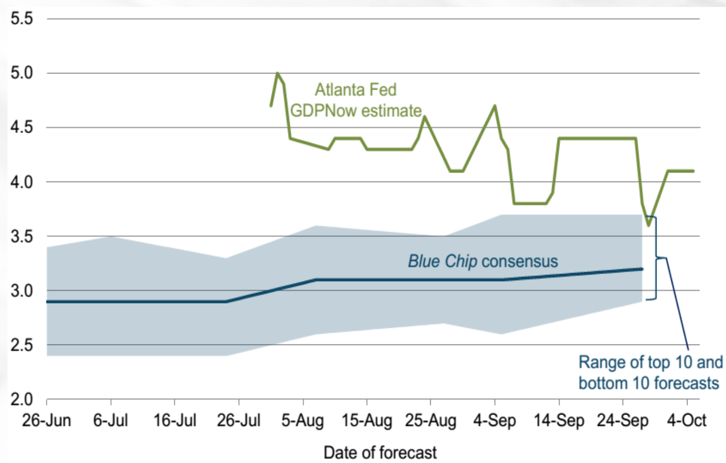
- The returns are not projections. They are historical. Future returns will vary.
- Annualized returns can generally be used to understand historical return trends.
- Calendar returns provide a general understanding of year-by-year return volatility.

Global Market Drivers

The third quarter is historically a fairly "ho-hum" period for the markets as trading volumes tend to decline in July and August before picking back up in September. This doesn't mean markets stop or news flow ceases. In fact, news flow remained rather robust in the third quarter of 2018.

The Economy

Data indicated the U.S. economy was on course to maintain its strong performance. The Atlanta Fed GDPNow estimate suggests the economy will grow at +4.1% (see chart below), which would be the 9th consecutive quarter of accelerating growth. The strength was primarily driven by a strong U.S. consumer on the back of the Tax Cuts and Jobs Act passed in 2017. We are still awaiting most of the September data, but August data was particularly strong. The consumer confidence index hit its highest level since 2000 as retail sales were up +6.6% year-over-year. On the business side, a survey of optimism among U.S. small businesses produced its strongest reading ever and the Institute for Supply Management's Manufacturing Index reached a 14-year high.



Emerging markets pressures that had been building since early in the year reached a new level of intensity in September. Even though Argentina and Turkey are the countries facing the most serious economic problems, many investors sold the entire group on fears of contagion. The main cause of stress in emerging markets has been the rise of the U.S. dollar in response to tightening monetary policy from the U.S. Federal Reserve (the Fed). The pressure on currencies primarily developed due to narrowing growth and interest-rate differentials between the United States and the rest of the world. Widespread uncertainty about trade has also sparked concerns. Although the U.S. did reach an agreement with Mexico and Canada on a revised NAFTA deal, the Trump administration maintained its tough stance on trade with China.

Interest Rates

Interest rates ended the third quarter on a sour note. Short-term interest rates climbed, as the Fed raised the overnight Federal Funds target range by +25 bps (0.25%) to 2.00%-2.25%. The Treasury curve continued to flatten. The 1-month Treasury led the way higher, increasing +44 basis points (0.44%), while 10-year to 30-year maturities increased approximately +20 basis points (0.20%). The widely followed 10-year vs. 2-year spread (difference between rates), also continued to flatten, ending the quarter at just 23 basis points (0.23%). However, the Fed's preferred metric, the 3-month vs. 10-year Treasury spread, ended September at 84 bps (0.84%), still well away from negative territory.

Earnings

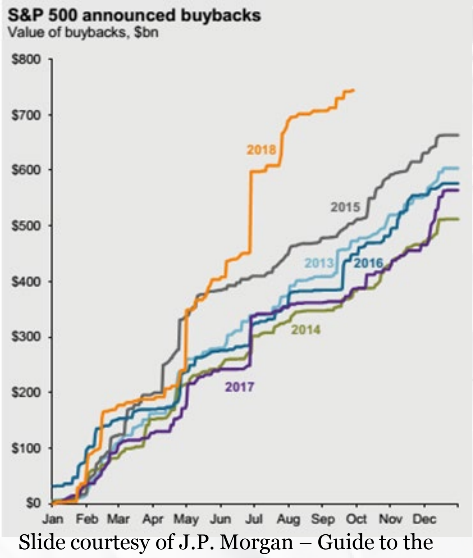
Corporate earnings growth (year-over-year) is expected to be +19.2% (S&P 500® Index) for the third quarter. If earnings come in as expected, it would be the fourth straight quarter of double-digit earnings growth. Based on current estimates, earnings growth for calendar year 2018 is expected to finish at nearly +21%. The surge in earnings growth is primarily because of the significant boost corporations received from the largest stimulus package (corporate tax cuts and government spending increase) the U.S. economy has received outside of a recession since the 1960's. Earnings growth is expected to remain strong in 2019; however, year-over-year growth rates will not be as robust as they have been thus far in 2018.

At first glance, it may appear that a continuation of strong earnings growth would bode well for broader equity market results in 2019. However, because the equity market is a forward-looking mechanism, we believe that much of the expected good news from earnings has already been "priced in" to existing stock prices. While this is not necessarily bad at the surface, especially if future earnings come in better than expected, we believe that downside risks have increased. Most of our concern centers on three factors: corporate operating margins, top-line (revenue) growth and inflated earnings per share data. Corporate operating margins are currently near record highs. We do not believe this level of margins is sustainable for a variety of reasons, but primarily because data has shown that wage growth has finally started to increase, driven by record low unemployment levels and weak productivity growth. One of the ways to compensate for a decline in margins is by increasing earnings through stronger top-line revenue growth. However, we believe this will become increasingly difficult for corporations (particularly global/multi-national companies) because global growth has begun to slow while the U.S. dollar has continued to strengthen (revenues earned in foreign currencies will be worth less when translated back to U.S. dollars).

Another possibility for corporations to grow earnings per share (EPS) at the same time margins are declining and revenue growth is slowing is through financial engineering. For instance, if the "E" (earnings) is stagnant or declining in the numerator of the ratio, then corporations could modify the "PS" (per share) in the denominator of the ratio by decreasing the number of shares outstanding. This tactic has been seen throughout the market recovery but has accelerated this year (see chart below on announced share buybacks in the S&P 500® Index).

Unfortunately, many corporations have not just been using profits to repurchase their shares, but have actually been financing share repurchases through an increase in debt. To this point in the cycle, this has not necessarily been the worst course of action for some corporations considering historically low interest rates. However, this strategy can only be pursued for so long, especially with rising interest rates (increased interest expense). Furthermore, companies using debt to finance stock repurchases following the longest bull market in history is not necessarily a strategy we believe many shareholders should be thrilled about.

Considering where we are currently at in the economic cycle, in tandem with the previously discussed risk factors, we believe that downside risks now outweigh the potential for surprises to the upside. As such, we have gradually repositioned client portfolios for this possibility, and continue to explore opportunities to improve the intermediate-term risk/return profile of portfolios.



Slide courtesy of J.P. Morgan – Guide to the Markets (4Q 2018).

Equity Market Results

Third quarter performance was largely characterized by a wide divergence in results across global equity markets, regions, styles and sectors. Strong corporate earnings growth and near record high corporate operating margins, along with a backdrop of U.S. GDP growth that has accelerated for nine straight quarters, led to outsized gains for the U.S. equity market. Outside of the U.S., equity market results were not nearly as robust as investors grappled with the possibility of contagion emanating from economic instability in Turkey and Argentina, a strengthening U.S. dollar, escalating trade tensions between the U.S. and China and declining global growth expectations. As a result, domestic equities (+7.71% as represented by the S&P 500® Index) outperformed developed foreign (+1.35% as represented by the MSCI EAFE® Index) and emerging markets equities (-1.09% as represented by the MSCI Emerging Markets Index) by a significant margin.

Within the U.S. equity market, growth-oriented equities registered another strong quarter of returns (+9.17% as represented by the Russell 1000® Growth Index), driven by a relatively small basket of large- and mega-cap technology-focused stocks. On the other end of the style spectrum, value-oriented stocks posted solid absolute returns (+5.70% as represented by the Russell 1000® Value Index), but lagged their growth brethren. The growth-oriented technology, consumer discretionary and health care sectors led the charge from a sector perspective, while value-oriented sectors and industries such as energy, materials and banks finished with minimal (or negative) returns.

Special Section – Divergent Results

On a year-to-date basis, the S&P 500® Index (U.S. stocks) has gained +10.56% compared to losses of -1.43% for foreign developed markets (as represented by the MSCI EAFE® Index) and emerging markets of -7.68% (as represented by the MSCI Emerging Markets Index).

Taking a closer look at the U.S. equity market, year-to-date performance has varied widely from a style and sector perspective and has also been narrow from an individual stock perspective. Among equity styles, growth stocks have generated a return of +17.09% (as represented by the Russell 1000® Growth Index), while value stocks have returned only +3.92% (as represented by the Russell 1000® Value Index). Among U.S. equity sectors, the technology sector (S&P 500 GICS) has been the top performer with a gain of +24.98%, while the consumer staples sector (S&P 500 GICS) has been the weakest performer with a negative return of -3.70%. From a contribution standpoint, just 3 out of 11 equity sectors (S&P GICS technology, consumer discretionary and health care) have been responsible for over 85% of the S&P 500® Index's return. Taking it one level deeper, at an individual stock level, over one-third of the contribution to the S&P 500® Index's return in 2018 has come from only three stocks – Amazon.com, Apple and Microsoft.

Narrow and widely divergent market environments are not necessarily rare. However, they do present investors with unique challenges, many of which tend to be behavioral in nature. One of the most common behaviors that surface during these periods is the tendency for investors to question the need for certain asset classes (or sub-asset classes) in their portfolios, particularly asset classes that have underperformed. This type of behavior appears to be surfacing once again, as we have recently heard stories from asset managers that some clients have openly questioned the need to invest in foreign equity markets. Considering the relatively weak returns from foreign equity markets compared to the U.S. equity market recently, we are not surprised. While we have not yet experienced these interactions with our clients, we have been confronted with these types of questions during similar periods in our careers. Some of the more notable examples include: 1) The time leading up to the technology/dot.com bust in 2000, when many people began to believe that "value investing was dead"; 2) The period prior to the commodity bust in the mid-2000's, when individuals proclaimed that "peak oil" would result in permanently higher energy prices; 3) Before the global financial crisis in 2008 when investors believed that investment banks, mortgage companies and homebuilder stocks were an attractive way to invest in a historically resilient housing market; 4) A time in the mid- to late 2000's when many large institutional investment consultants recommended that their clients significantly increase the allocation of foreign securities to 45% or more in equity portfolios (as a percentage of equity) because the "world had changed."

In all instances, investors and consultants extrapolated recent returns (or "cycle" returns of 7+ years) forward in time indefinitely. Add in the fact that it is easy to make an investment case for an asset class that has already performed exceedingly well for an extended timeframe, and you have a recipe for long-term disappointment. Unfortunately, this is what occurred in every one of the examples we just provided. Supposed fact-based opinions (largely built upon recent historical performance) led investors astray from long-held investment principles, such as being properly diversified. The current widely divergent returns in global equity markets and a narrow U.S. equity market, make the topic of diversification particularly relevant right now. We examine this topic in greater detail in the Research Focus section of this newsletter.

Equity Market Comments

As we do 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? The S&P 500® Index's forward P/E ratio (price-to-earnings ratio) expanded slightly to approximately 16.8x in the third quarter. As a reminder, 16.8x is roughly the amount that investors are willing to pay for $1 of future earnings. This is higher than the 10-year average of 14.5x and 25-year average of 16.1x. This quarter we thought we would also share some data about the CAPE ratio, which is an alternate valuation measure for the S&P 500 Index®. "CAPE" is an acronym for cyclically-adjusted price-to-earnings ratio.

S&P 500® 10-year forward annualised returns from different starting CAPE ratios, Q1 1926 – Q2 2017

	Starting CAPE ratio			Real 10-year S&P 500® Ann. Returns			
	Average	Low	High	Average	Worst	Best	Std Dev
	8.6	5.6	9.6	9.8%	4.2%	17.2%	2.2%
	10.3	9.6	11.0	10.6%	3.8%	16.9%	3.4%
	11.5	11.0	12.1	10.0%	2.6%	14.7%	3.4%
	13.0	12.1	13.9	8.7%	0.7%	14.1%	3.7%
	15.0	13.9	16.1	7.8%	-1.6%	15.0%	4.9%
	17.0	16.1	17.8	5.4%	-3.8%	14.6%	5.4%
	18.7	17.8	19.9	5.0%	-4.0%	13.5%	4.2%
	21.0	19.9	22.0	2.7%	-3.3%	8.6%	3.9%
	24.1	22.0	26.4	2.5%	-4.0%	7.3%	3.6%
We are currently here →	33.2	26.4	44.2	0.9%	-6.1%	5.8%	3.4%

Note: This table is a compilation of the ten-year forward real returns of the S&P 500® over every possible rolling decade since 1926 for different starting CAPE ratios and is then separated by deciles.

Slide courtesy of Robert J. Shiller – Are Stocks Too High? A Historical Perspective (2018 Jacobs Levy Center Conference).

The CAPE ratio varies from the most commonly quoted P/E ratios (forward and trailing – calculated by using forward 12-month earnings estimates and past 12-month earnings, respectively) because it is calculated by using a 10-year inflation-adjusted average earnings level in relation to current price. The ratio is meant to provide a better feel for how much investors are paying for "real" (i.e. inflation-adjusted) corporate earnings over an economic cycle (a timeframe that incorporates both rising and falling periods of economic growth) in order to "smooth" out shorter-term variability in earnings. The ratio is a notoriously poor predictor of short-term movements in the equity market (the current CAPE ratio has been higher than its long-term average for many years while the stock market continued to advance). However, it is a much more useful indicator of longer-term return potential for the equity market. As can be seen in the table on the prior page, the current CAPE ratio of 33.2x, highlighted in the purple row, is significantly elevated relative to history, which does not bode well for future returns.

We track a variety of valuation measures, but as we have said many times in the past, valuation levels have minimal predictive abilities in the short-run (or even over intermediate timeframes). Elevated valuations may become even more elevated, or conversely, low valuations may drift even lower. What is typically needed to tip the scales and reverse the course of equity markets is a catalyst. We do not know what specific catalysts will be, or the exact time when those catalysts will emerge. More than likely, it will be a confluence of multiple catalysts as opposed to only one. Nevertheless, where valuations do assist in our analysis is determining longer-term expected returns for markets, and what markets, regions, styles and market-capitalizations may be relatively (when compared to each other and relative to each segment's valuation history) attractive areas to invest capital. It is in these segments where we attempt to capture longer-term expected return potential by emphasizing (overweighting) or de-emphasizing (underweighting) assets in portfolios.

Since we do not have a "magic 8" ball that tells us the exact perfect time to make adjustments in portfolios, we have the distinct possibility of looking very wrong over shorter timeframes (6-18 months). However, by staying true to our relative value process, we believe we have the ability to position client portfolios for longer-term success. We repeatedly stress the "long-term" because it is critically important to remember that the biggest asset for most investors is time. With that in mind, we believe it is paramount to be patient when others are chasing returns and aggressive when others are selling due to short-term pressure.

Client Portfolio Impact

The largest detractor to performance in portfolios during the quarter was emerging markets equities. Considering the divergence in returns between domestic equities and foreign equities so far this year, we wanted to revisit emerging markets equities in greater detail once again this quarter. Emerging markets continued to be weak for a number of reasons including (but not limited to):

1) U.S. Federal Reserve policy has resulted in sustained U.S. dollar strength relative to most emerging markets currencies, which negatively impacts U.S.-based investors in these markets.
2) The possibility of a full-blown, sustained trade war between the U.S. and China spooked investors that are unsure what the overall impact a trade war would have on the global economy.
3) Weakness in financially fragile economies such as Argentina, Turkey and South Africa have led some to worry that this weakness may spread to healthier economies (financial contagion).
4) Skittish investors pulled money out of emerging markets (equities and fixed income), which has resulted in additional downward pressure on prices.
5) Signs have begun to point to the possibility that overall global growth has peaked.

So, what does this mean now? Unfortunately, we cannot say with certainty that things will get better in the short run. In fact, we would not be surprised if emerging markets equity performance continued to be challenged in the short-term. However, we do not believe that the relative performance gap (compared to U.S. equities) will diverge too significantly from here either. Overall, while it may not be a popular view, we maintain a favorable intermediate- to long-term outlook for the asset class because of positive underlying factors, such as:

1) Current emerging markets valuations are relatively attractive across a variety of metrics (Chart 1). Historical relative valuation ratios are also attractive (Chart 2). Chart 2 displays a historical snapshot of relative forward P/E ratios of emerging markets equities compared to developed market equities. Currently, emerging markets equities are priced at a discount of nearly 30%, which is greater than the historical average of roughly a 22% discount.

2) Unlike prior historical periods of emerging markets weakness, there has not been a collapse in forward earnings expectations. Earnings for emerging market equities grew at a double-digit clip in 2017 and remain strong on a go-forward basis. 2019 estimated earnings growth is expected to be 11.50% for the MSCI Emerging Index compared to 10.50% for the S&P 500® Index, while estimated 3-5 year earnings growth is projected to be 14.05% and 13.24% for each Index, respectively.

3) Emerging markets growth is supported by long-term secular trends such as high consumer savings rates, productivity growth, infrastructure spending and market reforms, to name a few. In addition, emerging markets economic growth (in aggregate) is expected to continue to exceed growth in developed markets. See Chart 3.

4) As noted earlier, the U.S. Federal Reserve continues to increase interest rates, which has resulted in U.S. dollar strength relative to emerging markets currencies. While the U.S. dollar may strengthen during future periods of global market stress, we do not believe it is a sustainable trend over the intermediate- to long-term. It is also important to note that in the recent past, the U.S. dollar has peaked relative to emerging markets currencies at roughly the same time emerging markets currency volatility has peaked (2002, 2009, 2018?). See Charts 4 and 5 at the top of the next page.

Chart 1

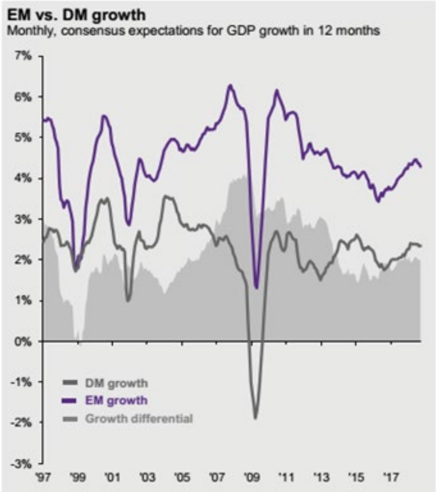
Index Comparison

	S&P 500	MSCI EM
Price to Book	3.42	1.68
Price to Cash Flow	13.5	8.34
Price to Sales	2.24	1.26

Data Source: FactSet as of 8/31/18
Data Courtesy of: Eaton Vance - Monthly Market Monitor September 2018

Chart 2

Chart 3



Slide courtesy of J.P. Morgan – Guide to the Markets (4Q 2018).

Chart 4

Slide courtesy of Neuberger Berman – Investment Strategy and Asset Allocation (September 2018).

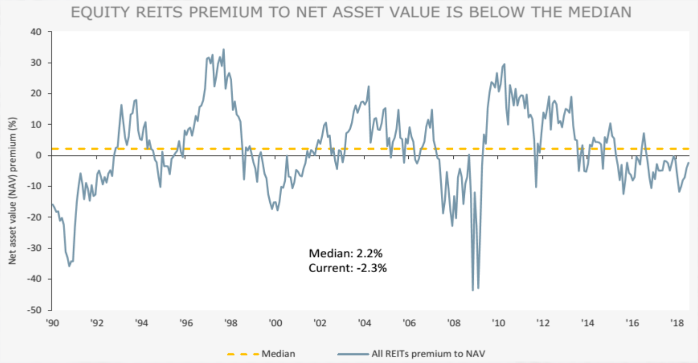
Chart 5

Slide courtesy of Ashmore – Weekly Investor Research (August 28 2018).

5) The underlying fundamentals for emerging markets remain strong (in aggregate). Global trade has not deteriorated, commodity prices have not collapsed, and inflation has not spiked, all of which have been harbingers to previous sustained market sell-offs or market collapses.

Overall, we are disappointed in the recent performance of emerging markets equities. However, we are cognizant that emerging markets equities are a volatile asset class and have endured many bouts of short-term weakness in the past. We would obviously prefer that all investments registered consistent gains, but since this is not possible, we need to continually balance short-term concerns (and losses) with longer-term opportunity.

In domestic equity markets, we moved portfolios away from a heavy focus on growth-oriented equities towards a more neutral stance from a style perspective in the second quarter. This was due in part to concerns surrounding valuation levels of growth-oriented equities, but also because of our expectation that U.S. growth may not end up being as robust in the coming quarters as many investors currently anticipate. We still maintain this view, which is one of the reasons we have continued to look for relatively attractive opportunities in value-oriented segments of the market. One of the areas that has caught our attention is real estate. As relative value investors, real estate has been on our radar screen for a while because of relatively weak short- to intermediate-term performance and relatively attractive valuations (see chart below). However, we do not make investments in out-of-favor segments of the market simply to be contrarian. Seeing relative value in a sub-asset class is important, but we also need to see positive underlying dynamics that may assist in unlocking perceived value.



Slide courtesy of Wells Fargo Investment Institute – Market Charts (October 2018).

With this in mind, two of the more positive underlying factors that are currently present in the real estate market include the possibility that wage growth may lead to consumption growth for consumers, and that interest rates may be nearing a short-term peak. In addition, yield-oriented sectors (notably REITs), have proven to be resilient during periods of equity market weakness. This is particularly true during times when economic growth (GDP growth) is decelerating. Overall, we believe that an allocation to REITs may provide relatively attractive downside protection in the event of market weakness and may also improve the overall level of diversification in client portfolios. We will keep you posted on our research.

Fixed Income Market Results

With interest rates broadly higher and a mixed bag on the credit side, returns varied widely across the fixed income landscape. Domestically, U.S. Treasury bonds were the worst performing sector. For the quarter, they were down more than -0.50% as a result of rising interest rates. Conversely, investment grade and high-yield corporate bonds generated the best performance. Non-dollar denominated bonds continued to underperform, as a strengthening dollar led to negative performance. Non-dollar developed and emerging markets bonds were down over -1.00%.

Last quarter, moves in the municipal market largely mimicked the U.S. Treasury market. Municipal yields rose by roughly 20 basis points (1 basis point = 0.01%) across maturities of three years and longer. Short-term yields (1-year to 2-year maturities) rose by approximately 30 basis points, flattening the curve. Higher yields across the municipal curve pushed total returns into negative territory across all maturities. The higher durations (most price sensitive to interest rate changes) of the longest maturities made that group the worst of the pack. Short maturities held up the best for the quarter and remained the only maturity sub-set to have positive returns year-to-date. On the municipal credit side, lower rated bonds continued to outperform high quality bonds.

Fixed Income Market Comments

After a relatively strong first three quarters of 2018, we believe economic growth has the potential to underwhelm heading into 2019. We are not expecting a recessionary environment, but a slower pace of growth seems likely. Our view reflects the ongoing tightening (rising interest rates) of monetary policy by the Fed, a stronger U.S. dollar, a less favorable trade environment and less support from fiscal stimulus. Short-term leading indicators (6-12 months) continue to suggest economic growth should come in close to long-term potential (2.0%-2.5%). We continue to have concerns about the intermediate term (12-36 months) growth outlook. The same factors that are expected to slow growth into 2019 have the potential to take us into a recession over the intermediate-term if they continue at the recent pace and magnitude. There are scenarios in which they don’t, but they depend heavily on how aggressive the Fed is and how well the U.S. gets along with its trading partners. As we think about positioning portfolios over this period, we will be watching these factors very closely.

Credit spreads (the difference in yield between a bond and a similar maturity U.S. Treasury) ended the third quarter mixed, as several fixed income sectors experienced spread tightening, while a sub-set of interest rate sensitive sectors saw their spreads widen. Corporate bonds of all qualities stood out positively, as high-yield and investment grade spreads tightened 43 and 18 basis points, respectively. On the negative side, the spreads of preferred stocks widened approximately 70 basis points, as many investors cut their exposure to the space as interest rates increased. Many preferred stocks are issued into perpetuity (have no maturity date), which causes spreads to widen when interest rates rise.

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 now between 3.25%-3.50%. The high end is unchanged, but the low end has pushed up a bit. It ended 3Q18 at 3.05%, which was slightly higher than three months ago. The minutes from the most recent Fed meeting indicated it expects to increase the short-term rate one more time in 2018 and three times in 2019. It is also expected the Fed will continue to let its balance sheet shrink at a moderate pace over that time frame. Taking all of this into consideration, we believe it is likely interest rates will continue to rise over the short-to-intermediate term. However, now that we have made significant progress towards a 3.00% Fed Funds rate, which is the rate the Fed considers to be neutral (not accommodative or restrictive), it is possible the Fed may stop increasing rates when we reach that point. If so, we are closer to the end of rising rates than the beginning.

Yield Curve

Considering our fair value estimate for the 10-year Treasury bond is 3.25%-3.50%, and we expect the Fed to raise rates toward a neutral 3.00%, 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 year-to-date relative performance. We continue to prefer structured/securitized credit based on our opinions about valuation, the defensive nature of the credit exposures and the limited risk of outright losses. We also believe mortgage-backed securities are reasonably priced and a good source of income. Despite recent weakness, we have a positive long-term view on high quality emerging markets assets. We believe bouts of volatility similar to the one we have recently experienced can provide attractive entry points for long-term investors like us.

As the municipal market advances into the last quarter 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 for tax reform to create 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. 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. Finally, as interest rates have increased, we have seen opportunity developing in the closed-end fund space, which is starting to look attractive.

Client Portfolio Impact

- We continue to position portfolios with less interest rate exposure than their benchmarks. We are 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 markets bonds, securitized assets, insurance-linked securities and infrastructure debt. In tax-aware client portfolios, we continue to focus on higher quality municipals and have a defensive interest rate posture.
- Our investment vehicle selection is currently favoring 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. Our research in the closed-end fund space is focused on strategies that we believe offer value from an interest rate, credit spread and discount perspective. We will update you as our research progresses.

A Review of Diversification

Most likely, many readers are familiar with the phrase, "Don't put all your eggs in one basket." However, many may not know that the origin of the phrase can be traced back to the book *Don Quixote*, which was published in 1605 and 1615. Essentially, it means that an individual should not risk everything on just one venture or possibility, because if something goes wrong, you may lose everything. Instead, risk should be spread among many things, so that if something does go wrong, you still have something left. Like many wise idioms, it has stood the test of time, and remains relevant today. In the investment world, this phrase could be likened to the concept of diversification.

In a nutshell, diversification is the practice of spreading your investments across a variety of investment types, so that exposure to any one segment of the markets is limited. The primary goal of diversification is to reduce the volatility or risk of a portfolio over time. However, it is a long-term concept. Over short periods there is generally always one asset class that will have a better risk/return profile than a diversified portfolio. Diversification works over time though because there are no asset classes that have proven to move up every year. In addition, asset classes and sub-asset classes do not consistently move up and down with one another (are not perfectly correlated). Instead, asset classes perform better or worse than one another during different market environments.

There are many benefits that come from diversification, such as the potential to reduce the risk of loss or improve risk-adjusted returns (increased return for a given level of risk). Diversification may also assist in modifying behavior – specifically overconfidence in one's ability to "outsmart" the market. By smoothing out large movements in asset classes (or sub-asset classes), investors are less prone to buy or sell asset classes at inopportune times. This is critical because maintaining a disciplined investment process has been shown to help generate wealth, while market timing (seeking out the best asset class over short periods) has been shown to damage returns.

There are many ways to illustrate diversification and the benefits of building a portfolio of uncorrelated or low correlated assets. The most common is to show how adding bonds and cash to a portfolio of stocks can help to dampen losses when the stock market declines, but we thought an example of diversification at the sub-asset class level would be a bit more informative. The diversification analysis shown at the top of the next page was conducted by T. Rowe Price and displays the potential benefit of diversification in the foreign equity component of portfolios.

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

Summary

The primary goal of diversification is to reduce the volatility or risk of a portfolio over time.

Diversification may assist in modifying behavior – specifically overconfidence in one's ability to "outsmart" the market.

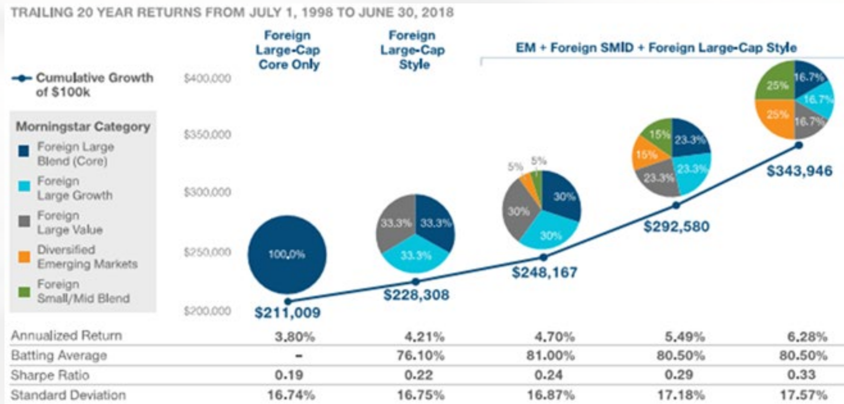
The equity market has followed the mantra of "keep buying what has worked" this year as momentum stocks (including growth-oriented stocks) have shot higher while most other types of stocks have had much less meaningful (if any) returns.

The current U.S. equity bull market is the longest bull market in history.

As history has demonstrated, however, trends don't last forever. We believe investors should not have "all their eggs in one basket," but instead be properly diversified among many baskets.

Research Focus

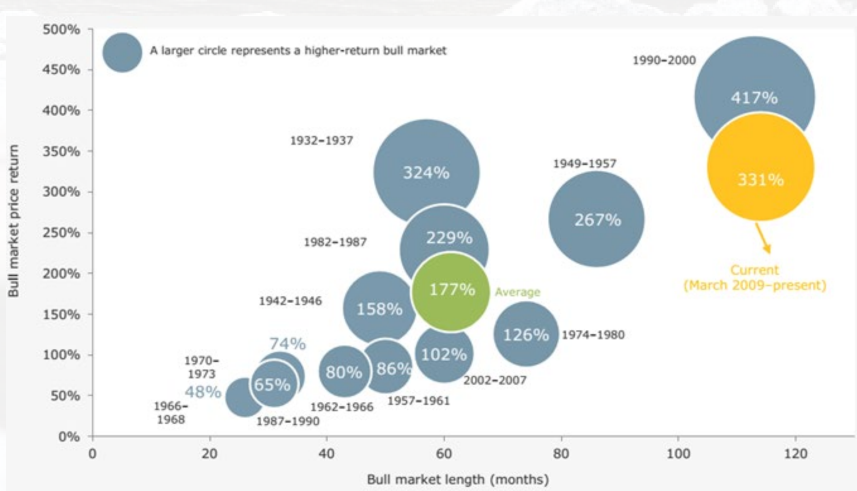
The all-blue pie chart on the far left displays a portfolio that is only allocated to foreign lap-cap core equities. The 20-year annualized return (through 06-30-18) was +3.80% and the standard deviation of returns (volatility) was 16.74%. However, by increasing the diversification of the foreign large-cap core equity portfolio to also include investments in foreign large-cap growth, foreign large-cap value, foreign small-/mid-cap equities and emerging markets equities, the 20-year annualized return increased to +6.28%, with only a slight increase in the volatility of returns (17.57%). In this example, returns at the sub-asset class level were significantly enhanced without a correspondingly large increase in the volatility of the portfolio. While diversification at the broad asset class level (stocks/bonds/cash) may not necessarily enhance the return profile of a portfolio, there is the potential for investors to benefit from better diversification at the sub-asset class level (i.e. within equities, diversifying by style, market-capitalization, etc.).



Slide Courtesy of T. Rowe Price – Pillars of International Equity (August 23, 2018)

Why reinforce the concept of diversification now? One reason is the current return profile of equity markets this year. Generally speaking, the equity market has followed the mantra of "keep buying what has worked" this year as momentum stocks (including growth-oriented stocks) have shot higher while most other types of stocks have registered much less meaningful (if any) returns. As we noted in the equity market review section of this quarter's newsletter, this type of behavior typically takes hold near the end of a cycle in a strong, up trending market. Greed, and the allure of seemingly easy outsized market returns, appear at the exact wrong time – when investing seems easy and out-of-favor investment strategies (and asset classes) are avoided like the plague.

A second reason is that it helps to inform existing investors of why we remain invested in certain out-of-favor areas of the market. Along those lines, our current view is that the broad equity market (and sub-asset classes) may be nearing key inflection points. The current U.S. equity bull market is the longest in history and has also surpassed the average return of prior bull markets as seen in the chart to the right.



Slide Courtesy of Wells Fargo Investment Institute – Market Charts (October 2018)

Does this mean that the U.S. equity market will soon plunge into a bear market? Not necessarily, but it shows that the current bull market has lasted for a historically long time, which raises the question, "How long can the good times last?"

Within the global equity asset class, the performance of many sub-asset classes have diverged meaningfully. For example, we have seen wide performance differences build between U.S. equities (as measured by the S&P 500® Index) and foreign equities (notably, emerging markets equities, as measured by the MSCI Emerging Markets Index), as well as between domestic growth equities (as measured by the Russell 1000® Growth Index) and domestic value equities (as measured by the Russell 1000® Value Index). The rolling eight-year charts that plot the relative performance (excess return) of these two sub-asset class comparisons over the previous 30+ years are shown below.

We believe there are two key takeaways from the charts.

1) The relationship/relative performance between these sub-asset classes varies over time (what outperforms and underperforms).
2) The relative performance differences between U.S. equities compared to emerging markets equities, and domestic growth stocks compared to domestic value stocks, are nearing historical extremes.

As history has demonstrated, however, trends don't last forever. Value stocks have outperformed growth stocks and emerging markets equities have outperformed U.S. stocks. It has happened before, and it will happen again.

Regrettably, there is not a calendar to follow to determine a precise answer of when. As can be seen from the data in the charts we have included, stock market cycles and relative performance cycles (between sub-asset classes) vary. We know cycles happen, but the length of time and magnitude are always different. This is one of the primary reasons we believe investors should not have "all their eggs in one basket," but instead be properly diversified among many baskets.

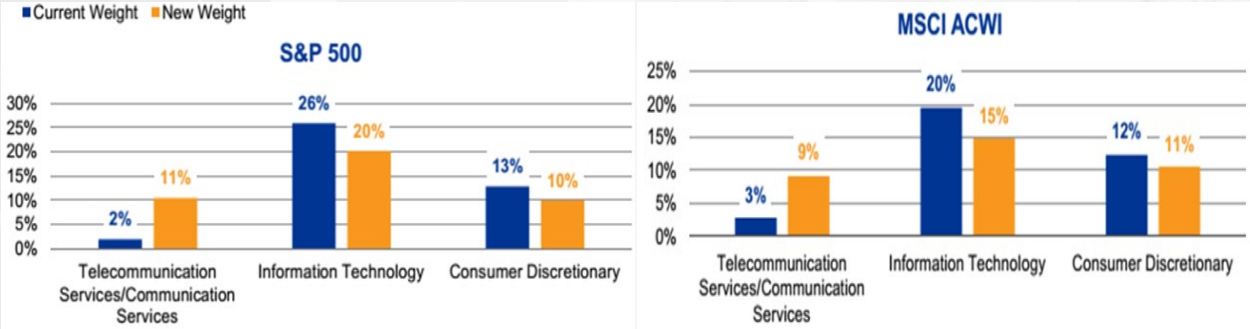
Source: Morningstar Direct

This quarter our Client Focus is going to review S&P GICS Sector Classification Changes.

The Global Industry Classification Standards (GICS) recently implemented the largest revision to its sector/industry methodology in its 19-year history. This is relevant to all investors because leading index providers, including MSCI and S&P Dow Jones, utilize the classification system, which renamed the telecommunication services sector to the communications services sector. In addition to renaming the sector, select companies from the information technology and consumer discretionary sectors were moved to the new communications services sector. In all, the reclassification impacted roughly 2,100 companies globally. Well-known U.S.-based companies such as Facebook, Netflix and Alphabet (parent company of Google) were among those impacted.

Why the Change?

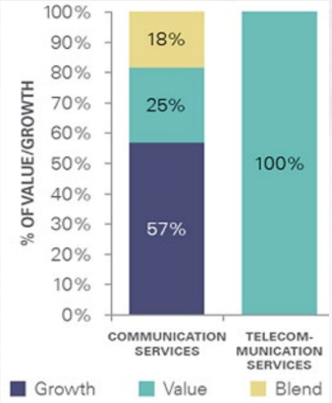
Business models for many companies in the old telecommunications sector and the information technology and consumer discretionary sectors evolved significantly over the past two decades. This evolution resulted in many of these companies no longer fitting neatly into existing sectors. The bar chart below displays how sector weights changed as a percentage of the S&P 500® Index (U.S. stocks) and the MSCI ACWI Index (global stocks).



Charts Courtesy of BlackRock – GICS Sector Reclassification (August 2018)

Why Does it Matter?

The newly formed communications services sector will have different underlying characteristics compared to the previous telecommunications services sector because of new company additions from the technology and consumer discretionary sectors. The business models of these companies tend to be more cyclical (growth-oriented) in nature as opposed to the relatively more stable business models in the previous telecommunications services sector (value-oriented). As a result, the communications services sector will be more sensitive to underlying economic and business conditions. See style breakout comparison to the right.



Slide Courtesy of SPDR Blog – GICS Changes Upend the Sector Apple Cart (Jan 19, 2018)

The individuals most impacted by the changes will be investors in sector-focused exchange-traded funds (ETFs) that track the communication services, information technology and consumer discretionary sectors. Outside of those individuals, there will be a modest impact on style investors. For most, the impact will be minimal and only apparent in reports.

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^{SM}** 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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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

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