ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

4Q2018

Last quarter our opening comments centered on the fact that the success of a few standout market performers was masking the struggles of the broad market. Well, in the fourth quarter of 2018 the mask came off.

Global equity market returns across the major indices we report each quarter on the next page were all down double digits with the exception of emerging markets, which held up better, but still posted negative results. On the other side of the ledger, fixed income returns were broadly positive. This was the first time in quite a while where the value of balance and diversification in a portfolio could be seen so obviously.

We will not know until we have the benefit of perfect hindsight if the fourth quarter was a minor setback or an early indication of an even bigger pullback. What we do know is that the right portfolio strategy and financial plan should be indifferent in the short-term. Negative returns and market volatility can be hard to watch when returns are tough, and "water cooler" talk and the behavioral pull of "missing out" can be significant influences when returns are good. However, if the strategy and plan are on task, neither should create a pull that leads to bad market timing decisions. Our Research Focus and Client Focus tackle these concepts directly.

We hope you find a portion of this newsletter useful.

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

Bob

Market Performance	Market Notes	Equity Portfolio Comments
Fixed Income Portfolio Comments	Research Focus	Client Focus

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 12/31/18)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	-4.38	9.26	8.49	13.12
Russell 1000 Index	Mid/Large Cap Stocks	-4.78	9.09	8.21	13.28
Russell 1000 Growth Index	Growth Stocks	-1.51	11.15	10.40	15.29
Russell 1000 Value Index	Value Stocks	-8.27	6.95	5.95	11.18
Russell 2000 Index	Small Cap Stocks	-11.01	7.36	4.41	11.97
MSCI EAFE Index	Non-U.S. Developed Market Stocks	-13.79	2.87	0.53	6.32
MSCI Emerging Markets Index	Emerging Markets Stocks	-14.58	9.25	1.65	8.02
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	-18.20	3.82	1.96	10.02
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	-4.34	2.67	6.09	7.65
Barclays Municipal Bond Index	U.S. Municipal Bonds	1.28	2.30	3.82	4.85
Barclays Aggregate Bond Index	U.S. Bonds	0.01	2.06	2.52	3.48
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	0.88	1.70	1.86	2.90
BofAML U.S. Treasury Master Index	Treasury Bonds	0.80	1.46	2.23	2.12
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	1.00	1.70	2.51	3.11
BofAML U.S. Corporate Master Index	Corporate Bonds	-2.25	3.32	3.34	6.10
BofAML U.S. High Yield Master II Index	High Yield Bonds	-2.27	7.27	3.83	11.02
BofAML Convertible Bonds Index	Convertible Bonds	0.68	9.35	7.29	12.73
BofAML Euro Broad Market Index	European Bonds	-4.39	3.22	-0.55	2.17
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	-4.90	5.13	-0.47	2.88

Calendar Year % Returns (QTD as of 12/31/18)

Source: Morningstar Direct

	QTD	2018	2017	2016	2015	2014	2013
S&P 500 Index	-13.52	-4.38	21.83	11.96	1.38	13.69	32.39
Russell 1000 Index	-13.82	-4.78	21.69	12.05	0.92	13.24	33.11
Russell 1000 Growth Index	-15.89	-1.51	30.21	7.08	5.67	13.05	33.48
Russell 1000 Value Index	-11.72	-8.27	13.66	17.34	-3.83	13.45	32.53
Russell 2000 Index	-20.20	-11.01	14.65	21.31	-4.41	4.89	38.82
MSCI EAFE Index	-12.54	-13.79	25.03	1.00	-0.81	-4.90	22.78
MSCI Emerging Markets Index	-7.47	-14.58	37.28	11.19	-14.92	-2.19	-2.60
MSCI ACWI Ex USA Small Cap Index	-14.43	-18.20	31.65	3.91	2.60	-4.03	19.73
BofAML Preferred Stock Fixed Rate Index	-4.56	-4.34	10.58	2.32	7.58	15.44	-3.65
Barclays Municipal Bond Index	1.69	1.28	5.45	0.25	3.30	9.05	-2.55
Barclays Aggregate Bond Index	1.64	0.01	3.54	2.65	0.55	5.97	-2.02
Barclays Intermediate U.S. Gov/Credit Index	1.65	0.88	2.14	2.08	1.07	3.13	-0.86
BofAML U.S. Treasury Master Index	2.60	0.80	2.43	1.14	0.83	6.02	-3.35
BofAML U.S. Mortgage Backed Securities Index	2.04	1.00	2.45	1.67	1.46	6.07	-1.39
BofAML U.S. Corporate Master Index	-0.06	-2.25	6.48	5.96	-0.63	7.51	-1.46
BofAML U.S. High Yield Master II Index	-4.67	-2.27	7.48	17.49	-4.61	2.51	7.41
BofAML Convertible Bonds Index	-9.78	0.68	16.03	11.94	-1.15	9.97	26.60
BofAML Euro Broad Market Index	-0.73	-4.39	14.61	0.37	-9.30	-2.48	6.89
BofAML Local Debt Market Plus Index	1.92	-4.90	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

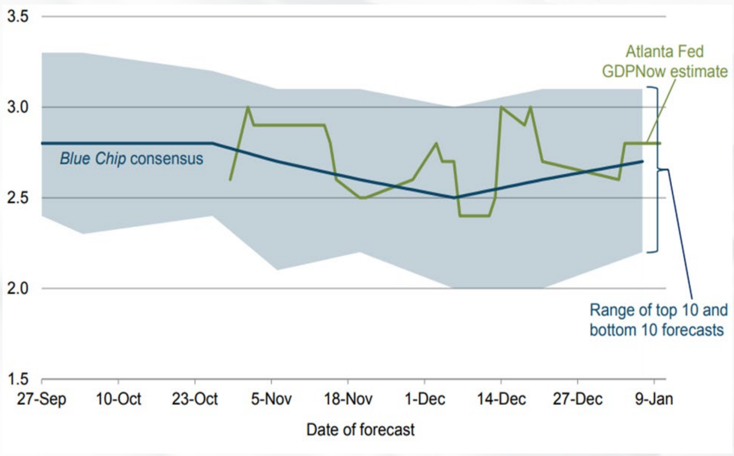
Fourth quarter equity market performance could aptly be described with one word – brutal. U.S. equity markets, which had largely avoided losses witnessed in foreign developed markets and emerging markets during the second and third quarters, reversed course abruptly in the fourth quarter. As is typically the case in broad market equity selloffs, multiple concerns coalesced at the same, resulting in a waterfall of panic across a wide swath of market participants. A chief concern among many was that the U.S. economy, after accelerating for nine straight quarters, began to show signs of rolling over. Decelerating economic growth, combined with a continuation of restrictive policy from the Fed (U.S. Federal Reserve), stoked fears that the Fed was on a path to raise rates too far and too fast, which would trigger a broad economic recession. Cracks also began to emerge on the corporate front as the "sugar high" from tax reform began to wear off. Waning stimulus combined with trade concerns, higher interest rates, significant debt on corporate balance sheets, a strong U.S. dollar, rising wage growth and the potential for declining corporate operating margins led to fears that corporate earnings would disappoint. As a result, defensive fixed income investments suddenly looked attractive.

The Economy

Recent data suggests the U.S. economy continued to slow in the fourth quarter of 2018. The Atlanta Fed GDPNow estimates the economy will grow at 2.6%, which is still above potential, but down meaningfully from the near 4.0% pace it averaged the prior two quarters. See chart below. The slowdown was primarily driven by an inventory drawdown and weak housing demand. The drawdown in inventories comes on the back of a substantial build in the second and third quarters. Manufacturers and suppliers raced to build inventories at lower prices prior to the onset of tariffs related to the administration's ongoing trade dispute with China. Housing demand continued to weaken due to increasing mortgage rates, rising building material costs and shortages of land and labor.

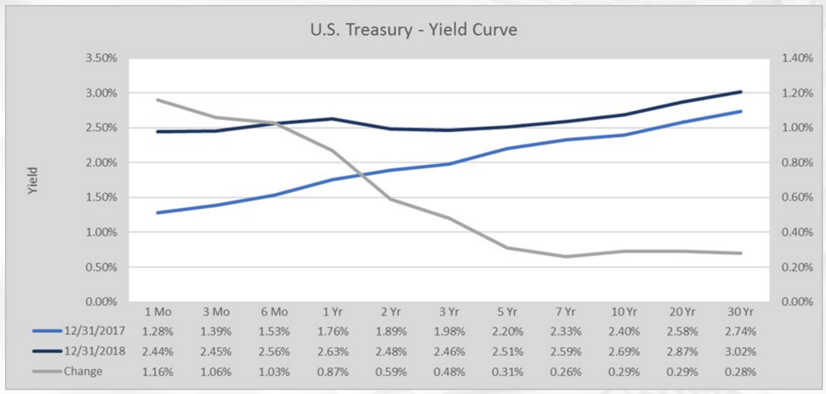
For 2018, analysts are predicting the global economy grew 3.7% year-over-year, which is strong from an absolute perspective. However, when we look closer there was a noticeable slowdown midway through the year caused by tightening monetary policy, worsening trade disputes and slower demand growth from major economies. Recent data suggests the slowdown will continue into 2019. For instance, the new orders component of the global manufacturing purchasing managers index (PMI) slowed considerably to levels that project flat to minimal growth. China reported its weakest reading since 2016, which had a negative effect on the data. Several major European economies also contributed weak data. On the corporate front, several major global companies also warned of slowing growth, including Apple which reduced its sales forecast due to a considerable drop in activity in China. FedEx cut its earnings outlook due to slowing global trade and weakening global growth. AP Moller-Maersk, the world's biggest operator of container ships, warned the U.S-China trade dispute could significantly impact the global container shipping industry in 2019 if not rectified soon.

Federal Reserve Bank of Atlanta Fed 4Q18 GDPNow Estimate



Interest Rates

U.S. interest rates were volatile during 2018, but finished higher across the maturity spectrum. The market entered the year anticipating three 25 bps (0.25%) increases to the overnight lending rate from the Fed. However, the strength of the U.S. economy, notably over the first half of the year, resulted in one more rate hike than expected. The overnight policy rate ended the year at 2.5%, which is generally considered the bottom end of the estimated "neutral" range of 2.5%-3.0%.

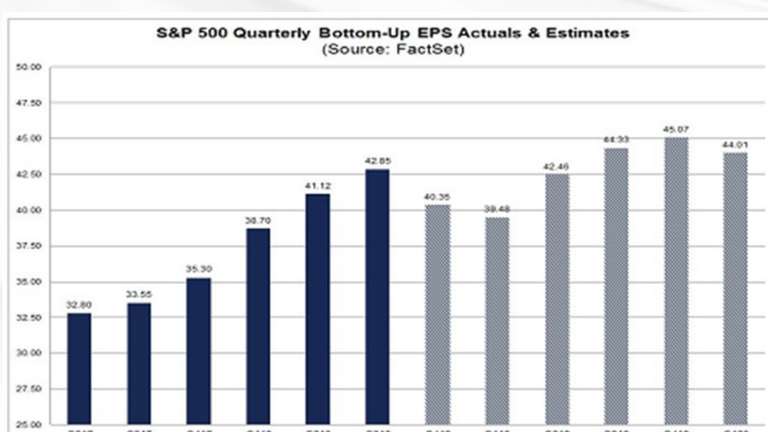


The Fed's definition of neutral is a level that does not support the economy nor restrict it. The last rate hike in December was not without controversy considering signs of slowing growth in the U.S. Rates on bonds with maturities less than five years increased at a faster pace in 2018 than those that mature further into the future because they are more directly influenced by Fed policy. Bonds with longer maturities tend to be more volatile, which was the case in 2018. The 10-year U.S. Treasury moved higher in two distinct phases before ending with a sharp move lower. Overall, its yield ranged from 2.5% to 3.2%.

Earnings

Corporate earnings growth (year-over-year) is expected to be 10.6% (S&P 500 Index) for the fourth quarter. If earnings come in as expected, it would be the fifth straight quarter of double-digit earnings growth. However, it will also be the first quarter since 4Q 2017 that the S&P 500 Index has not reported earnings growth above 20%. Estimated earnings growth for calendar year 2018 is anticipated to be approximately 19.9%. These earnings growth numbers are impressive; however, it is important to remember that the market is forward looking, which means that these growth rates have largely been accounted for in current stock prices.

Looking ahead to 2019, earnings growth is not expected to be nearly as robust. In fact, "tepid" is probably a better descriptor, especially for the first three quarters of 2019 (year-over-year growth of 1.3% for 1Q 2019, 2.6% for 2Q 2019 and 3.4% for 3Q 2019). See chart to the right.



Slide courtesy of FactSet Earnings Insight (January 11, 2019)

Equity Market Results

When the dust finally settled for the fourth quarter, domestic equities (-13.52% as represented by the S&P 500 Index) and developed foreign equities (-12.54% as represented by the MSCI EAFE® Index) had posted double-digit declines. Emerging markets equities, which had fared poorly during the third quarter on the back of U.S. dollar strength, also registered losses, (-7.47% as represented by the MSCI Emerging Markets Index) but declined much less than their developed market brethren.

Within the U.S. equity market, growth-oriented equities were hit particularly hard (-15.89% as represented by the Russell 1000® Growth Index) as were small-capitalization stocks (-20.20% as represented by the Russell 2000® Index). Value-oriented equities were not spared from losses (-11.72% as represented by the Russell 1000® Value Index), but held up the best among domestic equity sub-asset classes. From a sector perspective, the energy sector and the growth-oriented technology sector were the two weakest performers for the quarter (-23.78% and -17.34%, respectively – S&P500® sector performance), while traditionally defensive sectors such as utilities and real estate performed much better (+1.36% and -3.83%, respectively – S&P 500® sector performance).

The significant decline in the fourth quarter cemented losses for 2018 across all major markets. The breadth of losses in 2018 across asset classes was historic. Approximately 90% of asset classes ended 2018 with losses, which was the largest such percentage since 1901. The S&P 500® Index finished with a loss of -4.38%, while developed foreign markets (-13.79% as represented by the MSCI EAFE® Index) and emerging markets equities (-14.58% as represented by the MSCI Emerging Markets Index) also finished in the red. Despite the relatively good results in the fourth quarter, U.S. value-oriented equities (-8.27% as represented by the Russell 1000® Value Index) lagged U.S. growth-oriented equities (-1.51% as represented by the Russell 1000® Growth Index) for the year.

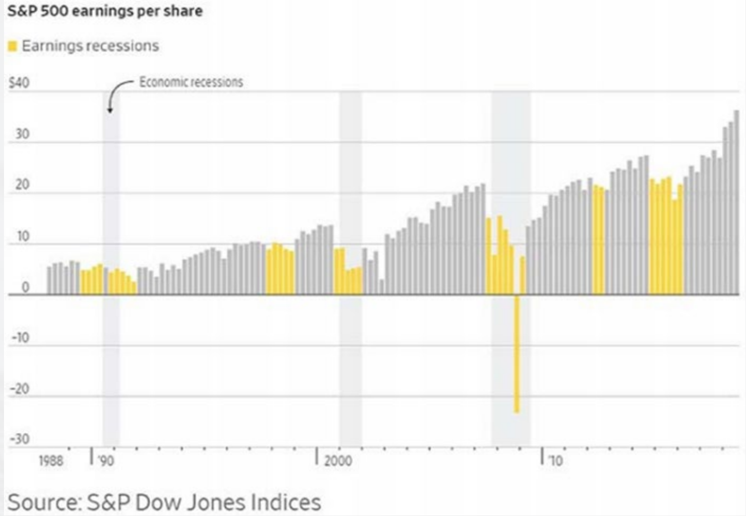
Equity Market Comments

Estimated earnings growth for 1Q19 and 2Q19 were cut by a combined -4.5% over the course of the fourth quarter, reflecting concerns on several fronts from analysts. We highlighted a number of these concerns in recent newsletters; the most pressing of which centers on uncertainty surrounding corporate operating margins and top-line revenue growth. Unfortunately, we do not have much in the way of good news to share on either front as we expect operating margins to contract from near record highs, primarily because of increased pressure from wages and increased cost pressure associated with a stronger U.S. dollar (the U.S. dollar strengthened relative to most currencies in 2018). A similar story could be told on the revenue front as U.S. dollar strength in tandem with reduced global growth expectations portend to softer top line revenue growth, especially for large multi-national companies.

At the time we published this newsletter, fourth quarter revenue growth was relatively weak for companies that already reported. The chart to the right shows that the percentage of companies beating revenue estimates for the fourth quarter has been weak and corresponds to other periods of equity market weakness (i.e. early 2000's, 2008, 2011 and 2015).

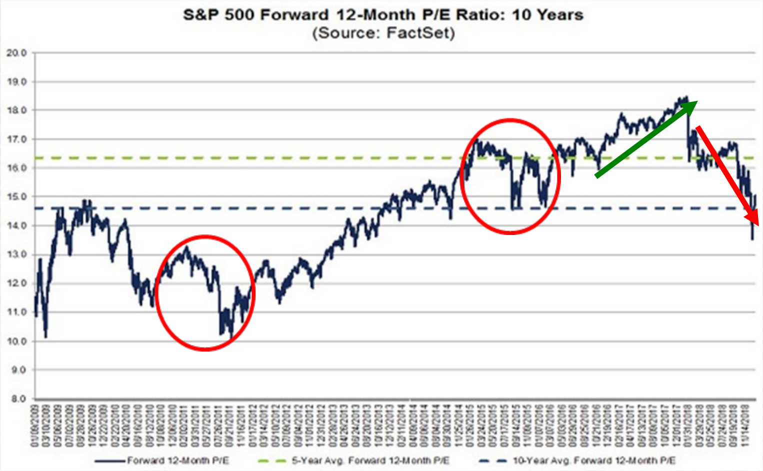
Slide courtesy of Bespoke Investment Group

Low single-digit earnings growth expectations for the first three quarters of 2019 also highlight the possibility that it would not take much from current levels to fall into a corporate earnings recession in the coming quarters (defined as two consecutive quarters of year-over-year earnings declines). As we've noted in the past, stock prices tend to follow corporate earnings over the long term, so negative year-over-year earnings growth expectations would not necessarily bode well for shorter-term stock market performance. The chart below highlights (in yellow) other periods where the S&P 500® Index fell into earnings recessions. Not surprisingly, a few of the more notable recent periods of equity market weakness correspond to periods with earnings recessions (i.e. early 2000's, 2008 and 2015).



Does all of this mean that the equity market is destined for further weakness? Not necessarily. However, we do believe the risks are much more elevated compared to what we have seen in recent years. As a result, we continue to believe that downside risks outweigh the potential for surprises to the upside, particularly in the U.S. equity market. We have positioned client portfolios for this possibility, and continue to explore opportunities to improve the short- to intermediate-term risk/return profile of portfolios.

Turning from growth to valuation, the S&P 500® Index's forward P/E ratio (price-to-earnings ratio) contracted to approximately 15.3x in the fourth quarter. As a reminder, 15.3x is roughly the amount that investors are willing to pay for $1 of future earnings. This is higher than the 10-year average of 14.6x, but below the 5-year average of 16.4x. See the chart below.



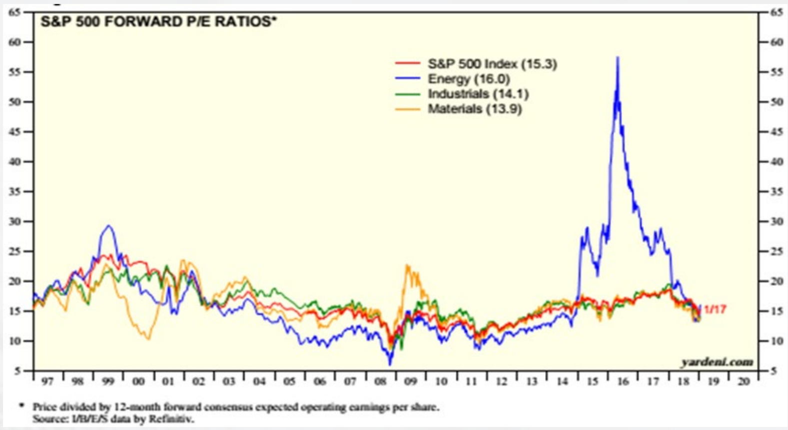
Slide courtesy of FactSet Earnings Insight (January 11, 2019)

At face value (forward P/E above 10-year average, but below 5-year average), and if we were to look at no other data, we could make a reasonable assumption that the stock market was fairly priced at current levels. However, that assumption comes with many potential pitfalls.

First, we circled two recent periods on the chart when P/E levels were declining or had plateaued – 2011 into 2012 and 2015 into 2016. You may recall from the previous earnings recession chart that during both of those timeframes, the S&P 500 experienced earnings recessions. Not surprisingly, the U.S. equity market struggled during these time periods.

Second, we also added green and red arrows to the chart to highlight that P/E multiples generally <u>expand</u> during periods when underlying earnings are accelerating (or expected to) and <u>contract</u> during periods when underlying earnings are decelerating (or expected to). This is important to consider for many reasons, but chiefly because it helps to highlight that future earnings expectations tend to drive stock prices higher (or lower).

Lastly, we want to stress that the "P" (individual stock or broad market prices) is not the sole driver of movements in the "P/E" ratio. Said differently, the P/E ratio does not only expand when prices move higher. To the contrary, there are plenty of instances when the "E" (individual stock or broad market earnings) declines, sometimes abruptly and unexpectedly, which drives the P/E ratio significantly higher. One stark example of this is when the valuation of the S&P 500® energy sector skyrocketed as crude oil prices plummeted and earnings for energy companies evaporated. See the chart below.



Slide courtesy of Yardeni Research, Inc. – Stock Market Briefing: S&P 500 Sectors and Industries Forward P/Es (January 21, 2019)

These considerations provide support to our opinion that while valuation levels are a key factor to consider, they are not the only data set for making investment decisions. Stocks, sectors and markets may be cheap (or expensive) for a reason. Without insight into what those reasons are, valuation levels are just data. As we have stated ad nauseum in previous newsletters, stock prices do not move higher simply because something appears to be "inexpensive," and they do not decline simply because something appears to be "expensive." There needs to be a catalyst to move the market in one direction or the other. The key question in the coming months will be whether or not there is a catalyst that will move the market into an earnings recession. We obviously cannot say with certainty one way or another, but as we noted previously, the current earnings environment is not nearly as robust as it had been in recent years. Furthermore, despite lower valuation levels (forward P/E), we think it will be difficult for valuations to expand without a corresponding significant boost to top-line revenue growth, which we believe is unlikely at this point in the cycle. Generally speaking, this has led to cautious portfolio positioning.

Client Portfolio Impact

As we noted above, some market pundits have pointed towards the possibility of multiple expansion (i.e. investors paying more for $1 of earnings – P/E ratio) following the market selloff in the fourth quarter. Performance so far in January points to the possibility they may be correct. However, we are not as optimistic. This largely stems from the fact that we do not believe the market has fully adjusted prices for the potential of weaker than anticipated earnings in the coming quarters. Looking ahead, we believe the market will be more cautious, and more selective with what is favored, which will lead to bouts of volatility, and a higher degree of differentiation in asset class performance.

More specifically, we believe the equity market will favor:

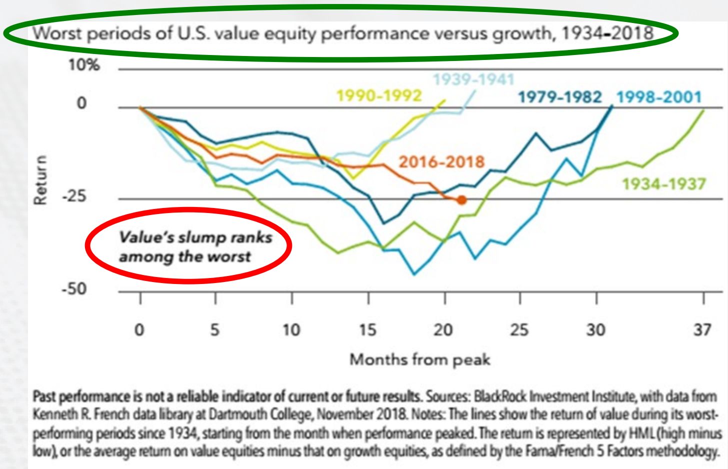
- Economic sectors and companies that have less exposure tied to global growth (largely because of concerns around foreign trade and the delayed impact of a strong U.S. dollar in 2018).

Equity Portfolio Comments

- Areas of the market that appear to be less expensive (lower P/E companies that are not "priced to perfection").
- Companies with earnings stability and predictability (consistent growth, not high-growth).
- Companies with relatively strong balance sheets (less leverage/debt).
- Areas of the global market that posted meaningful declines in 2018 and have relatively more attractive growth outlooks.

These views were largely expressed in client portfolios through trades implemented over the course of 2018. Most notably, we sold a dedicated U.S. growth manager in the second quarter of 2018 and redeployed the proceeds into investments that had more of a focus on high-quality, sustainable and predictable levels of earnings growth. Some client portfolios also saw the addition of a long/short equity manager and/or a U.S. REIT manager. These trades were made to further bolster the overall level of resilience of U.S. equity exposure in client portfolios. While we were a bit early with some of the trades, which dampened returns in the third quarter, the new investments performed as expected (held up better than the broad U.S. equity market) during the equity market selloff in the fourth quarter. As always, we prefer to be a bit early, rather than late. For a more detailed explanation of the trades and our thinking prior to making the trades, please read the equity portfolio positioning section in our 2Q18 and 3Q18 newsletters.

Looking ahead, we continue to favor value-oriented stocks over growth-oriented stocks among U.S. equities. This is partially because value-oriented companies share many of the same qualities of companies we believe the market will favor looking ahead (noted in the bulleted list above), such as earnings stability, predictable growth and healthy balance sheets. In addition, considering our penchant to invest in out-of-favor areas of the market, the chart to the right lends support to our decision to emphasize value over growth.



Slide courtesy of BlackRock Investment Institute – Global Investment Outlook 2019

It is important to note that asset class underperformance in and of itself does not make an investment attractive. However, we believe current market dynamics, our outlook and the underlying characteristics of value companies, combine to create a favorable environment for a shift towards value outperformance.

Equity Portfolio Comments

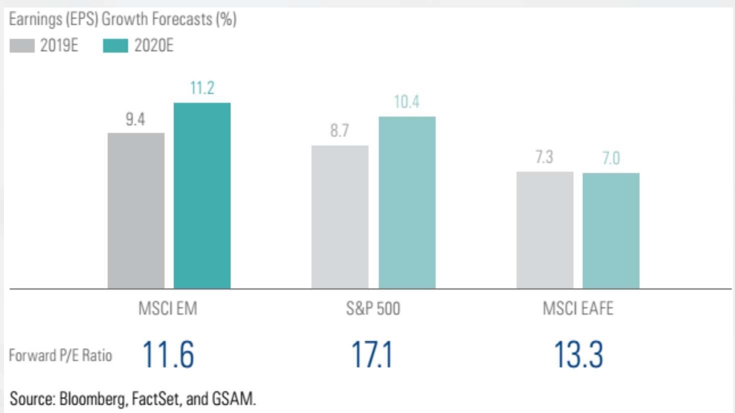
In the foreign equity portion of client portfolios, we remain convicted in a slightly more aggressive approach that places an emphasis on emerging markets equities and small-/mid-cap stocks. Overall, we believe the relatively defensive nature of our U.S. equity positioning will serve to counterbalance the more aggressive approach in our foreign equity positioning. Said another way, we are optimistic for more attractive foreign equity market returns compared to U.S. equity market returns when looking forward over an intermediate- to long-term investment horizon (3-5+ years).

This is particularly true for emerging markets equities, which we believe display a number of attractive characteristics. The first is that emerging markets earnings growth is more attractive than the U.S. and developed foreign markets when looking forward. Second, valuation levels are relatively less expensive. See chart 1 to the right.

Lastly, emerging markets equities have the added benefit of relatively strong underlying economic growth. This growth is expected to become sizable on a cumulative basis when looking out over the next five years. See chart 2 to the right.

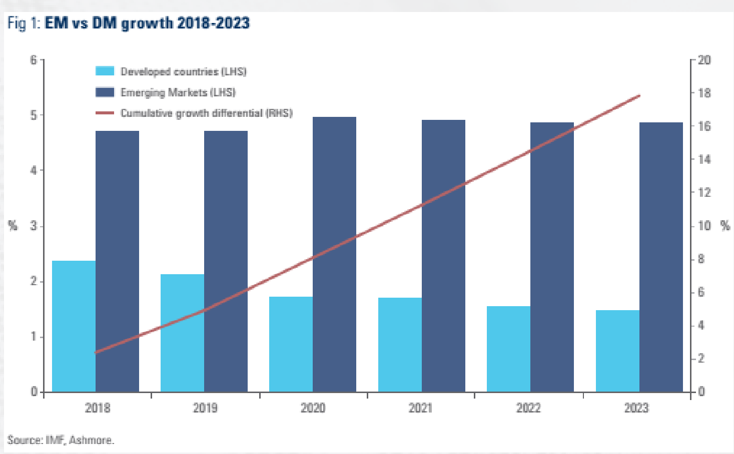
In summary, we believe the combination of strong corporate earnings growth, relatively attractive valuations and strong underlying economic growth bodes well for emerging markets equities over the intermediate- to long-term.

Chart 1



Slide courtesy of Goldman Sachs Asset Management – Market Know-How 2019: Edition 1

Chart 2



Slide courtesy of Ashmore – Weekly Investor Research (December 17, 2018).

Fixed Income Portfolio Comments

Fixed Income Market Results

As a reminder, when growth slows and the demand for credit weakens, interest rates must increase to attract new buyers. When interest rates go up, the price of bonds goes down. Conversely, as interest rates go down, the price of bonds goes up.

To determine how much the price of a given bond will decrease (or increase) given a change in rates, we need to know its duration, which is roughly how many years remain until a bond matures. A bond's duration is multiplied by the change in rates to determine the price change after applying the following scale. For every 1.0 year of duration a bond's price will change 1.0% for every 1.0% change in interest rates. For example, if the duration of a high yield corporate bond is approximately 4.0 years, if we apply a 2.0% increase in spreads (the difference between the yield on a U.S. Treasury bond and a similar maturity bond in a different sector) the price of the high yield corporate bond would decline 8%. This formula does not include interest income, which would be added to calculate total return.

With interest rates and credit spreads higher in 2018, returns were mostly negative across the fixed income landscape. Fixed income sectors that were able to generate enough income to offset their increased rates (and lower prices) included municipal bonds, U.S. Treasury bonds and mortgage-backed securities. The common thread among this group is all are high-quality sectors that experienced a limited increase in spreads. Sectors that are more sensitive to economic conditions struggled in 2018. Emerging market bonds, preferred stocks and corporate bonds generated negative returns for the year.

Fixed Income Market Comments

Our outlook has not materially changed since last quarter. We continue to believe growth will slow in 2019, but that we will avoid a recession. As growth continues to decelerate, we believe asset markets will continue to adjust in-kind. Our view is based on uncertain monetary policy, a stronger dollar, weaker global economy, less favorable trade environment and less support from fiscal stimulus. In addition, short-term leading indicators (6-12 months) are suggesting economic growth will continue slowing to a 1.5% to 2.0% pace. We continue to believe the risk of a recession over the intermediate term (12-36 months) is above average. If we add reduced global liquidity, increased budget deficits and high debt burdens to our list of short-term concerns, the combination of factors has the potential to push us into a recession over the intermediate-term. There are scenarios in which we do not enter a recession, but it depends heavily on how aggressive the Fed is, how well we get along with our trading partners and how effective other major economies deal with a slowdown in growth. As we adjust portfolio positioning, we will continue to focus on long-term fundamentals, while doing our best to avoid noise from day-to-day headlines.

Prior to the fourth quarter, credit investors handled slowing growth with relative calm. However, as the slowdown in data intensified, anxiety set in, which led to considerably wider spreads across the fixed income landscape. Below investment grade bonds were impacted the most, which is typical, as they have the smallest cushion to absorb weakening cash flow during periods of slow growth. Below investment grade corporate bonds were the weakest, widening 205 basis points (2.1%) in the fourth quarter. The chart at the top of the next page provides detail. The 12/31/18 spread level is subtracted from the 9/30/18 spread level to determine how much a given asset class widened or tightened during a given period. Preferred stocks and emerging market bonds also widened significantly, 133 basis points (1.3%) and 65 basis points (0.7%), respectively. BBB-rated corporate bonds widened 59 basis points, which was the most in the investment grade space.

Fixed Income Portfolio Comments

Fixed Income Market Monitor - Option Adjusted Spread		*Current Level*	*Historic Level*				*Change*			
Plot Area 2018										
Index	Code	12/31/2018	11/30/2018	9/30/2018	12/31/2017	12/31/2006	MTD	QTD	YTD	1-Year
A Corp	CoA3	124	113	89	77	84	11	35	47	40
AA Corp	CoA2	87	80	62	56	61	7	25	31	26
BBB Corp	CoA4	202	184	143	128	122	18	59	74	80
30YrFN/FR MBS	MF30	50	47	39	23	43	3	11	27	7
GNMA master	MGNM	40	37	25	23	37	3	15	17	3
Mtg Master	MoAo	45	42	33	22	45	3	12	23	0
CMBS Fixed Rate	CMBS	101	92	78	83	63	9	23	18	38
AAA ABS master	RoA1	55	48	36	37	46	7	19	18	9
Euro Secuitized	EAoo	170	151	111	84	25	19	59	86	145
Developed Sovereign	WSAV	21	23	22	15	2	-2	-1	6	19
Euro Investment Grade Corporate	ERoo	154	149	115	87	50	5	39	67	104
Asian Dollar Investment Grade Corporate	ACIG	183	172	152	122	91	11	31	61	92
high yield master II	HoAo	533	429	328	363	289	104	205	170	244
US BB-Rated Corporate HY	HoA1	360	280	213	218	194	80	147	142	166
US B-Rated Corporate HY	HoA2	574	459	348	369	286	115	226	205	288
Euro High Yield	HEoo	506	480	355	279	233	26	151	227	273
Asian Dollar High Yield Corporate	ACHY	759	739	566	403	297	20	193	356	462
EMD Global HY Credit	ICoo	563	529	495	337	287	34	68	226	276
EMD Sovereign BBB or lower	IPoo	376	359	303	251	148	17	73	125	228
EMD Credit USD BBB and Below	ICPD	406	385	331	257	214	21	75	149	192
EMD Credit	EMCB	328	311	263	210	155	17	65	118	173
preferred DRD elig	PoDo	274	228	162	106	-34	46	112	168	308
us preferred fixed	PoP1	242	193	109	-29	19	49	133	271	223

Corporate bonds typically widen further in times of stress because they are not secured by a specific asset. Bonds that are secured by assets like houses or airplanes tend to widen less during times of stress because the collateral can be sold to recover some of an investment if the issuer defaults. This was the case in the fourth quarter, as mortgage-backed and asset-backed securities held up better, widening only 12 (0.1%) and 19 (0.2%) basis points, respectively.

Municipal bonds were among a small group of asset classes to generate positive total returns in 2018. Municipal rates were pulled higher by strong U.S. growth and rising Treasury yields. However, a strengthening fundamental backdrop for municipal credit helped to hold spreads in check, which allowed interest income to offset the modest move higher in rates.

U.S. Interest Rates

As we start 2019, the outlook for Fed policy is more uncertain than it was a year ago. As of year-end market participants anticipated the Fed would not move the funds rate in 2019, which was at odds with Chairman Powell's comments after the December Fed meeting. During that meeting, he implied the Fed would increase rates two more times in 2019, which created significant interest rate volatility to start the year. Since that time, the Fed has shifted its policy stance to be more in line with the outlook of market participants. 2019 is shaping up to be the year of "data dependency," which means it could be another wild ride if market participants overreact to every data point and word from Powell. Based on probabilities we have assigned to likely economic scenarios, we believe fair value for the 10-year U.S. Treasury yield is between 2.3%-3.0%. It ended 4Q18 at 2.7%.

Yield Curve

Our call for a flatter yield curve in 2018 turned out to be correct. As a result, positioning portfolios to take advantage of rising short-term rates benefitted client performance. After beginning the year at +54 basis points, and reaching a single digit low in the fourth quarter, the spread between 2-year and 10-year U.S. Treasuries ended 2018 at +21 basis points. Going forward, the yield curve is likely to continue flattening as the economic cycle ages. An inversion (2-year rates higher than 10-year rates) typically precedes a recession, but that has not yet occurred.

Sector & Quality Management

We have held a cautious view on corporate bonds for the last several quarters, which benefitted client performance in 2018. We continue to favor structured/securitized credit based on valuation and the defensive nature of the credit exposures. With the recent back-up in spreads, mortgage-backed securities are reasonably priced and offer a good source of income. Emerging market exposure detracted significantly from performance in 2018. However, despite short-term weakness, we continue to have a positive long-term view on high quality emerging markets assets. We believe bouts of volatility similar to the one recently experienced can be attractive entry points from a long-term perspective.

In spite of a slowing economy, the municipal market enters 2019 with a solid fundamental backdrop. On the income side, it is expected that state and local tax revenues will continue to increase in 2019. On the liability side, municipalities have not increased their debt burdens nearly as much as other areas of the economy, which makes their balance sheets much more attractive over the intermediate-term. However, we are aware that rising pension and healthcare costs may present long-term challenges. The pension reform process has started in select areas, but there is still a long way to go across much of the country.

Investment Vehicle Selection

At this point in the economic and credit cycles, 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 municipal bonds. We are also finding significant value in the illiquidity premiums offered in insurance-linked securities and infrastructure debt. Finally, as interest rates have increased, we have seen some discount widening in the closed-end fund space, which is starting to look attractive.

Client Portfolio Impact

- Overall, less interest rate exposure when rates were increasing benefitted client performance in 2018. Going forward, our process suggests we should look to add U.S. Treasury duration at this point in the economic and credit cycle.
- Given our call for continued yield curve flattening, on the credit side, we continue to favor short duration assets that can benefit from shorter reinvestment windows. As we look to add duration, we will focus on longer dated U.S. Treasuries.
- We remain underweight corporate credit. We favor 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.
- To express our views in portfolios, we continue to partner with active managers that have expertise in these markets. 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 debt markets is by using interval funds. Interval funds do not offer daily liquidity, which means they can hold a much higher percentage in illiquid securities than open-end mutual funds. In the closed-end fund space, we are exploring opportunities to add strategies that offer value from an interest rate, credit spread and discount perspective.

Research Focus

Corrections

The phrase "two steps forward, one step back" could apply to many things in life since long-term progress is rarely made without some type of pitfall along the way. As is typically the case, these types of phrases tend to have a rather simple origin. In this instance, the phrase originated from an anecdote about a frog that was trying to scale a wall to escape from a well. The frog attempted to climb the wall of the well, but for every two steps (or hops?) it took, it fell back one step. Overall, a simple story, yet effective in its meaning. The phrase was later rearranged to the more well-known phrase "one step forward, two steps back" popularized by a book written by Vladimir Lenin in 1904 by the same title to describe politics in Russia at the time. Maybe I'm a more optimistic person by nature, but I tend to prefer the original phrase.

What does this have to do with the stock market? Well, for the first time since the global financial crisis in 2008, the broad U.S. equity market registered a negative calendar year total return. Because there have been many more positive years than negative years since 2008 (and since the early 1900's), the ratio of steps forward to steps back described above does not necessarily fit the stock market perfectly, but the overall meaning is still relevant. In life, it never feels good to stumble along the way while making progress towards a goal. Regardless, people know that stumbling is part of the overall journey, and without stumbling and subsequent learning along the way, the end would not nearly be as satisfying. Or, maybe it would be satisfying for some. Nonetheless, it is not realistic.

Even though negative calendar year returns do not occur frequently, market downturns (intra-year pullbacks) do. The table below looks at market downturns of varying severity for the Dow Jones Industrial Average (DJIA) from 1900-2017.

Dow Jones Industrial Average 1900-2017

	-5% or more	-10% or more	-15% or more	-20% or more
Average Frequency[1]	About 3 times a year	About once a year	About once every 2 years	About once every 3.75 years
Average Length[2]	46 days	115 days	216 days	338 days

[1] Assumes 50% recovery of lost value
[2] Measures market high to market low

Slide courtesy of Capital Group – How to handle market declines (June 29, 2016 – updated 2017)

As you can see in the "Average Frequency" row, pullbacks are a regular occurrence in the stock market. That being said, it is also important to remember that pullbacks are temporary in nature. Regardless of the severity of the pullback, the stock market has never declined and not subsequently moved higher. The timeframe

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

Summary

For the first time since the global financial crisis in 2008, the broad U.S. equity market registered a negative calendar year total return.

Pullbacks are a regular occurrence in the stock market. That being said, it is also important to remember that pullbacks are temporary in nature.

One of the most effective ways to counter emotional reactions to short-term volatility in equity markets is to have a well-diversified portfolio that encompasses multiple asset classes and sub-asset classes.

We cannot fully prevent pullbacks from occurring, but we can attempt to construct portfolios to be well-diversified, so clients avoid "going the way of Lenin."

associated with the recovery varies, but the end result does not. The key for long-term investors in these environments is to exercise patience in the face of short-term losses. Without patience, investors risk (if they were to sell at the bottom) making temporary losses, permanent losses. This concept also relates to the difficulty of market timing, which we cover in our Client Focus, and why we believe investors should avoid the temptation to trade more frequently on their own.

We will concede that it seems to be more difficult for investors to be patient now than it has been in the past. Some of this has to do with how rapidly information is disseminated because of technological developments (also likely increasing the short-term focus among investors). However, some of this may also have to do with the fact that stock market pullbacks occur much more quickly than in the past. For instance, the recent stock market selloff of approximately -20% occurred over a period of roughly three months, which is a much shorter period than the table on the prior page displays for historical market moves of similar magnitude (216 days to 338 days). Both characteristics tend to trigger behavioral impulses (i.e. panic) that work against the long-term orientation of most individual investors and their goals.

One of the most effective ways to counter emotional reactions to short-term volatility in equity markets is to have a well-diversified portfolio that encompasses multiple asset classes (i.e. fixed income, cash) and sub-asset classes (within equities, foreign securities, investment styles and market-capitalizations). We discussed the benefits of diversification in greater detail in the Research Focus section of our 3Q2018 newsletter, which we would encourage you to read if you have not done so already. One point that was touched on in that piece was that a well-diversified portfolio helps to smooth out the relatively severe peaks and troughs of movements in the equity market, which may help an investor to remain invested and focused on their long-term goals.

An example of the positives associated with diversification came during the fourth quarter of last year. Prior to the fourth quarter, many individuals questioned the need for relatively low-return fixed income securities in their portfolios because the equity market was consistently moving higher. However, the benefits associated with their fixed income investments became much clearer during the equity market selloff. During the same timeframe the S&P 500® Index declined -13.52% (4Q18), the broad fixed income market delivered a positive return of +1.64% (as measured by the Bloomberg Barclays US Aggregate Bond Index). For investors that had a portion of their portfolios invested in fixed income securities, the positive return from these securities helped to partially offset losses from the equity market. The table below shows recent equity market corrections (since 2010) and how fixed income securities performed over the same timeframe as the correction.

	Cumulative Total Return			
	Correction 4/23/10-7/2/10	Correction 4/29/11-10/3/11	Correction 5/21/15-8/25/15	Correction 11/3/15-2/11/16
S&P 500 Composite Index	-15.63%	-18.64%	-11.89%	-12.71%
Bloomberg Barclays U.S. Aggregate Index	3.00%	5.35%	0.04%	1.92%

Sources: Bloomberg Index Services Ltd., RIMES, Standard & Poor's. Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the unmanaged S&P 500 with 50% recovery between corrections.

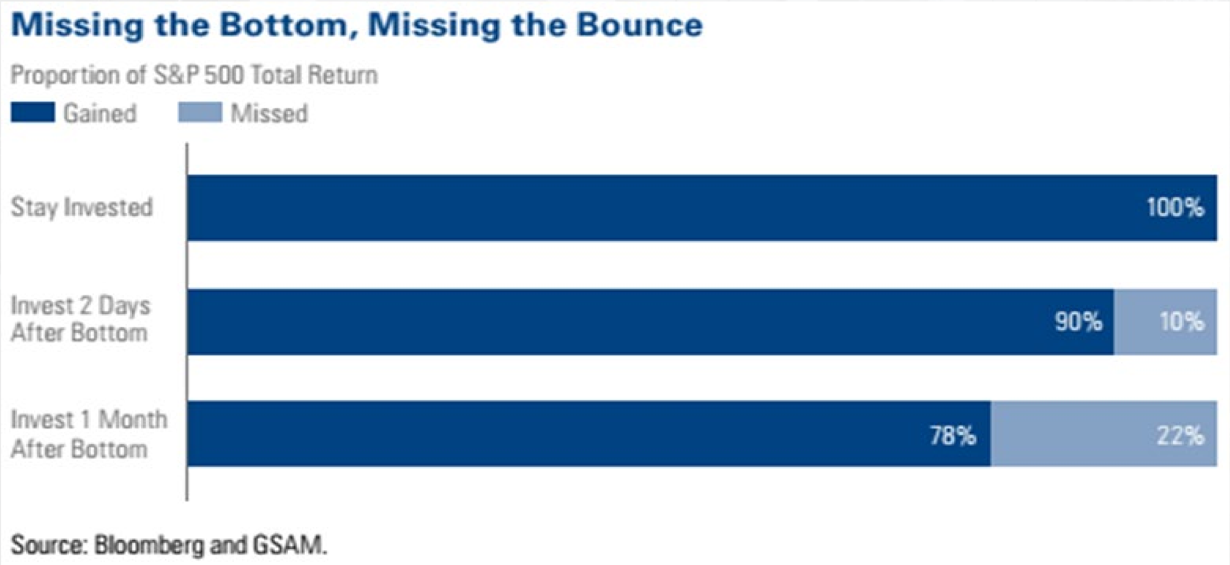
While fixed income may not always generate a positive return, the table shows that fixed income securities have generally been resilient during equity market corrections. What cannot be shown by looking at the data in the table are the potential positive impacts from a behavioral standpoint for investors. By helping to offset losses from the stock market (for individuals invested in both asset classes), we believe this may help keep investors focus on long-term goals rather than short-term worries. Furthermore, from a more concrete mathematical perspective, by losing less during equity market downturns, investors also have less ground to make up when the equity market recovers.

As we have noted throughout the newsletter, we understand that short-term losses in the equity market are never enjoyable. However, what we have also shown here are that corrections, and market pullbacks occur on a regular basis, and will continue to be a part of equity market cycles going forward. We cannot fully prevent pullbacks from occurring, but we can attempt to construct portfolios to be well-diversified, so clients avoid "going the way of Lenin." As has always been the case, we endeavor to make sure our clients continue to take two steps forward and only one step back.

Market Timing.

We realize short-term losses, especially when they occur quickly, can be painful for investors. From a behavioral standpoint, increased anxiety during these types of periods is common since most investors experience a disproportionate amount of mental anguish from losses relative to joy from gains (If you would like to read more on this topic, we would encourage you to read the Research Focus section titled "Performance Swings" in our 2Q2018 Newsletter if you have not done so already). Nonetheless, it is also important to remember that short-term losses and market turbulence have been, and will continue to be, a part of equity market cycles. With this in mind, we encourage investors to exercise patience in the face of short-term market adversity. We would also discourage long-term investors from attempting to time markets as this practice is fraught with significant challenges and may also rack up significant trading costs. One of the largest challenges with attempting to time markets is that it requires individuals to be right two times.

An individual has to sell before the market goes down and then buy before the market goes back up. If you don't time it perfectly, long-term returns can be negatively impacted (see bar chart below).



Slide courtesy of Goldman Sachs Asset Management – Market Know-How 2019: Edition 1

The bar chart reveals the importance of being perfectly correct with both decisions. For instance, even if you were able to perfectly time the market on the way out (to avoid losses), if you were to miss the "bounce" higher, an investor could significantly erode the long-term return potential of their portfolio. More specifically, if an investor missed the first month (or even the first two days!) after the last three economic cycles' market bottom, they would have missed a large portion (22% and 10%, respectively) of subsequent gains (as a percentage of 5-year total returns from the market bottom). This is due to the fact that some of the market's strongest gains at the beginning of market recoveries have come within days of a market bottom.

Our analysis of this phenomenon leads us to this concluding market axiom – it could be said that "time in the market" is more valuable than "timing the market."

Our Team

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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.

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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

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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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