RAFTING IN LATE-CYCLE WATERS

QUARTERLY COMMENTARY, 4Q 2017

> *"You must be shapeless, formless, like water. When you pour water in a cup, it becomes the cup... when you pour water in a teapot, it becomes the teapot. Water can drip and it can crash."*
>
> *– Bruce Lee*

Whitewater rafting is on my bucket list. Guided by a professional, throttle-seeking adventurers leak adrenaline as they somehow navigate the nooks and crannies of a treacherous ravine or gorge.

When you go whitewater rafting, the primary goal *is to survive*. That's it.

Like water, the markets are a system that adapts to its surroundings. New securities are created and others erode; new channels flow into the river, while retirement or capital expenditures act as drainage along the way.

As investors, we either sit and let the market take us—or we paddle. At times, experts tell the rafters to paddle in what appears to be a curious direction. When they do, aren't you glad you listened to their orders?

There is little time to look back and reflect while in the rapids, but self-reflection is central to the learning process. As professional investors, self-reflection is perhaps the most critical aspect of investing. With that, here is a review of 2017 with some lessons learned as well as our outlook for 2018.

2017: In Review

Last year was a Class 1: 'Very small rough areas, might require slight maneuvering.'

A crystal ball would have told us to bring an inner tube and a cooler—leave the raft, paddles and helmet at home—because the living is easy. In fact, the S&P 500 was positive in all 12 months of the year… *the first time that has ever happened in the history of the index!* International markets outperformed the US market in US Dollar terms for the first time since 2009. Going further out on the risk spectrum helped, as emerging markets outperformed developed markets.

Going into 2017, our major themes were:

1) The end of the bond bull market;

2) The beginning of upside inflation risk;

3) Populist policies would continue to drive markets; and

4) Global cooperation would move toward global competition

We surmised that the prudent investor's paradox (see this old letter) should keep careful investors from buying too much into the risk-on rally. As the year progressed, we challenged our assumptions and modified our allocations. We believe our portfolios were better for it.

- We increased our equity exposure throughout the year
- We raised our event-driven exposure to reflect a pro-business Trump stance in the White House

Index Returns in 2017[1]

Equity		Fixed Income		Real Assets		Alternatives	
Global Stocks	24.0%	Global Bonds	3.0%	Commodities	1.7%	Long/Short Equity	7.6%
Developed	22.4%	US Bonds	3.5%	Crude Oil	5.1%	Global Macro	2.8%
Emerging	37.3%	Emg Mkt Bonds	9.3%	MLPs	-6.5%	Event-Driven	4.3%
United States	21.2%	US High Yield	7.5%	Real Estate	8.7%	Relative Value	3.3%
Europe	25.5%	10-yr Tsy Yield	2.41%	Gold	12.8%	Multi-Strategy	7.1%
Japan	24.0%	2-yr Tsy Yield	1.88%				

*US Treasury yields as of 12/29/2017

- We bought European stocks the day after the Dutch election, which the market saw as favorable for pro-EU politics
    - o We used the French election as our precursor—markets responded favorably to a more moderate Macron victory over the populist Le Pen)
- We added significantly to US energy equities when oil prices rose but energy stocks kept falling
- We added to select higher-beta emerging market equities
    - o Our belief was that before the market can hit a top, relative strength must travel from "stable equities" (low vol + dividend) to "safe high-growth" (technology) to "really risky" (emerging markets)

Macro decisions like these are not easy. Furthermore, good decisions are <u>never</u> universally popular—to skate to where the puck is going necessarily requires bucking the current trend—and performing sufficient research in order to get comfortable with bucking the trend takes time. One can never see a complete picture, which is why the disciplined investor aims to build a diversified portfolio with diversified ideas.

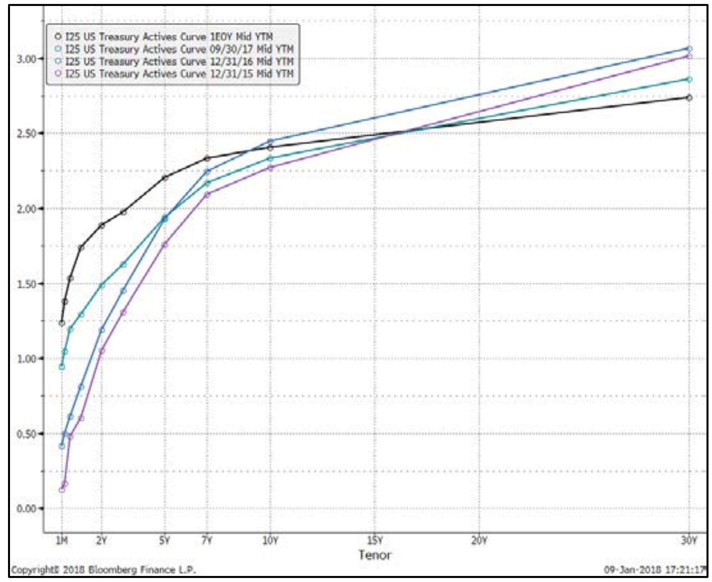
Our themes going into 2017 still hold true for 2018 and we are keeping a close eye on them. Finally, the US Dollar can have a dramatic impact on global trade flows and global markets. The one major difference between this year and last is that the US Federal Reserve will begin to unwind the balance sheet.

The next sections will cover:

1) Rates and the US Dollar
2) Global reflation
3) Greek banks
4) Active management
5) Value/Growth dispersion

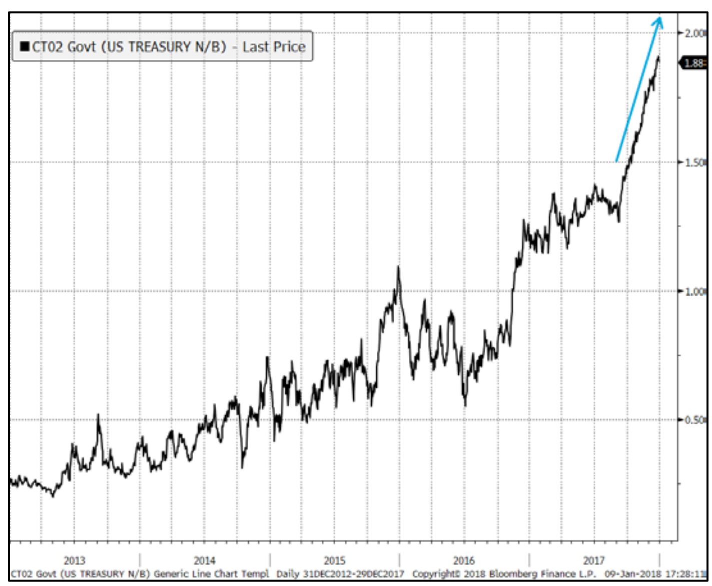
Rates are probably moving higher. This statement alone is tricky: How are they moving higher? Is the yield curve moving up in parallel or will the shape of the curve change? I am going to cheat and say the short end of the curve is moving higher because the Federal Reserve is raising rates. And the long end of the curve will probably move higher, too, but more slowly.

The following chart plots the US Treasury curve's tenors along the x-axis and the interest rate on the y-axis. Notice the most recent (black) line is much less steep than the Treasury curves of yesteryear. This trend should continue. We believe the curve will probably move up and also become less steep.



Source: Bloomberg, as of 12/31/2017

The 70bp move from 1.2% to 1.9% in the 2-year Treasury in 2017 was significant, especially given the gradual pace it had risen even through the taper tantrum in 2013.



Source: Bloomberg, as of 12/31/2017

So if rates are moving higher, what does that mean for the US Dollar?

The US Dollar has retreated from the "Trump bump" that brought it to multi-year highs at the beginning of 2017. In fact, the Bloomberg Trade-Weighted US Dollar Index fell approximately 9.7% in 2017. The Dollar has fallen while US short-term Treasuries have sold off (and seen yields move higher), which is somewhat common market action.

Today, though, the yields for short-term US Treasuries are attractive relative to other developed nations' short-term sovereign bonds. This relative attractiveness at some point entices foreign buyers to step in and buy US bonds.

All of that said, international investment won out in 2017 and market participants need a reason to stop stepping further out on the risk spectrum. As it stands, emerging market currencies (using MSCI emerging market country weights) were up 11.3% against the US Dollar in 2017.

All of these factors lead us to believe the global reflation trade is a stool with many legs. Kick out one leg of the stool and global reflation will probably still remain intact. First, we have breadth in global economic growth. The IMF in its most recent World Economic Outlook revised upward its global growth targets. Analysts at sell-side investment banks are generally upgrading their global growth targets. Second, we saw the trend in rates and the US Dollar above. Third, European and Japanese monetary policy is behind the US and appears to be following in United States' footsteps. Finally, the move away from protectionism (which appears to be the direction we are headed) is good for global markets.

Topping it all off (pun intended), oil prices appear to be breaking above $60—a number nobody thought they would rise above. All of this bodes well for inflation expectations. The chart below depicts the 5Y5Y forward swap in the US (green), Europe (blue) and Japan (black). The 5Y5Y forward swap is a well-established measure of inflation expectations that has been steadily rising in the US and Europe since mid-2016 when global bond market yields bottomed.

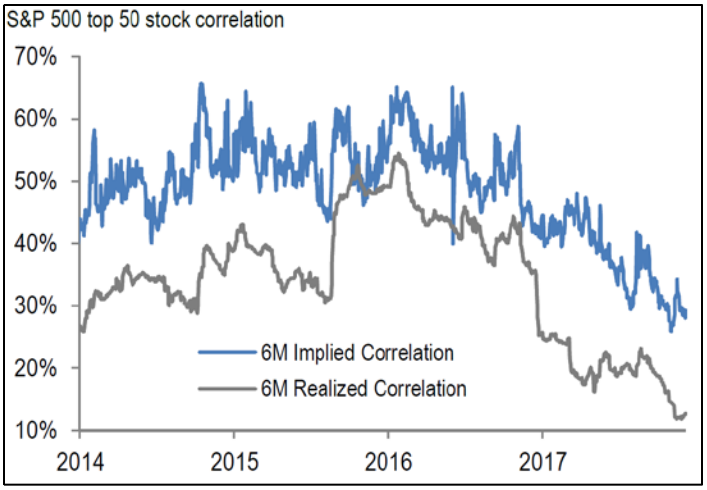
The trend is not conspicuously up but instead poses upside "risk" should the trend continue.

Source: Bloomberg, as of 12/31/2017

Greek Banks.

Speaking of upside risk, we wanted convex exposure to a European recovery. At the heart of Europe's woes in 2011 was the Greek debt debacle. Greek banks have recapitalized almost once a year since the European debt crisis and are well positioned to profit if pro-EU policy remains constructive. These banks are trading at approximately one-third of book value and we believe they could provide incredible returns on capital for those who believe they have enough loan loss reserves. This investment thesis can be summarized as "Europe is following the US and Greece will not be left behind" and the guidelines for our investment are similar to those for our overweight in broad European equity exposure.

To look for mispriced situations is at the heart of **Active Management.** While the secular "move into passive ETFs" is still strong—2017 was another strong year for passive inflows and active outflows—we believe the groundwork has been sufficiently laid for a multi-year run in active management. We are not calling for that run to happen in 2018, per se, but the ingredients are there. For example, below is a chart from JP Morgan that shows the correlation between the 50 largest stocks in the S&P 500. As the reader can see, that number is at multi-year lows. This low correlation is not just true between stocks in the index but is true for sectors as well.



Source: JP Morgan, as of 12/14/2017

Low correlation between stocks and sectors bodes especially well for long/short equity managers—it means there is significant potential to add value by being different from the index.

We believe this equity environment may be somewhat similar to the 1990's—characterized by unwavering investor optimism surrounding major disruptive technology, traders-by-day-waiters-by-night and a **tremendous dispersion between value and growth**. Following the tech bubble, value went on a fantastic six-year run, outperforming growth by double-digits and providing the patient investor with fantastic returns.

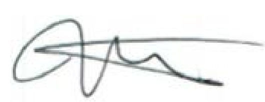
Source: Bloomberg, as of 12/31/2017

If I was forced to wager a guess, I would say we are in 1999. I'm inferring in that comment that it is possible value may significantly underperform growth again this year. That said, over the next five years, I would place a big stack of chips on value outperforming growth. Under the "growth" category one might include the likes of blockchain or cryptocurrency (I swore I wasn't going to write about it!).

It bears mentioning that "growth" is not an investment style that academics have espoused because there is not "premium" one historically receives for buying growth characteristics. In fact, the premium is negative, which means an investor historically loses money by owning growth instead of market-cap! While that may be true over long periods of time, there are short bursts of time where growth characteristics pay off well.

Markets were generous in 2017. Optimism was the word of the year. "Me too" investing (i.e. performance-chasing) has been rewarded, and waters have been anything but choppy. Bruce Lee would probably have done well this year. But now is the time we must force ourselves to be most thoughtful because just as water can drip, it can also crash.

Here's hoping there are no big waterfalls around the bend.



Jonathan Belanger, CFA

Director of Research

AlphaCore Capital, LLC

1. *Source: Bloomberg, Wilshire. The performance presented utilizes index returns, and you cannot invest directly into an index without incurring fees and expenses of investment in a security or other instrument. In addition, hypothetical performance does not account other factors that would impact actual trading, including but not limited to account fees, custody, and advisory or management fees, as applicable. All of these fees and expenses would reduce the rate of return on investment.*

EQUITY-Global stocks represented by MSCI ACWI Index NR USD; Developed stocks represented by MSCI World Index NR USD; Emerging Market stocks represented by MSCI Emerging Markets NR USD; US stocks represented by MSCI United States TR; Europe stocks represented by MSCI Europe NR USD; Japan stocks represented by MSCI Japan NR USD. FIXED INCOME-Global Bonds represented by Bloomberg Barclays Global Aggregate Bond Index Hedged USD; US bonds represented by Bloomberg Barclays US Aggregate Bond Index; Emerging Market bonds represented by JP Morgan Emerging Market Bond Index (EMBI) TR USD; US High Yield represented by ICE BofAML High Yield; 10-yr Tsy yield is the 10-year US Treasury yield on 12/29/2017; 2-yr Tsy Yield is the 2-year US Treasury yield on 12/29/2017. REAL ASSETS- Commodities represented by Bloomberg Commodities Total Return index; Crude oil represented by Bloomberg Crude Oil Subindex; MLPs represented by Alerian MLP Total Return index; Real Estate represented by NAREIT All REIT Total Return Index; Gold represented by Bloomberg Commodity Gold subindex. ALTERNATIVES- Long/Short Equity represented by Wilshire Equity Hedge category; Global Macro represented by Wilshire Global Macro category; Event-Driven represented by Wilshire Event-Driven category; Relative Value represented by Wilshire Relative Value category; Multi-Strategy represented by Wilshire Multi-Strategy Alternative category.