Taxable Fixed Income Strategies

October 2016

FIERACAPITAL

Overview

3rd Quarter 2016 Positioning

Recent years have been littered by crises that threatened to undo the post Great Recession recovery: Grexit, falling oil prices, government shutdowns, China's Yuan devaluation and periodic China growth panics, various forms of flash crash just to name a few. This parade of crises has sustained accommodative central bank policies, low rates, and investors' search for yield. The latest flashpoint, Brexit, sparked a risk-off move in markets which reversed in just a matter of weeks, with global stocks recovering to make new highs and corporate bond credit spreads reaching their tightest levels this year. Commodities staged a rally and even inflation protected securities began to outperform. While we are growing more cautious on corporate spreads, we expect TIPS to continue to do well.

We have long argued that central banks are erring on the dovish side to support growth and will add liquidity should financial conditions deteriorate. While this long-term outlook has guided our overweight allocations to corporate bonds, and our underweight to Treasuries, we are beginning to rebalance and to move up in quality after the recent tightening in corporate spreads. While central bank activity is supportive, fundamentals, while healthy, are beginning to erode.

However, there is no need to rush to the exit doors when it comes to corporate credit: the major central banks of the world either added stimulus or delayed plans to hike rates in the past 3 months. The Bank of Japan is using its bond buying to target interest rates, the European Central Bank is buying corporate bonds, and the Fed has reduced the number of expected interest rate increases in coming years. We expect to use this support to the market as an opportunity to rebalance methodically, and strategically.

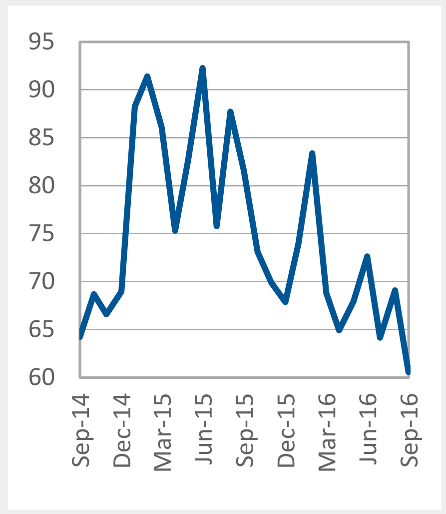
For those worried that a sudden spike in rates might derail our plan to act deliberately, we are guided in our sector allocation strategy by the grim truth that there is no free market for interest rates. Central planners at central banks will control the trading range in developed market sovereign debt, and in this environment there may be volatility – but in a narrow band. We believe central bankers have banished the probability of a 1994 sell-off in bonds. The MOVE Index, the worry index for the bond market, has sunk back to its lowest levels in almost 2 years.

Market and Strategy Returns

		3Q16	YTD
HGST	**Gross**	**0.07%**	**1.76%**
	Net*	-0.02%	1.50%
BC US Gov/Cred 1-3Y		0.02%	1.68%
Ex BBB		-0.05%	1.48%
HGCI	**Gross**	**0.31%**	**4.19%**
	Net*	0.22%	3.92%
BC Int. Agg		0.31%	4.10%
Ex. BBB/CMBS/ABS		0.17%	3.66%
Int Gov	**Gross**	**-0.05%**	**3.59%**
	Net*	-0.14%	-3.32%
BC Int Gov		-0.24%	3.30%
Corp 1-5	**Gross**	**0.32%**	**3.54%**
	Net*	0.26%	3.34%
BC 1-5 Corp		0.52%	3.71%
BC Int. Treasury		-0.26%	3.39%
BC Int. TIPS		0.57%	5.57%
BC U.S. MBS		0.60%	3.72%
BC Int. Corp		0.89%	5.99%
Industrials		0.95%	6.79%
Financials		0.86%	4.75%
BC Muni 5 Year		-0.02%	2.30%

*Please see important disclosures at the end of this commentary.
Sources: Barclays (BC), Bloomberg 9/30/16.

MOVE Index



Source: Bloomberg 9/30/16.

Past performance is not a guarantee of future results. Inherent in any investment is the potential for loss.

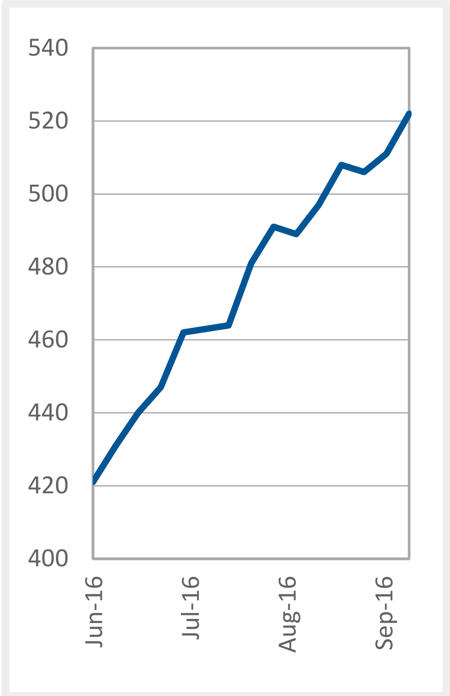
At its September meeting, the Federal Reserve opted to keep rates unchanged but, in subsequent statements, noted that the economic data was moving towards a hike – possibly later this year. Our view has been that the timing of rate hikes is less important than the pace and at what level those hikes stop. In their summary of economic projections, Fed members yet again downgraded the pace of tightening. If the Fed Funds target rate is indeed stuck at levels below historical average to keep the economy stable, then longer maturity rates will have a difficult time rising as well. This, along with the fact US bond yields are higher than other sovereign issuers, argues for duration at or above benchmark.

Corporate Credit

Valuation and fundamentals aided our decision to reduce our exposure to financials throughout the quarter. Fears of inadequate capital at a large European bank, and a customer account scandal at a domestic institution has resulted in a crisis of confidence in the sector. On the whole, the system has done a lot to repair the balance sheet of institutions post financial crisis, however while the US banking sector was quicker to raise fresh capital and address legal issues the European system has been slower to act. Banks hoping that they could earn their way out of this position have been pressured by central bank policies that have kept interest rates low globally. We have been reducing exposure to names with potential for legal fines to grow larger than anticipated, loss of revenues, and business models being called into question. But overall the health of the US banking sector remains solid, with strong levels of capital and liquidity. This new round of scrutiny will bring calls for increased regulation, with additional stress test capital buffers being discussed. With final rules on regulatory debt issuance expected, we may see increased supply and more issuance of callable securities in order to meet regulatory debt requirements rather than for operational purposes.

In other credit developments, the energy sector saw a boost in prices after the announcement of potential OPEC (Organization of the Petroleum Exporting Countries) production caps US Rig count has also seen its 14th weekly increase out of 15 suggesting demand increase. We took a more positive tone on riskier names that are focused on maintaining a strong balance sheet. We continued to see bondholder friendly action in the basic materials space and favored industrial gas companies that are highly rated, have a defensive business model, and focus on de-leveraging. In the media sector, there has been increased demand for content to help with negotiating power against pay-TV providers who have grown in scale given M&A. Also, content companies are looking to gain access to online streaming and on-demand platforms given cord cutting disruption. Some have been successful in this regards while others have lagged. This has resulted in drama around the potential for consolidation of two large industry players.

US Rig Count



Source: Baker Hughes.

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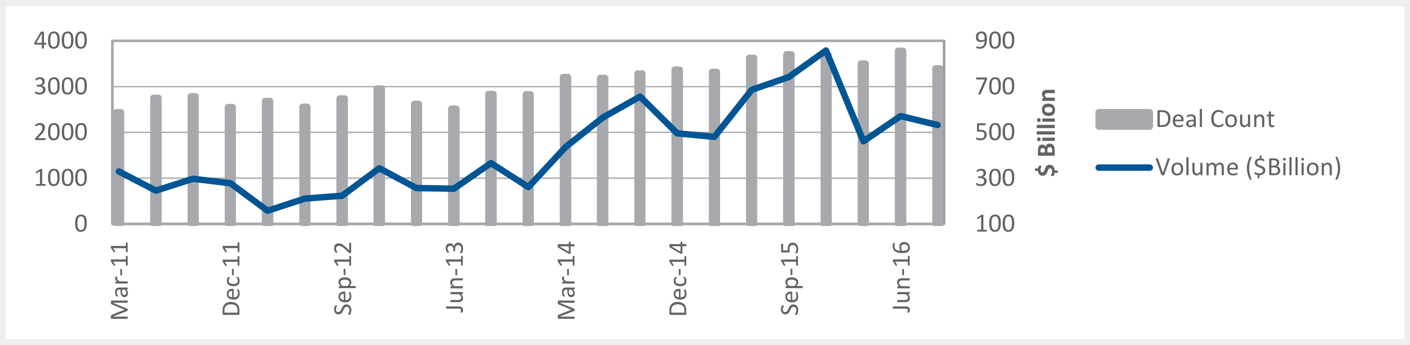
One of the largest corporate bond M&A deals ever was approved in the beverage sector. This was supportive of bonds in the credit complex that contain special mandatory redemption language – these are bonds used to pre-fund M&A deals which can be called at $101 if the deal is terminated or does not close by a specific date. However shortly after the end of the 3rd quarter, another M&A deal was terminated due to regulatory concerns. Given the heightened level of scrutiny on M&A deals this year, particularly in an election season, we have become more cautious on bonds with special mandatory redemption language.

With the election season heating up, both parties have discussed policies that could have implications for high grade sectors. Certain sectors such as healthcare and financials could face increased regulatory scrutiny. There is also a risk of more protectionist measures, though the extent of impact may be limited if control is split between both parties. There has been some decline in shareholder friendly announcements which could partly be attributed to political uncertainty.

US M&A Activity



Source: Bloomberg.

Relative Value

Our analysis of global central bank policy has played an important role in our sector allocation strategy. There is no doubt central bank policy has influenced corporate bond valuations throughout developed capital markets, with the European Central Bank and the Bank of Japan's asset purchase programs of particular note in the last quarter. Tightening spreads overseas influence spreads across the world as investors evaluate all corporate credit through the lens of relative value analysis. When a large percentage of investment grade bonds globally trade with negative yields, US investment grade corporate bonds (with positive yields) are an attractive option for investors and are cheap on a global bond relative value basis. We expect central bank purchases in this area to continue and to be supportive of longer-term valuations. This positive global technical development, coupled with moderate US domestic growth, has created a benign, and supportive, environment for US corporate bonds spreads.

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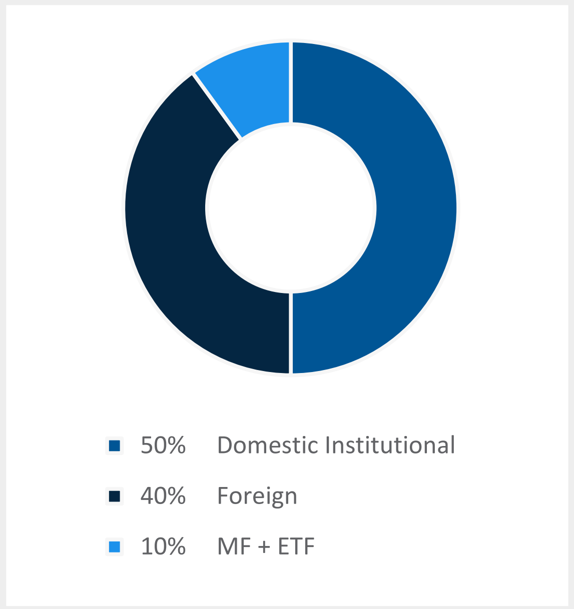
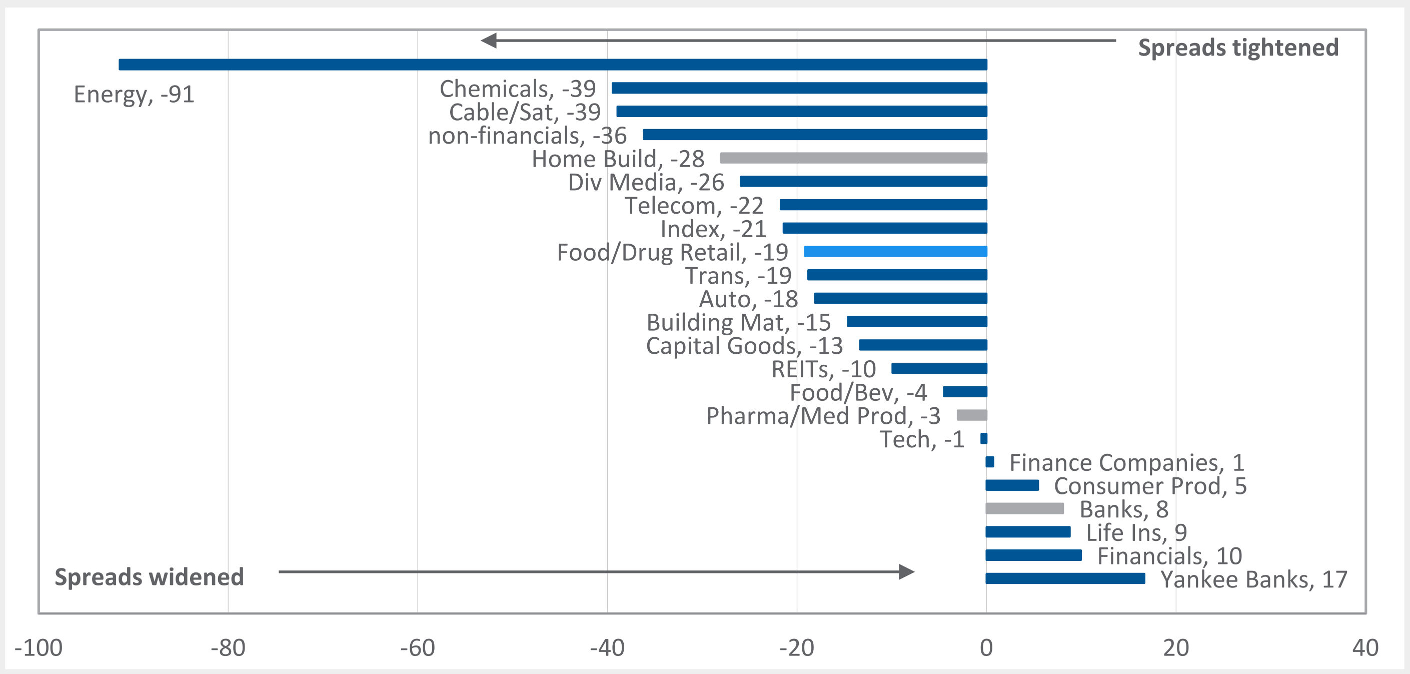
Ownership of Corporates



Source: Wells Fargo.

While market technical factors dictated corporate bond relative value during the 3rd quarter, credit fundamentals began deteriorating. The credit cycle is in its later stages, and corporate re-leveraging is occurring broadly. Most sectors have experienced meaningful spread compression and have richened. Given that we are generally at or near year-to-date tights on corporate spreads, we are more cautious generally on corporate spread valuations, particularly in sectors that have materially outperformed this year.

JULI Index Relative Value Spreads

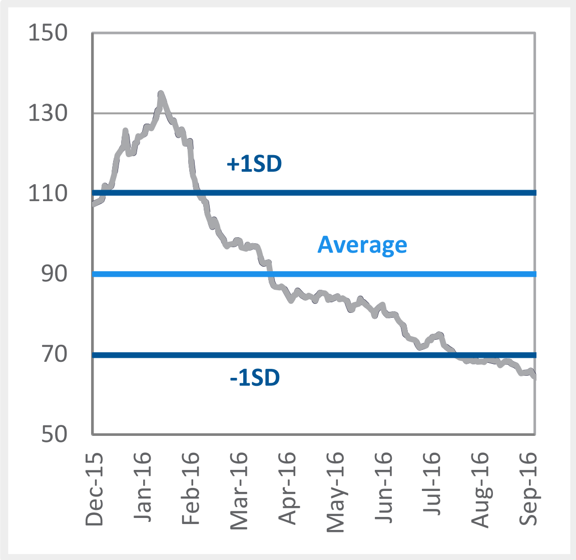


Source: JP Morgan.

Lower quality bonds have outperformed their higher quality counterparts, as illustrated by the meaningful tightening of the BBB-A spread. Although we generally do not invest in issuers from the higher beta sectors of the market, we should note their relatively rich valuations, which in addition to the stabilization in oil prices, is a reflection of the global reach for yield. Investors are moving further down the credit spectrum as the higher quality valuations are stretched.

Should the Fed tighten in December and/or signal tighter future monetary policy, we could see heightened volatility in corporate bond spreads. We currently prefer defensive industrial names that are less sensitive to commodity shocks and monetary policy. We remain cautious on financials despite their continued underperformance in the third quarter. We should note that the financial-industrial spread has widened this year, a notable divergence from this point last year. However, given recent events and credit trends, we are not yet ready to call this an opportunity.

Barclays Capital BBB-A Spread



Source: Barclays Capital.

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Outlook

Despite periods of uneven GDP growth, US payroll numbers are consistently positive. Other indicators, such as purchasing managers indices, initial jobless claims, and bank loan growth point to an economy that remains on a positive, if occasionally worrisome, growth path. Consumer confidence is high, wages are firming, and consumer spending is healthy. Of course, macro shocks can turn into sustained downturns, but that is not our base case given the level of central bank largesse and macroeconomic measures such as those listed above.

While we are overweight corporate debt, we have begun to trim our holdings and in the process increased our allocation to Mortgage-backed Securities (MBS). Agency MBS has long been a core holding in the strategy. Agency MBS are backed stopped by the U.S. government and trade with low transaction costs. This is a high quality sector we think will become even more attractive to foreign buyers as trillion of dollars of global government bonds (Germany, Switzerland, Japan, etc.) trade at negative yields. This is a natural fit for our approach which emphasizes quality and liquidity.

We look across high quality bond markets to identify opportunities – even those not in the benchmark, such as tax-exempt municipal bonds. Just like our credit analyst team scrutinizes each company's fundamentals, we conduct the same stringent review for states, cities and other municipal issuers. The yield ratio of municipals to Treasuries has risen as municipal issuers have taken advantage of low rates to increase supply. An allocation to municipals thus offers us a way to maintain yield and quality in a defensive manner as, historically, tax-exempt municipals have outperformed Treasuries at elevated yield ratios. We also continue to own TIPS as we believe the Fed will ultimately succeed in raising inflation over 2%. The market is not priced for that outcome and inflation protection remains cheaply valued.

While our strategy is structured to benefit from a gradually improving economy, we are monitoring risks to our outlook both at home and abroad. US elections, Britain's departure from the EU and fears about the strength of global banks may introduce volatility. We are prepared to rebalance as needed to deliver clients the benefits of quality fixed income as an asset class.

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Strategy Definitions:

- High Grade Short Term (HGST) – utilizes the same investment themes and sector rotation methodology as the Core Intermediate strategy but focuses on shorter maturities, limiting the interest rate risk.
- Intermediate Government (Int Gov) – emphasizes government quality bonds, but in a diversified approach that looks beyond Treasuries to include to pre-refunded municipals, Treasury Inflation-Protected Securities and U.S. dollar denominated sovereign-supported issuers.
- High Grade Core Intermediate (HGCI) – relative return focused versus the Barclays Capital Intermediate Aggregate Index, which offers diversification benefits comparable to the Aggregate Index, but with what we believe to be favorable risk/return metrics.
- Corporate Index Replication (Corp 1-5) – seeks to provide the return and risk profile of a selected benchmark with fewer securities through a separately managed account. This is designed for clients interested in a specific asset class, but wishing to avoid the premium/discount issues of exchanged traded funds.

Index Definitions:

- Barclays 1-3 Yr Gov/Credit is the 1-3 Yr component of the U.S. Government/Credit Index. The Government/Credit Index includes securities in the Government and Credit Indices. The Government Index includes treasuries (i.e., public obligations of the U.S. Treasury that have remaining maturities of more than one year) and agencies (i.e., publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The Credit Index includes publicly issued U.S. corporate and foreign debentures and secured notes that meet specified maturity, liquidity, and quality requirements.
- Barclays Intermediate Aggregate Index is the intermediate component of the US Aggregate Index. The Barclays U.S. Aggregate In dex represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.
- Barclays U.S. Corporate Investment Grade Index is a rules-based and market value weighted index of publicly issued U.S. corporate bonds. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued.
- The Barclays 1-5 Corporate Index the 1-5 year component of the index.
- The Barclays Intermediate Corporate Index is the Intermediate component of the index.
- Barclays Intermediate Corporate Industrial Index is the Intermediate component of the Investment Grade Industrial Index. To b e included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued. Bonds in the Index must belong to the Industrial sector.
- Barclays Intermediate Corporate Financial Institutions Index is the Intermediate component of the Investment Grade Financial Institutions Index. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds in the Index must have at least one year to final maturity regardless of call features and have at least $250 million par amount outstanding. Bonds in the Index must be fixed rate, although it can carry a coupon that steps up or changes according to a predetermined schedule, must be dollar-denominated and non-convertible and must be publicly issued. Bonds in the Index must belong to the Finance sector.
- Barclays 5 Year Municipal Index is the 5 Year component of the Municipal Bond Index. The Barclays Municipal Bond Index is a r ules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of transaction of at least $75 million. The bonds must be fixed rate, have a double date after December 31, 1990, and must be at least one year from maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
- Barclays US MBS is a component of the US Aggregate Index. The MBS Index covers the mortgage -backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates. In other words, each aggregate is a proxy for the outstanding pools for a given agency, program, issue year, and coupon. The index maturity and liquidity criteria are then applied to these aggregates to determine which qualify for inclusion in the index. About 600 of these generic aggregates meet the criteria. The aggregates included in the index are priced daily using a matrix pricing routine based on trader price quotations by agency, program, coupon, and degree of seasoning.
- The US Intermediate Treasury Index represent the intermediate securities of the U.S. Treasury Index, which represents public obligations of the U.S. Treasury with a remaining maturity of one year or more.
- The Barclays Intermediate TIPS Index consists of securities in the intermediate maturity range of the Inflation-Protection securities issued by the U.S. Treasury.
- The JPMorgan US Liquid Index, or JULI, provides performance comparisons and valuation metrics across a carefully defined univ erse of investment grade corporate bonds, tracking individual issuers, sectors and sub-sectors by their various ratings and maturities.
- Goldman Sachs Commodity Index (GSCI) is a composite index of commodity sector returns which represents a broadly diversified, unleveraged, long-only position in commodity futures.