ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

1Q2018

It seems as though we have been discussing the possibility of a turn in the economic and market cycle for some time. During the first quarter, further signs flashed that we may be nearing that point. Perhaps the most obvious sign was increased equity market volatility after a historically tranquil 2017. So, what has that meant for our client's portfolios?

Before answering we should say that one of our favorite reads at this time of year is Warren Buffett's letter in Berkshire Hathaway's Annual Report. It is never dull and always filled with great investing axioms. Not to be outdone, the 2017 version had a couple that struck a chord when we were thinking about answering that question because they capture our investing beliefs nicely.

- Axiom 1 – Stick with big, "easy" decisions and eschew activity.
- Axiom 2 – Performance comes, performance goes. Fees never falter.

With those axioms in mind we turn back to the question, what has recent volatility meant for client portfolios? In short, two well-researched investment decisions. One on the equity side of client portfolios and one on the fixed income side of client portfolios; both were incidental to increased volatility – not driven by it.

We believe in research. We believe in low fees. Knee-jerk reactions have a negative influence on both so we are committed to avoiding them to the greatest degree possible. Over the short-term our timing may be "off", but our decisions will be grounded in thorough research, and we will never create unnecessary activity that will compound fees in client portfolios. Experience has taught us that both are damaging to our goal of compounding wealth for our clients.

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 box to skip to a new section.

Market Performance

Annualized % Returns (As of 3/31/18)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	13.99	10.78	13.31	9.49
Russell 1000 Index	Mid/Large Cap Stocks	13.98	10.39	13.17	9.61
Russell 1000 Growth Index	Growth Stocks	21.25	12.90	15.53	11.34
Russell 1000 Value Index	Value Stocks	6.95	7.88	10.78	7.78
Russell 2000 Index	Small Cap Stocks	11.79	8.39	11.47	9.84
MSCI EAFE Index	Non-U.S. Developed Market Stocks	14.80	5.55	6.50	2.74
MSCI Emerging Markets Index	Emerging Markets Stocks	24.93	8.81	4.99	3.02
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	20.60	10.40	8.57	5.51
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	4.06	5.24	5.45	4.36
Barclays Municipal Bond Index	U.S. Municipal Bonds	2.66	2.25	2.73	4.40
Barclays Aggregate Bond Index	U.S. Bonds	1.20	1.20	1.82	3.63
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	0.35	0.94	1.25	2.92
BofAML U.S. Treasury Master Index	Treasury Bonds	0.51	0.47	1.18	2.82
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	0.74	1.11	1.79	3.45
BofAML U.S. Corporate Master Index	Corporate Bonds	2.68	2.35	3.03	5.36
BofAML U.S. High Yield Master II Index	High Yield Bonds	3.70	5.19	5.02	8.18
BofAML Convertible Bonds Index	Convertible Bonds	13.26	8.62	11.37	9.67
BofAML Euro Broad Market Index	European Bonds	17.71	5.50	2.75	2.02
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	12.47	4.97	-0.16	3.03

Calendar Year % Returns (QTD as of 3/31/18)

Source: Morningstar Direct

	QTD	2017	2016	2015	2014	2013
S&P 500 Index	-0.76	21.83	11.96	1.38	13.69	32.39
Russell 1000 Index	-0.69	21.69	12.05	0.92	13.24	33.11
Russell 1000 Growth Index	1.42	30.21	7.08	5.67	13.05	33.48
Russell 1000 Value Index	-2.83	13.66	17.34	-3.83	13.45	32.53
Russell 2000 Index	-0.08	14.65	21.31	-4.41	4.89	38.82
MSCI EAFE Index	-1.53	25.03	1.00	-0.81	-4.90	22.78
MSCI Emerging Markets Index	1.42	37.28	11.19	-14.92	-2.19	-2.60
MSCI ACWI Ex USA Small Cap Index	-0.35	31.65	3.91	2.60	-4.03	19.73
BofAML Preferred Stock Fixed Rate Index	-1.00	10.58	2.32	7.58	15.44	-3.65
Barclays Municipal Bond Index	-1.11	5.45	0.25	3.30	9.05	-2.55
Barclays Aggregate Bond Index	-1.46	3.54	2.65	0.55	5.97	-2.02
Barclays Intermediate U.S. Gov/Credit Index	-0.98	2.14	2.08	1.07	3.13	-0.86
BofAML U.S. Treasury Master Index	-1.21	2.43	1.14	0.83	6.02	-3.35
BofAML U.S. Mortgage Backed Securities Index	-1.21	2.45	1.67	1.46	6.07	-1.39
BofAML U.S. Corporate Master Index	-2.20	6.48	5.96	-0.63	7.51	-1.46
BofAML U.S. High Yield Master II Index	-0.91	7.48	17.49	-4.61	2.51	7.41
BofAML Convertible Bonds Index	3.23	16.03	11.94	-1.15	9.97	26.60
BofAML Euro Broad Market Index	3.16	14.61	0.37	-9.30	-2.48	6.89
BofAML Local Debt Market Plus Index	3.83	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

Markets hate uncertainty. Investors witnessed this firsthand over the course of the first quarter as equity markets swung in both directions. After a strong showing in 2017, stocks were priced for near perfection. Unfortunately, the first quarter of 2018 turned out to be far from perfect.

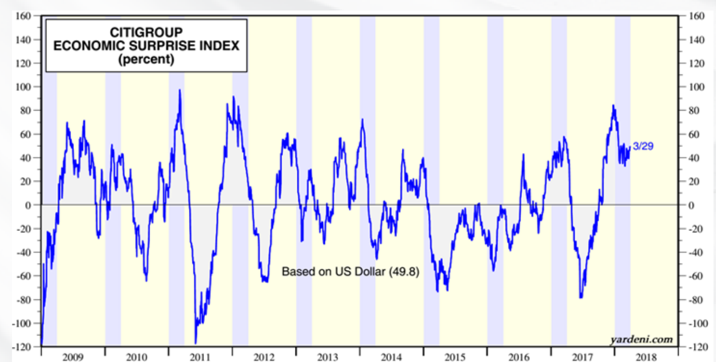
Over the course of the quarter, most of the attention (especially in the financial media) was focused on three different topics. The first was the confirmation of new Federal Reserve Chairman Jerome Powell. Powell was not expected to rock the boat too significantly compared to his predecessor, but until his first official meeting there was a degree of uncertainty as to the exact tone he would strike with markets. In the end, Powell's first meeting produced little fanfare. However, it did appear that he would be more "hawkish" (i.e. more aggressive in raising rates) than his predecessor Janet Yellen.

The second topic centered on President Trump's announcement of steel and aluminum tariffs. On many measures, the financial impact of the initial round of tariffs was not expected to be too significant, but the President followed up on the broader steel and aluminum tariff announcement (initially to be levied against imports from all countries) with an announcement of tariffs on $60 billion of Chinese goods, primarily geared towards products in the tech sector. Stocks sold off sharply following the announcement as investors feared it was an opening salvo into a much wider trade war with China. These fears gained some traction over the latter days of March and into April as President Xi Jinping of China and President Trump exchanged threats of further tariffs on goods imported by each country. Time will tell if both sides hold their ground or things calm, but the discussion left investors on edge.

Lastly, politicians from around the globe increasingly targeted large U.S. technology companies for a variety of reasons. In Europe, pressure began to build to break-up or constrain companies such as Google, Apple, Facebook and Amazon as political leaders felt that these companies' monopolistic control of specific segments of the market hurt competition. As a result, politicians in certain countries (notably France) raised the possibility of increased taxes or implementation of anti-trust measures against the companies. Unfortunately for technology investors, political angst against the tech giants was not confined to overseas markets as President Trump took aim at Amazon, while Facebook dealt with a data scandal that resulted in founder Mark Zuckerberg testifying before Congress. Needless to say, it ended up being a tumultuous period for many tech companies that were market leaders in 2017.

The Economy

Last quarter, we theorized that economic data could fall short of expectations and spark long suppressed volatility in markets. Our concern was based on several factors, but one indicator we follow closely, the Citigroup Economic Surprise Index (shown at the right), was flashing a brighter warning sign than others. From our research, we know the index is mean reverting, and at the end of 2017, the index was near a high for this cycle suggesting it was more likely to go down than increase.



Source: Yardeni

Economic data started to underwhelm as the first quarter unfolded, moving GDP forecasts for the first quarter, which had approached 6% in some cases, down to 2%. So, the indicator proved correct. Digging into the details, the incoming data suggests the slowdown can be attributed to a broad-based slump in consumption growth. We have also recently seen weakness in data outside of the U.S. First quarter 2018 retail sales were weak in Europe and Japan, and at the same time, business surveys had fallen in many countries, notably in Europe. One bright spot was China, where activity held up better than expected. Including the U.S., it is estimated that world GDP expanded by roughly 3.5% in the first quarter of 2018, which is moderately lower than the 4% expectation coming into the quarter.

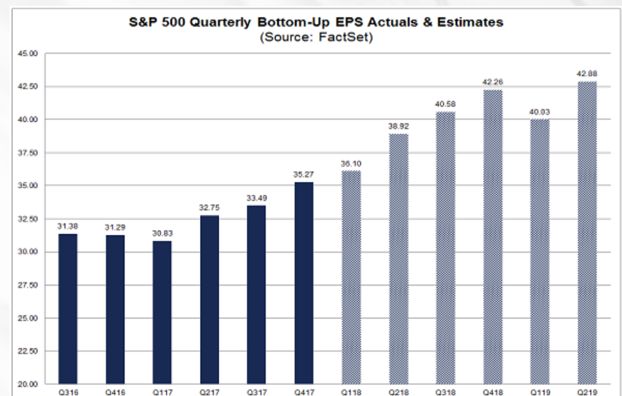
Interest Rates

During the first quarter, short-term interest rates continued to climb, as the U.S. Federal Reserve (Fed) raised the overnight funds rate by 25 basis points (1 basis point equals 0.01%). It marked the fourth such increase in the last year and was the first under new Fed Chairman Jerome Powell.

Earnings

Corporate earnings growth (year-over-year) is expected to be +17.1% (S&P 500® Index) for the first quarter. If this growth rate materializes, it will mark the highest earnings growth rate for the S&P 500® Index since the first quarter of 2011 (+19.5%). An earnings growth rate of +17.1% would also be the fourth time out of the past five quarters that the S&P 500® Index registered double-digit earnings growth.

The estimated earnings growth rate of +17.1% was a significant uptick from expectations coming into the quarter. As of December 31, earnings growth for the first quarter was expected to be +11.3%. However, a record (since FactSet began tracking the data in 2Q '06) number of positive earnings guidance pushed earnings expectations higher. Based on company-by-company data, many of the positive revisions were because of a reduction in the corporate tax rate. This is expected to carry-through for the remainder of 2018, which can be seen in the quarterly earnings (estimates and actuals) in the chart to the right.



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

Based on that data, it would seem that the rest of 2018 would be great for the equity market, right? Not necessarily. It is important to remember that the equity market is a forward-looking mechanism and likes to see a continuation in the acceleration (or improvement) in earnings and other data. While absolute levels of earnings and other data are important, the direction of the data tends to carry the day and where our concern begins to creep into the equation. Even though the data is expected to be good for the second half of the year, we believe the improvement in earnings over this timeframe may not be as robust as expected. This largely stems from our belief that broad economic growth may have reached its peak for this part of the economic cycle. Earnings disappointments (or simply "less good" earnings levels than currently forecasted) may be one of the causes that leads to a change in market leadership from a style and sector perspective over the latter half of 2018.

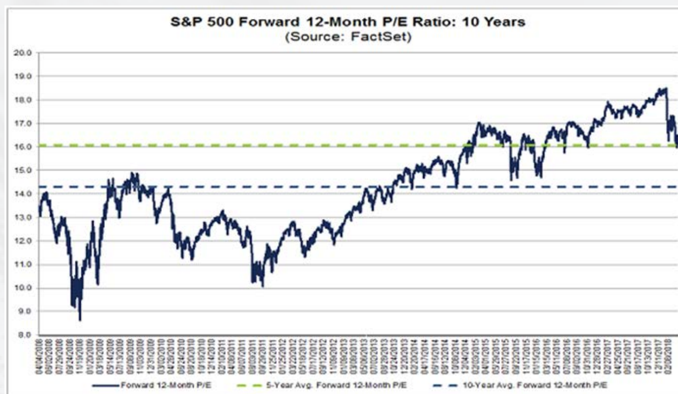
Equity Portfolio Comments

Equity Market Results

Despite significant day-to-day volatility, the U.S. equity market, as represented by the S&P 500® Index, finished the quarter with a relatively small decline of -0.76%. Developed foreign equity markets, as represented by the MSCI EAFE® Index, fared slightly worse with a loss of -1.53%. Emerging markets, as represented by the MSCI Emerging Markets Index, ended the period as the "winner" with a positive return of +1.42%. From a style perspective, growth-oriented domestic equities (+1.42%, Russell 1000® Growth Index) outpaced value-oriented domestic equities (-2.83%, Russell 1000® Value Index), while among domestic equity market-capitalizations, large-cap equities (-0.76%, S&P 500® Index) lagged small-cap equities (-0.08%, Russell 2000® Index).

Growth stock performance relative to value stock performance noted above may seem counterintuitive at first glance considering the negatives headlines noted earlier. However, much of the turmoil in growth-oriented sectors occurred over the latter part of the quarter after these sectors posted large positive gains in January. For instance, growth stocks (Russell 1000® Growth Index) lagged value stocks (Russell 1000® Value Index) by roughly 1% in March. We will discuss this trend more later.

Equity Market Comments



Source: FactSet Research Systems – Earnings Insight April 6, 2018.

The S&P 500® Index's forward P/E ratio (price-to-earnings ratio) contracted to approximately 16.5x in the first quarter. As a reminder, 16.5x is roughly the amount that investors are willing to pay for $1 of future earnings. This amount is higher than the five-year average of 16.1x and 10-year average of 14.3x. Based on the chart above, the equity market appears overvalued. However, as we have stressed time and time again, <u>valuation is not a catalyst by itself</u>. Elevated valuations may result in faster equity market declines when the market reverses course, but valuation alone does not cause the market to decline. Investors need a catalyst, or reason to sell, before stock prices will generally fall.

We listed a number of potential negative catalysts in our last newsletter. We did not have confidence if or when any of the catalysts on the list would surface, but we noted that the emergence of any one of them may trigger a market decline. Out of the nine that we listed, trade protectionism emerged as a negative catalyst during the quarter. At this point, it is hard to know whether cooler heads (and trade deals) will prevail, or if further escalation will materialize. There also remains the possibility that one of the other eight negative catalysts from our list emerge. Headlines, panic and euphoria come and go. The only thing that we can focus on is how short-term events can ultimately impact our view of the long-term business cycle and how that will provide guidance for portfolio construction. With that in mind, we stress that clients do not get caught up in short-term headlines or movements in their portfolios. Instead, we encourage clients to remain anchored in a well-thought-out investment plan that can be followed in the good times and the bad. Decisions made amid emotion tend to never have productive outcomes for portfolios.

Client Portfolio Impact

In foreign equity markets, we continue to have a high degree of confidence long-term in small- and mid-cap equities, as well as emerging markets more broadly. Regarding emerging market equities, we do not expect results to be nearly as steady or strong on an absolute basis as they were in 2017. However, we believe emerging markets may provide relatively good value over the intermediate- to long-term when compared to the broad foreign equity market and U.S. equity market. For additional color on our view of emerging markets please see our ViewPoints titled Relative Value Analysis – The Anatomy of an Investment Decision.

In U.S. equity markets, we continue to favor large-capitalization companies over small-capitalization companies. However, we do not believe the relative value gap between the two segments of the market is as large as it once was. The more notable item as it relates to domestic equity markets is that we recently decided to reduce our significant bias towards domestic growth-oriented companies. We did this through the redemption of a dedicated large-cap growth fund across client accounts.

As a reminder, we originally purchased the large-cap growth fund in the fourth quarter of 2016. At the time, we used a combination of proceeds from a partial redemption of a passively-managed total market equity index ETF (exchange-traded fund) and a full redemption of an equity income fund (value-oriented) to fund the purchase of the investment. A number of factors led us to make the trade in portfolios at the time.

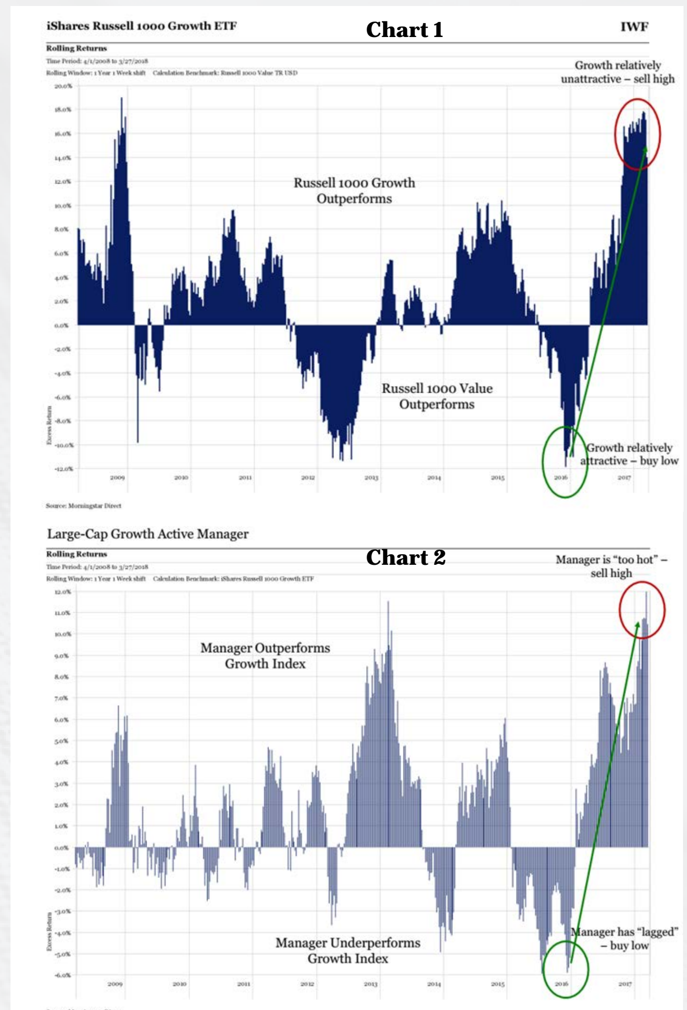
1) Value-oriented stocks had outperformed growth-oriented stocks for much of 2016.
2) One of our high-conviction actively-managed growth managers had lagged its large-cap growth benchmark in 2016.
3) There were signs of a resumption in broad economic growth (growth had troughed and had begun to accelerate).
4) Corporate earnings growth, particularly in growth-oriented sectors of the market, had begun to accelerate.

Like all of our trades, when we made the investment, we were unsure how long it would take for our thesis to materialize, but we felt that after taking all factors into consideration, the relative risk/reward of the opportunity was attractive, especially over a short- to intermediate timeframe (1-3 years). Fortunately for our investors, the trade took less time to materialize than expected. Growth-oriented stocks outperformed value-oriented stocks and the actively-managed large-cap growth manager we invested in outperformed its benchmark by a wide margin from December 2016 through the first quarter of 2018. As a result of the significant outperformance, many of the attractive characteristics that had initially led us to invest in growth-oriented stocks and the large-cap growth manager had diminished or had in fact shown signs of a reversal. So, we thought it was prudent to take gains (absolute and relative) and redeploy the proceeds of the redemption to an area of the market (and active manager) with a more attractive risk/return profile.

The decision to sell the large-cap growth manager may have been met with surprise by some of our clients considering it was the best (or one of the best) performing investments in many client portfolios in 2017. The easy, non-controversial decision would have been to keep the investment in portfolios. In fact, some advisors will do this as a reminder to their clients that they made a good decision, but we are not interested in optics. We are interested in making what we believe to be the best decisions for our clients, even if that means making the hard decision to sell a “winner.”

This trade (buy and subsequent sell) highlights a few key parts of our investment process. First, we will typically invest in areas of the market that are out of favor, or that have underperformed. As can be seen in Chart 1 below, we will typically become interested in a segment of the market (in this case growth-oriented stocks) when it is out of favor (see green circle). Second, within the segment of the market we like, if we are choosing to express our investment view by using an active manager, we will typically make an initial investment (or add to an existing manager) when that manager has underperformed its benchmark. In chart 2 below, our initial interest occurred again at the green circle. Taken together, the underperformance of a segment of the equity market and underperformance of a manager in which we have high conviction and long-term confidence, led to an ideal environment to make an investment (or trade).

We believe this discipline is critical to long-term success given the propensity to chase hot sectors due to recency bias, which we highlighted in another ViewPoints titled [Manager Research – The Anatomy of an Investment Decision](). Of course, other factors besides charts need to be taken into consideration, such as underlying economic and corporate earnings strength (broader factors), but these two charts provide a simplified picture of what we look for prior to making a trade in portfolios.



Finally, fast forwarding from 2016 to 2018, it can be seen in the charts that the factors that were initially present are no longer today. When paired with our growing concerns that economic growth and corporate earnings may have in fact peaked (not in an absolute sense, but on a rate of change basis), we believe that the trade was warranted. We are keenly aware that we may look very wrong for selling this manager in the short run because we are never going to get the timing exactly right (unless we're lucky), but we will continue to make decisions that we believe are in the best interest of our clients and their long-term goals no matter how hard or uncomfortable those decisions may be.

From a portfolio characteristics perspective, the overall impact of the trade is that the defensive nature of portfolios has increased. In general, this means that clients may perform relatively better than the broad equity market if/when stock prices decline. However, this also means that clients may not participate as much as they have over the previous 12 months if stock prices increase sharply. We believe this is prudent especially when considering our short- to intermediate-term outlook and recent results relative to history.

Fixed Income Portfolio Comments

Fixed Income Market Results

As in prior quarters, short-term interest rates continued to climb. The difference between the first quarter and the last several was that interest rates across the yield curve moved up in a parallel fashion. The 2-year U.S. Treasury bond increased 38 basis points while the yield on the 10-year Treasury bond increased 34 basis points. Credit spreads also saw a reversal of recent trends by widening (the difference in interest rate between a corporate bond and similar maturity U.S. Treasury bond) throughout the quarter.

Domestically, preferred stocks and investment grade corporate bonds led the way by widening 20 basis points and 18 basis points, respectively. Mortgage-backed securities generally fared better. Commercial mortgage-backed securities and residential mortgage-backed securities widened only 5 and 8 basis points, respectively. Internationally, European high-yield bonds and developed market sovereign bonds were on the opposite end of the spectrum. European high-yield bonds widened 36 basis points, while developed market sovereign bonds tightened 3 basis points. All other fixed income sectors we track fell between those general ranges.

Because interest rates increased across the maturity spectrum and credit spreads generally widened, it should come as no surprise that most fixed income sectors posted negative returns in the first quarter. Investment grade corporate bonds were the worst performing sector with a -2.20% return. However, there were bright spots. Non-dollar denominated bonds continued to perform well as the U.S. dollar continued to retreat. Specifically, emerging market local currency bonds gained +3.83%, while European bonds generated a +3.16% return.

Similar to taxable bonds, municipal bonds posted negative returns during the first quarter as yields across the maturity spectrum moved higher. In general, longer-term yields (7-year to 30-year maturities) increased at a faster pace than short-term rates, which led to a steeper yield curve. A steeper yield curve caused longer-term bonds to underperform. Somewhat mitigating the negative performance was municipal bond issuance, which declined by approximately -32% when compared to a year earlier. The decline was primarily due to tax reform. The demand side of the equation was also positive as municipal bond funds experienced inflows in 10 of the first 13 weeks of 2018.

Fixed Income Market Comments

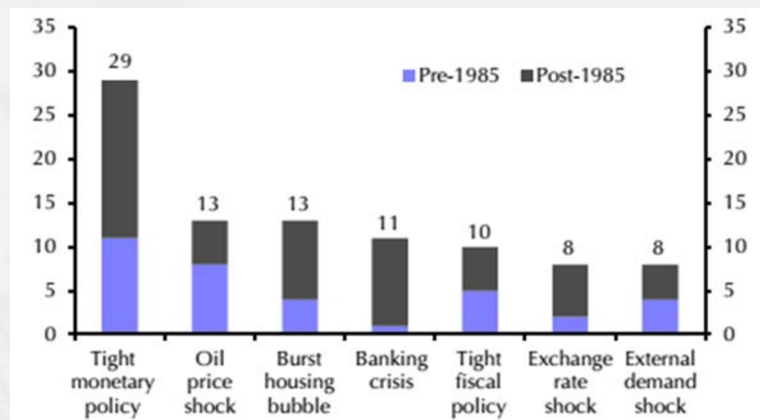
Despite an underwhelming first quarter, we do not think a recession is imminent over the short-term (6-12 months). Several highly accurate leading indicators (from a historical perspective), point to relatively solid growth over the short-term. However, these also may have signaled peak growth for this cycle is behind us. In fact, our proprietary U.S. cyclical indicator is on the verge of calling a peak for the cycle. Data coming in over the next couple of months should tell us whether this is true or not. If it is, it would not necessarily signal a recession is imminent, but that the trajectory of growth has changed from accelerating to decelerating. When this happens, a recession typically follows in the subsequent 12-18 months. Needless to say, we will be watching it closely.

Looking beyond the short-term, there are several factors we are tracking that may tell us where we're headed next. On the positive side, U.S. households just received a tax cut, jobs growth is strong and consumer confidence is at a 14-year high, all of which suggests the slowdown in consumption growth

could be temporary. On the negative side, we are experiencing increased inflation, tightening credit conditions and rising debt levels. There are several external factors that could play a role as well. The most glaring is a potential trade war with China. Ongoing geopolitical tensions with North Korea, Russia, Iran and Syria, and slowing growth outside our boarders, particularly in Europe, Japan and China, also have the potential to be impactful. Should we be concerned?

One way to find out is to analyze the past. To quote Mark Twain, "History doesn't repeat itself, but it often rhymes." Capital Economics (a leading private research firm) recently published a paper identifying a list of conditions that played a major role in the 45 recessions that occurred in G7 economies since 1960.

Frequency of Events Preceding the 45 Recessions in G7 Economies since 1960



Source: Capital Economics

Each of the recessions was unique, but it was found all were caused by some combination of the elements in the chart to the right. When looking at the data and comparing it to today, it is interesting to note that tightening monetary policy played a role in 29 of the 45 recessions, making it by far the most common ingredient. If you bundle banking and housing-related issues together, credit shocks played a role in 24 of the last 45, making it the second most common. This is why we have been consistently commenting on the progression of tightening monetary policy and deteriorating credit fundamentals (in the corporate, government and private sectors), as our primary concerns. If we add in the increased probability of rising inflation leading to a price shock, slowing external growth leading to an external demand shock, and trade wars leading to an exchange rate shock, things become even more concerning. Our economy has proven it can fight off most of these factors in isolation, but if history "rhymes", as more factors are introduced, the probability of recession increases. What does that mean?

It is not our goal to predict the exact timing of a recession. Rather, the data is important to us in order to understand the risk and return environments for asset classes we follow and how they may evolve over our three- to five year investment horizon. This ultimately helps us determine the extent to which we should be playing offense or defense in portfolios.

U.S. Interest Rates

Based on our highest probability scenarios, we believe fair value for the 10-year U.S. Treasury is between 2.80%-3.40%. It ended the first quarter at 2.74%, but traded at the bottom end of the fair value range for much of the first quarter. The minutes from the most recent FOMC (Federal Open Market Committee) meeting indicated a likelihood that short-term rates would be raised three more times this year. It is also expected the Fed will continue to let its balance sheet shrink at a moderate pace over the remainder of the year. Taking all of this into consideration, it is likely interest rates will continue to rise over the short-to-intermediate term.

Fixed Income Portfolio Comments

Yield Curve

After projecting interest rates would move up in a parallel fashion (short-term and long-term interest rates rise together) or re-steepen (long-term interest rates rise faster than short-term rates) slightly, the past few quarters, our patience finally paid off in the first quarter. The 2-year U.S. Treasury rose 38 basis points while the 10-year U.S. Treasury rose 34 basis points. Client portfolios benefited from having less exposure to long-term rates than their respective benchmarks, as the yield curve shifted upward. Client portfolios also benefitted from having exposure to assets that rise in value along with short-term rates. Going forward, we are less worried about a steeper yield curve as inflation expectations have moderated somewhat. This suggest the yield curve will likely continue flattening over the short-to-intermediate term, as Fed rate increases outpace growth and inflation.

Sector & Quality Management

We have held a cautious view on corporate bonds for the last several quarters. The underperformance in the first quarter benefitted client performance, but has not materially shifted our stance. We continue to believe we are not being adequately compensated for taking excess credit risk. The relative value of local currency emerging market bonds has moderated somewhat over the past few quarters as significant outperformance has closed the gap between it and other fixed income sectors. We still believe it is attractive, but not nearly to the extent it was. Considering that outlook, we have continued to research opportunities that offer late-cycle diversification such as the insurance-linked and infrastructure debt markets.

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. Generally speaking, these are best found with active managers. Sectors that we believe are best leveraged with active management are non-agency mortgage-backed securities, commercial mortgage-backed securities, asset-backed securities and revenue-backed municipal bonds. We are also finding significant value in the illiquidity premiums offered in insurance-linked securities and infrastructure debt. In those markets we are investing using interval funds. Interval funds do not offer daily liquidity. As a result, they can hold a much higher percentage in illiquid securities than open-end mutual funds.

Client Portfolio Impact

- We continue to position fixed income portfolios to have less interest rate exposure than their benchmarks. At the beginning of 1Q18, we increased our defensive posture in client portfolios by reducing interest rate exposure from approximately 85% to 75% of their benchmarks.
- We remain underweight corporate credit. Where we do have exposure, we favor high quality bonds over below investment grade securities. We continue to like opportunities outside of corporate credit that we believe offer better late cycle diversification and better risk-adjusted value. Broadly, we like emerging market bonds, securitized assets, insurance-linked securities and infrastructure debt. We reduced our exposure to high-yield municipal bonds at the beginning of 2018 and are maintaining our higher quality bias. We believe the path of municipal rates will generally follow U.S. Treasuries, so we have maintained a defensive posture.
- We continue to de-emphasize the use of passive index-based mutual funds and exchange-traded funds in favor of active managers.

Research Focus

Our research process is designed to be all-encompassing. We will not invest in everything, and in fact, limit our research work lists to a focused set of asset classes, but we regularly have meetings to discuss the merits of more than 20 asset classes for inclusion in client portfolios. Certain asset classes like U.S. equities and U.S. Treasuries tend to always find their way into client portfolios. Within those asset classes, our exposure generally just varies by sub-asset class. Other asset classes emerge for consideration based on our view of the market or economic cycle, or because of the development of the asset class itself. The goal of our meetings is to ensure that our client portfolios have the potential to benefit from a mix of asset classes that sit at the optimal intersection of return, risk and cost. In short, we always want to invest with an open mind, but will never force a conclusion. All asset classes have to meet the hurdles of our research and fit each client circumstance to justify a decision to invest.

One asset class that came under consideration from a recent research meeting was infrastructure debt. A summary of the analysis conducted to determine if inclusion in client portfolios was warranted is included here. We will produce a detailed ViewPoints on the asset class in the coming weeks.

Infrastructure Debt Asset Class Primer

What is infrastructure?

Infrastructure includes a wide range of projects, assets and companies, but the asset class can broadly be categorized into four main sectors.

Utility and Energy:

- Provision or transportation of essential services, such as water, gas, electricity
- Power generation (conventional and renewables)
- Storage assets

Transportation related:

- Toll roads, bridges, tunnels, rail
- Airports, ports, ferries, car parking, service stations

Communications:

- Telecom, TV and broadcasting towers
- Cable and fiber optic networks
- Smart meters, data centers

Social Infrastructure:

- Schools, hospital, housing and judicial facilities
- Public transport

Source: UBS

Mike Peters, CFA
Chief Investment Officer – Fixed Income

Infrastructure Debt Highlights

- Higher yields relative to similar corporate debt
- Lower default rates and higher recovery rates
- Resiliency during recessions
- Lower correlations to other fixed income sectors

Infrastructure Debt Risks

- Relatively limited secondary market
- Regulatory risk
- Construction and operational risk
- Market and counterparty risk

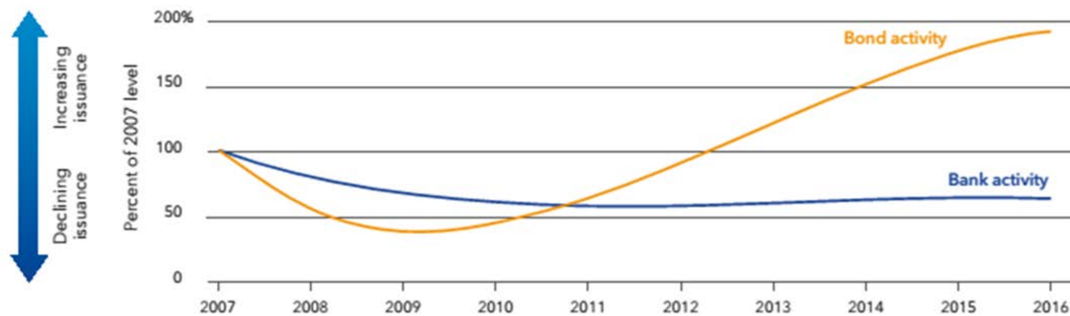
Infrastructure can be owned by governments, non-profit organizations or the private sector. The private sector includes public and private corporations. In the current landscape, most toll roads, bridges, tunnels, airports, seaports, water distribution systems and sewage networks are owned by governments. Most power generation and telecommunications networks are owned by corporations (public and private). The ownership of social infrastructure is more evenly distributed. However, relatively speaking, it is where non-profit organizations play their biggest role.

The Ambassador Bridge, pictured below, is a great example of transportation-related infrastructure. It connects Detroit, Michigan to Windsor, Ontario and is known for being the busiest international border crossing in North America, with approximately 10,000 trucks and 4,000 autos crossing it daily. The total of activity the bridge sees accounts for more than 25% of all merchandise traded between the United States and Canada, making it essential for the orderly operation of our economy. Like other important elements of our economic success, infrastructure needs capital, which is increasingly being provided by capital markets. There are several ways to invest in infrastructure. One of those is private infrastructure debt, which has recently emerged as an alternative asset class for bond investors.

When and why did the asset class emerge?

As society continues to advance, so does the demand for infrastructure. However, funding has rarely kept pace, particularly on the government side. This has never been truer than it is now. Aging populations and increased debt levels have constrained infrastructure budgets. It is estimated that $57 trillion of global infrastructure projects will need to be financed by the year 2030. As a result, the private sector and non-profit organizations have stepped in to fill the shortfall.

Lenders are drawn to infrastructure because of its asset-backed nature, stable cash flows and monopolistic qualities. Consequently, infrastructure is typically financed using 50-80% debt. Historically, 80-90% of debt financing was provided by the banking sector, while only 10-20% came from other sources. However, this has rapidly changed because of banking regulation. (See chart at the top of the next page.) Basel III, an internationally agreed upon framework, has disincentivized banks from holding infrastructure loans on their balance sheets. The regulation requires banks to post incremental capital against each loan. This erodes net interest margins, which makes it economically unwise to pursue. Since 2011, banks have increasingly adopted an “originate-to-distribute” model. This means banks have continued to originate loans, but then seek institutional partners via the capital markets to buy the loans. The end result is a new market for infrastructure debt investing.



Source: BlackRock

How is infrastructure debt different from corporate or municipal debt?

Infrastructure bonds differ from most corporate bonds in that they are project or asset-based. They can be defined as bonds associated with a real asset that provides an essential service to the public. Investors get exposure at a project level or at the corporate level, but the cash flows that service the debt should be driven by the underlying project, not corporate activity. These assets usually have long economic lives and predictable cash flow. Compared to municipals, infrastructure bonds are similar to revenue bonds, which are issued by municipalities. The primary difference is ownership. Revenue bonds finance projects owned by governments. Infrastructure bonds finance projects owned by the private sector or non-profit organizations. Bonds issued by non-profit organizations are sometimes considered hybrids because they can be issued with tax-exempt interest.

Investing Opportunities	**Investing Risks**
Higher relative yields	Regulatory risk
Lower default rates and higher recovery	Limited secondary market
Diversification due to lower correlations	Operational and construction risk
Resiliency during recession	Market and counterparty risk

What is our current view of the asset class?

We believe the asset class offers diversification and attractive yields at this point in the economic and business cycle. Our vehicle selection process suggests the most efficient way to gain exposure for our clients is through a pooled vehicle, such as a mutual fund or interval fund. For several quarters we have believed we are not being properly compensated for risk in the corporate bond sector and we have used the opportunity we see in infrastructure debt to further reduce our exposure to that sector.

Client Focus

This quarter our Client Focus discusses the question, “What is normal?”

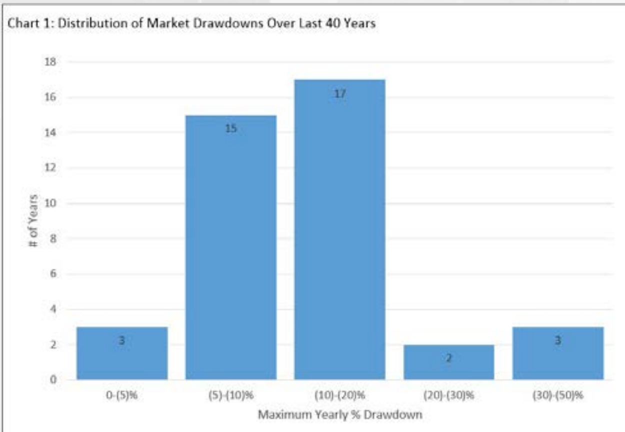
- In 2017, the U.S. equity market (as measured by the S&P 500 unless noted) returned nearly +22%.

- In the first few months of 2018 the U.S. equity market experienced a more than -10% drop from its peak at the end of January to its bottom in early February. The maximum drop the U.S. equity market experienced in 2017 was less than -3%.

- In 2017, the U.S. equity market experienced zero trading days of -1% or more returns. During the first quarter of 2018, the U.S. equity market experienced eight trading days of -1% or more returns.

So, has 2018 been a volatile year so far? Or was 2017 just unique due to its lack of volatility? What is normal?

Historically speaking, 2017 was an incredibly tranquil year that ultimately resulted in a nearly +22% gain in the U.S. equity market. The experience of 2018, thus far, has felt volatile, but is actually more “normal” than 2017. In a recent report by FactSet, which analyzed the past 40 years of U.S. equity market returns, 22 of those years experienced a -10% correction like we saw during the first quarter. Conversely, only THREE of the past 40 years have experienced a less than -5% pullback in the U.S. equity market like we saw in 2017. If you pair that fact with the understanding that 20%+ returns have occurred only about 1/3 of the time over the past 90 years, 2017 was more unique than normal.



Source: FactSet

S&P 500 Returns (Last 90 years)		
Range	**Frequency**	**Rate**
> -30%	3	3%
-20% to -30%	3	3%
-10% to -20%	5	6%
0% to -10%	13	14%
0% to 10%	15	17%
10% to 20%	19	21%
20% to 30%	15	17%
> 30%	17	19%

Source: Aswath Damodaran

So, what is someone supposed to do with that information? If 2017 was unique and 2018 (so far) is shaping up to be a more “normal” year, what does that mean for investors? Experience has taught us that discipline, process and logic are more useful to long-term wealth compounding than emotion.

- Do not let recent experience (recency bias) skew expectations. U.S. equity market returns have averaged more than +10% over the past 90 years, but have not achieved those averages in an even path. Volatility is more the norm than the exception.
- Your time horizon should define your expectations and influence your risk tolerance. Do not adjust your plan significantly based on short-term outcomes.
- Markets cycle, but cycle lengths (peak to trough) have varied significantly over time. Trying to time the market can be very damaging to long-term wealth compounding.

Our Team

Bob Batchelor, CFA
CEO
Co-Founder

Bob J. Batchelor, CFA is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 20 years of experience in the investment industry. Prior to founding Entasis, Bob worked at Artisan Partners where he held a variety of roles including Head of Corporate Communications, Managing Director, Head of Marketing and Technology and Head of Marketing and Communications. He also served as a member of Artisan Partners Executive Committee. Before Artisan Partners, Bob worked at Strong Capital Management as Client Account Manager and Director of Investment Research and Communication.

Bob holds an M.B.A. from Marquette University and a B.B.A. from the University of Wisconsin-Madison. He has earned the right to use the CFA designation. Bob is a member of the CFA Institute and CFA Society of Milwaukee.

C.J. Batchelor, CFA
CIO – Equity
Co-Founder

Charles J. (C.J.) Batchelor, CFA is Co-Founder and Chief Investment Officer – Equity of Entasis Asset Management. C.J. has 15 years of experience in the investment industry. Prior to founding Entasis, C.J. worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Director of Investment Research. He also served as a member of Cleary Gull's Investment Policy Committee, Investment Committee and Equity Strategy Group.

C.J. holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. C.J. is a member of the CFA Institute and CFA Society of Milwaukee, where he currently serves on the Board of Directors.

Mike Peters, CFA
CIO – Fixed Income
Co-Founder

Mike Peters, CFA is Co-Founder and Chief Investment Officer – Fixed Income of Entasis Asset Management. Mike has 15 years of experience in the investment industry. Prior to founding Entasis, Mike worked at Cleary Gull, a multi-billion dollar investment advisory firm, as Fixed Income Portfolio Manager. In his role he served as voting member of Cleary Gull's Fixed Income Strategy Group and Complement (Alternative) Strategy Group. Before Cleary Gull, Mike worked for several years at Madison Investment Advisors, a multi-billion dollar asset management firm, as a Fixed Income Analyst.

Mike holds a B.B.A. in Finance from the University of Wisconsin-Milwaukee. He has earned the right to use the CFA designation. Mike is a member of the CFA Institute and CFA Society of Milwaukee.

David LaCroix
Senior Financial
Advisor

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

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

IMPORTANT INFORMATION

Statements may be forward looking and are not intended as specific investment advice without further review of individual circumstances. Commentary, opinions, analysis, and recommendations may be subjective, do not guarantee future performance, and could change at any time without notice. Under no circumstances does the information contained within represent a recommendation to buy or sell any security. Charts and graphs provided are for illustrative purposes only.

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The **Dow Jones Industrial Average℠** is a price weighted index that measures the performance of thirty component large-cap U.S. stocks. The **S&P 500® Index** is a market capitalization weighted index that measures the performance of 500 leading companies in leading industries of the U.S. economy. The **Russell 1000® Index** measures the performance of roughly 1,000 U.S. large-cap companies. The **Russell 1000® Growth** Index measures the performance of U.S. large-cap companies with higher price/book ratios and forecasted growth values. The **Russell 1000® Value Index** measures the performance of U.S. large-cap companies with lower price/book ratios and forecasted growth values. The **Russell 2000® Index** measures the performance of roughly 2,000 U.S. small-cap companies. The **MSCI EAFE® Index** is a market capitalization weighted index that is designed to measure the performance of developed markets, excluding the U.S. and Canada. The **MSCI Emerging Markets Index** is a market capitalization weighted index that is designed to measure equity market performance of emerging markets. **The MSCI ACWI Ex USA Small Cap Index** is a market capitalization weighted index that represents the performance of smaller capitalization companies in developed and emerging markets excluding the U.S.

The **Barclays Aggregate Bond Index** tracks the performance of intermediate-term government bonds, investment grade corporate debt securities and mortgage-backed securities with at least one year to final maturity. The **Barclays Intermediate U.S. Gov/Credit Index** tracks the performance of intermediate U.S. government and corporate bonds. The **Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

The **BoAML Fixed Rate Preferred Securities Index** tracks the performance of fixed rate U.S. dollar denominated preferred securities in the U.S. domestic market. The **BoAML Treasury Master Index** tracks the performance of the direct sovereign debt of the U.S. Government. The **BoAML U.S. Mortgage Back Securities Index** tracks the performance of U.S. dollar denominated fixed rate and hybrid residential mortgage pass-through securities publicly issued by U.S. agencies in the U.S. market. The **BoAML U.S. Corporate Master Index** tracks the performance of U.S. dollar denominated investment grade corporate debt publicly issued in the U.S. domestic market. The **BoAML High Yield Master II Index** is a broad based index consisting of all U.S. dollar-denominated high-yield bonds with a minimum outstanding of $100 million and maturing over one year. The **BoAML All Convertibles All Qualities Index** measures convertible securities' performance of U.S. dollar denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance. The **BoAML Euro Broad Market Index** gives exposure to euro-denominated investment grade debt publicly issued in the Eurobond or euro member domestic markets including government, quasi-government, corporate, securitized and collateralized securities. The **BoAML Local Debt Markets Plus Index** is a broad composite designed to track the performance of local currency sovereign debt of emerging markets countries.

Past performance is no guarantee of future results. All indices are unmanaged. Investors cannot invest directly in an index. Index returns do not include expenses.

Investment Terms

Valuation levels are typically shown by calculating the price level of an index or a company relative to any number of characteristics of an index or company. For instance, the price-to-earnings valuation metric looks at the price of an index (or stock) divided by the total earnings of an index (or stock). Based on the multiple (in this instance, the multiple is how much investors are willing to pay – the price – for a given amount of earnings), it provides investors with a general sense of how expensive, or cheap, the overall market is at the present time. While there are a significant number of valuation metrics that are used in practice, and many ways to vary/modify the calculation of the price-to-earnings ratio, in this summary we are focused on the price investors are willing to pay (the level of the S&P 500® Index) divided by earnings expectations for the equity market (S&P 500 Index) over the next 12 months. This valuation metric is referred to as the forward P/E. A **yield curve** is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. A **basis point** is a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001). **Interest coverage** is a measure of a company's ability to meet its interest payments on its debt. **Federal funds rate** is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. It is one of the most influential interest rates in the U.S. economy, since it affects monetary and financial conditions, which in turn have a bearing on key aspects of the broad economy including employment, growth and inflation.

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