ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

2Q2019

During the quarter, our firm celebrated its three-year anniversary. The interesting part about the anniversary is that it passed without anyone noticing. And we are thankful for that. We are thankful we didn't notice because we were too busy working on new client relationships and spending time discussing financial goals with existing clients. We appreciate being busy and we are humbled by the trust our clients have place in us. We will never take that for granted.

Amid the activity one of our potential clients asked what our goals are for number of clients and assets. The honest reply we had was that we have never had one and never will. Early in our careers we saw the negative impact of arbitrary goals like those. They lack alignment with client goals and consequently they limit long relationships. We can't grow without more clients and we will never gain new clients if we don't prioritize what is in their best interests.

At Entasis we believe in accountability, so we do our own research. We believe investors generally pay too much for investment advice, so we prioritize cost management in everything we do. We believe in focus because distractions limit return outcomes, so we invest in understandable portfolios.

If we continue to emphasize those things, we are confident growth will occur, but we will never make it a goal.

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
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Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 6/30/19)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	10.42	14.19	10.71	14.70
Russell 1000 Index	Mid/Large Cap Stocks	10.02	14.15	10.45	14.77
Russell 1000 Growth Index	Growth Stocks	11.56	18.07	13.39	16.28
Russell 1000 Value Index	Value Stocks	8.46	10.19	7.46	13.19
Russell 2000 Index	Small Cap Stocks	-3.31	12.30	7.06	13.45
MSCI EAFE Index	Non-U.S. Developed Market Stocks	1.08	9.11	2.25	6.90
MSCI Emerging Markets Index	Emerging Markets Stocks	1.21	10.66	2.49	5.81
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	-5.94	7.76	2.77	8.48
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	7.07	4.87	6.08	8.59
Barclays Municipal Bond Index	U.S. Municipal Bonds	6.71	2.55	3.64	4.72
Barclays Aggregate Bond Index	U.S. Bonds	7.87	2.31	2.95	3.90
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	6.93	1.99	2.39	3.24
BofAML U.S. Treasury Master Index	Treasury Bonds	7.33	1.34	2.64	3.12
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	6.32	2.10	2.57	3.26
BofAML U.S. Corporate Master Index	Corporate Bonds	10.56	3.96	4.03	6.13
BofAML U.S. High Yield Master II Index	High Yield Bonds	7.58	7.54	4.70	9.20
BofAML Convertible Bonds Index	Convertible Bonds	7.48	14.28	8.29	12.25
BofAML Euro Broad Market Index	European Bonds	3.01	2.50	-0.62	2.30
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	10.46	4.62	0.19	3.51

Calendar Year % Returns (QTD as of 6/30/19)

Source: Morningstar Direct

	QTD	YTD	2018	2017	2016	2015	2014
S&P 500 Index	4.30	18.54	-4.38	21.83	11.96	1.38	13.69
Russell 1000 Index	4.25	18.84	-4.78	21.69	12.05	0.92	13.24
Russell 1000 Growth Index	4.64	21.49	-1.51	30.21	7.08	5.67	13.05
Russell 1000 Value Index	3.84	16.24	-8.27	13.66	17.34	-3.83	13.45
Russell 2000 Index	2.10	16.98	-11.01	14.65	21.31	-4.41	4.89
MSCI EAFE Index	3.68	14.03	-13.79	25.03	1.00	-0.81	-4.90
MSCI Emerging Markets Index	0.61	10.58	-14.58	37.28	11.19	-14.92	-2.19
MSCI ACWI Ex USA Small Cap Index	1.21	11.60	-18.20	31.65	3.91	2.60	-4.03
BofAML Preferred Stock Fixed Rate Index	3.02	11.98	-4.34	10.58	2.32	7.58	15.44
Barclays Municipal Bond Index	2.14	5.09	1.28	5.45	0.25	3.30	9.05
Barclays Aggregate Bond Index	3.08	6.11	0.01	3.54	2.65	0.55	5.97
Barclays Intermediate U.S. Gov/Credit Index	2.59	4.97	0.88	2.14	2.08	1.07	3.13
BofAML U.S. Treasury Master Index	3.06	5.30	0.80	2.43	1.14	0.83	6.02
BofAML U.S. Mortgage Backed Securities Index	2.01	4.32	1.00	2.45	1.67	1.46	6.07
BofAML U.S. Corporate Master Index	4.35	9.57	-2.25	6.48	5.96	-0.63	7.51
BofAML U.S. High Yield Master II Index	2.56	10.16	-2.27	7.48	17.49	-4.61	2.51
BofAML Convertible Bonds Index	3.79	14.54	0.68	16.03	11.94	-1.15	9.97
BofAML Euro Broad Market Index	4.29	5.01	-4.39	14.61	0.37	-9.30	-2.48
BofAML Local Debt Market Plus Index	5.44	9.58	-4.90	14.71	6.53	-12.02	-4.50

How should you use the information provided in the table?

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

Global Market Drivers

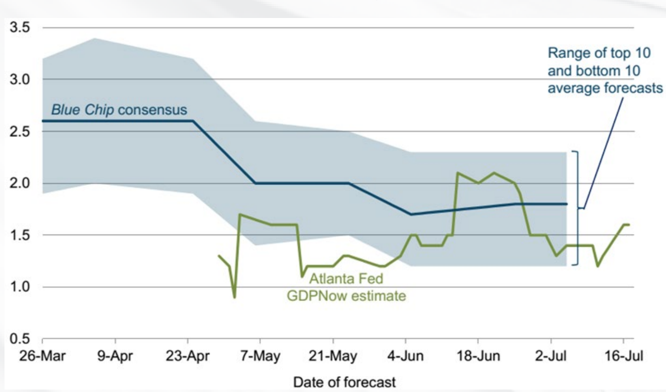
The second quarter ended with relatively solid gains despite a sharp pullback in global equity markets in May. Most of the volatility during the quarter could be directly attributable to investor angst surrounding trade tensions, and investor hope that weakening economic data would trigger interest rate cuts from the U.S. Federal Reserve (Fed). On the trade front, investors were optimistic early in the quarter as news that an “epic” trade deal between the U.S. and China was in the final stages. However, that optimism quickly eroded in early May when the U.S. increased the tariff rate on $200 billion in Chinese goods from 10% to 25%, and China responded with retaliatory tariffs on $60 billion of U.S. goods. The news sent stocks into a brief tailspin, particularly companies with significant exposure to China (such as Apple). Stocks were hit late in May once again as investors faced the possibility of a trade spat between the U.S. and Mexico. However, as the calendar turned to June, tensions abated as the U.S. suspended tariffs on Mexican goods and President Trump announced he would partake in an extended meeting with Chinese President Xi Jinping.

While headlines were largely focused on trade developments for the first part of the quarter, weakening U.S. economic data began to garner more attention over the second half of the quarter. U.S. manufacturing and services data, payroll data and consumer confidence all showed signs of weakness. In response to poor economic data and the potential negative economic impact from trade tensions, Fed Chair Jerome Powell stated (June 4) that the Fed would “act as appropriate to sustain the expansion.” Powell’s statement was all that it took for the stock market to rocket higher for the remainder of June, as investors largely shrugged off any other negative economic news. (It also served to buoy returns in virtually all fixed income sectors.) In fact, in a somewhat perverse relationship, poor economic data was met with better equity performance, as investors calculated that the weaker the data was, the higher the likelihood of intervention by the Fed. Whether or not the Fed can navigate trade, economic and market crosscurrents effectively will be a key theme for the second half of the year, as will be the overall direction of corporate earnings.

The Economy

U.S. GDP grew at a +3.1% pace in 1Q19. However, the report was considered by many to be misleading, as approximately half was attributed to net exports and inventories, leaving underlying domestic demand up only +1.6%. Based on incoming data, economists are now projecting Q219 economic growth will slow considerably to +1.5-2.0%. On the positive side, domestic demand seems to have rebounded as consumer spending picked up from a +0.9% pace in 1Q to approximately +3.5% in 2Q19. Business capital spending is projected to grow at a moderate pace and the housing market is finally showing signs of life, after a year-long slowdown, now that mortgage rates have fallen. On the negative side, net exports and inventories are projected to detract from 2Q19 economic growth. Based on the Atlanta Fed’s GDPNow estimate, inventories are expected to shave nearly -1.0% from economic growth, while net exports are anticipated to detract

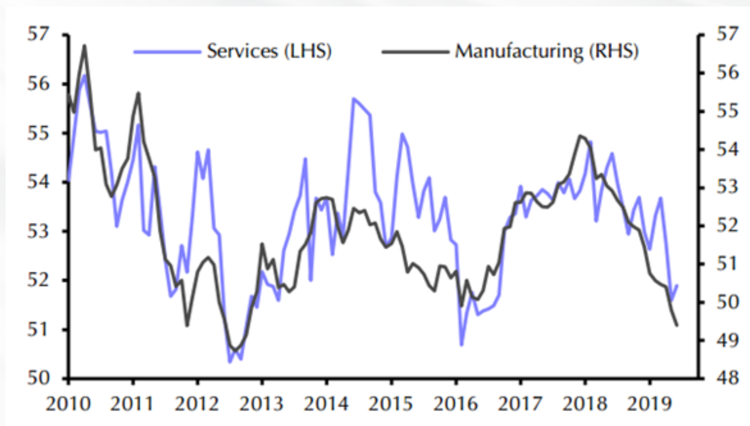
Federal Reserve Bank of Atlanta Fed 2Q19 GDPNow Estimate



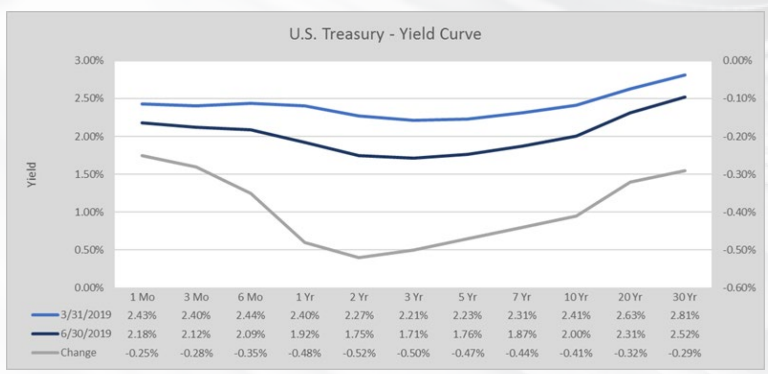
-0.50%. Global economic growth has not yet picked up from the below-trend pace that emerged in 4Q18. Growing uncertainty driven by the escalation of the U.S.-China trade dispute has led to a sustained slowdown in global manufacturing, business investment and trade. As a result, many commodity sensitive emerging markets (Russia, Brazil and South Africa) posted outright declines in nominal GDP in the first quarter. The declines were attributed to softer oil prices and weaker global demand. Developed markets have also had troubles coping with weaker global demand, as the Eurozone and Japan both posted sub 1.0% growth in 1Q19. Based on incoming data, relatively soft global performance persisted throughout the second quarter. Global PMI's, one of the most accurate leading indicators, have continued to decelerate. Manufacturing in developed economies and emerging economies has decelerated sharply over the past six months. A recent reading below 50 indicated a manufacturing contraction. The services sector has also decelerated significantly, but a recent reading above 50 provided a glimpse of growth. See chart below.

Interest Rates

Due to slowing economic growth, the 10-year Treasury yield declined -41 basis points (0.41%) in the second quarter ending at 2.00%. The 2-year yield finished the quarter at 1.75% down -52 basis points (0.52%) from the previous quarter-end. The widely followed 10-year to 2-year spread, steepened (long-term rates higher than short-term rates) slightly as the market began to price in interest rate cuts from the Fed. It ended the quarter at +25 basis points (0.25%), up +9 basis points (0.09%) from 1Q19. See chart to right.



Source: Capital Economics, Markit Global PMI's



Earnings

Corporate earnings growth (year-over-year) is expected to decline -3.0% (S&P 500® Index) for the second quarter. If that negative rate of growth was to materialize, it would be the first time the S&P 500® Index experienced negative year-over-year earnings growth since 1Q16 and 2Q16.

Estimated earnings growth is expected to slowly improve over the next two quarters of 2019 prior to a larger increase into the first half of 2020 (-0.8% for 3Q, +6.0% for 4Q, and +9.8% for 1Q20, +13.5% for 2Q20). From a reporting standpoint, corporations do not seem to be as optimistic as analysts, particularly over the short-term. As of the third week of July, 88 companies in the S&P 500® had issued negative earnings guidance for 2Q19, which was the second largest number of companies issuing negative guidance since 2006.

Equity Market Results

U.S. equities ended the second quarter with a gain of +4.30% (as represented by the S&P 500® Index) amid a fair amount of volatility. Among equity styles, growth-oriented equities gained +4.64% (as represented by the Russell 1000® Growth Index), while value-oriented equities returned +3.84% (as represented by the Russell 1000® Value Index). Small-cap equities were the clear laggard in U.S. markets as the Russell 2000® Index posted a gain of only +2.10%.

Equity sectors within the U.S. market were as volatile as trade headlines during the second quarter. The best and worst performers vacillated with the news cycle between higher-growth companies (technology and communication services) and relatively more defensive, dividend-oriented equities (real estate and utilities). The table below displays sector performance for three distinct periods during the quarter (shown in the table below): 1) optimism of a U.S. and China trade deal in April; 2) breakdown of trade discussions and tariffs imposed by the U.S. and China in May; and 3) renewed optimism of a U.S. and China trade deal, and Fed Chairman Jerome Powell's reassurance that the Fed would intervene if/when necessary to sustain the economic expansion.

	4/1/2019 4/30/2019	5/1/2019 6/3/2019	6/4/2019 6/30/2019
Index/Sector Investment Returns	Return (%)	Return (%)	Return (%)
Real Estate Select Sector SPDR®	-0.48	1.59	1.32
Utilities Select Sector SPDR® ETF	0.91	0.24	2.23
Communication Services Sel Sect SPDR®ETF	7.12	-8.91	8.11
Technology Select Sector SPDR® ETF	6.41	-10.27	11.04

Overseas, developed foreign stocks registered solid gains for the quarter (+3.68% as represented by the MSCI EAFE® Index). Like the U.S. equity market, gains in Europe largely stemmed from central bank announcements. Following on the heels of news in March that the European Central Bank (ECB) would restart its stimulus program, the ECB President assured investors in the second quarter that the bank may implement further stimulus measures earlier than expected if growth continues to disappoint.

Emerging markets equities managed to stay in positive territory (+0.61%, as represented by the MSCI Emerging Markets Index) despite the negative headlines surrounding trade. The clear leader for the quarter on a country basis was Russia, which gained over +17% in part because of rising oil prices due to an escalation in tensions between the U.S. and Iran. After a strong first quarter, Chinese equity performance was negatively impacted (loss of roughly -4%) by trade uncertainty with the U.S. Emerging markets performance from a regional perspective varied widely. The emerging markets region of Europe, Middle East and Africa posted a return in excess of +7% (as represented by the MSCI Emerging Markets EMEA Index), while the emerging markets Asia region declined approximately -1% (as represented by the MSCI Emerging Markets Asia Index).

Equity Market Comments

The weakness in corporate earnings has caused us to generally be less optimistic about the outlook for the market. This is primarily because we believe the market, and analyst expectations, are underestimating the strength of headwinds currently facing corporations. These include uncertainty surrounding tariffs and foreign trade, margin pressure stemming from rising wages, and the effects of U.S. dollar strength (and slowing global growth) on corporate revenues. To be sure, many of these concerns have already begun to impact corporate earnings, particularly for businesses that derive a significant portion of their earnings and revenues from overseas.

For example, the bar chart below displays 2Q19 earnings growth (left axis) for S&P 500 companies that derive over 50% of their revenue in the U.S. (light blue bar) compared to companies that derive less than 50% of their revenue in the U.S. (green bar). The dark blue bar includes all S&P 500 companies.

As the chart shows, companies with a significant portion of revenues from overseas (green bar) have been negatively impacted by a stronger U.S. dollar and slowing economic growth in those markets. Without a turnaround in economic growth in foreign markets or a decline in the value of the U.S. dollar relative to other currencies, we believe these types of companies will continue to struggle relative to mostly domestic businesses and be a drag on overall S&P 500 earnings.

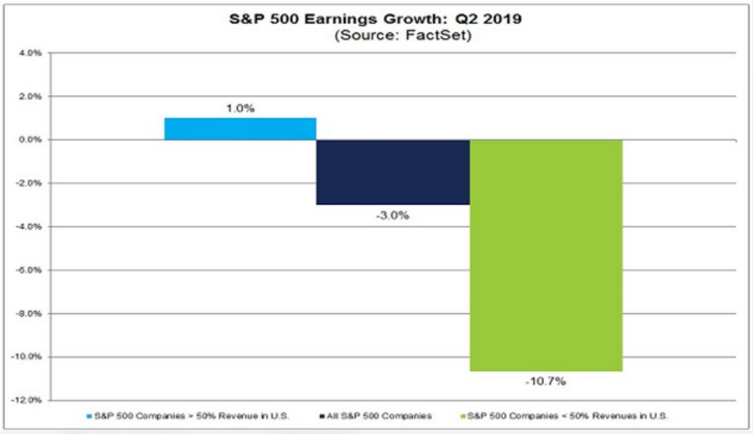


Chart courtesy of FactSet Earnings Insight (July 12, 2019)

As a general rule, equity prices follow earnings over the long-term. However, over the short run, many different factors can result in a disconnect in the relationship as investors focus on variables outside of earnings. This is what occurred over the first half of 2019. See the chart below.

The chart plots the direction of 3Q19 earnings per share (EPS) expectations for the S&P 500® Index (left axis) relative to the change in price of the S&P 500® Index (right axis) over the course of the last year (note earnings expectations for full calendar year 2019 and 2020 have followed a similar downward path over the past year). The large increase in price (green line) without a subsequent increase in earnings and earnings expectations (red line) means that the rally we have experienced in the stock market so far in 2019 has primarily been due to multiple expansion (an increase in valuation levels). As a reminder, valuation multiples tend to expand during periods of accelerating economic growth and contract during periods of decelerating economic growth.

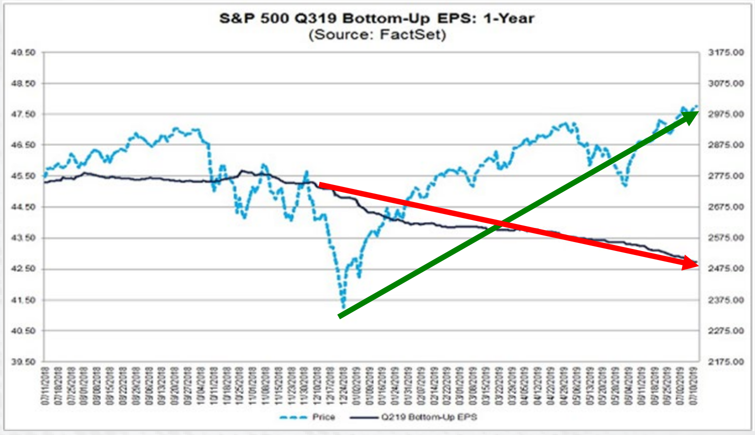


Chart courtesy of FactSet Earnings Insight (July 12, 2019)

We believe most of the market gains (and multiple expansion) have come from investors placing too much blind confidence in the Fed's ability to perfectly navigate the economic slowdown and jumpstart corporate earnings. Even though we are keenly aware of the mantra, "Don't fight the Fed," we do not share the market's same level of optimism. As one market prognosticator stated, "The Fed can print money, but it cannot print earnings." We agree.

In summary, our overriding belief at this point is that the market may have gotten ahead of itself.

Unfortunately, this belief does not provide us with any degree of certainty in what direction stock prices will move in the near-term. Nonetheless, we do feel comfortable stating that we do not believe equity prices will continue to ramp significantly higher from this point without a meaningful turnaround in corporate earnings. Said differently, what occurred over the first half of 2019 (stock prices rose double-digits while earnings languished) will not last indefinitely. In our view, investors currently consumed with “FOMO” (fear of missing out), should think twice before committing more capital to their equity allocation to chase short-term gains. As always, investors should remember the adage that “investing is a marathon, not a sprint.”

Sticking with the topic of valuation, The S&P 500® Index’s forward P/E ratio (price-to-earnings ratio) expanded to approximately 16.7x at the end of the second quarter (17.1x as of mid-July). As a reminder, 16.7x is roughly the amount that investors are willing to pay for $1 of future earnings. This is higher than the 10-year average of 14.8x and the 5-year average of 16.5x. See the chart below.

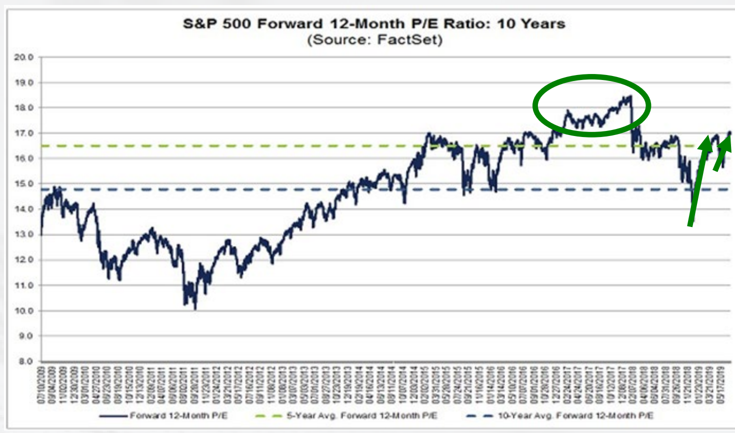


Chart courtesy of FactSet Earnings Insight (July 12, 2019)

Based on the forward P/E chart to the right, notice that P/E multiples expanded twice in 2019 (green arrows) – at the beginning of the year and more recently in June. Both movements higher corresponded with investor hope that the Fed can delay a recession and spur an uptick in growth through stimulus measures (interest rate cuts).

We also marked the 2017 timeframe (green circle), to highlight the last time that forward P/E multiples expanded past the 17.0x level (as they have once again in mid-July 2019). Unfortunately, the underlying fundamentals that were present during that timeframe, which were significantly more favorable, are absent today. During 2017, economic growth had rebounded off lows experienced in 2016 and accelerated throughout 2017 and 2018. The stock market (and corporate earnings) also received a sizable boost from the Tax Cuts and Jobs Act of 2017. While the Act was not passed until December 2017, the market had already begun to anticipate the positive impact the legislation would have on corporate earnings, which drove the price of equities (and multiples) higher. The subsequent decline in forward P/E multiples during 2018 was not representative of significantly lower prices. It was reflective of corporate earnings “growing into” valuation multiples.

Fast forward to the present time, and what we have seen recently is that economic growth (year-over-year GDP growth) has “rolled over” from its peak and is decelerating. Furthermore, the prospect of a large stimulus package from a divided Congress does not appear to be likely soon. This means that two major positives that were present during the 2017 period of multiple expansion are not present today. We would also argue that the equity market is starting at a sizable disadvantage today relative to 2017 in its quest to expand multiples significantly higher, largely because corporations are starting at a sizable disadvantage to grow earnings meaningfully. The lack of these two major tailwinds in combination with the headwinds we discussed in the earnings section earlier, build the case for our belief that investors have placed too much hope (and confidence) in the Fed to meaningfully stimulate economic growth (and corporate earnings growth) from this point forward.

If corporations can overcome challenges associated with declining margins and weak revenue growth, and the Fed can suspend weakening economic data in the U.S. to stabilize and spur GDP growth, there is the possibility of a more sustainable movement higher in equity prices. However, if corporations continue to struggle and the Fed does not deliver as investors currently expect, then there is the distinct possibility of a contraction in valuation levels as prices decline. We are obviously in the latter camp, as of now, which leads us to be less constructive on equity market returns in the short run.

Client Portfolio Impact

We continue to favor a relatively defensive posture among U.S. equities, which is based on current valuations, our outlook for earnings and where we currently reside in the economic cycle. However, we are not defensive in our equity positioning across all markets. To the contrary, we believe our defensive posture among U.S. equities provides somewhat of a counterbalance to our more aggressive positioning in foreign equity markets, where we believe valuations and long-term return potential are more attractive compared to the U.S.

We will always stay fully invested relative to our client's broad asset allocation targets (equities vs. fixed income) that are outlined in their investment policy statement with us. However, we will "tilt" the portfolio at the sub-asset class level (within the equity or fixed income "buckets") towards areas of the market we believe are attractive. These "tilts" are based on our outlook for various markets, the current economic environment, relative valuation levels and other sub-asset class considerations. A recent trade can illustrate how we use this data in our decision-making process.

Economic Environment

One of the pieces of data that we look at prior to making a sub-asset class "tilt" in client portfolios is the historical performance of equity markets (broad asset classes and sub-asset classes) during similar periods of economic activity. Inevitably, every business cycle and economic environment is unique, but as we have also learned over time, even though "history doesn't repeat itself, it does rhyme."

What data are we looking at today? At the present time, two of the more notable themes impacting markets are that the U.S. economy has begun to slow, and the Fed may begin to cut interest rates. If we were to look at prior economic periods where U.S. GDP growth was slowing, and then cross-referenced those with periods when the Fed began to cut interest rates, we would find eight similar timeframes stretching back to 1982. For the purpose of this newsletter, we will focus on the performance of four data points during those timeframes – the S&P 500® Index, U.S. low beta large-cap stocks (note that "beta" refers to how volatile an individual stock's performance is compared to the total market), U.S. growth stocks (companies with relatively high growth rates) and the U.S. Dollar Index (depending on the direction of the U.S. dollar relative to other foreign currencies, it may be supportive of foreign returns, or may detract from foreign returns).

What was found in these eight periods is that three months after the first Fed rate cut, the S&P 500® Index averaged a gain of +1.73%, U.S. low beta large-cap stocks returned +6.04%, U.S. growth stocks declined -4.86% and the U.S. Dollar Index fell -1.49%. In addition to these averages, it is also important to note that U.S. low beta large-cap stocks outperformed U.S. growth stocks in seven out of eight of the periods and U.S. low beta large-cap stocks registered positive returns in six out of eight of the periods. While this data is not solely responsible for our current positioning in U.S. equity markets, it does provide support from an economic perspective.

Equity Portfolio Comments

Relative Value

Based on relative value (how attractive segments of the market are relative to one another from a valuation perspective), stocks with relatively high yields (dividend payout/stock price) appear to be undervalued. The chart below looks at the relative P/E of high-yielding stocks compared to the broad market since 2002.

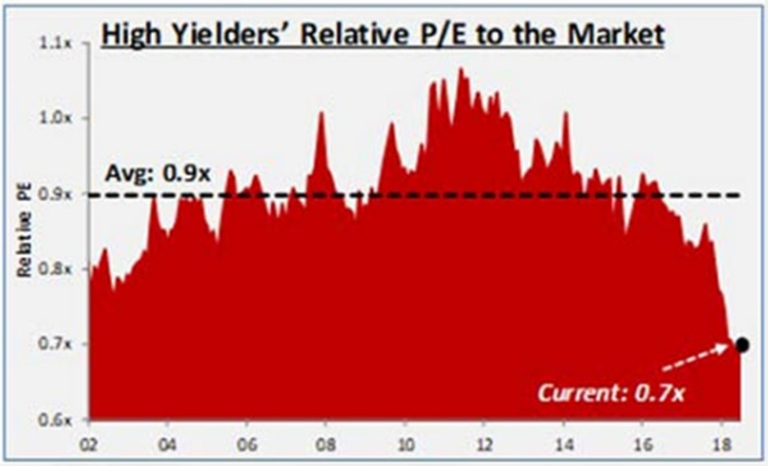


Chart courtesy of 361 Capital

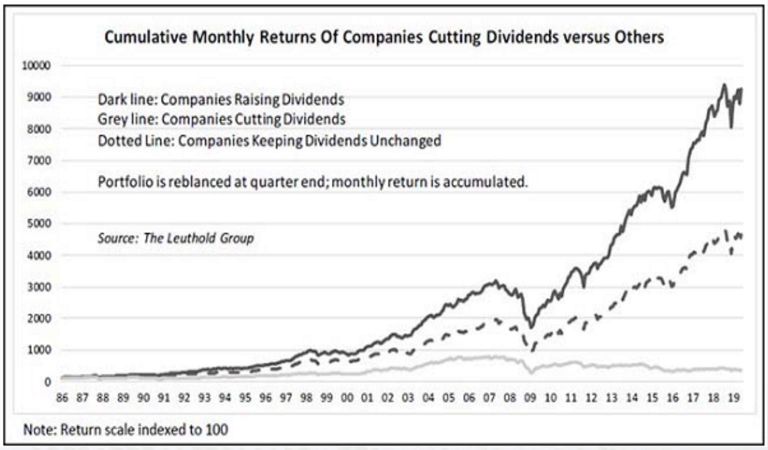


Chart courtesy of Leuthold Group

Based solely on the data in the chart to the right, equities with high yields appear to be "inexpensive" relative to history when compared to the broad equity market.

Other Sub-Asset Class Considerations

Despite the data in the first chart to the right, the performance of dividend paying equities has been very different over time when factoring in the overall level of consistency with which companies have paid those dividends. The data in the second chart to the right from the Leuthold Group looks at the performance (from December 1985 to June 2019) of three types of dividend paying companies – companies that cut dividends, companies that keep dividends steady and companies that increase dividends.

Over the timeframe in the chart, companies that cut dividends returned +2.8% annualized, companies that kept their dividends unchanged gained +12.1% annualized and companies that consistently raised their dividends posted gains of +14.4% annualized. Needless to say, the market disproportionately rewarded companies that raised their dividends over time. This is due to a variety of reasons, but primarily because rising dividends demonstrates financial strength, consistent growth and good allocation of capital within the business.

As a result of the data shown in this section, among other data, we recently made an investment in a mutual fund whose mandate is to invest in companies that have a history of growing dividends. Overall, these types of securities are attractive from a valuation perspective and have also demonstrated relatively less volatility, better downside protection (as was the case during May) and solid results during similar periods of economic and business activity. Outside of U.S. equity markets, we continue to have a relatively favorable outlook for emerging markets equities and foreign small-/mid-cap stocks.

Fixed Income Portfolio Comments

Fixed Income Market Results

With interest rates down considerably and spread movements muted during the second quarter, subsector performance was primarily driven by interest rate risk. In general, sectors with the highest sensitivity to falling U.S. Treasury yields did the best, while those with less did worse. Investment grade corporate bonds led the rally, driven by generally longer duration, generating +4.35% during the quarter. While still nicely positive at +2.01%, residential mortgage-backed securities were the weakest sector. Other notable sectors included U.S. Treasuries +3.06%, preferred stocks +3.02% and high-yield corporate bonds +2.56%.

After a broad-based rally in first quarter, the change in credit spreads was more modest in the second quarter. High-yield corporate bond spreads (difference in yield compared to similar maturity Treasury bonds) tightened -14 basis points (0.14%), investment grade corporate bonds -4 basis points (0.04%), and non-agency commercial mortgage-backed securities -2 basis points (0.02%). Conversely, emerging market debt widened +11 basis points (0.11%), residential mortgage-backed securities +11 basis points (0.11%) and asset-backed securities +2 basis points (0.02%).

Municipal yields continued to decline in the second quarter, as sharply lower Treasury yields boosted demand. For the quarter, 10-year municipal yields fell -27 basis points (0.27%). At the same time, 2-years yields were down 23 basis points (0.23%) resulting in a flatter municipal curve. The riskiest municipal bonds continued to outperform higher quality counterparts, as credit spreads tightened, and interest rates declined. For instance, bonds with maturities 22-years and longer generated a +2.89% return, while bonds with maturities between 1-5 years generated a return of +1.12%. Similarly, lower - rated, or high-yield municipal bonds outperformed AAA-rated bonds, returning +2.73% versus +1.83%, respectively.

Fixed Income Market Comments

Looking ahead, domestically leading economic indicators suggest weakness in the export oriented industrial sector will continue, but a strong consumer and favorable credit conditions will keep economic growth positive over the short-term (6-12 months). Despite our expectation for positive GDP growth over the short-term, the speed and persistence of the deceleration in the data continues to have us concerned about the potential for a recession over the intermediate-term. On the positive side, low inflation and international weakness should give enough cover for the Fed to begin stimulating the economy. On the negative, trade concerns and weak global demand may be too much to overcome.

Internationally, the escalation in trade tensions adds to an already challenging economic outlook. The OECD's composite of leading indicators has fallen considerably over the past 12 months. The last reading of -1.4% is the weakest since the financial crisis more than 10 years ago. Outside of trade, there are numerous sources of potential downside, including an increased likelihood of a disorderly Brexit, the Italian-EU budget fight, a slowdown in China and rising tensions in the Middle East, to name a few.

U.S. Interest Rates

At the June FOMC meeting, the Fed left rates unchanged at 2.25%-2.50%. However, its forward guidance introduced the expectation for rate cuts in 2019. It was just a short time ago that we were writing about the potential for rate hikes and now many Fed voting members have already come out in favor of cutting rates by 25 basis points (0.25%) at the July 2019 meeting. The expected rate cut should lead to an equivalent repricing of the front-end of the Treasury yield curve (0-6-month rates). Rates between 1-year and 3-years began pricing in rate cuts during the second quarter and already reflect most of what is expected in 2019. Based on the probabilities we have assigned to likely economic scenarios, we believe fair value for the 10-year Treasury is between 2.00%-2.58%. It ended 2Q19 at 2.00%, which is at the bottom end our fair value range.

Yield Curve

Based on our belief that the Fed will cut rates in July, we see the potential for the yield curve to steepen (short-term rates below long-term rates) slightly. However, with the curve mostly flat and long-term Treasury valuations near fair value, any change in the shape of the curve should be muted.

Sector & Quality Management

Corporate credit has been the best performing sector in 2019, largely due to the Fed's dovish (more accommodating or likely to cut interest rates) pivot in the first quarter. There were some minor sell-offs due to trade concerns, but credit investors seem to believe that rate cuts will be enough to reverse the trend despite a slowing economy and deteriorating credit metrics. We are still skeptical. As a result, we continue to hold a cautious view on corporate credit. We continue to believe we are late cycle, not end cycle, which makes credit investing prudent. However, being careful with our allocation is at the top of our mind.

In spite of a slowing economy, the municipal market continues to have a solid fundamental backdrop, which is largely unchanged from our commentary last quarter. Rising pension and healthcare may present long-term challenges, but it is expected state and local tax revenues will continue to increase in 2019. In addition, municipalities have not increased their debt burdens as much as other areas of the economy, which makes their balance sheets much more attractive over the intermediate-term.

Investment Vehicle Selection

At this point in the economic and credit cycles, our broad positioning remains consistent. We favor idiosyncratic opportunities such as non-agency mortgage backed securities, commercial mortgage-backed securities, asset-backed securities and municipal bonds. We also believe that the illiquidity premiums offered in insurance-linked securities and infrastructure debt represent attractive opportunities for investment.

Client Portfolio Impact

- In early 1Q19, as economic growth slowed and the outlook deteriorated, we added some high-quality duration (longer-term bonds) to client portfolios. The move was designed to take portfolios from being a fraction shorter than benchmarks to approximately neutral. Our positioning continued to benefit client portfolio in the second quarter, as rates declined significantly. Based on the combination of fair value and being in the late stages of the business cycle, we plan to keep client portfolio's close to benchmarks from a duration perspective over the short- to intermediate-term.

Fixed Income Portfolio Comments

- Given our belief that the yield curve is likely to steepen slightly, we favor a more bulleted (focused on specific bond maturities) yield curve posture with a small preference to the 5- to 10-year part of the curve. We still like owning credit in the short end of the yield curve (and high quality issues) and find intermediate maturities more attractive in Treasuries.
- Overall sector positioning remains generally cautious and defensive, particularly towards below investment grade securities. Our emphasis continues to be on higher quality and non-cyclical parts of the credit markets. As a result, we continue to like emerging market bonds, securitized assets, mortgage-backed securities, insurance-linked securities and infrastructure debt.
  - We believe securitized sectors provide attractive risk-adjusted opportunities for high-quality, liquid returns with less potential downside than corporate credit.
  - We like emerging market bonds due to a combination of above average income and the potential for price appreciation due to the Fed's dovish shift.
  - Infrastructure assets continue to offer yields equivalent to corporate credit, but are collateralized by hard assets that are essential to the economy, which makes them much more attractive at this point in the business cycle.
  - Finally, the uncorrelated nature of insurance-linked securities, combined with significantly higher premium income, due to 2017 and 2018 claims, makes that sector an attractive investment.
- In spite of a solid fundamental backdrop, we are more inclined to reduce public market municipal exposure in our tax aware strategies than add to exposure due to rich valuations. Public municipal valuations continue to be historically rich relative to Treasuries. However, the potential for an increase in supply during the third quarter may provide an opportunity in the space. Until that occurs, we favor investments in the private and direct origination markets.
- Active managers and select investing in individual securities continue to be represented relatively more in client portfolios than passive index-based mutual funds and exchange-traded funds on the credit side. We believe the best way to take advantage of the illiquidity premiums offered in the insurance-linked and infrastructure markets is to gain access 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. In the closed-end fund space, discounts have tightened significantly over the past 12 months. We continue to research a handful that offer attractive income.

Foreign Small Caps

One of the first items clients and prospective clients may notice in their asset allocation with our firm is a relatively large allocation to small- and mid-cap companies. While some individuals may initially surmise this is due to an allocation among U.S.–based investments, that is not the case. At the present time, we have found relatively meager investment opportunities among smaller domestic companies, primarily because of where we believe we reside in the economic cycle. However, the story is much different among foreign small- and mid-cap companies. There are a variety of reasons for our current stance (a few of which we will touch on later), but from a longer-term asset class perspective, we are most attracted to this segment of the market because of two key reasons: 1) We believe it represents a large opportunity set of potentially attractive companies. 2) In aggregate, it is a relatively inefficient market segment based on analyst coverage of individual companies. From a more quantitative perspective, the asset class has also delivered relatively attractive risk-adjusted returns (return measures that incorporate risk, or volatility into the calculation) and is one of the few segments of the equity market that still offers attractive diversification benefits (relatively low correlation to U.S. stocks).

Based on the attractive characteristics noted above, one would think foreign small-cap investments would be a common piece of investor portfolios. However, if we were to look at the entirety of mutual fund assets in the U.S., we would find that less than 1% of assets are invested in small caps outside of the U.S. We believe this is largely because few investors segment the foreign portion of their portfolios between market capitalizations, instead relying on broad, passively managed index-based products, or actively managed large-cap foreign investments for their foreign exposure. Unfortunately, these products provide little, if any, exposure to this segment of foreign equity markets (in the case of broad-based foreign indices, less than 1% is allocated to foreign small caps). Investors may also be under allocated to this space because they are unaware of the opportunity, or if they are aware, may be under the false assumption that foreign small caps are too risky, or that they are lower quality businesses.

Before providing greater detail on what we believe are the long-term positives associated with the asset class, we will first address two of the most popular misconceptions among many investors. The first misconception is the overall risk profile of foreign small-cap stocks. This can be measured many ways, but for this exercise, we will look at one of the most popular measures of risk, which is how volatile the asset class's returns have been over longer timeframes (standard deviation of returns). The table at the top of the next page reflects the standard deviation of returns for four broad market segments over the past three-, five- and ten-year periods.

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

Summary

We have found relatively meager investment opportunities among smaller domestic companies, primarily because of where we believe we reside in the economic cycle. However, the story is much different among foreign small- and mid-cap companies.

We are most attracted to this segment of the market for two key reasons: 1) We believe it represents a large opportunity set of potentially attractive companies. 2) In aggregate, it is a relatively inefficient market segment based on analyst coverage of individual companies.

Foreign small-cap stocks have experienced similar levels of volatility as foreign large-cap stocks and notably less volatility compared to U.S. small-cap stocks.

Foreign small caps appear to be superior to U.S. small caps across a range of financial metrics, including profitability ratios, balance sheet strength and dividend payout ratios.

We believe the combination of historically strong relative and absolute returns, a low correlation to U.S. equities, and a large, inefficient market will continue to make foreign small caps an attractive piece of a client's long-term equity portfolio.

As can be seen, foreign small caps (as represented by the MSCI ACWI ex USA Small Cap Index) have experienced similar levels of volatility as foreign large caps (as represented by the MSCI ACWI ex USA Index) and notably less volatility compared to U.S. small cap stocks (as represented by the Russell 2000® Index). Based on this measure, foreign small caps are not as volatile as some may believe.

Standard deviation for periods ending 12/31/18

Index	3 Year	5 Year	10 Year
MSCI ACWI ex USA SC	12.34	11.78	16.94
MSCI ACWI ex USA	11.38	11.82	16.31
Russell 1000® Index	10.95	10.91	13.70
Russell 2000® Index	15.79	15.30	18.36

Source: FactSet. **Past performance is no guarantee of future results.**

The second misconception is that foreign small caps are lower quality companies compared to U.S.-based companies. The second table to the right displays a variety of financial metrics that demonstrate various degrees of financial strength.

Characteristic (as of 12/31/18)	MSCI ACWIxUS SC	Russell 2000® Index
Forward EPS Growth[1]	12.6	15.0
ROE	12.1	6.1
ROA	6.3	1.0
LT Debt / Capital	24.3	33.1
P/E Ratio (weighted harmonic average)[2]	13.1	14.3
Dividend Yield (%)	2.9	1.6

Source: FactSet, MSCI, Russell.

Past performance is no guarantee of future results.

[1] Estimated 3 to 5 year forward EPS growth.
[2] Estimated using FY1 (current forecast year).

Foreign small caps appear to be superior to U.S. small caps (in aggregate) across a range of financial metrics, including profitability ratios (higher return on equity and higher return on assets), balance sheet strength (lower long-term debt relative to capital) and dividend payout ratios (higher dividend yield). Based on these metrics, foreign small caps can certainly "hold their own" when compared to U.S. small caps.

We noted earlier the key positives we associate with foreign small caps. The first is that the market segment has a relatively large opportunity set. There are approximately 2,000 companies defined as small cap in the U.S. (Russell 2000® Index), while there are more than double that amount (over 4,100 in the MSCI ACWI ex USA Small Cap Index) in foreign markets. If we were to also include foreign mid- and micro-caps in the total with small caps, we would be looking at a total opportunity set well in excess of 15,000 companies.

The second positive is that the asset class is relatively inefficient based on the number of analysts assigned to cover foreign small-cap companies. In aggregate, there are only five analysts (on average) assigned to cover each stock in the MSCI ACWI ex USA Small Cap Index, which compares to an average of eight analysts for foreign large caps and roughly 16 analysts for larger cap U.S. stocks (Russell 1000® Index companies). Furthermore, approximately 17% of companies in the MSCI ACWI ex US Small Cap Index have no coverage at all.

Why do these two factors matter? These are important because it becomes exceedingly difficult to add value from a research perspective as increasingly large numbers of analysts follow (provide research on) a company. With minimal (or no) analyst coverage, in combination with a large universe of companies, the foreign small cap space provides relatively fertile ground for investment managers to add value through differentiated, "boots on the ground," in-depth research. The ability of a manager to add value is an important consideration for us because one of the first questions we ask when deciding whether to use an actively managed or passively managed investment in a given market segment is if the actively managed fee is justified. Can the manager generate a return in excess of their fee over the long run? In the case of foreign small cap equities, we believe the answer is a resounding yes.

Our long-term outlook for foreign small cap stocks, is also supported by our positive short- to intermediate-term view. Our outlook stems from our view that the U.S. dollar may be entering a period of sustained weakness relative to other foreign currencies (following a nearly nine year period of relative strength), that a historically long period of U.S. equity outperformance over foreign equities is nearing an end (on a rolling five-year basis, U.S. stocks have outperformed foreign stocks for 8.1 years compared to an average since 1970 of 7.4 years), and that foreign small cap stocks will lead the way when foreign equities (in aggregate) begin to outperform U.S. stocks (since inception of the MSCI ACWI ex USA Index in 1994, foreign small caps have outperformed foreign large caps in 81% of rolling five-year periods and 94% of rolling ten-year periods).

In summary, we believe the combination of historically strong relative and absolute returns, a low correlation to U.S. equities, and a large, inefficient market will continue to make foreign small caps an attractive piece of a client's long-term equity portfolio.

Client Focus

This quarter our Client Focus focuses on the danger of looking back versus looking forward.

At the beginning of this newsletter we talked about our anniversary and growth for our firm highlighting some recent interactions with clients and prospects. One item we regularly discuss with potential clients, because a few will ask us very plainly, is what our expectations are for market returns and consequently their portfolio. It is a reasonable question, but on occasion, the question comes loaded with a comparison to a recent, similar quote the prospective client received from their existing advisor or another advisor the client is interviewing along with us. It is not uncommon in those comparisons for our projections to be lower than those received from our competitors. The answer about why, is often very simple – we look forward, not backward. We will elaborate.

Looking backward, Looking forward.

In the absence of a research process or asset allocation strategy, one of the easiest things to do is use the past as a guide. The numbers are readily available, and they are in fact – facts. However, to rephrase what we said in an earlier section, "history may rhyme, but it doesn't repeat itself." And the reason history doesn't repeat itself is very simply that conditions change.

Every quarter we write about our views on the global economy, interest rates and corporate earnings. There are a multitude of factors that drive equity and bond performance, but those three are foundational to many others. As a result, we use them as a starting point. If we were to look at what global economic growth, interest rates and corporate earnings were 10 years ago they would be considerably different. So, why does it make sense to imply market returns will be the same? In short, it doesn't. Therefore, we don't, but others do. We prefer to use forward-looking capital market assumptions. (We subscribe to several, but the investment policy statement we establish for clients generally rely on JP Morgan's annual long-term capital market assumptions.) We believe they are more rational, often more conservative and, by default, more useful. To be clear, they are not more useful to us making ourselves look good, but considerably more useful to establishing a long-term relationship with a potential client. Take a look at the table below, which highlights three asset classes. The Looking Back numbers are the 10-year historical returns from our table on page 3 using the Barclays Aggregate Bond Index, S&P 500® Index and MSCI Emerging Markets Index as proxies. The Looking Forward numbers are from the JP Morgan 2019 Capital Market Assumptions report.

	Looking Back	Looking Forward
Bonds	3.90%	4.00%
U.S. Large-Cap Stocks	14.70%	5.25%
Emerging Markets Stocks	5.81%	8.50%

As you can see from the simple presentation of numbers in the table, using the "simple" historical numbers creates a very "rosy" scenario for portfolio returns that are presented using them. The forward-looking numbers are not without their own faults, but by taking into consideration current information, and not relying on history repeating itself, we think they are much more productive to creating alignment with clients about expectations. This may cost our firm the opportunity to work with some clients, but those relationships would never last.

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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