ENTASIS ASSET MANAGEMENT

QUARTERLY NEWSLETTER

1Q2021

CEO Comments

For years, my family has gone to Sanibel / Captiva for vacation over the kids' break from school. For those that don't know, Sanibel and Captiva are two islands off the coast of Florida on the Gulf side of the state. Both islands have beautiful white sand beaches. Sanibel faces southeast with nice views of the coast and Captiva faces southwest with picturesque sunsets. Over the years, everyone in our family has come to love different things about our visits. The kids love ordering lunch and smoothies at the Tiki hut, my wife loves the warm sun on the beach, and I love that the islands seem almost completely disconnected from reality. We ride bikes or golf carts to the stores and restaurants, the islands are mostly void of big chain companies and the tallest buildings top out at about four stories. The islands are a true respite from the busyness of life. I, of course, stay aware of market activity and am available for client calls, but I have to say an island office is not all bad.

Last year, we did not get to go because of the Covid shutdown, which made this year even more enjoyable. Most of our days were spent playing games, sitting on the beach and enjoying great seafood, but one day we (the kids) decided they wanted to try parasailing. For obvious reasons, the idea of sitting on a two-inch-wide strap, 300 feet in the air while flying behind a boat, did not seem instantly appealing as I sat firmly on the beach. After much consternation, we were on the boat and ready to go.

We each went up in pairs. I was with my youngest son Charlie. As we slowly ascended from a sitting position on the back of the boat to about 300 feet in the air, I was shocked by the calm that came over me. All the noise on the ground went away. It was almost silence. Here we were, literally hovering above the birds, (that small spot in the sky is us) and I was fully relaxed. Charlie and I were pointing at things happening on the beach, enjoying the views of the coast and looking at a huge loggerhead turtle swimming below. It was an incredible experience. I am thankful my kids suggested it and talked me into going. I would recommend it to anyone. After returning to the beach my mind started to wander. It was amazing how quickly my perspective had changed. I went from anxiety to peaceful.

Bob Batchelor, CFA®, CFP®
Chief Executive Officer

Summary

It does not take much to have a change in perspective. And not letting a new perspective influence decision making is very hard.

This type of investing environment can, and usually does, breed a lot of gloating and envy. However, as an investor and client, the only relevant perspective is my own.

We are proceeding with the best information we have today, in a way that is in the best interests of our clients.

CEO Comments

In the investment business, perspective can also have an unbelievable impact. Unfortunately, it is rarely in the same positive way as it was for parasailing. Usually, a new perspective can influence decision making and return outcomes in a very negative way. This past 12 months has been one of the most dizzying examples of that in my career. Over the 12 months ended March 31, 2021, mortgage-backed bonds returned +0.10% and corporate bonds returned +9.30%. If on April 1st of last year someone would have said to me that a year later unemployment would still be significantly higher, GDP output would still be below pre-pandemic levels and corporate earnings would still be trailing prior year levels I think I would have taken those returns. However, now knowing that over the same period the S&P 500® Index was up over +56%, should my perspective change? It reminds me of the parable of the workers in the vineyard.

As an investor, if we set out a strategy for clients that managed risk and generated a solid return in a very uncertain business and economic environment, should our perspective change? As a client (I work for Entasis, but I am also invested alongside clients with my own money.), if I had goals for my account that were realized or exceeded should my perspective change? I probably don't need to elaborate further for anyone reading to know where I am heading here. (There is also a separate commentary embedded in these notes about the risks of relying on specific end points given the S&P 500® Index was down -30%+ the four weeks leading up to March 31, 2020, but I will save that for another time.)

I will admit that not letting a new perspective influence decision making is very hard. This type of investing environment can, and usually does, breed a lot of gloating and envy. However, as an investor and client, the only relevant perspective is my own. No one has the same clients as we do. No one has the same financial goals as I do. The only thing we can do is make informed decisions based on what we know today. We can't know what March 31, 2022 looks like. We can only prepare for what is relevant to our situation.

In the pages to follow, CJ and Mike will share our perspectives. We are proceeding with the best information we have today, in a way that is in the best interests of our clients. We hope you find the information useful.

Bob

Market Performance

Equity Portfolio Comments

Fixed Income Portfolio Comments

Click on any button to skip to a new section.

Market Performance

Annualized % Returns (As of 03/31/2021)

Source: Morningstar Direct

Index Name	Index Category	1 year	3 year	5 year	10 year
S&P 500 Index	Large Cap Stocks	56.35	16.78	16.29	13.91
Russell 1000 Index	Mid/Large Cap Stocks	60.59	17.31	16.66	13.97
Russell 1000 Growth Index	Growth Stocks	62.74	22.80	21.05	16.63
Russell 1000 Value Index	Value Stocks	56.09	10.96	11.74	10.99
Russell 2000 Index	Small Cap Stocks	94.85	14.76	16.35	11.68
MSCI EAFE Index	Non-U.S. Developed Market Stocks	44.57	6.02	8.85	5.52
MSCI Emerging Markets Index	Emerging Markets Stocks	58.39	6.48	12.07	3.65
MSCI ACWI Ex USA Small Cap Index	Non-U.S. Small Cap Stocks	69.82	6.61	10.40	6.32
BofAML Preferred Stock Fixed Rate Index	Preferred Stocks	16.09	6.38	5.82	6.30
Barclays Municipal Bond Index	U.S. Municipal Bonds	5.51	4.91	3.49	4.54
Barclays Aggregate Bond Index	U.S. Bonds	0.71	4.65	3.10	3.44
Barclays Intermediate U.S. Gov/Credit Index	Government/Corporate Bonds	2.01	4.36	2.75	2.88
BofAML U.S. Treasury Master Index	Treasury Bonds	-5.11	4.06	2.22	2.96
BofAML U.S. Mortgage Backed Securities Index	Mortgage Backed Bonds	0.10	3.86	2.49	2.86
BofAML U.S. Corporate Master Index	Corporate Bonds	9.30	6.19	4.92	5.04
BofAML U.S. High Yield Master II Index	High Yield Bonds	23.22	6.50	7.92	6.30
BofAML Convertible Bonds Index	Convertible Bonds	83.71	24.40	21.63	13.95
BofAML Euro Broad Market Index	European Bonds	10.65	1.02	2.53	2.21
BofAML Local Debt Market Plus Index	Emerging Markets Bonds	12.19	1.34	3.74	1.46

Calendar Year % Returns (QTD as of 03/31/2021)

	QTD	2020	2019	2018	2017	2016
S&P 500 Index	6.17	18.40	31.49	-4.38	21.83	11.96
Russell 1000 Index	5.91	20.96	31.43	-4.78	21.69	12.05
Russell 1000 Growth Index	0.94	38.49	36.39	-1.51	30.21	7.08
Russell 1000 Value Index	11.26	2.80	26.54	-8.27	13.66	17.34
Russell 2000 Index	12.70	19.96	25.52	-11.01	14.65	21.31
MSCI EAFE Index	3.48	7.82	22.01	-13.79	25.03	1.00
MSCI Emerging Markets Index	2.29	18.31	18.44	-14.58	37.28	11.19
MSCI ACWI Ex USA Small Cap Index	5.53	14.24	22.42	-18.20	31.65	3.91
BofAML Preferred Stock Fixed Rate Index	-1.03	6.95	17.71	-4.34	10.58	2.32
Barclays Municipal Bond Index	-0.35	5.21	7.54	1.28	5.45	0.25
Barclays Aggregate Bond Index	-3.37	7.51	8.72	0.01	3.54	2.65
Barclays Intermediate U.S. Gov/Credit Index	-1.86	6.43	6.80	0.88	2.14	2.08
BofAML U.S. Treasury Master Index	-4.61	8.22	6.99	0.80	2.43	1.14
BofAML U.S. Mortgage Backed Securities Index	-1.15	4.09	6.51	1.00	2.45	1.67
BofAML U.S. Corporate Master Index	-4.49	9.81	14.23	-2.25	6.48	5.96
BofAML U.S. High Yield Master II Index	0.91	6.07	14.41	-2.27	7.48	17.49
BofAML Convertible Bonds Index	3.04	55.68	23.06	0.68	16.03	11.94
BofAML Euro Broad Market Index	-5.73	13.35	4.11	-4.39	14.61	0.37
BofAML Local Debt Market Plus Index	-6.62	4.50	16.44	-4.90	14.71	6.53

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.

Equity Portfolio Comments

Corporate Earnings

Year-over-year earnings growth for the S&P 500® Index is expected to be 30.2% for the first quarter, which would be the highest rate of growth since the third quarter of 2010. The large increase is partially the result of a favorable comparison period (1Q 2020), a point in time when earnings cratered due to the COVID-19 related economic shutdown. Nonetheless, the sharp earnings rebound is a testament to the speed at which the economy has reopened since the rollout of vaccinations. The rise in earnings was expected to be boosted by a 7% year-over-year uptick in revenue growth, along with net profit margins of approximately 11.4% (year-over-year). The sizable increase in net profit margins came at a time when the full impact of rising input costs and potential labor shortages had yet to hit corporate balance sheets.

The S&P 500® Index continued to rise throughout the period, but it was a welcome sight to see earnings attempt to catch-up, or at least rise in a similar trajectory as underlying prices. See chart below.

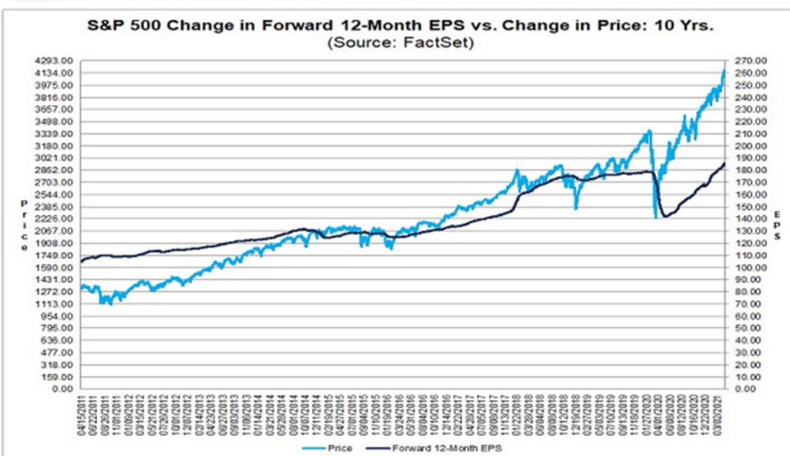


Chart courtesy of FactSet Earnings Insight (April 16, 2021)

Looking ahead, analysts anticipate double-digit earnings growth for the remaining calendar quarters of 2021, with an overall earnings growth rate of 27.9% for the full calendar year. Earnings growth for the first half of 2022 is expected to moderate as base effects (year-over-year comparison periods) become less favorable. See the chart at the top of the next page.

Business re-openings, increased hiring, massive amounts of stimulus from the government, an accommodative U.S. Federal Reserve (Fed), and pent up demand, among other factors, were all expected to be contributors to “blowout” first quarter earnings; however, concerns began to bubble towards the surface for future quarters. Unfortunately, large government spending programs and easy

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

Summary

Year-over-year earnings growth for the S&P 500® Index is expected to be 30.2% for the first quarter, which would be the highest rate of growth since the third quarter of 2010.

Inflationary pressures began to mount during the quarter, which caused input costs for businesses to rise, and rise significantly in some instances.

Emerging markets equities, U.S. value stocks and foreign small-cap stocks are all relatively inexpensive across various valuation metrics when compared to the S&P 500® Index, Russell 1000® Growth Index and Russell 2000® Index, respectively.

Experience has taught us that maximizing risk to maximize return is fraught with pitfalls when managing portfolios for the long term. The psychological benefit may be great for the short period of time that it does work, but the damage that may be created when trends reverse course, tends to be detrimental.

monetary policy are not one-way, positive streets. These types of programs and policies have potential drawbacks (which people tend to ignore when times are good and equity prices are rising), not the least of which center around inflationary pressures and future tax increases.

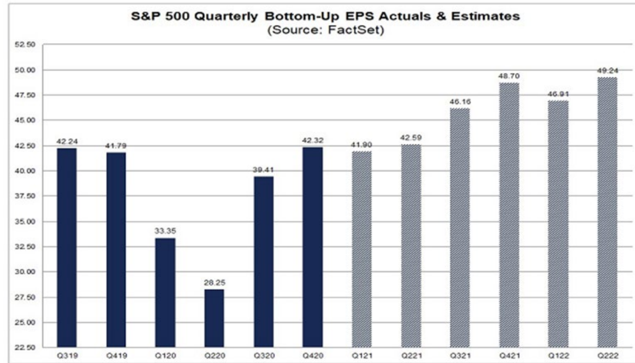
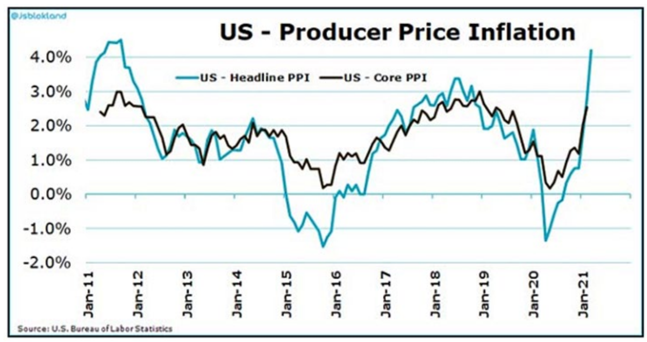


Chart courtesy of FactSet Earnings Insight (April 16, 2021)

On the former issue, inflationary pressures began to mount, which caused input costs for businesses to rise, and rise significantly in some instances. See chart on the right. It examines U.S. producer price inflation, which has gone almost "vertical" recently.



Rising input costs led some market participants to question the soundness of future earnings estimates as uncertainty increased regarding the ability of companies to pass on higher input expenses to customers without eroding profit margins. Historically, there has been a fine line between a small amount of inflation being neutral or beneficial to companies and negatively impacting revenues and earnings from cost overruns. For the time being, positive economic activity, driven by businesses reopening and government stimulus, was sufficient to offset future profit margin worries.

The increase in inflation also caused concern among some individuals, notably about whether the Fed would be able to continue its extremely easy monetary policy or whether it would cause them to remove the "punch bowl" earlier than expected. So far, Fed Chairman Powell has stated the Fed would remain accommodative. Additionally, the Fed signaled they had become more "outcome-based" as opposed to "outlook-based." Essentially, this means the Fed will wait to see that their objectives have been achieved prior to making any significant changes in policy. While the market has thus far been agreeable to this stance, rising inflation (and the potential for it to rise too quickly) has caused some economists to move their estimates forward for when the Fed would raise rates. While any tightening of monetary policy appears to be a way off (latter portion of 2022 at the earliest), it is important to remember that even though the Fed has begun to embrace a backwards looking policy, the equity market remains a forward-looking mechanism. Therefore, inflationary pressures will remain a key factor to monitor in the coming months and quarters.

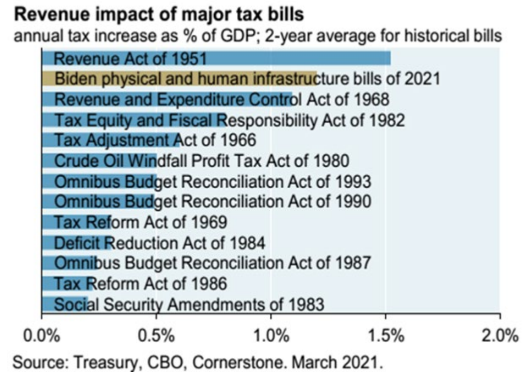
Government spending in the form of stimulus and other measures increased dramatically in 2020 in response to the COVID-19 economic shutdown. Thus far in 2021, the government has continued its spending binge as additional stimulus plans and massive government spending programs are rolled out. While the spending may boost economic activity in the short run (which the market tends to like), how to pay for the spending is never as much fun to debate since it usually comes in the form of tax increases. The most recent infrastructure bills from the government are expected to bring with them some of the most widespread tax changes in decades. The chart at the top of the next page compares the projected revenue impact of major post-WWII tax increases.

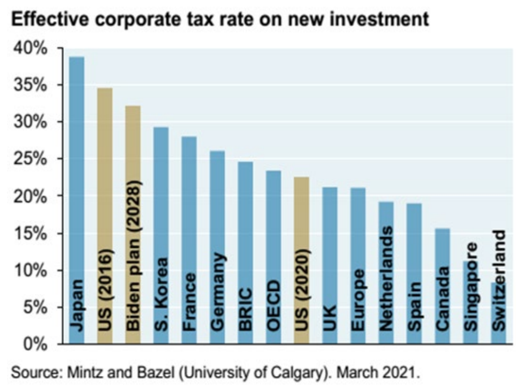
Equity Portfolio Comments

Based on data provided by J. P. Morgan, the current administration's proposed tax increases to fund spending in the infrastructure bills are geared approximately two-thirds towards corporations and one-third towards high income earners. For our purposes, corporate tax increases are front and center. The data in the second chart on the right examines the effective corporate tax rate on new investment across countries and recent U.S. tax regimes.

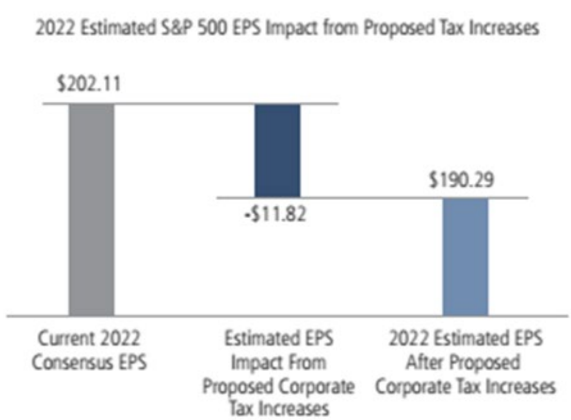
What can be seen in the chart is that the proposed corporate tax changes would nearly eliminate the favorable corporate tax policy that was put in place approximately five years ago. If enacted, this may significantly impact earnings estimates and estimated growth rates for the S&P 500® Index next year.

The data in the two charts below, provide an analysis of the potential impact to earnings and earnings growth rates in 2022. Charts courtesy of Neuberger Berman – Investment Quarterly (Spring 2021). Source: Strategas.





Charts courtesy of J. P. Morgan – Eye on the Market (April 1, 2021)

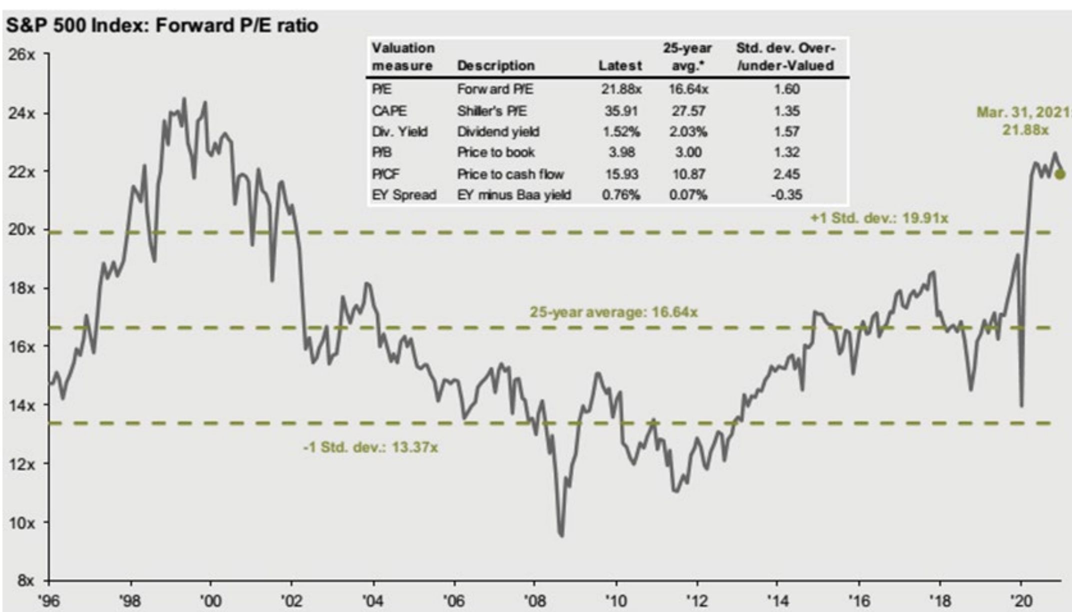


We are not politicians. We are investors. Therefore, our objective is not to analyze the overall societal impact of government spending and tax policy, but to determine the potential impact on earnings and underlying equity prices. Considering the large boost to stock prices following corporate tax cuts that were put into place five years ago, along with historically high valuations (discussed shortly), rising inflationary concerns (input costs and potential labor shortages/wage increases) and an earnings recovery that is hitting its stride, any potential negative impacts to earnings will need to be closely monitored, particularly because of the already large dislocation between stock prices and underlying earnings as downward surprises in earnings could be met with a recalibration of equity prices.

Market Valuation

Without repeating our lengthy discussion from last quarter on the veracity of valuation measures in relation to underlying equity prices, we will keep it simple this quarter. Our belief is that traditional valuation measures have a place in the analysis of markets as they provide insights into future return potential and help to determine long-term areas of opportunity across asset classes and sub-asset classes. However, it is also important to remember that valuation metrics have historically done a relatively poor job in predicting short-term market movements. Areas of the market with high valuation levels may remain high or get stretched even further, while other areas of the market that have relatively low valuation levels may remain low or decrease even more. That being said, over the long run, valuation metrics do a good job at providing insights into the potential path of market returns. In turn, we use valuation metrics as a guide to determine long-term, strategic allocations in portfolios as opposed to using them to determine short-term tactical adjustments.

As a result, it has been welcome news that earnings have improved off the depressed levels experienced last year. However, the improvement in earnings has yet to deliver an improvement across valuation metrics (reduction), as equity prices have continued to rise. Nonetheless, valuations have stabilized after spiking throughout much of last year. See the chart (and table) below.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.88x	16.64x	1.60
CAPE	Shiller's P/E	35.91	27.57	1.35
Div. Yield	Dividend yield	1.52%	2.03%	1.57
P/B	Price to book	3.98	3.00	1.32
P/CF	Price to cash flow	15.93	10.87	2.45
EY Spread	EY minus Baa yield	0.76%	0.07%	-0.35

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Chart courtesy of J.P. Morgan – Guide to the Markets 2Q21

The elevated valuation levels shown above do not mean that the entire market is wildly overvalued either. As with anything, further context is needed prior to making a blanket statement. For instance, in the chart at the top of the next page, the data shows that the ten largest stocks in the S&P 500® Index have a forward price-to-earnings ratio (P/E) of 30.1x (how much an investor is willing to pay for one dollar of future earnings), which boosts the overall S&P 500® Index forward P/E. The line chart also helps to show the significant increase in the forward P/E ratios of the top 10 stocks in recent years.

Equity Portfolio Comments

To be fair, it is not only the top 10 largest stocks that have stretched overall forward P/E ratios. Speculative, momentum-driven stocks have also been very popular among investors. The second chart on the right reveals that the combined market-capitalization of these speculative companies (with low- to no earnings and high P/E ratios) have become an increasingly large portion of the total U.S. market capitalization.

Looking at U.S. stocks by market-capitalizations and styles, along with comparisons of the U.S. and foreign markets is also insightful. These comparisons help to paint a somewhat clearer picture of where the U.S. equity market ranks in the world and compared to other market segments (i.e., relative valuation as opposed to an examination of just one index relative to its own history). This is important since investment opportunities are not simply relegated to U.S. large-cap stocks (i.e., S&P 500® Index), but encompass opportunities across global markets, market-capitalizations, and styles.

The table at the bottom displays valuation metric comparisons for the S&P 500® Index (large-cap U.S.) vs. the MSCI EM (foreign emerging markets), Russell 1000® Growth (large-/mid-cap U.S. growth) vs. the Russell 1000® Value (large-/mid-cap U.S. value), and Russell 2000® (small-cap U.S.) vs. the MSCI World ex U.S. Small Cap (foreign small-cap).

When examining the data in the table below, there are several notable insights to glean from the data. The first is that emerging markets equities, U.S. value stocks and foreign small-cap stocks are all relatively inexpensive across all valuation metrics when compared to the S&P 500® Index, Russell 1000® Growth Index and Russell 2000® Index, respectively.

Chart courtesy of J.P. Morgan – Guide to the Markets 2Q21

Charts courtesy of J. P. Morgan – Eye on the Market (April 1, 2021)

	S&P 500	MSCI EM	R1000 Growth	R1000 Value	R2000	MSCI World ex US Sm Cap
Forward P/E	21.84	14.91	29.20	18.17	30.83	19.19
Price to Book	4.24	2.10	11.85	2.56	2.67	1.57
Price to Cash Flow	16.19	9.56	24.92	12.44	16.48	9.15
Price to Sales	2.98	1.80	4.86	2.14	1.67	1.10

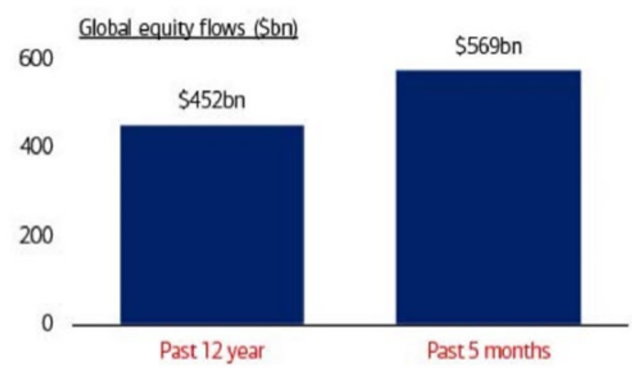
Data courtesy of Eaton Vance – Monthly Market Monitor (April 2021)

U.S. growth stocks, while having superior growth characteristics, are particularly expensive on both an absolute and relative perspective. The same can be said for U.S. small caps, which after a recent stretch of strong gains, have seen their valuation levels become stretched. U.S. value stocks, despite their recent sizable gains, remain relatively inexpensive compared to their U.S. growth counterparts and the broader U.S. equity market. The other glaring observation is that foreign (both developed and emerging markets) stocks are significantly less expensive than their U.S. counterparts.

As we noted at the beginning of the valuation discussion, valuation metrics are not the "be all, end all" when making investment decisions. However, when constructing portfolios with a long investment horizon, valuation data (absolute and relative) helps to inform decision-making for longer-term, strategic allocations in portfolios.

Outlook

Equity markets moved higher in the first quarter on the back of strong corporate earnings, another round of stimulus, sustained support from the Fed, widespread distribution of COVID-19 vaccinations, a sharp increase in the number of businesses reopening and an improvement in U.S. and global economic data. The flow of good news did not go unnoticed by market participants as money poured into stocks. In fact, equity inflows over the last five months were greater than the combined inflows of the prior 12 years. See the chart below.



Source: BofA Global Investment Strategy, EPFR Global
BofA GLOBAL RESEARCH

Flows provided a tailwind for rising equity prices. However, some viewed the massive flows into stocks as a contrarian indicator – one of many signs that stock prices were running too "hot" and had gotten significantly ahead of underlying fundamentals. Other potential areas of concern included a decline in overall trading volumes and short interest (bets that stocks will go down). Margin debt also hit a record high (individuals using leverage to buy stocks), insider selling increased significantly following a prolonged period of insider buying 6-12 months ago, and U.S. equity issuance reached a record high during the quarter. The rapid pace of equity issuance in the quarter followed an already fevered pace in 2020 when 480 IPOs (initial public offerings) came to market, a total that surpassed the 406 IPOs registered during the technology/telecom/dotcom mania in 2000. While these factors helped to nudge stocks higher for the quarter, many of these data points, among others, pointed to a large one-directional trade as individuals chased strong equity returns that had been generated off the market bottom approximately one year ago.

Anecdotally, it has also appeared that the behavior of market participants, particularly stock market "bulls" (individuals that believe the market will continue to shoot higher), had gotten increasingly aggressive in defense of equity market gains, historically high market valuations and future return expectations. Individuals that attempted to bring some historical perspective to underlying market fundamentals, or (gasp!) believe the market may be overpriced, is increasingly risky and may decline, have been met with louder voices in opposition to their views. As someone that recently hit the "40 mark," has two growing children and entered college during the tech/telecom boom, I can sympathize with these individuals and the growing chorus of "you just don't understand." Unfortunately, what experience has taught me is that when so many variables scream of a one-way trade (that stocks will continue to spike higher) in tandem with historically high valuations, that has typically meant the yellow caution flag should be waved, and investors should buckle up for a rockier road.

Does this mean that the "road" is destined to crumble in the very near term (i.e., second quarter)? Not necessarily since we remain in a short-term environment where corporate earnings and economic data have very easy year-over-year comparisons. Investors just need to be aware that the market has priced in a Utopian scenario for earnings and economic recovery, and that even though many investors tend to look backwards when making investment decisions (i.e., chase returns), it is important to remember that the overall market tends to look forward. On that front, if the market senses any storm clouds gathering on the horizon in the form of heightened inflation expectations, profit margin erosion, or tax hikes, market participants will more than likely be quick to react, especially given market returns since the depths of the COVID-19 crisis in March of last year. This does not mean we are stocking up on canned goods and gold for portfolios either. We just believe future return expectations need to be reined in. As we noted, there continue to be plenty of positives and areas of long-term opportunity.

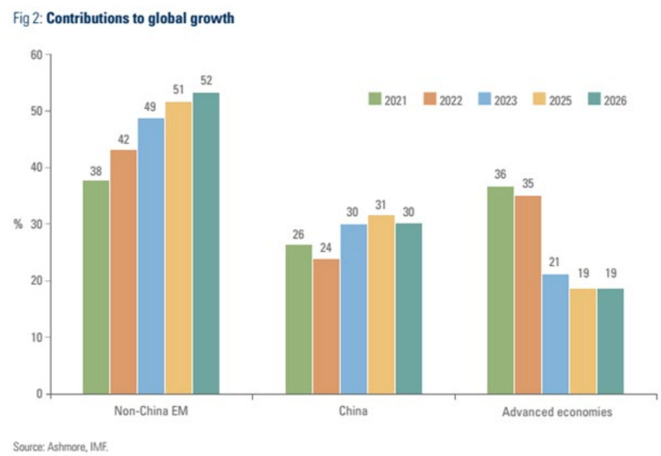
One area of opportunity that we highlighted last quarter, and that has benefitted portfolios more recently, was the addition of a dedicated deeper value manager in the fourth quarter of last year. One of the catalysts of the trade was that performance between so-called growth stocks and value stocks had reached historically high levels as growth stocks, and their valuation levels, had rocketed higher. Our patient approach, in combination with our long-term focus, led us to wait to make this adjustment in portfolios until we believed economic activity (in part, driven by businesses reopening) would begin to move higher, thereby benefiting cyclically oriented businesses that had been hurt during the COVID-19 economic shutdown. Further improving the relative attractiveness of value over growth was an increase in inflation expectations over the past six months, which caused market participants to reexamine the valuation levels of growth stocks (rising inflation and interest rates leads to a greater decrease in the present value of these stocks as future earnings are discounted back using a higher level of interest rates). In turn, value-oriented stocks registered relatively strong performance compared to growth stocks over the past two quarters.

Looking ahead, we continue to favor value stocks over growth stocks, although the relative attractiveness is not as great as it was in the latter portion of 2020. Furthermore, we believe there may be a slight shift in investor preference from "deeper value" cyclical businesses to "quality value" (i.e., well-run businesses, relatively low levels of debt, attractive rates of growth, strong competitive advantages, and pricing power) in the nearer term. We have positioned the domestic side of equity portfolios accordingly.

Elsewhere in the equity side of portfolios, we continue to favor foreign equities, in particular developed market small- and mid-cap stocks and emerging markets equities. Despite pressure from a strengthening U.S. dollar in the first quarter, which we believe was a short-term move in response to rising interest rates in the U.S., we believe longer term these areas of the market will benefit from rising earnings, attractive valuations, and a gradual weakening of the U.S. dollar. Earnings improvements in emerging markets have also been impressive. In addition to an acceleration in corporate earnings, underlying economic conditions are expected to be strong as well. This is true for both China and non-China emerging markets. See charts at the top of the next page.

Developed market growth is projected to contribute meaningfully to global growth for the next two years (2021 and 2022) before enduring a slowdown in subsequent years. The result is that emerging markets' contribution to global growth is expected to climb from 64% this year to approximately 81% by 2026. Because the market is a forward-looking mechanism, we believe the combination of earnings improvements seen this year, a gradual weakening of the U.S. dollar, and a supportive underlying economic environment (especially relative to developed markets) will result in relatively attractive returns for emerging markets security prices when viewed over an intermediate- to long-term investment horizon.

Chart courtesy of John Hancock Market Intelligence. Data provided by FactSet as of 3/31/21.



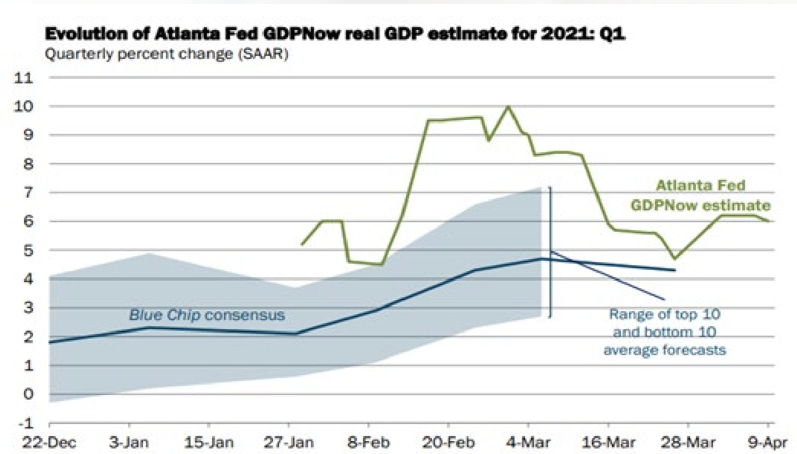
In summary, we continue to favor value over growth domestically, foreign small- and mid-cap stocks among developed markets and emerging markets more broadly. Areas of opportunity in the U.S. include quality value, and traditionally more defensive sectors of the market. We also believe that active management and individual security selection will be important as some companies are able to deliver in a more challenging environment while others are not.

During periods of what we believe to be speculative excess, it is important to remember that we utilize an approach that does not seek to maximize return potential in portfolios without consideration of underlying risk inherent in the investments we make on behalf of our clients. To the contrary, we seek to maximize returns for our clients while also minimizing the risk of the investments needed to achieve attractive rates of return. Experience has taught us that maximizing risk in an attempt to maximize return is fraught with pitfalls when managing portfolios for the long term. The psychological benefit may be great for the short period of time that it does work, but the damage that may be created when trends reverse course, tends to be much more detrimental to long-term financial goals. We will continue to manage client portfolios in what we believe to be a prudent manner, maximizing risk-adjusted long-term returns on investment.

Fixed Income Portfolio Comments

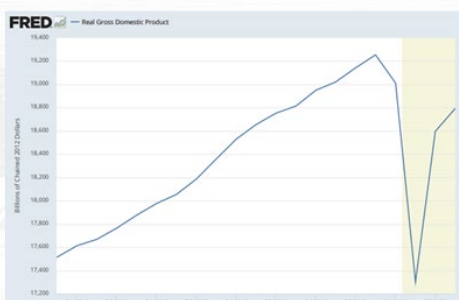
Economic and Policy Review

During the first quarter of 2021 the economic outlook continued to improve, as the combination of better-than-expected vaccine availability and a new $1.9 trillion stimulus package were added to the mix. This prompted an increase in the Fed's median estimates for 2021 real GDP growth, from 4.2% to 6.5%. The Atlanta Fed GDP Nowcast is projecting first quarter growth of 6.00%, which is in line with the Fed's full year outlook.



Source: Federal Reserve Bank of Atlanta

However, all is not as it appears on the surface, the inflated growth numbers can primarily be attributed to easy comparisons. Simply reopening the economy and getting back what we lost from shutdowns has been the primary driver of growth.



Despite the last three outsized quarterly growth numbers, the economy is still not as big as it was in the fourth quarter of 2019 (see chart above). On its current trajectory, it is likely we will reach pre-pandemic output at some point in late 2021.

After the masses are vaccinated and the economy is fully reopened, the easy comparable phase of the recovery will be behind us, and that is when the outlook gets more challenging. The pandemic has forced a fundamental transformation of our economy. Despite a 6.5% unemployment rate, the economy is still over 8 million jobs below its pre-pandemic level. The misleading headline number can be explained by the labor force participation rate, at 61%, which is two

Mike Peters, CFA
Chief Investment Officer – Fixed Income

Summary

Inflated economic growth numbers can primarily be attributed to easy comparisons. Simply reopening the economy and getting back what we lost from shutdowns has been the primary driver of growth.

An increase in U.S. Treasury yields and wider spreads, left most fixed income subsector returns negative. U.S. Treasuries were the worst performing sector generating a -4.61% return. Investment grade corporates were not far behind with a return of -4.49%.

We continue to position client portfolios to have less interest rate risk than investment policy statement benchmarks. We are cautious about investing in lower quality corporate bonds. We like the relative value and yields in the municipal sector.

percentage points below pre-pandemic levels. Also, we have yet to see what transpires post government and Fed intervention. Once that support subsides, and the economy is forced to stand on its own two feet, solvency problems that have been masked by stimulus payments will likely begin to appear.

The data continues to improve outside the United States as well. At the current pace, global growth is forecast to reach nearly 6.5% in 2021; however, vaccine implementation will be key to realizing this estimate. China's recovery continues to provide a boost to global growth, as the country largely exceeded its pre-pandemic growth levels at the end of last year. As a result, it has already begun withdrawing COVID-19 related stimulus. Elsewhere, Europe's recovery remains uneven. Manufacturing has started to rebound, but services are recovering much more slowly, weighed down by COVID-19 lockdowns. A third wave of COVID-19 cases in some of the major economies are stoking concerns about further economic gains, especially given the delayed roll-out of vaccines. As a result, the ECB said it would increase accommodation under its pandemic emergency bond purchase program.

Performance Review

From a performance perspective, a quick rise in intermediate-to-long dated U.S. Treasury rates explained most of the price movements during the quarter. The 10-year U.S. Treasury bond yield rose 82 bps (1 basis point = .01%) to end the quarter at 1.74%. This led to a steeper yield curve, as 2-year rates remained well anchored by the Fed's expectation it will keep short-term rates at zero through 2023. Credit spreads tightened during the quarter across most subsectors, with below investment grade corporates leading the way at -50 basis points. Investment grade corporate spreads were modestly tighter at -5 basis points. Agency mortgage-backed securities tightened -27 bps, ending the quarter at 12 bps, as the Fed continued its rapid pace of purchases. Conversely, emerging market debt and asset-backed securities widened during the quarter, 20 basis points and 2 basis points, respectively.

Option-Adjusted Spreads (in bps)

	12/31/20	2/28/21	3/31/21	1Mo Chg	Q1 Chg
U.S. Aggregate Index	42	34	31	-3	-11
U.S. Agency (non-mortgage)	10	4	4	0	-6
Mortgage and ABS Sectors					
U.S. Agency Pass-throughs	39	20	12	-8	-27
U.S. Agency CMBS	44	38	34	-4	-10
U.S. Non-Agency CMBS	109	94	99	5	-10
Asset-Backed Securities	33	29	35	6	2
Corporate Sectors					
U.S. Investment Grade	96	90	91	1	-5
Industrial	101	95	93	-2	-8
Utility	106	97	99	2	-7
Financial Institutions	83	77	84	7	1
Other Govt. Related	66	62	58	-4	-8
U.S. High Yield Corporates	360	326	310	-16	-50
Emerging Market Debt	503	498	523	25	20

Source: Bloomberg Barclays Indices

Source: Baird

Taken together, the increase in U.S. Treasury yields and wider spreads, left most fixed income subsector returns negative. U.S. Treasuries were the worst performing sector, generating a -4.61% return. Investment grade corporates were not far behind with a return of -4.49%. In previous rising rate periods, investment grade corporates offered more protection. However, this cycle is proving to be different, as companies extended bond maturities to provide a longer bridge to post-pandemic cash flows, which lengthened the duration of the corporate index significantly, making it more susceptible to negative performance during periods of rising rates. Of the primary investment grade sectors, mortgage-backed securities fared the best at -1.15%. The lone bright spot was high-yield, which was up +0.91%.

Fixed Income Outlook

Interest Rates

The combination of better-than-expected growth, an expanding vaccine rollout, and new fiscal stimulus, drove U.S. Treasury yields sharply higher during the quarter. The move was very similar to what we saw during the taper tantrum of 2013. The 10-year Treasury ended the quarter at 1.74%, which was in line with our fair value estimate of 1.67%. The front-end of the yield curve remained well anchored by the Fed's plan to leave rates at 0.00% into 2023. This combination pushed the widely followed 2–10-year yield curve to its steepest level since mid-2015. See chart below.

Fed officials have made the case that rising rates are primarily a function of future growth expectations, which provides them cover from tightening policy. However, the markets are forming a different opinion. The widely followed 5-year forward rate of 5-year breakeven inflation is up over 1.00% from the March 2020 lows, which indicates inflation is to blame. If true, the Fed may be forced to act earlier than it plans. We will be watching closely to see if the increase in inflation numbers are transitory, or something more durable.

From a portfolio construction standpoint, we continue to position client portfolios to have less interest rate risk than investment policy statement benchmarks. We prefer a more bulleted portfolio focused on strategies with intermediate durations (3-7 years). Our approach is designed to capture yield while playing defense against a rise in yields on the long end of the yield curve (10-30 years).

Corporate Bonds

Investment grade credit's -4.61% return was the worst first quarter since 1980. Despite negative returns, corporate bond demand remains healthy. During the quarter, total investment grade supply was up approximately 11% (when compared to 2020), which was met with over $50 billion of demand from investment grade credit funds. In total, demand slightly outpaced supply, leading to spread tightening (corporate bond yields moving closer to Treasury yields) of 5 basis points.

Fundamentally, the global economy bounced back much more quickly than anticipated due to unprecedented stimulus (fiscal and monetary) and record vaccine production. These factors helped keep businesses solvent through the worst of the pandemic. Due to Fed action, issuers were able to issue or refinance their debt at record low rates while simultaneously pushing their obligations further into the future. These actions extended the maturity profile of corporate debt to record levels. At over 8.1 years, the duration of the ICE BofA Corporate Bond Index significantly exceeds the 6.4 year average of the past several decades. With low yields and spreads, investors have little cushion to produce a positive return if we see a modest increase in interest rates, or a widening of spreads. Additionally, these factors accelerated the deterioration of private sector balance sheets. As stimulus wanes, we are likely to uncover many "skeletons" hiding in the credit closet. Given this backdrop, our positioning continues to be cautious from a duration and credit quality perspective. We prefer to target our exposure through tactical active management, where credit selection can lead to alpha generation while also protecting against defaults.

Securitized Bonds

During the first quarter, agency mortgage-backed securities struggled, as yields increased along with the Treasury sell-off. Under the hood, increased mortgage rates led to an extension of mortgage durations, which caused longer dated and lower coupon bonds to underperform despite solid demand. However, the repercussions of the pandemic continue to weigh on commercial properties. Hotel and retail properties have been hit the hardest, with appraisal reductions ranging from 28% to 41% since March 2020. These sectors account for 85% of all loans in forbearance. On a positive note, the number of delinquent commercial mortgage-backed securities declined during the quarter. Substantial fiscal support has kept the consumer afloat through the worst of the pandemic, resulting in better-than-expected delinquencies in consumer asset-backed securities.

Overall, we continue to have an overweight to the securitized sectors when compared to benchmarks. When comparing yields and spreads through the lens of duration and credit quality, the space stands out from a relative value perspective. We continue to gain exposure through diversified actively managed mutual funds, which can add value through sector and credit selection.

Non-U.S. Credit

Although the U.S. dollar's decline took a pause during the first quarter, its negative trend is likely to continue over the intermediate-term, which makes us constructive on non-U.S. credit, particularly emerging market debt. We have direct exposure to the asset class in our high-income mandates and are gaining exposure through our multi-sector strategies in intermediate and core plus.

Municipal Bonds

Like Treasuries, AAA-rated tax-exempt yields rose during the first quarter in all but the shortest maturities. However, the moves higher were lower in magnitude. This, in combination with tighter spreads, led to one of the best quarters for municipals since 1981. Fueling this was the passage of the American Rescue Plan Act (ARPA), which provides an estimated $668 billion of support to state, local and other municipal entities. S&P wrote shortly after the legislation was signed into law, "all sectors stand to benefit," which it backed up by revising sector outlooks to "stable" from "negative" for states and local governments, charter schools, airports, toll roads and mass transit. We continue to emphasize the use of municipal bonds in our tax-aware strategies. Improving fundamentals and tax-free yields offer good relative value when compared to taxable sectors.

Our Team

Bob Batchelor, CFA®, CFP®
CEO
Co-Founder

Bob J. Batchelor, CFA®, CFP® is Co-Founder and Chief Executive Officer of Entasis Asset Management. Bob has 22 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. Bob has also earned the Certified Financial Planner™ certification.

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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 17 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.

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CIO – Fixed Income
Co-Founder

Mike Peters, CFA® is Co-Founder and Chief Investment Officer – Fixed Income of Entasis Asset Management. Mike has 17 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 49 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

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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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