Absolute Return Strategy

1Q 2018

Market Review

Global yields moved higher in January while yield curves steepened. The US ten year yield peaked at 2.95% in late February, up 0.55% from 2.40% at the start of the quarter. European and Australian yields followed a similar pattern, with 10YR bunds topping out at 0.74% and Australian 10YR yields reaching 2.94%. As US yields approached 3.00%, the market became concerned about the impact of higher interest rates on equity pricing. Volatility spiked in February, most notably in equity markets but also in fixed income markets. 2017 had the lowest interest rate volatility in the modern (post 1980) era but we may be moving towards a higher volatility regime. Small cracks appeared in the synchronized global growth story. European data underperformed high expectations, pointing to 2-2.5% 1Q GDP growth rather than 3-3.5% growth. US projections of 3-4% 1Q GDP growth faltered as the quarter went on, ending around 2.0%. Global rates fell throughout March while yield curves flattened. The US ten year held most of its increase, closing at 2.74%. German rates gave back most of their increase, ending the quarter at 0.49%, up only 0.05% on the quarter. Australian rates actually declined on the quarter, closing at 2.60%. The yield on the Australian 10YR fell below the yield on the US 10YR for the first time in 18 years.

Spread sectors had a difficult quarter, finally reversing the spread tightening trend that had been in place for two years. MBS spreads widened in January, hurt by extension risk fears and higher volatility as the 10YR yield approached 3.00%. MBS stabilized in February when yields peaked but credit spreads began to widen. IG corporates led the way, widening 16 bps to +109. EM spreads widened 14 bps to +240. HY outperformed IG, particularly on a beta adjusted basis, widening only 11 bps to +354. This was an unusual spread widening period as high quality sectors underperformed lower quality. The reasons IG spreads underperformed HY spreads include 1) Repatriation based selling of short, high quality IG bonds as a result of US tax reform, 2) IG supply pressure from two enormous new issues, 3) Tight spread levels that left IG investors with little margin for error, and 4) the absence of actual credit concerns due to the strong economy and favorable corporate revenue outlook.

The Jay Powell era began at the Federal Reserve. Powell was a continuity candidate and no major policy changes seem imminent. The market expects 3 to 4 hikes over the next 12 months but very little after that. For the first time in a long time market pricing and FOMC forecasts are in synch over a 12 month horizon. Market pricing remains three hikes lower than FOMC projections on a 3YR horizon. ECB President Draghi and other council members continue to stress the need to be 'persistent and patient' and 'reactive' rather than 'proactive.' The timing of the first 15bp hike by the ECB has shifted from March 19 at the beginning of the quarter to currently September 19.

In the UK, the market is pricing in a 90% probability of a 25bp hike at the next meeting in May. This probability was 40% at the beginning of the quarter. The UK labor market continues to tighten and wages are rising gradually.

Portfolio Performance[1]

The Absolute Return strategy returned 0.02% during the quarter. The one year return is 1.52%. All figures are gross.

Interest Rates and FX

Our macro positions underperformed during the quarter. We were generally positioned for steeper curves and rising rates which worked in January but hurt in March and overall. The primary sources of underperformance in March were short positions and steepening positions in Australian and EU rates. We were also short US rates, which was an overall positive as US rates rose much more in January than they fell in March. Other winning positions included being short UK rates vs German rates and long Italian rates vs German rates. UK rates have been able to rise versus German rates as monetary policy normalization is much farther along in the UK. The MPC is likely to raise rates in May while the ECB is still growing its balance sheet with no chance of rate hikes until sometime in 2019 at the earliest. Potential for higher UK rates received a boost when the UK and EU Brexit negotiators agreed in principal to a 21 month transition period after the UK leaves the EU in March 2019. Italian rates managed to compress vs German rates as the timetable for ECB normalization extended. Our long/short basket of FX positions underperformed modestly.

[1] Performance figures do not reflect the deduction of investment advisory fees. A client's return will be reduced by the investment fees. If a client placed $100,000 under management and a hypothetical gross return of 10% were achieved, the investment assets before fees would have grown to $259,374 in 10 years. However, if an advisory fee of 1% were charged, investment assets would have grown to $234,573, or an annual compounded rate of 8.9%.

Securitized Sectors

Our securitized sector positions outperformed. Our short position in agency MBS gained as volatility bounced off the bottom and spreads widened. We remain short MBS going forward. The supply/demand balance is poised to fall apart in June as the seasonal pickup in organic supply collides with increasing Fed balance sheet runoff. Additionally, MBS spreads will be vulnerable if we transition to a higher volatility regime. We benefited from a long position in CMBS in January as spreads tightened sharply as the year started. We became concerned about potential spread widening and unwound the position in late January. Our student loan ABS performed well, helped by the increase in LIBOR which supported bid levels for all floaters indexed to LIBOR. We also had a profitable investment in data center ABS, a new sector that was initially priced cheap to attract investors.

Corporate Markets

Investment grade positions detracted from performance during the quarter while High Yield positions added value. Each month of the quarter felt like a unique regime. Credit spreads tightened in January and our IG and HY holdings outperformed. Spreads began widening in February. We tactically went long overall credit in mid-February when spreads appeared to stabilize. Unfortunately we were too early and capitulated on this position at wider spreads in mid-March. Despite spread widening, we had positive credit returns in February, primarily due to timely adjustments to the CDX.HY hedge used to offset risk from our HY bond holdings. Credit positions significantly underperformed in March as spread widening continued. This was an unusual spread widening period as high quality sectors underperformed lower quality sectors. Our underperformance was exacerbated due to our preference for high quality, liquid IG investments. The other major factor in our underperformance was the breakdown in correlation of the beta adjusted synthetic hedge we used to guard against IG corporate bond spread widening. CDX.IG substantially outperformed corporate bonds in March, widening much less than anticipated based on historical relationships. The strategy gained from a tactical short in Asian credit initiated in late January and a subsequent long position later in the quarter. A long position in Australian credit produced a modest gain in January.

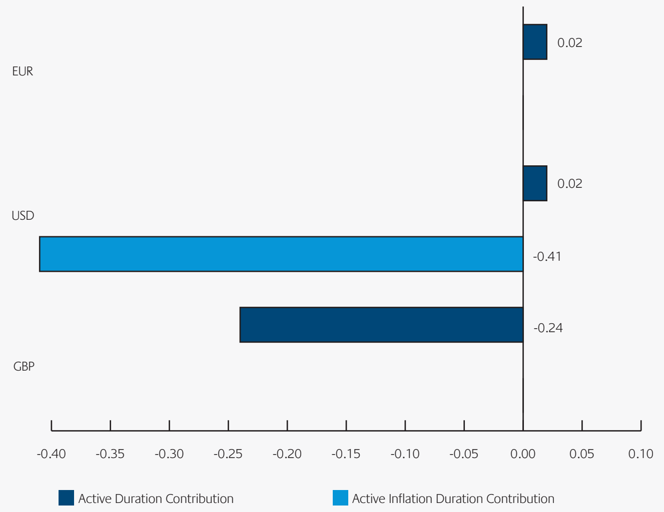
Outlook

The growth outlook is an important focus for the 2nd quarter. Economic surprise indices declined sharply throughout the quarter. Our expectation is that this is more about elevated expectations going unmet rather than a real slowdown but we will watch this closely. We are more confident about the US economy than most others because the US surprise index held up better than other regions, residual seasonality may have artificially depressed 1Q growth, and the US has less potential downside from global trade tensions. Ongoing NAFTA negotiations and steel & aluminum tariffs have roiled the market. China appears to be the primary target of US trade policy adjustments but there is no clear roadmap for investors to follow. Inflation will be important to watch in the US, particularly as base effects will push Core CPI towards 3.0% annually over the next 6 months.

Political developments may be important, particularly in Europe. The agreement on a Brexit transition period is a positive while the continual struggle to form a government in Italy may eventually cause problems.

We enter the second quarter fairly light on overall risk positions after closing many of them out in March. Within the Eurozone we are long French rates vs German rates. We are positioned short UK rates and positioned for US inflation prices to increase. We are optimistic that many of our corporate holdings will outperform CDX going forward as we own many high quality IG bonds that widened more than we think is sustainable on a relative basis. Within structured securities we will look for opportunities to go long, noting the CMBS spreads followed corporate spreads wider. We remain short agency MBS as we expect supply to overwhelm demand in 2Q.

Active DM Rates by FX



Active Spread Duration Contribution