

MARKET REVIEW

“The market taketh and the market giveth away” sums up the activity for the first quarter of 2017.

The Republican electoral sweep in 2016 propelled small cap stocks to new highs as smaller companies appeared to benefit from fiscal policies that suddenly looked to be within reach. A lower tax rate with fewer loopholes could provide relief from high effective tax rates. A reversal in regulatory activity would benefit smaller firms given the large portion of their resources such regulations consume. The greater domestic focus of smaller companies also stood to protect them versus large cap names from the impact of potential protectionist trade policies. Meanwhile, underneath the political blustering, the domestic economy continued the improving trends that began during the summer.

As 2017 unfolded, however, the possibility that these proposals would actually become policy slowly waned. The failure of the health care bill cast doubt on tax reform or dramatic deregulation. Talk of trade wars proved to be unfounded as the administration took more docile trade positions in the name of geopolitical cooperation.

Thus, small cap stocks as measured by the Russell 2000 index returned 2.46% while the large cap S&P 500 returned over 6% for the first quarter of 2017. While part of this underperformance can be attributed to the reversal of political fortunes, growing anxiety regarding economic trends was the primary factor.

The ISM index, a measure of economic trends, showed signs of peaking, and even as the Federal Reserve raised rates in March--the second time in four months--the longer end of the curve remained stubbornly high, causing a flattening that can indicate a slowing economic environment. Consumers and investors remain optimistic, but the hard data is beginning to tell a different story.

PORTFOLIO POSITIONING

The portfolio remains well diversified. The portfolio management team is comfortable allowing some momentum stocks to build in the portfolio. Returns to momentum stocks have stabilized and their valuation levels have moderated considerably.

The team believes that as a segment, small caps are fairly-valued. The team sees considerable upside from here, but with credit spreads at such tight levels, there is little to fuel a rapid relative run in smaller stocks versus larger companies.

Nevertheless, with stock correlations at low levels, and individual stock performance increasingly being driven by company-specific events instead of macroeconomic events (politics aside), the team sees considerable potential to add alpha within the small cap space.

PRODUCT OVERVIEW

The Small Cap Core strategy seeks to outperform the Russell 2000 Index by constructing a diversified portfolio using an investment process that combines analysis of economic and market forces; individual stock analysis and risk management; and efficient strategy implementation and trading. The core of our process is knowledge-based investing which uses signals from the activity of unique market participants to assess potential company appreciation.

TOP FIVE CONTRIBUTORS (%)

| Security | Avg. Weight | Portfolio Impact |
|--------------------------|-------------|------------------|
| Nutri Systems Inc. | 0.95 | 0.46 |
| Coherent Inc. | 1.12 | 0.35 |
| Advanced Energy | 1.57 | 0.32 |
| Clovis Oncology Inc. | 0.74 | 0.21 |
| GCP Applied Technologies | 1.10 | 0.21 |

TOP FIVE DETRACTORS (%)

| Security | Avg. Weight | Portfolio Impact |
|-------------------------|-------------|------------------|
| Xperi Corporation | 0.91 | (0.20) |
| Tetra Technologies Inc. | 0.86 | (0.18) |
| Chemours Co. | 0.00 | (0.16) |
| Synergy Pharmaceutical | 0.63 | (0.15) |
| Matrix Svc Co. | 0.42 | (0.13) |

REPRESENTATIVE BUYS AND SELLS

| Bought | Sector |
|---------------------|------------------------|
| Masimo Corp. | Health Care |
| Logmein Inc. | Information Technology |
| AdvancePierre Foods | Consumer Staples |

| Sold | Sector |
|------------------------------|------------------------|
| Coherent Inc. | Information Technology |
| West Pharmaceutical Services | Health Care |
| Livanova PLC | Health Care |

SMALL CAP CORE INVESTMENT MANAGEMENT TEAM

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Chief Equity Officer

- Investment experience since 1991
- Tenure with HighMark since 2008
- MBA – University of Michigan
- BA – Computer Science, University of California, Berkeley

Yanping Li, Ph.D.
Senior Equity Research Analyst/ Portfolio Manager

- Investment experience since 2008
- Tenure with HighMark since 2011
- PhD – Applied Physics, Cornell University
- MS – Financial Engineering, University of California, Berkeley
- MA – Physics, Brandeis University

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- Tenure with HighMark since 2014
- PhD – Chemical Physics & Statistical Analysis, University of California, Los Angeles
- MBA – University of California, Berkeley
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- Tenure with HighMark since 2014
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The information provided herein represents the opinion of the manager of the market environment at a specific point in time and should not be relied upon as research or investment advice. Information presented for Top Contributors and Detractors is based on a representative account within the Small Cap Core Composite, and on a trade date basis. As of March 31, 2017 the composite consists of equal to or less than five accounts, and composite represents 1.16% of the total firm assets. The minimum portfolio size for inclusion in the composite is \$500,000. The benchmark for this composite is the Russell 2000 Index. The benchmark is used for comparative purposes only and is provided to represent the market conditions during the period shown. The benchmark measures the performance of the small-cap segment of the U.S. equity universe. The Index is a subset of the Russell 3000® Index representing approximately 8% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. An index of approximately 1,000 of the largest companies in the U.S. equity markets, the Russell 1000 is a subset of the Russell 3000 Index. The Russell 1000 comprises over 90% of the total market capitalization of all listed U.S. stocks, and is considered a bellwether index for large cap investing. The Russell 1000 is a market capitalization-weighted index, meaning that the largest companies constitute the largest percentages in the index and will affect performance more than the smallest index members. Benchmark returns do not reflect the deduction of advisory fees, custody fees, transaction costs, or other investment expenses. The benchmark returns assume the reinvestment of dividends and other earnings. An investor cannot invest directly in an unmanaged index. Specific securities identified and described do not represent all of the securities purchased, sold or recommended for advisory clients, and you should not assume that investments in the securities identified and discussed were or will be profitable. Please call (800) 582-4734 or write to highmark.capital@highmarkcapital.com to obtain the calculation methodology for contributors and detractors and a list of every holding's contribution to the overall representative account's performance during the quarter.

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