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CAPITAL MANAGEMENT

Core Fixed Income Commentary

Q2 2017

MARKET REVIEW

During the second quarter the yield curve continued to flatten as long term interest rates declined 18 basis points while short term rates increased 25 basis points. The yield curve flattened as a result of slower inflation and investors' fears that continued Federal Reserve rate hikes could slow the economy. As a result, the Bloomberg Barclays U.S. Aggregate Bond Index returned 1.5%, the best quarterly return in a year. Longer duration bonds outperformed shorter duration, as the two-year Treasury gained 0.1%, while ten-year and thirty-year bonds returned 1.3% and 4.3%, respectively. Credit risk was also rewarded as investment-grade corporate bonds outperformed similar duration Treasuries by 112 basis points. Lower credit quality outperformed higher quality as bonds rated AA and above returned 1.8%, while BBB rated bonds gained 2.7%, and high yield bonds returned 2.2%. Among investment-grade corporate bonds, the best performing industries included Refining, Life Insurance, Paper, Pharmaceuticals, and Communications. Industry laggards included Oil Field Services, Integrated Energy, Automotive, Diversified Manufacturing, and REIT's.

In terms of the economy, we are in the eighth year of an economic expansion that began as we excited one of the most severe recessions since the 1930s. Yet despite an extraordinary amount of fiscal and monetary stimulus, the US economy has averaged a modest real growth rate of about 2% since the beginning of 2010. The job market has largely recovered and continues to maintain a moderate level of growth consistent with maintaining today's low unemployment rate, but wage growth remains stubbornly depressed. Additionally, inflation remains low, generally below the Federal Reserve's target level, and productivity has been expanding at its slowest rate in the post-World War II era.

With this as a backdrop, the Federal Reserve is reducing accommodation through a combination of a higher Fed Funds rate, three increases over the past eight months, and a clear indication that they plan to reduce the level of quantitative easing though the reduction of reinvestment of principal and interest payments. Yet even before the impact of higher rates gains traction, certain segments of the economy have suggested concerns. One example is US Auto Sales which reached a post-recession peak in December 2016 of 18.3 million units and has now fallen to a seasonally adjusted level of 16.4 million units while at the same time, delinquencies in auto lending have steadily increased since the trough in 2014. As a result, we are concerned that the US economy faces headwinds with a risk of a slowdown over the intermediate term. If the consensus outlook for the economy changes, we believe the impact on valuations and increase in speculative grade defaults will be significant.

PORTFOLIO REVIEW

During the second quarter, Treasury yields increased for maturities of three years or less and declined for maturities beyond three years as the yield curve flattened. Since the portfolio had a slightly shorter duration than the benchmark the interest rate impact was a negative 8 basis points. The portfolio was also overweight the intermediate maturity portion of the yield curve, which underperformed longer maturities, subtracting 5 basis points from relative returns. The portfolio benefitted from an underweight to Treasuries and overweight to corporate bonds as the sector allocation and extra income added 10 basis points for the quarter.

We continued to transition the portfolio to a more defensive position during the quarter. Our positioning reflects the interplay between current valuations and our expectations for the economy. Today our concerns are based on the combination of higher valuations on spread product, nearing the tightest spreads since 2009, and our cautious outlook for the macroeconomic environment and the geopolitical situation as the uncertainty regarding Trump policies unfolds in 2017.

Data for the above commentary is from Bloomberg and Barclays as of June 30, 2017.

PRODUCT OVERVIEW

The Core Fixed Income strategy seeks to benefit from opportunities arising from changes in interest rates, volatility, credit and sector spreads and the shape of the yield curve in constructing a portfolio that seeks to outperform the Barclays U.S. Aggregate Bond Index over time. Our process is based on the belief that fixed income markets are inefficient and that active management which emphasizes sector and security selection can generate superior long-term results.

TOP FIVE CONTRIBUTORS (%)

Security	Portfolio Impact	Excess Return Contribution
New Jersey St Tpk Auth Tpk	0.09	0.054
Johnson & Johnson	0.09	0.045
Los Angeles Calif Dept Wtr	0.06	0.027
Verizon Communications Inc.	0.04	0.020
Dow Chemical Co.	0.05	0.020

TOP FIVE DETRACTORS (%)

Security	Portfolio Impact	Excess Return Contribution
FNMA Pool - 829431	0.00	(0.003)
United States Treas NTS	0.02	(0.004)
Petro-CDA	0.00	(0.006)
Macy's Retail Hldgs Inc.	0.00	(0.012)
Ensco PLC	(0.01)	(0.052)

CHARACTERISTICS

	Portfolio	Benchmark
Average Maturity	6.81 yrs	7.72 yrs
Effective Duration	5.33 yrs	5.84 yrs
Average Quality	Aa3	Aa2
Yield to Maturity	2.66%	2.49%
Average Coupon	3.39%	3.05%

CORE FIXED INCOME INVESTMENT MANAGEMENT TEAM

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Information presented for Top Contributors and Detractors is based on a representative account within the Core Fixed Income Composite, and on a trade date basis. As of June 30, 2017, the composite consists of equal to or less than ten accounts, and represents 3.52% of the total firm assets. The minimum portfolio size for inclusion in the composite is $3 million. The benchmark for the composite is the Barclays Capital (BC) U.S. Aggregate Bond Index, which is composed of U.S. securities in Treasury, Government-Related, Corporate, and Securitized sectors. All securities included in the index are of investment-grade quality, have at least one year to maturity, and have an outstanding par value of at least $250 million. 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.

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