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CAPITAL MANAGEMENT

Short Term 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, 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. Returns for the quarter were positive, but muted as the Bloomberg Barclays U.S. Government/Credit 1-3 Year index gained 0.3% for the quarter, 1-3 Year U.S. Treasuries returned 0.2%, 1-3 Year corporate bonds returned 0.6%, and 1-3 Year Mortgage-Backed securities added 0.3%.

Credit risk was rewarded as 1-3 Year investment-grade corporate bonds outperformed similar duration Treasuries by 38 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 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 fund had a slightly shorter duration than the benchmark the interest rate impact was a negative 3 basis points, while the flatter curve contributed a positive 7 basis points. The fund benefitted from an underweight to Treasuries and overweight to corporates as the sector allocation and extra income added 15 basis points for the quarter. Mortgage-backed securities underperformed Treasuries resulting in a negative 4 basis point impact.

We continued to transition the portfolio to a more defensive position. 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 Short Term 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. 1-3 Yr Govt/Credit 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
Capital One Bank USA Nat'l Assn	0.01	0.010
Caterpillar Financial Svcs MTNS B	0.01	0.008
Shire Acquisitions Invts IRE	0.01	0.006
Ford Motor Credit Co LLC	0.01	0.006
Dow Chem Co	0.01	0.006

TOP FIVE DETRACTORS (%)

Security	Portfolio Impact	Excess Return Contribution
FNMA Pool – AL5434	0.00	(0.001)
Delta Air 2012-001-A	0.00	(0.001)
FNMA Pool – 829431	(0.00)	(0.001)
United States Treasury NTS	0.02	(0.002)
FNMA Pool – AL3620	0.00	(0.002)

CHARACTERISTICS

	Portfolio	Benchmark
Average Maturity	1.95 yrs	2.01 yrs
Effective Duration	1.80 yrs	1.94 yrs
Average Quality	A1	Aa1
Yield to Maturity	1.80%	1.57%
Average Coupon	2.39%	2.03%

SHORT TERM FIXED INCOME INVESTMENT MANAGEMENT TEAM

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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 Short Term Fixed Income Composite, and on a trade date basis. As of June 30, 2017, the Short Term Fixed Income composite consists of equal to or less than five accounts, and the composite represents 2.42% of the total firm assets. The minimum portfolio size for inclusion in the composite is $10 million. The benchmark for this composite is the Barclays Capital U.S. 1-3 Yr Government/Credit Index. The benchmark is used for comparative purposes only and is provided to represent the market conditions during the period shown. The Barclays Capital U.S. 1-3 year Government/Credit Index measures corporate and non-corporate fixed income securities that are rated investment grade and have 1-3 years to final maturity. It is formerly known as the Lehman Brothers 1-3 year Government/Credit Index. 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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