RESEARCH REVIEW

FIRST QUARTER 2016

Fund Evaluation Group®
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Market Commentary: Chronic Problems and No Ammo

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"Once again, markets are rising because of something that a central banker said."[1]

–Twitter post from The Economist, March 30, 2016.

Perhaps no other sentence so succinctly and accurately summarizes the global investment landscape over the past three months and, in reality, the past few years, than this one. The influence that central banks in general and the U.S. Federal Reserve (Fed) in particular wield today is staggering. The unprecedented actions of central banks have rendered many traditional fundamental concepts less effective.

Observers resoundingly viewed Fed chair Janet Yellen's opinions in a speech on March 29th as dovish and risky assets leapt in response. Not only was her tepid language considered a signal that the previously expected four rate hikes in 2016 would now be something less onerous, but Chair Yellen's remarks included recognition of developments that seem to extend beyond the Fed's dual mandate:

> *"The proviso that policy will evolve as needed is especially pertinent today in light of global economic and financial developments since December, which at times have included significant changes in oil prices, interest rates, and stock values."*

Unconventional Actions

Market reactions to central bank policies are swift, sizeable, and powerful. The Fed enacted a bond-buying program of quantitative easing in part as an attempt to reflate the roiling stock and credit markets after the financial crisis of 2008. What resulted was one of the greatest bull markets for financial assets in history. But times have since changed.

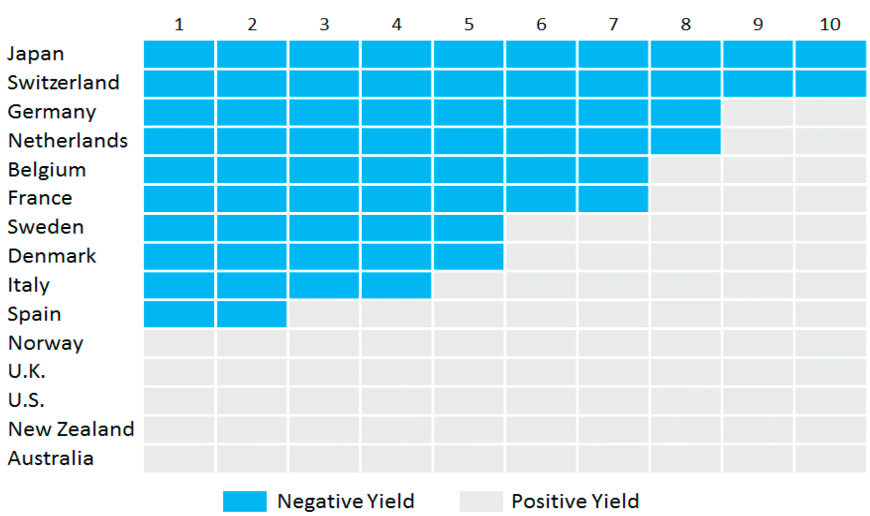
Until recently, global central bank policy had been coordinated—or at least seemed to be—as all parties executed the standard Keynesian responses of monetary easing to address the most pointed financial crisis since the Great Depression. Now, however, a mixed bag of self-serving and unconventional monetary actions has resulted in over $7 trillion of sovereign debt, exhibiting (in some areas) negative sovereign debt yields.[2]

The illustration below is particularly telling. Today, there are 10 countries that collectively represent approximately 29% of the global economy,[3] with negative yields on their debt. Much of that debt has maturity dates that extend beyond 5 years.

Negative interest rates were a previously unthinkable, perhaps impossible idea until it actually happened. Backed into a corner in a desperate war against deflation, central bankers fired every monetary policy gun at their disposal, including negative rates.

Perversely, negative rates may actually have the exact opposite effect of what central bankers intended. Negative interest rates are meant to spur credit demand within companies and households. If banks are unwilling to impose negative rates on depositors, lending rates could actually increase as banks attempt to maintain margins to offset losses they face on their central bank reserves. In such a case, less money would be getting into the economy, actually crimping growth potential.

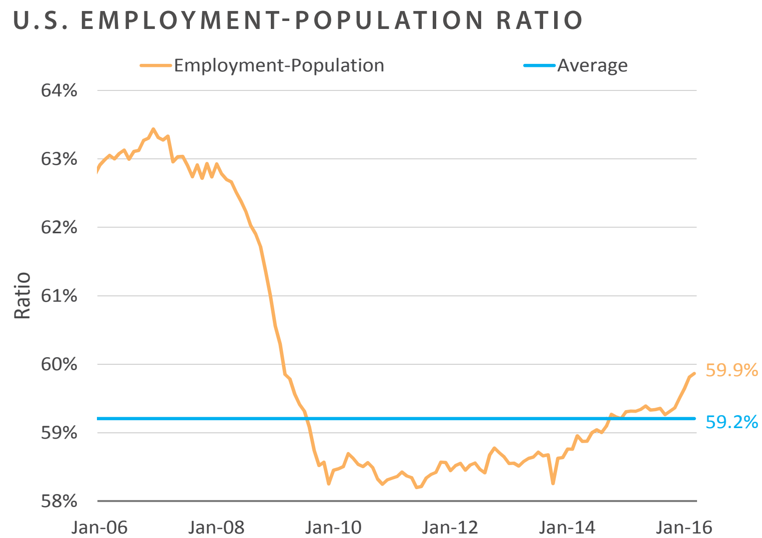
BOND MATURITY IN YEARS



Data source: The Wall Street Journal

Chronic Problems and No Ammo

The primary global economic problem is chronically low demand—a consequence of low growth and low inflation. Japan is suffering near-zero growth and minimal inflation. Euro zone inflation has again turned negative, and British inflation is zero with slowing economic growth. The U.S. economy is a bit more robust, but the recovery from the 2008 financial crisis remains disappointingly slow. Employment in the US has improved but is not ideal, and annual inflation is barely reaching the Federal Reserve's 2% target.



Data sources: BLS, Bloomberg, L.P.; Data as of 3/31/2016

Negative rates and quantitative easing are certainly radical monetary policies, suggesting a dearth of conventional solutions. Are central banks "out of ammunition" as a recent cover of *The Economist* suggests? Maybe. Impotent central banks are a scary thought because a self-feeding deflationary spiral could have catastrophic consequences, that would extend across the globe. In this light, it is easy to appreciate the lengths to which central bankers are going to prevent deflation.

Central bankers talk frequently about the limits of their monetary policies, suggesting that what are really necessary are fiscal actions and structural reforms. Structural reform can cover quite a few issues, such as promoting free trade, labor market reforms, etc., but those things do not happen quickly. Moreover, in many cases these reforms are too politically sensitive to discuss, let alone implement.

Source: The Economist, February 20 issue.

Global demand is tepid and monetary policies are not having the desired effect. But how bad are things really? Bad enough that some central bankers are considering some truly radical ideas. One idea to spur global demand—and ultimately growth—is a so-called "helicopter drop" policy that involves direct monetary financing of public spending. Rather than increase deficits for fiscal spending on infrastructure, education, or other public programs correlated with growth, central banks implementing the helicopter drop policy would just print money as needed. Of course, the economy would have to be on the verge of collapse in order for policymakers to consider this a viable strategy, as in extreme cases this strategy could actually lead to runaway inflation.

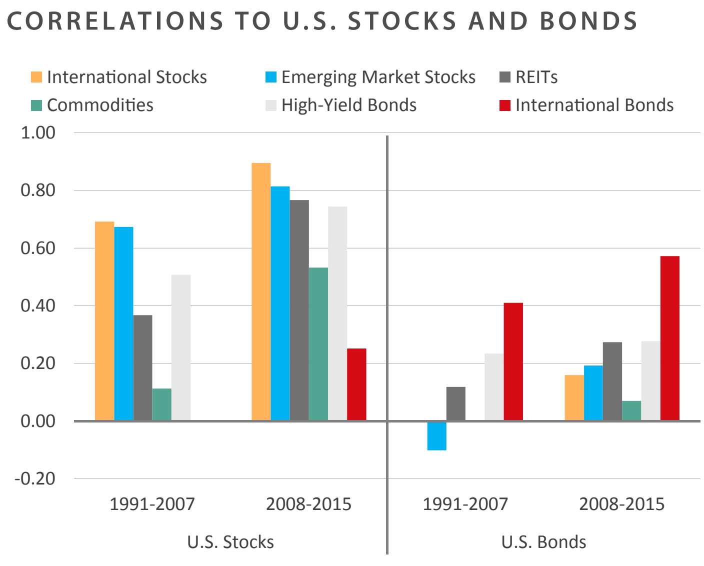
The point here is that perfectly fallible human beings working in central banks around the world are pulling levers and setting into motion a series of events that are without historical precedent. Furthermore, these policies are often isolationist. The European Central Bank (ECB) and Bank of Japan (BOJ) do not care about the impact of their negative interest rate policies on the profits of large American multi-national companies if the U.S. dollar strengthens, their only focus is the fiscal solvency of their own nation. In the same vein, the Fed will make moves to help U.S. companies in correlation with their own employment-related mandate. All of these central bank actions will influence the complex, adaptive financial markets in some ways that may be foreseen, but in many others that will not.

Who knows, maybe Central Banks will get it right. But investors must be prepared for any outcome.

Market Swings

Without question, central bank influence has led to an environment where correlations between different asset categories have increased in recent years as fundamentals matter less in a world of risk on—risk off.

As illustrated in the graph, different, historically diversifying asset categories exhibited lower respective correlations to U.S. stocks and bonds prior to the financial crisis than since then. Diversification has been less effective in recent years as nearly every asset category either rallies fast or falls hard all at the same time.



Data source: Lipper

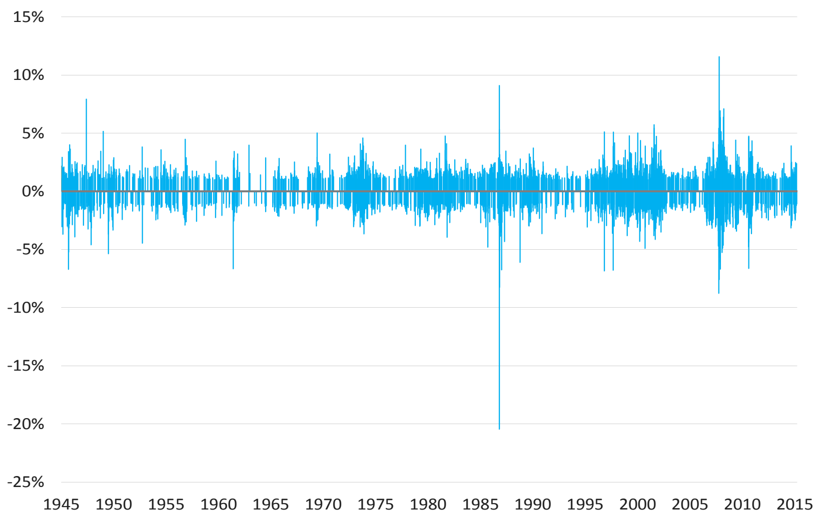
Rather than recoil against this reality, we must accept it and adapt as necessary. Markets have been demonstrating more volatility than normal of late and are providing little evidence that this trend will change in the near future.

Beyond the fact that markets just "feel" more volatile, some examples can help confirm this feeling.

First, at one point during the first quarter of 2016, the S&P 500 Index dropped more than 10% from the prior quarter-end, only to close out the first three months of the year in positive territory. That level of deep intra-quarter plunge and black quarter finish has occurred only one other time since 1927 in the fourth quarter of 1933.[4]

Second, the frequency and magnitude of daily price swings is also on the rise. The graph shows days when the index ends up or down 1% or more. Notice that in recent years the data is more densely packed, indicating a greater frequency of large moves; furthermore, the sizes of the moves are elevated relative to other points in history.

S&P 500 INDEX DAILY PRICE MOVES OF 1% OR MORE
December 31, 1945 – March 31, 2016



Data source: Bloomberg

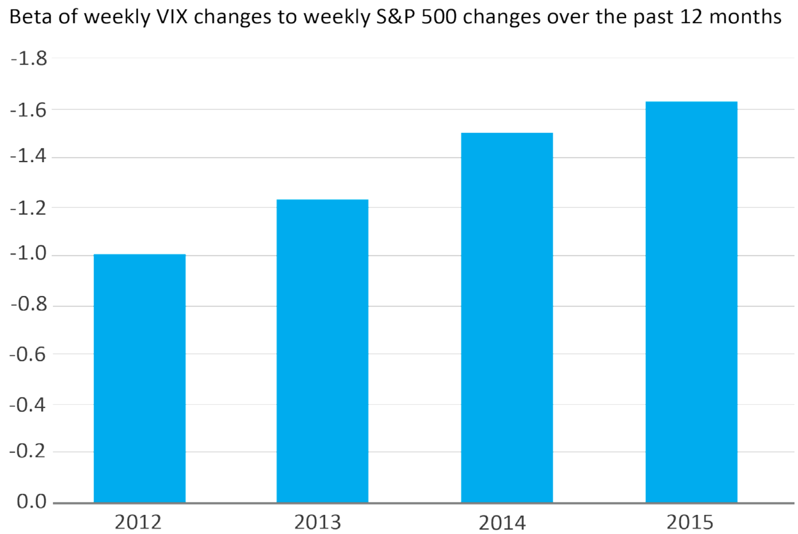
The third, and perhaps most telling, piece of evidence supporting this volatility is the pricing in the options market.

We know that volatility increases when stock markets decline. The CBOE Volatility Index (VIX) has a strong inverse correlation to the S&P 500. But volatility in this sense is not synonymous with standard deviation, rather the VIX calculation is based upon the implied volatility priced into index options. When the stock market goes down, demand for put options increases and implied volatilities jump.

The implied volatility of an option is the only demand-driven piece of an option's price. Thus, during periods of market stress demand drives volatility higher and option prices increase.

The VIX goes up when the stock market declines, but the VIX's reaction has become more pronounced for the same unit of market decline in recent years as illustrated in the graph below.

VOLATILITY HAS BECOME MORE SENSITIVE TO EQUITY MARKET WEAKNESS



Source: Chicago Boards Options Exchange (CBOE) Volatility Index (VIX), S&P 500 Index data through December 2015, PIMCO calculations. In 2015 the VIX Index – which is a measure of the markets' expectation for price volatility – tended to spike higher on average in response to equity market sell-offs. The measure is negative because the spikes upward in volatility tended to occur when the stock market declined.

This data statistically represent what many are feeling. Markets seem more volatile today than they have been historically, and investors are reacting accordingly. The VIX data illustrated here are not a measures of market fluctuations; but a graphic representation of investor reaction to those fluctuations.

This is the reality of the investment landscape today, but that should not deter investors. In difficult, volatile periods, emotions may prompt misguided feelings or desires to act and intercede. However, panic is not required during such times. Instead, investors must employ perspective. Rather than giving in to short-term flight-or-fight reactions, we have a responsibility to guide client portfolios toward a trusted, long-term foundational investment philosophy.

Equities

In a wide variety of equity markets across the globe, a bias toward the value style has outperformed growth over time. The academic research that supports this concept is voluminous and empirical evidence is readily accessible across time spans throughout history. Over the past few years, however, growth stocks have dominated value stocks as investors seeking rare growing opportunities in a stubbornly slow economic recovery are increasingly willing to pay a premium for them.

Last quarter, these pages highlighted the vast divergence between the recent performance of value stocks relative to their history, with the implication that maintaining a bias toward the less expensive names is expected to improve performance in the future. This quarter, we dig a bit deeper into the current state of value and reiterate our belief in the viability of this approach.

Equities can be categorized in a myriad of ways. One common means of segregating stocks is to rank a universe by “factors,” such that a portfolio comprised of stocks exhibiting favorable characteristics is expected to outperform a portfolio with less favorable characteristics or the market in general. This is the basic idea behind “smart beta” strategies.

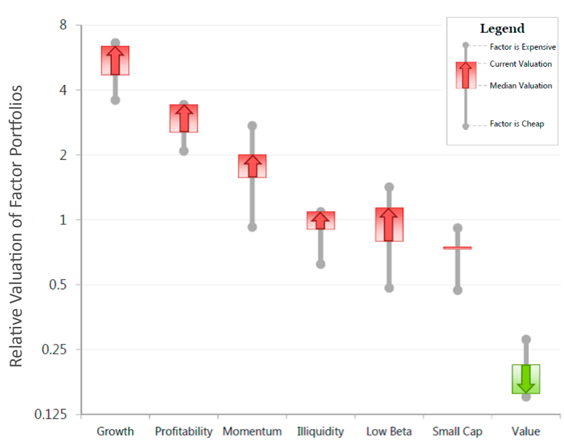
In a recent presentation, Research Affiliates (RA) described six independent factors (methods of equity classification) with the aim of outperforming from tilts to those factors. RA discussed how each has performed of late as well as over the long-term. The six factors presented were:

- Value—the expectation that lower priced stocks will outperform higher priced stocks
- Momentum—the expectation that recent price performance will persist
- Small Cap—the expectation that smaller market capitalization stocks will outperform larger stocks
- Illiquidity—the expectation that less liquid stocks will outperform more liquid stocks
- Low Beta—the expectation that stocks with lower market risk (beta) will outperform those with higher market risk
- Gross Profitability—the expectation that stocks with higher profitability will outperform those with lower profitability

RA found that over the past 10 years, only one factor failed to produce positive returns: value. They then isolated how much of the performance came from changes in valuations for that factor. Specifically, how much of the negative returns were due to the cheapening of value stocks. As it turns out, virtually all.

Over the entirety of the RA study that dates back to 1967, the value factor exhibited a powerful return enhancement, yet is vastly undervalued today while other factors are expensively priced. With the expectation that relative valuations will necessarily revert to more normal levels, now is a particularly good time for an investor to hold a bias toward inexpensive stocks, a strategy FEG confidently recommends for clients.

WHERE ARE WE TODAY?



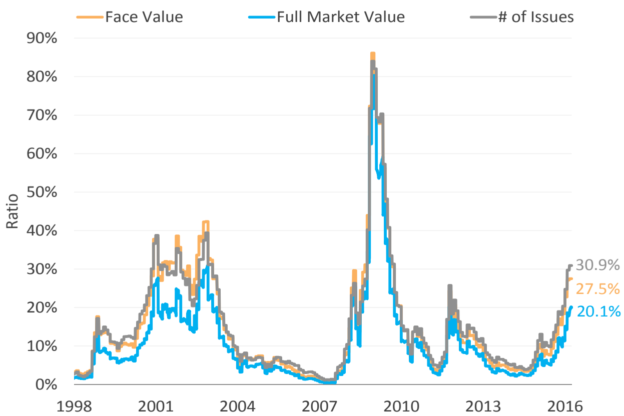
Source: Research Affiliates, using data from CRSP and Compustat. 1967-2015

Fixed Income

Investors know that risk comes with the territory and that in order to achieve a higher return, a greater amount of risk must be taken. But it is not always a linear trade-off. In some instances the return does not justify the risk, which is the current state of the high yield bond market. However FEG maintains a close eye on the market to establish when the potential rewards might outweigh the potential risk.

The graph illustrates the U.S. high yield distressed ratio. The distressed ratio represents the percentage of the high yield market with yields in excess of 1,000 basis points above Treasuries relative to the broader high yield market. In past cycles, readings of the "full market value" metric at 25% or higher have preceded tremendous returns over multi-year periods thereafter. Interestingly, after reaching 25%, the 1-year return of the high yield market is positive each time.

U.S. HIGH YIELD DISTRESSED RATIOS



Data sources: Bank of America/Merrill Lynch, Bloomberg, L.P.; data as of 3/30/2016

The energy market's stress has led to spread widening in that sector, and the entirety of the high yield market is feeling the pinch. When oil prices rebounded in recent weeks, spreads tightened modestly, hinting that the 25% threshold for the distressed ratio may not be hit soon. Stress could return, and expectant banks are cautiously steeling themselves. Wells Fargo, for example, has raised a $1.2 billion cushion against its $17 billion book of mostly non-investment-grade oil and gas loans.[5]

At some point—most likely amidst severe volatility and a general crisis in confidence—an opportunity to re-enter high yield fixed income may develop. When such an opportunity presents itself, the return potential will be great enough to justify the risk. Despite yields creeping upwards for over a year now, that point is still in the future.

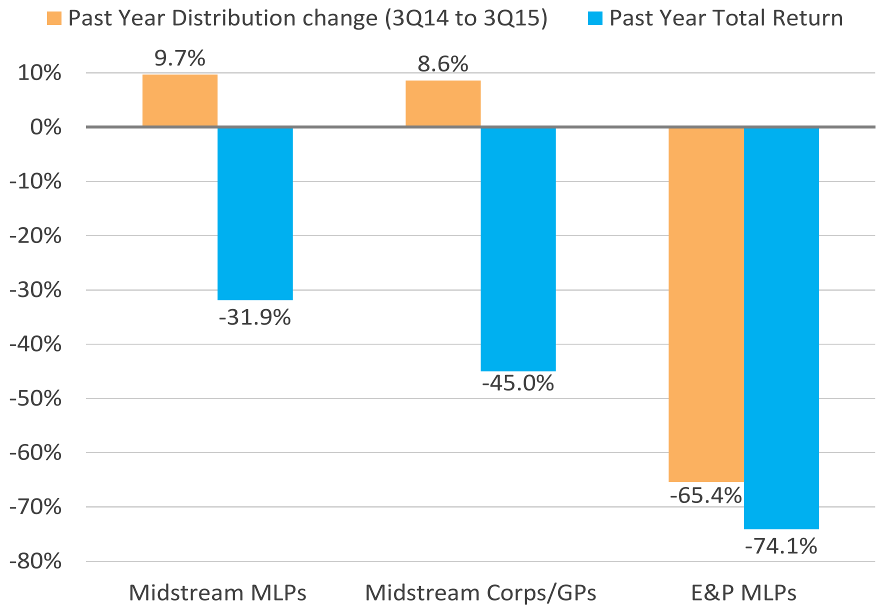
Real Assets

Depending upon the specific area within real assets, performance has been either quite good or just so-so—or perhaps really bad, depending upon the timeframe. REITs posted a solid mid-single-digit return during the first quarter of 2016, while commodities trimmed early losses to end essentially flat, but MLPs continued to suffer.

Since reaching a peak in August 2014, MLPs have fallen roughly 50% and yield spreads are now well above any level seen since the financial crisis. MLPs are undeniably cheap, but are they cheap because they are fundamentally broken? Or are they the proverbial baby thrown out with the bathwater? The answer is, it depends. Not all MLPs are created equal.

Upstream (energy and production related, or E&P) MLPs are certainly in crisis, but the fundamental picture for midstream (largely infrastructure) MLPs is not as dire. Despite significant declines in commodity prices, midstream companies in aggregate grew distributions during 2015. Each of the top-10 midstream MLPs increased distributions on a year-over-year basis. Thus, given the vast differences between types of MLP's in the current environment, an active manager who is able to navigate through these options and can identify individual opportunities is a stronger option than avoiding risks altogether via a passive index fund. That being said, investors who require full liquidity can take comfort in knowing that an overwhelming majority of the Alerian MLP Index is dedicated to midstream companies.[6]

CHANGES IN DISTRIBUTIONS AND DIVIDENDS (3Q14—3Q15) VS. TRAILING TWELVE MONTH RETURN



Note: Changes in distributions and dividends above include KMI's 4Q15 distribution cut. Other distributions reflected are as of 3Q15. Midstream MLPs: EPD, ETP, WPZ, MMP, MPLX, PAA, OKS, BPL, EEP, SXL. Midstream Corps/GPs: KMI, ENB, TRP, WMB, SE, ETE, WGP, PAGP, OKE, ENLC.E&P MLPs: VNOM, LINE, VNR, DMLP, MEMP, BBEP, EVEP, LGCP, ARP, MCEP. WPZ's distribution adjusted lower for WPZ/ACMP merger in 2014; excluding adjustments for WPZ, midstream MLP distribution growth was 16.7% Trailing twelve month returns are as of 12/31/2015

Source: Kayne Anderson Capital Advisors, LLC

A *Barron's* article in early February[7] conveyed another point of view, citing a report from Hedgeeye Risk Management's research analyst, Kevin Kaiser, who outlined the challenges that MLPs face such as high leverage, aggressive accounting, and counterparty risk due to contracts with financially distressed energy producers. All reasonable concerns, but the devil is always in the details. What may apply to some MLPs certainly does not always apply to all of them. It is also reasonable to consider that prices may already reflect many of those issues, and that different MLPs face different fates. It is important not to blindly paint all MLPs with the same broad brush.

Regardless of the fact that many of the mid-stream MLPs are more reliant on natural gas than oil, crude has been driving the market and MLPs have become mind-numbingly volatile. Daily moves in the mid-single-digits percentages are uncomfortably commonplace.

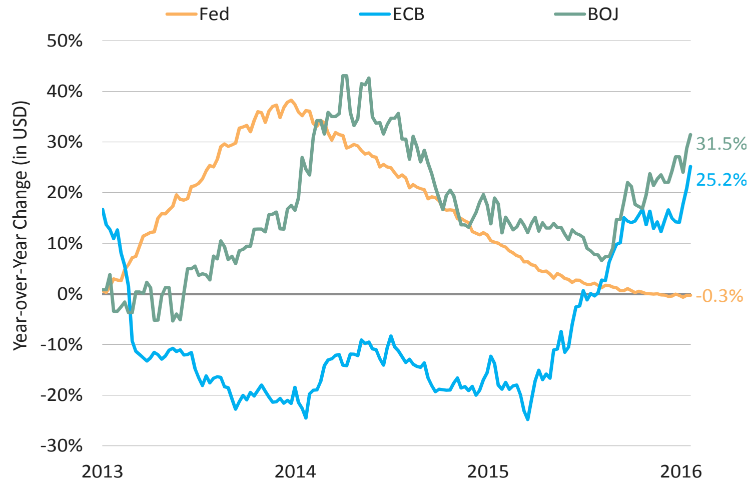
Interestingly, in the same *Barron's* issue, there was a cover story entitled "Here Comes $20 Oil." Of course, that is a tagline designed to sell newspapers. The article actually discussed oil prices recovering to $55 later this year. Supply and demand imbalances naturally correct themselves, and the reality is that analysts expect oil prices to boost based on upcoming refinery demand and expectations of reduced supply from the U.S. and other countries. The commercial net short position is also dwindling to a level lower than it has been in a few years, perhaps signaling that the smart money is becoming a bit more optimistic.

Diversifying Strategies

The aforementioned volatility that permeates investment markets across the globe can prove frustrating unless investors have a strategy designed to profit from volatility and have a trusted manager that exhibits the expertise necessary to execute that strategy.

We believe that in a world of widely divergent central bank policies where the influence of those banks is vast, the importance of global macro managers who can insulate themselves from the wild swings in stock and bond markets has arguably never been greater.

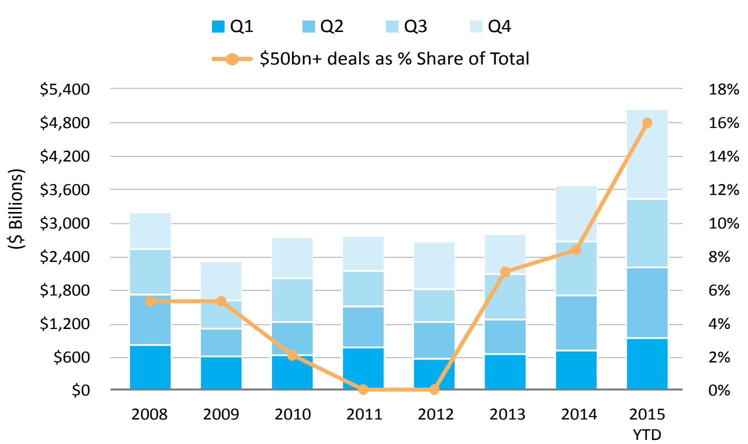
FED, ECB, AND BOJ BALANCE SHEET GROWTH RATES



Data source: Bloomberg, L.P. Data as of January 6, 2016

Additionally, event-driven strategies are finding fertile ground. The graph illustrates that global merger and acquisition activity has been rising for four years and did so markedly in 2015. Smart, accomplished investors who have the demonstrated ability to analyze and determine whether the risk that a deal may not be consummated at the publicly-disclosed price is worth taking can find a wealth of opportunities to bring their skill to bear with the heated pace of M&A activity today.

GLOBAL M&A VOLUME 2008-2015



Data Source: http://www.dealogic.com/media/market-insights/ma-statshot/.4Q2015

Conclusion

Hiding under the surface of mostly tepid first quarter stock and bond market returns is central-bank-driven volatility. The monetary policies driving this volatility have no historical precedent in terms of size and scale, and the volatility has few precedents either.

There are many targets for blame here: high frequency trading, exchange traded funds, structured products, and the unintended consequence of Dodd-Frank's Volcker Rule—the removal of what had traditionally been a bank-based shock absorber for the markets. Some of the explanation for volatility can certainly be attributed to these factors, but monetary policy and the occasional statement by policymakers are the true market drivers today, a circumstance that does not appear set to change anytime soon.

FOCUS TOPIC FOOTNOTES

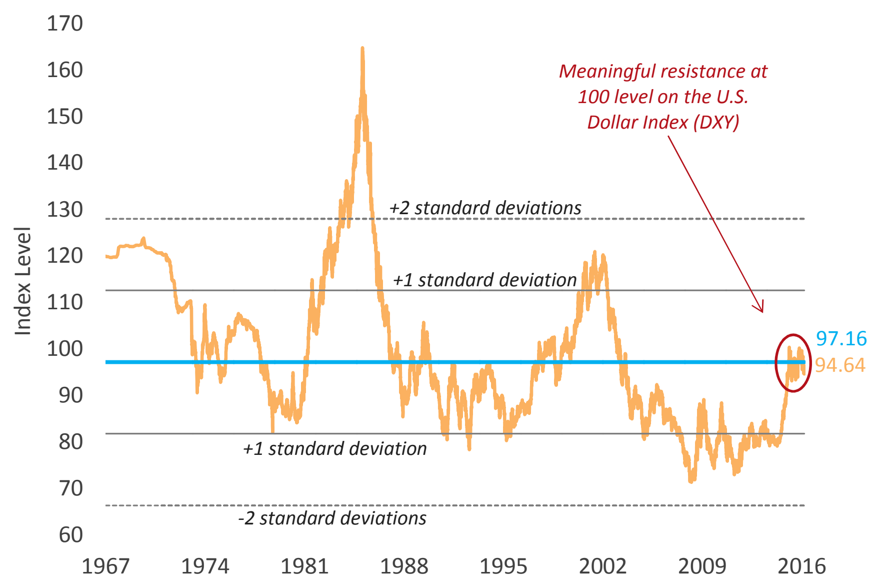
1. Chair Janet L. Yellen, At the Economic Club of New York, New York, New York. March 29, 2016.
2. Bob Rice, Advisor Perspectives, "The Rise of the Machines – Volatility's Back," March 31, 2016.
3. Bloomberg.
4. Bob Rice, Advisor Perspectives, "The Rise of the Machines – Volatility's Back," March 31, 2016.
5. Kaja Whitehouse, USA Today, "It's official! Wells Fargo passes Citi as 3rd largest bank," January 15, 2016.
6. As of the March 18, 2016 rebalancing, 81.9% of the index's constituents were defined as "Pipeline Transportation". Alerian.com.
7. Andrew Bary, Barron's, "MLPs: Is the Worst Over?" February 6, 2016.

Economic Update

USD Strength Takes a Breather

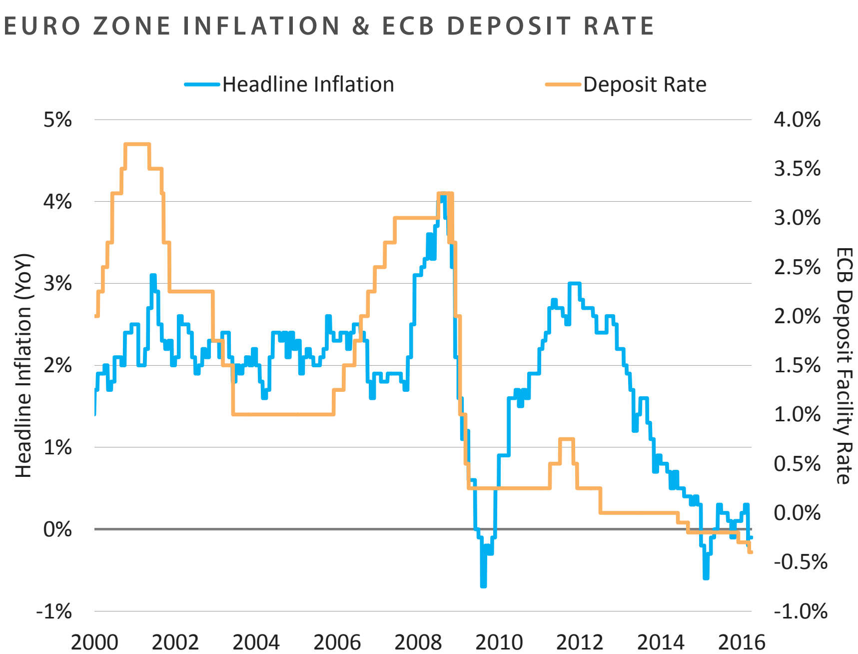
The strengthening U.S. dollar (USD), a trend that began in 2011 and gathered steam in 2014, cooled during the first quarter of 2016. The ICE Dollar Index (DXY), which tracks the global relative value of the USD against a basket of six major currencies, closed out the quarter at 94.64, a quarter-over-quarter decline of 4.1 percentage points. One of the primary factors driving down the value of the USD included numerous dovish remarks by Federal Open Market Committee (FOMC) Chair Janet Yellen and other Federal Reserve officials, who focused on the future path of monetary tightening. The Fed's widely followed "dot plot" summary displays FOMC committee members' expectations for the appropriate level of the federal funds rate. This summary, covering a period from the Fed's first rate hike on December 16, 2015, to the FOMC's March 15–16, 2016, meeting (when the "dot plot" was once again updated), showed that the committee halved their anticipated path of monetary tightening from the previous estimate of four rate hikes this year to just two. This delay—or, better yet, pause—in the rate normalization process helped take the wind out of the USD's sails.

DOLLAR INDEX (DXY)



Data source: Bloomberg, L.P.; Data as of 3/31/2016

Not only did the FOMC back off from their relatively hawkish posture, which was a key contributor to the downside volatility in risky asset prices in late-2015/early 2016, but the Japanese and euro zone economies continued to struggle. Japan and Europe contended with persistently low levels of realized economic growth and inflation, in addition to subdued inflation expectations, with each of these forces serving as support for the yen and euro (and thus downward pressure on the USD). With monetary authorities in these economies vying to enact effective policies aimed at reversing these trends, these efforts have largely failed. Both the European Central Bank (ECB) and the Bank of Japan (BOJ) dropped their respective deposit rates further into negative territory during the first quarter, but saw their local currencies appreciate against the USD during the quarter. This visual exemplifies this struggle between structural economic forces (low inflation) and monetary policy mechanisms (negative rates) aimed at reversing these force's consequences (e.g., strengthening local currency):



Data sources: European Central Bank, Bloomberg, L.P.; Data as of 3/31/2016

As the euro zone economy, for example, struggled with low or negative realized inflation rates, the ECB dropped the deposit rate (i.e., that rate that the ECB remunerates for deposits that banks hold at the central bank) further into negative territory. Economic theory states that when policy rates fall into low or negative territory, the market interest rate should follow suit, which, in turn, should ease financial conditions and spur business activity. In the euro zone's case, however, the opposite occurred, as the euro appreciated nearly 5% versus the USD during the first quarter alone. A strong euro, however, is exactly what the ECB seeks to avoid, because a strengthening local currency helps put downward pressure on inflation, which, in the euro zone's case, is already negative.

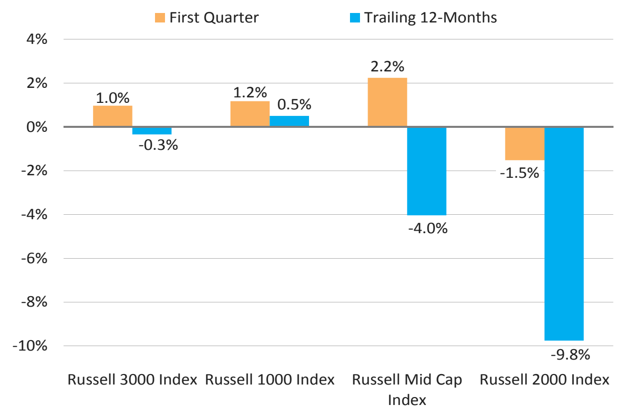
Over the cyclical horizon, as many central banks around the world seek to substitute monetary policy for organic economic growth, the potential for continued elevated currency volatility remains a key risk. The recent rebound in risky assets (e.g., high yield bonds, emerging and frontier market equities, emerging market currencies, among others), which seems to be fading at the time of this writing, appears to have been an overreaction to transitory currency-related tailwinds. Should U.S. economic data improve, the market's expectations for future rate hikes will increase, which should help support the value of the USD. On the other hand, if U.S. economic data moderate further, the Fed will feel compelled to guide the market's expectations for tighter monetary policy deeper into the future, in turn serving as a critical headwind to the USD's appreciation potential.

Global Equity

U.S. Equity

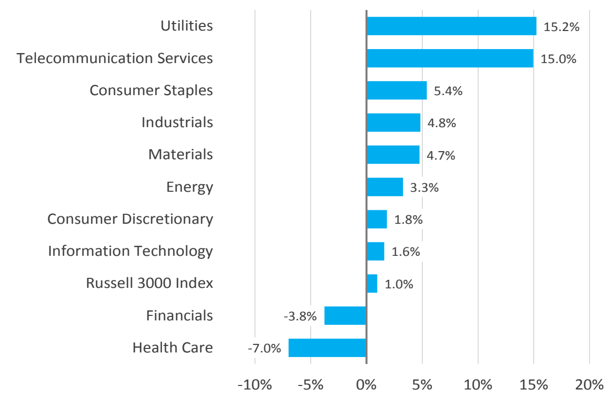
- The U.S. stock market, represented by the Russell 3000 Index, increased slightly in the first quarter (+1.0%). Worries about slowing economic growth and falling oil prices caused markets to plummet in January and early February. However, a mid-quarter rally, driven by improving U.S. economic data and new stimulus measures in China, pulled returns back into positive territory.
- Large cap (+1.2%) and mid cap (+2.2%) stocks were up modestly, outperforming small cap stocks (-1.5%) in the quarter. Over the trailing one-year period, the higher quality and more resilient businesses of large cap companies limited losses in large cap stocks, and outperformed mid and small cap stocks.
- Eight of ten sectors posted gains, led by defensively oriented areas. Telecommunications (+15.0%) and utilities (+15.2%) outpaced all other sectors amid a flight to safety.
- The healthcare and financials sectors had negative returns, -7.0% and -3.8%, respectively. Possible restrictions on drug pricing hurt biotechnology and pharmaceutical companies. Bank stocks came under pressure due in part to declines in investment banking and trading, and with worries about an expected surge in high yield bond defaults.
- With strength in less-cyclical areas, value outperformed growth across market capitalizations in the quarter. Mid cap value led, returning 3.8%. Small cap growth was the most challenged stylistic asset class, declining 4.7%. In the trailing 12-months, as growth stocks outperformed, large caps held up better than their mid and small cap counterparts.

RUSSELL INDICES PERFORMANCE



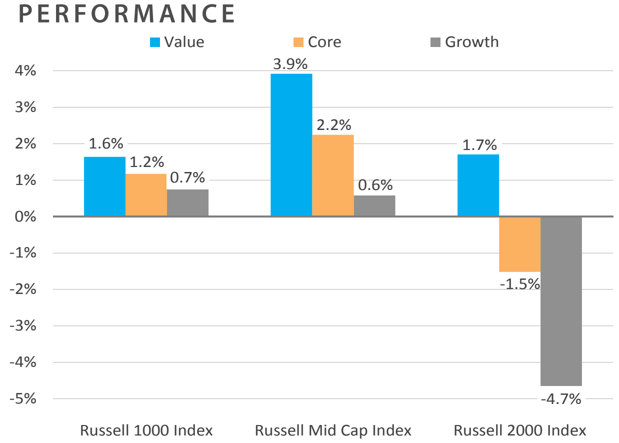
Data source: Russell

FIRST QUARTER RUSSELL 3000 SECTOR PERFORMANCE



Data source: Russell

FIRST QUARTER RUSSELL INDICES PERFORMANCE



Data source: Russell

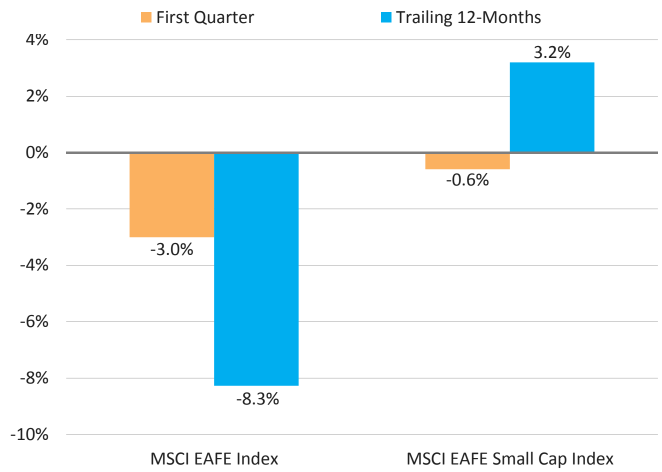
International Equity

All returns in local currency unless otherwise indicated.

INTERNATIONAL DEVELOPED MARKETS

- International developed equity markets posted losses, down 6.5% for the month, but U.S. investors were aided when adjusting for currency fluctuations (-3.0% in U.S. dollar terms).
- Europe (-4.9%) led non-U.S. developed markets, though the U.K. was the only positive performing country (+0.2%) in Europe. Weak economic growth, deflationary pressures, and ongoing turmoil in the banking sector pushed stocks lower across Europe. Italy was the worst performing country (-15.8%).
- The Pacific region (-9.3%) showed weakness as Japanese equities fell sharply during the volatile quarter (-12.7%). Global concerns added to worries about sluggish growth, a strengthening yen, and the slumping banking industry. The Bank of Japan implemented negative interest rates in late January to combat economic contraction and persistently low inflation.
- Currency had a significant positive impact on U.S. investors due to U.S. dollar depreciation against most major developed market currencies, including the Japanese yen (-6.4%), the Australian dollar (-5.0%), the Euro (-4.5%), and the Swiss franc (-4.1%). The U.S. dollar appreciated 2.4%, however, against the British pound.
- Small cap stocks, as measured by the MSCI EAFE Small Cap Index, fell 4.3% (-0.6% in U.S. dollars), outperforming large cap stocks in the quarter. Italian small cap stocks were the notable poor performers, down 11.6%, as financial stocks fell sharply.

MSCI INDICES PERFORMANCE
Returns in U.S. Dollars



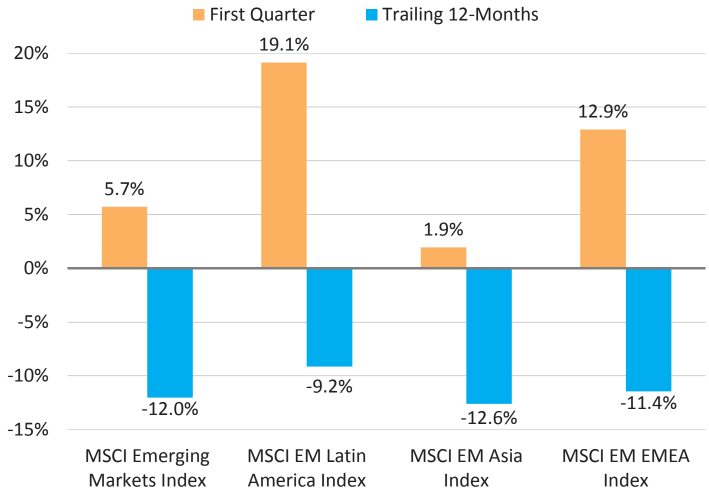
Data sources: MSCI

EMERGING MARKETS

- Emerging markets, as measured by the MSCI Emerging Markets Index, snapped back after a rocky start to the year. They gained 2.7% (5.7% in U.S. dollars), outperforming developed markets.
- Following a period of poor performance, Latin America continued its gains and posted strong positive returns, up 11.8%. Peru (+27.0%), Columbia (+15.9%), and Brazil (+15.1%) were strong during the quarter. Speculation mounted that President Dilma Rousseff would face impeachment, and Brazilian stocks rallied on fresh hopes for political change and recovery in commodity prices.

- Returns in Asia were mixed, leading to flat returns (+0.3%) for the region. China fell 4.7% as concerns grew about the health of its economy and the effectiveness of its monetary policy. India declined 2.4% amid concerns about the strength of corporate profits and rising doubts about the prime minister's ability to pass important economic legislation. Thailand (+14.3%) and Indonesia (+7.0%) offset most of the declines.
- The Eastern European region gained 7.5%. Turkish (+17.3%), Hungarian (+11.2%), and Russian (+7.8%) stocks increased despite geopolitical turmoil, as Brent crude prices climbed above $40 a barrel.
- The impact of currency fluctuations was positive for U.S.-based investors. The U.S. dollar depreciated most notably against the Russian ruble (-7.8%) and South African rand (-5.1%).

MSCI INDICES PERFORMANCE
Returns in U.S. Dollars

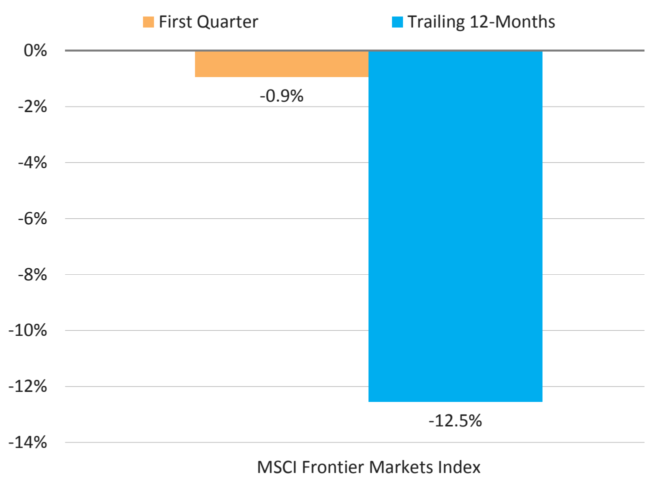


Data source: MSCI

FRONTIER MARKETS

- Frontier market returns were modestly negative in the quarter, declining 1.8% (-0.9% in U.S. dollars). While outperforming developed markets, frontier markets underperformed emerging markets. Over the last 12 months, frontier markets fell 12.1% (-12.5% in U.S. dollars).
- Declines in Asia (-4.6%) and Africa (-4.4%) were offset by gains in Latin America (+8.4%). Argentina continued positive momentum from the recent election of a market-friendly government, gaining 8.4%. Argentina is the second largest frontier market within the MSCI Frontier Markets Index; therefore, that market's gains were the primary driver of positive returns.
- The Asian region's performance suffered due to Sri Lanka (-13.7%) and Vietnam (-8.7%).
- Middle Eastern oil-producing countries performed negatively, with Saudi Arabia (-8.3%) and Bahrain (-7.5%) posting the largest losses.

MSCI INDICES PERFORMANCE
Returns in U.S. Dollars

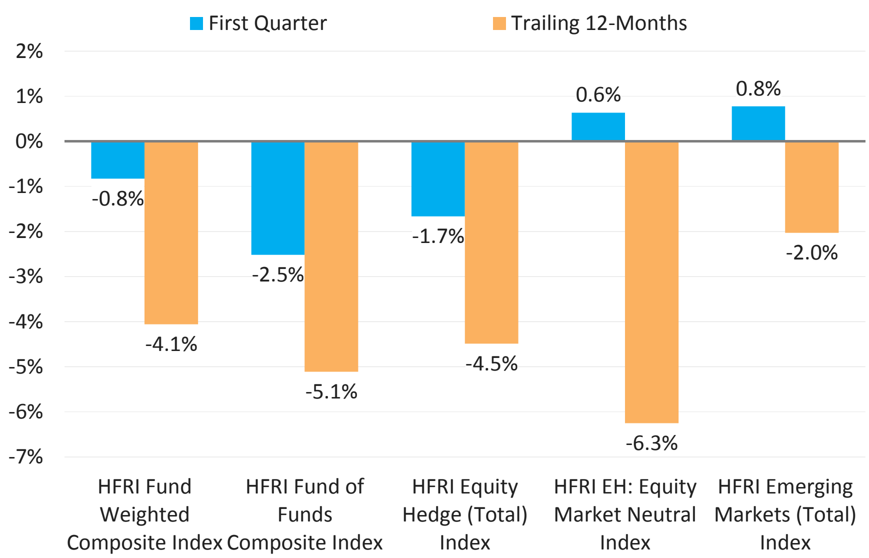


Data source: MSCI

Hedged Equity

- Hedged equity endured a challenging environment to begin the year, characterized by significant volatility and sharp reversals in equity markets. The HFRI Equity Hedge (Total) Index returned -1.7%. The long-only S&P 500 Index and the MSCI ACWI Index returned 1.3% and -0.6%, respectively.
- Larger hedge funds tended to underperform smaller organizations, as demonstrated by the significant underperformance of the HFRI Equity Hedge (Total) Index–Asset Weighted (-4.1%), which is driven by large fund performance.
- Short-biased strategies delivered a strong quarter of performance with the HFRI EH: Short Bias Index returning 7.0%, making it the top performing HFRI hedged equity sub-index. The HFRI EH: Equity Market Neutral Index returned 0.6%.
- Quantitatively driven strategies outperformed fundamentally focused counterparts. The HFRI EH: Quantitative Directional Index returned 0.1%, while the HFRI EH: Fundamental Value Index and the HFRI EH: Fundamental Growth Index returned -2.1% and -1.8%, respectively.
- Sector specialists generated mixed performance. The HFRI EH: Sector–Energy/Basic Materials Index returned 2.2% amid ongoing volatility in the energy complex. The HFRI EH: Sector–Technology/Healthcare Index returned -6.2%, as certain widely held companies suffered substantial losses.
- The HFRI Emerging Markets (Total) Index continued to recover third quarter 2015 losses, returning 0.8%. Performance was generally negative across regional sub-indices; however, strong performance from managers focused in Latin America drove the broad index positive. The HFRI Emerging Markets: Latin America Index returned 14.2%. Conversely, the HFRI Emerging Markets: China Index returned -6.1%, as concerns over economic growth and the effectiveness of central bank policy continued.

HFRI INDICES PERFORMANCE
Returns in U.S. Dollars



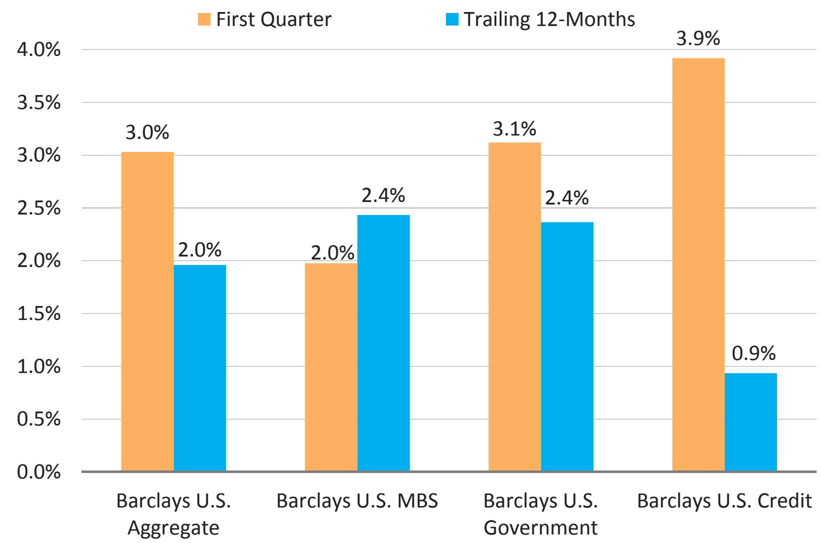
Data source: HedgeFund Research

Fixed Income

OVERVIEW

- The Barclays U.S. Aggregate Bond Index (BAGG) increased 3.0% in the first quarter. Agency mortgage-backed securities lagged, returning 2.0%. Investment-grade credit was the strongest performing area of the BAGG, returning 3.9%. U.S. government securities returned 3.1%, performing in-line with the index.
- Investment-grade commercial mortgage-backed securities (CMBS), a smaller component of the BAGG, increased 3.6% during the month.
- Emerging market debt (EMD) local currency posted a gain of 5.5%, and dollar-denominated EMD increased 5.9%.

BARCLAYS BOND INDICES PERFORMANCE



Data sources: Bloomberg Finance, L.P., Barclays

RATES

- The two-year note yield decreased 33 basis points to 0.72%, the 10-year note yield decreased 50 basis points to 1.77%, and the 30-year bond yield decreased 41 basis points to 2.61%.
- Inflation expectations cooled during the month. The 10-year break-even rate of inflation increased 5 basis point to 1.63%, and concluded the month 37 bps below the Fed's 2.0% target. The yield on the benchmark 10-year Treasury Inflation-Protected Securities (TIPS) moved 57 basis points lower to 0.13%, and the Barclays U.S. TIPS Index posted a gain of 4.5% during the quarter.

CREDIT

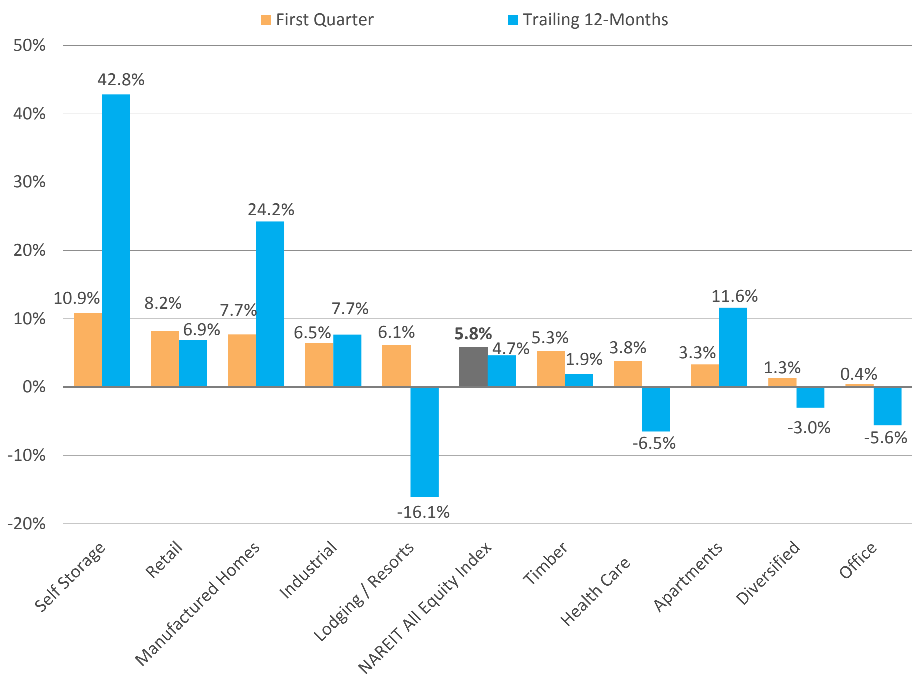
- Investment-grade corporate bonds increased 3.9%, with utilities being the best sector, gaining 5.0%. Industrials climbed 4.7%, but financials lagged, increasing only 2.3%.
- Both fixed income credit risk sectors were up, with a 3.4% gain for the Barclays U.S. Corporate High Yield Index and 1.5% gain for bank loans.

Real Assets

DOMESTIC REITs

- Real estate investment trusts (REITs), as measured by the FTSE NAREIT All Equity Index, gained 5.8% in the first quarter. Strong real estate fundamentals boosted profitability, even as lofty asset prices made acquisitions more difficult.
- At the end of the first quarter, REITs' dividend yield stood at 3.8%, versus a yield of 1.8% for the 10-year Treasury.[1]
- The Self-Storage sector posted the strongest return, gaining 10.9%. The sector's fundamentals remained solid. With occupancy rates averaging 92% and strong demand, the sector is positioned well for further growth in the spring leasing season.
- Although all sectors posted gains for the quarter, the office sector was the relative laggard, increasing only 0.4%. While overbuilding has not been a substantial concern for the broader real estate market, office space, particularly in tech-heavy markets, has started to elicit signs of excess supply.
- The REIT implied capitalization rate averaged over the past three months was 202 bps, significantly above the long-term average of 137 bps. While the spread remains attractive, recent spikes in corporate bond yields and the gradual normalization of interest rates could begin to affect REITs negatively.

FTSE NAREIT ALL EQUITY INDEX
Sector Returns - First Quarter 2016

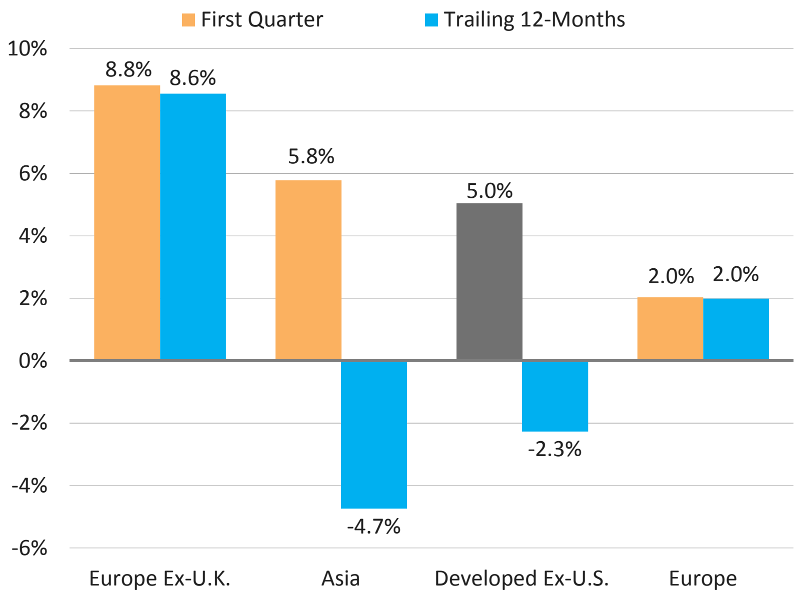


Data source: NAREIT

INTERNATIONAL REAL ESTATE SECURITIES

- International real estate securities, as measured by the FTSE EPRA/NAREIT Developed Ex-U.S. Total Return Index, increased 5.0% in U.S. dollar terms in first quarter.[2]
- Europe Ex-U.K. property markets gained 8.8% and are up 8.6% over the last year. While all property market sectors exhibited positive returns, the broader European property market gained only 2.0%, as German (+12.4%) and French (+10.3%) property markets far outpaced the U.K. (-9.3%) market. Negative interest rates, low inflation, and rising wages positively impacted the office and retail sectors within Germany.
- Asian also performed well, gaining 5.8%. The prevalence of low or negative interest rates throughout the world, coupled with stabilizing Chinese and commodity markets, supported international property values.

FTSE EPRA / NAREIT DEVELOPED MARKET INDICES
Regional Returns (U.S. dollars)



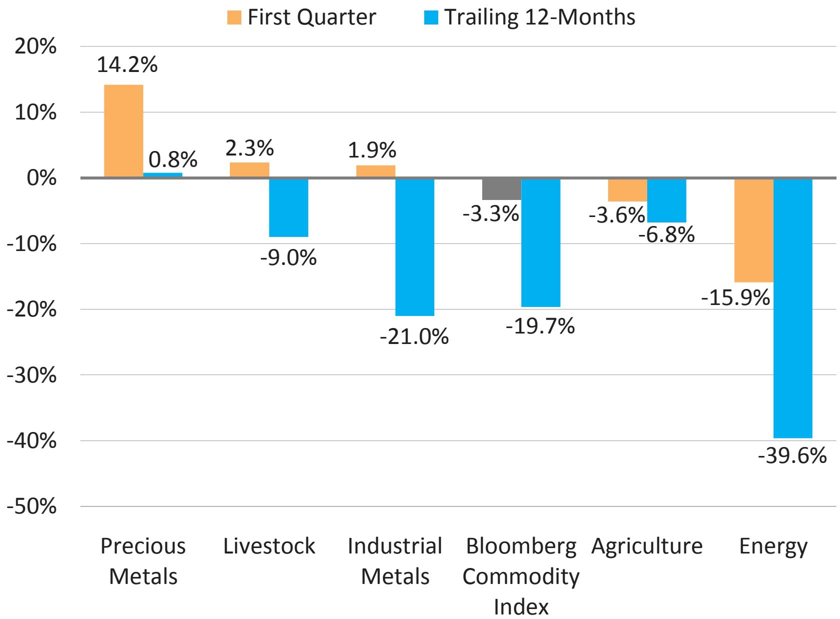
Data source: Bloomberg, L.P.

COMMODITIES

- Commodities, as measured by the Bloomberg Commodity Index (BCOM), declined 3.3% during the first quarter. The index gained 3.8% in March, ending an eight-month losing streak, but was still down 19.7% for the past year.[3]
- The precious metals sector gained 14.2%, driven by the 17% rally in gold futures. Gold is the best-performing constituent in the index this year, amid the bear market in global stocks. Furthermore, rising expectations that the Federal Reserve will not soon raise interest rates, at least waiting until the latter half of 2016, increased gold's appeal as a store of value.
- Conversely, the energy sector declined 15.9%, as U.S. natural gas futures plummeted 27.8% due to an unseasonably warm winter. The decline pushed the futures curve to its lowest level for March delivery since 1991, with inventories 29% above their five-year average. Energy futures showed signs of rebounding in March, however, as natural gas and WTI crude oil futures surged 8.4% and 7.8%, respectively.[4]

BLOOMBERG COMMODITY INDEX

Sector Returns



Data source: Bloomberg, L.P.

MASTER LIMITED PARTNERSHIPS

- Master Limited Partnerships (MLPs), as measured by the Alerian MLP Index (AMZ), declined 6.5% during the first quarter. As of the end of March, MLPs' distribution yield stood at 8.4% versus a yield of 1.8% for the 10-year Treasury.[5]
- After bottoming on February 11th, MLPs' price performance has been largely positive, albeit volatile. Following a 22.1% move in February off of the bottom, March gains helped MLPs gain back some of the decline. MLPs were up 8.4%, outperforming the S&P 500's increase of 6.6% through the rally. Performance was driven by stabilizing crude prices, which led to improved investor sentiment and a modest positive reversal to fund flows.[6]
- Blue-chip midstream MLPs, which dominate the AMZ, continued to exhibit solid fundamentals. MLPs spent a record amount on organic CAPEX in 2015, and are projected to spend an additional $76 billion in 2016–2018.
- Additionally, each of the top 10 MLPs in the AMZ (comprising roughly two-thirds of the market capitalization) grew their distributions in 2015, and are projected to grow them further in 2016, even in the face of a harsh commodity price and capital markets environment. The top 10 MLPs had a weighted-average yield of 8% and distribution growth of 11.7% in 2015.

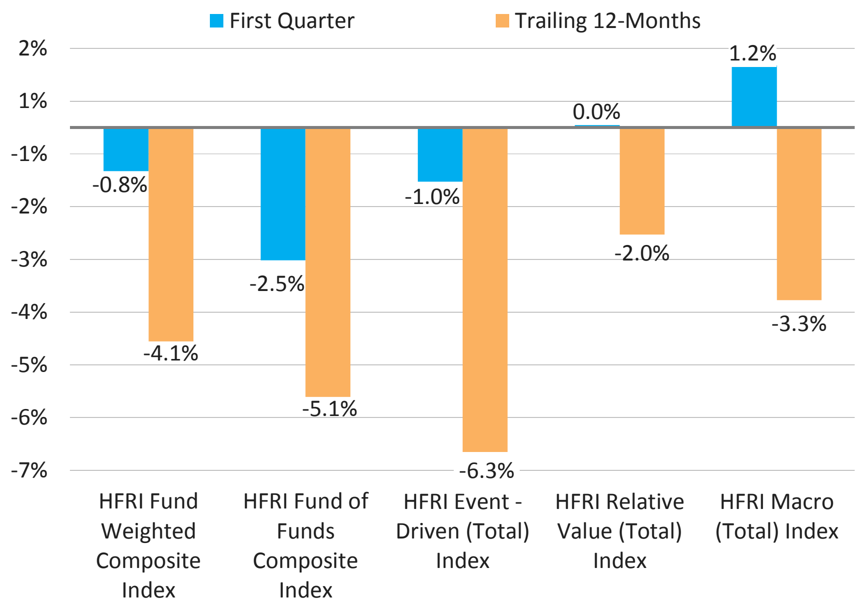
REAL ASSETS FOOTNOTES

[1] All performance data from www.nareit.com. Accessed on April 6, 2016.
[2] All performance data from FTSE EPRA/NAREIT Indexes, Bloomberg L.P. Accessed on April 8, 2016.
[3] All performance data from Bloomberg L.P. Accessed on April 6, 2016.
[4] Bloomberg Commodity Index (BCOM) Tables & Charts – March 2016.
[5] All performance data from www.alerian.com Accessed on April 6, 2016.
[6] Wells Fargo MLP Monthly: April 2016. Accessed on April 8, 2016.

Diversifying Strategies

- The HFRI Fund Weighted Composite Index returned -0.8%. Smaller, more nimble hedge funds tended to navigate the first quarter's market volatility more effectively than their larger brethren, who are reflected in the HFRI Asset Weighted Composite Index (-2.7%). Fund of funds performed similarly (HFRI Fund of Funds Composite Index down 2.5%).
- The HFRI Event-Driven (Total) Index returned -1.0%. Only one event-driven sub-index generated positive returns, the HFRI ED: Merger Arbitrage Index, which increased 1.1%. Merger arbitrage managers continued to benefit from heightened deal activity and attractive deal spreads. The HFRI ED: Activist Index, the worst performing event-driven sub-index, returned -4.3%.
- The HFRI Relative Value (Total) Index was flat. Sub-strategy performance was mixed, with four of the seven sub-indices generating positive performance. The HFRI RV: Fixed Income–Sovereign Index generated gains of 2.6%, which were largely driven by the settlement proposed between the Argentinian government and its holdout bondholders, which included several hedge funds. Traders took advantage of large movements in volatility as the HFRI RV: Volatility Index returned 1.3%. The HFRI RV: Fixed Income–Asset Backed Index and the HFRI RV: Yield Alternatives Index returned -2.3% and -2.0%, respectively.
- The HFRI Macro (Total) Index returned 1.2%. Despite trend reversals in equities, currencies, and certain commodities, systematic managers outperformed discretionary managers, capitalizing on persistent trends in fixed income and energy. The HFRI Macro: Systematic Diversified Index and the HFRI Macro: Discretionary Thematic Index returned 2.2% and -0.8%, respectively. The HFRI Macro: Commodity Index was the top performing macro sub-index, returning 3.0%.

HFRI INDICES PERFORMANCE
Returns in U.S. Dollars



Data source: HedgeFund Research

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All data is as of March 31, 2016 unless otherwise noted.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

Barclays Capital Fixed Income Indices is an index family comprised of the Barclays Capital Aggregate Index, Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, Municipal Index, High-Yield Index, and others designed to represent the broad fixed income markets and sectors within constraints of maturity and minimum outstanding par value. See https://ecommerce.barcap.com/indices/index.dxml for more information.

The CBOE Volatility Index (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index. FTSE Real Estate Indices (NAREIT Index and EPRA/NAREIT Index) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded real estate securities. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See www.ftse.com/Indices for more information.

HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc. (HFX), and are used by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund- of- funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

J.P. Morgan's Global Index Research group produces proprietary index products that track emerging markets, government debt, and corporate debt asset classes. Some of these indices include the JPMorgan Emerging Market Bond Plus Index, JPMorgan Emerging Market Local Plus Index, JPMorgan Global Bond Non-US Index and JPMorgan Global Bond Non-US Index. See www.jpmorgan.com for more information.

Merrill Lynch high yield indices measure the performance of securities that pay interest in cash and have a credit rating of below investment grade. Merrill Lynch uses a composite of Fitch Ratings, Moody's and Standard and Poor's credit ratings in selecting bonds for these indices. These ratings measure the risk that the bond issuer will fail to pay interest or to repay principal in full. See www.ml.com for more information.

Morgan Stanley Capital International – MSCI is a series of indices constructed by Morgan Stanley to help institutional investors benchmark their returns. There are a wide range of indices created by Morgan Stanley covering a multitude of developed and emerging economies and economic sectors. See www.morganstanley.com for more information.

Russell Investments rank U.S. common stocks from largest to smallest market capitalization at each annual reconstitution period (May 31). The primary Russell Indices are defined as follows: 1) the top 3,000 stocks become the Russell 3000 Index, 2) the largest 1,000 stocks become the Russell 1000 Index, 3) the smallest 800 stocks in the Russell 1000 Index become the Russell Midcap index, 4) the next 2,000 stocks become the Russell 2000 Index, 5) the smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index. See www.russell.com for more information.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors by the S&P Index Committee, which is a team of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value and is designed to be a leading indicator of U.S. equities, and meant to reflect the risk/return characteristics of the large cap universe. See www.standardandpoors.com for more information.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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Research Team as of date of publication.