NEWS & INVESTMENT INSIGHTS

SECOND QUARTER | JULY 27, 2017

- Increasingly Overvalued Public Markets
- Washington's Influence
- Fracking Makes its Move
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- Delegate Asset Class Perspectives

SUMMARY OF MARKET INDEX RETURNS AS OF JUNE 30, 2017

FIXED INCOME	QTD	YTD	1-YEAR	3-YEAR	5-YEAR
Barclays Global Aggregate	2.6%	4.4%	-2.2%	-0.4%	0.8%
Barclays U.S. Aggregate	1.5%	2.3%	-0.3%	2.5%	2.2%
Barclays Corporate High Yield	2.2%	4.9%	12.7%	4.5%	6.9%
S&P/LSTA U.S. Leveraged Loan Index	0.8%	1.9%	7.4%	3.4%	4.6%

EQUITIES	QTD	YTD	1-YEAR	3-YEAR	5-YEAR
S&P 500 (Large Cap)	3.1%	9.3%	17.9%	9.6%	14.6%
S&P Small Cap 600	1.7%	2.8%	22.5%	9.3%	15.5%
MSCI EAFE Index (International)	6.1%	13.8%	20.3%	1.2%	8.7%
MSCI Emerging Markets Index	6.3%	18.4%	23.8%	1.1%	4.0%

OTHER	QTD	YTD	1-YEAR	3-YEAR	5-YEAR
HFRI Fund of Funds Diversified Index	0.3%	2.1%	5.1%	1.2%	3.6%
HFRI Fund of Funds Composite Index	0.7%	3.0%	6.3%	1.5%	3.8%
Bloomberg Commodity Index	-3.0%	-5.3%	-6.5%	-14.8%	-9.3%

Source: Morningstar, Bloomberg. Returns for periods longer than one year are annualized.

This letter will address three topics that we believe will drive the global economy during the second half of 2017: public market valuations, the influence of events in Washington and the supply and demand dynamics of the energy market. Additionally, we will highlight certain broad recommendations upon which investors should act to protect and grow their portfolios in 2017. Finally, this letter will incorporate information from our annual Mid-Year Update Presentation (available upon request).

INCREASINGLY OVERVALUED PUBLIC MARKETS

With the S&P 500 Index setting 10 new daily all-time closing highs during the second quarter, domestic equity markets continue to appear yet more overvalued on an absolute basis while international markets appear relatively more attractive. As illustrated below, the current forward 12-month price/earnings ratio of major indices (with the exception of Japan) are in the upper quartile of weekly observations since the date referenced in the chart. The current 12-month forward price/earnings ratio of the S&P 500 and S&P 600 are currently higher than 82% and 93%, respectively, of weekly observations over the time period noted in the chart. Conversely, the current 12-month forward price/earnings ratio of the MSCI Japan Index is currently lower than 72% of weekly observations over the analysis period.

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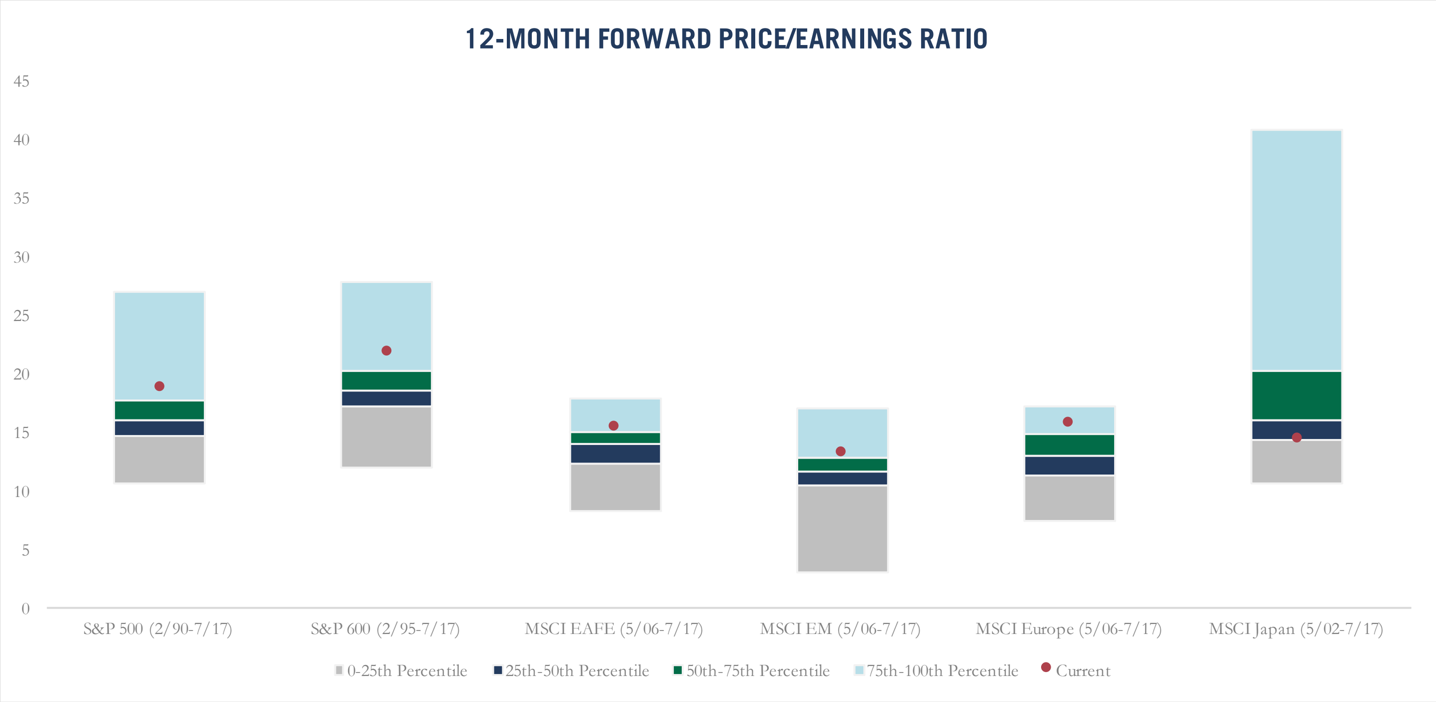

Source: Bloomberg. Forward price/earnings ratio is Bloomberg's proprietary BEst ratio, calculated by Bloomberg based on consensus earnings estimates for the next 12 months.

As the Fed is in a tightening posture and corporate earnings growth continues to be challenged, the US appears to be nearing the end of its 8-year bull market. In Europe, however, recent political events, including the election of Macron in France and the continued stimulus implemented by the European Central Bank, have created an environment supportive of growth, justifying the relatively high valuation. Japan, facing economic pressure largely driven by unfavorable demographics and the uncertainty created by North Korea, is relatively cheap compared to its history. **Thus, we maintain a neutral/underweight posture on domestic equities and are raising our outlook for EAFE equities from neutral/underweight to neutral.**

Domestic public fixed income markets (both high-yield and investment grade) also appear to be overvalued. As illustrated below, investment grade and high-yield spreads have tightened by ~110 bps and ~480 bps, respectively, since their early 2016 highs. These tight spreads are evidence that public fixed income may be largely "priced to perfection" and that any stress in the credit market could cause spreads to blow out quickly and substantially. **For this reason, we continue to recommend a neutral/underweight posture on domestic public fixed income.**

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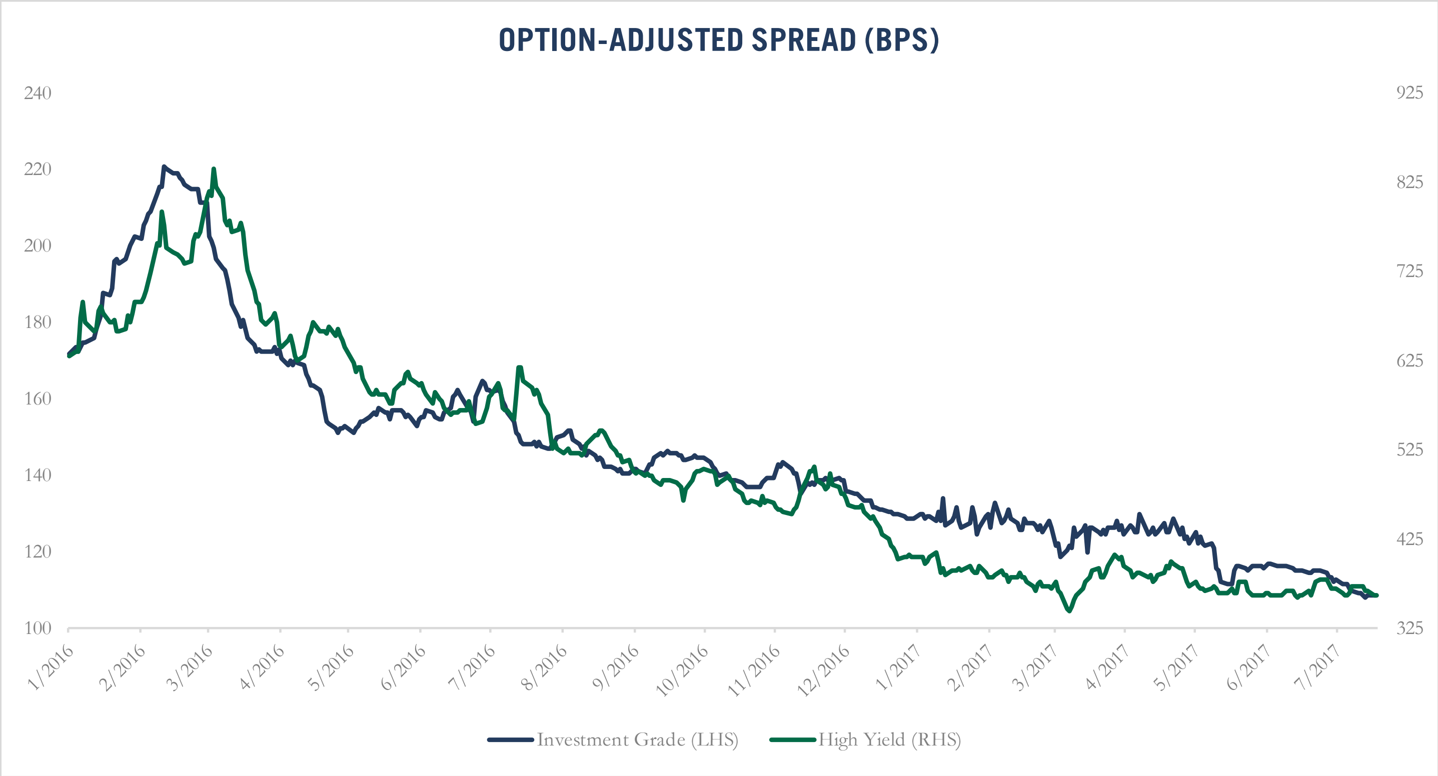

Source: Bloomberg. Investment grade index used is the Bloomberg Corporate Bond Index. High yield index used is the Bloomberg Barclays US Corporate High Yield Bond Index.

Because public domestic equity and global fixed income markets appear to be overvalued (in some cases substantially), we continue to recommend that investors focus on private markets, both equity and debt, wherein managers often have the ability to capitalize on inefficiencies, and investors can capitalize on illiquidity and complexity premiums.

WASHINGTON'S INFLUENCE

The inability of the Trump administration to enact legislation and the current posture of the Federal Reserve are beginning to cause concerns that they may threaten domestic economic growth expectations. In our last letter, we noted that the "Trump Trade" could potentially stall due to concerns that the current administration may not be able to implement its optimistic agenda of robust tax cuts combined with substantial infrastructure spending that it promised during the campaign. This concern came into sharper focus in early July as the attempt to pass sweeping health care reform ran into trouble when Senate Republicans could not agree on the legislation that would repeal and replace Obamacare. While the repeal of Obamacare may eventually pass, this turn of events casts into doubt the administration's ability to implement a robust infrastructure spending package and tackle the more complex issue of tax reform, both of which would likely have a more substantial effect on financial markets than health care reform. Failure to pass these two initiatives in a timely and meaningful manner may exert downward pressure on markets.

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The Federal Reserve continued to tighten monetary policy during its June meeting by announcing a 0.25% hike in its benchmark interest rate. The Fed also announced that it would begin reducing its balance sheet, **which has grown to over $4 trillion,** in an attempt to "unwind" the scheduled asset purchases it has made as part of its quantitative easing program. While the timing is still undetermined, the Fed plans to runoff maturing principal payments initially of $10B per month, gradually increasing to $50B per month. The Fed's ability to subtract trillions of dollars' worth of fixed income securities from its balance sheet without flooding the market and driving down prices will be an unprecedented challenge.

The realization that fiscal stimulus might not materialize and the reality that the Fed is clearly entering into a period of greater monetary tightening through both rising rates and balance sheet reduction lead us to conclude that the headwinds to the growth of the domestic economy are increasing. **In an environment where markets are priced at or near perfection as noted in the prior section of this letter, investors should expect significantly lower returns over the next decade than they realized over the last decade.**

FRACKING MAKES ITS MOVE

In order to better frame the current state of the energy market, it is helpful to revisit events that have contributed to its supply and demand dynamics over the past few years. The most drastic change in the global oil market in recent years has been the increase in domestic companies' ability to use fracking to generate production, greatly increasing global oil supply. OPEC, in response to this new threat to its market share, decided in late 2014 to keep output constant to put downward pressure on prices. OPEC's desired long-term result of this strategy was that temporarily low prices (below the frackers' cost of production) would drive these new entrants out of business for good, and that once the frackers were out of the market, the oversupply would subside and prices would rise.

In the short term, OPEC's strategy appears to have worked, as oil prices experienced a steady climb throughout 2016 as the supply and demand dynamics stabilized, buttressed by a late-2016 OPEC decision to cut output. This supply and demand balance is illustrated in the chart below, where the oversupply that drove the price down prior to 2016 has largely abated.

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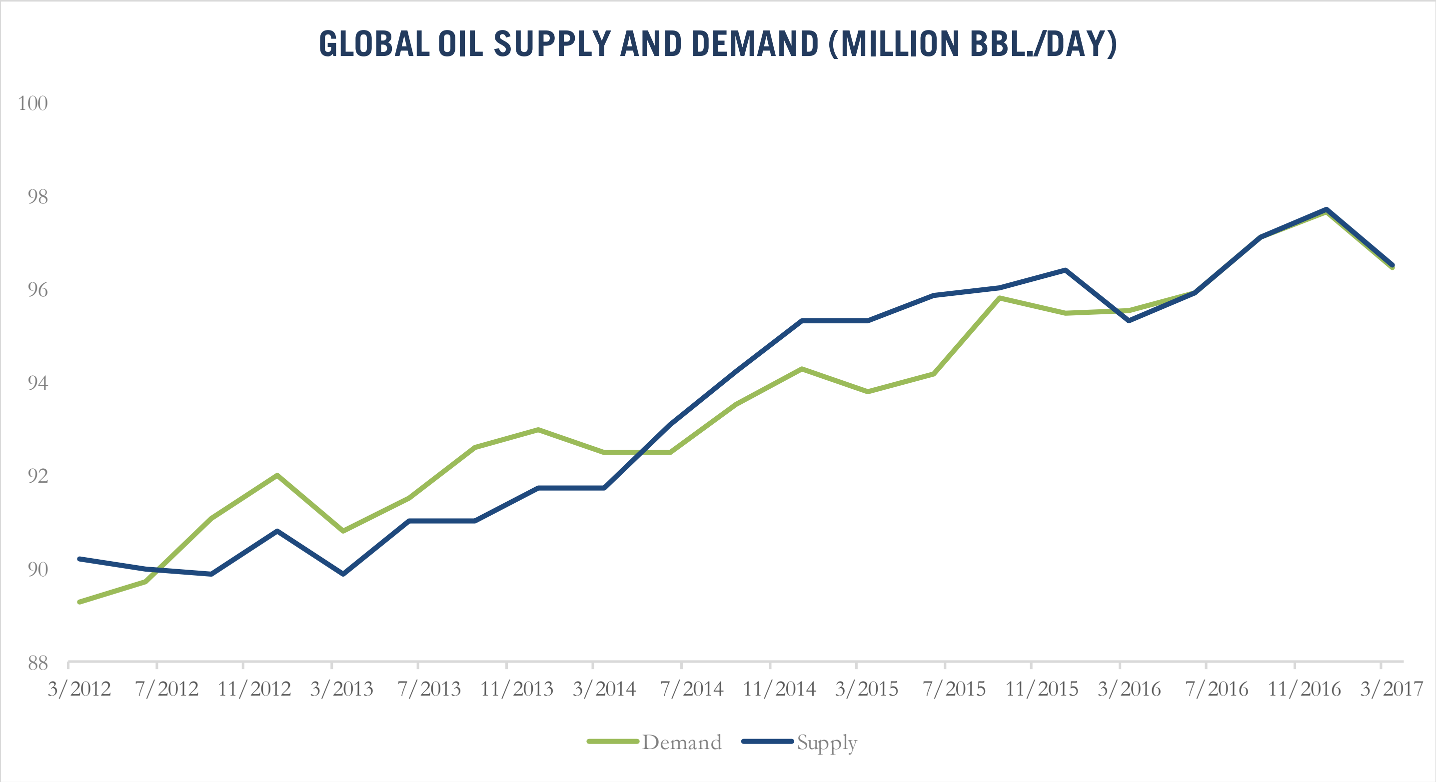

Source: Bloomberg, IEA.

Recently, however, it has become clear that OPEC's strategy has backfired and that the low oil prices of 2015 only caused the domestic frackers to become more efficient in order to survive. Driven primarily by innovation and investment in technology, domestic frackers have quickly and drastically driven down their break-even cost of production to levels that are profitable even in a low oil price environment. Frackers have quickly developed improved "cocktails" of water and chemicals to vastly improve yield, invented ways to increase well pressure to drive out more oil, and adopted technology (e.g., drones that are able to replace certain laborers) to cut costs. As a result, frackers' average break-even price fell by over 40% from early 2016 to approximately $40/bbl. in early 2017. In certain areas, the average breakeven price is lower. For example, the average break-even price in the Bakken shale formation (North Dakota and Montana) is close to $30.[1]

As newly efficient domestic frackers reenter a market where capital remains cheap, the growth in the global supply of oil will eventually begin to outpace the growth in demand. While supply is expected to remain in check for the remainder of 2017, the International Energy Agency has predicted that oversupply will begin to accumulate in the market in 2018. Non-OPEC producers are expected to increase production by 1.5 million barrels per day, while global demand is only expected to increase by 1.4 million barrels per day. The market is beginning to anticipate this oversupply, leading to a year-to-date oil price decline of ~20%. While global oil demand has generally remained constant, a decline in demand in response to global growth falling short of expectations as a result of, for example, lower than expected fiscal stimulus in the US, could put additional downward pressure on the price of oil.

[1] The Atlantic, "How Frackers Beat OPEC," January-February 2017 issue.

The effect of a low oil price will have short- and long-term ramifications on various asset classes. In the short term, commodities and high-yield debt will likely come under the most pressure. The price of oil itself is a large component of a broad basket commodity indices; thus, commodity index funds may decline in value. Additionally, the high-yield debt market (comprised of a high percentage of energy companies) will likely experience spread widening and potential defaults. **As we do not see these energy market dynamics reversing in the short term, we reiterate our neutral/underweight posture in high-yield debt and lower our posture in commodities from neutral to neutral/underweight.**

Over the long-term, a prolonged low oil price environment may have destabilizing consequences for the global economy because many nations rely on selling oil to generate national revenue. However, many of these countries assume a higher than market oil price to balance budgets as illustrated below. Russia, for example, has assumed a $72 price of oil to balance its budget for 2017. As a result, countries will likely increase production to generate revenue necessary to fund national operations, further increasing supply.

OIL PRICE NECESSARY TO BALANCE NATIONAL BUDGET ($/BBL.)

Source: Bloomberg. Oil price is WTI crude spot.

Finally, should the price of oil remain low, OPEC will likely pressure its members to keep production low, which will put even more pressure on national budgets and may cause members to act against the cartel's wishes, as the benefit of producing more than mandated (i.e., additional revenue) begins to outweigh the cost (i.e., keeping Saudi Arabia happy).

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INVESTOR TAKEAWAYS

While our quarterly letters generally serve to inform investors of market events that influence shorter-term decisions, it is equally (and perhaps more) important to remember that investing to manage family wealth is a long-term activity. In this regard, we would like to take this opportunity to reiterate a few of our longer-term investing tenets that we employ when managing client assets:

- Remain patient and disciplined and resist the urge to chase yield and return
- When valuations are high relative to history, understand that return expectations for the future are generally lower than if assets were more fairly valued
- Thoughtful portfolio diversification provides downside protection in periods of volatility

Additionally, below are several observations that are currently driving our investment philosophy for the remainder of 2017:

- Investors should seek to capture excess return in niche and opportunistic strategies that profit from market inefficiencies and illiquidity premiums (e.g., certain private equity and private debt strategies)
- Public fixed income appears overvalued, forward return expectations are low and structural liquidity challenges may magnify volatility
- Investors should maintain a healthy cash position to capitalize on volatility as the opportunity cost for holding cash remains historically low

Our short- to medium-term asset class perspectives are below:

⇊ UNDERWEIGHT ↓ NEUTRAL-TO-UNDERWEIGHT = NEUTRAL ↑ NEUTRAL-TO-OVERWEIGHT ⇈ OVERWEIGHT

ASSET CLASS	VS. POLICY ALLOCATION (AS OF 3/31/16)	VS. POLICY ALLOCATION (AS OF 6/30/17)	NOTES
Cash	⇈	⇈	Carries material option value, especially during times of uncertainty and high valuations.
U.S. Investment Grade Debt	↓	↓	Low coupons and low yields fail to adequately compensate investors for duration risk.
Global Fixed Income	⇊	⇊	Fails to adequately compensate investors for duration risk. Elevated currency volatility risk adds an additional level of uncompensated risk.
Bank Loans	↑	↑	While bank loan prices have recently rallied, they provide protection from rising rates due to floating rate structures and relatively attractive yields.
U.S. High-Yield Debt	↓	↓	Increased risk due to relatively tight spreads and long duration. Surge of fund outflows could cause liquidity issues. Stress in the energy market could overflow into the greater high-yield market.

ASSET CLASS	VS. POLICY ALLOCATION (AS OF 3/31/16)	VS. POLICY ALLOCATION (AS OF 6/30/17)	NOTES
Emerging Market Debt	=	=	Provides relatively high current yield. Stabilization in commodities markets aids net exporters.
Private Debt	⇈	⇈	Compelling illiquidity premium relative to public markets with a relatively high yield.
U.S. Large Cap Equity	↓	↓	Anticipated policy initiatives may take longer to implement and at a lower magnitude than originally expected. Valuations remain elevated.
U.S. Small Cap Equity	↓	↓	Anticipated policy initiatives may take longer to implement and at a lower magnitude than originally expected. Valuations remain elevated. MLPs remain attractive due to relatively high yields and long-term growth potential. .
EAFE Equity	↓	=	While valuations appear elevated, the effect of monetary stimulus has only recently begun to manifest itself in economic stabilization and improvement. After the French election, the threat of populism has subsided, for now.
Emerging Market Equity	=	=	If underweight, we recommend buying on weakness due to long-term growth potential and low valuations relative to domestic equities.
Private Equity	⇈	⇈	Compelling illiquidity premium relative to public markets. We favor small and middle market buyout, secondaries and sector specialists.
Hedged Strategies	⇈	⇈	Provides uncorrelated returns, alpha opportunities and a reduction in overall portfolio risk.
Real Assets	=	=	We recommend seeking to capitalize on idiosyncratic risk; but, we recommend being wary of the effect of rising rates.
Commodities	=	↓	Unfavorable supply and demand dynamics may continue to exert pressure on oil prices.