Q2 2017
Investment Perspectives

Dave Keevins
Chief Investment Officer

Andrew Krei, CFA
Head of Investment Research

July 2017

- **INTERNATIONAL MARKETS LEAD EQUITIES HIGHER:** Equity indices around the world extended their year-to-date gains, led by strong relative performance from developed international and emerging markets stocks. Improving economic data and loose monetary conditions in Europe and Japan helped international stock mutual funds and ETFs garner over $106B of asset flows in 2017 through May, per Morningstar data.
- **THE FED STAYS THE COURSE:** The market was pricing in a near 100% probability that the Fed would hike its benchmark borrowing rate by 0.25% at its June meeting, and the Open Market Committee did not disappoint. With three 0.25% rate hikes since December, the Fed is continuing down the long path toward monetary policy normalization, even suggesting that it would begin tapering its balance sheet later this year in its June meeting minutes.
- **COMMODITIES SLUMP:** The commodities complex moved lower during Q2 2017 as concerns over global supply/demand imbalances and a crackdown on speculative activity in China led to heavy selling in oil and base metals, respectively.

Market Recap

Equities and fixed income advanced in tandem during Q2 2017 as a synchronized global economic acceleration phase began to take shape against a backdrop of relatively low inflation and accommodative monetary policy. Non-US markets fared especially well thanks to a weaker US dollar and reinvigorated investor enthusiasm for global stocks.

Talk from central bankers about gradually tightening monetary policy did not roil markets, but there is a growing sense that the extraordinarily accommodative financial conditions enjoyed by markets since the financial crisis may finally be unwound. Over the coming months, investors will be listening closely to comments from the US Federal Reserve, European Central Bank (ECB), Bank of England (BOE), and Bank of Japan (BOJ) for hints about how this normalization process will unfold.

FIXED INCOME

	USD Total Return (%)	
INDEX	**Q2**	**YTD**
Barclays 1-10 Yr Muni	1.4%	3.0%
Barclays US Agg. Bond	1.5%	2.3%
BofA/ML HY Master II	2.1%	4.9%

EQUITIES

	USD Total Return (%)	
INDEX	**Q2**	**YTD**
Russell 3000	3.0%	8.9%
S&P 500	3.1%	9.3%
Russell 2000	2.5%	5.0%
MSCI All Country World	4.3%	11.5%
MSCI EAFE	6.1%	13.8%
MSCI Emerging Mkts	6.3%	18.4%

Source: Morningstar (Data as of 6/30/17)

A "GOLDILOCKS" ENVIRONMENT

With economic data, inflation, and financial conditions being neither "too hot" nor "too cold," markets found a comfortable middle ground during the quarter that allowed for broad gains across most asset classes. The combination of solid, if unspectacular, corporate revenue growth and declining interest rates has been supportive of stronger profit margins, and with US and European inflation data cooling in the quarter, the probability of an aggressive Fed tightening cycle or a rapid move by the ECB to reduce stimulus has been greatly diminished. How long markets can remain in this comfort zone remains to be seen, but many are speculating that it will take some sort of exogenous event—e.g., a military escalation with North Korea—or a central bank misstep to knock markets out of their current groove.

VOLATILITY HITS MULTI-YEAR LOWS

There appears to be a bull market in complacency as the CBOE S&P 500 Volatility Index—better known as the VIX, or colloquially known as the "fear gauge" (the VIX typically goes up when markets are going down)—plummeted to multi-year lows during the quarter. As a market-based measure of near-term volatility expectations, the VIX is reflective of investors' concerns about a market correction. As evidence of investors' current lack of concern, consider that the VIX briefly broke through the psychologically significant 10 level on the downside for only the fourth time since 1990. A lower VIX means less demand for market hedging, and historically, these levels have been contrarian indicators, signaling that markets are likely to become more volatile.

RATES DECLINE AND CORE FIXED INCOME RALLIES

After suffering a 3.2% drawdown in the immediate wake of the US election, core fixed income—as measured by the Barclays US Aggregate Bond Index—has staged an impressive comeback in 2017, nearly recovering all of its losses by the end of Q2. With 10-year Treasury rates declining from 2.45% at the beginning of the year to 2.31% at the end of Q2 2017, core fixed income has generated a total return of 2.27% year-to-date.

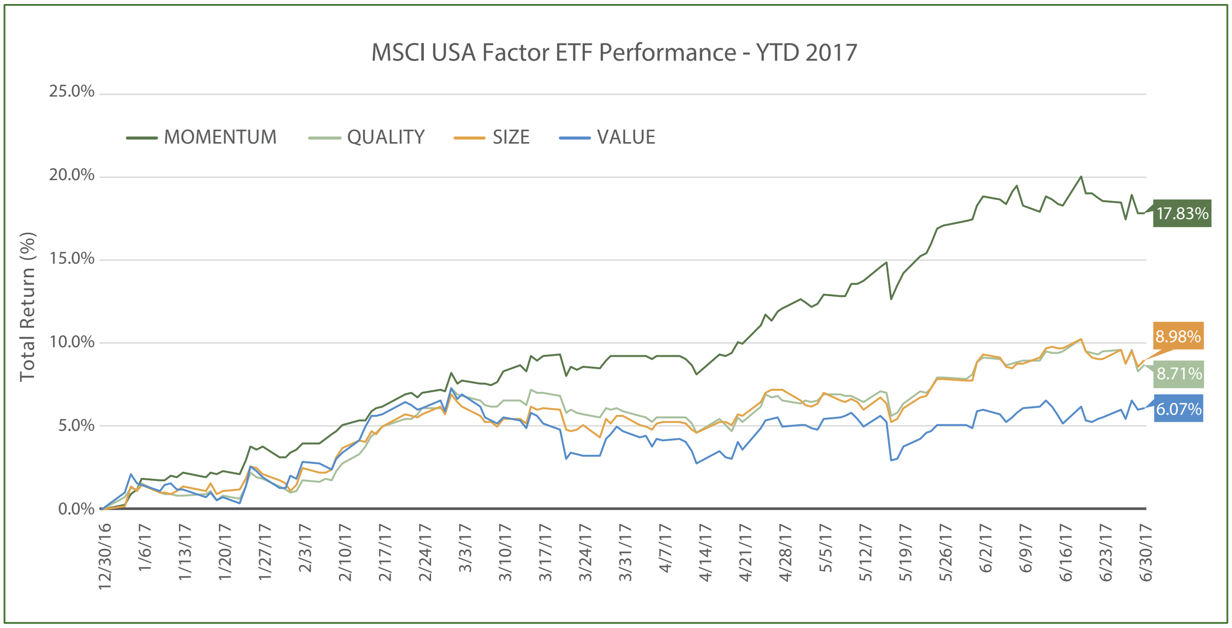
On the heels of the disappointing Q1 2017 GDP growth report that showed the US only growing 0.7%—subsequently revised up to 1.4%—and the diminishing likelihood of any growth-stimulating legislation passing in the near-term, market participants have taken a more skeptical view of US economic growth prospects. In concert with some softer-than-expected inflation readings, investors showed a renewed appetite for core bonds at lower yields. In fact, Treasuries that are adjusted for inflation, better known as TIPS, actually declined during the quarter as the market's implied measure of annual inflation over the next 10 years has dipped 0.22% since the beginning of 2017.

Municipal bonds have fared well in 2017 after yields rose and prices tumbled post-election as investors feared a potential change to the bonds' tax-exempt status and re-evaluated the relative attractiveness of the asset class under a lower tax regime. Concerns about tax reform were proven to be premature as dysfunction in Washington has reduced the odds of meaningful tax legislation passing in the near-term. On a year-to-date basis, the Barclays 1-10 Year Municipal Bond Index was up 2.96%.

continued on page 3

MOMENTUM TAKES US EQUITY MARKETS HIGHER

When the US stock market is broken down by the four main "factors" that explain returns—momentum, size, value, and quality—the clear winner in 2017 has been momentum stocks. Investors continue to pile into the year's biggest gainers, driving prices higher. In fact, you can see the magnitude of the outperformance as measured by the MSCI factor ETFs on the chart below; momentum stocks are up 17.8% in 2017 whereas the other factors are up anywhere from 6.1% to 9.0%.



Source: YCharts (Data as of 6/30/17)

Practically speaking, this has translated into a period of significant outperformance for large cap growth and underperformance for funds/managers focused on smaller companies trading at lower valuations.

OVERSUPPLY TAKES ITS TOLL ON THE OILPATCH

Despite OPEC's best efforts to rein in the global glut of crude oil, production continued to exceed estimates throughout Q2, leading to renewed selling pressure. While the global demand picture remains robust, market participants simply see too much supply to support $50-60 crude oil prices. Output growth from US shale producers and countries exempt from the OPEC agreement—namely, Libya and Nigeria—has more than offset the production declines from an OPEC group that has been surprisingly compliant with the terms of its recent pact. With Saudi Arabia eyeing an IPO of its massive, state-owned oil producer, Saudi Aramco, there is speculation that the Saudis will do "whatever it takes" to support prices over the coming months.

continued on page 4

GEOPOLITICS FRONT AND CENTER

After a tough stretch for pollsters in the wake of an unexpected United Kingdom "Brexit" vote and a Trump victory in the US, France's presidential election results played out as anticipated. Emmanuel Macron was overwhelmingly elected as France's new president in May, defeating far-right candidate, Marine Le Pen. The news was welcomed by pro-European centrists concerned about Le Pen's populist and nationalistic rhetoric, and markets cheered a more status quo path forward for the euro as well as the potential for business-friendly legislative reforms.

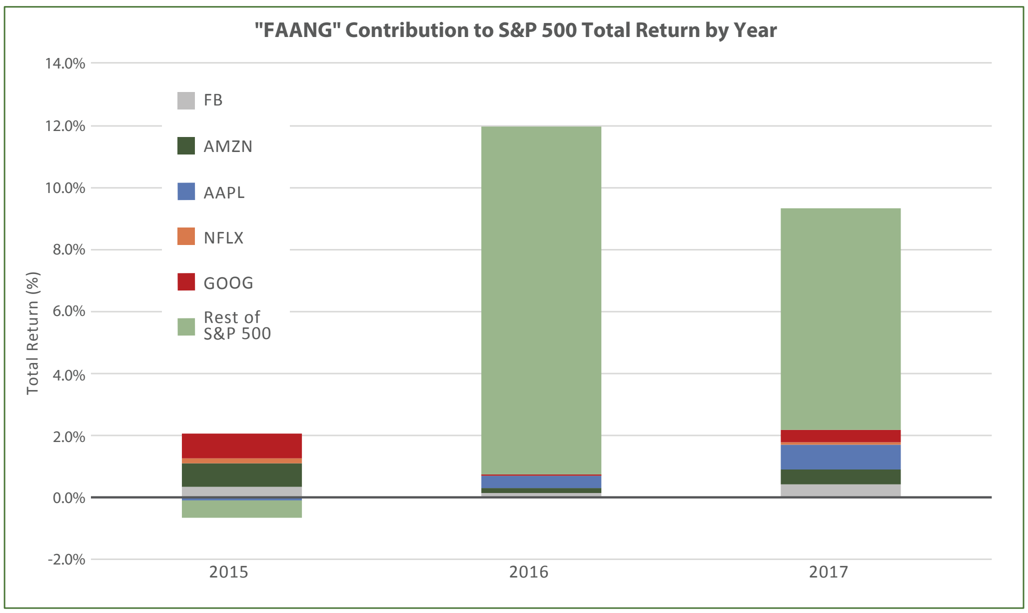
The pollsters' success was short lived as the June elections in the United Kingdom produced unexpected gains by the Labour Party, leading to a hung parliament. Pressure has increased on the UK's current Prime Minister, Theresa May, to resign, and uncertainty about the political path forward for the Conservative Party led to a steep decline for the pound sterling in the immediate aftermath of the election. With Brexit negotiations ongoing, the election results created an additional layer of complications for the UK in its talks with European Union representatives.

Finally, shortly after the end of Q2 2017, North Korea successfully tested an intercontinental ballistic missile (ICBM) capable of reaching Alaska. The test was widely criticized by countries around the world, and US representatives put increased pressure on China to ratchet up its influence on North Korea. President Trump has not taken military action off of the table, but with North Korean artillery trained on heavily-populated Seoul, South Korea, a military escalation could endanger millions of lives. This powder keg has the potential to rattle markets regionally and globally if mishandled. ●

The "FAANG" Stocks

Much has been written about the so-called "FANG" stocks over the past couple of years—Facebook, Amazon, Netflix, and Google (now known as Alphabet). Recently, the acronym has been modified to allow Apple into the club of high-flying tech names (hence, "FAANG") that have been standout performers. This group of five now comprises roughly 9.7% of the total S&P 500 weighting thanks to their huge market capitalizations (up from 7.9% in 2015 and 8.8% in 2016).

Since the beginning of 2015, the FAANG stocks have been responsible for approximately 5% of the S&P 500's 24.1% advance. Think of it this way: roughly one-fifth of the index's performance over the past 30 months has been generated by 5 companies—or, one-hundredth of the market. In fact, the S&P 500 would have been negative in 2015 were it not for the sizeable contributions from the FANG names. The chart below illustrates this phenomenon.



Source: Morningstar (Data as of 6/30/17)

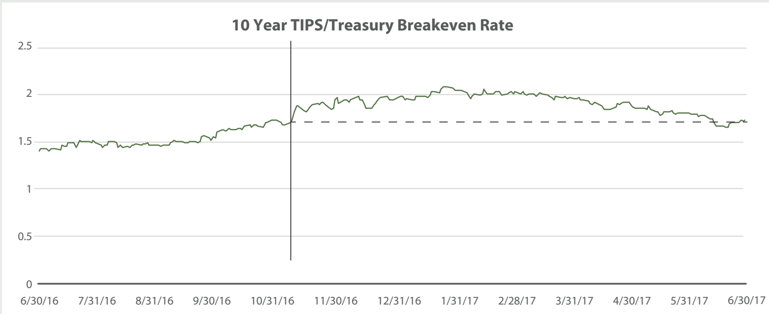
While there are countless start-ups looking to disrupt entrenched players in various industries, the FAANG story has more of a winner-take-all feel to it. As these companies continue to expand their user bases, grow their ecosystems, and enhance their already impressive infrastructure advantages, it is increasingly difficult to imagine them ceding ground in their respective sectors. Further, FAANG companies have the ability to acquire nascent competitors and further solidify their leadership positions.

FAANG stock performance, on the other hand, is a different story. Investors continue to bid these names higher, particularly as passive investment vehicles garner a greater share of the market. Market capitalization-weighted index funds effectively act as a momentum strategy, buying more and more of the biggest, best performing names. If, however, capital inflows turn into capital outflows, investors could see the FAANG stocks experience disproportionate pain.

Charts of the Quarter

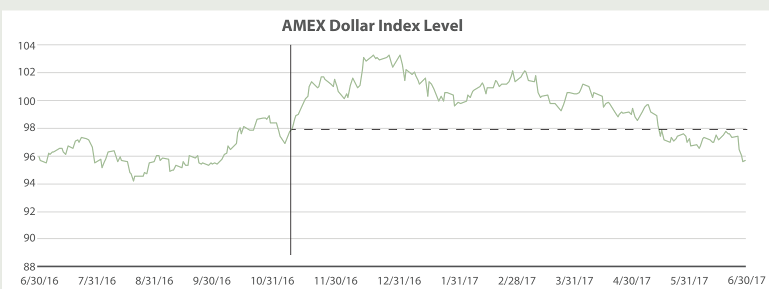
With over seven months behind us since the US elections in November 2016, our Charts of the Quarter consist of 3 graphs that tell an intertwined story of the economy, markets, and policy during that period. In short, this has been a tale of great expectations that were subsequently tempered by the sobering reality of the political environment and a lukewarm economic recovery.

On the charts below, the vertical lines represent the US election date, and the dotted lines represent the level of each metric the day prior to the election.



(1) **10 Year TIPS/Treasury Breakeven Rate:** This is a market-based measure of future inflation expectations. The election of Donald Trump caused a rapid increase in the US inflation outlook as investors were primed for fiscal stimulus via infrastructure spending and tax cuts. Progress on these initiatives has stalled and inflation expectations are now below their pre-election levels.

(2) **10-2 Year Treasury Yield Spread:** The 10-2 year spread levels provide a quick gauge of the shape of the yield curve. In a non-recessionary environment, the 10-year yield generally will exceed the 2-year yield by an amount commensurate with future economic growth, inflation, and volatility expectations. The yield curve steepened substantially immediately following the election but quickly reversed the initial move and approached its lowest levels since 2007 in Q2 2017. If the downward trend continues, this could portend trouble for the economy; the 10-2 year spread has turned negative—i.e., the yield curve has inverted—before the last five recessions, dating back to 1975.



(3) **AMEX Dollar Index Level:** This is a trade-weighted index that tracks the value of the US dollar (USD) against a basket of currencies from around the world (including the euro, yen, Canadian dollar, etc.). Post-US election, the USD rapidly strengthened and held its gains into Q1 2017, but since March, the USD has steadily declined, reaching its weakest levels since Q3 2016. Not only has there been more hawkish (or at least "less accommodative") rhetoric about monetary policy coming out of Europe, but also capital flows have been directed toward non-US assets, as evidenced by the strong performance from developed international and emerging markets stocks in 2017.

Source: YCharts (Data as of 6/30/17)

Lessons Learned

We recently received an interesting prompt within a request for proposal: *Please provide a few examples of lessons that you have learned over the years as it relates to investment manager selection and/or due diligence*. We are often asked about our vetting process and due diligence philosophy in a general sense, but rarely are we asked about how we have evolved through the years or the experiences that have informed our current thinking.

Here are a few of the "lessons learned" that we highlighted in our response:

- **AUM "bloat."** We have seen multiple examples of investment managers growing assets under management (AUM) at a faster pace than their strategies and infrastructure can handle, ultimately leading to sub-par returns. Oftentimes the allure of greater fee revenue outweighs a manager's desire to preserve the integrity of its strategy. We try to avoid these situations a few ways:

  - ONGOING AUM MONITORING. Via Morningstar and our other research tools, the Crescent Grove Investment Committee monitors strategy AUM levels on a monthly basis and tracks strategy inflows/outflows.

  - UNDERSTAND MANAGER COMPENSATION. We want to know if portfolio managers (PMs) and analysts are more incentivized to gather assets or generate consistently strong performance. These goals are certainly not mutually exclusive, but we prefer that the balance is tilted toward performance-based compensation.

  - UNDERSTAND CAPACITY. During our initial due diligence, we push managers to give us AUM levels at which they would close their strategy and explain how AUM growth could impact the strategy's repeatability. Then, we hold them to it through our ongoing monitoring processes.

  - LOOK AT THE FIRM'S TRACK RECORD. Specifically, does the firm have a history of closing other strategies when they are deemed to have reached capacity?

- **Organizational change.** Beyond the standard personnel changes that would trigger an immediate review of our investment managers (e.g., the departure or firing of a PM or lead analyst), we have become wary of the impact of a parent company/holding company merger or acquisition on our managers. In some cases the changes are easily observed (e.g., teams are consolidated, reporting structures are realigned), but oftentimes the PMs and marketing folks purport that nothing is changing. In our experience, even if nothing is demonstrably changing, rarely does a corporate transition happen seamlessly and without impacting management teams—which often has a negative effect on performance. For that reason, we avoid adding managers to our platform in the midst of a corporate transaction and view M&A's impact on our existing platform managers with a healthy dose of skepticism.

- **The "J-curve" and "gross/net spread."** As it relates to private equity fund structures, we are especially attuned to strategies that may experience a deep "J-curve"—where fees significantly exceed investment returns during the early years—and ultimately lead to a wide "gross/net spread", or the difference between the fund's gross return (before fees) and its net returns to investors (after fees). This issue often stems from a misunderstood or rapidly changing opportunity set that extends the anticipated deployment timeline. We prefer deals with fees only on called capital to avoid this issue entirely, but if we decide to pursue a strategy with a committed capital fee structure (i.e., the investor pays fees on the full commitment amount rather than the amount called), it will be because we are comfortable that the manager has a clear path to deploying capital, that the fund is not trying to deploy too much capital and, typically, that the fund has some sort of cash flow component that will start to return capital to investors early in its life cycle.

A healthy part of performance evaluation is not just comparing the numbers, but understanding how your process and decision-making—the things within your control—fed into the results. These are just a few examples of how we have evolved over the years in an effort to produce better outcomes for our clients.

Contact us

Dave Keevins
Chief Investment Officer

Andrew Krei, CFA
Head of Investment Research

Crescent Grove Advisors, LLC

100 Field Drive, Suite 120, Lake Forest, IL 60045
847-752-0292

333 N. Plankinton Avenue, Suite 216, Milwaukee, WI 53203
414-386-5340

3284 Northside Parkway NW, Suite 495, Atlanta, GA 30327
678-585-6625

crescentgroveadvisors.com

CGA 003-2017