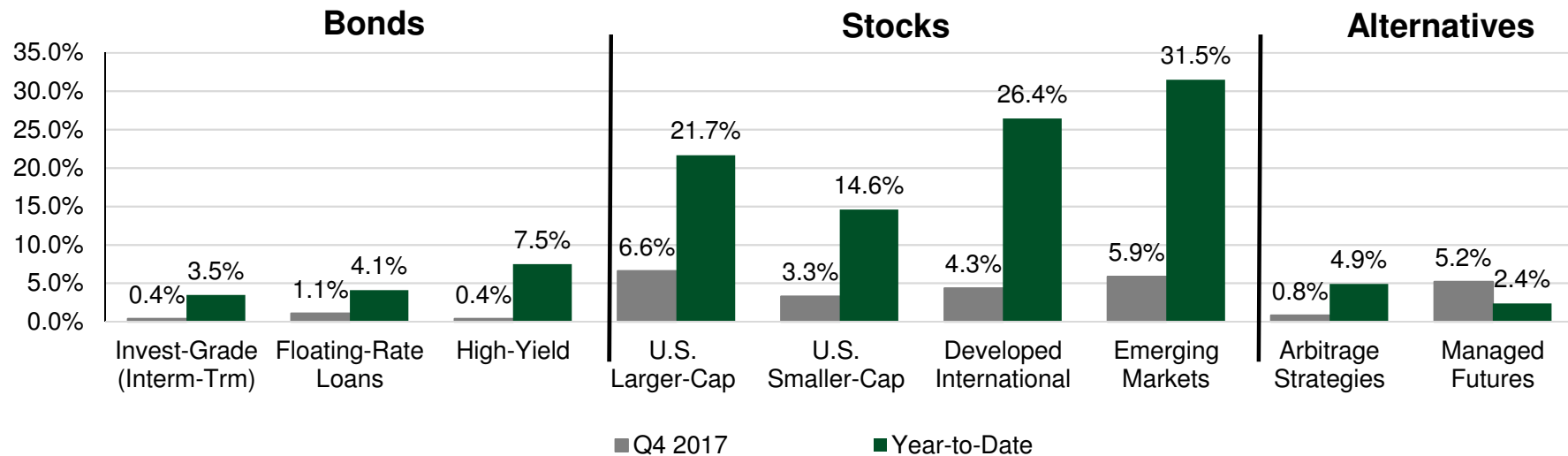


# Fourth Quarter 2017 Review



# A Stellar Year for Financial Markets

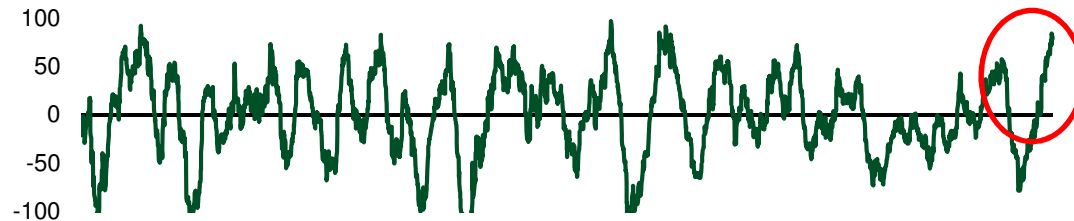


- The fourth quarter capped a stellar year for global stock markets. Rebounding corporate earnings growth, supported by solid economic data, moderate inflation, and still accommodative monetary policy were the broad drivers of performance. U.S. stocks got an additional catalyst in the fourth quarter with the passage of the Republican tax cut plan, presumably reflecting investors' optimism about its potential to further boost corporate after-tax profits, at least in the near term.
- Political uncertainties notwithstanding, Europe continues its economic recovery within what appears to be a benign fiscal and monetary environment. Europe is matching the United States in terms of economic growth, while corporate earnings growth in Europe has surpassed the United States over the past 12 months. Like European stocks, emerging-market stocks posted robust returns driven by a rebound in corporate earnings growth of nearly 20%.
- Amid the surge in stocks, the Federal Reserve raised short-term rates three times (75 basis points) and cautiously continued the well-publicized reduction of its multi-trillion-dollar balance sheet. Despite the rise in short-term rates, yields at the long end of the curve declined and the yield curve flattened.

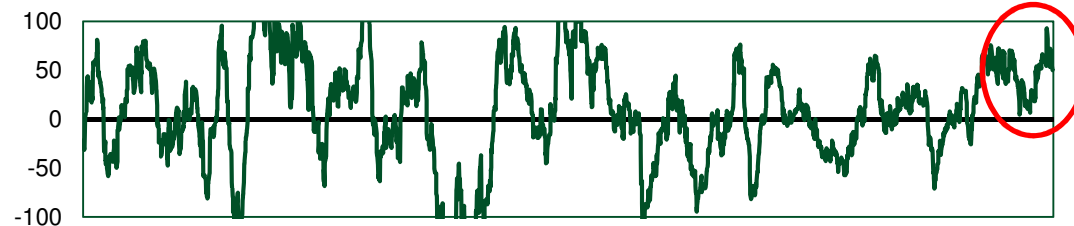
# The Global Economy Remains in a Synchronized Expansion

## *Economic Data Exceeding Expectations Around the*

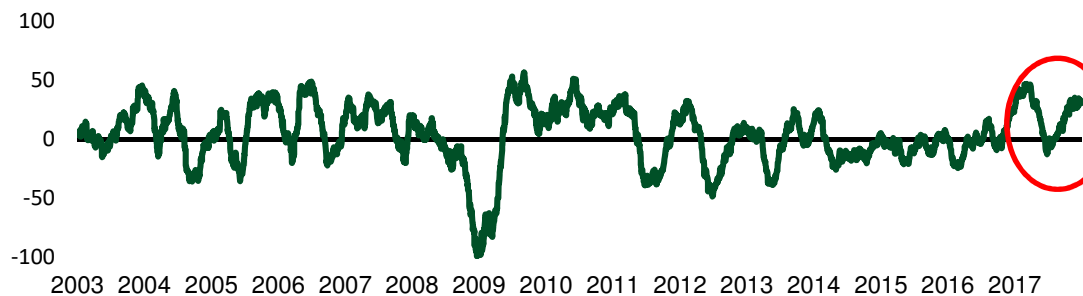
Citigroup Economic Surprise Index: United States



Citigroup Economic Surprise Index: Eurozone

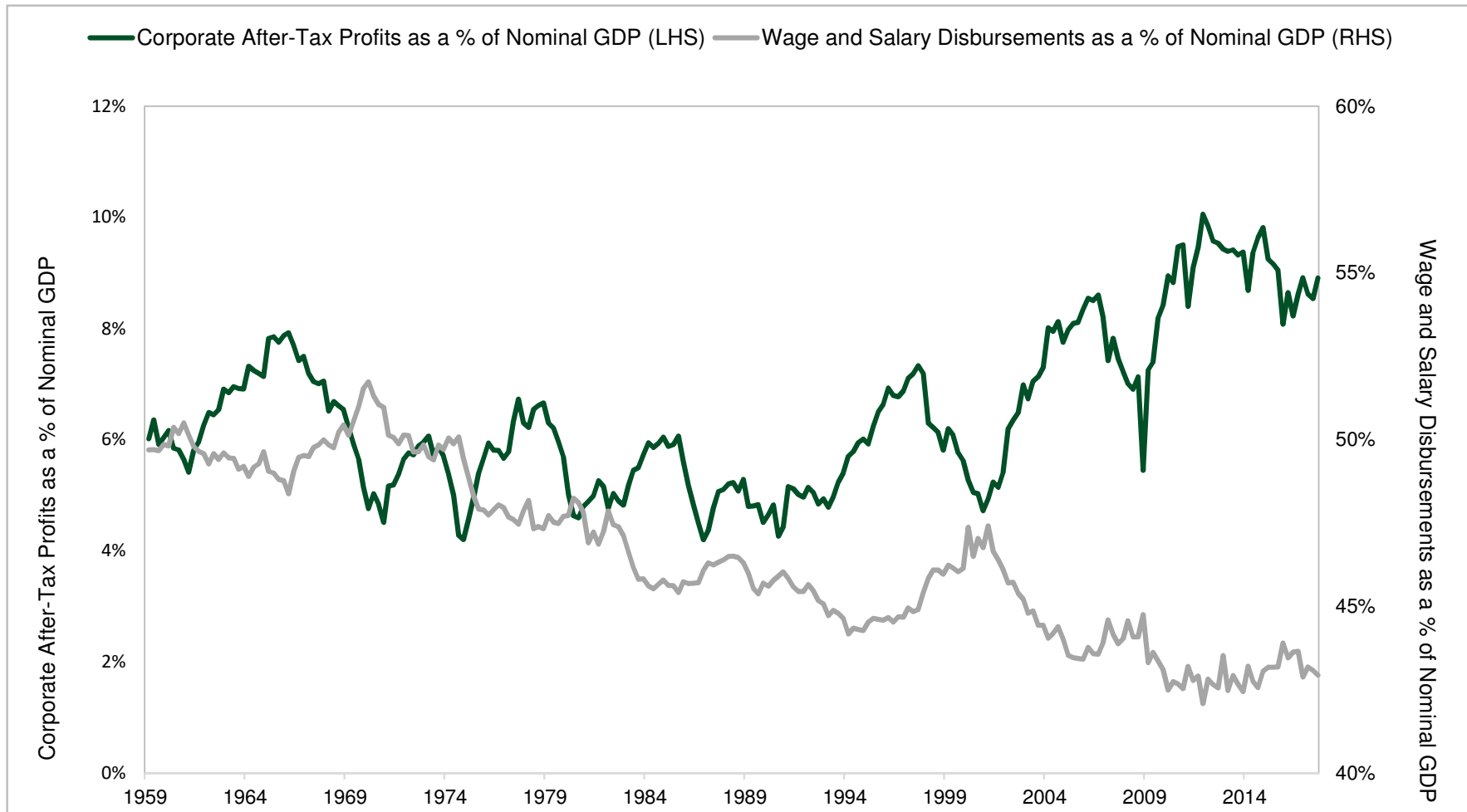


Citigroup Economic Surprise Index: Global

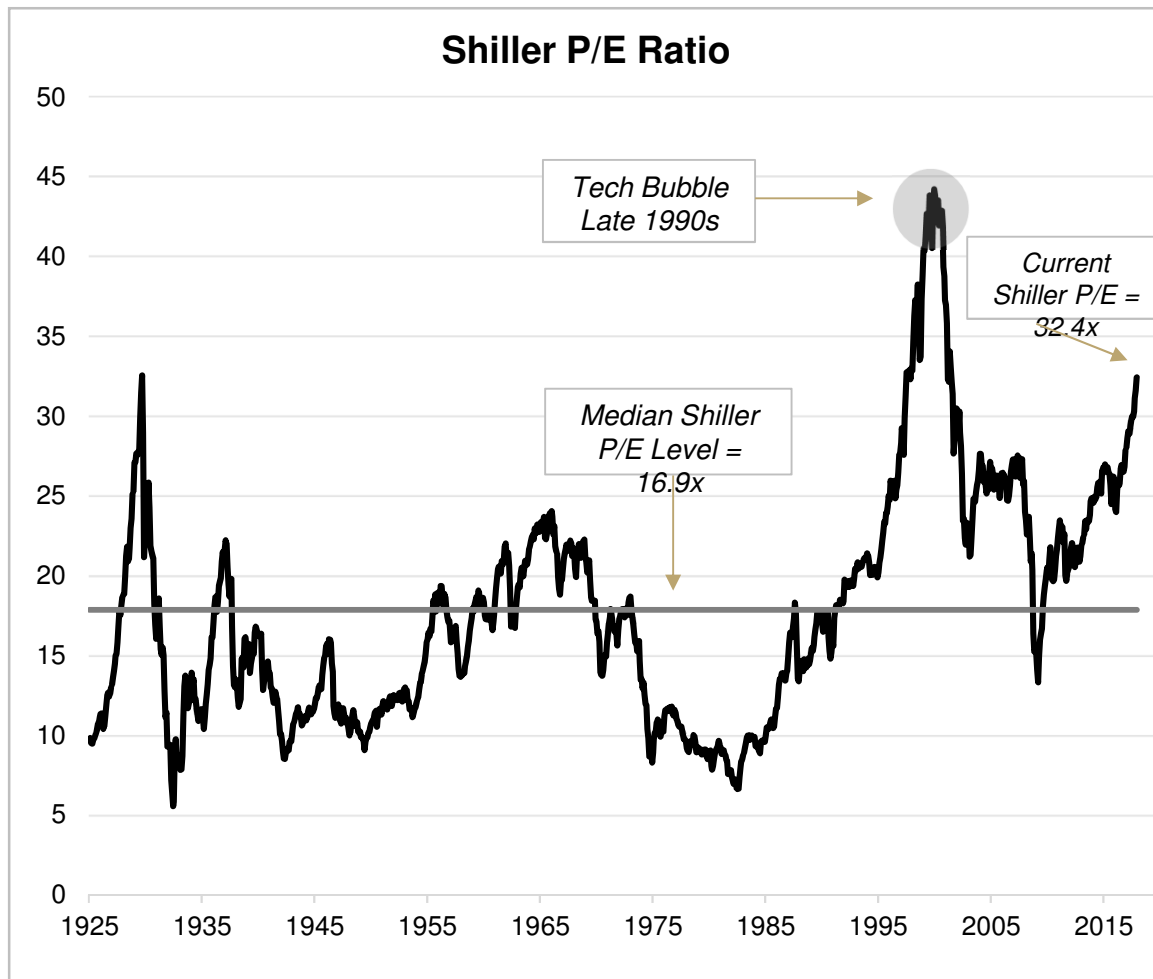


- The global economy remains in a synchronized expansion—the strongest since the financial crisis—and the consensus view is that there is little risk of a U.S. or global economic recession over the next year at least.
- Strong growth, ample liquidity, and low inflation have produced an extended period of exceptionally low volatility across global stock, bond, and currency markets.
- U.S. economic data are beating expectations by the most in nearly six years. However, our analysis suggests the positive economic outlook has already been discounted to a meaningful degree in current U.S. stock market prices.
- Economic growth outside the United States also continues to surprise on the upside. The eurozone is enjoying its fastest economic expansion since 2011, while above-trend economic growth in the emerging markets helped companies deliver strong earnings growth.

# Corporate Profits Have Expanded at the Expense of Labor



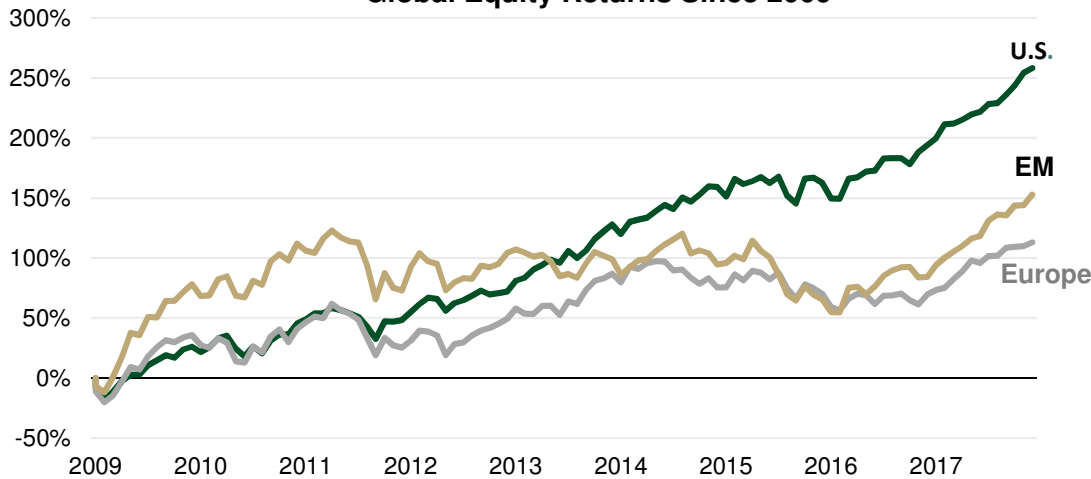
# U.S. Stocks Offer Poor Risk Adjusted Return Potential Given Expensive Starting Valuations



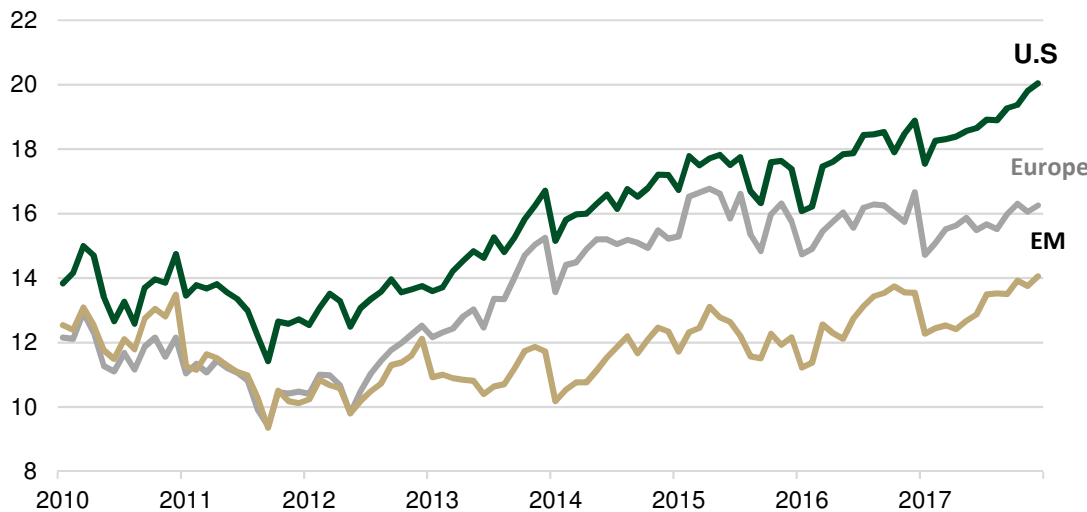
- We expect low-single-digit annualized returns for U.S. stocks in our base-case scenario over the next several years—a potential return that is not high enough to compensate for their downside risk. As such, we remain underweight U.S. stocks in our portfolios.
- Our low-return assessment of U.S. stocks is driven primarily by “valuation risk”. Much of the rally in U.S. stocks over the past few years has been driven by expanding valuation multiples—investors paying higher prices to own U.S. stocks.
- In our base-case scenario, we expect valuation multiples to decline toward historical norms over the next several years, which will have a negative impact on total returns.

# Equity Outlook: Favor International Stocks

Global Equity Returns Since 2009



Estimated Forward P/E Ratios



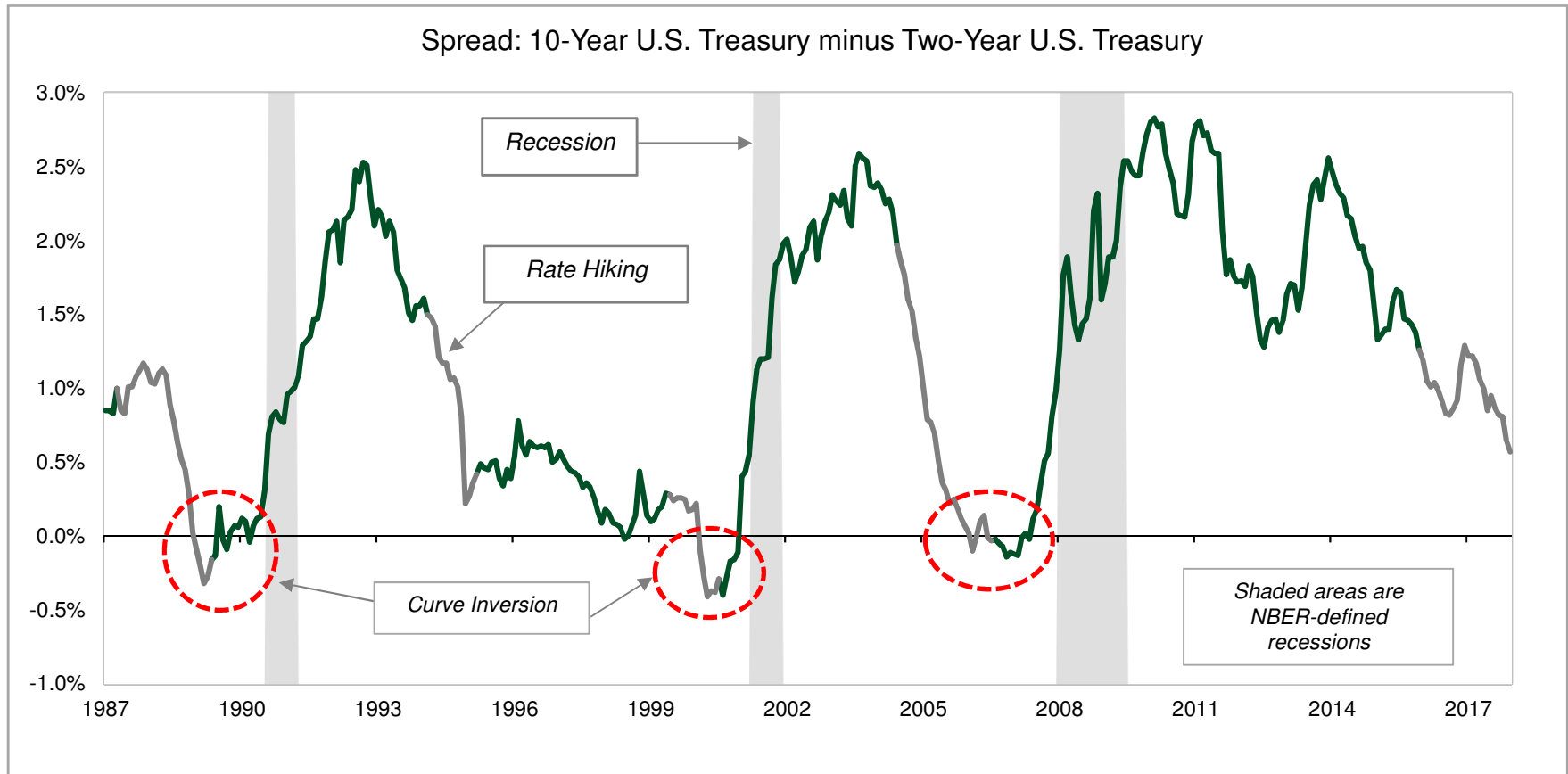
## U.S. Stocks: Risk

- U.S. stocks are up more than 250% since 2009 and nearly 100% over the past five years.
- Valuations for U.S. stocks are expensive and historical outcomes from current valuation levels are not encouraging.
- Potential returns from U.S. stocks—given their expensive valuations—is not high enough to compensate for their downside risk.

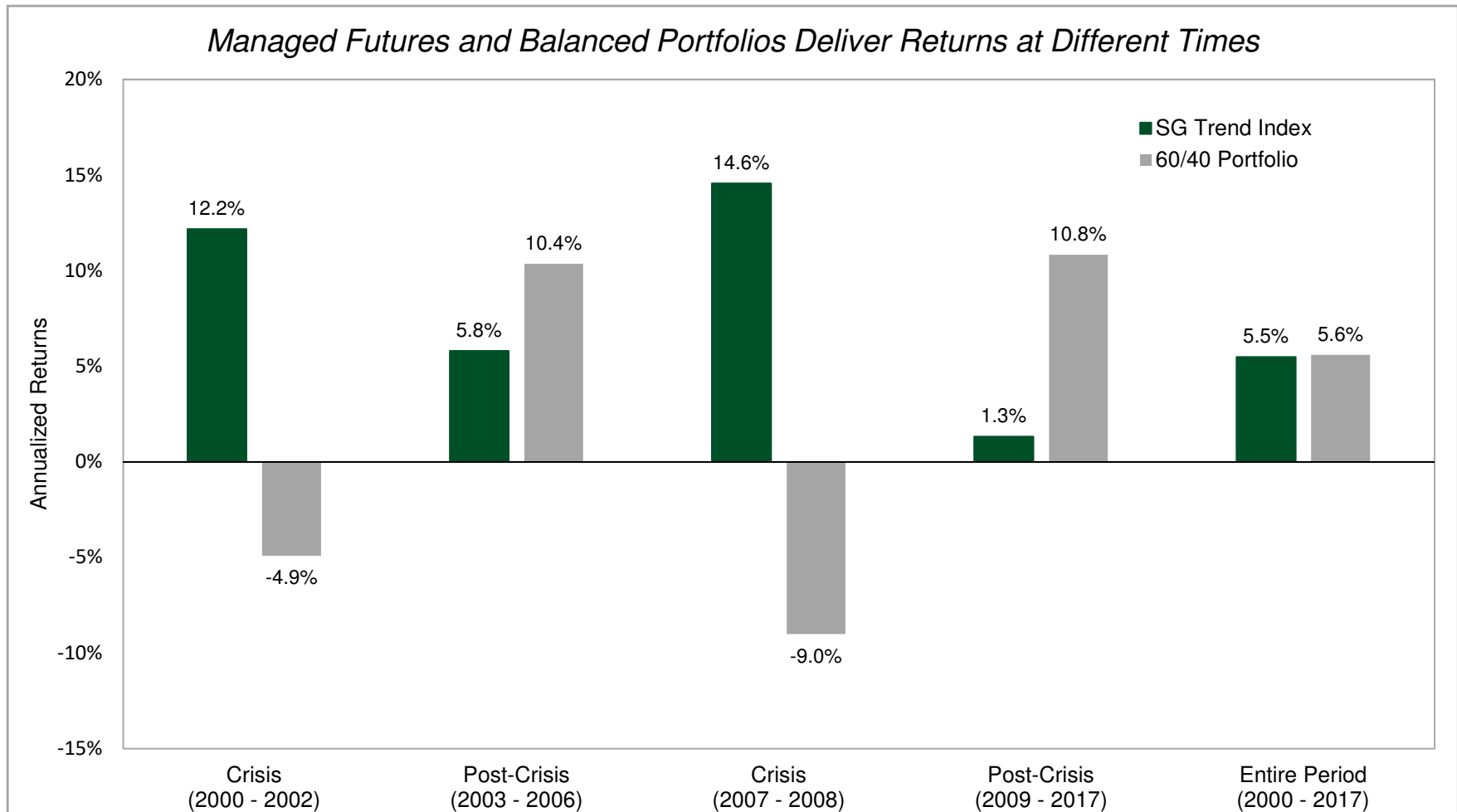
## International Stocks: Opportunity

- Valuations and long-term return potential remain attractive despite recent strong performance.
- Our analysis suggests corporate earnings growth will continue to improve and be higher than what the market is expecting.
- We expect international stocks to benefit from expanding valuation multiples—consistent with an economic and earnings recovery—and for their performance to “catch-up” to U.S. stocks.

# The Yield Curve Has Flattened But Not Inverted

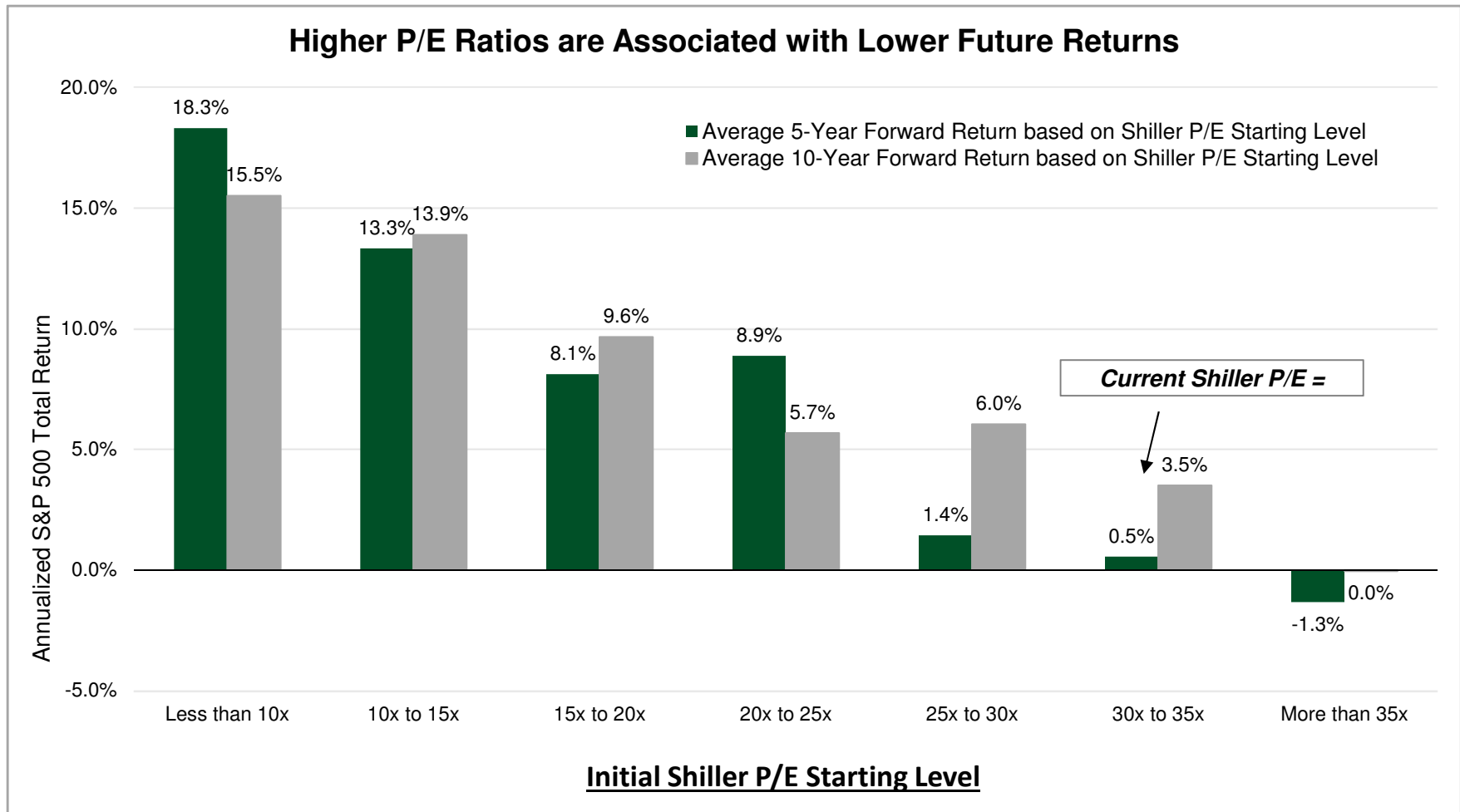


# Managed Futures: Great Diversifier for Balanced Portfolios





# Expensive Starting Valuations Imply Lower Future Returns



Source: Robert J. Shiller and Morningstar Direct. Data as of 12/31/2017.

# Investment Outlook

- Our base-case macroeconomic scenario calls for a continuation of the moderate economic recovery, both in the United States and globally. Assumes GDP growth rates and interest rates “normalize” toward the end of our five-year investment time horizon. Moreover, we don’t believe a recession is likely over the near term (12 months), but it is very likely within the next five years.
- Our analysis suggests very low expected returns for both U.S. stocks and U.S. core bonds. As such, our portfolios are tilted toward opportunities we believe offer more attractive risk-adjusted return potential—specifically, non-U.S. stocks, non-core fixed-income strategies, and select alternative strategies.

Asset Class	Outlook and Positioning
<i>U.S. Stocks</i>	U.S. stocks are quite overvalued and their longer-term return potential is unattractive. We maintain meaningful exposure to U.S. stocks but remain underweight relative to our strategic, or neutral, allocation.
<i>Developed International Stocks</i>	An economic and corporate earnings recovery is unfolding across the eurozone. Valuations for European stocks are attractive and potential returns are in the low double digits over the next few years. We have meaningful exposure to international stocks, with a slight overweight position in Europe.
<i>Emerging-Market Stocks</i>	Corporate earnings growth is recovering, yet remains far below the peak reached before/during the financial crisis. Valuations for emerging-market stocks remain attractive, both in absolute terms and relative to U.S. stocks. We maintain a slight overweight to emerging-market stocks.
<i>Investment-Grade Bonds</i>	Low current yields and the likelihood of rising interest rates imply low potential returns. We’re heavily underweight investment-grade bonds in favor of flexible core bond funds, unconstrained and absolute-return-oriented funds, and floating-rate loan funds we believe have the ability to generate higher returns and better manage their sensitivity to rising interest rates.
<i>Alternative Strategies</i>	Mid-single-digit return potential that offers a degree of portfolio protection and additional diversification relative to stocks and bonds. We own a mix of alternative strategies we believe improve the overall risk-adjusted return potential of our portfolios, with different risk and return drivers than traditional stocks and bonds.

# Estimated Asset Class Returns

## Average Annual Returns Over Next Five Years

### Equity Asset Classes

	Bear Case	<b>BASE CASE</b>	Bull Case
U.S. Larger Cap	-8.5%	<b>0.5%</b>	7.6%
Developed International - Europe	-8.5%	<b>10.4%</b>	17.6%
Emerging Markets	-4.9%	<b>5.7%</b>	12.6%
REITS*	4.2%	<b>5.9%</b>	4.7%

### Fixed-Income Asset Classes

	Bear Case	<b>BASE CASE</b>	Bull Case
Investment-Grade Bonds	3.3%	<b>1.9%</b>	1.3%
High-Yield Bonds	1.7%	<b>2.4%</b>	2.1%
Floating-Rate Loans	5.9%	<b>5.7%</b>	6.9%
Treasury Inflation-Protected Securities (TIPS)	2.3%	<b>1.1%</b>	-0.9%

### Alternative Asset Classes

	Bear Case	<b>BASE CASE</b>	Bull Case
Alternative Strategies	Mid-single-digit returns in most scenarios		

As of 12/31/2017, S&P 500 at 2674, Barclays Aggregate yield at 2.7%, MSCI Europe Index at 1797, MCSI EM Index at 1159, BofA High Yield Cash Pay Index at 5.8%. Asset-class return estimates, with the exception of TIPS, are in nominal terms. TIPS return estimates are shown in real terms i.e., inflation-adjusted. Litman Gregory Analytics

\*REITS face shorter-term downside risk not reflected in this slide.

# S&P 500 Five-Year Return Estimates Under Each Scenario

## Potential Five-Year Avg. Annual Returns for S&P 500

		Bear	Base	Bull
GAAP Earnings		\$96	\$145	\$174
P/E		16x	17x	20x
Starting S&P 500 Level				
Fair Value Range	1700	1.1	11.1	18.8
	1900	-1.4	8.4	15.9
	2100	-3.6	6.0	13.4
	2300	-5.5	3.9	11.1
	2500	-7.2	2.0	9.1
	2700	-8.7	0.3	7.3
	2900	-10.1	-1.2	5.7
	3100	-11.4	-2.6	4.2
	3300	-12.6	-3.9	2.8
	3500	-13.7	-5.1	1.5
	3700	-14.7	-6.2	0.3

### HOW THIS WORKS:

If the S&P 500 were at 2300 today, and we factor in our estimate that earnings in our Base Case Scenario would reach \$145 over five years, and apply a 17x P/E multiple to those earnings, then add in dividends (which are not shown here), the annualized five-year return would be 3.9%.

## Our Base Case Economic Scenario Continues to be a Moderate Economic Recovery

SCENARIO	DEFINITION
<i>Bull Case</i>	U.S. economic growth is above average and/or earnings end the period above the long-term trendline. Helped by stronger non-U.S. growth, releveraging of the U.S. consumer, and corporate investment spending, a self-reinforcing global growth cycle develops.
<i>Base Case</i>	Moderate economic recovery continues with no major crisis, but a normal recession is likely within the five-year time horizon. Assumes GDP growth rates and interest rates start to “normalize” toward the end of our five-year horizon.
<i>Bear Case</i>	The economy falls into recession for any of various reasons, such as deleveraging/deflation from Europe or China, an unexpected systemic shock, a Fed policy error, etc. This scenario does not assume another severe financial crisis (i.e., not a repeat of 2008–2009).

# Disclosures

## **Asset Class Descriptions:**

**Domestic Investment-Grade Bonds (Barclays Capital U.S. Aggregate Bond Index):** We are currently using the Vanguard Total Bond Market Index Fund to represent the Barclays Capital U.S. Aggregate Bond Index, an index of domestic investment grade bonds.

**Floating Rate Loans (S&P/LSTA Leveraged Loan Index):** We are currently using the S&P/LSTA Leveraged Loan Index to represent an index of floating rate loans.

**High Yield Bonds (Merrill Lynch U.S. High Yield Master Cash Pay Index):** We are currently using the Merrill Lynch U.S. High Yield Master Cash Pay Index to represent an index of domestic high yield bonds.

**Domestic Larger-Cap Stocks (S&P 500 Index):** We are currently using the Vanguard 500 Index Fund to represent the S&P 500, an index of primarily domestic larger-cap stocks.

**Domestic Smaller-Cap Stocks (Russell 2000 Index):** We are currently using the Russell 2000 Index iShares Exchange Traded Fund (ETF) to represent the Russell 2000, an index of primarily domestic smaller-cap stocks.

**International Developed-Market Stocks (FTSE Developed ex North America Index):** We are currently using the Vanguard FTSE Developed Markets Exchange Trade Fund (ETF) to represent an index of international developed-market stocks. Prior to May 2013, this Vanguard Exchange Traded Fund followed MSCI-EAFE. Prior to the July 2007 inception of Vanguard MSCI EAFE ETF, we use iShares MSCI EAFE Index from September 2001 to July 2007, and the MSCI EAFE Index adjusted for 0.35% expenses annually prior to September 2001.

**International Emerging-Market Stocks (FTSE Emerging Markets Index):** We are currently using the Vanguard FTSE Emerging Markets Index Exchange Traded Fund (ETF) to represent an index of emerging market stocks. Prior to January 2013, this Vanguard Exchange Traded Fund followed the MSCI Emerging Markets Index. Prior to the March 2005 inception of Vanguard MSCI Emerging Markets ETF, we use iShares MSCI Emerging Markets Index from May 2003 to March 2005, and the MSCI Emerging Markets Index adjusted for 0.67% expenses annually prior to May 2003.

**Managed Futures:** We are currently using an average of the AQR Managed Futures Strategy HV, Natixis ASG Managed Futures Strategy Y and PIMCO TRENDS Managed Futures Strategy.

**Arbitrage Strategies:** We are currently using an average of the AQR Diversified Arbitrage Strategy (ADAIX) and the Arbitrage Event Driven Strategy (AEDNX).

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