

Third Quarter 2017

QUARTER IN REVIEW

With few grand shifts in themes over the past three months, global investible markets provided reasonably generous returns for the inherent risks they present. Solid gains seen across the board, broad-market investors may have been pleased with the results, driven by coordinated global macroeconomic growth and durable corporate fundamental strength. It seems many continue to believe great risks lie just around the corner, and that markets will turn quickly and furiously once those risks come into view. With more than a few major market meltdowns in our mental history books, we know there are reasons to be both optimistic and vigilant. But, such always is the case, in our view. That thinking driving our approach to investment management, we continue to recommend careful review of tolerance for market risk. The intention of such reviews is to provide a source of confidence that, whatever path markets will take, we may participate in a manner appropriate to our individual goals for growth and appetites for volatility.

Global Growth in Sync

Double-digit earnings growth, alongside expanding global trade amidst a much more encouraging scene in Continental Europe, some easing of tension in Latin America and solid views from Asia have provided a comfortable backdrop for investible market gains. With trends seemingly neither hot, nor cold we do not expect the scenery to change sharply heading into the new year.

Tough Talk Masks Present Peril

Seems like we might be belaboring the points, having repeated them here for the past few quarters, but the past three months suffered from no lack of reasons for investor skittishness. North Korea once again topping that list, we understand if readers are more than a bit baffled by geopolitics and the relative lack of market interest in them. Have investors learned to look past the noise? Honestly, we doubt it. Perhaps the bolshevik repartee has obscured the weightiness of such matters. History has shown that the setting in of some sort of reality sets light-footed investors into a panic run, on occasion pressuring the masses to bolt along with.

Cognizant Approach

So, we must know that markets cannot go up without pause. Indeed, in history times as calm these are rare. “Wait for it...” isn’t the right expression, but neither is “Hope for the best!”. True, geopolitical strife or some other catalyst may at once prove the proverbial straw that breaks, but positive trends already noted may remain a foundation for further stability. Even as we wonder when the font of confidence will run dry, we understand that we can seek to prepare our portfolios for whatever eventuality, at least in terms of our abilities to cope with any upside we miss and/or decline we endure.

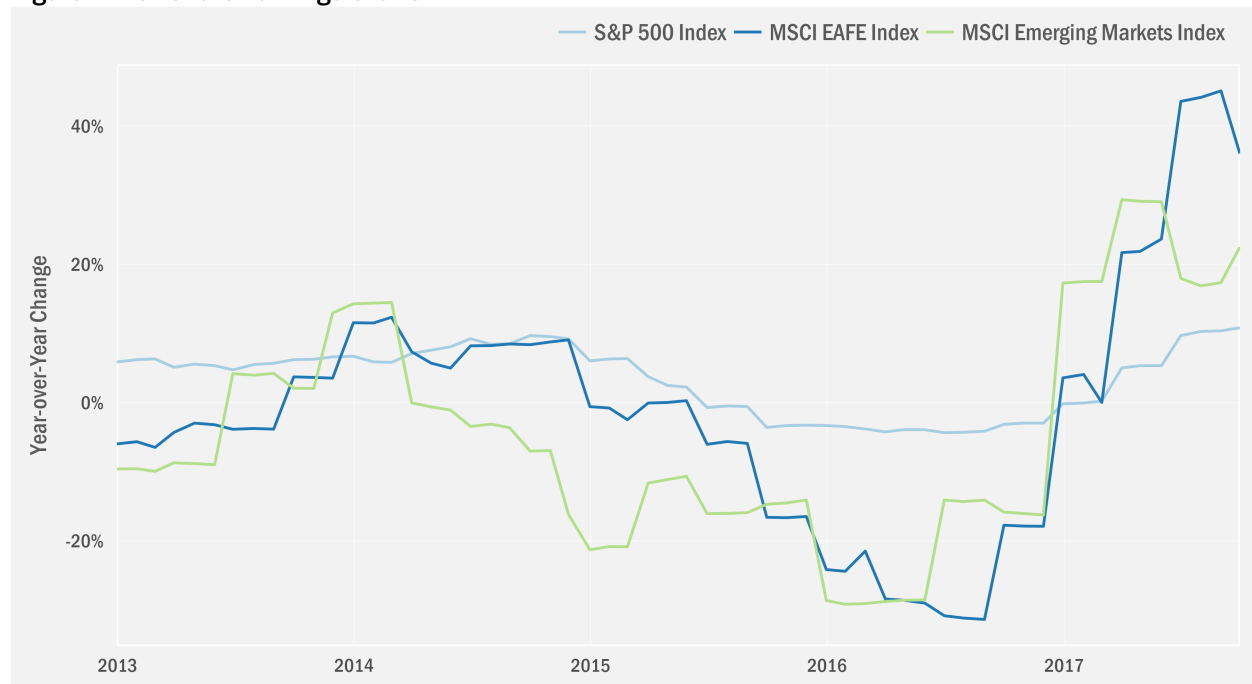
Figure 1: Quarter Summary

Overall Take				
↑	↑	Equity: Tame macroeconomic and corporate-fundamental trends buoyed investor enthusiasm for stocks, even as geopolitical tensions remained high		
	↑	Fixed Income: Further clarity in regard to going-forward monetary policy and the relative stability of mostly positive broader macroeconomic trends left domestic interest rates mostly unchanged for the quarter		
Equity				
↗	Domestic Welcome fundamental growth supported further gains in U.S. equities. Small-Caps outperformed large-caps, while Value stocks underperformed Growth		↑	International Stronger-than-U.S. fundamental growth supported further gains in global equities, with an additional boost from the weakening U.S. dollar. Small outpaced the Large here, too, while Value ran slightly more slowly than Growth
Fixed Income				
↗	Domestic Relatively tame interest rate movements left the domestic bond market similarly trained		↑	International Currency trends figured strongly in the factors driving positive results from global bonds

Macro Focus

After a healthy showing the second quarter for international macroeconomic growth, signs generally point to robust third-quarter growth among advanced and emerging economies. In the United States, the horrific hurricane season will dent results in an otherwise strong season for corporate investment and consumer spending and continued improvement in the employment picture. Generally positive trends left the Federal Reserve unchanged in its expectations to continue on a path toward more normal interest rates. Further, the Fed provided detail in regard to plans to begin to reduce the size of its balance sheet, which it had expanded through the purchase of debt securities in a desire to enhance macroeconomic stability and boost growth after the Financial Crisis. Similarly less accommodative tones were heard from the European Central Bank as growth there remains on the upcycle. Mixed, but in many ways more constructive trends among emerging economies complete the generally positive present review of the global economy. These economic trends are supporting of continued improvement in corporate fundamentals. Rising earnings across most major economies, charted in Figure 2, are more directly supportive of the gains in equities we have experienced so far this year.

Figure 2: Per-Share Earnings Growth



From 12.31.12 to 09.29.17. Please see important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Equity Market Review

Prior quarter and prior twelve-month gains in equity markets demonstrate the value of having lots of proverbial eggs in our baskets. This story of mixed performance is charted in Figures 3 and 4. Over the three- and twelve-month periods, small-cap Value stocks generally outperformed the rest of the market, even as Growth stocks otherwise tended to outperform. And international stocks edged out U.S. equities, with emerging market stocks turning in yet another very strong quarterly gain. Looking a bit closer, we see that the international Value returns were better than those for U.S. stocks, versus their respective broader markets over the past year. While we would have liked to have seen broader support for Value, we will acknowledge that equity returns in general have been very good for the past year when placed in the historical context.

Figure 4: Trailing Broad Equity-Market Performance

Broad Equity-Market Indexes						
	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Global	5.18	17.25	18.65	7.43	10.20	3.88
World ex. U.S.	6.27	21.47	19.55	5.16	7.32	1.59
World ex. U.S. Small-Cap	6.90	23.54	19.19	8.14	9.68	3.58
U.S.	4.44	13.70	18.61	10.95	14.29	7.63
U.S. Large-Cap	4.48	14.24	18.61	10.81	14.22	7.44
U.S. Mid-Cap	3.22	9.40	17.52	11.18	14.43	9.00
U.S. Small-Cap	5.96	8.92	21.05	14.07	15.60	9.27
Developed Markets	5.40	19.96	19.10	5.04	8.38	1.34
Emerging Markets	7.89	27.78	22.46	4.90	3.99	1.32

Value Component of Equity Indexes						
	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Global	4.59	12.80	18.17	5.64	9.21	2.74
World ex. U.S.	6.11	18.34	21.52	3.56	6.55	1.07
World ex. U.S. Small-Cap	6.86	22.46	21.31	7.75	10.05	3.95
U.S.	3.56	8.31	16.66	9.19	13.40	5.91
U.S. Large-Cap	3.48	8.49	16.47	8.93	13.21	5.57
U.S. Mid-Cap	3.26	6.60	17.04	10.41	14.64	8.38
U.S. Small-Cap	6.28	7.20	20.71	13.21	15.33	8.77
Developed Markets	5.87	17.63	22.55	3.50	7.80	0.49
Emerging Markets	5.47	19.87	18.55	1.62	1.34	0.67

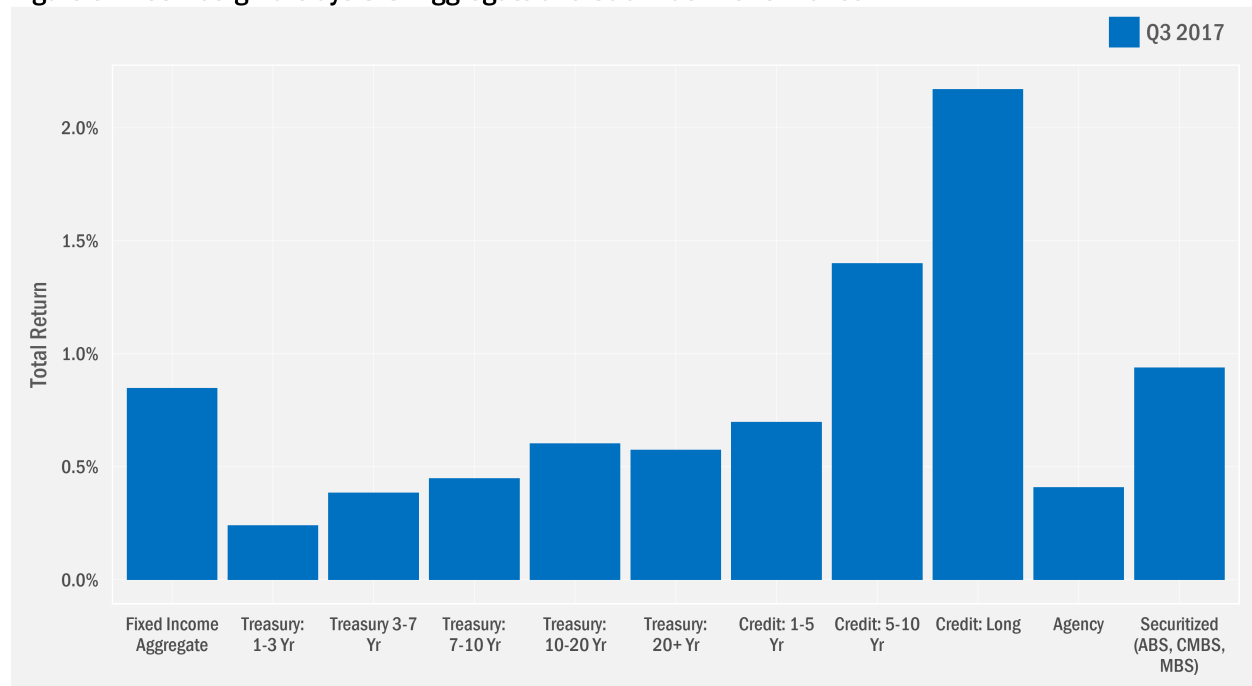
Value Component Vs. Aggregate Equity Indexes						
	3 Month	YTD	1 Year	3 Year	5 Year	10 Year
Global	-0.59	-4.45	-0.48	-1.79	-0.99	-1.14
World ex. U.S.	-0.15	-3.13	1.97	-1.60	-0.78	-0.51
World ex. U.S. Small-Cap	-0.04	-1.08	2.12	-0.39	0.37	0.37
U.S.	-0.88	-5.39	-1.96	-1.76	-0.90	-1.72
U.S. Large-Cap	-1.00	-5.75	-2.14	-1.88	-1.01	-1.87
U.S. Mid-Cap	0.04	-2.80	-0.48	-0.77	0.21	-0.62
U.S. Small-Cap	0.32	-1.73	-0.34	-0.86	-0.26	-0.50
Developed Markets	0.46	-2.33	3.44	-1.54	-0.58	-0.85
Emerging Markets	-2.42	-7.91	-3.91	-3.28	-2.65	-0.65

From 09.30.07 to 09.30.17. Total return data for are annualized for periods greater than 1 year. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

Fixed Income Market Review

In U.S. Treasury bond markets, returns were solidly positive. Though yields bounced around a bit during the quarter, they mostly ended where they began in early July. Corporate bonds fared well as spreads—the extra yield offered over Treasury bonds with a similar maturity due to the solvency risk inherent to corporate bonds—compressed over the three months.

Figure 5: Bloomberg Barclays U.S. Aggregate and Sub-Index Performance



From 06.30.17 to 09.30.17. SOURCE: SRCM using data from Bloomberg

Statera Model Context

In the aggregate, inclusive of fees, our portfolios as measured within our composites have underperformed their benchmarks on a net-of-fee basis, though that underperformance was relatively modest across the board both on the quarter and year bases.

For the quarter, before considering fees, Statera models generally outperformed across the equity and the fixed income components. The primary drivers of the equity outperformance were the portfolio tilts to small-cap stocks, both here and abroad, and to small-cap Value stocks in particular. Our broader emphasis on Value generally detracted from relative performance. With international stocks generally having outperformed U.S. stocks, our domestic bias detracted from the relative performance of our portfolios. For the year, Value stocks have shined a bit more brightly abroad, while the small-cap value story has remained a compelling one. Within fixed income, stronger tilts toward corporate bonds boosted performance relative to the fixed income benchmark.

Additional composite performance details are available upon request.

Near- and Medium-Term Outlook

Heading into the Season of Cheer, we are not expecting any major changes on the macroeconomic front and we are heartened by the continued strength in corporate fundamentals. Still, we must acknowledge that the domestic equity markets have not seen any manner of even normal volatility, such that we remain concerned of any potential surprise among investors were certain not-so-calm spirits to foster greater instability. We know such surprises can cause fear, which may lead to more than a bit of unnecessary market turnover.

We hope, though, that the conversations we have shared this year have provided sufficient notice that markets have been and are likely to be quite different at some point in the future than those we have experienced in the past few years. Of course, we welcome any discussions with regard to tolerance for market risk and hope that readers will reach out to their advisors were any material changes in financial goals or situations to warrant a shift in portfolio exposures.

Important Information

Investing involves risks. Past performance is not indicative of future results.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

Asset classes and their respective indexes mentioned in this report include the following:

International (global non-U.S. dollar-denominated) fixed income: The Bloomberg Barclays Global Aggregate Index is a multi-currency benchmark that measures global investment grade debt and includes fixed-rate treasury, government-related, corporate and securitized bonds from developed and emerging markets issuers while excluding U.S. dollar-denominated debt.

Domestic (U.S.) fixed income (Fixed Income Aggregate): The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. Components of the index include Treasury, Corporate, Agency and Securitized bonds.

Global equity: The MSCI All Country World Index (ACWI) captures large- and mid-cap representation across 23 Developed Markets and 23 Emerging Markets countries. The index covers approximately 85% of the global investable equity opportunity set.

International equity: The MSCI ACWI ex. USA Index captures large- and mid-cap representation across 22 Developed Markets countries and 23 Emerging Markets countries. The index covers approximately 85% of the global equity opportunity set outside the U.S.

International small-cap equity: The MSCI ACWI ex. USA Small Cap Index captures small-cap representation across 22 Developed Markets countries (excluding the U.S.) and 23 Emerging Markets countries. The index covers approximately 14% of the global equity opportunity set outside the U.S.

International small-cap value equity: The MSCI ACWI ex. USA Small Cap Value Index captures small-cap securities exhibiting overall value style characteristics across 23 Developed Markets countries and 23 Emerging Markets countries.

Developed markets equity: The MSCI EAFE Index captures large- and mid-cap representation across Developed Markets countries around the world, excluding the United States and Canada. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

Emerging markets (EM) equity: The MSCI Emerging Markets Index captures large- and mid-cap representation across 23 Emerging Markets countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The value investment style characteristics for MSCI index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

Domestic (U.S.) equity: The S&P Composite 1500 Index represents approximately 90% of the investable U.S. equity market. The S&P Composite 1500 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P Composite 1500 Index. The S&P Composite 1500 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P Composite 1500 Index.

Domestic (U.S.) large-cap equity: The S&P 500 Index measures the performance of the large-cap segment of the U.S. equity market. The S&P 500 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P 500 Index. The S&P 500 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P 500 Index.

Domestic (U.S.) mid-cap equity: The S&P MidCap 400 Index measures the performance of the mid-cap segment of the U.S. equity market. The S&P MidCap 400 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P MidCap 400 Index. The S&P MidCap 400 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P MidCap 400 Index.

Domestic (U.S.) small-cap equity: The S&P SmallCap 600 Index measures the performance of the small-cap segment of the U.S. equity market. The S&P SmallCap 600 Value Index is composed of those stocks exhibiting relatively stronger Value characteristics among the constituents of the S&P SmallCap 600 Index. The S&P SmallCap 600 Growth Index is composed of those stocks exhibiting relatively stronger Growth characteristics among the constituents of the S&P SmallCap 600 Index.

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