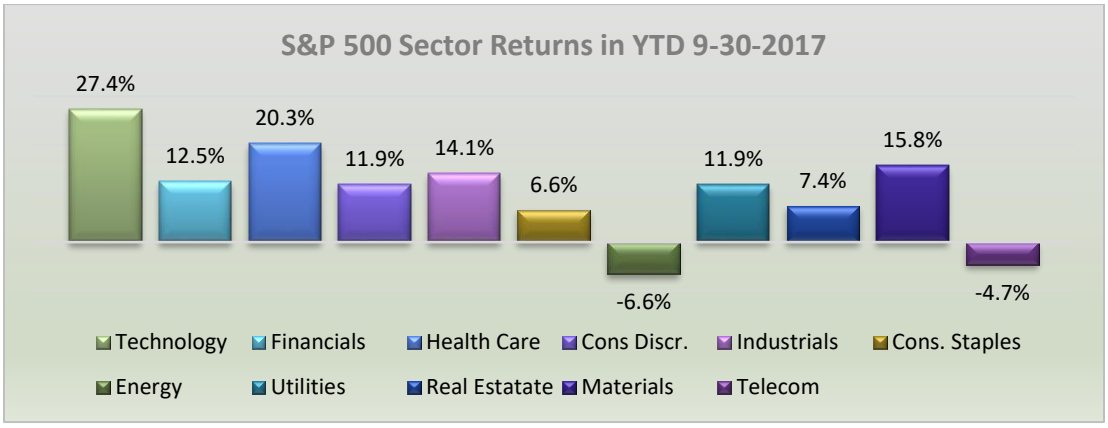
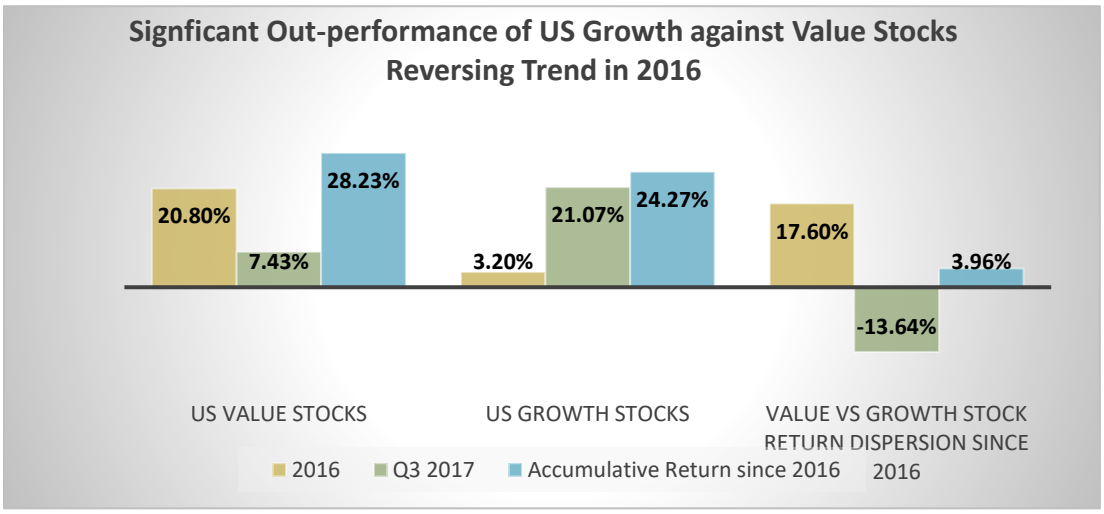
Songbird Capital Research

Market Commentary 3Q 2017

2017 3Q Market Reviews:

- **US Equities –** US equities continue the trend from the first half of 2017 with growth outperforming value, and international outperforming the US. At sector level, Technology had the best performance as of 9/30/2017, returning 27.4%, contributing 45% of the S&P 500 returns, followed by Healthcare, Materials and Industrials, returning 20.3%, 15.8% and 14.1% respectively. Energy and Telecom sectors were laggards, down 6.6% and 4.7% respectively.





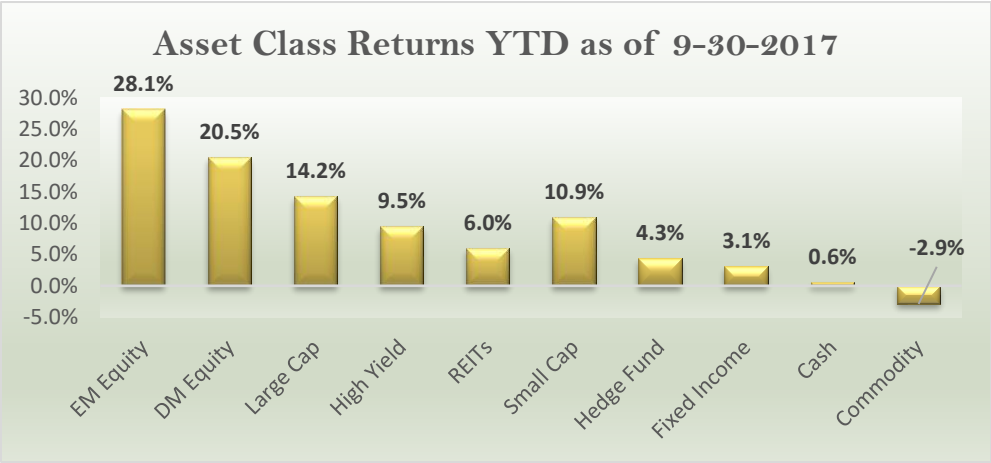
Data sources (two charts above): Standard & Poor's, JP Morgan AM, Morningstar and Songbird Capital

- As Songbird's year-end report pointed out that 17.6% out-performance of US value over growth stocks in 2016 set a stage for growth to outperform value stocks in 2017. As of the end of the 3rd quarter, investors have witnessed over 13% of out-performance of growth over value stocks across all caps in US equities. Our investors have benefited from growth oriented allocation decisions.

- **International equities** had strong performance led by emerging markets and Europe ex UK delivering 28.1% and 26.6% returns respectively year-to-date. The significantly outperformance against S&P 500 total return of 14.2% was partially due to US Dollar weakening against most international currencies. Within emerging markets, China had the strongest performance topping 43.4%. Both India and Brazil delivered 24.1% and 26.9% returns in dollar terms respectively. The continuing recovery, increasing political certainties in Europe, and strong fundamentals in most emerging markets supported strong rally in international equities.

- **Global fixed income –** Credit sensitive fixed income continues to outperform rate sensitive fixed income as the Global ex-US yield stays close to 1.06%. US bond aggregates returned 3.14% and US High Yield delivered 6.83% year-to-date. Currency became the biggest driver for international fixed income performance which is evident in the Global fixed income ex-US return of 8.2% and Euro High Yield return of 18.3% where returns were largely due to currency appreciation. Emerging markets local currency fixed income also benefited from declining yields and currency appreciation delivering 14.28% return year-to-date.

- **Alternative Investments** such as Hedge Funds, REITs and Commodities were muted as commodities prices moderately declined, and low volatility has been unfavorable for hedge fund strategies. As of September 30, Hedge fund index – HFRI Asset Weighted Composite only returned 4.3% year-to-date in 2017.



Data sources: Barclays, Bloomberg, Russell, Standard & Poor's, MSCI, NAREIT, Morningstar, Songbird Capital.
EM Equity (MSCI EME), DM Equity (MSCI EAFE), Large Cap (S&P 500), High Yield (Barclays Global HY Index), Small Cap (Russell 2000), Fixed Income (Barclays Aggregate) and Commodity (Bloomberg Commodity Index), Hedge Fund (HFRI Asset Weighted Composite)

Investment Outlook:

Is volatility coming? - As the US equity market has been hitting new highs recently, market volatility measured by VIX has been falling this year dipping below 10 in September and credit spreads are tightening. Some concern that the relative calm in the US equity market is unlikely to continue and the increase in volatility is inevitable.

Anticipated tax cut is driving the market in the short term - The US equity market is likely to be driven by tax cut proposal of the current administration in the near term. This propels momentum trades where the investors and corporations like Berkshire, hold on to winners in the portfolios and defer gains if they need to sell the stocks with large appreciation till 2018 when they can potentially benefit from the tax cuts, while the losers are sold to realize losses for tax loss harvesting purpose. Even Warren Buffett publicly offered his opinion on market impact by potential large capital gain tax cut in his recent interview with CNBC, Becky Quick. For anyone who is interested in the interview can refer to the link here. See the excerpt of the interview below:

Warren Buffett: "In Berkshire…, holding on potential sales and realizing losses" … "It doesn't happen very often that you're in the month October with a major tax act being a real possibility. Who knows whether it's a 20% chance, 50% chance? But one thing I know about it. I'll know the answer within a month or two. I mean, there are not than many days left to legislate. And I would feel kind of silly if I realized a billion-dollar worth of gains to pay $350 million of tax on it if just waited a few months and would have paid 250. Now, if enough people are doing that, that may mean that the market's being affected fairly substantially."

Warren Buffett: "…It will tend to depress stocks that behaved badly because people are taking losses now. And It would tend to defer gains, and reduce sellers currently that would be in stocks with very large appreciation."

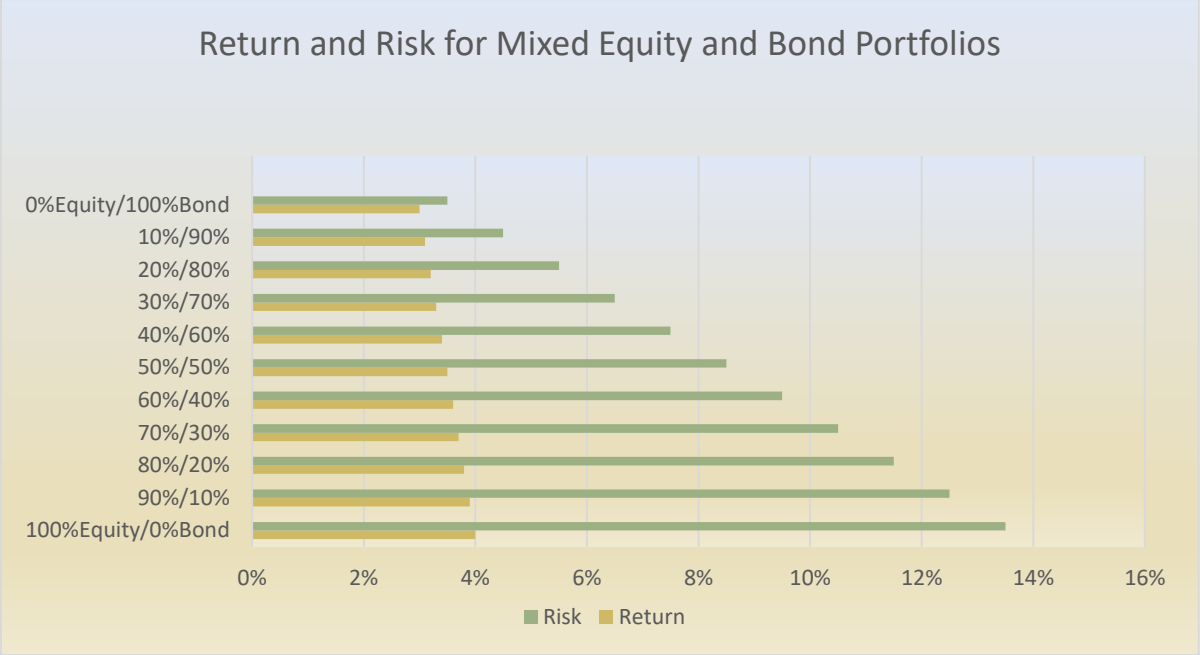
Maybe this is once in life event. But I would agree that it is a natural course that investment managers including me should consider taking to maximize potential benefits for clients' portfolios.

Long-term Outlook - Instead of attempting to forecast near term market movements, I would extend the investment horizon and scopes by focusing on future returns and risk premium as parameters to structure portfolio, and explore the possible scenarios of market shifts taking place.

Vanguard founder Jack Bogle recently provided his intuitive view on US equity return and risk premium, which he believes that in the next decade the US equity is expected to have an annualized return of 4% and US Bond 3% return per annum, which leads to only 1% premium for US equities over bonds. If his view holds, it means that for passive investors who buy and hold a portfolio with 75% equities and 25% bonds for the next 10 years will have return of 3.75% with 11% volatility while a portfolio with 25% equities and 75% bonds will deliver 3.25% return with only 6% volatility, which is half risk of 75% equity/25% bond

portfolio by giving up only 0.5% return per annum. For an actively managed portfolio, the fees most likely eat away the investors' returns.

You may agree or disagree with Jack Bogle's "reasonable expectations" on the future returns from US equities and bonds as he has a quite different approach to returns, which he breaks the sources of returns down into investment returns and speculative returns. The former comes from dividend yield and future earnings growth, which he estimated around 6% per annum. The latter is from valuation, which he believes will knock down 2% off from investment returns, which gets to 4% realized return in equities.



Data sources: Songbird Capital Notes: The chart is and based upon Jack Bogle's view on returns of US equity and bond in the next decade. It is for illustration purpose only.

In the past 10 years, the speculative returns measured by S&P 500 P/E ratio has expanded from 10x to over 20x, which added 7.5% additional speculative returns from multiple expansions per annum for investors. This will unlikely happen again in the next 10 years. Given the current valuation level, equity market will be vulnerable for slowing future earnings growth. Bogle's estimates have taken these risk factors into consideration and discounted the current Price/Earnings (PE) multiples to historical average. It is rather an intuitive approach, but I believe it is quite an effective approach to understand shifting dynamics between the risk and return among asset classes when constructing a portfolio**.**

I believe that investment managers like Songbird Capital that have institutional experience in portfolio and risk management, and is specialized in asset allocation across multiple asset classes, strategies and managers, will provide more valuable services for our investors. Songbird's competitive fees in the industry always helps our clients to keep more along the way. (See Songbird fees against industry average and "Savings from fees compounded over 20 years" on our website) .

Sincerely Yours,

Jie Hayes / Principal of Songbird Capital

Disclaimer:

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