HIGHLAND

CAPITAL MARKETS QUARTERLY
FOURTH QUARTER 2016

THE WORLD IN 3-D

HIGHLIGHTS:

- In an economic setting that is beset with geopolitical fears, it becomes more important to understand how shifts in politics can affect financial markets. In this environment, investors cannot simply rely on investing in broad geographic markets to generate returns. The framework to achieve success is viewing the world's opportunity set in 3-D: Decode and Deconstruct to Deliver Value.

- Investors must be more intentional in garnering their investment exposures. This may involve focusing on certain factors, countries or industry exposure to achieve higher returns.

- There remains a lot of uncertainty with the new U.S. administration's economic and trade policies which can have overarching effects on industries, thereby separating the winners from the losers. Furthermore, some of these policies could result in higher inflation if there is no corresponding increase in business productivity.

The loser of Super Bowl 50, the Carolina Panthers, was the natural pick from the football experts to return to the Super Bowl the next year. By contrast, the Panthers' hated rival, the Atlanta Falcons, were given 50-to-1 odds to make it to the big game the next year. On February 5th, the Falcons will play in their second Super Bowl in franchise history while the Panthers didn't even make it into the playoffs. With so many factors in play, it is not uncommon for experts to miss their mark.

The art of investing also requires careful examination of many variables, which by their very nature are extremely unpredictable. For this reason, successful investors set up frameworks for making decisions instead of focusing on outcomes. By doing this, investors can succeed even when change is unforeseen. This past year was a turbulent year for the markets, filled with numerous twists and turns. Investors had to interpret many different events and outcomes in order to generate returns needed to meet long-term goals.

FEDERAL RESERVE RATE HIKE

In late 2015, the Federal Reserve ("Fed") raised interest rates for the first time in nine years. This announcement was a foregone conclusion, but what was important was the Fed signaling to the market they expected four interest rate hikes in 2016. Highland's belief was that structural forces, such as high debt levels, aging workforces, and low yields globally, would keep a ceiling on how high rates could move. We expected the Fed to move much slower than its notorious "Dot Plot" suggested, which is exactly what happened with only one rate increase in 2016 (see *Capital Markets 4Q15*). Even though the Fed continued throughout the year to reiterate multiple hikes, Highland stayed the course, as we saw no evidence of a reversal of the "***Triple L***" (***low*** growth and ***low*** yields for a ***long*** time) environment (see *Figure 1*).

INVESTING FOR THE TOTAL CLIENT

- *Investment services*
- *Reporting services*
- *Business services*

ABOUT OUR FIRM

Highland Associates, Inc. is an independent institutional investment advisor headquartered in Birmingham, Alabama. Highland was founded specifically to help develop, implement and maintain investment management programs for institutions. We serve a national client base of investors including not-for-profit healthcare organizations, foundations, endowments, defined benefit plans, defined contribution plans, and high-net worth individuals. As of September 30, 2016, we serve as investment consultant on approximately $19 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

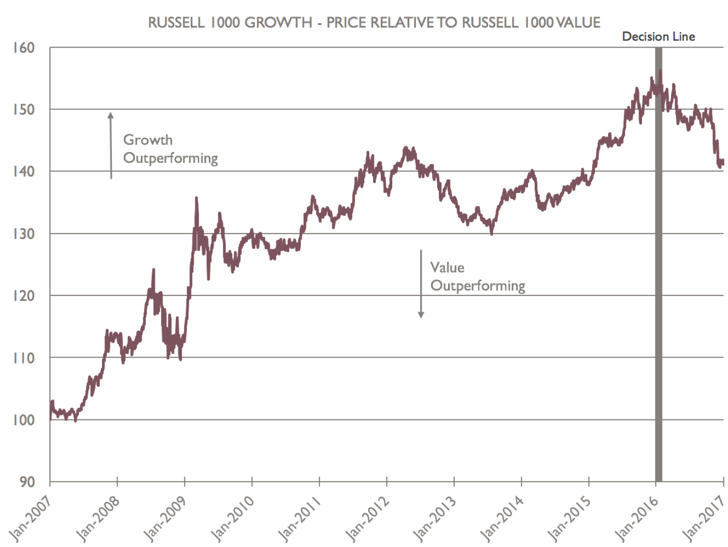
FIGURE 1

SOURCE: FACTSET; HIGHLAND ASSOCIATES; U.S. 10-YEAR TREASURY YIELDS INDEXED TO 100, CALENDAR YEAR 2016

VALUE OVER GROWTH BIAS

Growth stocks were experiencing the longest period on record of outperformance over value stocks. We noted that amid rising Fed policy, along with depressed commodity prices, that value stocks should outperform growth. We positioned portfolios for a value bias with a quality tilt (see *Capital Markets 2Q16*). During the year, value stocks outperformed growth stocks by a wide margin due to their higher allocation to cyclical sectors, such as industrials, financials, and energy (see *Figure 2*).

FIGURE 2

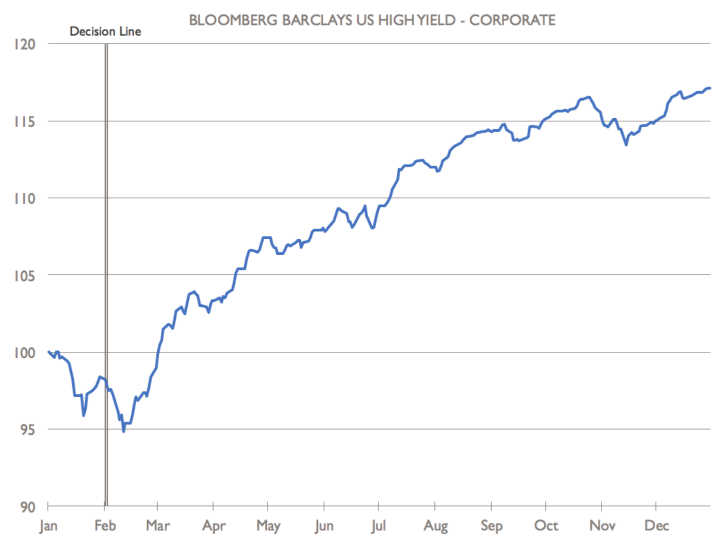


SOURCE: FACTSET; HIGHLAND ASSOCIATES; INDEXED TO 100: INCREASING INDEX SIGNIFIES RUSSELL 1000 GROWTH OUTPERFORMING 1000 VALUE WHILE INDEX DECREASING IS VALUE OUTPERFORMING VALUE

HIGH YIELD BONDS

The signaling of higher rates by the Fed along with a substantial decline in commodity prices set off a chain reaction whereby credit spreads widened, bond yields dropped, equity markets fell, and the U.S. dollar strengthened. As high yield bonds began to trade at distressed levels, these bonds became very illiquid. Although the expected return on high yield bonds looked attractive, Highland was apprehensive about the illiquidity in these bonds and worried that an increase in defaults and downgrades could cause contagion in other areas of the market. We recommended a wait-and-see approach and felt it best to either invest in investment-grade corporate bonds or distressed hedge funds (see *The State of High Yield*). While we did not participate in the high yield rebound, the exposures to distressed debt private markets did provide some upside to our clients (see *Figure 3*).

FIGURE 3

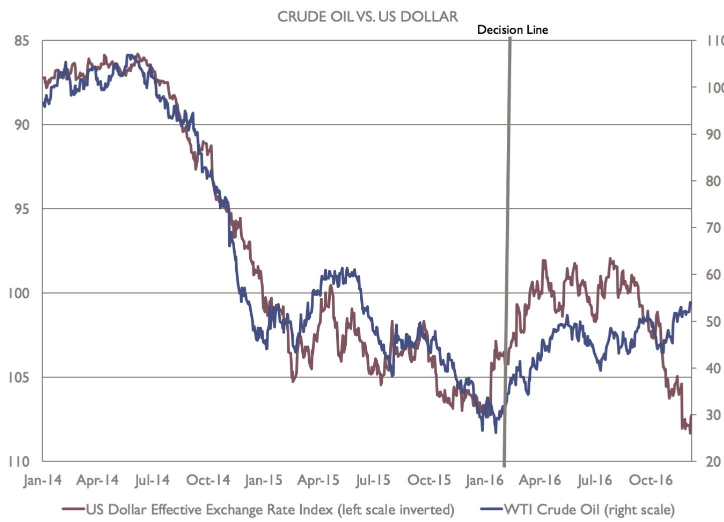


SOURCE: FACTSET; HIGHLAND ASSOCIATES; BARCLAYS U.S. HIGH YIELD INDEXED TO 100, CALENDAR YEAR 2016

ENERGY REBOUND

The U.S. dollar weakened in February 2016 (see *Figure 4*), and risk assets such as commodities, equities, and high yield bond prices rallied. While oil prices bounced off their lows, there was still some concern that prices would revisit these levels due to the excess supply from North American shale producers. In March 2016, we wrote that in light of a shift in the supply and demand equilibrium, we expected oil prices to be range-bound in the $40-$50 range, which is where they ended the year (see *New Oil Era*). Our thesis centered on the adage "The cure for low prices is low prices." As we moved through the remainder of the year, the price of oil did not drift lower, supported by lower U.S. production and the Organization for Petroleum Exporting Countries ("OPEC") and Russia agreeing to a cut of over 1.5 million barrels/day.

FIGURE 4



SOURCE: FACTSET; HIGHLAND ASSOCIATES; CRUDE OIL – RIGHT SCALE AND U.S. DOLLAR – LEFT SCALE AND INVERTED

NEGATIVE INTEREST RATES

During the first quarter of 2016, Japan instituted a negative interest rate policy while Europe moved its rates further into negative territory. Many central bankers believed this new type of accommodative policy could be the remedy their struggling economies needed to jump-start growth. Highland believed that this new policy would eventually fail because it ultimately hurt the banking system, which is vital to their economies. The banking system is the primary means of distributing credit to businesses and consumers, unlike in the U.S., which relies more on the capital markets. Ultimately, the policies did more harm than good as banking profits were negatively impacted by a flattening yield curve (see *Capital Markets 2Q16*). The market reaction was that bank shares were severely punished. Additionally, the movement to negative interest rates in Japan had the unintended consequence of pushing real interest rates higher, resulting in the Japanese yen strengthening (the exact opposite of what Prime Minister Abe desired), further depressing Japanese profits.

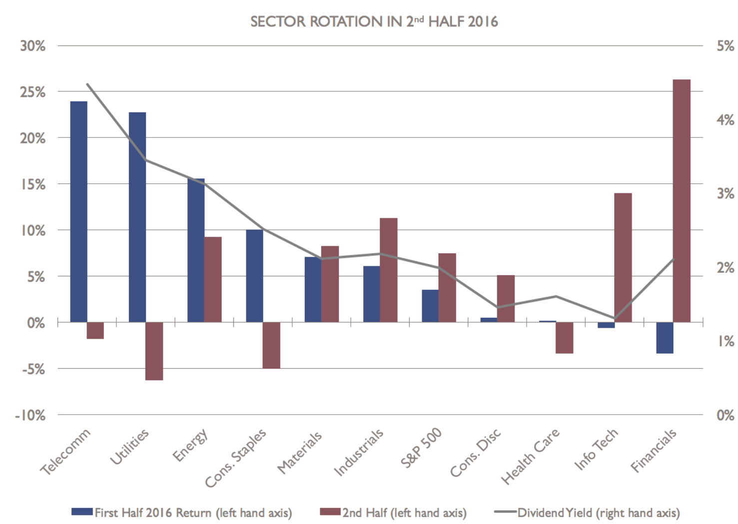
RETURN OF ALPHA - HEDGE FUNDS

In early summer, many investors had lost faith in investing in hedge funds. Highland took the opposite stance and noted that hedge funds remain a viable portion of an investment portfolio (see *Hedge Funds Still Viable*). Our approach involves pursuing alpha through portfolio construction and targeting managers who can generate returns in any market environment. We recommended adding more event-driven and credit exposures due to these markets being more inefficient and ripe for outperformance. Since May, these indices have been up over 9%, beating global equities with less volatility.

YIELD-SEEKING BEHAVIOR

In late summer, we cautioned that bond proxies, or low-volatility sectors with higher yields, had become expensive (see *Newton's 1st Law*). Investors were buying these stocks based on current dividend yields and were disregarding fundamentals. We labeled this phenomenon the "yield fad" and remarked that, like other fads, it would eventually subside. These sectors were the best performers in the first half of 2016. However, when the 10-year U.S. Treasury bond yield reached its low of 1.36% in early July and began moving higher, these sectors experienced weakness as we predicted. As we finished out the year, cyclical sectors such as industrials, information technology, and financials had the strongest returns (see *Figure 4*).

FIGURE 5



SOURCE: FACTSET; HIGHLAND ASSOCIATES

BREXIT

The beginning of the unwind of the yield trade had its roots entrenched in one of the biggest surprises of the year. In June, the United Kingdom ("U.K.") voted to leave the European Union. We expected the vote to be close, but ultimately believed the polls and prognosticators that forecast the U.K. would remain (see *Capital Markets 3Q16*). The masses had reached a boiling point, and populist ideas were leading the day. It was not until we could view it through the lens of the anger that simmers in a low-growth world that we were able to understand the far-reaching consequences. In a backdrop of stagnant economic growth and high political uncertainty, we must expect the unexpected. Events that were once thought impossible, such as a founding member of the European Union voting to leave the bloc of nations, were now a reality. Whenever the markets are surprised by an outcome, they initially overreact and move much more than is probably warranted. In the wake of the outcome, the U.K. pound sterling fell to its lowest level in over 30 years, the U.S. 10-year Treasury yield declined over 30 basis points, and equity markets fell as much as 10% in some countries. However, once the market digested the news, equity and bond markets recovered. Even so, the winds of change were in motion as the populism mantra was gaining steam.

ELECTION OF TRUMP AND HIS POLICIES

The final shock of the year was the election of Donald Trump as the 45th President of the United States. We did not formally call the winner of the election but did note that the scales had shifted from capitalism to populism (see *Capital Markets 3Q16*). President Trump was elected because of his outsider status from Capitol Hill and his promise to challenge the status quo and enact significant structural changes. His pro-America rhetoric resonates with the disenfranchised who believe they are worse off due to trade and immigration policies.

As the President's economic and foreign policies begin to take shape, some aspects of his proposed platform appear beneficial for growth while others are less positive. To date, the market has fixated on his pro-growth policies:

- De-regulation of industries
- Infrastructure spending
- Defense spending
- Tax reform

In our 3rd quarter commentary we noted that Trump's policies of higher fiscal spending, tax reform, and deregulation would initially benefit equities, which is what has occurred. U.S. Large and Small Cap equities were up 5% and 14% since election day, respectively. The idea of less regulation and lower taxes has resulted in the Small Business Optimism Index surging to its highest level in 12 years. In addition, other indices suggest that CFOs are more willing to hire and invest and CEOs more confident in the business outlook. The election of Trump and his pro-business mantra has ignited "animal spirits" in investors.

On the discussed infrastructure spending, the nation appears poised to invest; however, there remains uncertainty as to how many "shovel-ready" projects exist at present. The important factors to watch are not just the investment in infrastructure, but how productive the investments will be. If this spending is just a misallocation of capital, then inflation will increase and we will see no real economic benefit.

Additionally, an increase in fiscal spending when inflation was negligible and the unemployment rate was higher would have been more beneficial. Although we believe a stimulus package is an important step to garnering more business investment and increasing productivity, the threat of higher inflation also increases.

Despite these near term positives, the following policies give us pause:

- Protectionism
- Tariffs
- Stricter immigration

These policies ultimately lead to lower real growth and higher inflation. Many of Trump's top cabinet appointees are focused on stricter rules with America's trading partners. His head of the National Trade Council, Peter Navarro, has written two books on the coming trade wars with China. Navarro has stated that China is effectively waging an economic war by subsidizing exports to the U.S. and impeding imports from the U.S. If the U.S. were to reduce trade with China and other lower-wage countries, then the U.S. consumers would pay through higher prices for goods and services. Some of the policies, such as tariffs on goods, could result in retaliation from other countries. This shift toward protectionist policies is also coming at the same time that the world trade growth rate hit its lowest level since the financial crisis. Declaring a trade war would result in waning economic confidence and could push countries into a worldwide recession.

HIGHLAND VIEWPOINT: WHERE DO WE GO FROM HERE?

In an economic setting that is beset with geopolitical fears, it becomes more important to understand the overall trends in behavior and the ramifications if they persist in the future. We have written extensively about the ***"Triple L"*** Environment, and this past year's events were a consequence of what happens in a low-growth world. Voters in the U.S. and the U.K. loudly exclaimed that they believe the government and its policies should do more. As we move into 2017, we are witnessing that this is the first time since the global financial crisis that all the largest countries are providing both monetary and fiscal stimuli. The outcome of this coordinated approach is that bond yields likely bottomed in 2016, and the path of least resistance going forward is higher.

The U.S. equity market has been the best performer since the crisis, but margins are at historic highs and certain segments of the market are quite pricey. Abundant liquidity and the search for yield have pulled several years of returns forward. In the short-term, emerging markets will be impacted by the pro-America approach from Trump, but over the long-term emerging markets are expected to generate higher earnings due to better demographics and developing markets. Based on this global backdrop, Highland prefers a global equity approach versus domestic only.

Furthermore, we continue to favor value over growth stocks, as these are more closely tied to economic growth. Lastly, we prefer an All-Cap equity approach, as the smaller stocks will benefit more from less regulation and lower taxes, as their sales and earnings are more domestically focused.

With macroeconomic factors driving the market and impacting companies' earnings prospects going forward, investors must not rely on what has worked in the past. The playbook has changed, and investors searching for returns must look at the world's opportunity set in **3-D**: ***Decode*** and ***Deconstruct*** to ***Deliver*** value. In this environment, simply investing in broad geographic markets will not work. The policies that are being instituted are going to separate the winners from the losers. Certain industries will benefit more from deregulation and a more U.S.-centric approach. In addition, specific countries will be negatively impacted from the stance of the U.S. It is still vital to build cycle-resilient investment portfolios that can outperform in any environment. As we move forward, investors must peel back an additional layer within some asset classes in order to generate necessary returns. This can involve investing in more single deals in private markets versus large funds, targeting certain factors in equity, and being more intentional with the exposures overall. By taking a more micro view, investors can avoid the areas with higher downside risk and commit capital to the ones that should benefit from this new era of nationalism and populism. Instead of relying on unforeseen outcomes, we believe this framework will lead to success going forward.

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