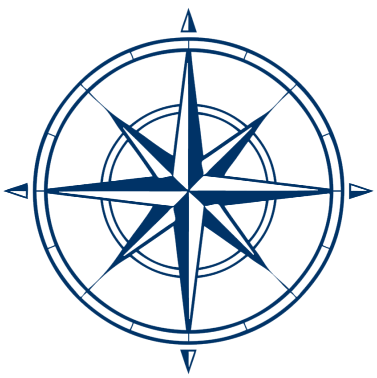
CAPITAL MARKETS QUARTERLY
SECOND QUARTER 2017

NAVIGATING TODAY'S MARKETS



Earlier this summer our Chief Investment Officer was hiking in a remote region of Yellowstone National Park with his family. Initially, the path they ambled along was wide and easy to navigate. As they trekked farther into the woods, they began to lose their bearings and found themselves lost. There was no cell phone service, but fortunately they had their trusty compass to provide direction.

Sometimes the markets can act in a similar manner. Lately, the path has been wide and easy to navigate, as markets have been trending upward due to global coordinated monetary policy. Yet, as we journey farther into this expansion and look toward the second half of 2017 and into 2018, what direction should we turn? Are markets diverging? It is important to recognize when the market is pivoting and to understand where the risks and opportunities lie. Investors must have a compass or framework to navigate these markets and avoid letting the short-term noise cloud the path to reaching the long-term objective.

Highland's capital markets framework is a four-pronged approach that analyzes fundamentals, relative value, momentum, and the economic regime (***see Figure 1***). The fundamental approach emphasizes forecasting the building blocks of return through a long-term lens. A sample list of these drivers could include the following:

- Current cash flows
- Future growth
- Purchase price

We compare the current levels of these key drivers to history with an eye toward identifying extremes and/or changes in trends. We also evaluate whether there are certain factors that could drive these changes; for example, how could peak profit margins threaten current levels of earnings growth? We then monitor our expectations and compare them to actual performance to assess our results.

FIGURE 1

FUNDAMENTALS
Highland's long-term capital market asset class expectations are based on a fundamental approach. We examine the underlying drivers of return over time: cash flow, future growth, and current price. The output determines long-term expected returns for each asset class.

RELATIVE VALUE
Based on our long-term expected returns, we allocate capital based on the attractiveness of each asset class relative to one another and to its own history.

MOMENTUM
To tactically allocate between the sub-asset classes, we incorporate a momentum overlay. We evaluate the relative strength of an asset class to determine positive or negative momentum.

ECONOMIC REGIME
The state of the global economy frames all asset allocation discussions - both short-term and long-term.

SOURCE: HIGHLAND ASSOCIATES

INVESTING FOR THE TOTAL CLIENT

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

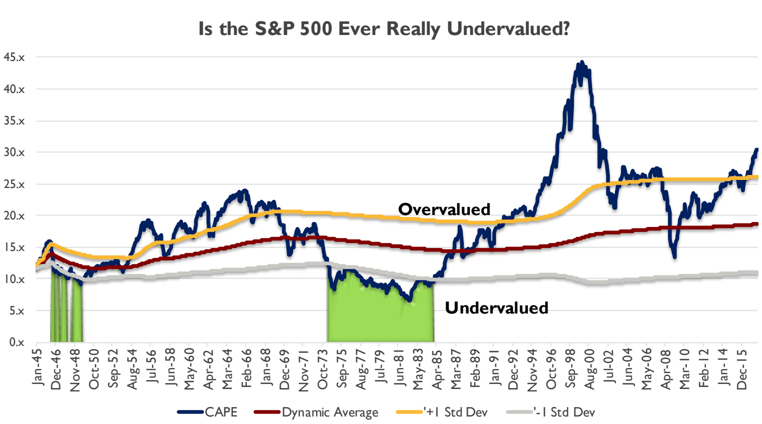
ABOUT OUR FIRM

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 and defined contribution plans. As of March 31, 2017, we serve as investment consultant on approximately $20 billion in assets. Please visit the website at www.highlandassoc.com to learn more.

The next step is to review the relative attractiveness of each asset class compared to one another and to its own history. This is not just analyzing the return but also considering the risks associated with the return, such as volatility and potential drawdowns. We then rank order the asset classes and strategically overweight the most attractive and underweight the least attractive. Take fixed income as an example of our process. Based on our assessment of low yields begetting lower future returns, fixed income, from a rank order perspective, has the least amount of return potential. From a strategic standpoint, we have been underweight fixed income since August 2009. We do believe that a relatively small allocation to fixed income is appropriate, as it serves as a safety asset during market extremes.

It is the fundamental approach that is the long-term backbone of our process. We understand that fundamentals take time to manifest. They are helpful for explaining long-term performance but are not as effective in the short-term. For instance, look at the cyclically adjusted price-to-earnings (CAPE) of the S&P 500 over time (see ***Figure 2***). Since 1900, the S&P has only been undervalued 24% of the time. If we look at this same metric since 1980, then the market has only been undervalued 13% of the time. This is because of the long-term upward drift of valuations. The average CAPE of the S&P 500 since WWII is 18.7x, whereas the average since 1990 is 25.4x. If we waited to invest when the market was undervalued, then we would miss out on some significant gains in the market.

FIGURE 2



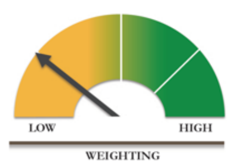
SOURCE: SHILLER; HIGHLAND ASSOCIATES; CAPE: CYCLICALLY ADJUSTED PRICE TO EARNINGS RATIO; SHADED AREA DENOTES PERIODS S&P WAS UNDERVALUED

The way we bridge the gap between the long-term fundamental view and the short-term is by employing momentum. We use this system to over- and underweight sub-asset classes, such as U.S. vs. International Developed vs. Emerging Markets equities. By reviewing the sentiment and momentum of different sub-asset classes, we can tactically allocate to areas that have stronger momentum and underweight areas with weaker momentum. We are not attempting to time the market, but we are looking for sustained signs of momentum to confirm the trend. This allows us to avoid being whipsawed by the market and control for risk.

Lastly, we analyze the economic regime that serves as the backdrop for the global markets. Highland reviews the long-term drivers of economic growth, such as labor force growth and productivity. We scrutinize current levels of economic growth and evaluate items such as business surveys, consumer spending, confidence, business investment and capital expenditures, etc. We look for catalysts that could impact structural economic forces, such as tax reform or deregulation. The real emphasis on this approach is determining exactly what kind of regime we are in because economic cycles vary and certain asset classes tend to outperform in specific market environments.

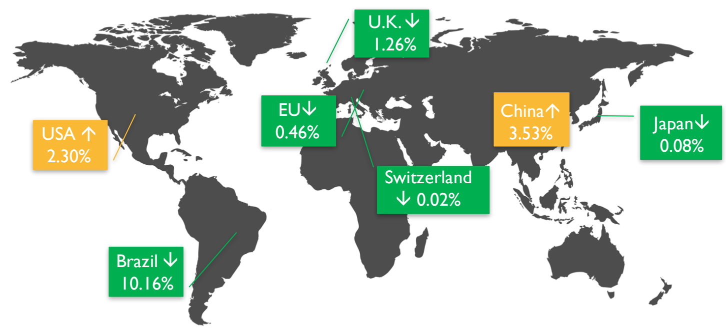
It is the long and short-term view of the market that drives our capital markets process. Using this approach, let's get out the trusty capital markets compass to help us navigate the changing terrain.

CASH AND FIXED INCOME



We continue to live in a low interest rate world. Despite the Federal Reserve's recent increases, $9.5 trillion of negatively yielding global debt continue to suppress yields in the U.S. In total, central banks are expected to purchase $2 trillion of assets this year, keeping a ceiling on yields. U.S. bonds will continue to be in high demand due to the yield advantage over European and Japanese bonds (see ***Figure 3***). Currently, one of the biggest drivers of bond yields in the U.S. is bond yields in Europe and other developed countries. Over the past 12 months, the movement in the German 10-year bund explains close to 90% of the movement in the U.S. 10-year yield. Yields will remain low unless this relationship changes. In his latest press conference, European Central Bank (ECB) president Mario Draghi stated that unwanted tightening is the last thing the ECB wants. This implies that extraordinarily easy monetary policy will remain in Europe for the foreseeable future.

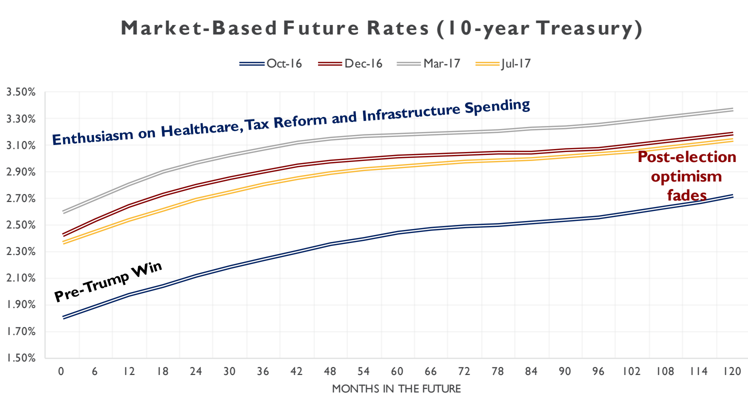
FIGURE 3



SOURCES: HIGHLAND ASSOCIATES; 10-YEAR YIELD SHOWN AS OF JUNE 30, 2017; GREEN DENOTES REGIONS WHERE CENTRAL BANKS LAST MOVEMENT WAS TO LOWER INTEREST RATE; YELLOW DENOTES REGIONS WHERE CENTRAL BANKS HAVE RAISED INTEREST RATES, BUT THE PATH IS GRADUAL COMPARED TO HISTORY

Low U.S. inflation will keep rate hikes very gradual and significantly lowers the odds of the Fed hitting its long-term Fed Funds target of 3.25%. Some Fed members have publicly questioned whether the long-term target is too high. Furthermore, when we compare the 10-year U.S. Treasury forward curve (see ***Figure 4***), market expectations have declined since Trump's election. Many of the factors that pushed the forward rate higher, such as expected tax reform and infrastructure spending, have not materialized. With low inflation and easy global monetary policy as a backdrop, Highland remains underweight fixed income.

FIGURE 4



SOURCE: HIGHLAND ASSOCIATES

EQUITIES

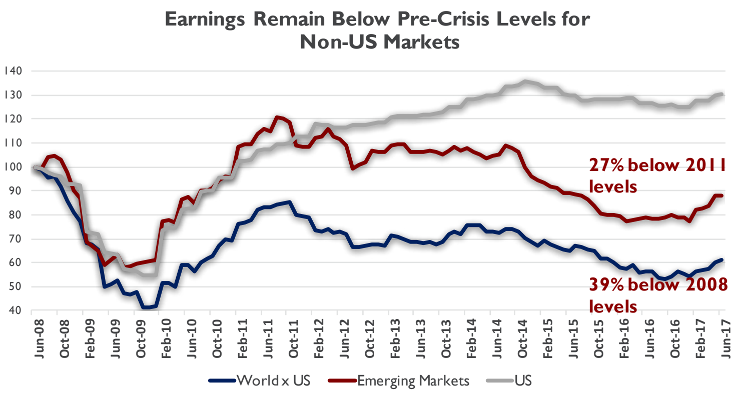
U.S. equities have continued their strong performance as earnings growth has been robust. Valuations, which were already elevated, keep rising. There are also some concerns about economic growth slowing. The International Monetary Fund recently downgraded its forecast for economic growth in the U.S. based on the assumption that fiscal policy will be less expansionary than previously assumed, in light of the uncertainty around timing and nature of policy changes. The market expected that a Republican-led Congress and President would pass healthcare or tax reform this year. We are now six months into Trump's term and there have been no signature legislative accomplishments.

Yet, U.S. equities are benefiting from a relatively steady, synchronized global expansion. Manufacturing activity has reaccelerated and become more broad-based, boosted by strengthening global demand. If the U.S. were to get some type of tax reform, then U.S. equities would have another tailwind to push them higher.

International markets have also witnessed strong equity performance, handily beating U.S. markets this year. Europe has consistently delivered positive surprises on economic and higher earnings growth. Markets in Europe rallied on French President Macron's overwhelming election win and desire to more closely unite the European Union. A stronger Euro and weaker dollar also buoyed returns for non-U.S. assets. From a fundamental perspective, both emerging and developed international markets have lower valuations relative to U.S., which have witnessed a steady increase over the past eight years.

Earnings growth has more room for improvement in emerging and foreign markets where earnings remain below 2007 levels (see ***Figure 5***). The market is expecting this gap to narrow as consensus 2017 forecasts for Europe and emerging markets are 12% and 20%, respectively. As we outlined in a recent paper "***Investors Without Borders, Part II***," cheaper valuations overseas and depressed earnings growth compared to history for the U.S. are why we favor a global approach within equities.

FIGURE 5

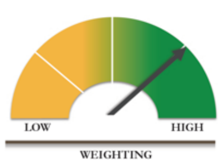


SOURCES: FACTSET; HIGHLAND ASSOCIATES; TRAILING 12 MONTHS EARNINGS PER SHARE INDEXED TO 100

Although both international and emerging markets are exhibiting signs of improvement, there are still some areas that give us concern. In Europe, there's the uncertainty around BREXIT and whether Macron can deliver on his promises. In the emerging markets, there is uncertainty with impeachment of Brazilian President Temer as well as the threat of tariffs in China and Mexico.

For now, we find no compelling reasons to be over- or underweight certain regions. We favor both emerging and developed international markets over the long-term, but we need to see more confirmation before overweighting these areas of the market. The movement in the U.S. dollar will be a key indicator for us to monitor.

ALTERNATIVE STRATEGIES

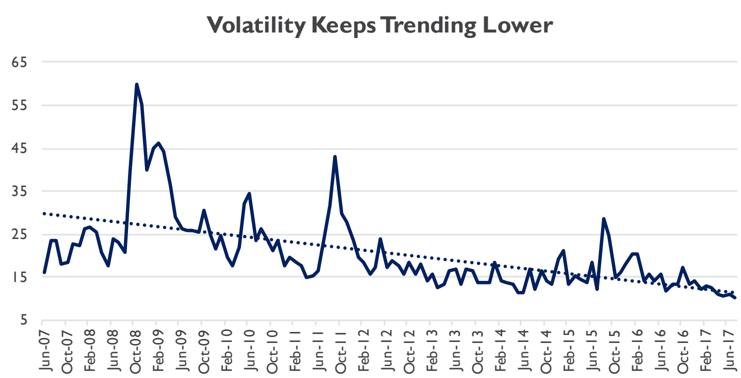


Highland looks at alternative strategies in two distinct categories. The first category, diversified alpha strategy, is more liquid and primarily provides return through structural and informational advantages in public markets. For additional information on the portfolio construction, please read "***Conformists, Rebels, and Realists: Are Hedge Funds Still Viable***." Diversified alpha strategy remains a key allocation within client portfolios, especially compared to low-returning fixed income. The portfolio construction is designed to provide a diversified return stream that is not tied to either equity or fixed income. This is accomplished through hiring strong managers who are investing based on idiosyncratic or company-specific risks and less on market risk.

One of the main goals of our diversified alpha strategy is to target high single digit returns with a controlled volatility profile. Over the last 12 months, this portion of the portfolio has generated double digit returns with very low exposure to the market. This is during a period in which market volatility has been very low (see ***Figure 6***). Since 1990, the VIX index has had five months in which the VIX has averaged lower than 11. Three of those five months have occurred in 2017. If volatility were to creep up in response to a geopolitical or economic event, then this part of the portfolio would be expected to outperform.

Within diversified alpha strategy, we continue to prefer investments that can take advantage of disruption within traditional banking systems. This involves investing in niche, technology-driven consumer credit strategies. We are also allocating toward more distressed for control event-driven strategies where returns are centered on company and security-specific catalysts as opposed to overall market risk.

FIGURE 6



SOURCES: FACTSET; HIGHLAND ASSOCIATES; CBOE VIX INDEX

The second category of alternative investments is our opportunistic sleeve, which involves private debt and equity strategies. Our preference is to shy away from large private equity buyouts where valuations are at extreme highs. The median Earnings before Interest, Tax, Depreciation, and Amortization (EBITDA) multiple paid in 2016 private equity buyouts was 11x, which is close to all-time highs experienced in 2007. Our focus is on allocating toward strategies with higher income streams, thereby limiting the downside. The overall yield in direct lending to middle market companies is approximately 10%. Since these are floating rates, as rates rise, the income yield increases as well. For investors who can take on the illiquidity risk, we believe allocating toward opportunistic is prudent in achieving long-term returns, especially considering this lower yielding environment.

INFLATION-SENSITIVE

From a long-term perspective, we continue to allocate toward inflation-sensitive strategies to protect the purchasing power of all client portfolios. Our focus is on building a portfolio that is sensitive to the rate of change in inflation and not just the level of inflation. We believe that approach allows our clients to earn a real rate of return and ultimately add to the purchasing power of the organization, whether that be a capital outlay or spending policy amount.

From a short-term perspective, inflation has been less of a concern. After inflation rose above 2% on both a core and absolute basis in March of this year, it has since fallen back to 1.7% as of its latest reading. The lack of fiscal packages in the U.S. as well as a supply glut of oil have been major factors. From a sub-asset class perspective, real estate remains a core piece of client portfolios. Its higher income component protects during inflationary periods, occupancy rates are high, and the amount of supply remains low compared to history. Another sub-asset with higher income streams is global infrastructure, which has benefited from investors' demand for yield. Global infrastructure dividend yield is more than 1% higher than equities and is less volatile due to its more predictable earnings stream.

Conversely, commodities have not performed as well as one would expect when growth is rising and the dollar is falling. This is a function of too much supply in many areas keeping prices lower. Even with OPEC's production cuts, oil and natural gas prices have fallen 15% since the beginning of the year. This is because oil demand in China has flattened while U.S. production is approaching its 2015 record of more than 9.5 million barrels a day. For these reasons, we are tactically overweight global infrastructure and underweight commodities.

HIGHLAND'S VIEWPOINT

It is both the long- and short-term views of the market that drive our capital markets approach and how we tactically shift portfolios. Over the last 12 months we have seen equities outperform and bonds return less than their yield. We may be seeing a change in leadership from U.S. equities to non-U.S. equities as inflows into these markets are outpacing U.S. by a wide margin this year. Yet, there is also a noticeable shift within broad asset classes. In equities, sector and equity correlations have declined precipitously since June of last year. Within bonds, credit is well outperforming Treasuries as spreads continue to tighten. As investors, we must look through broad markets to find value. It is this manner that drives our ***3-D*** approach to ***Decode*** and ***Deconstruct*** to ***Deliver*** Value.

Even in a low-growth, low-yielding world, there are opportunities out there. We are seeing these in small-cap international stocks, where earnings growth is well above large-cap multinational companies. Also as technology changes the ways of identifying mispricings in risk, we are investing in areas of the market that have historically been dominated by banks. It is this nimbleness and ability to invest in smaller opportunity situations that allow us to find higher alpha opportunities.

Investing with a mindset toward the client's long-term goals while taking advantage of short-term dislocations, we can more readily aid our client's investment experience. By utilizing our four-pronged capital markets approach as our compass, we are better equipped to follow the appropriate path in these uncertain times. The route going forward will not be as easy, but our framework should provide more clarity in a market that is constantly changing.

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