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As Volatility Looms, Non-Traditional Risk Assets May Offer Opportunity

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STANDISH
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In portfolios primarily allocated to government and corporate investment grade bonds, the familiar risk asset classes of equity, high yield and emerging market debt play indispensable roles by offering the potential for higher returns and diversification. However, we believe adding additional and less familiar varieties of risk assets may benefit investors. In particular, we believe that asset-backed securities and commercial real estate deserve consideration by investors seeking returns as well as protection from the volatility that will eventually return to financial markets.

A CHANGE IS GONNA COME

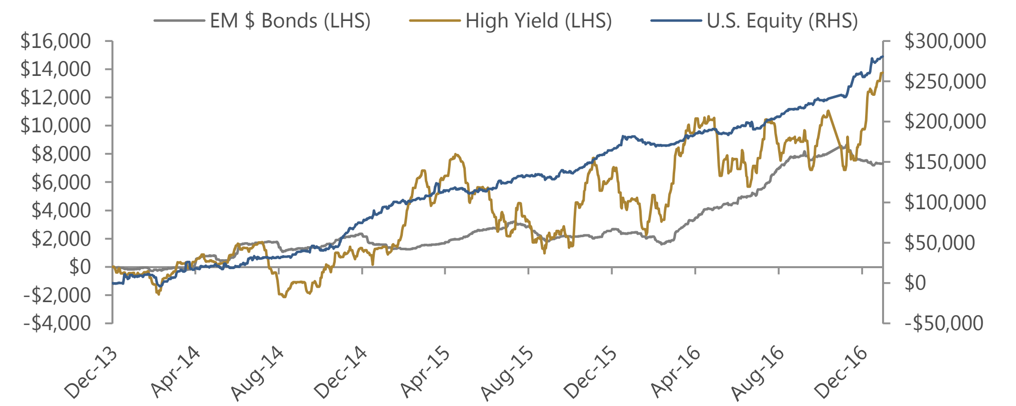
Since the global financial crisis, investors' ongoing search for yield in a low-rate world has spurred demand for these traditional assets, which has outpaced supply and driven their valuations up. Meanwhile, abundant liquidity from central banks' quantitative easing policies has helped keep volatility far below historical average levels. We caution investors not to expect volatility to stay abnormally low, nor to lose sight of the importance of the underlying fundamentals of equities and high yield and emerging market debt.

A look at those fundamentals reveals a mix of positive and negative characteristics that yield an investment view that is neither strongly positive nor strongly negative for these three risk asset categories taken together. For high yield, default expectations have declined since mid-2016, which is a positive development. Meanwhile, however, a rising dollar and the likelihood of increased trade tensions with the U.S. are creating headwinds for some emerging markets.

Despite their mixed fundamentals, valuations for the three asset classes have grown richer since the beginning of last year. While returns have been strong, investors are now receiving less compensation for owning these assets than they did a year ago. Valuations, either for industries or regions, appear only fair given the strong performance in spreads for most bond categories since the U.S. election. Only emerging market spreads have widened since the election, reflecting market concerns about potential shifts in the direction of U.S. trade, fiscal and monetary policy. Although some money has been flowing out of emerging markets, flows into equities and high-yield bonds remain positive and we believe this may remain the case for as long as another 6-12 months.

Investors who want to mitigate the volatility that will accompany this shift in the markets without prematurely reducing their exposure to risk assets and forsaking yield should consider diversifying beyond the three familiar categories.

Cumulative Flows Into Emerging Market Bond, High-Yield Bond and Equity ETFs ($ Millions)



Source: Bloomberg as of December 31, 2016

Investors, though, cannot chase yield rather than focusing on fundamentals forever and eventually the technical factors that have been driving markets will reverse, large quantities of securities will need to be unwound and spreads will widen. Investors who want to mitigate the volatility that will accompany this shift in the markets without prematurely reducing their exposure to risk assets and forsaking yield should consider diversifying beyond the three familiar categories.

ALTERNATIVES TO THE BIG THREE

The return and diversification benefits of equities, high yield and emerging market debt may also be found in lesser-known varieties of risk assets, including lower-quality auto asset-backed securities (ABS) and commercial real estate. Both not only have low correlations to the Bloomberg Barclays U.S. Aggregate Bond Index, but also to traditional risk asset classes. Commercial real estate is even negatively correlated to high yield and emerging market debt. While returns in these sectors are not necessarily higher than those of more traditional risk assets, we believe they offer lower overall volatility.

	Bloomberg Barclays U.S. Aggregate Bond Index	S&P 500 Index	Bloomberg Barclays U.S. Corporate High Yield Index	Emerging Markets USD Aggregate Index	BAML ABS Auto AA-BBB	Moody's National U.S. Commercial Real Estate
Traditional						
Bloomberg Barclays U.S. Agg Bond Index	1.00					
S&P 500 Index	0.03	1.00				
Bloomberg Barclays U.S. Corporate High Yield Index	0.22	0.73	1.00			
Bloomberg Barclays Emerging Markets USD Agg Index	0.55	0.61	0.81	1.00		
Non-Traditional						
Bank of America Merrill Lynch ABS Auto AA-BBB	0.17	0.29	0.55	0.39	1.00	
Moody's National U.S. Commercial Real Estate	(0.09)	0.16	(0.07)	(0.06)	(0.29)	1.00

Sources: Barclays POINT, Zephyr, September 30, 2006 – September 30, 2016

	10-Year Historical Std Dev
Bloomberg Barclays U.S. Agg Bond Index	3.22
S&P 500 Index	10.80
Bloomberg Barclays U.S. Corporate High Yield Index	9.60
Bloomberg Barclays Emerging Markets USD Agg Index	15.26
Bank of America Merrill Lynch ABS Auto AA-BBB	4.72
Moody's National U.S. Commercial Real Estate	3.32

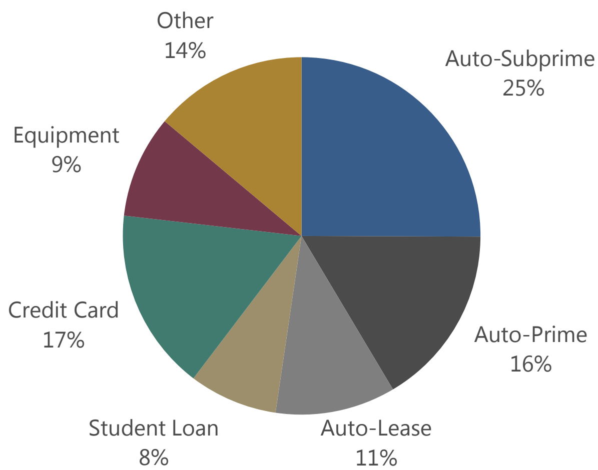
Sources: Barclays POINT, Zephyr, September 30, 2006 – September 30, 2016

ASSET-BACKED SECURITIES

ABS, as their name suggests, are securities backed by underlying collateral ranging from auto loans to credit card receivables to student loans. This asset class may carry a negative connotation for investors who remember the home equity fiasco that contributed to the global financial crisis. Today's ABS market is no longer focused on home equity, however. Instead, more than half of the bonds issued are backed by auto loans and leases and this is where we believe value exists for investors.

Despite capitalization rates having reached cyclical lows, commercial real estate continues to have value both from a fundamental and valuation standpoint.

Recent ABS Issuance



Source: Bank of America Merrill Lynch as of September 30, 2016

Auto-backed securities have multiple rating classes and typically short maturities of four years or less. This gives each investor the opportunity to allocate based on their acceptable risk and yield targets. In particular, we see value in the BBB- and BB- rated classes of ABS securities, especially when compared with spread levels for BBB and BB corporate bonds. Not only do their valuations appear attractive, the fundamentals and natural deleveraging of the sector are also appealing as the credit enhancement built into each deal is created with the expectation that it will grow over time.

COMMERCIAL REAL ESTATE (CRE)

Despite capitalization rates having reached cyclical lows, commercial real estate continues to have value both from a fundamental and valuation standpoint. CMBS issuance is well below where it was prior to the financial crisis and we expect new regulations to further limit issuance from traditional lenders and asset managers and the private market to fill the gaps in funding. Residential construction other than apartment buildings has remained relatively subdued and demand continues for retail, industrial and office space, suggesting that real estate valuations remain attractive. Given its negative correlations to other risk asset classes, allocating a portion of one's risk budget to CRE may help an investor achieve their target returns even when demand for equities and high yield bonds begins to wane.

CONCLUSION

By adding allocations to these unfamiliar but potentially worthwhile securities, we believe investors may be able to continue enjoying the benefits of risk assets while worrying less about what happens when equities, emerging markets and high yield inevitably fall out of favor and volatility rises.

Risks

General downturns in the economy could cause the value of asset-backed securities (ABS) to fall. In addition, asset-backed securities present certain risks that are not presented by mortgage-backed securities. Primarily, these securities may provide the fund with a less effective security interest in the related collateral than do mortgage-backed securities. Therefore, there is the possibility that recoveries on the underlying collateral may not, in some cases, be available to support payments on these securities. The value of investments that are concentrated in the securities of companies principally engaged in the real estate sector will be affected by factors particular to that sector and may fluctuate more widely than that of a fund which invests in a broader range of industries. The securities of issuers that are principally engaged in the real estate sector may be subject to risks similar to those associated with the direct ownership of real estate. These include declines in real estate values and defaults by mortgagors or other borrowers.

Main risks: Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. **Equities** are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. **Bonds** are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. **Management** risk is the risk that the investment techniques and risk analyses applied will not produce the desired results and that certain policies or developments may affect the investment techniques available to managing certain strategies.

Correlations measure the relationship between the changes of two or more financial variables in time. A drawdown is the peak-to-trough decline during a specific recorded period of an investment, fund or commodity. Price-earnings ratio is the current market price of a company share divided by the earnings per share of the company and is a means for measuring the value of a company relative to history or another company. **Standard deviation** is a measure of the dispersion of a set of data from its mean. If the data points are further from the mean, there is higher deviation within the data set.

Index Definitions:

Indices are unmanaged and are not available for direct investment.

Bloomberg Barclays U.S. Aggregate Bond Index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis.

Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks.

Bloomberg Barclays U.S. Corporate High Yield Index covers the universe of fixed-rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC-registered) of issuers in non-EMG countries are included.

Bloomberg Barclays Emerging Markets USD Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes fixed and floating-rate U.S. dollar-denominated debt issued from sovereign, quasi-sovereign and corporate EM issuers.

BofA Merrill Lynch AA-BBB U.S. Fixed Rate Automobile Asset Backed Securities Index is a subset of The BofA Merrill Lynch U.S. Fixed Rate Asset Backed Securities Index including all securities collateralized by auto loan receivables and rated AA1 through BBB3, inclusive.

Moody's Commercial Property Index measures price changes in U.S. commercial real estate based on "repeat-sales," or completed sales of the same properties.

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