

► 2Q 2016

Market Overview

THE VALUE MALAISE

Sometimes quarters produce events that so dominate global financial news, investor sentiment and market action that they become signposts in financial history. Black Monday of October 1987, the Russian debt crisis and collapse of Long-Term Capital Management in August/September 1998, Lehman Brothers bankruptcy in September 2008 are three of the most prominent. The surprise June 23 vote by the British people to leave the EU (“Brexit”) after a more than 40 year membership appeared as if it might be another. Global markets sold off sharply on the news, European stocks fell 9%, the S&P 500 fell 5% and financial media was filled with foreboding economic analyses that said Brexit would plunge the U.K. into recession, derail Europe’s grindingly slow recovery and weigh even on global growth. Yet global markets recovered as quickly as they fell when the main source of market strength since the 2008/2009 financial crisis — calming words from central banks — poured forth. The Bank of England said it stood ready to provide financial support and market liquidity after the surprise outcome and the ECB hinted at more aggressive QE moves in the Eurozone. The U.S. Federal Reserve also said it was ready to provide liquidity through swap lines with other central banks and it had previously noted that international developments are a factor shaping its interest rate policy. The shock vote also created speculation that other political or legal means could be invoked to prevent an actual Brexit; at quarter end, a British departure from the EU was seen as years away and confusion reigned about just what will happen and when.

Even in an internet age of non-stop news and nano-second attention spans it seemed remarkable how quickly the Brexit shock faded. By June 30 markets had recovered much of their losses and strength persisted into early July. For the quarter, the S&P 500 achieved a positive 2.5% return, the MSCI All-Country World ex-U.S. Index marginally lagged U.S. equities, returning -0.4% in dollar terms. Europe trailed the



Market Summary

- The flight to safety and quality inspired by Brexit volatility reinforced the ongoing theme — low to negative yields and global investors’ migration to U.S. markets in search of income.
- The U.S. dollar little changed in Q2, remaining above year-ago levels, but showed mixed performance against a variety of major currencies for both the quarter and trailing 12 months.
- Global markets were weaker than U.S. markets for the year, but on a relative basis, a low-volatility defensive trend was apparent.
- The global growth outlook remains weak. Real GDP for Eurozone expected to be only 1.6% for 2016. Japan’s outlook is even weaker as real GDP is estimated to be only 0.6% for 2016.
- Nevertheless, CBIS sub-advisers do not anticipate a global recession and Eurozone corporate earnings appear to be on an improving trend.

broad index slightly, but finished the quarter off only about -2.9% in U.S. dollars. Italy and Spain trailed Europe overall, returning -9.7% and -7.4% on concerns over solvency of their banking sectors, independent of Brexit developments. Germany was also a laggard, returning -5.0%. Local currency returns were slightly stronger given a 2.4% decline in the euro for the quarter. Japan, beset by its own macroeconomic struggles, managed a 1% gain but this resulted from an 8.1% appreciation in the yen. Emerging markets as a group returned about 1% in U.S. dollar terms, benefitting from a 26% gain in global crude oil prices — which ended the quarter at about \$47/barrel, nearly double the \$26/barrel February 2016 lows— and a near 13% gain in a broad basket of commodity prices.

U.S. equity market sector returns showcased persistence of a dominant theme of the past year, the strong performance of low volatility defensive companies that can produce steady (albeit modest) earnings gains in a backdrop of slow and fitful economic growth. Utilities (+6.8%), telecom (+7.1%) and healthcare (+6.3%) led S&P 500 sector returns along with energy (+11.6%), which added to Q1 gains on rebounding oil prices. Trailing one-year returns in the S&P 500 more strikingly display the dominance of low-volatility, defensive issues: utilities (+31.6%), telecom services (+25.1%), and consumer staples (+18.7%), where the tobacco industry gained +40.0%, all notably outperformed the Index's 4.0% overall return. Global markets were weaker than U.S. markets for the year, but on a relative basis the low-volatility defensive trend was similar; consumer staples (+10.5%), utilities (+0.3%), healthcare (-1.6%) and telecom services (-3.7%) led the developed market MSCI EAFE Index, which declined -9.6% for the year in U.S. dollar terms.

The flight to safety and quality inspired by Brexit volatility, and the outpouring of soothing words from central banks, reinforced in the bond markets the main theme that continues to shape bond returns — very low to negative global yields and global bond investors' migration to U.S. fixed-income markets in search of income. Indeed, in late June an astonishing range of European sovereign debt yields were in negative territory. Swiss government yields were negative out to the 20-year maturity, German bunds out to the 9-year point, Austria sovereign debt to the 8-year point, France to 7 years and even

Italian and Spanish sovereign yields were negative to the 3-year maturity. Thirteen European sovereigns joined Japan, whose government yield curve is negative to the 10-year maturity, in the negative yield club. According to Bloomberg, some \$10 trillion of bonds in the Bloomberg Global Developed Sovereign Bond Index had negative yields late in Q2.

The global hunt for yield and inaction during the quarter by the U.S. Federal Reserve, which has put further short-term rate increases on hold pending more consistent gains in employment data, drove U.S. yields down further. For the quarter, the yield curve flattened as rates fell 14 to 15 basis points across the 1- to 3-year segment and 20 to 33 basis points, increasingly from the 5-year to 30-year maturities. Yields have fallen more sharply over the past year, perhaps a surprising development from the perspective of the broad fears of rising rates that gripped investors in 2013. For the trailing year at June 30, yields for the 10- to 30-year segment of the curve are down more than 80 basis points, the 5-year is down over 60 basis points and the 3-year down 30 basis points. At June 30, the U.S. 10-year Treasury yielded only 1.47% and the 30-year bond only 2.28%. Credit spreads remained well off than their highs reached in February 2016 when global growth fears and risk-off sentiment roiled markets; spreads fell slightly further in Q2

The Barclays Capital Aggregate U.S. Bond Index returned 2.21% in Q2. Corporates led bond market returns, both investment grade (+3.6%) and high-yield (+5.5%). Mortgage-backed (MBS) and asset-backed (ABS) lagged, each returning about 1.1%. High-yield also dominated the quarter on a duration-adjusted basis, returning 4.1% while investment-grade corporates produced a relatively strong 1.0% duration-adjusted return. ABS and MBS lagged on a duration-adjusted basis as well. The trailing one-year pattern was different; Treasuries (+6.2%) and investment-grade corporates (+7.9%) led sector returns in absolute terms while high-yield (+1.6%) lagged all sectors and ABS (+2.7%) and MBS (+4.3%) also lagged. The benchmark returned a strong 5.95% for the trailing year. High-yield also lagged for the year on a duration-adjusted basis, returning -2.9%; ABS (+0.75%) and CMBS (+0.63%) led duration-adjusted sector returns.

ECONOMIC OVERVIEW

The U.S. economy defied pessimistic forecasts and managed to avoid a recession during its winter 2015/2016 slump, according to the latest government data. In late June 2016, the Bureau of Economic Analysis released its third estimate of Q1 2016 real GDP, placing growth at a 1.1% annual rate, ahead of the previous 0.8% estimate and down slightly from Q4 2015's 1.4% pace. The fears of slowing global growth and outright recession that produced a stock market correction and sharply higher credit spreads from late 2015 into early 2016 generally receded during Q2 (aside from concerns produced by the Brexit vote). The broad consensus of U.S. economic forecasts for the current year sees slow but positive gains, with real GDP growth estimated at 2.6% for Q2 and 2.3% in the year's second half. The consensus estimate for calendar year 2017 U.S. GDP growth is just 2.2%, reflecting in part the trend line of tepid growth since the financial crisis seven years ago and the weak global macro backdrop.

Europe likewise appears to have avoided a slip back into recession, the prospect of which has concerned investors seemingly for years and that accounts along with zero yields for the multi-year bear market in many European equity indices. Real GDP for the Eurozone, which grew only 0.9% in 2014 and 1.5% in 2015, is expected to achieve a similar 1.6% rate for the current year, with the strength of quarterly estimates tapering off slightly in the year's second half. Real growth estimates for France, Germany and Italy in 2017 range from 1.4% to 1.7%. The outlook for the U.K. is a more muted 0.5% forecast for 2017, strengthening to 1.2% in 2018; both numbers are down from pre-Brexit estimates of 2.0%. Core inflation readings for the Eurozone region remain under 1%, in part (but certainly not in whole) supporting the region's low interest rates.

The outlook for Japan is even weaker, as the nation struggles to find sources of growth given its aging and declining population and radical experiments with extraordinary monetary stimulus; real GDP is estimated to be 0.6% for 2016, rising only to 0.9% in 2017.

As we noted in last quarter's letter, the market rally that began in Q1 has had no counterpart in stronger corporate earnings estimates. In fact, U.S. corporate earnings are mired in their

worst slump since the financial crisis. According to Zacks data, S&P 500 Q2 earnings are set to fall about 5% vs. Q1's 6.5% decline (ex-energy, Q2 earnings are about flat). U.S. stocks continue to be held up by low rates, central bank support and investor hopes for a second half 2016 and 2017 profit recovery, although the recovery ramp has been extended yet again. Earnings for Q3, according to Zacks, are now expected to be down slightly instead of the predicted gain last quarter. If the latest forecast holds, that will mark six straight quarters of negative earnings comparisons for the S&P 500 (to be sure, this is partly due to energy sector struggles). Earnings growth estimates turn higher beginning in Q4 (+6.3%) and sharply higher in Q1 2017 (+12.4%) and Q2 2017 (+12.7%). Just as we noted last quarter, if historically unprecedented global central bank stimulus is going to produce real economic strength, the evidence cannot be postponed forever. In the long run, stock prices are based on earnings. Earnings growth, far more than central bank policy, will eventually be needed to power further market gains.

MAXIMUM REGRET PORTFOLIO

In our Q4 2015 letter we advised participants to embrace what we called a "maximum regret portfolio, i.e. a portfolio that contains some exposure to an out-of-favor and underperforming asset class or style. We noted that downside volatility allows our sub-advisers to commit capital to undervalued investments, even if the price is a near-term performance impact, and in so doing sets the stage for superior long-term gains. We know that embracing a maximum regret portfolio is very much an act of faith: faith in the ability of markets to value securities rationally, faith in the stability of political and social institutions that allow businesses to grow, sell their goods and services and generate earnings, and faith that our investment managers can successfully identify undervalued companies that perform well over the long-term. We acknowledged that owning a maximum regret portfolio is far from easy. "At any given moment in time," we wrote, "a fully and intelligently diversified portfolio will contain exposures to asset classes and styles that are underperforming, possibly declining and maybe even declining sharply. Many investors will chastise themselves for these exposures, 'If only I'd not been in that!' These emotional impulses are entirely human, but they are an investor's worst enemy."

There is no doubt investors now regret their exposure to value-style strategies. Most, if not all, flavors of value have been soundly trounced in recent years by growth and recently by low-volatility strategies that generally focus on sizeable companies with durable, steady earnings growth and strong market positions, and which are often synonymous with the idea of “defensive” investments. The market dominating returns produced by the staid utilities and telecom services sectors in the U.S., up 25% and 30% respectively over the past year compared to the S&P 500’s 4.0% return, are only one example of this trend. While it’s always difficult to assign exact causes to market trends, we (and our sub-advisers) believe an array of forces help explain the trend. These include the global economic backdrop of fitful sluggish growth, historically low and falling yields pinned down partly by unprecedented central bank asset purchases, the ever-present fear of recession, and the difficult and constrained policy options available to global governments given debt loads and fiscal covenants (in the Eurozone) have depressed the stock prices of many companies whose fortunes are tied to either cyclical macro trends or, in the case of the financial stocks that populate the value universe, to general prosperity and interest rate stability. The search for stability, defensive characteristics and dependable earnings in a low global growth environment becomes similar in some respects to the stretch for yield in the bond market (although the former shuns risk and the latter embraces it). In both cases, however, the valuations of the favored style become bloated and those of the shunned style become deeply undervalued. These are broad analytical brushes to be sure, but they do offer a reasonable explanation for the malaise affecting value investing.

A less abstract and more tangible manifestation of the value malaise is the recent relative performance of CBIS value managers, both domestically and within the CUIT International Fund. All have struggled in this market, and they are not alone. In fact, many of the most successful, veteran value managers have had a difficult time. In a recent CBIS research study, we looked at value-style products with 20 years or more history (about 100 total). Some use the Russell 1000 Value Index as their preferred benchmark (like our AJO Absolute Value product) while others designate the S&P 500 Index as their benchmark (like our Dodge & Cox U.S. Equity portfolio). We identified the ten best-performing products in

terms of average annual return (not compounded returns) over the recent 20 year period. The strategy employed by one of our sub-advisors, AJO Absolute Value, ranks 5th overall for average return over 20 years while the Dodge & Cox strategy ranks 9th overall on this measure.

We also looked at each product’s recent trailing 12 month excess return versus the Russell 1000 Index and looked back over the past 20 years to see the worst trailing 12 months for each of the 100 products. Nine of the ten top value managers over the 20-year period currently have negative 12-month excess return numbers and six (including both AJO and Dodge) are at -5.0% or worse. Five of the ten best managers of the total of 100 actually have had a 12 month trailing excess return number worse than -11% at some point during the 20-year period. Investors in these cases would have been well served by a maximum regret value exposure.

In the international sphere, Brexit-related market jitters and flight to quality clipped what appeared to be a nascent value-style rebound earlier in Q2. Our sub-adviser Causeway Capital Management (co-manager of the CUIT International Equity Fund) notes that, after the Brexit vote, developed market equity investors again embraced perceived stability in earnings while selling already-shunned European financial holdings with abandon. As global interest rates fell further after June 23, long duration, economically-defensive stocks such as U.S. utilities, U.S. pharmaceuticals, global tobacco and many consumer staples names saw multiples rise further, stretching already lofty valuations relative to other global market sectors – with financials at the opposite end of the valuation spectrum. As shown in the accompanying charts, by Causeway’s analysis such defensive stocks are trading at nearly the highest premium relative to cyclical stocks of the past 15 years, second only to the peak reached at the worst depths of the financial crisis in 2008. Likewise, the MSCI EAFE Value Index is near its lowest valuation relative to the MSCI Growth Index since 1992; only the growth-style peak in the late 1990s tech bubble and the period in early 2008, right before the financial crisis, are comparable. DeGroof Fund Management, sub-adviser for the CBIS Global European Equity Fund, observes a similar theme in the European equity markets. DeGroof notes that the “risk-off” market regime that has characterized much of the past year has favored defensive and higher quality issues,

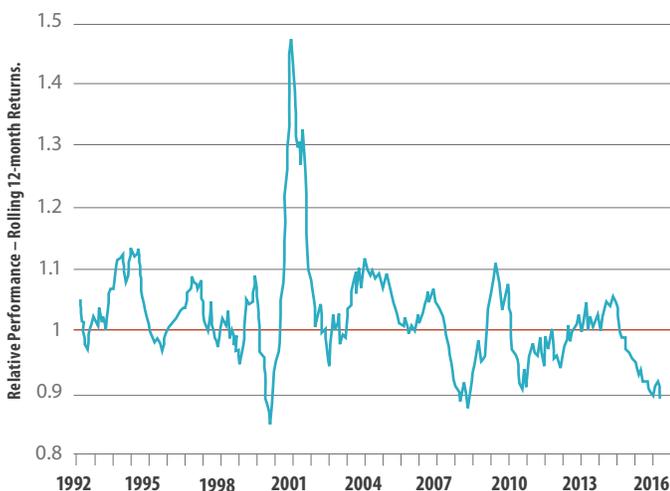
while value factors and styles have suffered. Yet value styles are now cheap relative to history and to other more defensive styles while dispersions (the spread between the cheapest and the most expensive stocks in the markets) are at levels that historically have led to a value style recovery.

Given the challenges that many value strategies have faced, AJO, co-manager of the CUIT Value Equity Fund along with Dodge & Cox, has struggled in 2016. The best hitters in baseball hit slumps and so do the best investment managers. AJO's year-to-date results fall in the painful left tail of its historical return distribution. Yet its long-term record, organizational strength and veteran team give us confidence in a potential rebound and renewed success. Causeway is optimistic about the long-term prospects of their portfolio as it is currently trading at a discount to the market in terms of both price-earnings and price-book, but also has a premium dividend yield. Dodge & Cox runs a concentrated low-turnover portfolio that, over a span of decades, has encountered similar bouts of underperformance and strong recoveries. Dodge views

its financials exposure as deeply undervalued and benefitting from positive fundamental trends such as healthy loan growth, successful regulatory reviews and modestly positive growth in fee income, yet PEs are extraordinarily low and price-to-book levels resemble those in the financial crisis. Nor do these portfolio holdings need a trend higher in rates to be successful investments, in Dodge's view; the values here are compelling even if rates don't rise.

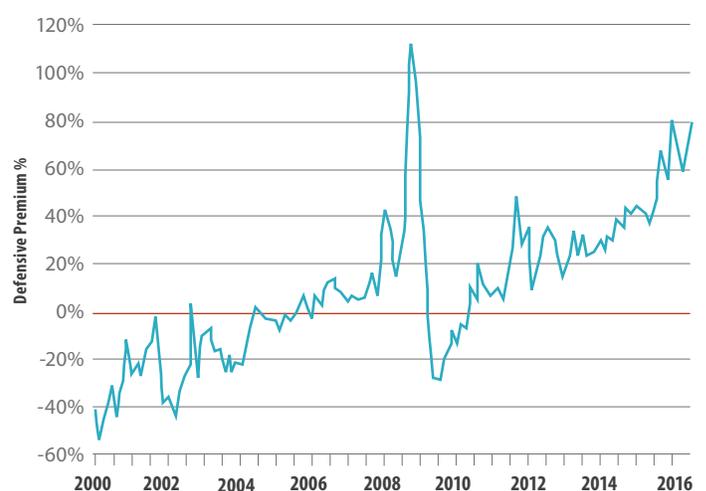
The value malaise has undoubtedly been a source of maximum regret in diversified portfolios during the past year, and during 2016 year-to-date in particular. CBIS does not pretend to know when the malaise will end. Valuations of favored companies can't stretch to the sky, nor can out-of-favor companies go, en masse, to zero. But we are as certain as any stewards of investment capital can be – based on market history and on analysis of the contemporary global macroeconomic and political landscape – that it will end. We trust our managers to position our value strategies to benefit when it does. We retain conviction in their abilities. And we urge that participants do as well.

VALUE VS. GROWTH



Source: Causeway Capital

DEFENSIVE PREMIUM



Source: Causeway Capital

Important Information

This is for informational purposes only and does not constitute an offer to sell any investment. The funds are not available for sale in all jurisdictions. Where available for sale, an offer will only be made through the prospectus for the funds, and the funds may only be sold in compliance with all applicable country and local laws and regulations.