AURUM

Strategy Newsletter
2nd Quarter 2016

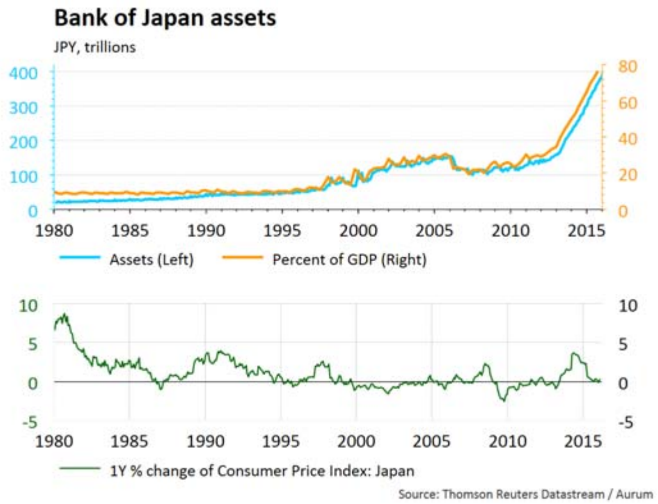
- Negative interest rates abroad and okay growth in the U.S. is the economic story.
- On the back of currency gains, emerging markets were a bright spot.
- The dive in interest rates has municipal bond prices back to all-time highs.
- Real estate and systematic hedged strategies led the way for alternatives.

Economy

One of the biggest misses in the last five years was the consensus prediction that a large expansion of the Federal Reserve balance sheet would lead to a high inflationary environment. It turned out that low rates and quantitative easing had a very tough time getting inflation going at home and overseas.

In fact, global interest rates are negative in many countries, including Austria, Czech Republic, Denmark, Finland, France, Germany, Japan, the Netherlands, Sweden, and Switzerland.

Let's look at Japan. The Bank of Japan now holds 400 trillion Yen, which is about 80% of GDP for the country (in the below graphic, top half).

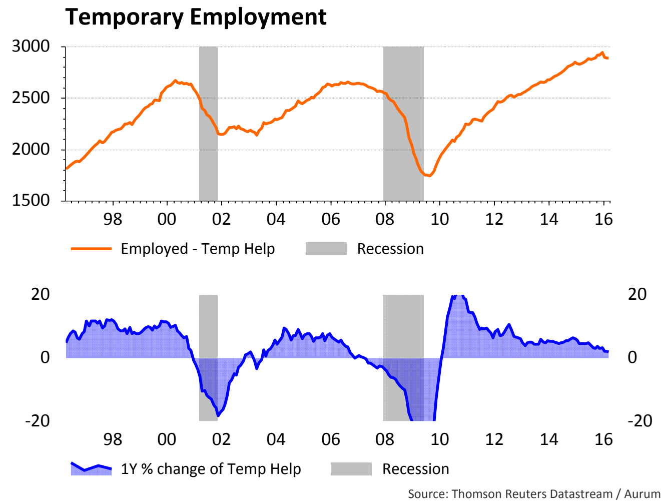


Despite this, inflation as measured by CPI in Japan is essentially still at zero, aside from very brief spikes higher in 1997, 2008, and 2014 (above, in *green*). The first and third of those were due to large government spending programs (fiscal stimulus), while 2008 was due to the oil price spike to $150/barrel.

What this tells us is that money printing alone does not cause inflation. There needs to be an impulse of credit creation to make the inflation go.

The big positive is the better demographic tailwinds that the United States has compared to the rest of the world. This should help inflation rise steadily over the long term and hopefully avoid negative interest rates coming to a bank account near you.

As for the cyclical outlook in the U.S., there are a few negatives to watch but Fed's leading economic indicator (LEI) data is still positive. Bank credit standards tightened and credit card delinquencies perked up. Temporary hires fell to a 2% growth rate, which it did last in 2000 and 2006.



Other leading indicators such as hires by staffing agencies are slowing, but not yet negative as during previous cycles. Growth of 2% is about par for the course.

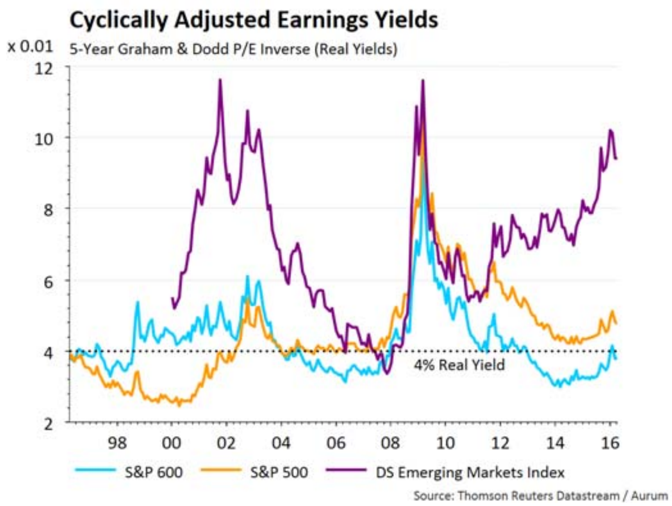
Equity

Emerging markets were the top performers in the first quarter, followed by the U.S. Value marginally outperformed growth as measured by the Russell 3000 indices, but it was just a small dent in the 9% performance gap between the two styles from 2015.

US Equity	1Q 2016
Large Cap Stock	
Dow Jones Industrial Average	2.20%
S&P 500	1.35%
Small & Mid Cap Stock	
Russell Mid Cap	2.24%
Russell 2000	-1.52%
Style Indices	
Russell 3000 Value	1.64%
Russell 3000 Growth	0.34%
International Equity	**1Q 2016**
MSCI EAFE	-2.88%
MSCI EAFE Value	-3.84%
MSCI EAFE Growth	-1.96%
MSCI Europe	-2.37%
MSCI Japan	-6.38%
MSCI Emerging Markets	5.75%

The rally in commodities and oil led to strong gains for equity markets in countries rich in natural resources with New Zealand and Canada being the top two developed markets. Japan struggled with the tinkering of the Bank of Japan further into negative interest rate territory. Peripheral European countries struggled on a broad basis, despite the Euro being a positive contributor from a currency basis. Overall, the MSCI World Index was up 0.2%.

When we look at emerging markets (EM), there is no doubt the valuation is cheap compared to the rest of the world. In the next column, we show one way to measure this. First, we do not want to look at just one-year of earnings, so we average the last five years (making it a 'cyclical' number rather than a 'one-year' number). Next, we divide this average by the price, which gives us an earnings yield. Because companies are presumed to have pricing power, this number is considered real (or 'inflation-adjusted). We can use this number as an input into expected returns looking forward over the long-term. The three lines are U.S. small caps (S&P 600) in *teal*, U.S. large caps (S&P 500) in *orange*, and Emerging Markets in *purple*.



Emerging markets yield just shy of 10% and are near the highest yields in the last 17 years for its history. It is not far from the highest yields reached by all three equity indices at the stock market lows in early 2009. The EM yield is at twice the level of both U.S. large and small caps. Small caps (along with mid-caps) finally served up fair valuations above 4% during the quarter, allowing us to add exposure.

The problem for EM has been the fundamentals and the persistently negative earnings. With the bottoming in commodity prices in 1Q and the U.S. dollar starting to fall, we are seeing a trough in earnings, which is a great step for these countries.

We continue to hold an overweight to emerging markets and an underweight to U.S. stocks (though to a lesser extent after additional exposure in the first quarter).

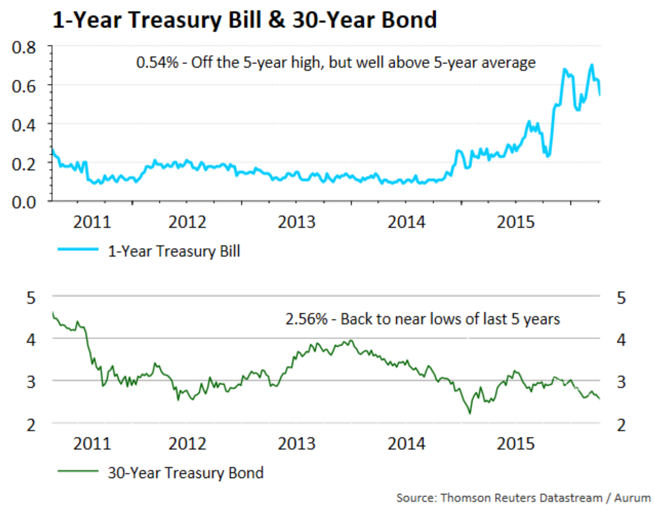
Fixed Income

The most highly cited bond yield in the world, the 10-year U.S. Treasury started the year at 2.27%. It seems miles away from where it finished on March 31st at 1.78%. With interest rates down, bond prices were up across the board with one of the best quarters in several years.

Fixed Income	1Q 2016
Barclays U.S. Aggregate Bond	3.03%
Barclays Corporate Inv. Grade	3.97%
Barclays High Yield Bond	3.35%
Barclays Global ex. U.S. Tres.	8.91%
Barclays Municipal Bond	1.67%

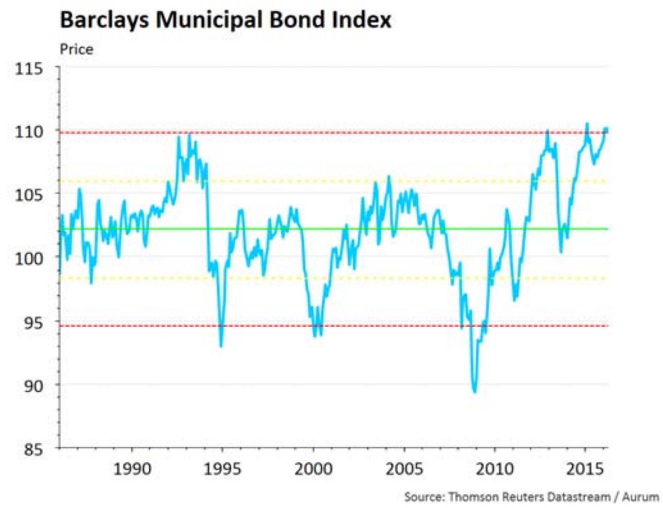
The Barclays U.S. Aggregate Bond Index started the year with a 2.6% yield-to-maturity (YTM). This is the annualized return expectations one should have over the duration of 5.8 years for the index. The 3.03% return in the first quarter equals over a year's worth of return in a single quarter, a drastic pulling ahead of this future return stream.

The Federal Reserve interest rate hike of 0.25% in mid-December did not have the expected effect of raising interest rates across the yield curve. Instead, interest rates fell. The 1-year Treasury bill (shown below in *blue*) reached a high of 0.71% but ended the quarter at 0.52% as the pace of interest rate hikes anticipated by the market came down,.



The 30-year bond ended the quarter near the lowest levels it hit in 2012 and 2014. It was surprising considering inflation expectations finally rebounded sharply in mid-February. This was the similar price action during the last four interest rate hiking cycles for the Treasury yield curve. The yields on short-dated maturities rise with the Federal Funds rate while longer-dated maturities tend to fall.

The average bond price in the Barclays Municipal Index topped $110, which is $8 above the average over the last 30 years. It reached this level in 1993, 2012, and 2014. It is in the 99th percentile of history and two standard deviations above the mean.



Many closed-end municipal bond funds prices recovered and trade near the net asset values after many years at big discounts, a sign that sentiment has done a 180-degree turn since the taper tantrum, when anything with a duration risk was sold. The bottom line is that prices look vulnerable.

We still like non-agency mortgages given that monthly defaults are below 1% and at the lowest levels in 9 years (whereas they reached a peak of 3.5% in 2009). CLOs (Collateralized Loan Obligations) had a bumpy quarter and did not snap back like most risk assets due to less liquidity. Still, our managers believe the bonds will continue to meet interest payments based on the fundamentals of the issuers.

The Aurum Asset Allocation Frameworks maintain fixed income allocations near strategic targets.

Alternative Investments

Since Treasury Inflation Protected Securities came into existence in 1997, only 15% of quarters did the asset class return over 4%. In the first quarter of 2016 TIPS did so again. Breakeven inflation rebounded and propelled the index to its highest quarterly return since 2011. REITs had another great quarter while hedge funds were down on a broad basis.

Alternative Assets	1Q 2016
HFRI Hedge Fund of Funds	-2.52%
Dow Global Select REIT	6.02%
Barclays TIPS	4.46%

Systematic trend followers (sometimes known as managed futures) were a bright spot among hedge fund strategies. Known for having a near zero correlation to stock and bond indices, the strategies seek to identify trends across asset classes on a long and short basis. The clear downtrend in bond yields lead the strategies to owning fixed income, which was a large contributor during the quarter. Some managers were whipsawed by the v-shaped increase in global equity prices. The rally in the Yen was also profitable for these managers.

We maintain a slight underweight to the alternative asset class broadly. Our alternative strategies are a combination of managers with modest exposure to the market and uncorrelated managers. For qualified investors, we also reconstituted the asset allocation frameworks to include private real estate as an asset class. In turn, we made an allocation to a special situations real estate manager.

Conclusion

Asset prices are at the higher end of historical values. The economy has a few indicators flashing yellow, but is broadly keeping to the trends of the last few years. Households are healthier but labor markets are tightening for businesses. Election years tend to be relatively choppy in the markets until November when we know who the next President will be. The volatility in the first quarter created mispricings, which we intended to take advantage of with thoughtful execution.

Aurum Asset Allocation Frameworks

	Income		Conservative		Moderate		Growth		Aggressive	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	21%	35%	37%	50%	52%	70%	74%
U.S. Equity	0%	0%	12%	10%	20%	17%	30%	25%	42%	38%
Int'l - Develop. Markets	0%	0%	6%	5%	12%	11%	16%	15%	21%	20%
Int'l - Emerg. Markets	0%	0%	2%	6%	3%	9%	4%	12%	7%	16%
Fixed Income	65%	63%	45%	42%	30%	30%	17%	19%	10%	10%
U.S. Fixed Income	56%	62%	39%	41%	26%	29%	15%	18%	7%	9%
Global Fixed Income	9%	1%	6%	1%	4%	1%	2%	1%	3%	1%
Alternative Invest.	25%	22%	28%	22%	30%	22%	30%	22%	19%	15%
Diversified Strategies	19%	22%	22%	22%	24%	22%	24%	22%	15%	15%
Real Estate & REITs	2%	0%	2%	0%	3%	0%	3%	0%	4%	0%
Inflation-Indexed Sec.	4%	0%	4%	0%	3%	0%	3%	0%	0%	0%
Cash/Equivalents	10%	15%	7%	15%	5%	11%	3%	7%	1%	1%
U.S. Dollar	10%	15%	7%	15%	5%	11%	3%	7%	1%	1%

The risk designations are relative only to the five Strategic Allocation targets and do not represent comparisons with any other investment or risk of the overall strategies.

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