AURUM WEALTH MANAGEMENT

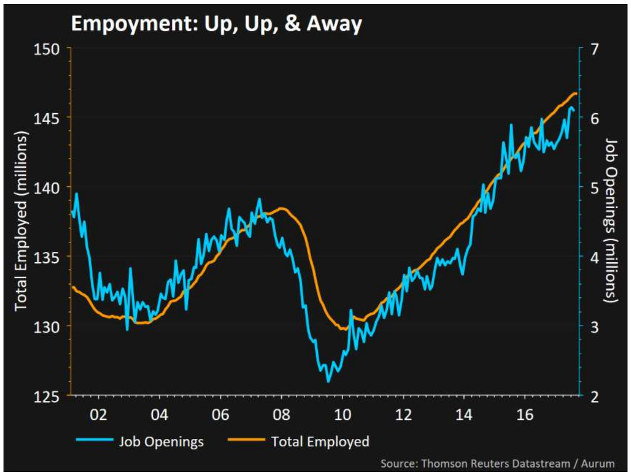
A SKODA MINOTTI FIRM

Strategy Newsletter – 4th Quarter 2017

- The U.S. economic outlook remains favorable.
- Emerging markets topped the regions with the best equity returns.
- Short end interest rates continue to rise.
- Alternatives turn in a positive quarter while many fundraisers turn to private credit.

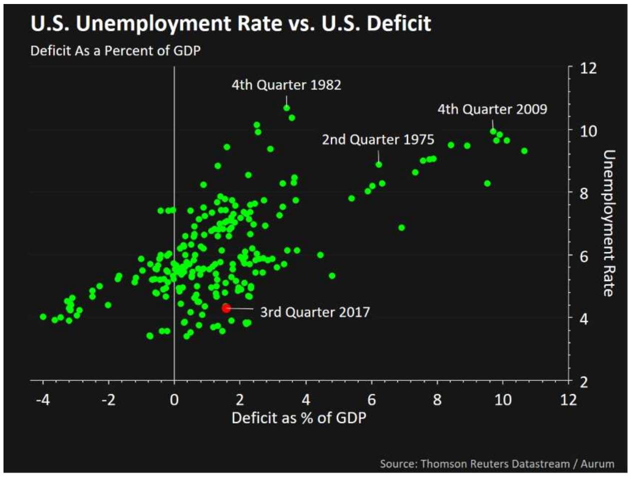
Economy

The economy continues to grow nicely and business activity picked up over the last year. Job openings are at highs and the unemployment rate is at the lowest level in 15 years. Many economists believe the unemployment rate would be higher if it considered all the individuals that dropped out of the workforce. What matters, however, is that the Federal Reserve trusts the data and is using it to justify a higher interest rate path.

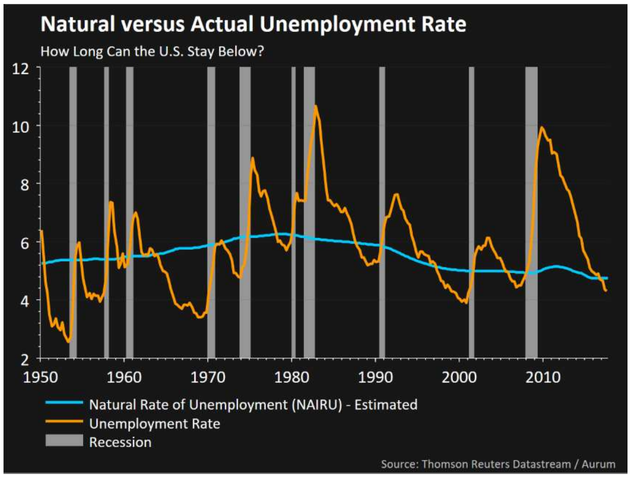


The debate in Washington today focuses on corporate and personal tax reform. It is tough to handicap the chances of it passing. It would provide a fiscal boost during the 9th year of this expansion, which is the second longest expansion ever.

The federal deficit is under control, but certainly not near its lows over the last forty-five years. We can look back at history and see that a fiscal boost at this time could be inflationary. The chart in the next column shows the latest data point in red along with when the unemployment rate peaked around recessions ('75, 82, '09).



The Natural Rate of Unemployment ("NAIRU") is the estimated unemployment rate that does not cause inflation to rise. It the blue line in the chart below. The actual unemployment rate is shown in orange. When the actual is below the natural rate, the Fed begins to worry about inflation accelerating.



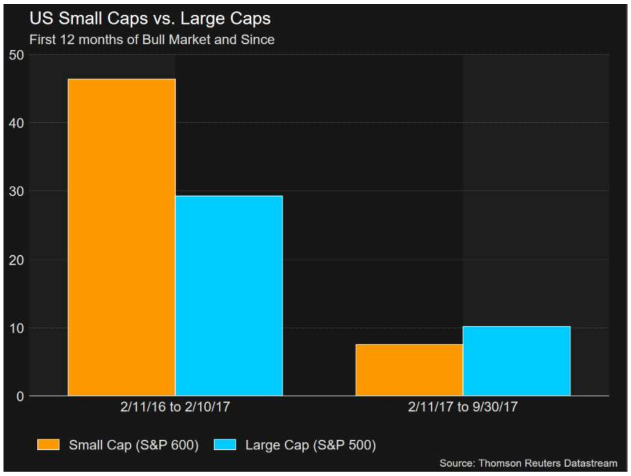
Economic expansions end for two reasons: higher interest rates and oil price spikes. Interest rates are climbing today. Oil is lower than it was three years ago due to the shale bust. The unemployment rate usually only spends so much time below the natural rate before a recession happens, roughly two to five years. It has only been a year and a half, so the economy has time before the clock strikes midnight.

Equity

Foreign stock markets are three for three in outperforming the U.S. on a quarterly basis in 2017.

US Equity	**3Q 2017**
Large Cap Stock	
Dow Jones Industrial Average	5.58%
S&P 500	4.48%
Small & Mid Cap Stock	
S&P 400 Mid Cap	3.41%
S&P 600 Small Cap	6.08%
All Cap Style Indices	
S&P 1500 Value	3.56%
S&P 1500 Growth	5.16%
International Equity	**3Q 2017**
MSCI EAFE	5.47%
MSCI EAFE Value	5.95%
MSCI EAFE Growth	4.99%
MSCI Europe	6.49%
MSCI Japan	4.10%
MSCI Emerging Markets	8.04%

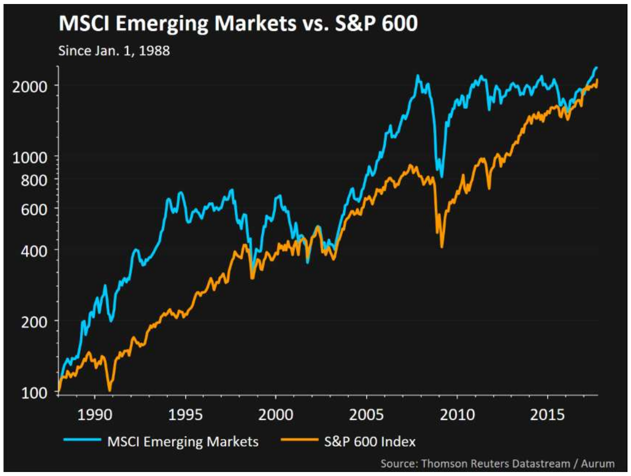
U.S. small caps jumped higher in September due to higher optimism on corporate tax rate cuts yet still lag the performance of large caps. The common definition of a bear market is a peak to trough fall in prices of 20%. Small caps just barely met this definition with the decline from the summer of 2015 to February of 2016. This cycle is following the same historical pattern that has held since 1929. Coming out of bear markets, small caps tend to outperform in the first twelve months, but then go on to trail large caps. The next chart shows the one-year data since the price bottom in February 2016 and the performance in the last 8 months.



After beating large caps by 17% in the first year of this small cap bull market, small caps lost by 3% since.

When international markets outperform domestic markets, as has been the case in 2017, emerging markets have outperformed. This is not surprising since these markets performed worse in the preceding period. Mean reversion is a powerful force in markets.

Over the last 30 years, emerging markets outperformed U.S. small caps. There were distinct shifts where emerging beat out U.S. small caps for 6 to 8 years and vice versa. 2017 is shaping up to be the first 'win' for emerging markets since 2009.



Our portfolios continue to have an overweight to emerging markets and minimal holdings in U.S. small caps.

Allocations to equities remain near the long-term strategic target. An overweight to emerging markets remains our key tactical allocation at the expense of domestic small caps.

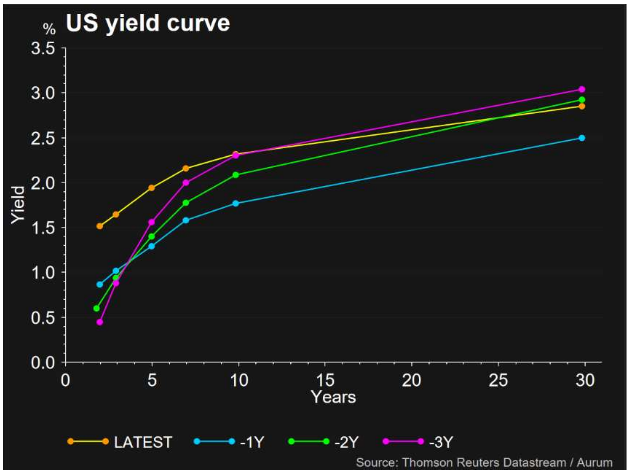
Fixed Income

Bond markets benefited from falling interest rates and cheaper borrowing spreads for companies. Below-investment grade rated companies led the way domestically while the falling dollar allowed global bonds to outperform.

Fixed Income	3Q 2017
Barclays U.S. Aggregate Bond	0.89%
Barclays Corporate Inv. Grade	1.39%
Barclays High Yield Bond	2.42%
Barclays Global ex. U.S. Tres.	3.41%
Barclays Municipal Bond	1.16%

Yields fell from the end of the June to early September before jumping higher. Increasing inflation expectations along with a faster rate of interest rate increases by the Fed led to the bump. The ten-year yield ended the quarter nearly unchanged, up only 0.02% while the two-year Treasury rose 0.15% from 1.37% to 1.52%.

The chart below shows the yield curve today versus the last one, two, and three-year periods.



The yields for two, three, five, and seven-year bonds are all higher. The 10-year and 30-year bonds are below the yields from three-years ago. This movement is called a flattening of the yield curve (as the front end moves higher, the line gets flatter).

Credit markets today are near the highest prices in the last ten years. This makes sense considering the 'goldilocks' economic environment currently. Nonetheless, many of our managers are beginning to upgrade the quality of portfolios today, given that marginally higher credit risk securities do not offer enough return premium.

Fixed income portfolios continue to hold steady. Mortgage and asset-backed securities make up the highest allocations. Select global bonds provide a currency hedge to rising inflation expectations. We remain equal weight fixed income overall in our Asset Allocation Frameworks.

Alternative Investments

Hedge funds performed well in the third quarter led by long/short equity and event driven strategies. REITs and TIPS also turned in a positive quarter.

Alternative Assets	3Q 2017
HFRI Fund of Funds Index	2.24%
S&P Global REIT	0.80%
Barclays U.S. TIPS	1.32%

Private credit, while being heavily marketed, offers an area of caution within alternative investments. While the siren song of 'banks not lending' is the main pitch, we find it rings hollow. The data simply does not back this at home or abroad. Still, investors are being promised double digit-type returns with little risk. This comes at a time when public market high yield indices yield around 5% (adjusted for expected losses, the return is closer to 2%). Loans with short maturities should be okay. However, surviving a full economic cycle will likely come with pain if a company has to borrow at 10%+ today when credit markets are hot. Investors should proceed with caution and stress test the holdings, as any due diligence process should cover.

Alternative assets that provide correlation differences make portfolios more efficient. Today our portfolios continue to be underweight alternative investments within our Asset Allocation Frameworks, while investing with thoughtful investment managers in real estate and hedged strategies.

Conclusion

Markets enter a positive seasonal period with positive economic and asset price momentum. No one wants to leave the party early as sentiment surveys reach new highs. There will be plenty of news to keep the market on its toes the next few months. Tax reform centers around nearly any macro conversation these days. This is moving many markets as the likelihood of passage changes (small caps, in particular). In addition, Fed Chair Janet Yellen's term ends in January 2018. Many controversial figures are being floated as potential replacements. Markets hate surprises and someone viewed as other than the steady-hand that Yellen steered with could be a catalyst for volatility in bonds. We continue to seek out investment opportunities offering cheap values and lean away from areas priced too optimistically.

Aurum Asset Allocation Frameworks

	Income		Conservative		Balanced		Moderate		Growth	
	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical	Strategic	Tactical
Equity	0%	0%	20%	24%	35%	40%	50%	56%	70%	76%
U.S. Equity	0%	0%	12%	10%	20%	16%	30%	24%	42%	36%
Int'l - Develop. Markets	0%	0%	6%	8%	12%	15%	16%	20%	21%	24%
Int'l - Emerg. Markets	0%	0%	2%	6%	3%	9%	4%	12%	7%	16%
Fixed Income	65%	65%	45%	47%	30%	33%	17%	22%	10%	10%
U.S. Fixed Income	56%	62%	39%	41%	26%	29%	15%	18%	7%	9%
Global Fixed Income	9%	7%	6%	6%	4%	4%	2%	4%	3%	1%
Alternative Invest.	25%	23%	28%	19%	30%	19%	30%	19%	19%	13%
Diversified Strategies	19%	23%	22%	19%	24%	19%	24%	19%	15%	13%
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%	12%	7%	10%	5%	7%	3%	3%	1%	0%
U.S. Dollar	10%	12%	7%	10%	5%	7%	3%	3%	1%	0%

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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