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3Q 2018 Commentary

MARKET COMMENTARY

September marked the tenth anniversary of the start of the financial crisis and few would have predicted the subsequent sustained growth in both the economy and in the financial markets. The momentum continued this past quarter with corporate profit growth benefiting not only from the tax cuts enacted at the end of last year, but also from surprisingly strong revenue growth, the highest since 2011. This good news was enough to offset the cloud of uncertainty surrounding trade negotiations and helped boost U.S. equity markets with the S&P 500 Index climbing 7.71%. Both the bond market and the Federal Reserve reacted to the news as interest rates rose across the yield curve, and the target Federal Funds rate was raised by another 25 basis points (0.25%). This was the Fed's third increase since the start of 2018 and the eighth since the tightening cycle started in late 2015. While the U.S. economy and financial markets continued to steam ahead, results were mixed elsewhere in the world with emerging markets in particular showing signs of struggle. With the threat of trade wars, a strong U.S. dollar, and rising interest rates, the MSCI Emerging Markets index declined again during the third quarter, bringing total year-to-date losses to 7.68%.

With rates rising once again during the quarter, the investment-grade bond market, as measured by the Bloomberg Barclays U.S. Aggregate index, was only up 0.02% for the quarter and down 1.6% since the start of the year. In contrast to the first six months of the year, investors were more willing to take on credit risk and spreads narrowed across the board, providing a cushion to the negative effects of rising rates. High yield bonds (as measured by the Bloomberg Barclays High Yield Index) were up 2.4% and investment grade corporate credit rebounded. Longer maturity corporates (as measured by the Corporate sector in the Bloomberg Barclays U.S. Aggregate Bond Index), which have become a much larger piece of the Index over the last eight years, was the best performer. Despite the strong quarter, this sector is still down 5.5% from the start of the year, a reversal from its 2016 and 2017 index leadership, and evidence of the return variability that accompanies longer duration assets.

While the S&P 500 Index posted impressive results, the breadth of the rise was limited, and once again heavily influenced by the largest and highest growing companies in the Index. Year-to-date, the Russell Top 200 Growth Index is up 18.23% compared to the returns of smaller, slower-growing companies, as measured by the Russell 2500 Value Index which is only up 5.75%. This persistent multi-year pattern has accumulated to the point where over the last 5 years, mega growth has outperformed small/mid-cap value by almost 47%. We see this as both a risk and an opportunity. For index investors, it is a risk. Indices that are top-heavy with expensive stocks can topple quickly when expectations aren't met. For the frustrated and patient valuation-conscious stock pickers, this is an opportunity. Not only are these stocks relatively cheap, there are private equity funds ready to use their record levels of cash and the accommodative debt markets to pay fair value if the public markets will not.

Core Fixed Income Composite

PORTFOLIO COMMENTARY

In the third quarter of 2018, the Core Fixed Income Composite returned 0.07% (gross of fees) and was down 0.01% (net of fees). The Intermediate component of the Bloomberg Barclays U.S. Aggregate Bond Index was up 0.11%.

The Composite's largest sector, agency commercial mortgage-backed securities (CMBS) was down 0.57%. Product spreads were unchanged during the month while swaps outperformed treasuries across most of the curve. On a stand-alone basis, the sector contributed nine basis points to income return (the Composite generated a total income return of 26 bps).

The Composite's second largest sector, agency mortgage-backed securities (MBS), was down 0.60% during the month, outperforming the Benchmark's U.S. MBS sector return by one basis point. The Composite's MBS had similar paydowns vs. the benchmark while generating two basis points (0.02%) of extra income. The sector was also able to overcome the lack of shorter-duration MBS by being underweight 3% coupon MBS, which was the worst performing coupon during the month.

The third largest sector in the Composite, taxable municipal bonds, returned negative 0.50%. Taxable municipals were able to outperform the two largest sectors in the Composite as spreads tightened in the space.

Lastly, the composite's asset-backed security sector was down 0.33%. The sector contributed three basis points (0.03%) of income return and generated the highest total income return of any sector in the Composite.

For the benchmark, corporate bonds led the way in September generating a negative 0.36% return. Spreads tightened by eight basis points during the month. Treasuries were the worst performing sector (down 0.93%) with the sell-off in rates across the curve while mortgages were down 0.61%. The non-corporate space of the benchmark (Sovereign, Supranational, Foreign Agency and Foreign Local Government, which roughly constitutes 4% of the index) also performed well generating a return of 0.24%, while the ABS (0.6% of the Index) and CMBS (2.3% of the Index) sectors were down 0.04% and 0.49%, respectively.

As of September 30, 2018, the Composite's Yield-to-Worst (YTW) is 3.74%, higher than the Benchmark's YTW of 3.34%, and it exhibited four percent longer duration (interest rate risk) to the Benchmark (4.58 vs. 4.38). The higher income profile contributed three basis points to relative returns. The Composite's exposure to swap rates also positively impacted returns.

Effective April 1, 2018, the benchmark for the Core Fixed Income Composite changed from Bloomberg Barclays U.S. Aggregate Bond Index to the Bloomberg Barclays Intermediate U.S. Aggregate Index.

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Bonds and bond funds are subject to interest rate risk and will decline in value as interest rates rise. Past performance does not guarantee future results. This performance report should not be construed as a recommendation to purchase or sell any securities held in composite accounts. Market conditions can vary widely over time and can result in loss of portfolio value. The results portrayed included the reinvestment of dividends, interests, and other earnings. The index information presented herein does not reflect the impact of fees; you cannot invest directly in an index.

Gross returns in this presentation do not include the effect of management fees. If included, returns would be lower. Gross returns will be reduced by management fees. For example, a 1% annual fee from an account with a ten-year annualized growth rate of 10% will produce a new result of 8.95%. Actual performance results may vary from this example. Sector attribution is presented on a gross only basis and does not reflect the deduction of management fees. For a more detailed description of fees and expenses, see Form ADV part 2A.

As of 9/30/18, the average annual gross returns for the Core Fixed Income Composite for 1-year, 5-year, 10-year and since inception (8/30/99) were -0.64%, 2.27%, 3.56% and 4.79%. As of 6/30/18, the average annual net returns for the Core Fixed Income Composite for the same time periods were -0.93%, 1.96%, 3.25% and 4.40%.