Portfolio and Economic Commentary
1st Quarter 2016
It was a tale of two halves in the first quarter of the year for global financial markets. Stock markets plunged early on, falling 10% to 15% or more, but then sharply reversed, staging a furious rally into quarter-end. Larger-cap U.S. stocks finished in the black, up 1.3%, though domestic small-cap stocks trailed, down 1.5%. Developed international stocks also failed to keep pace in the rally, ending with a 1.9% loss for the quarter. And while the 10-year Treasury yield rose around 15 basis points from its mid-quarter low, it was still almost half a percent below where it started the year, finishing the quarter at a paltry 1.78%. As such, core bonds gained 3.1% year to date.

Broadly speaking, the stock market decline in the first half of the quarter was due to

- ongoing fears of a hard landing in the Chinese economy, possibly accompanied by a sharp and sudden devaluation of the renminbi;
- a continuing plunge in oil prices to under $30 per barrel (bbl), using the WTI benchmark, from $40 at the start of the year;
- some weaker-than-expected U.S. economic data and growing fears of a global recession, if not also a U.S. recession; and
- a contagious loss of market confidence in the ability of global central banks to stimulate real economic growth and increased concern that current monetary policies (e.g., negative interest rates in Japan and Europe) are now causing more harm than good.

On the last point, the Bank of Japan surprised markets by joining the negative interest rate policy (NIRP) club at the end of January. The BOJ pushed its policy rate down to negative 0.1%, joining the European Central Bank, which later lowered its rate to minus 0.4% in March. Of note, Swiss, Swedish, and Danish central banks have policy rates ranging from negative 0.5% to negative 0.75%. However, rather than having the intended effect of weakening the yen, Japan’s move had the opposite effect and helped trigger another leg down in global stocks and other risk assets.

Then, beginning on February 12, everything changed. Oil prices and stock markets started moving higher. The renminbi stabilized, then started appreciating a bit. High-yield bond prices started moving higher and credit spreads fell. Core bond prices fell and the 10-year Treasury yield moved higher. These broad market trends continued through March, as shown in the table below.

As is often the case, there was no single obvious catalyst for the turnaround that began on February 12 other than speculation in the news that major oil producers might be ready to cooperate to cut oil output. At the same time, the head of the Federal Reserve Bank of New York dismissed the likelihood that the Fed would need to adopt NIRP given the U.S. economy’s strength and momentum. Then, over the following weekend, the head of the Chinese central bank stated it saw no basis for further yuan depreciation.

### A Tale of Two Halves

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>1/1/16–2/11/16</th>
<th>2/12/16–3/31/16</th>
<th>YTD 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Stocks</td>
<td>-10.3%</td>
<td>+12.9%</td>
<td>+1.3%</td>
</tr>
<tr>
<td>Developed Int'l Stocks</td>
<td>-12.2%</td>
<td>+11.8%</td>
<td>-1.9%</td>
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<td>European Stocks</td>
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<tr>
<td>Emerging-Markets Stocks</td>
<td>-10.9%</td>
<td>+18.8%</td>
<td>+5.9%</td>
</tr>
<tr>
<td>Core Bonds</td>
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<td>+0.7%</td>
<td>+3.1%</td>
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<td>High-Yield Bonds</td>
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<td>Floating-Rate Loans</td>
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<tr>
<td>Managed Futures</td>
<td>+9.0%</td>
<td>-5.4%</td>
<td>+3.1%</td>
</tr>
</tbody>
</table>

The rally continued in March, on the back of better economic news in the United States. Markets also reacted positively to dovish ECB and Fed actions during the month, as well as additional monetary and fiscal stimulus in China. On March 10th, the ECB went deeper into negative rates, cutting its policy rate to negative 0.4%—its third rate cut since adopting NIRP in June 2014. The ECB also expanded quantitative easing bond purchases by €20 billion per month (to €80 billion) and will also now include investment-grade non-bank corporates in the program, boosting prices for such bonds. Finally, it initiated a new program of targeted long-term refinancing operations, in which it will lend money at zero or negative interest rates to banks that increase their lending to the private sector. This should mitigate some of NIRP’s negative effects on bank profits; the fear of which had been driving European bank stock prices sharply lower this year.

In the United States, the Federal Open Market Committee held its mid-March meeting and did not raise the federal funds rate, stating that “global economic and financial developments continue to pose risks.” However, it also highlighted solid U.S. economic fundamentals. The FOMC also lowered its projection of the number of rate hikes for the rest of the year (from four to two) and longer term, communicating both a slower pace and a lower trajectory of rate hikes than what it had projected in December. This was broadly consistent with the market’s views (i.e. as reflected in Treasury futures markets), which had already discounted a high likelihood of just one or two hikes this year.

Financial markets responded positively to the Fed announcement, with stocks and oil/commodities continuing to rally and the dollar falling. After peaking in late January, the dollar (whose prior rise was likely driven in part by anticipated higher U.S. rates) ended the quarter down more than 4% for the year.

Looking ahead, however, with consumer price inflation expectations rising; stock, credit markets and oil prices rebounding; and the dollar no longer appreciating; the Fed may soon turn more hawkish again. In fact, just a few days after the March announcement, several Fed governors suggested the Fed could raise rates at the April meeting. This could trigger market reactions that reverse these recent reflationary trends.

More generally, we’d note that global monetary policy is moving deeper into uncharted, historically unprecedented territory, bringing with it unknown and unintended consequences. This continues to be a key uncertainty and risk as we construct and manage investment portfolios for a range of potential outcomes. How and when will the current extreme monetary policies be “normalized” and how will they impact the global economy and financial markets? Frankly, no one knows.

Our investment outlook—both in terms of potential return drivers and risks—has not materially changed over the past quarter. However, in the context of the market’s recent gyrations, we’d like to highlight reasons for optimism that the recent relative performance trends may be sustained for a while, to the benefit of our portfolios. In short, the post-financial-crisis period has been dominated by a few very strong market trends. It is important to view these for what we believe they are—cycles that will eventually turn and may be in the process of turning. Our next section discusses the concept of cycles as well as several very specific cycles we’ve experienced in recent years.

**Cycle of Investor Behavior**

We often talk about cycles when discussing our investment philosophy and tactical asset allocation approach. This is because financial market and economic history is a series of multiyear cycles—albeit in the case of most markets and economies they are cycles within a very-long-term (secular) growth trend.
These cycles, we believe, are driven by natural human group or herd behavior. Since we don’t believe human behavior is going to evolve much over the next few decades, we expect markets will also continue to behave cyclically.

The existence of market cycles creates significant risks for investors who ignore them (i.e. the “this time is different” syndrome) and great opportunities for disciplined long-term investors. However, while this time is rarely different when it comes to investing, seldom do history and cycles repeat exactly in terms of timing, duration, or magnitude.

Howard Marks, co-founder of the successful investment firm Oaktree Capital and the author of many insightful investment memos over the past 25 years, often emphasizes the importance of understanding cycles. He uses the metaphor of a pendulum to describe market behavior, as summarized in the following excerpt from his 2011 book, The Most Important Thing.

Investment markets follow a pendulum-like swing:
- between euphoria and depression (greed and fear),
- between celebrating positive events and obsessing over negatives, and thus
- between overpriced and underpriced.

This oscillation is one of the most dependable features of the investment world.

Marks notes that the oscillation of the investor pendulum is similar to the up-and-down fluctuation of economic and market cycles in that while the occurrence of the pendulum-like pattern is extremely dependable in most markets, one never knows exactly how far the pendulum will swing, how long it will stay at one extreme or another, or what might cause it to reverse.

It is impossible to consistently and accurately predict exactly when a cycle will turn or when the pendulum will start to swing back the other way or how far it will go at the extremes. However, with our longer-term analytical framework, and forward-looking assessments that are informed by and grounded in market history, we can position our portfolios to benefit from the cyclic swings of the pendulum. This requires having a long-term perspective and the discipline to stick to your process and consistently execute it over time, especially when the cycle and pendulum are swinging to extremes.

Market Cycles and Portfolio Positioning

In recent years, our portfolios have been positioned for a turn in some market cycles that haven’t yet changed course, namely our tactical move underweight to U.S. stocks versus foreign stocks, and our exposure to value or cyclical stocks (i.e., businesses that are more sensitive to the broader economic cycle). While this has negatively impacted our short-term performance, we remain confident the current market cycle will turn. The charts below show the relative performance cycles for both of these markets.

**U.S. Versus Foreign Stocks** — Our portfolios are positioned with the view that over our five-year tactical investment horizon, U.S. stocks are likely to deliver underwhelming returns (low single digit), while developed international stocks are poised to produce much higher returns. This has been a headwind to our
portfolio performance as the current cycle of U.S. stock outperformance versus foreign stocks now ranks as the longest relative performance streak for U.S. stocks since the inception of the international stock index in 1970.

Here are just a few points that illustrate why we believe this cycle will eventually turn in our favor:

U.S. profit margins (and earnings growth) have been coming down, as we expected. However, margins are still high relative to history and are likely to continue lower if wage pressures continue to build as the labor market tightens. Higher interest rates (and therefore higher corporate borrowing costs) would also be a negative for margins. Current corporate profit margins have been negatively correlated with future earnings growth. That is, historically high profit margins are associated with low five-year forward earnings growth and vice versa. If topline revenue growth remains subpar and profit margins decline, earnings growth will remain under pressure.

Meanwhile, on the valuation side, we see little room for market-multiple expansion in the United States. The 12-month trailing price-to-earnings ratio for the S&P 500 is 24x, and the 12-month forward P/E ratio is 18x (using analysts’ consensus forward earnings estimates).

These are both historically high levels. Our base case scenario assumes the P/E multiple contracts over time, bringing it in line with longer-term historical averages. Analyzing all of these variables together leads us to the conclusion of lower expected returns for U.S. stocks.

In contrast, developed international markets are almost a mirror image of the U.S market, with below-normal earnings and the potential for faster earnings growth from current levels. We also expect valuation multiples to expand somewhat from current levels as earnings improve. On this point, one additional supporting factor is that foreign markets have already suffered a steep decline, as if the markets expect a global recession even though it isn’t at all clear we are in such a recession or about to fall into one—although that’s one reasonable near-term scenario. In other words, at the low in February foreign stocks had discounted a lot of negative news, setting them up for a potential rebound if actual events turned out to be no worse (let alone better) than expected, which seems to be what we’ve seen over the past month.

**Value (Low Multiple) Versus Expensive (High-Multiple) Stocks** — In another unusually long market cycle, this has been the longest run of underperformance for value stocks since 1930. At nearly 10 years, it has outlasted the six-and-a-half years of the internet/tech stock bubble. The flipside has been that on the other end of the style spectrum, expensive growth and momentum stocks have had unusually strong returns.

The chart on the next page also shows that over the long term a value investment approach has meaningfully outperformed a strategy of buying expensive (high-multiple) stocks. However, cycles persist. Value investing has had several periods of significant underperformance. The inability of most investors to stick with a value approach during such cyclical reversals is likely what enables the “value premium” to persist over the long term. Moreover, the short-term performance-chasing tendencies of most investors pushes the pendulum still further.
Thus, both of these cycles have been headwinds to value investment managers like us who carefully consider the downside risks of overvalued/expensive companies and remain valuation-driven, researching fundamentals on a longer-term “normalized” basis (i.e. based on reasonable estimates of earnings and valuations through an entire cycle as opposed to overweighting a single point in time that may reflect unsustainably high or low earnings). As such, we have been underweight (expensive) U.S. growth stocks and have found (cheaper) foreign stock markets more attractive in terms of their expected returns relative to risk.

Consequently, the reversal in the markets starting in February may mark a change from a cyclical headwind to a tailwind for our tactical positioning. From the February 11th low, the MSCI ACWI ex USA Index is up 13.2%, beating the S&P 500 by 21 basis points. The MSCI ACWI ex USA Value Index has jumped 14.5%, beating the MSCI ACWI ex USA Growth Index by more than two-and-a-half percentage points. European stock indexes also have larger exposure to cyclical and traditional value sectors (such as financials, materials and industrials) than the S&P 500. Finally, our Unconstrained fixed income strategy, which contains high yield bonds, also performed nicely since the market lows, gaining over 10%, while the core bond index returned less than 1%.

Will Recent Market Trends Sustain?

It is certainly possible for a so-called reflation cycle to occur. If oil prices have bottomed, and the current rebound to around $40 per bbl (or higher) is sustained, it may have significant repercussions on a wide range of financial markets. Because the U.S. dollar has been inversely correlated with oil prices for the past 15 years, higher oil prices imply a weaker dollar (or at least minimal further appreciation). This would represent a major change from the strong-dollar trend of the past two years.

In addition, with the U.S. economy near full employment, wages and inflation are likely to continue to rise (barring a recession), thereby pressuring corporate profit margins, earnings growth, and U.S. stock valuations. Of note, we’ve been highlighting this risk to U.S. earnings growth expectations for a while. This should also lead to higher inflation expectations and higher U.S. interest rates. Rising rates would not be positive for core bond prices, but would likely not have a negative impact on our high yield bonds.

This reflation scenario also suggests many of the most popular investment themes of the post-financial-crisis U.S. bull market (such as defensive and growth stocks outperforming cyclical value stocks, and U.S. stocks outpacing foreign stocks) could be reversed during the balance of this recovery.

To be clear, this isn’t a prediction of what will happen over the near term; however, we believe it is one plausible scenario among many that could occur. While we use a short-term (12-month) time frame to run “reasonable worst case” stress-test scenarios as we manage our portfolios against various downside risks,
it is nice to sometimes look at a “reasonable best case” and acknowledge the shorter-term “upside risks” to our portfolios as well.

**Conclusion**

Markets are cyclical, and for the past several years our portfolios have been facing some meaningful cyclical performance headwinds given our tactical asset class positioning and, more broadly, our long-term, active, valuation-driven investment approach. As discussed during this letter, the sharp reversal in the markets beginning in the middle of the first quarter may indicate the market pendulum is starting to swing in our favor.

Even if the recent positive market trends turn out to be short term or reverse course, we remain confident that our disciplined investment process and risk-management process, consistently executed over time, will pay off over the completion of this full cycle, and through future cycles as well.

It is impossible to consistently time short-term market moves, trends, and reversals. As always, patience, discipline, and fortitude remain key to achieving one’s long-term investment goals, and to avoiding being swept away by the pendulum’s unceasing swings.

Should you have any questions regarding our economic and market outlook, or our value-based, income focused investment process, please don’t hesitate to contact us. We appreciate your continued trust and confidence.

-The Altrius Investment Team
GLOBAL INCOME STRATEGY COMMENTARY

Our investment philosophy is predicated on a time-tested, three pronged approach providing solid risk adjusted returns to our investors for well over a decade.

- We believe in the importance of getting paid immediately for the risks which are taken and focus on businesses which compensate our clients with dividends and above average interest. We believe this income stream, coupled with capital appreciation, is a vital aspect of total return.

- We dig deep for value often viewing crisis as an opportunity. We believe that fundamental research and patience are critical to long term success and that over time, the price of a company will rise to reflect the value of the underlying firm viewing each purchase as if were buying a piece of a business – not simply a stock certificate.

- We believe that global revenue generation is a key component to growth and sustainability and invest in companies with global growth opportunities. We are unafraid to take contrarian positions, but remain diligent about the risks of a global economy.

The Global Income strategy finished the first quarter with a 2.53% gain versus a gain of 1.37% for the blended balanced benchmark. The trailing 10-year returns for the strategy are 5.14% versus 5.79% for the blended benchmark. The twelve month trailing yield for the Global Income strategy stands at 5.35% versus 1.71% for the Vanguard Balanced index fund (VBINX).

During the quarter, we trimmed our exposure to basic materials after a significant short covering rally in order to marginally de-risk our portfolio. At the same time valuations in the high yield fixed income market are returning to more rational levels, of which we have begun to allocate more funds to the purchase of ‘higher quality’ non-investment grade issues. The recent market selloff presents opportunities both domestically and abroad and our portfolio has a more attractive price to earnings ratio of 14.15 which is far less than the broader market indices – most of which currently maintain multiples in excess of 18. Our focus continues to emphasize the importance of immediate income to our investors particularly in this volatile, low interest rate environment, which we believe will persist for longer than most economists. In the fixed income sector, our emphasis remains on high yield bonds, which we believe more adequately compensates our investors for credit risk, while providing better protection in a potentially rising interest rate environment.
US LARGE CAP DIVIDEND INCOME STRATEGY COMMENTARY

As value investors, we constantly focus on our duty to protect the principal of our investments even as we look for ways to grow them over time as well. As economists, we remain alert to trends taking place in the larger global economy. As analysts, we seek to invest in securities priced with a margin of safety in order to account for their near term volatility and our uncertainty about what the future holds. With this in mind, we look for opportunities in three specific categories: classic value, persistent earners, and distressed or contrarian.

Classic value stocks sell at attractive valuations and provide above-average dividend yields and growth. Persistent earners are companies which have steady and predictable earnings and that are selling below their historic valuation. The distressed/contrarian category refers to stocks that are out of favor due to what we perceive to be temporary factors and are likely to appreciate substantially as the temporarily distressing factor recedes. Typically the distressed category is the smallest in the portfolio.

PERFORMANCE COMMENTARY

The U.S. Large Cap Dividend Income strategy had an outstanding quarter gaining 4.53% well outpacing the Russell 1000 Value index which returned just 1.64% during the same period. The strategy has produced sound ten year risk adjusted returns roundly besting its indices and peer group for the period. The trailing annualized ten year returns were 7.73% for the strategy, 5.72% for the Russell 1000 Value index and 7.17% for the Dow Jones US Select Dividend index.

Our stock selection and sector allocation weighting both had a positive impact on relative and absolute performance during the first quarter. The consumer cyclical, communication services, basic materials and financial services sectors were our largest attributors to relative performance while the utilities, energy and technology sectors were the largest detractors. Though maintaining a focus on dividends, we believe the utility and real estate sectors remain overvalued and will perform poorly in a potentially rising interest rate environment; thus, we do not have any positions in the sectors. The top performers for the quarter were Freeport-McMoRan (52.7%), Mattel (25.3%), Verizon Communications (18.5%), AT&T (15.4%) and Caterpillar (14.1%). The bottom performers were ConocoPhillips (-13.1), Principal Financial Group (-11.4%), Marathon Oil Corp (-10.9%), Wells Fargo & Co. (-10.3%) and JPMorgan Chase & Co. (-9.7%).

Top Ten Holdings | Weight
--- | ---
International Business Machines | 3.13%
Marathon | 2.95%
Cisco Systems | 2.91%
Mattel | 2.87%
Verizon | 2.87%
Caterpillar | 2.85%
Aflac | 2.82%
Philip Morris | 2.82%
Phillips 66 | 2.81%
Chevron | 2.80%

Sector Allocation (Morningstar)

- Financial Services: 21%
- Energy: 17%
- Consumer Cyclical: 17%
- Technology: 15%
- Industrials: 11%
- Consumer Defensive: 9%
- Communications Services: 6%
- Healthcare: 5%
As one may recognize from the below chart, our firm has consistently provided a steady stream of income to our clients in the form of dividends. It is our assertion that this income stream has not only reduced the risk of our portfolio, but also provided a large part of the total return thereby leading to our performance success over this past tumultuous decade plus.

Dividends also act to align the interests of corporations and shareholders in helping to eliminate the agency effect. Corporate boards have recognized the value of dividends in stabilizing their stock price and encouraging investment during both high and lower tax regimes. In supporting and increasing dividends over time, managers are compelled to maintain a reliable stream of cash flows to shareholders rather than waste capital on those expenses adding little to corporate revenue including executive perks, pet projects, and ill-timed, unwise acquisitions. It appears a paradox; however, our experience and academic studies have displayed that sufficient investment for a good business can still occur in conjunction with dividends as managers are forced to invest cash flow more prudently and only in those capital investments in which they have the highest conviction in adding to corporate revenue particularly since stocks buybacks are often ill-timed.

The strategy has consistently delivered a higher dividend yield than the S&P 500 since inception.
After a 50+% move this year, we sold our position in Freeport-McMoRan (FCX) just before the quarter’s end replacing it with International Business Machines (IBM). IBM is a worldwide supplier of technology and business services, software and systems hardware with foreign sales consisting of 53% of 2015 revenues. IBM’s revenues have been in decline since 2011 with quarterly earnings experiencing uneven results as rapid changes in technology have negatively impacted IBM. In addition, currency headwinds and spending on new businesses have hurt margins reducing revenues and profits as the company attempts to transform its business. However, at 11 times trailing and forward earnings, we believe the company is a value and offers a lower beta proposition in a volatile economic climate. In addition, we believe successes in the company’s analytics and cloud computing will offset slow declines in the company’s legacy businesses giving it time to transform its business through its strategic imperatives. Lastly, the company has steadily increased its dividend for over twenty years and currently yields approximately 3 1/2% allowing us to be “paid to wait” while also increasing the company’s total return potential over the long term.
UNCONSTRAINED FIXED INCOME STRATEGY COMMENTARY

Based on our macroeconomic outlook over a three to five year period and our cyclical views from quarter to quarter, we employ top-down strategies that focus on yield curve positioning, volatility, and sector rotation. We then utilize bottom-up analysis to drive our security selection process and facilitate the identification of undervalued securities with the potential for above average income. We invest in securities that operate across diversified sectors in the fixed income markets of the United States, primarily those in U.S. dollar denominated high yield and investment grade bonds, including government securities, corporate bonds, and mortgage- and asset-backed. Sources of added value:

Credit Analysis - We emphasize independent analysis and do not rely on credit agencies.
Duration Risk - We avoid long, extreme duration shifts generally operating within a moderate duration range typically between two and four years.
High Income - Our research attempts to identify issues paying above average income.
Risk Premium Management - We seek to attain an attractive yield/spread in relation to a five-year treasury within acceptable levels of portfolio risk.

MARKET OVERVIEW

The first quarter of 2016 was exemplified by its volatility with aggregate high-yield spreads widening to over 800 basis points by mid-February over similarly dated U.S. Treasury bonds. The 10-year Treasury note, which started the year yielding 2.24%, fell to 1.78% by quarter-end, after having briefly touched a low of roughly 1.60% on February 11th. Concerns over a slowdown in industrial production in China, the continuing fall in oil prices, and investors’ uncertainty regarding the effectiveness of global central banking policies, all contributed to the volatility in the first half of the quarter. However, the domestic equity and fixed income markets launched a pronounced and sustained recovery beginning in the final weeks of February and continuing through the entirety of March, with all major bond indices recording positive returns for the quarter. TIPS (Treasury Inflation Protected Securities) posted the strongest quarterly returns of any fixed income asset class at +4.46%, despite widespread speculation that the Fed’s conviction in initiating two rate hikes over the course of 2016 might be fading. U.S. investment-grade corporate bonds were the second best performing fixed income market segment for the quarter, returning +3.97%, outpacing the high-yield market, which produced a very strong +3.35% return as oil prices

PERFORMANCE COMMENTARY

Top Ten Holdings

<table>
<thead>
<tr>
<th>Top Ten Holdings</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>International Game Technology</td>
<td>1.51%</td>
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<tr>
<td>Rent-A-Center</td>
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<tr>
<td>Icahn Enterprises</td>
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<tr>
<td>Cooper Tire &amp; Rubber</td>
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<td>AngloGold Ashanti</td>
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<td>Oppenheimer Holdings</td>
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<td>American Greetings</td>
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<tr>
<td>GAP Inc</td>
<td>1.35%</td>
</tr>
<tr>
<td>Credit Acceptance</td>
<td>1.29%</td>
</tr>
<tr>
<td>MetroPCS</td>
<td>1.27%</td>
</tr>
</tbody>
</table>
UNCONSTRAINED FIXED INCOME STRATEGY COMMENTARY

rebounded and headed higher toward $40/bbl by quarter end. Along with the recovery in energy prices, investors’ concerns over the commodities supply glut and a weakening Chinese economy showed significant signs of abating as fund flows back into high-yield bonds ramped up substantially in the latter half of the quarter, causing spreads to contract to more normalized levels of roughly +600 bps.

With that being said, corporate default rates, currently at 3.2% (below long-term averages of 3.9%) are expected to increase over the course of the year to a level forecasted around 6.0%, with the majority of defaults expected to occur in the energy sector. There could however be a number of upside surprises in 2016 as much of investors’ pessimism toward the energy sector is already reflected in current valuations, and should oil prices continue their upward momentum, banks may begin extending lines of credit to distressed companies; in which case the number of corporate defaults will not be as high as currently anticipated.

PERFORMANCE SUMMARY

Coming off a difficult year for performance in 2015, the Unconstrained Fixed Income strategy posted a positive return of 3.16% (gross of fees) for the first quarter of 2016; outpacing the Barclays U.S. Aggregate Bond index by 13 bps, but underperforming the Barclays Corp BB+ index by 80 bps. The strategy’s underperformance relative to the Barclays Corp BB+ index was due to the fact that higher quality corporate bonds, those rated ‘BB’ or higher, outperformed their lower rated peers. As displayed in the chart below, over 50% of the strategy’s assets are invested in companies rated ‘B+’ or lower (more discussion concerning credit ratings to follow).

The strategy’s exposure to the energy sector continued to have a negative effect on performance, with a number of positions remaining highly distressed (valuations below $0.40/$1.00) despite the upswing in oil prices experienced during the latter half of the quarter. Metals and mining was a very bright spot for the strategy during Q1, as a number of positions which had been hovering around distressed levels over the past year launched a dramatic recovery, with valuation gains in excess of 20% experienced by such companies as Aleris International, Coeur Mining, and ArcelorMittal S.A.; while both AK Steel and United States Steel saw their bond prices recover by more than 50% during the quarter.

STRATEGY CHARACTERISTICS

There was no significant change to the strategy’s overall sector diversification over prior quarters. Consumer discretionary and energy remain the strategy’s two most heavily invested sectors, with each accounting for roughly 24% and 18% respectively of the strategy’s total invested assets. Over a third of the strategy is also fairly equally invested across the financial, industrial, and materials sectors, with each accounting for roughly 13%, 11%, and 10% respectively. Despite maintaining high allocations in both the consumer discretionary and energy sectors, the strategy is invested in a wide array of unaffiliated companies across 12 major industry sectors in order to
UNCONSTRAINED FIXED INCOME STRATEGY COMMENTARY

provide broad portfolio diversification and help mitigate against issue specific credit risk.

The strategy’s overall credit quality is ‘B+’, which did not change over the prior quarter’s aggregate rating. Of the four new issues established during the first quarter of the year, each currently maintains a credit rating of ‘B+’ or better, which has been a consistent theme in the strategy over the past year as the volatility in the fixed income markets, particularly pessimism in the high-yield space, has presented numerous opportunities for us to establish positions in higher quality companies that possess greater long-term solvency profiles than those bearing ratings of ‘B-’ or below. With that being said, we still remain credit rating agnostic in our credit research and analysis approach, and the individual credit rating of any one particular issuer bears little weight in our overall investment decision process. As such, we remain open to investing in companies across the credit risk spectrum as long as said companies meet and pass both our qualitative and quantitative investment criteria.

Both the aggregate maturity profile and effective duration for the strategy continued to modestly contract with each closing out the first quarter of the year at 3.69 years and 2.99 respectively. With the longest dated ‘non-callable’ issue held within the strategy set to mature in February of 2021, we have continued to refrain from investing in issues with maturities greater than six years in order to better guard the strategy’s assets against the interest rate risk inherent in longer-term bonds (those maturing in 10+ years).

STRATEGY OUTLOOK

Although we are very pleased with the performance of the Unconstrained Fixed Income strategy for the first quarter of 2016, our overall mentality with respect to the construct of the strategy is no different than it ever has been. In fact, we view the recovery that occurred in the high-yield fixed income market in the latter half of the quarter as both a blessing and a curse, with more emphasis on the latter, as the abundance of attractive investment valuations for us to enter and lock-in have declined to a large degree as investors decided to re-enter the market, driving prices up and yields down. It is important to remember that the fluctuations in bond prices are not always related to the underlying fundamentals or long-term solvency profile of the issuing company; but are often times the result of ‘panic’ and/or ‘forced’ selling (an aspect common in the high-yield market) where investors’ short-term fear(s) for liquidity and cash overpower and diminish their long-term strategic investment positioning. Since its inception, the Unconstrained Fixed Income strategy’s primary goals have been to produce a high level of year-over-year income and above average long-term risk-adjusted returns, even withstanding periodic defaults. We seek to achieve these dual ends through broad issue diversification and maintaining a long-term disciplined mindset in our investment approach.
KB Home (KBH) is one of the largest and most recognized homebuilding companies in the United States with operations predominantly focused in the West, Southwest, Central, and Southeast regions of the country. Over the last few years KB Home has experienced significant negative operating cash flows as a result of investing heavily in its inventories, both in land acquisition and unit development. In the past year the Company’s investment strategy showed the first signs of paying-off as ‘Home Building’ revenues exceeded $3.0 billion in 2015, an increase of +26% over 2014, and the number of ‘Homes Delivered’ increased to 8,196, a 13.6% and 14.7% increase over both 2014 and 2013 levels respectively. KB Home has made significant strides in the reduction of its debt leverage, reducing its ‘total debt-to-capitalization ratio’ from a level of over 80% in 2012 and 2013, to a level of roughly 60% for year-end 2015 (a level more in-line with industry standards and KB Home’s peer group). The liquidity profile for KB Home, which has improved over recent years, should remain stable as the company’s current land holdings are viewed by management as being ample to support future unit development forecasts, with additional support provided by a current unrestricted cash position of $356 million and an undrawn $250 million revolving credit facility. Interest coverage, which has been positive over the past three years since KB Home returned to profitability, may experience year-over-year fluctuations depending on the state of the economy and the future rates of new household formations and home buyer appetite.

Micron Technology, Inc. (MU) is a global manufacturer and marketer of semiconductor devices, primarily DRAM, NAND Flash, and NOR Flash memory technologies, as well as multi-chip packaging solutions. Despite doubling its total debt outstanding over the past three years in the pursuit and completion of a number of strategic acquisitions, Micron maintains a leverage profile of less than 2.0x (total debt/EBITDA), which is a lower level relative to other BB rated issuers. Along with its modest leverage, Micron exhibits a strong liquidity profile supported by its maintenance of a consistent year-over-year cash position on its balance sheet in excess of $2.0 billion, minimal drawdowns on its $750 million credit facility, and positive albeit fluctuating year-over-year free cash flow generation (CFO – Capex). The roughly 10% discount to par value on Micron’s 5.875% 2022 senior notes is due in large part, we feel, to the markets overly pessimistic outlook on the memory chip industry, which is undoubtedly highly cyclical in nature, characterized by regular price deflation as a result of technological advances and strong competition amongst peer companies. Given Micron’s strong current financial position, modest leverage, and good liquidity, the company’s BB credit rating will most likely not come under threat of a downgrade; even if operating results contract in the coming year(s). As the second largest manufacturer in the memory industry, we feel Micron is well positioned to deal with unfavorable industry headwinds, should and when they arise, and we are confident in the company’s long-term solvency, especially as it relates to the risk-to-reward profile of the 5.875% 2022 senior notes.

Vale S.A. (VALE) is one of the largest metals and mining companies in the world, based on market capitalization, and the largest single producer of iron ore, iron ore pellets, and nickel globally. The collapse in commodity prices in recent years due to excess supply and the simultaneous slowdown in industrial production out of China, has caused Vale’s total revenues to contract over 50% from 2011 highs, and eroded profitability with Vale recording a net loss of over $12 billion (due primarily to a non-recurring $9 billion impairment write-down) for its most recent year-end. Despite the unfavorable economic variables affecting Vale’s year-over-year financial performance, the company continued to maintain a stable leverage profile with total debt/EBITDA remaining under 4.0x, while producing positive albeit variable year-over-year interest coverage (EBIT/interest expense), with the exception of the most recent year-end. Furthermore, Vale has slowly been
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reducing annual capital expenditures over the past four years, and began retiring a small portion of its total outstanding debt over the past two; these actions taken by management are viewed favorably by debt holders (including us), and given Vale’s robust mining infrastructure and position as the world’s low-cost producer of iron ore and other materials we don’t believe said operational divestments will hurt the company’s competitive position in the years to ahead. Although the 5.625% senior notes due 2019 are currently rated BBB- (the lowest ‘investment grade’ credit rating), we believe it is possible that Vale may receive a rating downgrade sometime this year to somewhere in the BB range (highest rated ‘non-investment grade’ credit rating), in which case the notes would experience some near-term downward price volatility due to forced institutional selling. However, being rating agnostic, we would be unfazed by such an event, as we are confident in Vale’s long-term solvency, given its modest degree of leverage, which should remain around current levels as a result of management’s conservative capital spending discipline, and our anticipation of an eventual recovery in commodity prices and global economic activity.

NEW PORTFOLIO PURCHASES

United Rentals, Inc. (URI)
7.625% 4/15/22 – 6.2% YTM

United Rentals, Inc. (URI) is an equipment rental company operating throughout the United States and Canada. The company operates across two business segments: General Rentals and Trench, Power, and Pump. The General Rentals segment provides general construction and industrial equipment such as backhoes, earthmovers, forklifts, etc; and the Trench, Power, and Pump segment which provides equipment for underground construction, trench safety, power & HVAC systems, as well as pumps for the oil and gas sector. United Rentals has been a previous holding within the Unconstrained Fixed Income strategy, and we capitalized on the opportunity presented by the market wide sell-off in the high yield space which occurred throughout February and into early March to re-establish a position in the company. Overall leverage (total debt/EBITDA) for United Rentals typically ranges between 2.0x and 5.0x for any given year, and as reported in its most recent fiscal year-end results for 2015, total debt/EBITDA came in just below 3.0x at roughly 2.7x. Along with maintaining a consistent year-over-year leverage profile, United Rentals also produces a relatively stable and predictable level of year-over-year interest coverage (EBIT/interest expense), typically in the range of 2.0x to 3.0x. As a frequent ‘refinancer’ of its outstanding borrowings, it is almost more than certain that our 7.625% senior notes due 2022 will be ‘called’ away sometime closer to our initial purchase date than to the schedule 2022 maturity date. However, as long as United Rentals’ senior notes remain available and attractively priced in the market, we intended to continue to accumulate a position in the company, as we find its stable and predictable operating results and positive year-over-year earnings production a source of dependable return at lower relative risk (both interest rate and credit) when compared to some its industry and BB- rated peers.
As value investors, we constantly focus on our duty to protect the principal of our investments even as we look for ways to grow them over time as well. As economists, we remain alert to trends taking place in the larger global economy. As analysts, we seek to invest in securities priced with a margin of safety in order to account for their near term volatility and our uncertainty about what the future holds. With this in mind, we look for opportunities in three specific categories: classic value, persistent earners, and distressed or contrarian.

The International ADR Dividend Income strategy had positive relative performance against one of its comparative indices, but negative absolute returns for the quarter declining 1.85%. The S&P Int’l Dividend Opportunities index gained 5.42% while the MSCI EAFE Value index was lower by 3.97%. Since its inception on June 1, 2010, the strategy has produced annualized returns of 3.61% versus 2.11% for the S&P Int’l Dividend Opportunities and 4.70% for the MSCI EAFE Value indices respectively.

Our sector allocations had a positive impact on our relative performance during the quarter against the EAFE Value index while our stock selection had a slightly negative effect. The basic materials, financial services and consumer defensive sectors attributed the greatest portion to relative performance while exposure to the energy, consumer cyclical and a lack of positions in real estate detracted the most from the strategy’s relative performance. Going forward, we believe we will find more value amongst international issues than U.S. companies while expecting the trend of downward pressure in the energy and basic materials sectors to eventually reverse as the global economy stabilizes. The top performers for the quarter were Posco (33.9%), Vale (28.0%), Eaton (21.4%), Taiwan Semiconductor (15.2%) and Siemens (14.8%) while the bottom performers were Credit Suisse (-34.9%), Ensco (-32.5%), Mitsubishi Financial (-26.2%), Transocean (-26.2%) and AstraZeneca (-14.4%).
After an almost 30% move this year, we sold our position in Vale Overseas (VALE) and replaced it with fixed income issues from our Unconstrained strategy.
DISCLOSURES

This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact. Altrius is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy and approach. Our views and opinions include “forward-looking statements” which may or may not be accurate over the long term. Forward-looking statements can be identified by words like “believe,” “expect,” “anticipate,” or similar expressions. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

The information provided in this material should not be considered a recommendation to buy, sell or hold any particular security. The S&P 500® Index is an unmanaged index of 500 selected common stocks, most of which are listed on the New York Stock Exchange. The Index is adjusted for dividends, weighted towards stocks with large market capitalizations and represents approximately two-thirds of the total market value of all domestic common stocks. The Russell 1000 Value Index is an unmanaged index commonly used as a benchmark to measure value manager performance and characteristics. The Dow Jones U.S. Select Dividend Index is an unmanaged index commonly used as a benchmark to measure dividend manager performance and characteristics. The Russell 2000 Index, the Russell 2000 Growth Index, and the Russell 2000 Value Index are unmanaged indices commonly used as benchmarks to measure small cap manager performance and characteristics. The MSCI EAFE® Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. & Canada. The Barclays Capital U.S. Aggregate Bond Index and Barclays Corporate BB+ Index are unmanaged indices that are commonly used as benchmarks to measure fixed income performance and characteristics. Index performance returns do not reflect any management fees, transaction costs or expenses. Investments cannot be made directly in an index. Investments made with Altrius Capital Management, Inc. are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested. Past performance is not a guarantee of future returns.