HALITE PARTNERS

EXECUTIVE SUMMARY

2017 was unique in that investment markets were both calm and profitable. Each of the major equity, bond, and commodity markets that we track traded steadily higher throughout the year, ending with yet another year of positive returns.

2017 Highlights

- **We are pleased with our strong performance in 2017, driven by our successful investment in credit focused hedge funds, sizeable allocations to private equity and non-US public equities, and limited exposure to US Treasuries and commodities.**
- 2017 was one of the least volatile years on record for equity markets, illustrated by the following:
  - The S&P 500 had its second least volatile year in terms of daily returns since 1928.
  - The S&P 500 had its second lowest drawdown since 1928, just 2.8%.
  - US and global equities posted positive returns in every month during the year.
  - Global stock volatility (based on monthly returns) was so low that it was equal to global bond volatility, a very rare occurrence.
- Economic growth was strong, the Fed raised rates at a measured and expected pace, the Trump administration focused on deregulation, and financial credit conditions were nearly as loose as they have ever been.

2018 Outlook

- **We believe strong market conditions (low volatility, high valuations, bullish sentiment) combined with high economic growth expectations from 2017 are unlikely to persist through 2018.**
- The market outlook for 2018 is not nearly as rosy as what occurred in 2017.
- The current economic expansion is already one of the longest in history and equity markets have historically priced in economic growth acceleration ahead of the actual event anyway.
- Volatility is unlikely to significantly decrease from already near historic lows and could even spike given the lack of fear in the market.
- The US stock market is trading near all-time high valuations in terms of many metrics (e.g., price/earnings, cyclically adjusted price to earnings, price/sales, US gross national product/total stock market capitalization).
- Investor sentiment in 2017 was among the most bullish ever, which is a contrarian signal.

2018 Portfolio Positioning

- **When we look at your portfolio through a risk management lens, we believe it is prudent to reduce risk in 1Q 2018.**
- While there is no magic bullet for determining the timing of a major pullback, the conditions in early 2018 suggest that we may be close to peak bullishness.

MARKET OBSERVATIONS

"Two super-contagious diseases, fear and greed, will forever occur in the investment community. The timing of these epidemics will be unpredictable. ... We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful." **– Warren Buffett**

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RISK TYPE	ASSET CLASS	ASSET NAME	YTD	Q4 2017	Q3 2017	Q2 2017	Q1 2017
Risk Asset	Equities	MSCI Emerging Markets Index	37.6%	7.4%	8.0%	6.4%	11.5%
		MSCI ACWI Index ex-US	27.8%	5.1%	6.3%	6.0%	8.0%
		MSCI EAFE Index	25.7%	4.3%	5.5%	6.3%	7.4%
		MSCI ACWI Index	24.6%	5.8%	5.3%	4.4%	7.1%
		S&P 500 Index	21.8%	6.6%	4.5%	3.1%	6.1%
	Fixed Income	BC US Corporate High Yield	7.5%	0.5%	2.0%	2.2%	2.7%
	Commodities	BC US Commodity Index	1.7%	4.7%	2.5%	-3.0%	-2.3%
	Alternatives	TR PE Index	28.5%	12.2%	4.9%	2.2%	6.8%
		HFRI Fund of Funds Index	7.7%	2.0%	2.3%	0.8%	2.4%
Risk Mitigator	Fixed Income	BC US Aggregate Index	3.5%	0.4%	0.8%	1.4%	0.8%
		BC US Treasury	2.3%	0.1%	0.4%	1.2%	0.7%

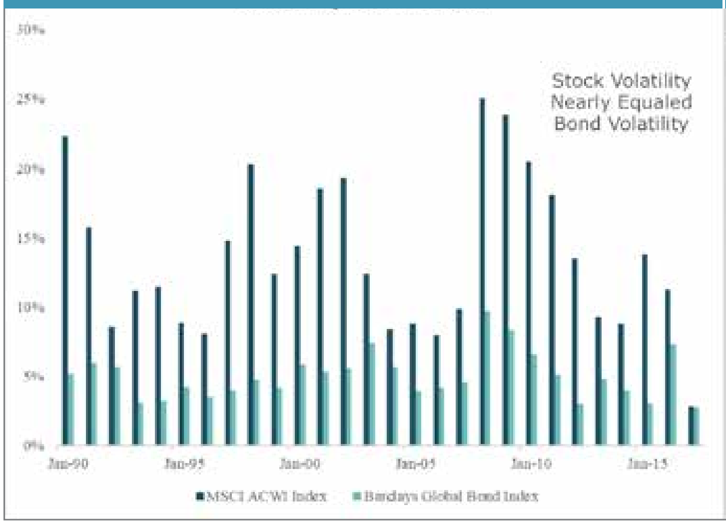
Data Source: Bloomberg

For the year, Global stock returns beat bonds and commodities once again as they increased a significant 24.6%, with emerging markets (+37.5%) leading all regions and Information Technology (+38.8%) leading all sectors[1]. Even every major hedge fund strategy posted positive returns in 2017 after years of disappointing investors[2].

We were very happy with our overall performance in 2017. Our biggest tilt added the most value. We were overweight illiquid credit focused hedge funds, which increased 10.1% on average[3]. This healthy double-digit return handily beat liquid public bonds that only returned 3.5%[4]. **In an era where investors are desperately searching for yield, we believe we found the answer, and they are already reaping the benefits.** We also benefited from having sizeable allocations to non-US public equities and private equity while having limited exposure to US Treasuries and commodities.

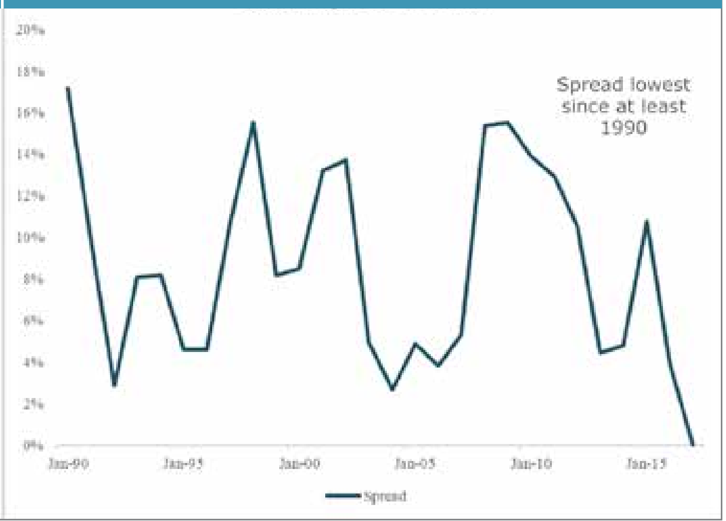
As odd as it may sound, one of the major signs that trouble is brewing on the horizon is the overwhelming sense of calm in the market. The major stock market rally in 2017 was accompanied by extremely little volatility and small temporary losses (i.e., "drawdown", which is measured by peak to trough market returns). As evidence, 2017 was the second least volatile year since 1928 in terms of S&P 500 daily returns and had the second lowest drawdown, just 2.8%[5]. Furthermore, both US and global stocks posted positive returns every month of the year[6]. And arguably most amazingly, global stock volatility of monthly returns was as low as global bond volatility[7], which is a statistic that does not make any fundamental sense. Given that bondholders receive cash flows before equityholders, bonds should have significantly less volatility than stocks. Since 1990, stocks have been 2.8 times as volatile as bonds on average with last year being the only year when stock volatility was nearly equal to bond volatility.

REALIZED RISK | GLOBAL EQUITIES VS. BONDS



Data Source: Bloomberg; Data from January 1990 – December 2017.

REALIZED RISK SPREAD | GLOBAL EQUITIES VS. BONDS



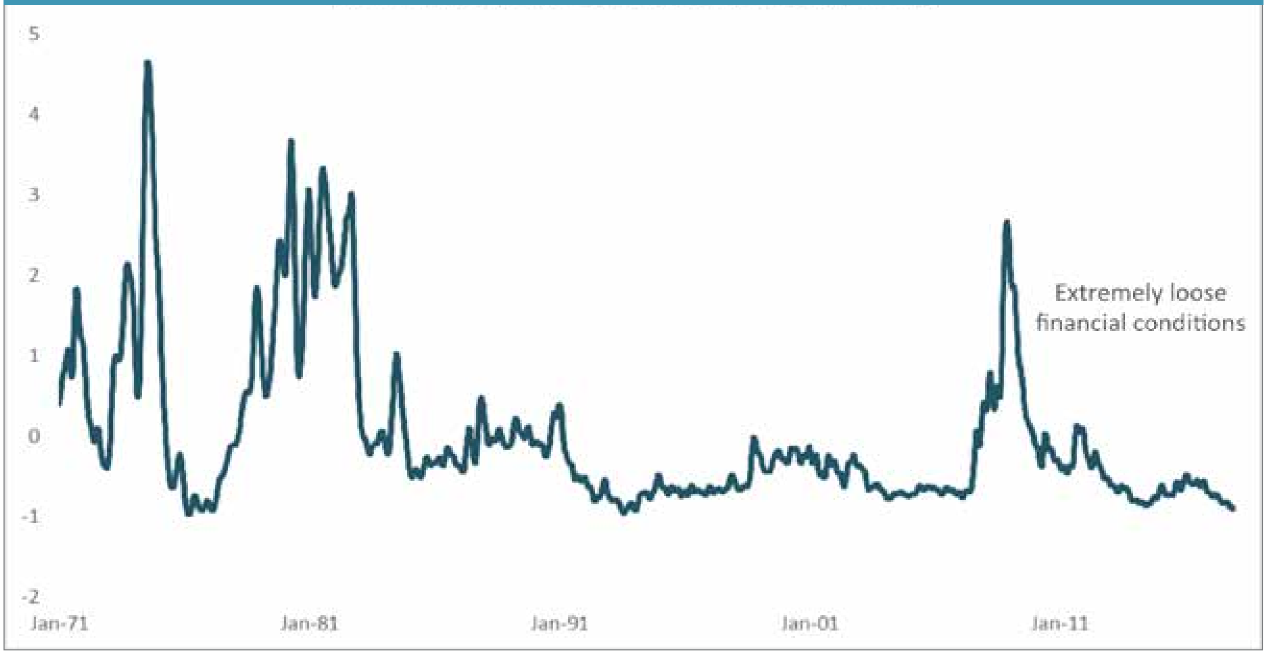
Data Source: Bloomberg; Data from January 1990 – December 2017.

[1] Bloomberg
[2] Bloomberg
[3] Bloomberg; Illiquid credit focused hedge funds proxy = HFRI Event Driven Distressed/Restructuring Index
[4] Bloomberg; Liquid public bonds proxy = Bloomberg Barclays US Aggregate Bond Index
[5] The Leuthold Group's PERCEPTION EXPRESS, 11/7/17
[6] Bloomberg
[7] Bloomberg

ECONOMIC OBSERVATIONS

From an economic perspective, there were many positives to the overall economy. Economic growth was strong, the Fed raised rates at a measured and expected pace, the Trump administration focused on deregulation, and financial credit conditions (NFCI) were as close to as loose as they have ever been (record was in the mid-1970s, right before inflation skyrocketed)[8].

NATIONAL FINANCIAL CONDITIONS INDEX (NFCI)



Data Source: Bloomberg; Data from 1/8/1971 – 1/5/2018.

Strong economic growth momentum, steady monetary policy, deregulation, and loose financial conditions are now accompanied by Trump's tax cuts which go into effect in 2018 (so now we have fiscal stimulus too as the Federal debt is expected to increase, excluding effects from macroeconomic feedback[9]). These are all undoubtedly good signs for continued economic prosperity in 2018. However, economic growth does not always lead to the best stock market returns. **In fact, since 1948 the quartile with the lowest returns for the S&P 500 over the following year was the one with the highest GDP acceleration over the previous quarter[10]!** Said in simpler terms, investors have not been able to successfully time the market simply by knowing that GDP growth is accelerating.

Predicting broad based stock market returns over the short-term, such as one year, is a daunting task. At the end of 2017, Wall Street strategists forecasted a 7.6% return for the S&P 500 in 2018[11]. However, **Wall Street strategists are almost always bullish.** There is no predictive power in their forecasts whatsoever. Since 1999, Wall Street forecasters have never once predicted a down year, putting the average annual gain at 9%[12]. They missed all four years in which the markets had negative returns, and in each instance markets sold off more than 9%. They even completely missed the 2008 meltdown. **Strategists projected a stock market return of 11% for 2008,** which was their most bullish projection of the previous five years. More than $7 trillion of equity value was lost as the S&P 500 plunged 39%. We will not invest your capital with any Wall Street forecasts in mind.

At Halite, we focus on the long term. On occasion however, there are two situations when we will adjust the portfolio from a tactical perspective:

- Tactical Buy: If there was a dislocation (e.g., oil sector in early 2016) that we deemed was unwarranted, stretched, and temporary, we would be willing to step in as a buyer, because the upside would be attractive while any further downside would be limited.
- Tactical Sell: If the expectation for any asset class became so rosy that we believed meeting or even beating that expectation would result in only a small gain while missing that expectation would result in a meaningful loss, we would trim for risk management purposes.

Entering 2018, we are focused on tactical sells because as we point out below, risks to the downside seem quite large for certain asset classes, such as US equities.

[8] https://www.chicagofed.org/research/data/nfci/background
[9] https://www.cbo.gov/publication/53415
[10] Bloomberg
[11] Bloomberg
[12] https://www.bloomberg.com/news/articles/2017-11-24/longest-s-p-500-rally-ever-it-s-wall-street-s-official-forecast

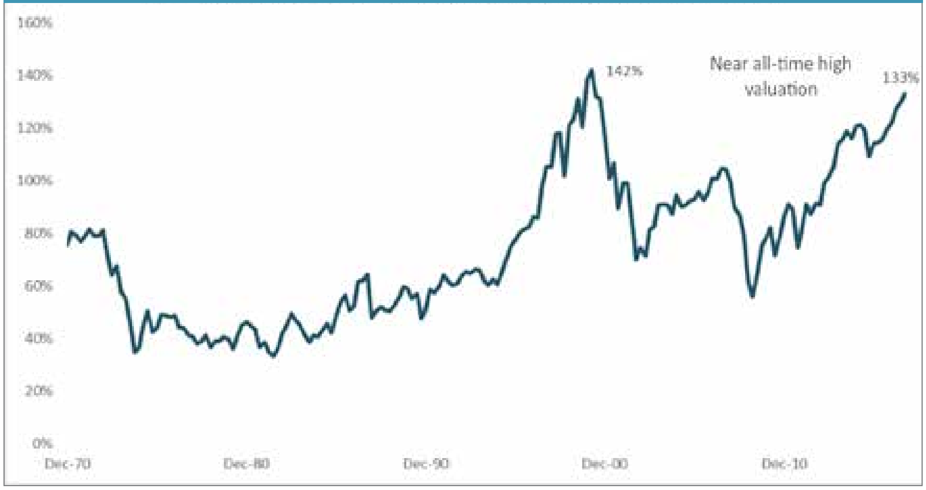
RISKS TO THE MARKET

The fundamental sources of fear that plagued the world over the past couple of years, such as a China hard landing, global deflation, Eurozone instability, and high levels of global debt, have seemingly disappeared. We are not arguing those particular risks are about to return any time soon. However, there are many numerous and unknown risks that could hit at any point. **What concerns us the most is that investors currently seem to lack any sort of fear.**

> "When you compare the fundamental risks that we see all around the globe with the lack of volatility in our securities markets, it's profoundly troubling... makes me wonder if we're not setting ourselves up for an '87, or a '98 or a 2008-2009... The defining moments for portfolio management [came in those years] and if you ignore that, you're not going to be able to manage your portfolio... I'm not worried about the economy so much, what I'm concerned about is valuation[13]." – Yale's David Swenson, 11/15/17

The US stock market is trading near all-time high valuations in terms of many valuation metrics, including price/earnings, cyclically adjusted price to earnings, price/sales, and US gross national product/total stock market capitalization[14]. Note that the last metric (shown below) is Warren Buffett's preferred metric as it "is probably the best single measure of where valuations stand at any given moment[15]." This high valuation starting point on top of the seeming lack of fear in the market leads us to believe that if there is any sort of a market correction, it may be much larger than it would have "normally" been.

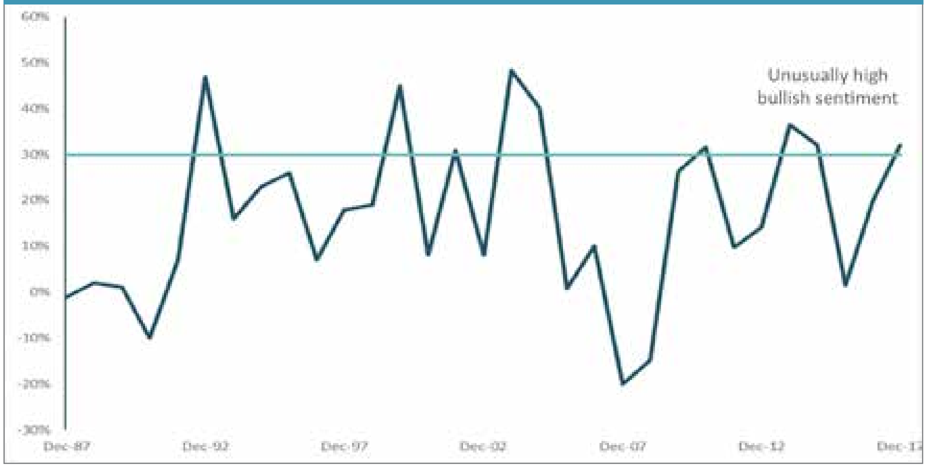
THE BUFFET INDICATOR | US STOCK MARKET CAPITALIZATION / US GNP



Data Source: Bloomberg; Data from December 1970 – September 2017.

We understand that market sentiment can shift quickly and that what is currently viewed as a bullish market has historically been an inopportune time to invest. Since 1988, there have been eight year-ends when the percent of bullish investors have been 30% greater than the percent of bearish investors. **In the eight years that began filled with bullish investors, the return of the S&P 500 the following year was only 1.5%, significantly less than the average return of 16%[16] for the other 21 years.**

ALL INVESTOR SENTIMENT SURVEY | BULLS - BEARS



Data Source: Bloomberg; Data from December 1987 – December 2017.

[13] http://www.pionline.com/article/20171115/ONLINE/171119897/yales-david-swensen-sees-low-volatility-as-profoundly-troubling
[14] Price/earnings = http://www.multpl.com/, Cyclically adjusted price to earnings = http://www.multpl.com/shiller-pe/, Price/sales = Bloomberg, US gross national product/total stock market capitalization = Federal Reserve of St. Louis and Bloomberg, data as of 9/30/17
[15] http://archive.fortune.com/magazines/fortune/fortune_archive/2001/12/10/314691/index.htm
[16] Bloomberg

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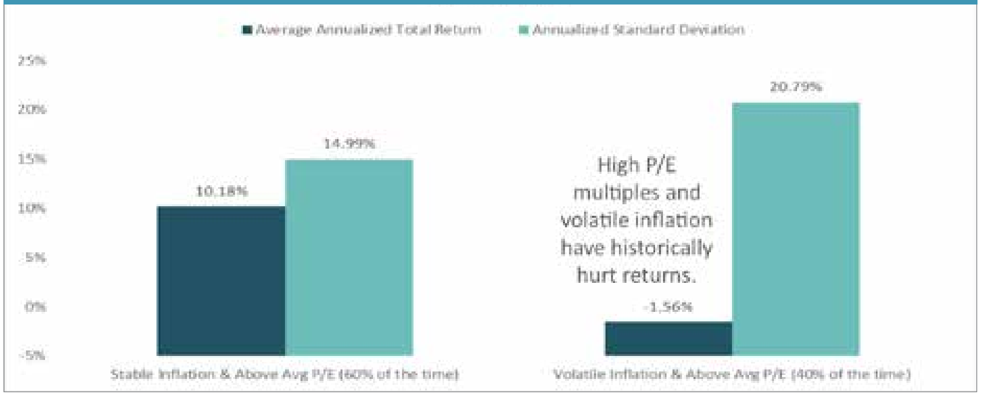
The current environment of low volatility, high valuations, and bullish sentiment is usually very fragile and characterized by an upside that is lower than usual and a downside that is higher than usual. The market is so complacent that even a small change could cause a large disruption. Changes include a negative geopolitical incident, a negative change in monetary or fiscal policy, or an unexpected change in inflation. For example, inflation has been quite steady over the last 10 years, mostly ranging around 0.7% to 2.5%[17].

However, even a small move in inflation from its current level of 2.1% to over 2.5% could prove detrimental to the market. **From 1924 to 2017, the S&P 500 had negative and very volatile returns when an above average P/E multiple was accompanied by inflation breaking out of its 10-year range[18].** We aren't necessarily predicting a rise in inflation over 2.5%, but we believe it is a possibility and are worried about the negative impact it could have on your portfolio.

TOTAL S&P 500 INDEX ANNUALIZED RETURN AND RISK BY INFLATION RATE STABILITY FOR ALL ABOVE P/E MULTIPLES 1924 TO 2017



Data Source: The Leuthold Group, 8/14/17, "How Long Will Inflation Stay in the SWEET SPOT"

PORTFOLIO CHANGES

The strong market momentum and the anticipation of Trump tax cuts compelled us to hold off derisking last quarter. However, U.S. public equity market multiples are already nearing all-time highs, investor sentiment is already incredibly bullish (especially after the tax cuts were enacted into law in December 2017), and volatility of market returns and economic statistics such as the Consumer Price Index (CPI) is practically non-existent. While there is no magic bullet for determining the timing of a major pullback, the conditions in early 2018 suggest that we may be close to peak bullishness. ***When we look at your portfolio through this type of risk management lens, we are compelled to reduce risk in 1Q 2018 in portfolios by making the following trades:***

1) Reduce equity allocation to slightly underweight our strategic target

- This allocation is a tactical underweight and is designed to reduce risk in the portfolio.

2) Increase exposure to illiquid credit investments that have much higher yields than public liquid fixed income markets

- This allocation is a tactical overweight and is designed to increase yield in the portfolio.
- Again, we are worried about the valuations in the public equity markets, not the strength of the economy. Thus, these low duration, high yielding bonds should be "money good", meaning they will pay as expected in a strong economic environment.

3) Increase exposure to Treasury Inflation Protected Securities (TIPS)

- This allocation is a tactical overweight and designed to protect the portfolio on the downside in case inflation rises.

2018 has started strong with the S&P 500 up 7.5% as of 1/26/18[19]. We hope that the rest of 2018 continues to be positive for investment assets, so our portfolios continue to increase in value. We understand a public equity market "melt-up[20]" is possible, but feel that our remaining allocation to public equities combined with a sizable allocation to private capital and credit focused hedge funds has the potential to capture much of that upside. Since capital preservation is always our #1 goal and public equity market expectations are already high, we are prudently preparing for much higher volatility and more market shocks than last year. This risk reduction trade should help protect the portfolio against major losses if the public equity market should turn negative.

As always, the Halite Investment Team is dedicated to serving you. Should you have any questions or comments, we encourage you to reach out to us.

[17] Bloomberg
[18] Bloomberg
[19] Bloomberg; Illiquid credit focused hedge funds proxy = HFRI Event Driven Distressed/Restructuring Index
[20] https://www.investopedia.com/terms/m/melt-up.asp: A dramatic and unexpected improvement in the investment performance of an asset class driven partly by a stampede of investors who don't want to miss out on its rise rather than by fundamental improvements in the economy. Gains created by a melt up are considered an unreliable indication of the direction the market is ultimately headed, and melt ups often precede melt downs.

DISCLOSURES

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An index is a portfolio of specific securities, the performance of which is often used as a benchmark in judging the relative performance of certain asset classes. An investor cannot invest directly in an index. An index does not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown.

INDEX DEFINITIONS

Equities

The **MSCI Emerging Markets (EM) Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The **MSCI ACWI (All Country World Index) Ex-US** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets, excluding the U.S.

The **MSCI EAFE Index (Europe, Australasia, Far East)** is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

The **MSCI ACWI (All Country World Index)** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets.

The **S&P 500 Index** is widely regarded as the best single gauge of the U.S. equities market. The index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. The S&P 500 Index focuses on the large-cap segment of the market; however, since it includes a significant portion of the total value of the market, it also represents the market.

Fixed Income

The **Bloomberg Barclays (BC) US Aggregate Bond Index** is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and nonagency).

The **Bloomberg Barclays (BC) US Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

The **Bloomberg Barclays (BC) US Corporate High Yield (HY) Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

Other asset classes

The **Bloomberg Barclays (BC) Commodity Index** and related sub-indices are composed of futures contracts on physical commodities and represents 22 separate commodities traded on U.S. exchanges, with the exception of aluminum, nickel, and zinc.

The **HFRI Monthly Indices (HFRI)** are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 4 main strategies, each with multiple sub strategies. All single-manager HFRI Index constituents are included in the HFRI Fund Weighted Composite, which accounts for over 2200 funds listed on the internal HFR Database.

The **Thomson Reuters (TR) Private Equity (PE) Buyout Index** replicates the performance of the Thomson Reuters Private Equity Buyout Research Index through a combination of liquid, publicly listed assets. The Index is calculated from the performance of six private equity sector portfolios.