HALITE PARTNERS

Quarterly Letter - Q2 2018

EXECUTIVE SUMMARY

The second quarter of 2018 saw the return of volatility, elevated trade war rhetoric, and rising inflation. Unemployment fell to multi-decade lows,[i] Q1 earnings for US companies came in well-above expectations[ii], and Q2 estimated earnings growth nears its highest since 2010.[iii] Despite strong fundamentals, we believe there are significant risks to markets that are already trading at top quartile or higher valuations. ***Thus, our portfolio remains defensively positioned with a slight underweight to public equities and an overweight to safe fixed income, including Treasury Inflation-Protected Securities ("TIPS").***

RISK TYPE	ASSET CLASS	ASSET NAME	Q2 2018	YTD	1 YEAR
Risk Asset	Equities	S&P 500 Index	3.4%	2.6%	14.4%
		MSCI EAFE Index	0.7%	-0.2%	11.3%
		MSCI EM Index	-7.9%	-6.6%	8.5%
		MSCI ACWI Index ex-US	-2.5%	-3.5%	7.8%
		MSCI ACWI Index	-1.1%	-2.4%	7.4%
	Fixed Income	BC US Corporate HY	1.0%	0.2%	2.6%
	Commodities	BC Commodity Index	0.4%	-0.0%	7.3%
	Alternatives	TR PE Index	3.7%	-1.4%	16.1%
		HFRX Global Index	-0.0%	-1.0%	2.3%
Risk Mitigator	Fixed Income	BC US Aggregate Index	-0.2%	-1.6%	-0.4%
		BC US Treasury	0.1%	-1.1%	-0.7%

Data Source: Bloomberg, HFRI

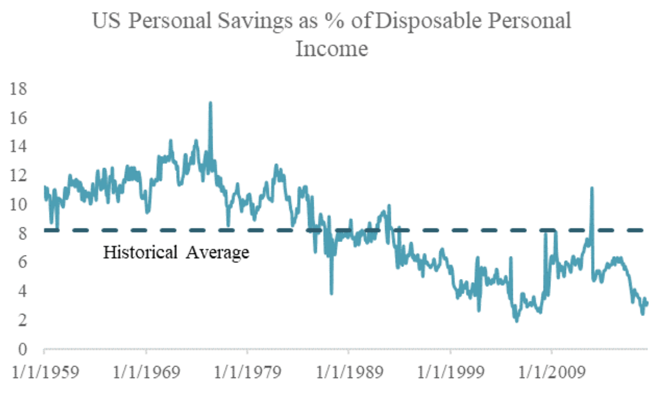
QUARTERLY COMMENTARY

"THE TRUE INVESTOR WELCOMES VOLATILITY"

– Warren Buffett

We witnessed elevated volatility in Q2 2018 and a wide dispersion in performance among emerging markets, international developed markets, and US markets. While US markets significantly outperformed non-US, we take a long-term view and opt for a globally diversified portfolio, especially since we view the current environment as late-cycle for US markets.[iv] In fixed income, our decision to rotate into inflation-linked fixed income investments led to material outperformance versus the benchmark, the Barclays US Aggregate Index.[v] Additionally, our investment in private credit (discussed later) has also been accretive to the portfolio.

We would like to reiterate that we are underweight equities despite the economic enthusiasm around markets. Periods of extended calm and market rallies lead to investor complacency, creating significant risks that manifest themselves in various places within the economy. We discussed the risk of inflation surprises and reactionary Fed Hikes in the previous letter, and we highlight two additional trends in this one: low personal savings rates and rising covenant-lite loans in the bond market. Corporate profits are bolstered by low personal savings rates, which are well below historical norms. Because the savings rate is near secular lows, we view the risks as asymmetric to the upside, and an increase of just a few percent would mean, ceteris paribus, that hundreds of billions of dollars disappear from aggregate US corporate profits, which should negatively impact stocks.



We also see risks from extended complacency arising in the loan market, where huge inflows of cash chasing fewer loans are leading to lower standards. The percentage of "covenant lite" loans, which offer less protection to investors, surged to 77% last year from just 23% in 2012.[vi] Not only are covenants generally weaker, but there is an increase of borrowers using loans as their primary form of debt, which may potentially force creditors to take more losses. Moody's Investors Service estimates that investors used to recovering around 77 cents on the dollar from first-lien loans may only recover 60 cents on the dollar when the credit cycle turns. Perhaps even more ominous, according to one of our illiquid credit hedge fund specialists, is that the remaining 23% of loans that are not cov-lite are issued by companies that are so bad that investors demand they put in covenants. ***Your portfolio remains underweight equities and overweight safe public fixed income.***

SPECIAL TOPIC: OPPORTUNITIES IN PRIVATE CREDIT

Halite's investment team seeks to identify exceptional value for our partners by finding the best risk-adjusted return across both public and private markets. We believe that current yields available in most public fixed income instruments do not appropriately compensate investors for the underlying credit risk they are taking. However, we deem private credit markets to be attractive because investors can earn extra yield in exchange for giving up liquidity while still maintaining a healthy risk profile.

Background

We refer to securities that have limited financial disclosure(s) and are not directly overseen by government regulators as "private" or "illiquid" investments. Exhibit 1 shows several categories of private credit investment options. These are areas of the market that have traditionally been dominated by banks, but regulatory changes post-2008 curtailed banks from taking excess risk, creating opportunities for individual investors. We believe that by diversifying across these strategies, collateral types, seniority levels in the capital structure, and geographies, we can provide investors with significantly higher returns than public fixed income investments without taking additional credit risk.

Exhibit 1: Examples of Private Credit Markets

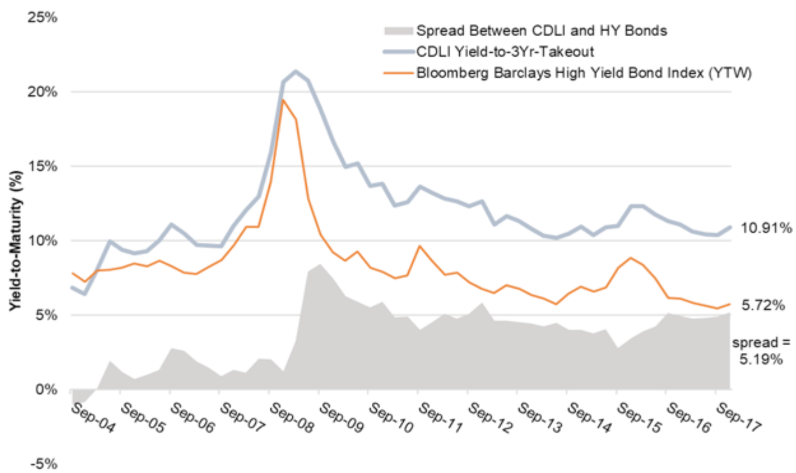
	Asset Type		
	Corporate	**Real Estate**	**Other Asset-Backed**
Low Risk	Bank Loans Secured Bonds Senior CLO	Senior Commercial Senior CMBS Agency RMBS	Trade Finance Credit Card & Auto ABS Royalties
Medium Risk	Direct Corporate Loans High Yield Bonds Mezz CLO	Non-Agency RMBS Commercial Mezz Single Family Rental	Infrastructure Debt Specialty Lending ABS Mezzanine
High Risk	Emerging Market Debt Distressed/Restructuring CLO Equity	Development Loans Single-Property CRE Non-Performing	Shipping & Aviation Insurance-Linked Direct Consumer Finance

Source: Halite Partners

Why This Opportunity Exists

Banks have traditionally been both the originators and holders of private credit due to their large balance sheets and low cost of capital. However, after 2008, Congress passed more than 30 regulations (e.g., Dodd-Frank, Volcker Rule, Basel III) to curtail banks from taking excess risk. As a result, banks have exited several parts of the credit market because the new risk-based capital limits make certain types of lending unprofitable in this new regulatory era. This withdrawal has consequently created a void of lending capacity. Similarly, broker-dealers have faced new restrictions on their commitments of capital, causing them to pull back from their market-making activities, again resulting in reduced capital available to credit markets.

Exhibit 2: Yield-to-Maturity, Sep 2004 to Dec 2017



Source: Cliffwater LLC - 2017 Q4 Report on U.S. Direct Lending

The financial regulations and curtailed market-making activities by the banks have created an attractive investment opportunity for individuals and institutions because the supply of credit has been reduced while the need for credit has increased as the economy has grown. This imbalance allows lenders to charge a premium and earn higher yields. To illustrate, Exhibit 2 shows the difference in yields between public markets (High Yield) and private direct lending (Cliffwater) over time. After 2008, this spread increased dramatically, meaning that investors in private markets have been earning 4-6% higher returns than their public market counterparts. Notably, as yields have compressed in recent years, this "illiquidity" premium has been remarkably consistent. As such, investors in private credit markets have been collecting almost double the yields relative to public markets for nearly a decade.

Halite Implementation

By investing through unconstrained private vehicles, we seek to capture the illiquidity premium and earn excess returns in portfolios. Our investment team has chosen to implement this theme by selecting a handful of private asset managers that focus on credit. We have chosen experts across multiple areas of the credit spectrum to diversify the portfolio across different types of risk and to give us the ability to tilt the portfolio to the most attractive segments of the credit market as the environment changes.

DISCLOSURES

This was prepared by Halite Partners, LLC, a federally registered investment adviser under the Investment Advisers Act of 1940. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. For more information please visit: https://adviserinfo.sec.gov/ and search for our firm name. This is for informational purposes only and is not to be construed as an offer or a recommendation to buy or sell a security.

Any return expectations provided are not intended as, and must not be regarded as, a representation, warranty or predication that the investment will achieve any particular rate of return over any particular time period or that investors will not incur losses. Investments in private funds are speculative, involve a high degree of risk, and are designed for sophisticated investors.

Past performance is not indicative of future results.

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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.

The **Cliffwater Direct Lending Index (CDLI)** seeks to measure the unlevered, gross of fee performance of U.S. middle market corporate loans, as represented by the asset-weighted performance of the underlying assets of Business Development Companies (BDCs), including both exchange-traded and unlisted BDCs, subject to certain eligibility requirements.

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.

ENDNOTES

i. Unemployment as measured by U-3 Unemployment Rate decreased to 3.8% in May 2018. Source: Bureau of Labor Statistics

ii. Approximately 78% of companies in the S&P 500 reported earnings above estimates, the highest since 2008. Source: Factset

iii. For Q2 2018, estimated earnings growth for the S&P 500 is 20%, which would be the second highest number since 2010. Source: Factset

iv. The Federal Reserve has hiked rate 7 times over the past few years, and US markets have significantly outperformed non-US markets over the past decade. Source: Bloomberg

v. The Barclays US Treasury Inflation Notes index was up 0.8% vs. -0.2% for the Barclays Aggregate Index; Source: Bloomberg

vi. CLO Machine Is Approaching Full-Tilt, and Credit Quality Suffers"; Source: Bloomberg