2018 First Quarter Portfolio Review

Market Overview

Volatility came back with a vengeance in the first quarter of 2018, but despite the increase in noise, the result was basically flat performance. Global stocks, as measured by the MSCI ACWI, declined by -1.03% during the quarter led by weak performance in the U.S. and Europe with the S&P 500 Index declining -0.76% and the MSCI Europe Index declining -1.98%. The weakness in Europe was masked by the robust performance of the euro as the market declined by -4.61% in local currency. Japan was also buoyed by its currency as the MSCI Japan Index fell -4.80% in yen terms but gained 0.13% in U.S. dollar terms. The MSCI Emerging Markets Index increased by 1.28% with little help from the changes in local currencies. Asset classes with a sensitivity to interest rates represented some of the hardest hit segments of the U.S. market. The Dow Jones U.S. Real Estate Index fell -5.91% and the S&P 500 Utilities Index fell -3.30%.

The change in U.S. interest rates was the biggest news during the quarter. The Bloomberg Barclays Global Aggregate Index declined -1.46% with investment-grade credit, as measured by the Bloomberg Barclays U.S. Credit Bond Index, leading the decline at -2.32%. Bonds with a higher coupon fared better than core Treasurys and corporate bonds. The Bloomberg Barclays U.S. Corporate High-Yield Bond Index declined -0.86% while the Bloomberg Barclays U.S. Municipal High Yield Index increased 0.58%. Emerging market (EM) corporate bonds were also able to avoid the worst of the rate-driven drawdowns, with the Credit Suisse Emerging Market Corporate Bond Index declining by -0.52% in the quarter.

Portfolio Overview

International equities experienced a turbulent first quarter 2018, but overall finished with a modest loss with the MSCI ACWI ex-USA, the portfolio's asset class benchmark, falling -1.33%. Equities started 2018 with a powerful rally, gaining 7.09% through January 26, but global economic optimism gave way to worries about less accommodation by the world's major central banks, including the expectation of four interest rate hikes by the U.S. Federal Reserve in 2018. Investors also fretted over the potential for a trade war as the U.S. announced new imported steel and aluminum tariffs and China responded with higher duties on U.S. agricultural products and scrap aluminum. Technology shares, the darlings of 2017 and early 2018, also corrected. Allegations of improper customer data use by Facebook hurt social media stocks globally. The Salient International Dividend Signal ADR Strategy outperformed the asset class benchmark and gained 0.20% in the difficult quarter. The portfolio also outpaced its style benchmark, the MSCI ACWI ex-USA High Dividend Yield Index, which lost -0.76%. For the trailing one year, the portfolio's 16.71% return bettered the 16.35% asset class benchmark return and the 11.70% style benchmark result.

Utilities, a generally less volatile sector, performed best in the erratic quarter in both the portfolio (14.62%) and benchmark (1.99%). Portfolio holding China Gas moved higher due to China's more environmentally friendly policies leading to increased natural gas demand. The portfolio's utilities sector also received a boost from Hong Kong-based water company Guangdong Investment, which surprised the market with better-than-expected dividend growth. Although the energy sector was a laggard for the index, the portfolio benefited from a positive price move by Lukoil. Investors applauded the company's share buyback and cancelation announcement. Farmed-fish producer, Marine Harvest, also positively contributed to the portfolio's return. The company's salmon production growth should more than compensate for an expected lower 2018 salmon price. Detractors for the quarter included German-based, RIB Software. The computer software company traded lower after the company issued additional equity late in the quarter and released news that their chief technology officer was leaving. Telecommunication services (-17.39%) was the notable detracting sector in the quarter. Philippines-based Globe Telecom pulled back on investors' worries about elevated capital expenditure spend and a third wireless service operator entering the country. We have been disappointed with the company's lack of free cash generation, but we believe the strong competitive position remains intact. London-based BT Group slipped on continuing regulatory and pension funding concerns. The regulatory environment has improved recently, and we believe the company has both the earnings power and balance sheet to resolve the pension deficit while continuing to pay an attractive dividend. Cyclicals like the materials sector dragged on both the benchmark and portfolio. Many investors perceive that the global economy may be peaking and questions continue to swirl about China's sustainable growth rate. Rising metal inventories contributed to the anxiety and mining stocks fell back. Although the portfolio does not hold mining shares, economically-sensitive Kuraray, a Japanese chemical company, and China Yuchai, a diesel engine maker, traded lower with the rising economic uncertainty.

Investment Outlook

Global economic momentum continues as global gross domestic product estimates for 2018/2019 generally moved higher in early 2018. However, geopolitical intrigue possibly escalated to more protectionist trade policies and late quarter economic data that suggested at least some deceleration raised investor risk concerns. The business climate remains healthy. In the U.S., the tax cuts appear to be having the intended impact of lifting employment and increasing investment, and fiscal spend should be supportive with the new Bipartisan Budget Act. Europe remains on a positive trajectory with low inflation and good employment growth. Japan showed continued momentum with better-than-anticipated capital investment and a general uptrend in domestic demand. That said, the news may be as good as it gets for this part of the cycle. Purchasing managers' indices and other leading indicators have rolled over recently and the strong yen and euro may impact corporate profits in Japan and Europe. Consumer and business confidence suffered with tough trade talk dominating the headlines. Ergo, we note the mixed data coming from several emerging markets. Central and East Asia continue to be bright spots, but Brazil and Russia are not keeping up with the global economic performance averages. As noted in last quarter's commentary, China's economy should decelerate with less stimulus after last year's National Congress. Massive leverage and excess industrial capacity will continue to slowly drag on China's economic performance. Overall, however, the fundamentals remain solid. We believe the enacted U.S. trade tariffs, if not followed by more actions, will have limited impact. The 25% steel and 10% aluminum tariffs will result in an effective $11 billion tax on consumers of these metals—a potentially big pill for certain industries like aircraft and machinery, but negligible for the $19 trillion U.S. economy. The announced duties by China are even less impactful. Assuming a successful renegotiation of the North American Free Trade Agreement (NAFTA) and no full-blown global trade war, we look for very modest impact on the global business climate. We also highlight the very slow inflation burn with some wage price pressures offset by other more modest inflation data, which suggests that central banks can continue to be measured in accommodation removal.

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As we highlighted at the end of 2017, we look for our higher-dividend yielding style to show better relative performance as the market expansion matures. We expect many of the momentum-oriented names in technology and other areas where growth expectations are excessive will lag in this part of the cycle. In a rising interest rate environment, our strategy will likely benefit as investors increasingly appreciate balance sheet quality and growing dividend streams. We believe our investments feature a good balance of reasonable valuation for current and future earnings power with consistent and propitious free cash generation.

Net returns are calculated using a highest management fee of 2.00%, applied monthly.

Investing involves risk, including a possible loss of principal. Past performance does not guarantee future results. Portfolio holdings are subject to change at any time.

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Bloomberg Barclays Global Aggregate Index represents a broad-based measure of the global investment-grade fixed income markets, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are U.S. domestic, taxable and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

Bloomberg Barclays U.S. Corporate High-Yield Bond Index covers the USD-denominated, noninvestment-grade, fixed-rate, taxable 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.

Bloomberg Barclays U.S. Credit Index is an index composed of corporate and non-corporate debt issues that are rated investment grade (Baa3/BBB) or higher.

Bloomberg Barclays U.S. Municipal High Yield Index measures the noninvestment-grade and nonrated U.S. dollar-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington D.C., Puerto Rico, Guam and the Virgin Islands).

Credit Suisse Emerging Market Corporate Bond Index consists of U.S. dollar-denominated fixed-income issues from Latin America, Eastern Europe and Asia.

Dividend yield is a financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Dow Jones U.S. Real Estate Index measures the performance of the real estate industry of the U.S. equity market.

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

MSCI ACWI ex-USA is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets, excluding the United States.

MSCI ACWI ex-USA High Dividend Yield Index reflects the performance of large- and mid-cap stocks across 45 developed and emerging market countries in the MSCI ACWI ex-USA that exhibit high, sustainable dividend income.

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

MSCI Europe Index is a free float-adjusted market capitalization index designed to measure developed market equity performance in Europe.

MSCI Japan Index is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of the developed markets in Japan.

Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

S&P 500 Utilities Index comprises those companies included in the S&P 500 that are classified as members of the GICS® utilities sector.

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

Yield is the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost or on the U.S. government's debt obligations.

Indexes shown for illustrative purposes only. It is not possible to invest directly in an index.

The specific securities identified and described do not represent all of the securities purchased, sold, or recommended for advisory clients, and the reader should not assume that investments in the securities identified and discussed were or will be profitable.

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