# 2017 Fourth Quarter Portfolio Review

## Market Overview

Taking a look back at 2017, global stocks, as measured by the MSCI All Country World Index, finished with a gain of 23.97%, with foreign markets leading the way due in part to a weak U.S. dollar. Emerging markets (EM) represented the strongest performers globally, with the MSCI Emerging Markets Index gaining 37.75% in U.S. dollar terms and 30.55% in local currency terms. Japan and Europe also posted strong gains with the MSCI Japan Index gaining 23.76% and the MSCI Europe Index gaining 26.62%. In this case, the weaker dollar played an even more significant role as European stocks only gained 13.06% in local currency and Japanese stocks gained 19.75% in yen. U.S. stocks were not left behind as the S&P 500 Index finished the year with a gain of 21.83%. Small-cap stocks, as measured by the Russell 2000 Index, finished the year with a gain of 14.65%. The gains were certainly impressive, but when we look behind the curtain we learn some very interesting facts, most notably that U.S. stocks have gone 282 days without a 3% correction as of year end—the longest period in history. Additionally, 42 of the 44 stock markets followed by MSCI posted gains as well as nine of the 11 sectors. The most unusual sector was energy, which posted a decline for the year despite the rise in oil prices, marking the first time in 15 years that the energy sector declined while the price of oil rose. Energy also posted the biggest sector swing in year-over-year earnings ever aside from the financials sector during the 2008-2009 financial crisis. This decline is likely a positive sign for energy stocks going into 2018.

Not to be outdone, bonds also had a very strange year. Global bonds, as measured by the Bloomberg Barclays Global Aggregate Index, increased by 7.65%; yet much of the gain can be attributed to currency effect as the local currency version of the index only increased by 3.04%. This number placed global bonds in a very similar position as U.S. bonds, which increased by 3.80% for the year, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index. Once again, emerging market bonds were the strongest performers with the Credit Suisse Emerging Market Corporate Bond Index rising 9.50% and the Bloomberg Barclays Emerging Market Bond Index rising 10.28%. Domestic credit investors were also rewarded for the year with the Bloomberg Barclays U.S. Corporate High Yield Bond Index rising 7.52% and the Bloomberg Barclays U.S. Municipal High Yield Index rising 9.95%. It is notable, however, that the volatility of most bond asset classes was unusually high in 2017, which is in direct contrast to stocks, which spent most of the year hugging all-time lows in terms of volatility.

## Portfolio Overview

International equities moved higher in the fourth quarter. The MSCI ACWI ex-USA gained 5.01% and the MSCI ACWI ex-USA High Dividend Yield Index rose 3.35%. This return was the smallest quarterly gain for these indices in 2017, but capped off an impressive run of positive monthly returns with both indices advancing every month in 2017, something that has not happened since their inception. The Salient International Dividend Signal Institutional Portfolio returned 4.25% (net performance) in the fourth quarter. Similar to most of 2017, stocks exhibiting higher dividend yield posted a lesser return in Q4. The highest yielding quartile in the MSCI ACWI ex-USA gained 3.68% compared to 9.09% for the lowest yielding quartile. Reflecting this dynamic, the MSCI ACWI ex-USA High Dividend Yield Index advanced 20.42% for the year compared to 27.19% for the MSCI ACWI ex-USA. Salient International Dividend Signal Institutional Portfolio returned 24.15% for the calendar year 2017.

Perceptions of continued global economic recovery helped commodity prices recover, which boosted materials (8.25%) and energy (7.94%) to lead the benchmark in sector returns for the quarter. Less-cyclical utilities (-0.72%) and healthcare (1.37%) posted the weakest sector returns for the benchmark. In the portfolio, telecommunication services (-2.38%) and healthcare (-1.19%) were the two detracting sectors. Holding GlaxoSmithKline faces generic competition for key drug Advair and investors worry about the U.K. currency strength negatively impacting earnings. We note, however, management's better research and development focus and competitive advantage in several pharmaceutical areas, including respiratory, HIV, vaccines and consumer health. In telecommunications, holding Globe Telecom weakened on prospects that a China telco company may help a competitor build a communication network in the Philippines. Such a prospect, while far from certain, would be expensive and take several years. The portfolio's information technology sector (12.84%) returned the best quarterly result. German construction software company, RIB Software, gained on news that its leading BIM (Building Information Model) solution will be used by a leading U.S. homebuilder. Philippine food ingredient maker D&L Industries reported stronger than expected earnings, helping lift materials (5.96%) to a leading sector contribution for the portfolio.

Regionally, Central Asia (12.67%) and Eastern Europe (9.44%) provided the strongest positive contribution while South & Central America (-0.46%) posted the sole negative result. Brazilian equities in general, including holding Ambev, struggled after the government announced another pension reform delay. Pension reform is crucial to bring the country's deficit under control. Istanbul-based TAV Havalimanlari Holdings, a Turkish airport operator, reported strong passenger growth, which helped the Eastern Europe portion of the portfolio. Central Asia received a boost from Infosys, one of the few relatively attractively valued India-based equities. The company confirmed revenue growth guidance for 2017 and provided a relatively upbeat projection for 2018.

## Investment Outlook

Continuing late 2016's momentum, the global economy accelerated in 2017, ending two years of slowing growth. We expect 2017's real global gross domestic product (GDP) growth to come in around 3.2% versus 2.5% for 2016. Major economies, like the U.S., Europe and Japan, and most emerging markets contributed to the largest global economic acceleration since 2010. Predictably, global confidence increased and the positive business climate pushed equities higher in 2017. For 2018, absent a major negative geopolitical event, the generally solid fundamentals suggest continued global economic improvement, although we believe the global economy will not return to the performance levels achieved in 2003 through 2007 due to structural challenges of high debt, an aging demographic and moderate productivity improvement. We expect less improvement in Europe and Japan relative to the U.S. in developed markets and look for better EM economic growth in Asia.


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**Europe**

Most investors and economists believe that the European Central Bank will eventually follow the U.S. Federal Reserve in raising rates, but will likely be reticent to hike or remove stimulus aggressively given the tame inflation environment. Europe generally suffers from a weaker banking system and political instability, so the strong euro may drag on corporate profit growth relative to U.S. counterparts. However, more attractive valuations and higher dividend yields still present equity investing opportunities in select European-based companies.

**Japan**

We believe Japan's better economic performance should continue in 2018. Infrastructure spend for the 2020 Olympics will be supportive and consumer spending has historically benefitted from strong tourism trends and higher wages, brought about by tight labor conditions. Like Europe, Japan's central bank will remove stimulus grudgingly based on statements made by the Bank of Japan, but Japan suffers less political intrigue and has better financial institutions. Moreover, the yen strengthened less than the euro in 2017, which points toward better corporate earnings compared to Europe.

**Emerging Markets**

Emerging markets are a mixed bag, with inflation rates, political stability, business climates, growth fundamentals and equity valuations much more variable than developed markets. We anticipate that China's economy will decelerate as policymakers reduce financial leverage, trim excess industrial capacity and lower home price appreciation, though in a risk-adverse, gradualist manner. Labor market conditions remain stable with new industry job creation (e.g., ride sharing, cloud-based and other new technology jobs) offsetting traditional industries like coal and steel. Although the economy will potentially slow, the 6% plus growth rate remains at an enviable level versus other economies. Outside the technology sector, valuations are still attractive in many Chinese industries.

Despite a slowing China, we believe Asia will contribute most to 2018 global economic growth as countries like Indonesia, the Philippines, Vietnam and Malaysia experience solid and accelerated growth. We believe India's growth will also likely rise as the disruptive impacts from demonetization and the imposition of the Goods & Services Tax fade. Further, India's government recently injected capital into the public banks to improve credit availability. Equity opportunities are relatively slim, however, due to high valuations. To be attractive, we believe the country needs not only cheaper equity prices, but financial institution reform, better infrastructure and greater market openness.

Based on economic trends and projections, South America's relatively anemic economy will likely improve and, if Chile's recent election is a guide, the political winds may turn toward a more pro-business and reform orientation. Emerging Europe has received a boost from Turkey and Poland, which we believe will continue, but we anticipate that Russia's recovery will remain relatively sluggish as it is burdened by poor infrastructure and unfavorable demographics, though the country will get a short-term boost from 2018 World Cup tourism.

As mentioned previously, most of this outlook is prefaced on lack of a high impact global shock. Indeed, North Korea's nuclear threat, monetary policy mistakes by the world's major central banks, and trade wars may be improbable, but any of these events could cause a dramatic business climate shift. With that disclaimer, we think the solid economic backdrop should allow for continued economic momentum in general, creating a positive environment for equities. Admittedly, some equities, such as technology and India, may look overvalued with many individual stocks trading above our intrinsic value calculations, but we feel opportunities still exist; many of our higher yielding stocks have been relatively left behind in this growth-leading market. As measured by MSCI ACWI ex-USA sub-indices, growth as an investment style in non-U.S. equities outperformed high dividend yield by 12.87% in 2017—the greatest margin since 1999. Notably, after 1999, the high dividend yield style in non-U.S. equities outperformed growth over the next five calendar years. With more attractive valuations, solid balance sheets and ample free cash generation providing cash dividend growth, we believe our higher yielding equity investments can potentially provide competitive future returns.

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 Emerging Market Bond Index** is an unmanaged index that tracks total returns for external-currency-denominated debt instruments of emerging markets located in the Americas, Europe, Middle East, Africa and Asia.

**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. 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.

**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.

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

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