Salient®

2017 Third Quarter Portfolio Review

Market Overview

The third quarter of 2017 continues a strong upward trend for nearly all asset classes. Global stocks, as measured by the MSCI All Country World Index, increased by 5.18%. Much of that growth can be attributed to emerging market stocks, as the MSCI Emerging Markets increased by 7.89%. Not to be outdone Europe, Japan and the U.S. stocks markets also posted strong gains with the MSCI Europe, MSCI Japan and S&P 500 all increasing by 6.45%, 3.97%, and 4.48% respectively and each of those indices ended the quarter at an all-time high. Concurrent to an all-time high in price, the advance-decline line for each of those indices also achieved new highs signaling that the market participation is broad and therefore likely to continue an upward trajectory. Thanks to a late quarter rally, small cap stocks as measured by the Russell 2000, increased by 5.67%, outperforming large cap stocks another signal supporting equity market strength. Much of the growth in Europe this year can be attributed to the appreciating value of the Euro relative the U.S. Dollar. At points during the year the currency impact was the difference between a gain and a loss. That trend continued this quarter as the appreciation of the Euro accounted for 3.72% of 6.45% gain. However, it should be noted that the European markets are up 11.45% for the year in Euros which is still a healthy gain and can be attributed to a dramatic pick up in overall margins throughout the region.

Bonds also finished a good quarter with the Bloomberg Barclays Global Aggregate Bond Index gaining 1.76% and ending the quarter with a yield to worst of 1.61%. Much of the gain among global bonds can be attributed to the growth off foreign sovereign bonds, as measured by the Bloomberg Barclays Global Treasury ex US Index which increased by 2.05% and ended the quarter with a yield to worst of 0.76%. Once again much of the gains for foreign sovereign bonds can be attributed to the appreciation of the Euro especially since rates among Euro bonds and Japanese Government Bonds have risen in the past quarter. In this case, the currency impact on foreign sovereign bonds is the entire difference between a gain and a loss in the asset class. Overall credit fared well with the Bloomberg Barclays U.S. Corporate High Yield Index rising by 1.98% and ending with a yield to worst of 5.79% and the Credit Suisse EM Corporate Index rising by 3.17% and ending with a yield to worst of 5.45%.

Portfolio Overview

Net Performance & Attribution as of September 30, 2017

	3 Month	12 Month
Equity	-0.31%	-0.56%
Fixed Income	0.48%	5.07%
Overall Excess	0.17%	4.53%
Strategy Return	2.44%	6.06%
Benchmark Return	2.28%	1.53%

- We added positive relative performance
  - Equity performance was **negative** on a relative net basis. Exposure to preferred stocks and U.S. real estate detracted from performance which was offset by exposure to emerging market (EM) stocks.
  - Fixed income performance was **positive** on a relative net basis. Exposure to credit sectors added to relative performance as long duration foreign bonds experienced a significant drawdown in September while credit outperformed.

Investment Outlook

There is an old Wall Street axiom that stocks climb a "wall of worry." and 2017 seems to perfectly encapsulate the meaning of this phrase. Much of the enthusiasm for 2017 was fueled by the growth catalysts of tax reform, infrastructure spending, and reduced regulations. However, nearly all those catalysts have failed to materialize and have been replaced by series of new foreign policy concerns with Russia, Iran and North Korea. Despite the lack of fiscal policy and a never-ending cycle of foreign policy hysteria, the MSCI All Country World Index has increased by 18.42% year to date. Much of these gains have been driven by a robust global economy that appears to be gaining in strength. Currently, 75% of the constituent countries in the MSCI ACWI are showing composite leading indicators that are above their long-term averages while the JPMorgan Global Composite Purchasing Managers Index (PMI) sits at 53.9, indicating the expectation of further economic growth. The strong PMI readings are in both service and manufacturing, indicating the strength is broad based. Additionally, the strength of the market is broad based with 86% of the constituent countries in the MSCI All Country World Index currently trading above their 200-day moving average. As a result, there really isn't any reason to change our outlook of preferring emerging market stocks and taking credit over duration.

Aside from risks that are hard to avoid, such as an escalation in North Korea, the issues facing this market seem clear and, fortunately, quite tame. As global central banks begin to unwind their various easing programs, it will likely put upward pressure on rates. Higher rates will eventually be an impediment to growth, especially when we consider that much of the earnings growth, particularly in the developed world, has been facilitated by financial engineering of corporate balance sheets. Inflation appears to be on the horizon once again and if the gradual increase in rates doesn't keep it contained, then unexpected inflation could become an issue for market growth. Finally, valuations are extended. While the value of assets tends to be a terrible timing mechanism, at some point it will matter and it is easy to state that long-term expected returns for stocks are likely quite small at the current price.

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One final silver lining: if growth-oriented policy fails to materialize in the near term, it may be a blessing in disguise. With unemployment at 4.37%, the economy is at or near capacity. Additionally, with a low interest rate environment, the Federal Reserve has very few levers to pull if the U.S. should slip into recession. Tax cuts and infrastructure spending would be excellent methods to help dampen a future recession, but, if implemented today, would leave no monetary or fiscal levers to pull in the event of an economic slowdown.

Historical Allocation Changes

- The strategy maintained an exposure of 40% to stocks, overweight the benchmark, the 85% Barclays Global Aggregate Bond Index/15% MSCI ACWI. In June, we decreased exposure to U.S. Stocks and Emerging Markets Stocks while increasing exposure to Foreign Developed Stocks.

Asset Class	28-July-2017	31-Aug-2017	30-Sep-2017
Cash	2.0%	2.0%	2.0%
Emerging Market (EM) Stocks	6.0%	6.0%	6.0%
Foreign Developed Stocks	14.0%	9.0%	9.0%
International Real Estate	5.0%	5.0%	5.0%
MLPS			
Preferred Stocks	20.0%	20.0%	20.0%
US Real Estate			
US Stocks			
Utilities			
Emerging Market Credit			
High Yield Credit	15.0%	20.0%	20.0%
High Yield Municipal Bonds	20.0%	20.0%	20.0%
Investment Grade Credit			
Municipal Bonds			
EM Sovereign Debt	18.0%	18.0%	18.0%
Treasurys			
	100.0%	100.0%	100.0%

Change Key	Added	Increased	Reduced	Removed

Important Strategy Information

The Salient Adaptive Income SMA utilizes a variety of ETFs to provide investors with a level of current income along with a rigorous risk management process. The fee schedule for the separately managed account is listed below:

Adaptive Income Portfolio Fee Schedule (minimum account size is generally $250,000):

0.50% First $500,000

0.40% Next $500,000

0.30% Excess over $1,000,000

Fees are negotiable on an account by account basis.

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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