# Unconstrained Fixed Income Strategy

## Portfolio and Economic Commentary – 1st Quarter 2017

ALTRIUS
CAPITAL MANAGEMENT

## Unconstrained Fixed Income Strategy Commentary

Based on our macroeconomic outlook over a three to five year period and our cyclical views from quarter to quarter, we employ top-down strategies that focus on yield curve positioning, volatility, and sector rotation. We then utilize bottom-up analysis to drive our security selection process and facilitate the identification of undervalued securities with the potential for above average income. We invest in securities that operate across diversified sectors in the fixed income markets of the United States, primarily those in U.S. dollar denominated high yield and investment grade bonds, including government securities, corporate bonds, and mortgage- and asset-backed. Sources of added value:

**Credit Analysis** - We emphasize independent analysis and do not rely on credit agencies.

**Duration Risk** - We avoid long, extreme duration shifts generally operating within a moderate duration range typically between two and four years.

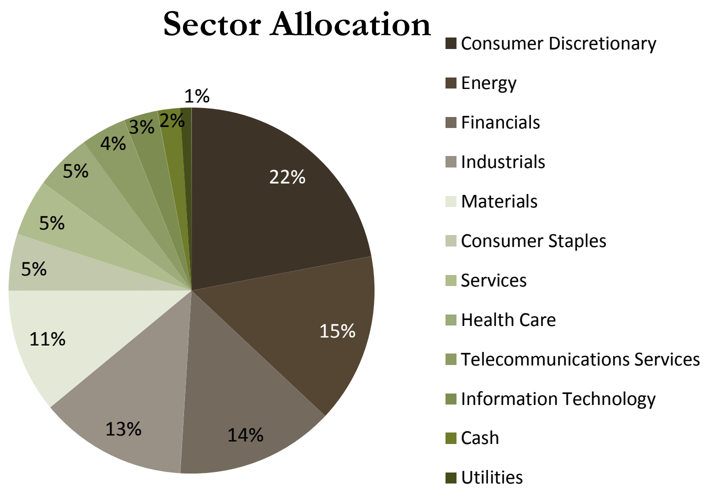
**High Income** - Our research attempts to identify issues paying above average income.

**Risk Premium Management** - We seek to attain an attractive yield/spread in relation to a five-year treasury within acceptable levels of portfolio risk.

## Performance Commentary

### Market Overview

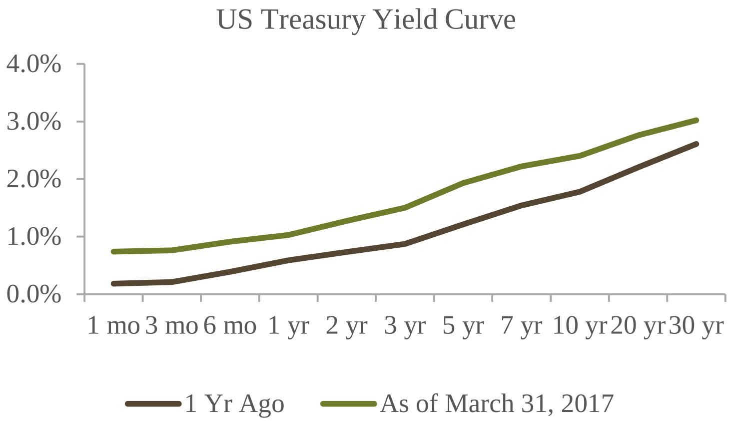
The fixed income markets got off to a strong start in 2017, with almost all market segments ending the first quarter of the year in positive territory. Building upon trends established in 2016, high yield corporate bonds continued to be the best performing taxable fixed income market segment, with the Barclays Capital US Corporate High Yield index producing a return of 2.70% for the first quarter of 2017, thoroughly outpacing investment grade corporate bonds which returned 1.22% (Barclays Capital US Corporate Investment Grade index). Longer dated US treasury bonds outperformed their shorter dated counter parts, with the 30-year Treasury returning 1.30% for the quarter, slightly outpacing TIPS which returned 1.26%. The 10-year Treasury note, which started the year off yielding 2.45%, closed out the quarter yielding 2.40%, but not before having sold off in early March to a yield of approximately 2.60%. In its March meeting, the Federal Reserve raised its benchmark interest rate a quarter point, moving the overnight funds rate to a target range of 0.75% to 1.00%. Spreads on corporate bonds, both investment grade and high yield, continued to contract to below long-term historical averages during the first quarter of 2017, with the Bank of America Merrill Lynch High Yield Option-Adjusted Spread falling from




| Top Ten Holdings | Weight |
|---|---|
| Blue Cube Spinco Inc | 1.41% |
| Icahn Enterprises LP | 1.37% |
| The ADT Corp | 1.36% |
| GAP Inc | 1.32% |
| Anglogold Ashanti Holdings | 1.32% |
| Credit Acceptance Corp | 1.31% |
| Centurylink Inc | 1.31% |
| American Axle & Manufacturing | 1.29% |
| Dish Network Corp | 1.24% |
| Rent A Center Inc | 1.23% |

## UNCONSTRAINED FIXED INCOME STRATEGY COMMENTARY

a level of 422bps as of December 30, 2016 to 392bps by quarter end, 189bps below its 20-year historical average of 581bps. The yield curve also flattened out by quarter end, with the slope of the 'belly of the curve', the differential between the 2-year and 10-year treasury notes, ending the quarter at 113bps.



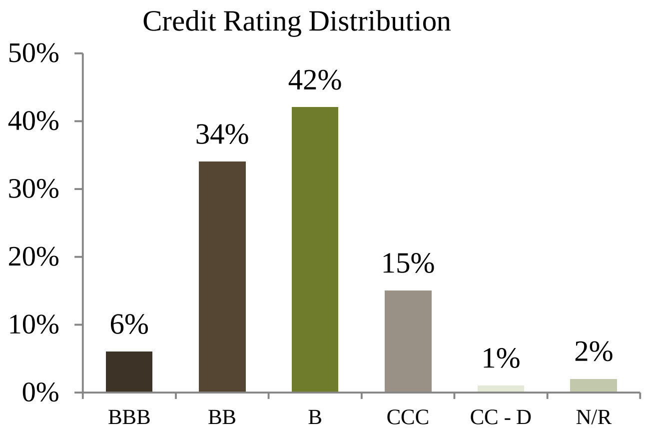

### PERFORMANCE SUMMARY

The Unconstrained Fixed Income strategy generated a gross return of 2.11% for the first quarter of 2017, underperforming the Bank of America Merrill Lynch High Yield index on an absolute basis by 60bps, but outperforming the Barclays US Aggregate Bond index by 129bps. A number of the strategy's previously distressed issues experienced substantial price recoveries during the first quarter of 2017, helping to boost aggregate returns of the strategy as a whole. Health care, which started to sell-off in December 2016, rebounded substantially in the latter half of the quarter on news that the Trump administration was unsuccessful in replacing and/or making alterations to current health care policy, which led to health care becoming the strategy's best performing sector for the first quarter of 2017.

### STRATEGY CHARACTERISTICS

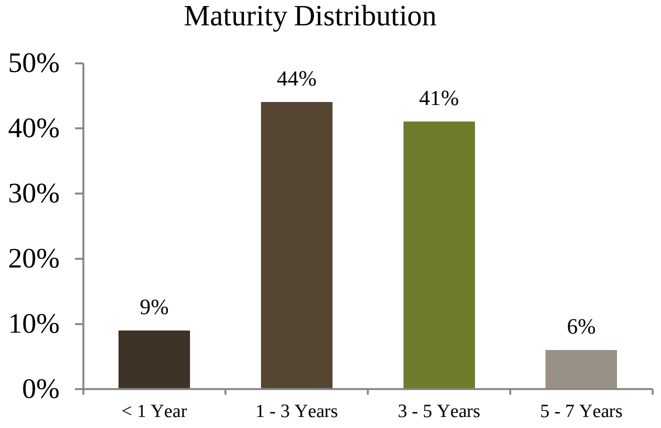
Consumer discretionary and energy remain the strategy's two most heavily invested sectors with aggregate exposure to each closing out the quarter at approximately 22% and 15% respectively. It should be noted that the strategy's exposure to the energy sector declined substantially during the first quarter of 2017 from levels consistently maintained in prior years of between 17% and 20%; contracting over 4.0% from the most recent quarter end December 30, 2016. This decline in sector exposure is predominantly the result of increased call activity of energy and energy related companies held within the strategy over the first three months of the year, and the scarcity of compelling new issues currently available in the energy sector possessing 'shorter durations' and stable credit metrics. The strategy's exposure to the financial, industrial, and materials sectors remained relatively robust with each sector accounting for approximately 14%, 13%, and 11% respectively of aggregate strategy assets. Health care, with the exception of energy, was the only sector that experienced a notable change in exposure, increasing from previous levels of approximately 3% to just under 5%. The increase in the strategy's exposure to health care was largely a result of the establishment of a couple new positions in companies directly involved in the running of preventative care and specialized health care facilities, as well as the previously mentioned price recoveries in a number of the strategy's long standing health care related holdings.

Despite establishing new positions in a number of 'BB' companies, the strategy's aggregate credit rating remained unchanged at 'B'. The distribution of the strategy's assets ratings is provided in the exhibit below.



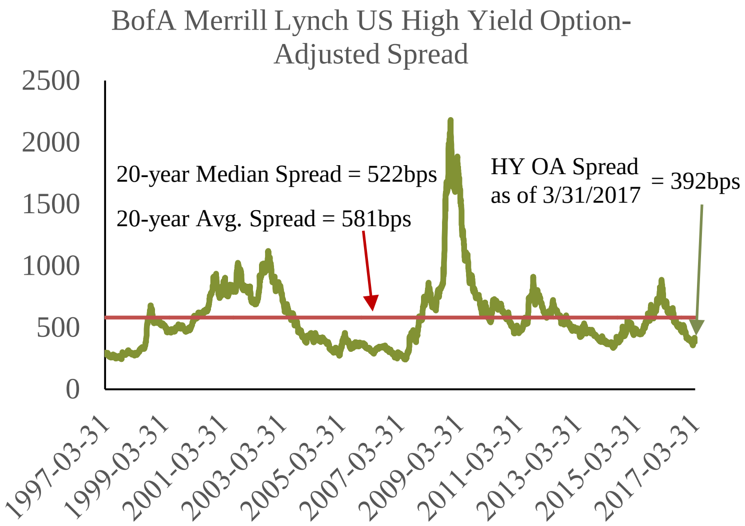
## UNCONSTRAINED FIXED INCOME STRATEGY COMMENTARY

Both the aggregate maturity and effective duration for the strategy expanded marginally from prior levels ending the quarter at 3.46 years and 2.90 respectively. The majority of new issues established during the quarter are callable at various dates prior to their individual designated maturity dates; however, the strategy's longest dated 'non-callable' issue is currently set to mature in December of 2023.




## STRATEGY OUTLOOK

We entered 2017 cautiously optimistic following 2016's exceptional year of performance, wherein the Unconstrained Fixed Income Strategy produced a total return for the year of 22.08% (gross of fees), which even outpaced the greater high yield market by approximately 500bps. In the final newsletter of 2016 we set forth an 'optimistic' total return expectation for the high yield market to generate a more modest annual total return for 2017 in the low to mid-single digits. Although very much welcomed, we did not anticipate such a strong start to the year, and with the greater high yield market already returning 2.88% for the first quarter of 2017, we remain cautiously optimistic concerning the stability of the fixed income markets going forward. Although broad market consensus is anticipating the likelihood of multiple rate increases by the Fed over the course of the year, our inflation expectations are a little more subdued given oil prices will likely remain range bound between $50/bbl and $60/bbl and wage increases should remain modest keeping the inflation rate around the Fed's 2.0% target rate, despite reported US unemployment rates forecasted to remain under 5.0%. Given the strengthening and perceived stability of the US economy, and persistently low rates globally, US corporate bonds, both investment grade and high yield, will likely continue to build upon the most recent quarter(s) gains, with periods of intermittent volatility likely to occur. Valuations in both the investment grade and high yield corporate bond markets are currently at levels near long-term historic highs as evidenced by option-adjusted spreads relative to similar dated US treasury securities, with high yield currently at 392bps, 189bps below its 20-year historical average of 581bps.




Despite such rich valuations, and in the face of high levels of call activity requiring the persistent replacement of existing issues, we are continuing to find numerous compelling investment opportunities across an array of sectors. We have continued to extend the maturity window on new investments slightly, going as far out as 2023, which has had little affect on the strategy's aggregate duration, which at 2.90 is less than half that of the aggregate high yield market. In closing, we still believe that high yield corporate bonds are attractive and remain the best risk/reward tradeoff opportunity in the fixed income markets for providing above average income and mitigating the affects of future interest rate increases.

## Disclosures

This report includes candid statements and observations regarding investment strategies, individual securities, and economic and market conditions; however, there is no guarantee that these statements, opinions or forecasts will prove to be correct. These comments may also include the expression of opinions that are speculative in nature and should not be relied on as statements of fact. Altrius is committed to communicating with our investment partners as candidly as possible because we believe our investors benefit from understanding our investment philosophy and approach. Our views and opinions include "forward-looking statements" which may or may not be accurate over the long term. Forward-looking statements can be identified by words like "believe," "expect," "anticipate," or similar expressions. You should not place undue reliance on forward-looking statements, which are current as of the date of this report. We disclaim any obligation to update or alter any forward-looking statements, whether as a result of new information, future events or otherwise. While we believe we have a reasonable basis for our appraisals and we have confidence in our opinions, actual results may differ materially from those we anticipate.

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