Fourth Quarter 2018 Commentary

January 11, 2019

Dear Client,

During this past quarter, markets experienced prolonged volatility starting in early October. Beginning in late 2017 and continuously throughout 2018, we have been counseling everyone to be prepared for increased overall levels of market volatility, and occasional volatility spikes. We believe that the equity markets began to sell-off as a result of the market's discomfort with the rise in interest rates and continued stress between the U.S. and China regarding trade. Not surprisingly, both issues still remain in the headlines.

STAR Spectrum models have been well-positioned for volatility in that the Cash or Money Market levels are in the 3-5% range, and enhanced cash holdings represents another 6-10% in most models. As a result, the models were nicely buffered from some of the recent market volatility. In addition to the above average cash levels going into the Fourth Quarter 2018, some models benefited from their use of risk-reducing options.

As we saw the volatility unfold in the market, Partnervest took additional steps to isolate portfolios from continued volatility. During this past quarter, most models experienced several trades as we repositioned the portfolios to further reduce overall volatility and capture potential market mispricing. Here are the themes of the trades placed in the STAR Spectrum model portfolios:

- Removed Alternative Real Estate Holdings – In order to reduce overall volatility, certain types of Real Estate Holdings were removed from the models during the Fourth Quarter 2018.

- Increased Multi-Asset Alternatives – Since Multi-Asset Alternatives can add a buffering effect to portfolios, especially in high volatility markets, as they often do not move in tandem with equity or fixed income positions, we increased allocations to this segment as applicable.

- Removed Tactical Allocation to U.S. Financial Sector – This allocation had been added in early 2017, to benefit from a rising-rate environment, potential deregulation and higher consumer/business spending. As this has begun to slow, we no longer believe the benefits outweigh the risk.

- Lowered Fixed Income Risk – Most of the Partnervest STAR Spectrum models going into the Fourth Quarter 2018 had already been adjusted to reflect lower duration risk, which is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates. We continued to lower this risk during the quarter.

- Reinvested cash into U.S. Large Cap - After volatility spiked again on December 24th, Partnervest's Investment Committee met in an extended session and our analysis and opinion was that the U.S. stock market is oversold. To capitalize on this market dislocation, we deployed approximately half of the cash designated for equity holdings back into the models and more specifically into U.S. Large Cap.

As we closed out 2018, we believe that our current overall strategy and holdings are well-suited for the current environment. So while this sell off feels a bit different from past ones, overall, the fundamental economic strength, earnings growth, amount of cash still waiting to be deployed, strong consumer and business confidence, and historically low interest rates lead us to believe that stocks will find solid footing and move forward over the models' investable time horizons.

Please note, we are in the process of creating our comprehensive Market Outlook for 2019. This is an intensive process which we view as a labor of love. During this process we analyze, criticize and review many parts of the Business Cycle, Economic Cycle and Market Volatility. This is an opportunity for us to look forward beyond what happened in the short-term and gain fresh perspective on the year to come.

Q4 2018 Highlights and Attribution:

- Global equity indices were negative in Q4 2018 on a total return basis: the S&P 500 lost 13.5%, the MSCI EAFE index was down 12.5%, and the MSCI Emerging Market index lost 7.4%. The Russell 2000 was the worst performer of the group, returning -20.2% in Q4.

- Amidst the volatility, investors took refuge in bonds—the Bloomberg Barclays Global Aggregate Total Return index returned 1.2% for the quarter, while the Bloomberg Barclays US Treasury Total Return returned 2.6%.

- The 10 Year Treasury fluctuated majorly during the quarter and began the period at 3.09% while finishing at 2.69% and having peaked at 3.24% on November 8th.

- The third and final reading of Q3 2018 US GDP growth came in at 3.4%, slightly below the second estimate of 3.5% growth. The Bureau of Economic Analysis noted in its release, "Personal consumption expenditures (PCE) and exports were revised down, and private inventory investment was revised up; the general picture of economic growth remains the same."

- The December report on homebuilder sentiment failed to inspire, having undershot forecasts by four points with a reading of 56.

- In its December 2018 policy meeting, the Federal Reserve raised the Federal Funds Rate by 25bps to a range of 2.25-2.50%, the fourth and final hike of 2018. Markets sold off during Fed Chair Powell's subsequent press conference, as market participants perceived his comments to be less dovish than expected.

- Pimco, last month, warned investors should "keep their powder dry and look for specific opportunities," in an outlook posted on its website. The bond giant forecast continued stock-market volatility and emphasized cautious positioning overall and a focus on high quality defensive growth.

- The Bank of England left its key interest rate on hold at 0.75% in a unanimous vote by the Monetary Policy Committee. In a statement, the central bank said "the near-term outlook for global growth has softened and downside risks to growth have increased."

- Italy reached a new budget deal with the European Commission, avoiding an EU disciplinary procedure and resolving a dispute that had vexed financial markets for months.

- Eurostat, the statistical office of the European Union, said that seasonally adjusted GDP rose by 1.6% in the euro area and by 1.8% in the EU28 in the third quarter of 2018. This is down from 2.2% and 2.1%, respectively, in the second quarter.

- IHS Markit commented on the December 2018 Eurozone Manufacturing PMI print of 51.4, "The slowdown of growth in the euro area's manufacturing economy, seen throughout much of 2018, carried on until the end of the year in December… Although extending the current run of expansion to five-and-a half years, the latest PMI reading was the lowest seen since February 2016.

- The World Bank forecast Chinese 2019 growth of 6.2% from an expected 6.5% in 2018, with the slowdown due to its trade dispute. "To stimulate the economy, fiscal policy could focus on boosting household consumption rather than public infrastructure", adding that China has room to further lower business taxes.

- China slowed signs of slowing down, as the Caixin China General Manufacturing PMI fell to 49.7, "signal[ing] a renewed deterioration in overall operating conditions", according to IHS Markit.

Attribution Based on Asset Classes

Multi-Asset portfolios participated pro-rata according to heir allocations to these building block strategies:

Equity:
- Positive Contributors: U.S. Large Caps, U.S. Small Cap
- Negative Contributors: U.S. Small Cap, Non-U.S. Developed

Fixed Income:
- Positive Contributors: U.S. Investment Grade
- Negative Contributors: High Yield

Alternatives:
- Positive Contributors: REITs
- Negative Contributors: Commodities

Sincerely,

Partnervest
Investment Management Team

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