KAR

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Investment Management

Market Review
Fourth Quarter 2016

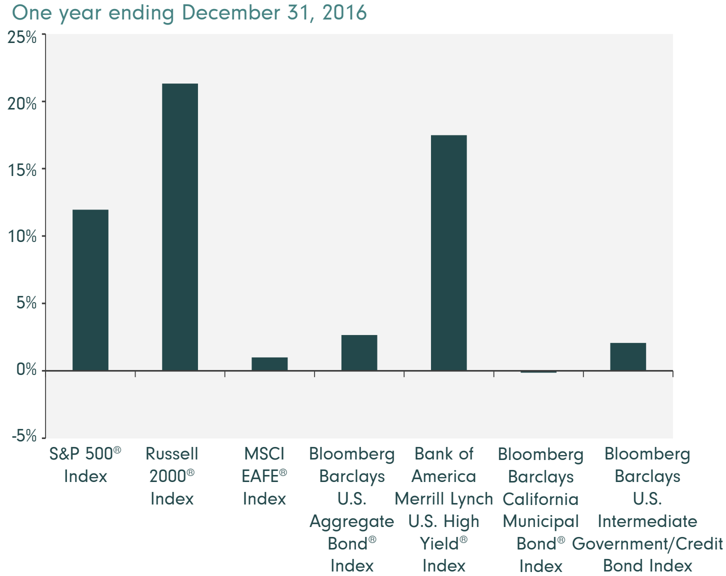
2016: A Year Full of Surprises

2016 Performance

Despite a terrible start to 2016, equities enjoyed a year of very solid returns, with the S&P 500 Index up 11.96% and small stocks registering an even more impressive gain, advancing 21.31%. However, large-cap international stocks struggled in 2016, posting a mediocre return of 1.00%. After a weak first half of the year, stocks began an impressive surge in the third quarter that continued through the fourth quarter, led by the surprise election of Donald Trump. Conversely, the broader fixed income market was very strong in the first half of the year, as the yield on the 10-year Treasury fell from 2.27% to below 1.5%. However, fixed income ended the year only slightly positive, returning 2.65%, as 10-year Treasury rates climbed in the second half of the year from 1.44% to over 2.4%. High-yield bonds performed exceptionally well, climbing 17.49%. However, California municipal bonds were flat, returning -0.14%, while intermediate bonds returned 2.08% (See chart: *Index Returns*).

Index Returns

One year ending December 31, 2016



Returns are total returns and are not annualized.
Data is obtained from FactSet Research Systems and is assumed to be reliable.
Past performance is no guarantee of future results.

What Happened in 2016?

Investors' risk appetite changed dramatically during 2016. For example, the first half of the year was marked by disappointing economic growth, falling bond yields, and defensive fixed income and equity positioning on the part of investors. After many commodities—particularly crude oil (up 45% for the year)—finally found a bottom after two years of dramatic declines (See chart: *Price of Oil*), investors adopted a much more aggressive risk appetite as the economy started to stabilize over the summer and improve into the fall. In November, President-elect Trump's pro-business, tax-cutting and less regulatory burdens agenda further accentuated the outlook that economic growth will accelerate further in 2017.

Stock Selection in 2016

The recent advance of the long-running bull market is being led by banks, industrials, materials, and more deeply cyclical (commodity) types of

Price of Oil

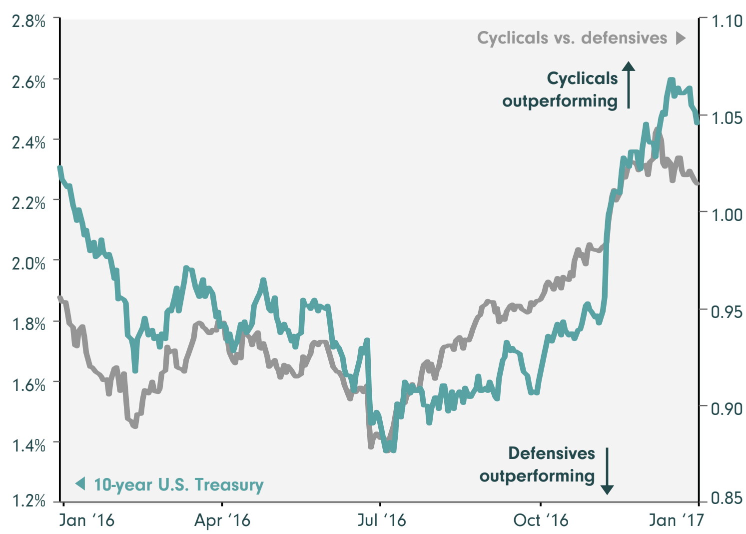
Brent crude, nominal prices, USD/barrel

Source: Source: J.P. Morgan Asset Management; FactSet
Brent crude prices are monthly averages in USD using global spot ICE prices.
Data as of December 31, 2016.

businesses—and not former leaders like "bond-proxy" types of equities, such as real estate investment trusts (REITs), consumer staples, health care and most technology (See chart: *Cyclicals/Defensives Relative Performance and Rates*). As we have repeatedly pointed out, deep cyclical areas, such as energy, have been in a recession—if not depression—over the last two and a half years. However, we believe these areas will continue to recover further in 2017—though it's unclear by just how much.

Cyclicals/Defensives Relative Performance and Rates

Cyclical/defensive performance*, 10-year U.S. Treasury yield



*Source: FactSet, J.P. Morgan Asset Management, MSCI. *Cyclicals represent the MSCI USA Cyclical Sector Index and defensives represent the MSCI USA Defensive Sector Index.*
Data as of December 31, 2016.

The shift in stock preferences has led the value indexes to dramatically outperform the growth indexes in almost every category (large, mid and small cap) by more than double for the year (See chart: *Value Vs. Growth Performance*).

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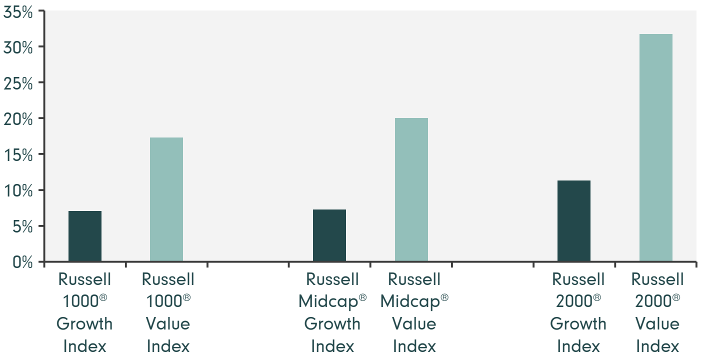
Value vs. Growth Performance

One year ending December 31, 2016



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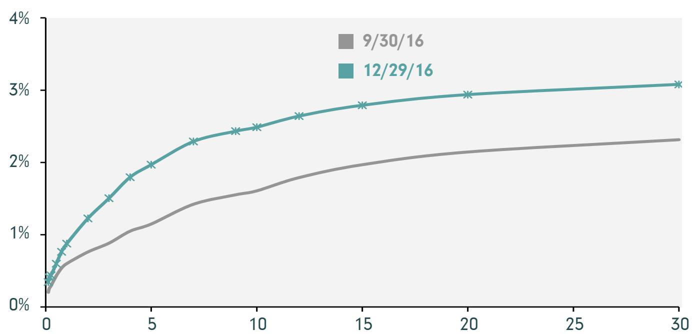
Data is obtained from FactSet. Past performance is no guarantee of future results.

That's because the value indexes tend to be populated with many of these deeply cyclical types of businesses, while growth indexes contain more of the bond-proxy types of businesses.

The increase in interest rates and the steepening of the yield curve has been accompanied by tightening high-yield credit spreads (See charts: *Yield Curve Steepened and High Yield Spreads Continue to Narrow*).

Yield Curve Steepened

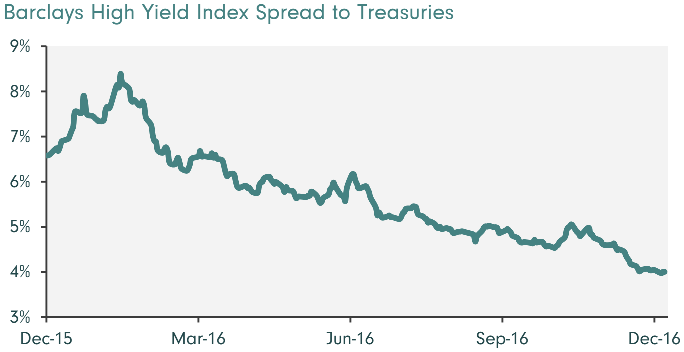
U.S. Yield Curve



Data is obtained from Strategas. Past performance is no guarantee of future results.
Data as of December 31, 2016.

High Yield Spreads Continue to Narrow

Barclays High Yield Index Spread to Treasuries



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Data as of December 31, 2016.

This type of interest rate increase is good for equities overall, as it signals an improvement in future growth prospects. Further, the strength in the U.S. dollar due to rising interest rates, in addition to Trump's unclear future trade policies, have caused large-cap international and emerging-market stocks to not participate meaningfully in this recent rally. Smaller stocks have been star performers because they aren't as negatively impacted by the strength of the U.S. dollar. They are also the primary beneficiaries of an improving domestic GDP environment and a higher appetite for risk by investors.

2017 Outlook

As we peer into 2017, we believe there is more than a usual amount of economic uncertainty. President-elect Trump has no public office track record to assess and judge how effective he will be in getting changes accomplished. It seems highly likely that some form of corporate and personal tax reform, partial Affordable Care Act repeal, increased infrastructure spending and less regulatory burden for many businesses will occur over the next two years. However, the timing of these changes is still unclear. If these events were to occur, we believe the economy may accelerate and grow in the range of 2.5% to 3.5% for the next couple of years. As economic growth increases over the next year, S&P 500 earnings-per-share growth should pick up from the low single-digit range to the mid-to-high single-digit growth range. The biggest unknown is what type of global trade policy will be pursued by the Trump administration, as meaningful tariffs on trading partners risk retaliation and a trade war, potentially providing a negative effect on the U.S. economic growth rate. Given this foggy outlook for 2017, it is more important than ever for investors to keep a properly positioned, well-diversified portfolio that is reflective of their longer-term risk and return profile. We will adjust portfolios accordingly over time as many of Trump's actual initiatives become reality rather than just speculation. In terms of actual stock selection in our proprietary equity portfolios, we will continue to focus on quality companies with protective moats that can do well in multiple economic environments.

Thank you for all your confidence and support. We wish you a happy and prosperous 2017.

Douglas S. Foreman, CFA
Chief Investment Officer
Douglas S. Foreman, CFA is Chief Investment Officer, Portfolio Manager, and a member of the Executive Management Committee. He has approximately 30 years of investment experience.

The S&P 500® Index is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. The Russell 2000® Index is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The Bloomberg Barclays U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The Bank of America Merrill Lynch U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The Bloomberg Barclays California Municipal Bond Index is a market capitalization-weighted index of California investment-grade municipal bonds with maturities of one year or more. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. The Bloomberg Barclays U.S. Intermediate Government/Credit Bond Index is a market capitalization-weighted index of government and investment-grade corporate fixed-rate debt issues with maturities between one and 10 years.

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