NOTTINGHAM ADVISORS
ASSET MANAGEMENT

Q3 2015 Select Managers Program Performance Update

Third Quarter Market Recap

The third quarter started off smoothly, but ended with a bang as volatility spiked and risk assets sold off. The benchmark S&P 500 lost -6.44% during the period, and is now down -5.29% for the year. International equities fared much worse, with both developed international and emerging markets falling sharply. Developed international equities, as measured by the MSCI EAFE Index lost -10.16%, while the MSCI Emerging Markets Index shed -17.79%. The indices are down -4.83% and -15.27%, respectively on the year. Bonds rallied, as the Federal Reserve left interest rates unchanged. The Barclays Aggregate Bond Index rose +1.23% on the quarter, after posting a negative total return through the second quarter, and is now up +1.13% on the year. High yield bonds sold off sharply as oil prices continued to decline and the commodity rout continued. The BofA Merrill Lynch U.S. High Yield Master II Index lost -4.90% on the quarter, and remains in negative territory for the year, down -2.53%. The selloff in high yield has pushed option adjusted spreads (OAS) to 662 basis points over Treasuries, as spreads widened 162 basis points on the quarter. High yield is looking increasingly attractive, with spreads having widened nearly +200 basis points since the end of May. With yields to maturity now over 8%, high yield is now the most attractive it has been since June of 2012. For investors seeking yield in a low interest rate environment, there remain few alternatives besides equities and “equity like” securities such as high yield debt.

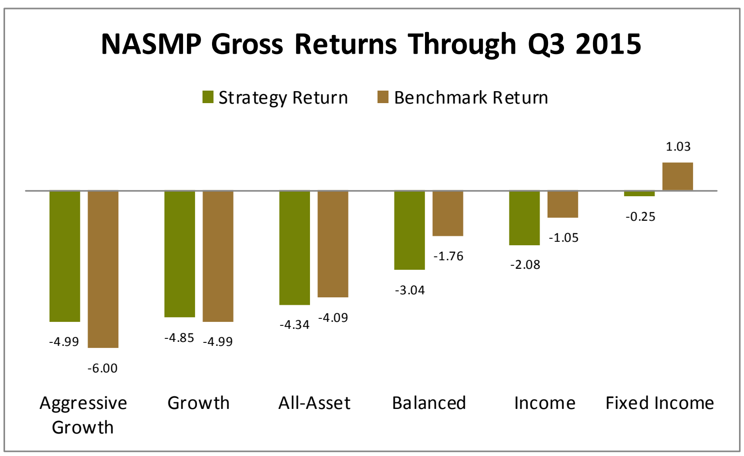
Strategy YTD Returns

During the third quarter, the Select Managers Program posted negative returns as the downturn in equity markets was swift and volatility was elevated. The more aggressive strategies (Aggressive Growth and Growth) posted the largest declines, bringing the year’s losses to -4.99% and -4.85%, respectively. The same strategies also held up the best versus their respective benchmarks, outperforming by +101 basis points and +14 basis points, respectively. While outperforming in a negative tape is nothing to get too excited about, it’s nonetheless noteworthy. The flagship All-Asset strategy trailed its benchmark by -25bps during the quarter, while more conservative strategies such as Balanced, Income, and Fixed Income lagged by wider amounts (-128bps, -103bps, and -128bps, respectively). Relative underperformance can be attributed to two main themes across managers: overweights to emerging markets and underweights to fixed income.

While emerging markets were the hardest hit during the period, funds such as the Dodge & Cox International Stock Fund (DODFX), a developed international stock fund benchmarked to the MSCI EAFE Index, held sizeable exposure to emerging markets, which aren’t part of its benchmark. According to the fund’s quarter end fact sheet, the fund held 23.1% of its portfolio in Brazil, China, India, Mexico, South Africa, South Korea, Thailand, Turkey, and the United Arab Emirates. This compares to a 0% weighting of those combined holdings in the MSCI EAFE Index. Geographic obscurity can be prevalent with active management in general, and clearly showed how such action can negatively impact a portfolio's performance in the near term. However, from a long-term perspective, emerging markets offer steep valuation discounts compared to their developed market peers, as well as favorable demographic trends over the coming decades. Furthermore, categorizing a company by its geographic location (developed or emerging market country) may not entirely represent where the company conducts business, which may explain their attractiveness to fund managers. Additionally, categorization of a country as developed or emerging is becoming increasingly blurred. For example, the index provider MSCI currently classifies both South Korea and Thailand as emerging markets; however, many fund managers view these countries as developed, with the differing of opinion hinging on a technicality. Eventually, these two countries will earn developed status, and fund managers may be getting in ahead of the inevitable reclassification by MSCI.

A fund that deviates from its stated benchmark can clearly have more opportunity to outperform – or underperform – its benchmark during any given period. With that in mind, the Dodge & Cox International Stock Fund underperformed its benchmark by -520 bps on the quarter, and was a negative contributor to portfolio performance.

Fixed income managers have continued to emphasize short duration and high quality securities in their portfolios. This has been a double-edged sword as the Federal Reserve has maintained a zero interest rate policy, and managers overweighting high quality short duration securities have not been rewarded.



Another theme across fixed income strategies has been to reach for yield, moving further out the credit quality spectrum. Lower credit quality came back to haunt managers as commodity prices plummeted and high yield spreads blew out during the third quarter. This had a negative impact on funds such as the Dodge & Cox Income Fund (DODIX), which has a nearly +50% overweight to securities rated BBB or lower. Coupled with an overweight to cyclical sectors, the fund underperformed the Barclays U.S. Aggregate Bond Index by -200 basis points during the period.

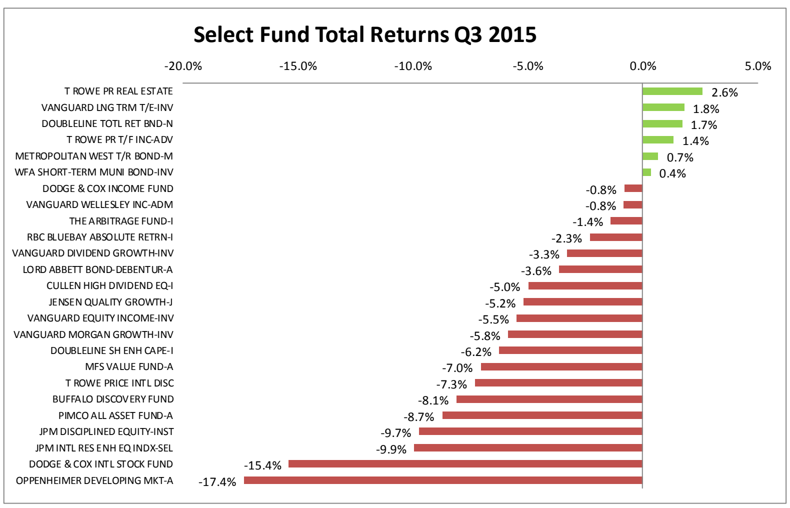
Cash Positions

Active managers continue to hold cash and cash equivalents, a trend we first spoke about during the first quarter. Such action looks timely in periods of market turmoil and rising rates, but can be costly in volatile and uncertain times like these. For those reasons, we remain focused on the long term, and are willing to accept conservatism by our managers in an effort to protect our client's principal and eventually put cash to work at better prices. As of the end of the third quarter, the trend appears to be even more pronounced, with actual bond and cash weights ranging from ~10-15% above model weights. This allocation demonstrates that active managers are purposefully holding cash/short term fixed-income instruments, compared to our model weights.

It is important to remember that these decisions are made at ***the manager level.*** As a "manager of managers," we remain responsible for setting an asset allocation and selecting active managers to fill each respective part of our global style-box. It should be noted that we typically have a model weight to cash of roughly 5%, providing us with a buffer for new opportunities, tactical trades, and day-to-day account maintenance.

Notable Fund Performances

Positive performance in Q3 was led by the T. Rowe Price Real Estate fund (TRREX), which benefitted from the Fed's decision to keep interest rates at historic lows. The fund's +2.6% gain during the period topped other positive performers, which were fixed income oriented. From a fixed income standpoint, returns were quite muted. However, bonds again proved their worth in client portfolios by buffering portfolio values on the downside. Funds such as the Vanguard Long Term Tax Exempt (VWLTX) and Metropolitan West Total Return (MWTRX) eked out positive gains, while balanced funds such as the Vanguard Wellesley Income (VWIAX) and Berwyn Income Fund (BERIX) posted slightly negative returns due mostly to their equity exposures. Fixed income managers have been rewarded for taking duration risk and finding value in more niche areas of the market such as residential and commercial mortgage backed securities (RMBS and CMBS), and asset backed securities (ABS), such as those found in the DoubleLine Total Return Fund (DLTNX). The fund's performance has benefitted from such exposure, resulting in an outperformance of +168bps against the Barclays U.S. Aggregate Bond Index.



Note: Some NASMP strategies may include alternative funds based on fund closures.

Source: Bloomberg

Negative performers in the third quarter largely centered on equity oriented funds, most notably those with international and emerging markets exposure. The Oppenheimer Developing Markets fund (ODMAX) was the worst performing fund during the period, losing -17.36% as Emerging Markets equities as a whole lost -17.79%. We continue to believe in the diversification benefits and long term promise of emerging markets as an asset class, and in the value oriented Oppenheimer fund. Other poor performers included the Dodge & Cox International Stock Fund (DODFX) and the PIMCO All-Asset Fund (PASAX), which lost -15.4%, and -8.7%, respectively during the quarter.

Fund Changes & Strategy Highlights

During the past two quarters, we've continued to build out dedicated portfolio sleeves to "balanced" and "alternative" managers. In our more conservative strategies (NASMP Balanced and Income), we added a new position in the Vanguard Wellesley Income Fund (VWIAX). The fund is a conservative allocation fund that has a different tilt on the traditional balanced fund. Typically, balanced funds have a higher allocation to equities – sometimes a 60/40 or 50/50 mix. Instead, the Wellesley Income fund allocated a third of its assets to stocks, and the rest to bonds, allowing it to maintain a higher distribution yield (currently 2.90%). The fund maintains a 0.18% expense ratio, placing it in the bottom fee quartile amongst its peers.

Turning to alternatives, we added to our position in The Arbitrage Fund (ARBNX) in the NASMP Aggressive Growth, Growth, All-Asset, and Balanced strategies, sourcing the funds from the Oppenheimer International Bond Fund (OIBAX). International bonds have become less attractive given quantitative easing (QE) strategies of the European Central Bank (ECB) and Bank of Japan (BoJ), which have put downward pressure on international bond yields. The Arbitrage Fund remains one of our favorite alternative funds for its unique strategy and low correlations with major asset classes such as the S&P 500 and Barclays U.S. Aggregate Bond Index. Moreover, The Arbitrage Fund should ***continue to benefit*** from two key dynamics that are on most investors' minds – increased market volatility and higher interest rates. The fund's strategy centers around purchasing shares of companies that have signed contracts in place to be acquired, and "arbing" out the spread between the announced deal price (i.e. $100) and where the stock trades in the market after the deal is announced (i.e. $98.50). The remaining $1.50 spread will be captured by the fund for holding the stock until the deal closes. This spread is largely based on the risk free rate and time expected until the deal closes (i.e. six months, thus a six month risk free rate). Given that premise, rising interest rates should allow the fund to capture *higher* risk premiums, which is a *positive* for investors. Furthermore, increased volatility in the market should allow the fund to purchase *more* shares of companies that have *signed deals in place to be bought* as their shares decline amidst higher volatility in the market place.

In closing, all Select Manager strategies are back in positive territory for the year through November 10. While we can't predict what might be in store for the markets heading into year end, all eyes will surely be on the Federal Reserve when it meets December 15th and 16th. We'll be sure to keep you informed of any material outcomes as they happen.

As always, please feel free to contact our office with any questions or comments regarding the Select Managers Program or any of the funds that we have added to the Program. We are always happy to discuss performance, portfolio strategy, and fund selection in more detail.

Matthew Krajna, CFA
Portfolio Manager
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