North American Management
Ten Post Office Square, Suite 1200S
Boston, MA 02109
Telephone: 617.695.2100
Fax: 617.695.2121

One North Brentwood Boulevard
Suite 1510
St. Louis, MO 63105
Telephone: 314.833.6641
www.namcorp.com

Fourth Quarter 2016

Great Expectations

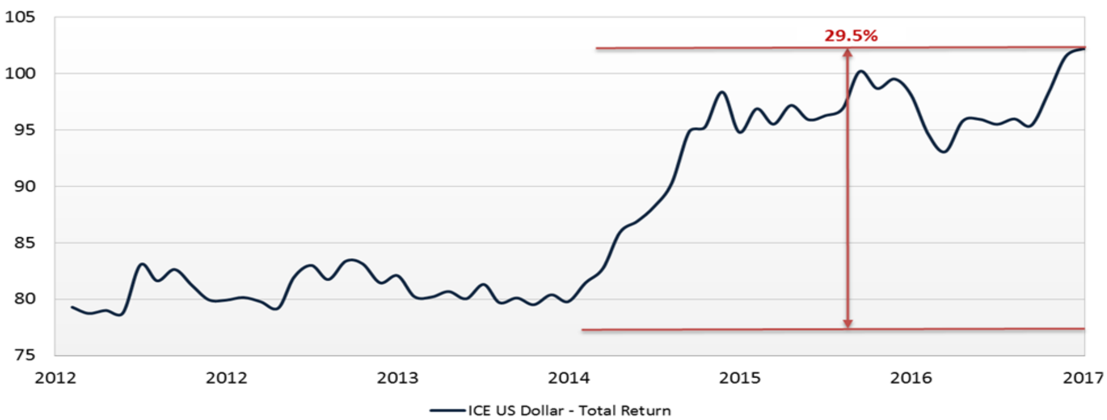
The second half of 2016, particularly the fourth quarter, may well be remembered for the birth of the "reflation trade." Or maybe not – investors are watching the early days of the Trump presidency closely for confirmation that the policy mix coming out of Washington will be as pro-growth as promised. Reflation is certainly a different investment narrative and a distinct pivot away from the malaise popularly known as secular stagnation. As we saw this quarter, reflation (especially when combined with expected and meaningful decreases in regulation) favors pro-cyclical or commodity sensitive sectors like financials, industrials and materials that are heavily geared to changes in global growth. On the other hand, yield-oriented stocks like utilities, REITs and some consumer names tend to suffer along with longer maturity bonds as interest rates rise.

Index (as of 12/31/2016)	Fourth Quarter 2016	First 9 Months 2016	Full Year 2016
S&P Financials	21.10%	1.40%	22.80%
Russell 2000	8.83%	11.46%	21.31%
S&P Utilities	0.14%	16.13%	16.29%
iBoxx USD Liquid High Yield	1.38%	13.76%	15.33%
S&P 500	3.82%	7.84%	11.96%
S&P GSCI (Commodities)	5.76%	5.30%	11.37%
MSCI EMF (Emerging Markets)*	(4.16%)	16.02%	11.19%
MSCI U.S. REIT INDEX – Gross Return	(2.96%)	11.91%	8.60%
MSCI AC World Index ex USA*	(1.25%)	5.82%	4.50%
Bloomberg Barclays U.S. Aggregate	(2.98%)	5.80%	2.65%
MSCI Japan*	(0.16%)	2.54%	2.38%
Bloomberg Barclays U.S. Treasury 20+ Year	(12.16%)	15.47%	1.43%
Bloomberg Barclays 10-Yr Municipal Bond	(4.29%)	4.35%	(0.12%)
MSCI Europe*	(0.40%)	0.00%	(0.40%)

Total Returns in U.S. Dollars. Returns are calculated with net dividends (where applicable) in U.S. Dollars.*

And rise they did. The table above shows significant losses during the fourth quarter among various U.S. bond markets including treasuries, municipals and the Bloomberg Barclays U.S. Aggregate. In fact, the bond sell-off was global, and the Bloomberg Barclays Global Aggregate suffered its worst month in November (down 4%, with $1.7 trillion of market value lost) since the index was introduced in 1990. Yields on the ten-year Treasury note (a key driver of housing, corporate, municipal and federal borrowing costs) hit 2.61% on December 15, a rise of about 125 basis points - a remarkable 92% surge off record lows reached after Brexit. As our municipal bond manager noted, "it was the fastest four-month rise in rates on a percent-change basis going back to the 1920s."[1] Finally, the U.S. dollar rallied 6% in just six weeks following November 4 as U.S. yields and stock prices outpaced most international markets, many of which delivered negative returns for the quarter. U.S. small caps, whose sales are almost exclusively domestic, had an outstanding quarter and an excellent year. Though the sharp 30% rise since 2014 (see graph below) in the U.S. dollar versus its trading partners has had a significant negative impact on commodity prices and has, on balance, been a headwind for client portfolios owning foreign stocks and U.S. exporters, we believe most of the painful adjustment is done. Any renaissance in U.S. manufacturing would likely be short lived if the dollar continues to appreciate against its major trading partners, tax cuts and protectionist bluster notwithstanding.

Total Return - United States Dollar Index
January 2012 - December 2016



The number and magnitude of changes being attempted by the new administration are ambitious, even jarring when one considers how accustomed Americans are to legislative gridlock. Politics aside, it looks as if the pendulum of monetary and regulatory response has finished its long arc begun after 2008 and will reverse quite rapidly from here. Our primary concern is with client portfolios and their positioning relative to long-term goals, so it makes sense to ask what other paradigms or popular perceptions might change in the months and years ahead (be sure to read our accompanying financial planning note). We can think of at least three that might jog investors out of their low growth, disinflationary mindsets. We list them below and follow each with either portfolio actions taken this quarter or observations worth considering for the future:

1) *Central banks drive the bus, investors are passengers, and politicians do nothing.*
    - Upsets and periodic volatility among global bond markets may continue as market participants try to balance a receding Fed, an active Congress and a hyperactive White House.
    - Where applicable, we reduced our exposure to TLT, a long-duration Treasury ETF intended to stabilize equity portfolios. While TLT acted well in the first half of 2016, it began to show somewhat exaggerated movements relative to stocks in the second half.

[1] GW&K Quarterly Investment Review - Year End 2016, Bloomberg, MKM Partners

2) *Low growth and low rates are dull, but safe. Or, when accidents happen at low speeds, nobody gets hurt and they don't need much insurance.*
   - This quarter's rotation was probably mild compared to what might unfold in a more capacity constrained global economy. What risks materialize if the administration's high growth targets are met?
   - Inflation hedges are back on our radar, because there are limits to how long interest rates, commodities and stock prices can move higher together.
3) *Multiple expansions supported by central banks lessen the need for disciplined price discovery.*
   - Rising valuations have dominated earnings growth, dividends and coupons as a source of total return among equities and bonds, but they may carry less water going forward while changes in fiscal policy and higher interest rates create more distance between winners and losers.
   - After a broad multiple expansion, expected future returns among various asset classes are understandably low. Rigorous and disciplined selection of securities and managers becomes even more important, and owning indexes may be less satisfying. This fits well with our consistent internal and external focus on individual securities and active managers who can differentiate winners from losers.

There will be no shortage of crises and problems over the next four years, but we encourage long-term investors who are worried to look past the surge of emotion following the election and think about how we got here. The country has been to the edge of an abyss and back since 2008, and it's undeniable that the private sector suffered and sacrificed greatly. Millions of jobs and houses were lost, lives were put on hold and living standards deflated while the economy retooled and weaned itself off excessive leverage. Central bankers went to extraordinary, unprecedented extremes to keep the economy from collapsing, and many state and local governments retrenched and reformed. The federal government by contrast is widely viewed on *both* sides of the aisle as less functional, more polarized, and either unwilling or unable to introduce successful fiscal stimulus or reforms since the crisis. In hindsight, the absence of a bi-partisan fiscal response (remember Simpson-Bowles?) probably forced the Fed to lower rates much further than they might otherwise have done, thus limiting flexibility in the next downturn.

Blustering and tweeting aside, demographics, technology and globalization are powerful forces that will persist for decades to come, with no small effect on growth potential among western democracies. Technology in particular is a great leveler that tends to diminish rather than increase the impact of nationalist impulses, making borders more porous, not less. We expect change, not miracles or meltdowns, and we will adapt.

Thank you for being a valued client of North American Management, and best wishes for a happy and prosperous 2017.

Robert G. Scott
Chairman & CEO

Fraser J. McLean, CFA, CFP®
Chief Investment Officer

Source of data not specifically cited: FactSet.

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Special Note to Clients

I am pleased to announce several recent promotions and one new hire at North American Management:

- **Alyssa Elliott** will become Chief Compliance Officer of the Firm, reporting directly to me and to our Chief Operating Officer, Blake Stuart. Congratulations to Alyssa on her advancement and thorough understanding of our principles based compliance culture. She has been a welcome addition to North American and will continue to build on the robust compliance platform that Blake has developed since I first asked him to take on the role of CCO in 2011. Blake's primary focus going forward will be on his continuing role as COO, although he will be available to assist Alyssa when needed.
- **Herbert Cayzer** has been promoted to Analyst. Bertie has done valuable work in support of a more robust platform of managers, with more and better quality analytics that give us all the tools we need to make better allocation decisions. Thank you, Bertie, and congratulations.
- **Willard Schoch** has been promoted to Senior Portfolio and Reporting Analyst. Will has brought tremendous energy and productivity to his role at North American, and I congratulate him on all his good efforts.
- **Patrick Murray** joins us from Brown Brothers Harriman, where he was a Senior Client Account Manager specializing in exchange-traded funds. Pat is a Client Services Administrator, and he will be assisting our clients with new and existing account transactions and processes, including cash requests. He has a Bachelor of Arts from Dartmouth College and is an avid soccer player.

Robert G. Scott
Chairman & CEO

Quarterly Reporting Note

We recently decided to change the name of our Core Equity Strategy to the Aggressive Growth Strategy in order to more accurately reflect its goal. In addition, effective January 1, 2017, we changed this strategy's blended benchmark from the S&P 500 Index (95%)/BOA Merrill Lynch 3-Month U.S. T-Bill Index (5%) to the MSCI All Country World Index (95%)/BOA Merrill Lynch 3-Month U.S. T-Bill Index (5%). It's important to note that the purpose of our benchmarks is not to be proxies for our clients' portfolios, but rather to provide a general measure of comparison. Please let us know if you have any questions.