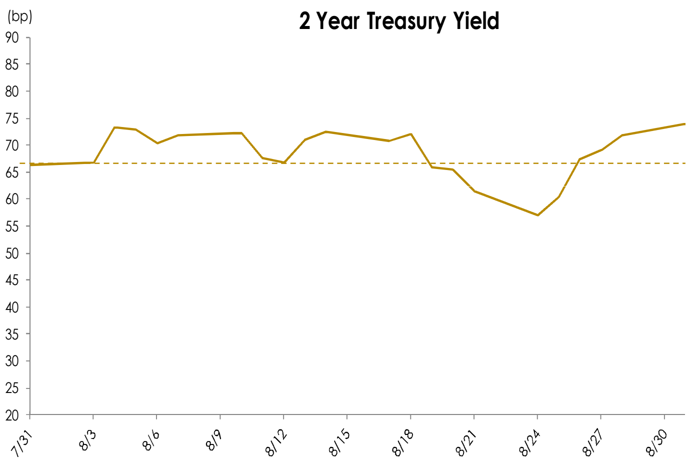
Fixed Income Overview

As volatility spiked across virtually all financial assets during the month of August, investors may feel as if they are hanging by a string. With global stocks officially entering "correction" territory for the first time since 2011, we would generally look toward fixed income exposures to be the last line of portfolio defense. Unfortunately, it was also a difficult month for diversified bond investors as "safe haven" trades really failed to kick-in and virtually anything trading with a spread over risk-free U.S. Treasuries struggled to produce excess returns. That said, in this environment characterized by enhanced economic and policy uncertainty, we continue to believe that it's important to identify nimble managers and/or strategies that are positioned to take advantage of other's complacency or excessive risk taking. Although a certain level of volatility is unavoidable, a well-designed fixed income portfolio should be able to satisfy the dual objective of providing income throughout a cycle and preserving capital in times of stress.

Benchmark relative performance across categories was skewed to the negative side as managers faced a combination of extreme interest rate volatility and ongoing spread widening in most sub-sectors throughout the month. Unhedged developed market global or international strategies led the way, with the municipal bond complex continuing to post results just ahead of cash and the broad investment grade indices. Those categories experiencing the greatest contraction once again included local currency emerging markets, equity-like convertibles, and high yield corporates. Dispersion increased modestly in August (~5.8% top-to-bottom among strategies), so there is clearly enough variability present for active managers to benefit from their prospective allocation and security selection decisions.

U.S. Treasury

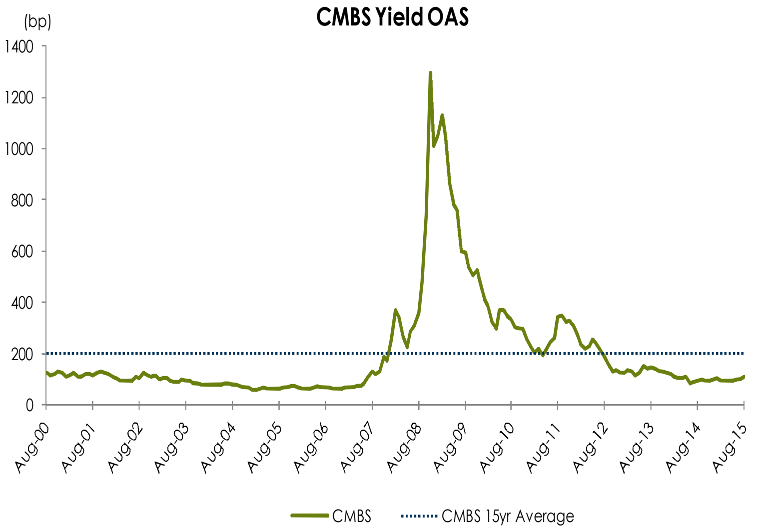


U.S. Treasury volatility surged this month, according to the Bank of America Merrill Lynch MOVE Index. After hitting its low point of the year in July, the gauge reached 94.5 on August 24th, the highest level since February and compared with a 12-month average of just below 79. Overall, the varied maturities traded in 17 to 28 basis point (bps) range throughout the month, with longer-dated issues showing the most erratic daily movements and the curve shifting back into a modest "bear flattener". Despite a whole host of events that reportedly pushed back the market's expectation for central bank action, the **policy sensitive front-end of the curve ended the month meaningfully higher.** On a month-over-month basis, the 2-year yield increased 8 bps to 0.74% and finished August at its highest point of the year. Although **FOMC communication around the timing for lift-off has left a lot of room for interpretation in recent weeks,** the futures market is now anticipating that a Fed hike is not likely before December.

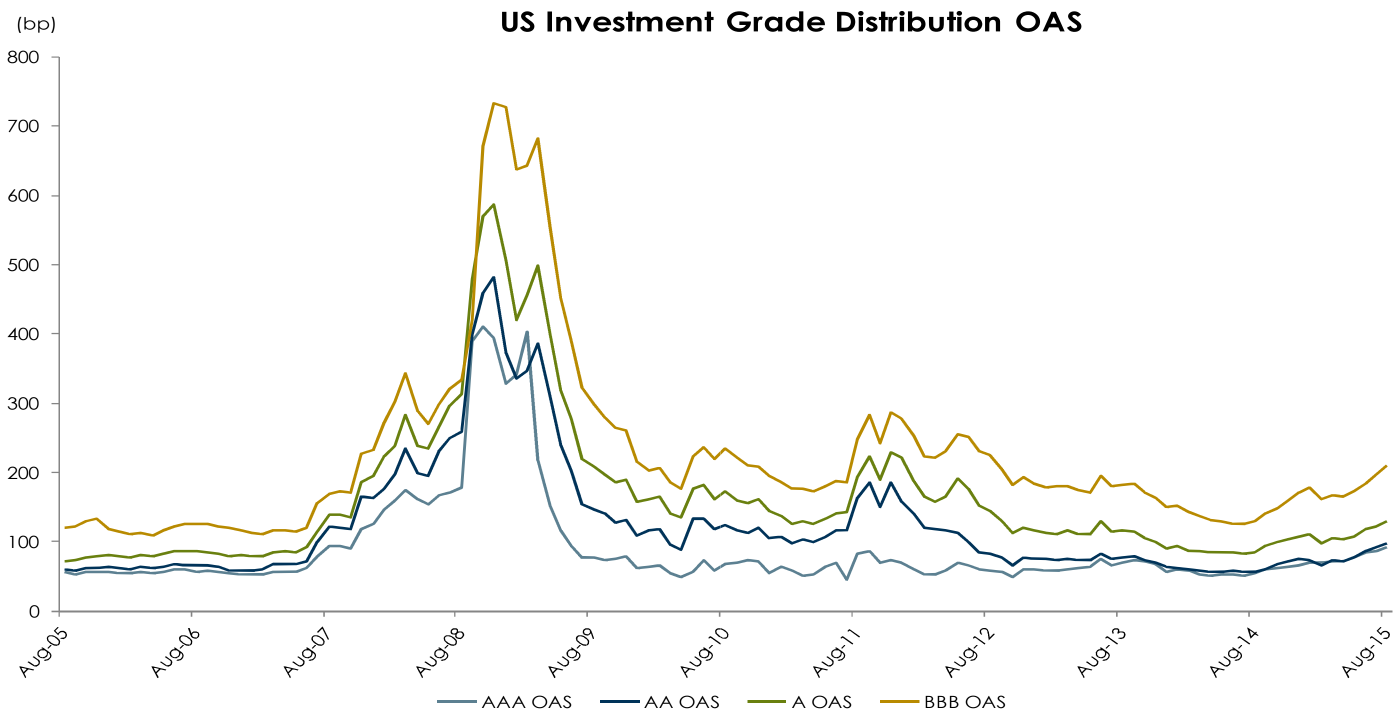
While the 5-year issue was slightly more volatile overall, its movements were essentially a round trip as the final yield of 1.55% was only 2 bps above the prior month end. A similar story could be told for the **closely watched 10-year bond** as it initially moved higher on a solid jobs report, then crashed back down to its lowest yield since April amid financial-market turmoil, only to ascend higher in the final five trading days of the month to end up 4 bps overall at 2.22%. Although the 30-year bond yield settled 6 bps higher at 2.96%, global growth and inflation concerns continue to keep the long bond below the psychologically important 3% level. Given these varied movements along the curve, the 1-3 year bucket recorded a total return of -0.05% during the month, while the 20+ year bucket was only able to muster a gain of +0.01%. With the steep sell-off in equity markets, this lack of performance across the U.S. Treasury curve is somewhat disappointing and speaks to a more limited opportunity set at such low absolute rates.

Barclays Aggregate U.S. Bond

The government-dominated **Barclays Aggregate U.S. Bond Index recorded a monthly decline of -0.14%, but remains in slightly positive territory year-to-date.** While the pace of new issuance slowed dramatically amid higher volatility and late-summer market dynamics, corporate bond spreads widened for the fourth consecutive month and ultimately reached levels last seen in 4Q-2010. Despite a modest recovery at month end, as investors stepped in to buy at cheap levels, credit spreads moved 9 bps wider throughout all of August and the investment grade corporate bond sector materially underperformed duration-matched U.S. Treasuries. Higher quality credit outperformed during the month, with crossover BBB-rated industrial names seeing the most weakness. Longer-dated issues also underperformed as credit curves steepened wit h buyers demanding more compensation per unit of duration. In the securitized space, CMBS continued to underperform as spreads across the capital stack widened to the highest levels seen in 2015 as lending and securitization activity remained robust. Spreads for highly liquid Agency MBS were modestly tighter during the month given a lower correlation to macro headlines and more balanced net supply expectations through year-end. Albeit modest, ABS continues to produce positive excess return amid economic data suggesting ongoing strength in consumer credit.



Core Plus or Multi-Sector

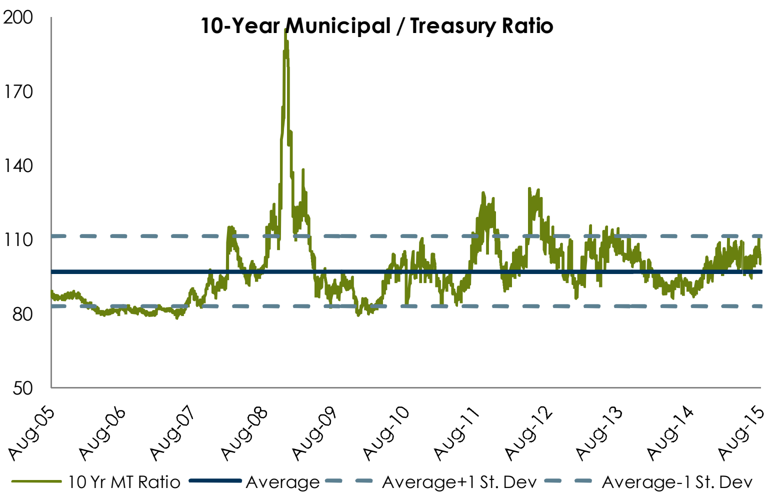


Despite the flexibility of expanding the universe and taking off-index positions, most **Core Plus or Multi-Sector** managers failed to outperform the traditional benchmark. Strategies that ended the month toward the top of the stack effectively managed their allocations to below-IG credits.

Absolute Return/Unconstrained

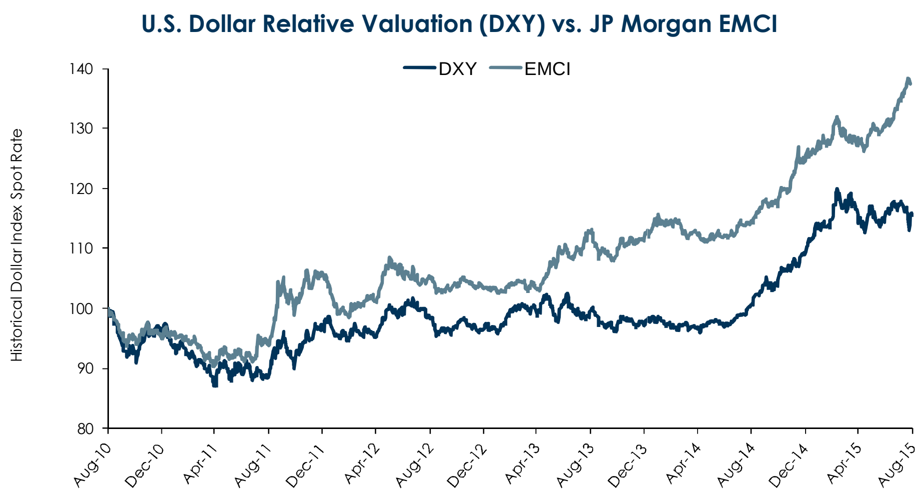
Absolute Return/Unconstrained category lost ground to LIBOR/cash, and generally underperformed long-only, duration-bearing counterparts. Despite somewhat disappointing results, and the failure to accomplish the LIBOR +3% to 6% objective in recent periods, we would make two points regarding this group: 1) on a 3-year annualized basis, median manager performance still exceeds the Barclays Aggregate U.S. Bond Index net of fees, and 2) some strategies are being run with a more intentional focus on drawdown and risk-adjusted returns. Going forward, we expect the observed separation of returns to persist as manager discretion is not tethered to any specific benchmark. Additionally, we continue to believe that expected bouts of volatility should only help to foster the stratification and identify the true defenders of absolute return.

Tax-Exempt Municipals



Tax-Exempt Municipals were a relatively attractive place to be during August, as they tracked a fairly steady course and provided stability in the face of intense volatility. Market technicals were mixed as supply was surprisingly robust (up 20% year-over-year), but demand for tax-exempt income was healthy enough to take down most deals without the need for yield concessions. Curve positioning mattered once again, as most of the maturity spectrum benefited from modestly declining yields throughout the month, but the five-year area saw rates rise 5 to 7 bps as selling pressure emerged in the later part of August. With the municipal curve behaving in a slightly different fashion than the U.S. Treasury curve, yield ratios generally fell (10-year ratio down 6% to 100%) but tax-equivalent relative value still exists across the curve for high income investors. Credit spreads widened in August, most notably New Jersey tax-backed debt which was impacted by the offering of a new $2.2 billion appropriated deal. At current levels, New Jersey bonds now match the cheapest levels reached by California debt back in 2009 during the depths of their fiscal crisis. Other poor performers for the month included Illinois, Chicago (Met Pier), and insured Puerto Rico bonds. On August 1st, as expected, Puerto Rico defaulted on a $58 million debt payment for its Public Finance Corporation, marking the island's first monetary default. There seems to be little concern amongst managers that this will in any way lead to contagion elsewhere.

Un-hedged Global



DXY Characteristics	
Average	99.43
Minimum (Intramonth)	112.96
Maximum (Intramonth	117.76
Current	115.60
90 Day Change	(1.01)

EMCI Characteristics	
Average	108.16
Minimum (Intramontl	134.46
Maximum (Intramont	138.33
Current	137.45
90 Day Change	8.22

Un-hedged Global indices slightly outperformed their domestic counterparts in August, with the Citi WGBI benchmark recording a monthly gain of +0.47%. While recent foreign yield curve movements have been notable, with the yield on 10-year developed market bonds generally rising in Europe and declining in the Asia Pacific region during the month, an overwhelming factor impacting returns for U.S.-based investors continues to be the direction of the U.S. Dollar. During August, the U.S. Dollar depreciated versus a basket of major developed currencies and ended 1.55% lower for the month. This translation effect meant the overall currency impact added 64 bps of return to the un-hedged global benchmark over the past month. International managers that have taken off-benchmark exposures or global managers that overweight U.S.-denominated bonds tended to underperform in August.

Emerging Market Bonds

Depending upon the benchmark orientation, investor outcomes within dedicated **Emerging Market Bonds** were either bad or worse during August. One event that cut across all categories was the Moody's downgrade of Brazil's credit rating. The J.P. Morgan Global Diversified index of external sovereign debt denominated in U.S. Dollars posted the best returns at -0.91%. The Merrill Lynch EM Corporate Plus index, which had been leading the way year-to-date, began to see some initial backsliding in credit spreads and produced a return of -1.36%. As emerging market currencies continued to weaken versus the U.S. Dollar, the JPM GBI EM Global Diversified index (local currency bonds) recorded a difficult -5.38% performance for the month. Most likely related to their position in Venezuela, which could have been expected to underperform as oil fell below $40 per barrel for the first time since 2009.

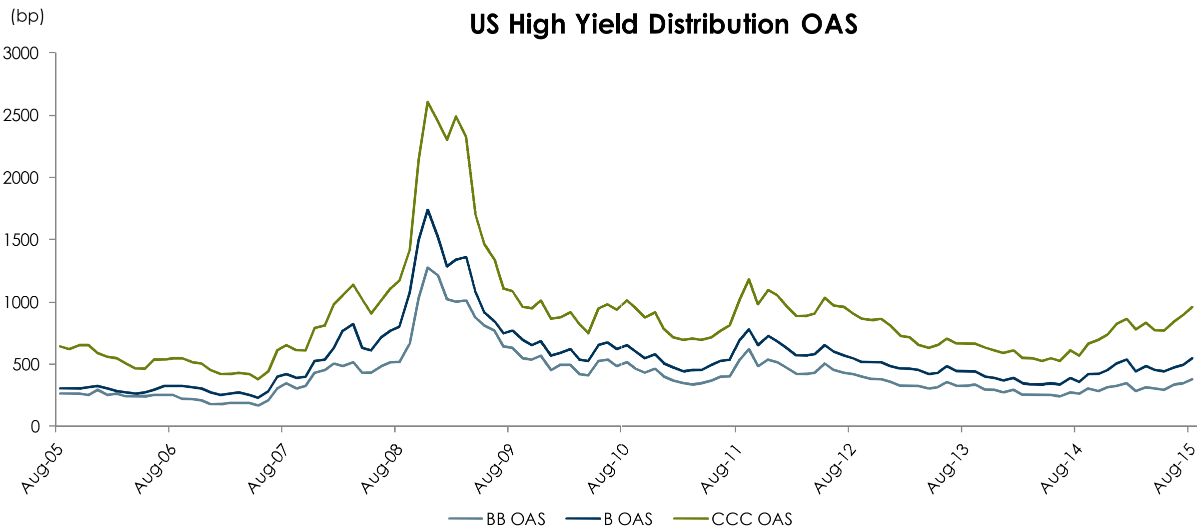
Inflation

Inflation expectations, as measured by the 10-year breakeven rate, are taking their lead from declining commodity prices and moved another 11 bps lower during August to end the month at 1.64%. This is slightly below July's year-over-year reading for Core CPI (up 1.8%), which remains unchanged despite a relatively weak month-over-month change in pricing. In the recent past, weakness in commodity pricing has been viewed as "transitory", however, it's unclear at this point whether these latest moves will impact the Fed's ability to feel comfortable that its longer-term inflation objectives can be met. With the linkage to inflation acting as a headwind, and with U.S. Treasury yields increasing modestly across the curve, most traditional TIPS portfolios surrendered more than 1% during August.

High Yield Bonds

High Yield Bonds (-1.76%) were meaningful underperformers during August, and are now back to around breakeven for all of 2015. Returns were once again driven by the fact that overall spreads widened by as much as 74 bps, pushing back to levels last seen in 4Q-2010 and causing all-in yields to temporarily exceed 7.55% at the index level. Both the Merrill Lynch High Yield Master II and Barclay's High Yield continue to be impacted by their roughly 15% allocations to the energy sector. Despite the dramatic recovery in near-term crude oil futures late in the month, the high yield energy category was down -6.95%, primarily the result of a -9.25% decline for the independent exploration & production sleeve. The rout in energy-company debt has all but shut off capital markets to the weakest companies, leading to an increase in anticipated defaults. In reviewing performance across the quality spectrum, a risk-off trade was evident with BB-, B-, and CCC-rated names producing returns of -1.25%, -1.85%, and -2.84%, respectively. Leveraged Loans (-0.65%) held up better than their high yield counterparts, and have now produced the best year-to-date performance of any bond category. Although robust demand from Collateralized Loan Obligation (CLO) formation is providing a strong (perhaps unsustainable) technical benefit, this category may remain attractive to those desiring to rotate up the capital structure, with the added benefit of floating rates (once embedded floor levels have been exceeded).

With overwhelmingly negative signals out of equities, convertible bond indices were down across the board. The Merrill Lynch All U.S. Convertible index, which includes a lot of unrated and/or small cap names, underperformed the investment-grade only benchmark. Manager performance in this space also depends largely on whether the strategy is pursuing the embedded equity optionality of this category (high delta) or if they are dealing in "busted" converts which trade more on a yield basis.



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