"Blessed is he who expects nothing, for he shall never be disappointed."– Alexander Pope

Fourth Quarter 2018 Update

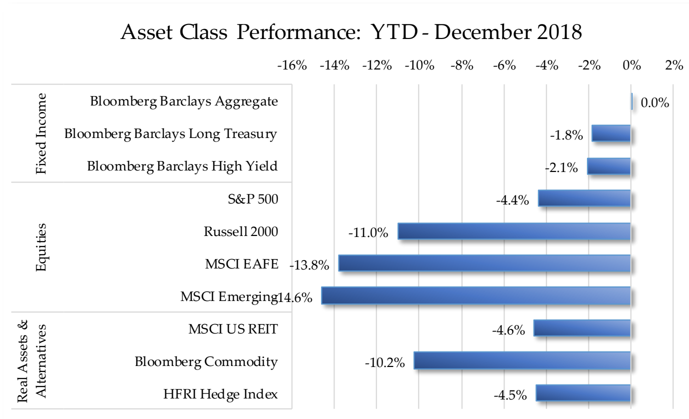
Alexander Pope made his name as a poet and satirist in the 1700's, also known as the "English Augustan" period. To the best of our knowledge, he never dabbled in the markets, but his comments ring true when we consider the importance of reading investor sentiment when making investment decisions. Thinking back to this time last year, expectations were high as we basked in the glow of a 2017 when U.S. equity indices were up over 20% with even higher returns in both developed and emerging market equities. It was also an incredibly smooth ride in 2017 with zero days in which the S&P 500 had an up or down move greater than 2%. Despite the "risk on" performance in 2017, treasuries also posted positive returns. How could you not love 2017?

The joy continued as stocks surged 7% in the first few weeks of 2018, then declined throughout the remainder of the year, migrating investors from a utopian world to a wall of worry in 2018. The S&P 500 was more volatile, moving more than 2% in a day on 20 occasions, 12 of which came in a chaotic fourth quarter. No major asset class generated a positive real return in 2018.

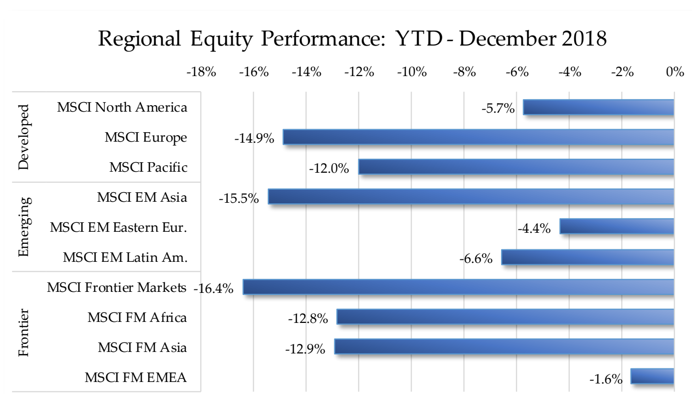
In this quarter's letter, we will review 2018, provide our thoughts on what investors might expect in the upcoming year, and close with a firm update.

2018 Financial Market Review

Volatility in the final quarter of 2018 resulted in steep declines for all markets in December, pulling the S&P 500 into negative territory for the full year. Trade related tensions between the United States and China, weakness in the tech sector, concerns about slowing global growth, and jitters about the Federal Reserve pushing interest rates higher translated into some ups, but more downs for global markets in 2018. Small cap equities had the roughest ride, as measured by the Russell 2000 index, declining -20.2% in the fourth quarter and -11.0% for the year. By comparison, large cap stocks outperformed small-caps over both periods, with the S&P 500 posting a double-digit decline of -13.5% in the quarter and losing -4.4% for the year. Foreign stocks also suffered heavy declines in 2018 with the MSCI EAFE index down -13.8% and the MSCI Emerging Markets index down -14.6%.



Thanks to a flight to quality in December, U.S. Treasury yields declined despite the Federal Reserve raising interest rates for the fourth time in 2018. Nevertheless, December's rally in rates did not provide much of a shock absorber for investor portfolios as the Bloomberg Barclays U.S. Aggregate Bond Index returned 0.0% in 2018 and long-term Treasuries were down -1.8% for the



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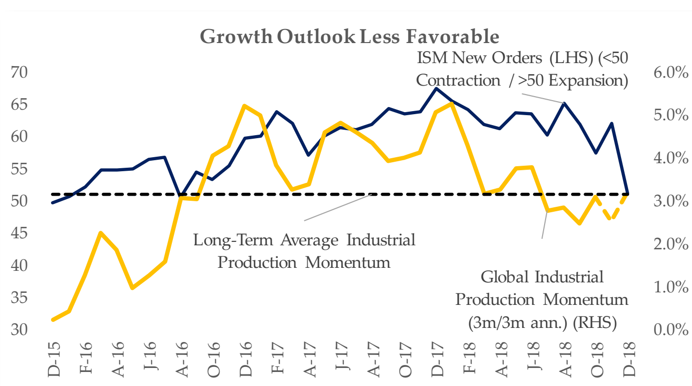
year. High-yield bonds, which usually outperform in a rising rate environment, declined -2.3%. U.S. REITs, despite strong gains throughout the spring, struggled in the early and latter part of the year, declining -4.6% for the year. The Bloomberg Commodity Index was also down -10.2% for the year with oil posting steep declines, partially offset by gains in precious metals and agriculture.

<u>Outlook for 2019</u>

As we ponder the outlook for 2019, we will stick with a framework that has served us well in the past and is applicable across all markets. We will discuss fundamentals/macro, valuations and investor sentiment. We blend all three together to determine our overall positioning to start the year. In short, fundamentals are mixed/weakening, valuations are cheaper than a year ago, yet still elevated from a historical perspective, and sentiment is guarded. We anticipate markets will remain volatile in 2019, yet afford opportunities for diversified portfolios that include selective active management and also utilize a broad range of alternative investments.

Fundamentals/Macro **-** The fundamental picture is mixed at best as we start 2019. This is a much different picture than the globally synchronized growth we experienced coming out of 2017. As noted in this chart, the pace of economic growth slowed significantly towards the end of 2018 as the Institute for Supply Management's index of new orders and the strength of global industrial production weakened.



While the absolute level of economic activity in the U.S. is robust, the pace of growth here and abroad has been decelerating lately. As we think about 2019, we remain mindful of two key factors:

1) *More restrictive monetary policy* - As we highlighted in early 2018, the Fed and Global central banks' balance sheet activity proved to be a significant risk factor in 2018. Although we underestimated the market's sensitivity to central bank balance sheets, we were reminded of the "taper tantrum" of 2013 when markets convulsed just as they did in December when Fed Chairman Powell suggested that the Fed was on auto pilot in terms of its balance sheet reduction program.

   In Europe, the ECB's monetary policy is becoming less stimulative as growth declines within the EU as countries continue to grapple with post crisis austerity programs and protectionist policies in the U.S. and abroad. Another major wild card to consider for Europe in 2019 is ECB President Mario Draghi's term which ends in October 2019.

2) *Less favorable economic tone from Washington DC* - We have quickly pivoted from a tax reduction to trade wars and a government shut-down. Strong arguments can be made for and against the administration's stance on trade. Nevertheless, the uncertainty will hamper global growth at least in the near term. The ever-increasing complexity and interconnected nature of global supply chains should not be underestimated. As for the shutdown, its implications go beyond the 800,000 directly impacted federal employees and will have some impact on millions of government contractors, productivity, security, social programs, travel, and consumer sentiment.

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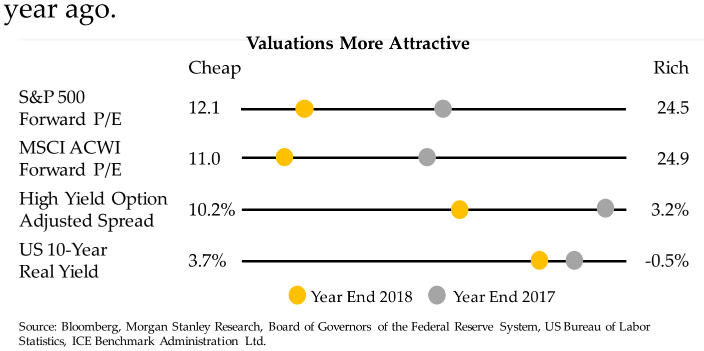
While the data presented above are a bit gloomy, there are some high points to discuss. One of which is the power of the almighty American consumer! Boosted by a robust employment market, the consumer held up quite well over the course of 2018. By almost all metrics, the U.S. labor market is in incredibly good shape. The current unemployment rate of 3.9% is a level the U.S. has not seen since December 2000. Furthermore, wages are also increasing. The U.S. is the largest economy in the world (for now) and consumer spending accounts for over two-thirds of GDP. So, this should provide some support to a softening global macro picture in 2019.

Valuations - While fundamentals are a bit mixed, valuations in many markets are more attractive than they were at the start of 2018. Equities and some credit markets look more attractive thanks to the unbridled carnage that was December 2018. A lump of coal in our stocking would have been a welcome upgrade from the volatility that played out during the holidays, including the dreaded "Christmas eve massacre" that took the S&P 500 down 2.7% in one day. In fact, the -9.0% return for the widely followed equity index was the worst December since way back in 1931.

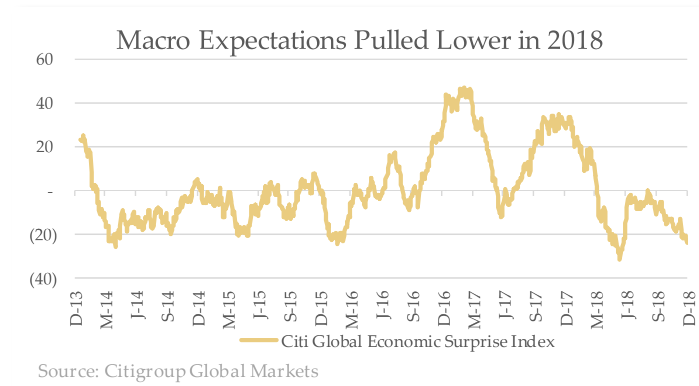
This has translated into more attractive equity valuations, especially when we consider that earnings expectations have been ratcheted lower. While credit markets have been hit quite hard, high yield valuations are only at the middle of their historical range. Treasury rates remain fairly low. Even after the strong early start to 2019, valuations have more cushion than they did a year ago.



Source: Bloomberg, Morgan Stanley Research, Board of Governors of the Federal Reserve System, US Bureau of Labor Statistics, ICE Benchmark Administration Ltd.

Sentiment - As we discussed in our 3Q18 letter www.disciplina.com//app/uploads/2018/11/Disciplina-3Q18-Letter.pdf, we felt markets were in a transitional period where earnings expectations needed to be adjusted lower and the Fed was struggling to find its message when communicating the path of monetary policy. Markets adjusted in the fourth quarter and following the carnage, expectations for 2019 are now much lower on the macro front. As Mr. Pope so eloquently stated, this leaves markets much less likely to be disappointed.

At the macro level, Citibank's Global Economic Surprise Index tracks a variety of economic statistics relative to economists' expectations. A reading below zero implies more readings have come in below expectations than above. The current reading of -25 is much lower than the



Source: Citigroup Global Markets

+30 we saw at the start of 2018. While -25 is low, we have seen worse when it did print as low as -44 during the chaos created by the Greek debt/European banking crisis in 2012. When we drill down on the regions within the index, European readings appear to be hitting a bottom, as the global index is being supported by U.S. readings which have come in roughly in line with expectations. The upshot here is that expectations at the global level have come down significantly and the bar may finally be set low enough in Europe to leave room for some upside surprises over the course of the year.

At the micro level we like to look at trends in earnings revisions and earnings expectations to get a feel for sentiment. The chart below illustrates what portion of

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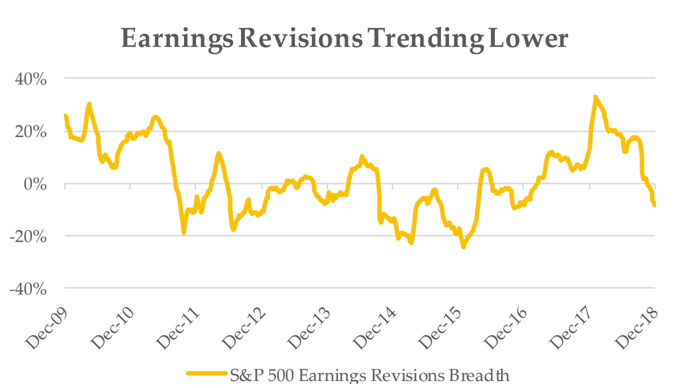
companies are reporting negative or positive earnings revisions. As you can see, the trend in revisions declined significantly over the course of 2018 and now resides in negative territory. As companies revise earnings lower, this pulls analyst's expectations for earnings in 2019 down with them, thus setting the bar lower for earnings to exceed expectations as we progress through the year. This is likely to happen in the back half of the year as trade turmoil and noise from the U.S. shutdown affects earnings in 1Q19.

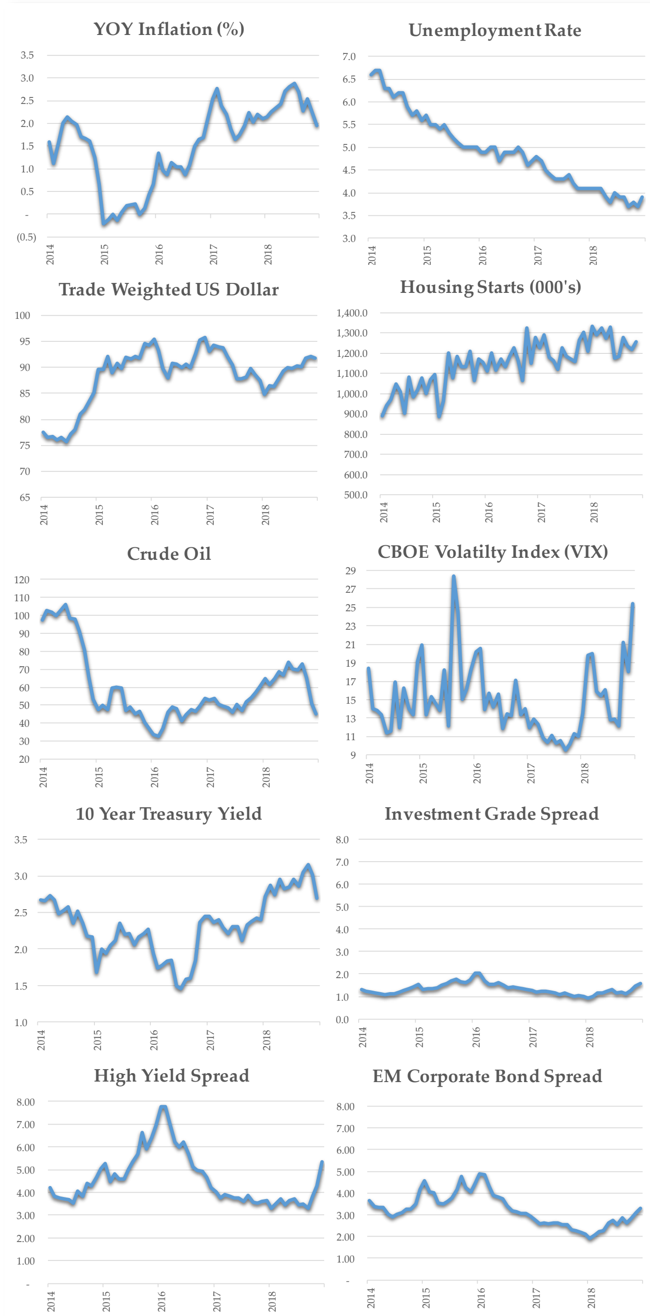


Source: FactSet, Morgan Stanley Research

2019 Investment Themes - As we have stated earlier in this note, there clearly has been no shortage of items to keep the markets on edge. Nevertheless, we are cautiously optimistic about 2019 as current valuations provide investors with greater margin for error than at the start of 2018. In addition, a more patient Fed, strong U.S. employment, a healthy U.S. consumer and recent declines in energy prices may temper any external threats to economic growth.

While we have a modestly positive outlook on the markets in general, Global central banks and other geopolitical factors mean that volatility will remain elevated in 2019. However, this will create opportunities for professionally managed portfolios with well constructed asset allocations, superior investment manager selection and robust risk management. Specific areas of focus for our team in 2019 include:

- Value versus Growth Equities
- Non-U.S. Equities
- Liquid and Illiquid Alternative Investments



* Sources: BofA Merrill Lynch; US Departments of Labor, Commerce & Energy; CBOE; Federal Reserve Bank of St. Louis, Board of Governors of the Federal Reserve System

Firm Update

Although 2018 was a challenging year for financial markets, we are pleased to report that our clients' portfolios weathered the market volatility well and outperformed their overall benchmarks. There were numerous bright spots within our clients' portfolios that mitigated the impact of negative returns across global equities and fixed income, such as manager selection, tactical tilts and robust risk management as market gyrated throughout the year. Our cash plus strategies also generated positive absolute and relative returns despite rising short term interest rates.

On the business front, 2018 was truly a transformational year for Disciplina. We added several new clients and received additional capital from a number of existing clients to make meaningful gains in assets under management. As we start the year, our new business pipeline also looks promising. Finally, we also added a new partner, Brian Arsenault, who will aid in delivering investment performance and a superior client experience as we continue to grow our firm.

We are grateful to our new and existing clients for partnering with Disciplina to manage their capital and more importantly, advance their respective institution's mission. We are also appreciative of our investment managers who delivered favorable returns for our client portfolios in such a challenging year. We look forward to seeing you and deepening our relationships in 2019.

Best Regards,

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