# COMMONWEALTH LIQUID ALPHA FUND

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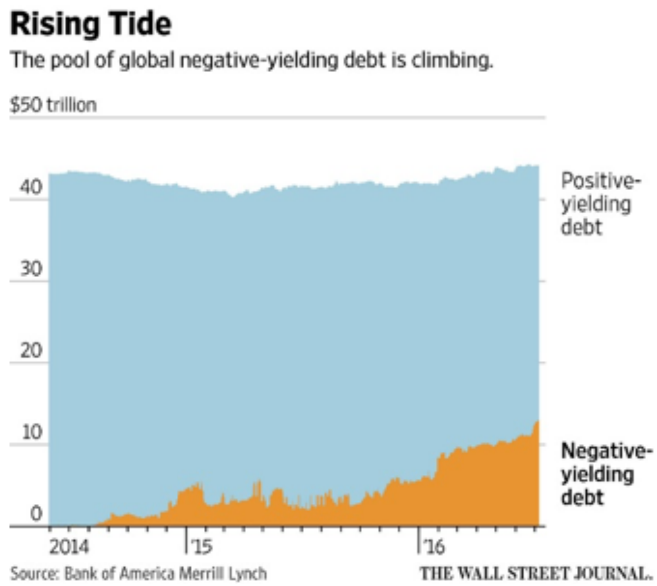
## 2Q16 MARKET REVIEW

As discussed in our market outlook, the second quarter was typified by an acceleration of the mad rush for yield we have seen over recent quarters.

Zero interest rate policy (ZIRP) has morphed into negative interest rate policy (NIRP). Nearly $13T in global government bonds were trading with a negative yield as of quarter-end – almost 25% of all global debt outstanding (see Figure 1). With so many "risk-free" fixed income assets suddenly guaranteed to lose money if held to maturity, safe havens with slim or even zero nominal yields (namely Treasuries and gold, respectively) have benefited enormously. At the same time, we see a seemingly endless bid for any asset perceived as generating stable and meaningful income. Junk and investment grade corporate bonds, telecoms, utilities, and dividend-paying stocks all continue to generate strong YTD returns.

**Figure 1: Negative Yielding Debt vs. Outstanding Global Debt**




As we've highlighted previously, these declining yields lower the expected return for pretty much every financial asset, thereby dramatically eroding the risk/reward of traditional portfolios. The days of being able to earn relatively low risk, high single digit returns, year in year out, with a traditional 60/40 stock/bond portfolio, may be over for the foreseeable future. While we have articulated our thesis on the low likelihood of a bear market this year, we can have no certainty over the long-term macroeconomic path. As Yogi Berra said, and we quoted in our 2016 Outlook, "it's hard to make predictions, especially about the future." Rather, our goal is to construct portfolios that can withstand the various events and pitfalls the future is certain to hold. In our view, the inclusion of truly uncorrelated alternative investments is the key to constructing portfolios capable of weathering a variety of future market environments.

| "INCOME" ASSETS | YTD PERFORMANCE |
|---|---|
| ML High Yield Corporate Bonds | +9.3% |
| Investment Grade Corporate Bonds (LQD) | +8.9% |
| Utilities | +23.4% |
| REITs (VNQ) | +13.4% |
| Telecom | +24.9% |

| "RISKY" ASSETS | YTD PERFORMANCE |
|---|---|
| Consumer Discretionary | +0.7% |
| Financials | -3.1% |
| Technology | -0.3% |
| Biotech (IBB) | -24.3% |
| Foreign Stocks | -4.0% |

| "SAFE" ASSETS | YTD PERFORMANCE |
|---|---|
| US Treasury Bonds (TLT) | +15.5% |
| Municipal Bonds (MUB) | +3.8% |
| Gold | +24.6% |
| Consumer Staples | +10.5% |
| Merrill Lynch US Bond Aggregate | +5.5% |

## 2Q16 PERFORMANCE REVIEW

The strong reversal of equities and commodities from their February lows was a headwind for Commonwealth Liquid Alpha Fund ("Liquid Alpha") early in the quarter, generating losses in April. Later in the quarter, as new trends established themselves and positioning shifted, the fund recouped some of these losses to finish 2Q16 down an estimated -2.6%, bringing YTD performance to an estimated -1.1%. As of this writing (July 11), the fund is up an estimated +1.8% MTD, putting performance back in positive territory for 2016 YTD.

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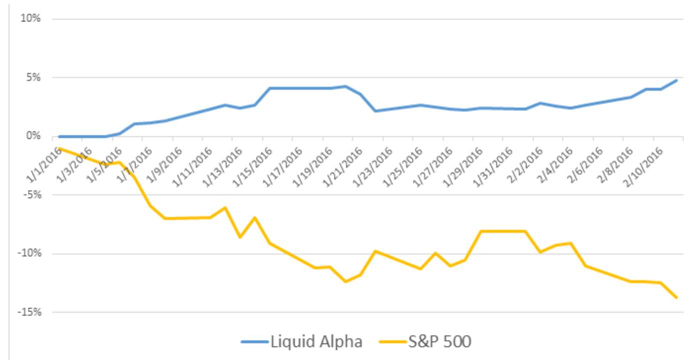
Liquid Alpha is an absolute return strategy and therefore any negative performance over an extended period is a failure. Having said that, the drawdown we experienced in 2Q16 is very typical for the types of strategies in which the fund invests. Moreover, as we highlighted last quarter, much of the 1H16 underperformance stems from underinvestment in January and February, when the fund was launching and our underlying managers performed extremely well. Had the current portfolio (as of July 11) been deployed at year-end 2015, 1H16 performance would have been in the neighborhood of +7%. We cite these numbers not to make excuses for underperformance, but to illustrate why we believe our process and portfolio construction is sound, and will bear out in strong risk-adjusted performance for our investors over the long term.

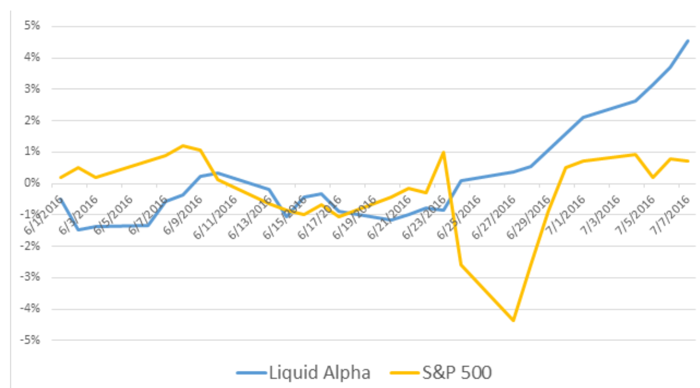
**Figure 2: Liquid Alpha vs. S&P 500 in 1Q16 Market Scare**




*Source: CB&T*

We highlight another area where Liquid Alpha has done its job in 1H16. As we have discussed previously, for reasons of diversification and long-term performance, Liquid Alpha focuses on managed futures strategies. These strategies are often associated with so-called crisis alpha, due to their historical tendency to provide counter-correlation during periods of equity market crisis. 1H16 contained two events which we believe dramatically illustrate the diversifying power of the types of strategies contained in Liquid Alpha.

**Figure 3: Liquid Alpha vs. S&P 500 in June/July Brexit**




*Source: CB&T*

The first we discussed in detail last quarter: from the beginning of the year to February 11, US equities declined over -10%, while Liquid Alpha gained nearly +5% (please see Figure 2).

The second event occurred late in 2Q16: Brexit. The surprise vote by Britain to leave the European Union caused an immediate selling panic across the globe. As the relatively minimal near-term global economic impact of the Brexit vote became clear, markets reversed equally quickly. Within the first two weeks of July, the S&P 500 had rapidly moved to new all-time highs. Brexit was, quite frankly, the relatively rare exogenous political event in which the systematic strategies favored in Liquid Alpha not only profited on the initial panic, but also on the ensuing market reversal (please see Figure 3).

Liquid Alpha's ability to make money on both sides of the event was due to three factors. First, our strategies entered the market long stocks and even longer bonds. When stocks sold off on the Friday and Monday following the Brexit vote, the fund made more on its bond positions than it lost on its stock positions. When equity markets reversed the rest of that week and continued into July, bonds markets stayed well-bid, and the fund made money on both stock and bond positons. Second, the fund entered the event with a small short positon in the British pound sterling, which dropped over 10% following Brexit. Third, we benefited from correct positioning in several smaller agricultural and metals markets that moved in our favor, for reasons not necessarily related to the vote.

In all, while we certainly benefited from some luck, it's entirely possible that Liquid Alpha would have performed well had the Brexit vote gone, as was expected, the other way (though of course it's impossible to know for sure). Sometimes, as another New York baseball legend, Branch Rickey, the man who brought Jackie Robinson into the major leagues, once said: "Luck is the residue of design." The event and its aftermath underscore the importance of "luck," but also the non-linear and asymmetric nature of markets, as well as the value of true portfolio diversification via true alternative investments.